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INDEPENDENT AUDITOR'S REPORT

The Shareholders and
Board of Directors
Redwood Capital Bank
Eureka, California

We have audited the accompanying balance sheets of Redwood Capital Bank (the Bank) as of December 31, 2006 and 2005, and the related statements of operations, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Richardson & Company

March 2, 2007

REDWOOD CAPITAL BANK

BALANCE SHEETS

December 31, 2006 and 2005

	2006	2005
ASSETS		
Cash and due from banks	$ 4,987,195	$ 3,987,470
Federal funds sold	8,160,000	5,925,000
Cash and cash equivalents	13,147,195	9,912,470
Investment securities available-for-sale, at fair value	9,680,336	13,576,473
Loans, net	74,717,657	54,627,368
Premises and equipment, net	2,286,751	2,420,340
Cash surrender value of life insurance	2,099,807	
Accrued interest receivable and other assets	1,309,533	662,618
	90,094,084	71,286,799
TOTAL ASSETS	$ 103,241,279	$ 81,199,269
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Deposits		
Non interest-bearing	$ 18,600,067	$ 17,211,395
Interest-bearing	73,156,777	55,595,917
Total deposits	91,756,844	72,807,312
Federal Home Loan Bank borrowing	2,000,000	
Accrued interest payable and other liabilities	567,311	439,084
TOTAL LIABILITIES	94,324,155	73,246,396
Commitments and contingencies (see accompanying notes)		
SHAREHOLDERS' EQUITY		
Preferred stock, no par value; 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, no par value; 30,000,000 shares authorized; 1,652,901 and 1,653,665 shares issued and outstanding in 2006 and 2005	10,983,285	10,976,453
Additional paid-in capital	298,331	187,121
Accumulated deficit	(2,276,063)	(3,025,293)
Accumulated other comprehensive loss	(88,429)	(185,408)
TOTAL SHAREHOLDERS' EQUITY	8,917,124	7,952,873
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 103,241,279	$ 81,199,269

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The accompanying notes are an integral part of these financial statements.

REDWOOD CAPITAL BANK

STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2006 and 2005

	2006	2005
INTEREST INCOME		
Interest and fees on loans	$ 5,465,906	$ 2,912,049
Interest on taxable investment securities	511,379	428,932
Dividend income	17,219	5,287
Interest on federal funds sold	237,507	201,083
Interest on deposits in banks	12,812	50,935
Total interest income	6,244,823	3,598,286
INTEREST EXPENSE		
Interest on deposits	1,956,723	839,322
Interest on other borrowings	1,168	136
Total interest expense	1,957,891	839,458
NET INTEREST INCOME	4,286,932	2,758,828
Provision for loan losses	228,000	375,000
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	4,058,932	2,383,828
OTHER INCOME		
Service charges and fees	175,847	108,262
Other income	794,422	432,517
Total other income	970,269	540,779
OTHER EXPENSES		
Salaries and employee beneits	2,289,623	1,690,988
Occupancy and equipment	466,811	421,366
Other	1,522,077	1,122,738
Total other expenses	4,278,511	3,235,092
Income (Loss) before provision for income taxes	750,690	(310,485)
Provision for income taxes	800	800
NET INCOME (LOSS)	$ 749,890	$ (311,285)
NET INCOME (LOSS) PER SHARE	$ 0.45	$ (0.19)
NET INCOME (LOSS) PER SHARE -ASSUMING DILUTION	$ 0.41	$ (0.17)

The accompanying notes are an integral part of these financial statements.

REDWOOD CAPITAL BANK

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the Years Ended December 31, 2006 and 2005

	Comprehensive Income	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
BALANCE AT DECEMBER 31, 2004		1,649,901	$ 10,951,893	$ 93,377	$ (2,714,008)	$ (20,135)	$ 8,311,127
Stock options exercised		3,000	24,560	(4,560)			20,000
Stock option expense				98,304			98,304
Comprehensive income:							
Net loss	$ (311,285)				(311,285)		(311,285)
Other comprehensive loss:							
Unrealized holding losses on securities available-for-sale arising during the year	(165,273)					(165,273)	(165,273)
Total comprehensive loss	$ (476,558)						
BALANCE AT DECEMBER 31, 2005		1,652,901	10,976,453	187,121	(3,025,293)	(185,408)	7,952,873
Stock options exercised		764	6,832	(1,742)			5,090
Fractional shares					(660)		(660)
Stock option expense				112,952			112,952
Comprehensive income:							
Net income	$ 749,890				749,890		749,890
Other comprehensive income:							
Unrealized holding gains on securities available-for-sale arising during the year	96,979					96,979	96,979
Total comprehensive income	$ 846,869						
BALANCE AT DECEMBER 31, 2006		1,653,665	$ 10,983,285	$ 298,331	$ (2,276,063)	$ (88,429)	$ 8,917,124

The accompanying notes are an integral part of these financial statements.

REDWOOD CAPITAL BANK

STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2006 and 2005

	2006	2005
OPERATING ACTIVITIES		
Net income (loss)	$ 749,890	$ (311,285)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	228,000	375,000
Deferred loan origination fees and costs, net	(18,030)	100,193
Depreciation and amortization	229,672	201,294
Stock options granted	112,952	98,304
Net increase in cash surrender value of life insurance	(99,807)	
Increase in accrued interest receivable and other assets	(267,215)	(651,375)
Increase in accrued interest payable and other liabilities	128,227	293,351
NET CASH PROVIDED BY OPERATING ACTIVITIES	1,063,689	105,482
INVESTING ACTIVITIES		
Net change in interest-bearing deposits in banks		3,564,000
Purchase of available-for-sale investment securities		(7,488,882)
Proceeds from maturity of available-for-sale investment securities	3,500,000	4,000,000
Proceeds from paydowns on mortgage-backed securities	500,133	487,633
Purchase of Federal Home Loan Bank stock	(142,200)	204,500
Purchase of Pacific Coast Bankers Bank stock	(237,500)	
Purchases of life insurance	(2,000,000)	
Net increase in loans	(20,300,259)	(32,346,068)
Purchases of premises and equipment	(103,100)	(119,809)
NET CASH USED BY INVESTING ACTIVITIES	(18,782,926)	(31,698,626)
FINANCING ACTIVITIES		
Net increase in deposits	18,949,532	29,102,599
Proceeds from exercise of stock options	5,090	20,000
Proceeds from Federal Home Loan Bank borrowings	2,000,000	
Cash paid for fractional shares	(660)	
NET CASH PROVIDED BY FINANCING ACTIVITIES	20,953,962	29,122,599
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	3,234,725	(2,470,545)
Cash and cash equivalents at beginning of year	9,912,470	12,383,015
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 13,147,195	$ 9,912,470
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the year for:		
Interest	$ 1,880,269	$ 789,304
Income taxes	$ 800	$ 800
SUPPLEMENTAL DISCLOSURES OF NONCASH ACTIVITIES		
Net change in unrealized gains/losses on available-for-sale investment securities	$ 96,979	$ 165,273

The accompanying notes are an integral part of these financial statements.

NOTE A--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business: Redwood Capital Bank (the Bank) was incorporated on November 3, 2003, received its state banking charter early in 2004, and commenced operations on March 24, 2004. The Bank is subject to regulation, supervision, and regular examination by the California Department of Financial Institutions (CDFI) and the Federal Deposit Insurance Corporation (FDIC). The regulations of these agencies govern most aspects of the Bank's business. The financial statements of the Bank are prepared in conformity with generally accepted accounting principle and general practice within the banking industry. The following is a summary of the significant accounting and reporting policies used in preparing these financial statements.

Nature of Operations: The Bank provides commercial, industrial, agricultural and personal credit and other banking services through its main branch located in Eureka, California.

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Investment Securities: Securities are classified as held-to-maturity if the Bank has both the intent and ability to hold those debt securities to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost, adjusted for amortization of premium and accretion of discount, computed by the interest method over their contractual lives.

Securities are classified as available-for-sale if the Bank intends to hold those debt securities for an indefinite period of time, but not necessarily to maturity. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Bank's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Securities held as available-for-sale are carried at fair value. Unrealized holding gains or losses are reported as increases or decreases in shareholders' equity, net of the related deferred tax effect. Realized gains or losses, determined on the basis of the cost of specific securities sold, are included in earnings.

Loans: Loans are stated at the amount of unpaid principal reduced by net deferred loan fees. Loan origination fees, net of direct origination costs, are deferred and recognized as an adjustment of the yield on the related loan. Amortization of net deferred loan fees is discontinued when the loan is placed on nonaccrual status. Interest on loans is accrued and credited to income based on the principal amount outstanding.

Allowance for Loan Losses: The allowance is maintained at a level which, in the opinion of management, is adequate to absorb probable losses inherent in the loan portfolio. Credit losses related to off-balance-sheet instruments are included in the allowance for loan losses. Management determines the adequacy of the allowance based upon reviews of individual loans, recent loss experience, current economic conditions, the risk characteristics of the various categories of loans and other pertinent factors. The allowance is based on estimates, and ultimate losses may vary from the current estimates. These estimates are reviewed monthly and, as adjustments become necessary, they are reported in earnings in the periods in which they become known. Loans deemed uncollectible are charged to the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance.

All loans, except those to individuals, are considered impaired, based on current information and events, if it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Allowances on impaired loans are established based on the present value of expected future cash flows discounted at the loan's historical effective interest rate or, for collateral-dependent loans, on the fair value of the collateral. Cash receipts on impaired loans are used to reduce principal.

NOTE A--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Recognition on Impaired and Nonaccrual Loans: Loans, including those considered impaired, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. If a loan or a portion of a loan is classified as doubtful or is partially charged off, the loan is classified as nonaccrual. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual if repayment in full of principal and/or interest is in doubt.

Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower, in accordance with the contractual terms of interest and principal.

While a loan is classified as nonaccrual and the future collectibility of the recorded balance is doubtful, collections of interest and principal are generally applied as a reduction to the principal outstanding. When the future collectibility of the recorded balance is expected, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded balance at the contractual interest rate. Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Premises and Equipment: Premises and equipment are stated at cost, less accumulated depreciation and amortization. The provision for depreciation and amortization is computed principally by the straight-line method over estimated useful lives of the related assets.

Income Taxes: Provisions for income taxes are based on amounts reported in the statements of operations (after exclusion of non-taxable income such as interest on state and municipal securities) and include deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred taxes are computed using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are recognized for deductible temporary differences and tax credit carryforwards, and then a valuation allowance is established to reduce that deferred tax asset if it is "more likely than not" that the related tax benefits may not be realized.

Net Income Per Share of Common Stock: Net income per share of common stock is computed by dividing net income by the weighted average number of shares of common stock outstanding during the year, after giving retroactive effect to stock dividends and splits. Net income per share--assuming dilution is computed similar to net income per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. Included in the denominator is the dilutive effect of stock options computed under the treasury method.

Advertising: Advertising costs are charged to operations in the year incurred.

Off-Balance-Sheet Financial Instruments: In the ordinary course of business the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they become payable.

Stock Option Accounting: The Bank has a stock-based employee and director compensation plan which is described more fully in Note L. The Bank applies Statement of Financial Accounting Standard (SFAS) No. 123, *Share-Based Payment* accounting for its plans. Accordingly, compensation cost for stock options is measured based on the grant-date fair value and is recognized in the income statement.

NOTE A--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Operating Segments: Reportable segments are based on products and services, geography, legal structure, management structure and any other manner in which management desegregates a company for making operating decisions and assessing performance. The Bank has determined that its business is comprised of a single operating segment.

Cash and Cash Equivalents: For the purpose of presentation in the Statement of Cash Flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption "Cash and due from banks" and “Federal funds sold.”

Reclassification: As a result of implementing SFAS No. 123R, the Bank has reclassified $93,377 at January 1, 2005, and $187,121 as of December 31, 2005 from Common Stock to Additional Paid-in Capital representing activity related to share-based compensation.

NOTE B--RESTRICTIONS ON CASH AND DUE FROM BANKS

Cash and due from banks include amounts the Bank is required to maintain to meet certain average reserve requirements of the Federal Reserve Bank. The total requirement at December 31, 2006 and 2005 was $784,000 and $323,000, respectively.

NOTE C--INVESTMENT SECURITIES

The amortized cost and approximate fair value of investment securities are summarized as follows:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities Available-for Sale				
December 31, 2006:				
U.S. government agency securities	$ 6,997,422		$ (40,147)	$ 6,957,275
Mortgage-backed securities	2,771,343		(48,282)	2,723,061
	$ 9,768,765		$ (88,429)	$ 9,680,336
December 31, 2005:				
U.S. government agency securities	$ 10,494,230		$ (124,134)	$ 10,370,096
Mortgage-backed securities	3,267,651		(61,274)	3,206,377
	$ 13,761,881		$ (185,408)	$ 13,576,473

The maturities of investment securities at December 31, 2006 were as follows:

	Amortized Cost	Fair Value
Due in one year or less	$ 3,997,943	$ 3,976,562
Due from one year to five years	4,968,431	4,909,122
Due from five years to ten years	802,391	794,652
	$ 9,768,765	$ 9,680,336

NOTE C--INVESTMENT SECURITIES (Continued)

The amortized cost and fair value of mortgage-backed securities are presented by contractual maturity in the preceding table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations without call or prepayment penalties.

There were no sales of investment securities during 2006 or 2005.

The following table shows the investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2006.

	2006	
	Greater Than 12 Months	
Description of Securities	Fair Value	Unrealized Losses
U.S. government agency securities	$ 6,957,275	$ (40,147)
Mortgage-backed securities	2,723,061	(48,282)
	$ 9,680,336	$ (88,429)

	2005			
	Less Than 12 Months		Greater Than 12 Months	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government agency securities	$ 6,933,846	$ (60,535)	$3,436,250	$ (63,599)
Mortgage-backed securities	2,534,157	(37,861)	672,220	(23,413)
	$ 9,468,003	$ (98,396)	$ 4,108,470	$ (87,012)

There were ten U.S. government agency securities and three mortgage-backed securities that were in an unrealized loss position as of December 31, 2006. There were thirteen U.S. government agency securities and three mortgage-backed security that were in a unrealized loss position as of December 31, 2005. The unrealized losses on these securities were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investment. Because the Bank has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Bank does not consider these investments to be other-than-temporarily impaired at December 31, 2006 and 2005.

NOTE D--LOANS, NET

Major classifications of loans at December 31 are summarized as follows:

	2006	2005
Real estate—mortgage	$ 11,504,363	$ 12,975,528
Real estate—commercial	35,593,135	25,186,276
Commercial	13,027,411	7,163,746
Agricultural	1,866,376	1,177,173
Installment and other loans to individuals	13,772,819	8,996,122
	75,764,104	55,498,845
Net deferred loan fees and costs	(128,447)	(146,477)
Allowance for loan losses	(918,000)	(725,000)
	$ 74,717,657	$ 54,627,368

The allowance for loan losses was $918,000 and $725,000 as of December 31, 2006 and 2005, respectively. The provision for loan losses was $228,000 and $375,000 as of December 31, 2006 and 2005, respectively. There were no charge offs or recoveries for the years ended December 31, 2006 and 2005. There were no impaired or nonaccrual loans at December 31, 2006 and 2005.

The maturity and repricing of the loan portfolio is as follows at December 31:

	2006	2005
Fixed rate loan maturities		
Three months or less	$ 520,499	$ 161,786
Over three months to twelve months	2,692,547	4,189,674
Over one year to five years	7,126,041	3,789,994
Over five years to fifteen years	5,339,614	3,486,877
Over fifteen years	752,063	951,280
Floating rate loans repricing		
Quarterly or more frequently	35,051,076	35,351,785
Quarterly to annual frequency	4,471,103	1,799,162
One to five years frequency	15,430,714	4,541,216
Five to fifteen years frequency	4,380,447	1,227,071
	$ 75,764,104	$ 55,498,845

NOTE E--PREMISES AND EQUIPMENT

Premises and equipment consisted of the following at December 31:

	2006	2005
Land	$ 400,000	$ 400,000
Building and improvements	1,669,273	1,648,445
Furniture, fixtures and equipment	800,856	718,584
	2,870,129	2,767,029
Less: Accumulated depreciation	583,378)	(346,689)
	$ 2,286,751	$ 2,420,340

NOTE E--PREMISES AND EQUIPMENT (Continued)

Depreciation and amortization included in occupancy expense totaled $236,689 in 2006 and $214,487 in 2005.

NOTE F--INTEREST-BEARING DEPOSITS

Interest-bearing deposits consisted of the following at December 31:

	2006	2005
Negotiable order of withdrawal (NOW)	$ 21,116,355	$ 13,418,278
Savings and money markets	32,301,411	30,219,902
Time, $100,000 and over	8,424,598	7,212,620
Other time	11,314,413	4,745,117
	$ 73,156,777	$ 55,595,917

Interest expense on these deposits for the years ended December 31 is as follows:

	2006	2005
NOW	$ 579,792	$ 154,947
Savings and money markets	763,190	451,215
Time, $100,000 and over	288,483	138,272
Other time	325,258	94,888
	$ 1,956,723	$ 839,322

The maturities of time deposits at December 31 are as follows:

	2006	2005
Three months or less	$ 11,390,448	$ 3,527,431
Over three months through twelve months	6,913,665	6,889,232
Over one year through three years	1,431,195	1,533,855
Over three years	3,703	7,219
	$ 19,739,011	$ 11,957,737

NOTE G--LENDING AGREEMENTS

The Bank has federal funds line of credit agreements with other banks. The maximum borrowings available under these lines amount to $7,500,000 at December 31, 2006 and 2005. There were no borrowings outstanding under these agreements at December 31, 2006 and 2005.

The Bank has an agreement to borrow from the Federal Home Loan Bank to the extent of pledged assets, up to 15% of total assets. Assets pledged under the agreement at December 31, 2006 totaled $103,241,279, resulting in a limit on borrowings of $15,486,192. There was $2,000,000 outstanding under this agreement as of December 31, 2006. Assets pledged under the agreement at December 31, 2005 totaled $81,199,269, resulting in a limit on borrowings of $12,179,890. There were no borrowings outstanding under this agreement as of December 31, 2005.

NOTE H--OTHER EXPENSES

Other expenses consisted of the following for the years ended December 31:

	2006	2005
Professional fees	$ 230,426	$ 214,547
Data processing	298,016	203,350
Marketing and promotion	201,769	161,046
Director and shareholder	227,878	80,615
Operating expense	140,703	110,390
Insurance expense	105,788	95,448
Loan and collection expense	70,696	56,511
Stationery and forms	67,165	62,382
Miscellaneous employee expense	63,503	55,169
Telephone expense	26,550	21,765
Operational losses	14,674	9,235
Dues and memberships	27,147	18,707
Postage and delivery	32,083	18,453
Miscellaneous processing/administration fees	4,689	3,910
Subscriptions	8,566	8,912
Security expense	2,083	2,188
Other non-interest expense	341	110
	$ 1,522,077	$ 1,122.738

NOTE I--RETIREMENT PLANS

The Bank has a defined contribution retirement plan covering substantially all of the Bank's employees. Employees may elect to have a portion of their compensation contributed to the plan in conformity with the requirements of Section 401(k) of the Internal Revenue Code. The Bank will make contributions equal to 100% of the effective deferral made by the employees, up to a maximum of 4% of the employees eligible earnings. Salaries and employee benefits expense includes Bank contributions to the plan of $78,734 during 2006 and $45,027 during 2005.

NOTE J--INCOME TAXES

Income tax expense included in the statement of operations consisted of $800 of current state tax paid for the years ended December 31, 2006 and 2005. The following is a reconciliation of income taxes computed at the Federal statutory rate of 34% to the effective rate used for the provision for income taxes for the years ended December 31:

NOTE J--INCOME TAXES (Continued)

	2006	2005
Income benefit at the Federal statutory rate	$ 255,235	$ (105,566)
State franchise tax benefit, less Federal income tax effect	53,708	(22,213)
Incentive stock option expense	19,720	19,720
Valuation allowance change	(285,832)	123,971
Interest on enterprise zone loans exempt from State tax	(39,882)	(18,606)
Life insurance earnings	(10,720)	
Nondeductible expenses and other	8,571	3,494
Provision for income tax	$ 800	$ 800

The expected tax expense shown above that would result from applying Federal and State statutory rates to the pretax loss differs from amounts reported in the financial statements primarily because the valuation allowance increased to offset the impact of operating loss carryforwards and other temporary differences until such time as realization becomes more likely than not. The tax effects of temporary differences that give rise to the components of the net deferred tax assets as of December 31 were as follows:

	2006	2005
Deferred tax assets:		
Net operating loss and contribution carryforwards	$ 812,293	$ 1,009,824
Start-up costs	110,238	159,233
Organizational costs	38,772	56,005
Nonstatutory stock option expense	66,212	39,447
Allowance for loan losses	81,409	38,008
Enterprise zone credits	12,001	12,001
Contribution carryforwards	4,092	9,419
Adjustment to cash basis		2,127
Total deferred tax assets	1,125,017	1,326,064
Valuation allowance for deferred tax assets	(943,223)	(1,229,054)
Deferred tax assets recognized	181,794	97,010
Deferred tax liabilities:		
Depreciation	85,587	91,364
Adjustment to cash basis	80,749	
Discount accretion	8,297	4,041
Federal Home Loan Bank dividends	7,161	1,605
Total deferred tax liabilities	181,794	97,010
Net deferred tax assets	$ -	$ -

Amounts presented for the tax effects of temporary differences are based upon estimates and assumptions and could vary from amounts ultimately reflected on the Bank's tax returns. Accordingly, the variances from amounts reported in prior years are primarily adjustments to conform to the tax returns as filed. The Bank had no income taxes receivable or payable at December 31, 2006. The Bank had income tax payable of $800 at December 31, 2005.

NOTE J--INCOME TAXES (Continued)

As of December 31, 2006, the Bank had federal and state net operating loss carryforwards available to reduce future taxable income as follows:

	Net Operating Loss Carryforward	Expiration Date
Federal	$ 1,757,472	2024
	45,656	2025
	$ 1,803,128	
State	$ 2,116,034	2014
	520,003	2015
	148,673	2016
	$ 2,784,710	

As of December 31, 2006, the Bank also had state contribution carryforwards of $57,170, which expire in 2009 through 2011.

NOTE K--EARNINGS PER SHARE

The following is a computation of basic and diluted earnings per share for the years ended December 31, 2006 and 2005:

	2006	2005
Basic:		
Net loss	$ 749,890	$ (311,285)
Weighted-average common shares outstanding	1,653,138	1,652,556
Earnings per share	$ .45	$ (.19)
Diluted:		
Net loss	$ 749,890	$ (311,285)
Weighted-average common shares outstanding	1,653,138	1,652,556
Net effect of dilutive stock options – based on the treasury stock method using average market price	186,645	143,965
Weighted-average common shares outstanding and common stock equivalents	1,839,782	1,796,521
Earnings per share - assuming dilution	$ .41	$ (.17)

NOTE L--STOCK OPTION PLAN

The Bank has a stock option plan established in 2004 under which incentive and nonstatutory stock options, as defined under the Internal Revenue Code, may be granted. The Bank's Stock Option Plan provides for the granting of a maximum of 495,000 shares of the Bank's common stock to directors, key employees and consultants at an exercise price not less than the fair market value of the shares on the date of grant and for a term of no more than 10 years. Options granted vest at a rate of 20% per year over five years from the date the option is granted. Generally, if an optionee's continuous status as a director, employee or consultant is terminated for various reasons, the non-vested options expire.

The fair value of options granted is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 2006 and 2005: dividend yield of zero; a range of expected volatility of 4% to 30% for 2006 and 7% to 30% for 2005; weighted average expected volatility of 28.77 percent for 2006 and 27.05 percent of 2005; risk-free interest rate of 4.73 percent for 2006 and 4.18 percent for 2005 and expected life of 10 years. Expected volatilities are based on historical volatility of the Bank's stock. The Bank uses historical data to estimate option exercise and employee termination within the valuation model. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

A summary of stock option activity, adjusted to give effect to stock dividends and splits follows for years ended December 31:

	Incentive Stock Options			
	2006		2005	
	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares
Shares under option at beginning of year	$ 6.67	154,500	$ 6.67	157,500
Options exercised	6.67	(763)	6.67	(3,000)
Options forfeited	6.67	(737)		
Shares under option at end of year	6.67	153,000	6.67	154,500
Options exercisable at end of year		88,180		57,556

	Nonstatutory Stock Options			
	2006		2005	
	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares
Shares under option at beginning of year	$ 7.33	165,932	$ 6.67	149,432
Options granted	14.67	16,500	13.33	16,500
Shares under option at end of year	7.99	182,432	7.33	165,932
Options exercisable at end of year		93,969		59,130

NOTE L--STOCK OPTION PLAN (Continued)

	Nonstatutory Stock Options			
	2006		2005	
	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares
Weighted-average fair value of options granted during the year	$ 4.57		$ 2.98	

Following is the intrinsic value and weighted average contractual term of stock options outstanding for the years ended December 31:

	Incentive Stock Options		Nonstatutory Stock Options	
	2006	2005	2006	2005
Intrinsic value:				
Outstanding shares	$ 1,887,000	$ 1,019,490	$ 2,007,995	$ 995,715
Exercisable shares	$ 1,124,553	$ 383,515	$ 1,112,676	$ 382,942
Weighted average remaining contractual term:				
Outstanding shares	7.11 years	8.11 years	7.67 years	8.37 years
Exercisable shares	7.11 years	8.11 years	7.32 years	8.19 years

Upon the exercise of stock options, new shares are issued. The total amount of cash received from the exercise of stock options during 2006 and 2005 was $5,090 and $20,000, respectively. There were no tax benefits realized for the tax deductions from stock options exercised during 2006 and 2005.

A summary of the status of the Bank's nonvested shares as of December 31, and changes during the years ended December 31, is presented below:

	Incentive Stock Options			
	2006		2005	
Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at beginning of year	96,944	$ 1.52	128,444	$ 1.52
Vested	(31,500)	1.52	(31,500)	1.52
	(624)	1.52		
Nonvested at end of year	64,820	1.52	96,944	1.52

NOTE L--STOCK OPTION PLAN (Continued)

	Nonstatutory Stock Options			
	2006		2005	
Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at beginning of year	106,802	$ 1.72	121,852	$ 1.52
Granted	16,500	4.57	16,500	2.98
Vested	(34,839)	1.80	(31,550)	1.60
Nonvested at end of year	88,463	2.22	106,802	1.72

As of December 30, 2006, there was $285,431 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. That cost is expected to be recognized over a weighted-average period of 32 months. The total fair value of shares vested during the years ended December 31, 2006 and 2005, was $115,158 and $98,304, respectively.

NOTE M--RELATED PARTY TRANSACTIONS

During the normal course of business, the Bank has entered into transactions with its directors, executive officers, significant shareholders and their affiliates (related parties). The aggregate amount of loans to such related parties totaled $ 1,090,422 and $986,733 at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, commitments to related parties of $1,146,003 and $1,071,051, respectively, were undisbursed. The Bank has received deposits from directors and officers and their related interests totaling $8,608,450 and $2,448,591 at December 31, 2006 and 2005, respectively.

NOTE N--CONTINGENT LIABILITIES AND COMMITMENTS

Financial Instruments with Off-Balance-Sheet Risk: The Bank's financial statements do not reflect various commitments and contingent liabilities which arise in the normal course of business and which involve elements of credit risk, interest rate risk and liquidity risk. These commitments and contingent liabilities are commitments to extend credit and standby letters of credit. A summary of the Bank's commitments and contingent liabilities at December 31, 2006 and 2005, are as follows:

	Contractual Amounts	
	2006	2005
Commitments to extend credit	$ 29,086,294	$ 29,688,682
Standby letters of credit	607,388	1,000

Commitments to extend credit and standby letters of credit include exposure to some credit loss in the event of nonperformance of the customer. The Bank’s credit policies and procedures for credit commitments and financial guarantees are the same as those for extension of credit that are recorded on the balance sheet. Because most of these instruments have fixed maturity dates, and because many of them expire without being drawn upon, they do not generally present any significant liquidity risk to the Bank.

NOTE N--CONTINGENT LIABILITIES AND COMMITMENTS (Continued)

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, deeds of trust on residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending facilities to customers.

The Bank did not incur any losses on its commitments in 2006 and 2005.

NOTE O--CONCENTRATIONS OF CREDIT RISK

Most of the Bank's business activity is with customers located within the State of California, primarily in and around the City of Eureka. Most of the Bank's loans have been granted to customers in the Bank's market area. General economic conditions or natural disasters affecting the primary market area could affect the ability of customers to repay loans and the value of real property used as collateral. The loans are expected to be repaid from cash flow or proceeds from the sale of selected assets of the borrowers. The Bank requires that all loans have adequate collateral to secure the loan or that the borrower has evidence of sufficient cash flows to repay loans when the loans are made. All collateral must have an appraisal, if applicable, and collateral is generally secured by liens. The Bank's access to this collateral is through judicial procedures.

The concentrations of credit by type of loan are set forth in Note D. Approximately 78% of the Bank’s loans are collateralized by real estate in the Bank’s service area. The National Banking Laws, Title 12 of the United States Code, generally restricts loans to a single borrower or group of related borrowers and investments by the Bank to 15% of the sum of the Bank's equity capital plus the allowance for loan losses, subject to certain adjustments. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank, upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies but may include residential and commercial real property, marketable securities, accounts receivable, inventory, equipment and savings accounts.

The concentrations by type of investment security are set forth in Note C. The Bank places its investments primarily in financial instruments backed by the U.S. Government and its agencies. In addition, at December 31, 2006 and 2005, the Bank had deposits in federally insured banks in excess of federally insured limits by $24,360 and $42,474, respectively.

At December 31, 2006, approximately 17% of the Bank’s deposits were from eleven depositors. Management monitors these accounts and maintains close contact with these depositors to minimize the impact on the Bank’s liquidity.

NOTE P--REGULATORY MATTERS

The Bank is subject to the dividend restrictions set forth by the FDIC. Under such restrictions, the Bank may not, without the prior approval of the FDIC, declare dividends in excess of the sum of the current year's net income plus the retained earnings from the prior two years. As of December 31, 2006, the Bank could not make a cash dividend distribution without prior approval.

NOTE P--REGULATORY MATTERS (Continued)

The Bank is subject to various regulatory capital requirements administered by its primary federal regulator, the FDIC. Failure to meet minimum capital requirements can initiate certain mandatory---and possibly additional discretionary---actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2006, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2006, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios are also presented in the table.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(in thousands)			
As of December 31, 2006:						
Total Capital (to Risk Weighted Assets)	$ 9,958	12.21%	≥$ 6,522	≥ 8.00 %	≥$ 8,153	≥ 10.00 %
Tier I Capital (to Risk Weighted Assets)	$ 9,005	11.05%	≥$ 3,261	≥ 4.00 %	≥$ 4,892	≥ 6.00 %
Tier I Capital (to Average Assets)	$ 9,005	9.34%	≥$ 3,858	≥4.00 %	≥$ 4,822	≥ 5.00 %
As of December 31, 2005:						
Total Capital (to Risk Weighted Assets)	$ 8,830	14.57%	≥$ 4,848	≥ 8.00 %	≥$ 6,060	≥ 10.00 %
Tier I Capital (to Risk Weighted Assets)	$ 8,138	13.43%	≥$ 2,424	≥ 4.00 %	≥$ 3,636	≥ 6.00 %
Tier I Capital (to Average Assets)	$ 8,138	10.42%	≥$ 3,123	≥4.00 %	≥$ 3,904	≥ 5.00 %

NOTE Q--SUBSEQUENT EVENTS

The Bank is seeking approval of a reorganization whereby the Bank will become a wholly-owned subsidiary of a new holding company, Redwood Capital Bancorp. Each share of outstanding Bank common stock will be converted into one share of Redwood Capital Bancorp common stock. This transaction is expected to take place during the first quarter of 2007.

NOTE Q--SUBSEQUENT EVENTS (Continued)

On January 1, 2007, 12,250 shares of restricted stock were issued to employees and members of management and on February 1, 2007 4,000 shares of restricted stock were issued to additional officers. These awards will result in an additional expense of $216,875 over the vesting period of five years.