Richardson & Company

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INDEPENDENT AUDITOR'S REPORT

The Shareholders and
Board of Directors
Redwood Capital Bancorp and Subsidiary
Eureka, California

We have audited the accompanying consolidated balance sheets of Redwood Capital Bancorp (the Company) and its wholly-owned subsidiary, Redwood Capital Bank as of December 31, 2008 and 2007, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company'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 consolidated financial position of Redwood Capital Bancorp and its wholly-owned subsidiary, Redwood Capital Bank as of December 31, 2008 and 2007, and the consolidated results of its operations and its consolidated cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Richardson & Company

March 30, 2009

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

December 31, 2008 and 2007

	2008	2007
ASSETS		
Cash and due from banks	$ 5,582,425	$ 3,458,835
Federal funds sold	9,615,000	435,000
Interest bearing deposit in other financial institutions		3,900,000
Cash and cash equivalents	15,197,425	7,793,835
Investment securities available-for-sale, at fair value	10,253,071	9,304,983
Loans, net	127,841,123	102,840,519
Premises and equipment, net	4,501,067	4,798,274
Cash surrender value of life insurance	2,298,540	2,193,628
Accrued interest receivable and other assets	1,689,142	1,786,935
TOTAL ASSETS	$ 161,780,368	$ 128,718,174
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Deposits		
Non interest-bearing	$ 25,725,450	$ 21,261,548
Interest-bearing	121,710,568	95,569,117
Total deposits	147,436,018	116,830,665
Other borrowings	3,000,000	1,315,000
Accrued interest payable and other liabilities	512,227	622,077
TOTAL LIABILITIES	150,948,245	118,767,742
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; 1,728,494 and 1,680,486 shares issued and outstanding in 2008 and 2007	11,611,403	11,211,107
Additional paid-in capital	455,759	393,890
Accumulated deficit	(1,502,338)	(1,695,695)
Accumulated other comprehensive income	267,299	41,130
TOTAL SHAREHOLDERS' EQUITY	10,832,123	9,950,432
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 161,780,368	$ 128,718,174

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

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2008 and 2007

	2008	2007
INTEREST INCOME		
Interest and fees on loans	$ 7,926,021	$ 7,474,428
Interest on taxable investment securities	475,560	354,155
Dividend income	31,740	19,642
Interest on federal funds sold	85,284	363,454
Interest on deposits in banks	77,318	29,195
Total interest income	8,595,923	8,240,874
INTEREST EXPENSE		
Interest on deposits	2,741,192	3,215,361
Interest on other borrowings	117,028	51,625
Total interest expense	2,858,220	3,266,986
NET INTEREST INCOME	5,737,703	4,973,888
Provision for loan losses	1,523,500	437,000
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	4,214,203	4,536,888
OTHER INCOME		
Service charges and fees	404,927	267,672
Other income	441,345	710,154
Total other income	846,272	977,826
OTHER EXPENSES		
Salaries and employee benefits	2,333,522	2,606,018
Occupancy and equipment	577,863	513,029
Other	1,954,133	1,813,699
Total other expenses	4,865,518	4,932,746
Income before provision for income taxes	194,957	581,968
Provision for income taxes	1,600	1,600
NET INCOME	$ 193,357	$ 580,368
NET INCOME PER SHARE	$ 0.11	$ 0.35
NET INCOME PER SHARE – ASSUMING DILUTION	$ 0.11	$ 0.31

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

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the Years Ended December 31, 2008 and 2007

	Comprehensive Income	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
Balance at January 1, 2007		1,653,731	$ 10,983,285	$ 298,331	$ (2,276,063)	$ (88,429)	$ 8,917,124
Stock options exercised		26,755	227,822	(42,888)			184,934
Stock option expense				138,447			138,447
Comprehensive income:							
Net income	$ 580,368				580,368		580,368
Other comprehensive income: Unrealized holding gains on securities available-for-sale arising during the year	129,559					129,559	129,559
Total comprehensive income	$ 709,927						
Balance at December 31, 2007		1,680,486	11,211,107	393,890	(1,695,695)	41,130	9,950,432
2008 activity:							
Stock options exercised		46,358	379,671	(70,464)			309,207
Shares adjustment							
Stock option and restricted stock expense				152,958			152,958
Restricted stock vested		1,650	20,625	(20,625)			
Comprehensive income:							
Net income	193,357				193,357		193,357
Other comprehensive income: Unrealized holding gains on securities available-for-sale arising during the year	226,169					226,169	226,169
Total comprehensive income	$ 419,526						
BALANCE AT DECEMBER 31, 2008		1,728,494	$ 11,611,403	$ 455,759	$ (1,502,338)	$ 267,299	$ 10,832,123

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

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2008 and 2007

	2008	2007
OPERATING ACTIVITIES		
Net income	$ 193,357	$ 580,368
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,523,500	437,000
Deferred loan origination fees and costs, net	(119,148)	57,839
Loss on disposal of furniture		3,748
Depreciation and amortization	304,938	241,135
Stock options granted	152,958	138,447
Net increase in cash surrender value of life insurance	(104,912)	(93,821)
Increase in accrued interest receivable and other assets	209,193	(413,002)
Increase in accrued interest payable and other liabilities	(109,850)	54,766
NET CASH PROVIDED BY OPERATING ACTIVITIES	2,050,036	1,006,480
INVESTING ACTIVITIES		
Purchase of available-for-sale investment securities	(2,963,183)	(6,024,246)
Proceeds from maturity of available-for-sale investment securities	1,000,000	6,000,000
Proceeds from paydowns on mortgage-backed securities	1,242,572	537,799
Purchase of Federal Home Loan Bank stock	(111,400)	(64,400)
Net increase in loans	(26,404,956)	(28,617,701)
Purchases of premises and equipment	(9,039)	(2,765,047)
NET CASH USED BY INVESTING ACTIVITIES	(27,246,006)	(30,933,595)
FINANCING ACTIVITIES		
Net increase in deposits	30,605,353	25,073,821
Proceeds from exercise of stock options	309,207	184,934
Repayment of Federal Home Loan Bank borrowings		(2,000,000)
Proceeds from other borrowings	1,685,000	1,315,000
NET CASH PROVIDED BY FINANCING ACTIVITIES	32,599,560	24,573,755
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	7,403,590	(5,353,360)
Cash and cash equivalents at beginning of year	7,793,835	13,147,195
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 15,197,425	$ 7,793,835
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for:		
Interest	$ 2,944,270	$ 3,208,165
Income taxes	$ 1,600	$ 1,600
SUPPLEMENTAL DISCLOSURES OF NONCASH ACTIVITIES		
Net change in unrealized gains/losses on available-for-sale investment securities	$ 226,169	$ 129,559

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

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business: During 2007, the shareholders of Redwood Capital Bank (the Bank) approved a Plan of Reorganization and Merger Agreement, which provided for the formation of Redwood Capital Bancorp (the Company) (a bank holding company) and the conversion of each share of outstanding Bank common stock into one share of no par value Company common stock. Effective April 17, 2007, the Company issued 1,658,665 shares of its common stock for all of the outstanding common stock of the Bank through a merger which has been accounted for similar to a pooling of interests in that the historical cost basis of the Bank has been carried forward. As a result of the merger, the Bank became the wholly owned subsidiary of the Company.

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.

Principles of Consolidation: The consolidated financial statements include the accounts of the Company and the Bank. All material intercompany accounts and transactions have been eliminated.

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.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral. The Company's loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on local economic conditions. While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Investment Securities: Securities are classified as held-to-maturity if the Company 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 Company 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 Company'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.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 Company 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.

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

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 Company 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 Company has a stock-based employee and director compensation plan which is described more fully in Note L. The Company 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.

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 Company 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."

NOTE B – RESTRICTIONS ON CASH AND DUE FROM BANKS

Cash and due from banks include amounts the Company is required to maintain to meet certain average reserve requirements of the Federal Reserve Bank or the correspondent bank. The total requirement of the correspondent bank at December 31, 2008 was $50,000. The total requirement of the Federal Reserve Bank at December 31, 2007 was $100,000.

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
December 31, 2008				
Securities Available-for-Sale				
U.S. government agency securities	$ 3,025,000	$ 61,780		$ 3,086,780
Mortgage-backed securities	5,143,509	122,332	$ (180)	5,265,661
Collateralized mortgage obligations	1,817,215	83,415		1,900,630
Total	$ 9,985,724	$ 267,527	$ (180)	$ 10,253,071
December 31, 2007				
Securities Available-for-Sale				
U.S. government agency securities	$ 3,000,000	$ 26,875		$ 3,026,875
Mortgage-backed securities	6,263,853	33,535	$ (19,280)	6,278,108
Total	$ 9,263,853	$ 60,410	$ (19,280)	$ 9,304,983

The maturities of investment securities at December 31, 2008 were as follows:

	Available-for-Sale	
	Amortized Cost	Fair Value
Due in one year or less	$ 287,257	$ 287,077
Due from one year to five years	1,022,218	1,024,912
Due from five years to ten years	8,676,249	8,941,082
	$ 9,985,724	$ 10,253,071

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 2008 or 2007.

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, 2008 and 2007.

	2008		2007	
	More than 12 Months		More than 12 Months	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Mortgage-backed securities	$ 287,077	$ (180)	$ 1,624,536	$ (1,980)
	$ 287,077	$ (180)	$ 1,624,536	$ (1,980)

NOTE C – INVESTMENT SECURITIES (Continued)

There was one mortgage-backed security that was in an unrealized loss position as of December 31, 2008. There were two mortgage-backed securities that were in an unrealized loss position as of December 31, 2007. 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 Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2008 and 2007.

NOTE D – LOANS, NET

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

	2008	2007
Real estate – mortgage	$ 19,480,293	$ 10,449,564
Real estate – commercial	51,787,385	47,647,742
Construction loans	14,317,228	14,018,112
Commercial	22,507,012	17,220,932
Agricultural	233,671	17,333
Installment and other loans to individuals	21,124,888	15,028,122
	129,450,477	104,381,805
Net deferred loan fees and costs	(67,138)	(186,286)
Allowance for loan losses	(1,542,216)	(1,355,000)
	$ 127,841,123	$ 102,840,519

Changes in the allowance for loan losses were as follows for the years ended December 31:

	2008	2007
Beginning balance	$ 1,355,000	$ 918,000
Provision for loan losses	1,523,500	437,000
Loans charged off	(1,321,284)	
Reclassification of reserve for undisbursed loan commitments	(15,000)	
Ending balance	$ 1,542,216	$ 1,355,000

At December 31, 2008, the recorded investment in loans for which impairment has been recognized in accordance with SFAS No. 114 totaled $2,857,621 with a corresponding valuation allowance of $94,610. At December 31, 2007, the recorded investment in loans for which impairment has been recognized in accordance with Statement No. 114 totaled $1,000,000, with a corresponding valuation allowance of $250,000. For the years ended December 31, 2008 and 2007, the average recorded investment in impaired loans was $1,642,490 and $115,068, respectively. During 2008 and 2007, $18,129 and $24,510 of interest was received and recognized on impaired loans, respectively.

At December 31, 2008 and 2007, the Company has no other nonaccrual loans for which impairment has not been recognized. The Company has no commitments to loan additional funds to the borrowers of impaired or nonaccrual loans.

NOTE D – LOANS, NET (Continued)

The Company receives fees for servicing retained on loans sold. Loans being serviced by the Company for others totaled approximately $5,768,646 and $6,390,778 for the years ended December 31, 2008 and 2007, respectively.

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

	2008	2007
Fixed rate loan maturities		
Three months or less	$ 1,249,808	$ 1,974,806
Over three months to twelve months	4,177,299	3,095,045
Over one year to five years	9,648,286	10,597,737
Over five years to fifteen years	7,807,910	8,678,747
Over fifteen years	1,784,369	1,847,067
Floating rate loans repricing		
Quarterly or more frequently	45,203,443	36,586,359
Quarterly to annual frequency	10,718,263	6,781,397
One to five years frequency	41,877,325	28,832,389
Five to fifteen years frequency	4,242,613	5,988,258
Non-accrual loans	2,741,161	
	$ 129,450,477	$ 104,381,805

NOTE E – PREMISES AND EQUIPMENT

Premises and equipment consisted of the following at December 31:

	2008	2007
Land	$ 800,000	$ 800,000
Building and improvements	3,795,283	3,795,283
Furniture, fixtures and equipment	1,042,876	1,033,838
	5,638,159	5,629,121
Less: Accumulated depreciation	(1,137,092)	(830,847)
	$ 4,501,067	$ 4,798,274

Depreciation and amortization included in occupancy expense totaled $306,245 and $249,776 in 2008 and 2007, respectively.

NOTE F – INTEREST-BEARING DEPOSITS

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

	2008	2007
Negotiable order of withdrawal (NOW)	$ 30,145,402	$ 28,090,694
Savings and money markets	43,301,020	32,846,834
Time, $100,000 and over	18,492,346	15,937,615
Other time	29,771,800	18,693,974
	$ 121,710,568	$ 95,569,117

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

	2008	2007
Negotiable order of withdrawal (NOW)	$ 552,991	$ 848,193
Savings and money markets	856,462	987,168
Time, $100,000 and over	580,838	638,344
Other time	750,901	741,656
	$ 2,741,192	$ 3,215,361

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

	2008	2007
Three months or less	$ 28,454,874	$ 19,158,182
Over three months through twelve months	16,379,530	13,046,828
Over one year through three years	2,852,768	2,272,982
Over three years	576,974	153,597
	$ 48,264,146	$ 34,631,589

NOTE G – LENDING AGREEMENTS

The Company has federal funds line of credit agreements with other banks. The maximum borrowings available under these lines amount to $9,000,000 at December 31, 2008 and 2007. There were no borrowings outstanding under these agreements at December 31, 2008 and 2007.

The Company 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, 2008 totaled $161,663,289, resulting in a limit on borrowings of $24,267,055. Assets pledged under the agreement at December 31, 2007 totaled $128,707,549, resulting in a limit on borrowings of $19,306,132. No amounts were outstanding under this agreement as of December 31, 2008 and 2007.

The Company has an agreement to borrow from another financial institution for $3,000,000. Interest on the outstanding balance is calculated at a variable rate equal to the prime rate. The interest rate at December 31, 2008 was 3.25% and at December 31, 2007 the rate was 7.25%. Eight quarterly interest payments are required beginning September 4, 2007 through July 4, 2009, after which principal and interest payments are due through June 4, 2017. The outstanding principal balance at December 31, 2008 was $3,000,000 and at December 31, 2007 was $1,315,000.

NOTE H – OTHER EXPENSES

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

	2008	2007
Professional fees	$ 311,763	$ 232,317
Data processing	416,204	378,363
Marketing and promotion	205,366	268,462
Director and shareholder	228,969	286,620
Operating expense	181,971	149,544
Insurance expense	220,423	164,143
Loan and collection expense	101,470	59,673
Stationary and forms	92,500	88,319
Miscellaneous employee expense	34,093	48,290
Telephone expense	51,634	42,406
Operational losses	6,333	2,102
Dues and memberships	40,724	30,117
Postage and delivery	49,514	41,453
Subscriptions	7,333	7,450
Security expense	3,809	5,235
Other non-interest expense	2,027	9,205
	$ 1,954,133	$ 1,813,699

NOTE I – RETIREMENT PLANS

The Company has a defined contribution retirement plan covering substantially all of the Company'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 Company 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 the Company's contributions to the plan of $76,025 and $81,500 during 2008 and 2007, respectively.

The Company purchased single premium life insurance policies in 2006 in connection with the implementation of retirement plans for two key officers. The policies provide protection against the adverse financial effects from the death of key officers and to provide income to offset expenses associated with the plan. The officers are insured under the policies, but the Company is the owner and beneficiary. At December 31, 2008 and 2007, the cash surrender value of these policies totaled $2,298,540 and $2,193,628, respectively.

In 2006 the Company established a retirement plan that is unfunded, which provides for the Company to pay the officers specified amounts for specified periods after retirement. If death occurs prior to or during retirement, the Company will pay the officer's beneficiary or estate the benefits set forth in the plan. Liabilities are recorded for the estimated present value of future salary continuation benefits. At December 31, 2008 and 2007, the liability recorded for the executive officer supplemental retirement plan totaled $59,213 and $31,421, respectively. The amount of expense related to this plan for 2008 and 2007 was $27,792 and $25,229, respectively.

NOTE J – INCOME TAXES

Income tax expense included in the statement of operations consisted of $1,600 of current state tax paid for the years ended December 31, 2008 and 2007. 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:

	2008	2007
Income benefit at the Federal statutory rate	$ 66,285	$ 197,869
State franchise tax benefit, less Federal income tax effect	13,948	41,636
Incentive stock option expense	19,525	29,780
Valuation allowance change	12,558	(190,250)
Interest on enterprise zone loans exempt from State tax	(50,539)	(39,978)
Earnings on cash surrender value of life insurance	(43,176)	(37,246)
Nondeductible expenses and other	(17,001)	(211)
Net provision for income taxes	$ 1,600	$ 1,600

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:

	2008	2007
Deferred tax assets:		
Allowance for loan losses	$ 341,371	$ 251,256
Net operating loss carryforwards	294,569	446,203
Nonstatutory stock option expense	112,647	116,068
Non-accrual interest	72,931	
Salary continuation accrual	24,369	
Enterprise zone credits	21,815	20,979
Allowance for loan commitments	20,577	
Non-qualified restricted stock	18,803	
Organizational costs	15,428	33,494
Accrued vacation	13,534	
Other	17,262	85,248
Total deferred tax assets	953,306	953,248
Valuation allowance for deferred tax assets	(792,503)	(779,944)
Deferred tax assets recognized	160,803	173,304
Deferred tax liabilities:		
Adjustment to cash basis	(92,552)	(82,534)
Depreciation	(32,737)	(68,375)
Federal Home Loan Bank dividends	(24,940)	(15,186)
Discount accretion	(8,495)	(7,209)
Total deferred tax liabilities	(158,724)	(173,304)
Net deferred tax assets	$ 2,079	$ -

NOTE J – INCOME TAXES (Continued)

Amounts presented for the tax effects of temporary differences are based upon estimates and assumptions and could vary from amounts ultimately reflected on the Company's tax returns. Accordingly, the variances from amounts reported in prior years are primarily adjustments to conform to the tax returns as filed. The Company had income taxes receivable of $115,000 at December 31, 2008. The Company had no income taxes receivable or payable at December 31, 2007.

The Company and its subsidiary file an income tax return in the U.S. federal jurisdiction and a franchise tax return in the State of California jurisdiction. The Company is no longer subject to U.S. federal income tax examinations and State franchise tax examinations by taxing authorities for years prior to 2005 and 2004, respectively.

The Company adopted provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. No adjustments were identified for unrecognized tax benefits which would require an adjustment to the January 1, 2007 beginning balance of retained earnings. There were also no adjustments identified for unrecognized tax benefits which would require an adjustment to the income statement for the years ended December 31, 2008 or 2007.

The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2008 and 2007, the Company recognized no interest and penalties.

As of December 31, 2008, the Company had federal and state net operating loss carryforwards available to reduce future taxable income as follows:

	Net Operating Loss Carryforward	Expiration Date
Federal	$ 324,224	2024
	45,656	2025
	$ 369,880	
State	$ 1,718,660	2014
	520,003	2015
	120,860	2016
	$ 2,359,523	

As of December 31, 2008, the Company also had state contribution carryforwards of $57,106, which expire in 2011 through 2012.

NOTE K – EARNINGS PER SHARE

The following is a computation of basic and diluted earnings per share for the years ended December 31, 2008 and 2007.

	2008	2007
Basic:		
Net income	$ 193,357	$ 580,368
Weighted-average common shares outstanding	1,694,952	1,672,724
Earnings per share	$ 0.11	$ 0.35
Diluted:		
Net income	$ 193,357	$ 580,368
Weighted-average common shares outstanding	1,694,952	1,672,724
Net effect of dilutive stock options - based on the Treasury stock method using average market price	101,159	191,493
Weighted-average common shares outstanding and common stock equivalents	1,796,111	1,864,217
Earnings per share - assuming dilution	$ 0.11	$ 0.31

Options to purchase 24,000 shares of common stock at $13.33 to $14.67 per share and 16,850 shares of restricted stock were outstanding during 2008 but were not included in the computation of diluted earnings per share because the options' exercise price and stock issuance price was greater than the average market price of the common shares.

NOTE L – STOCK OPTION PLAN

The Company has a stock option plan established in 2004 under which incentive and nonstatutory stock options and restricted stock may be granted. The Company's Stock Option Plan provides for the granting of a maximum of 495,000 shares of the Company'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.

NOTE L – STOCK OPTION PLAN (Continued)

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

	Stock Options			
	2008		2007	
	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares
Shares under option at beginning of year	$ 7.39	302,983	$ 7.39	335,432
Options granted				
Options exercised	6.67	(46,358)	6.91	(26,755)
Options forfeited	13.22	(6,705)	9.35	(5,694)
Shares under option at end of year		249,920	7.39	302,983
Options exerciseable at end of year		232,248		215,549

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

	Stock Options	
	2008	2007
Intrinsic value:		
Outstanding shares	$ 753,059	$ 2,001,870
Exercisable shares	724,721	1,486,465
Weighted average remaining contractual term:		
Outstanding shares	5.29 years	6.29 years
Exercisable shares	5.23 years	6.22 years

Upon the exercise of stock options, new shares are issued. The total amount of cash received from the exercise of stock options during 2008 and 2007 was $309,208 and $184,934, respectively. There were no tax benefits realized from stock options exercised during 2008 and 2007.

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

	2008		2007	
Nonvested Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value	Shares
Nonvested at beginning of year	$ 2.01	87,434	$ 1.93	153,283
Vested	1.64	(63,052)	1.75	(60,155)
Forfeited	3.54	(6,710)	2.38	(5,694)
Nonvested at end of year	2.78	17,672	2.01	87,434

NOTE L – STOCK OPTION PLAN (Continued)

As of December 31, 2008 and 2007, there was $58,228 and $157,328 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 1.67 years and 2 years, respectively. The total fair value of shares vested during the years ended December 31, 2008 and 2007, was $103,504 and $136,241, respectively.

A summary of restricted stock activity follows for the year ended December 31, 2008:

	Restricted Stock					
	2008			2007		
	Shares	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value	Shares	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested at beginning of year	8,250	$ 12.50				
Granted	11,250	12.00		8,250	$ 12.50	
Shares Vested and Issued	(1,650)	12.50				
Forfeited	(1,000)	12.50				
Nonvested at end of year	16,850	12.20	$ 168,500	8,250	12.50	$ 115,500

As of December 31, 2008 and 2007, there was $172,128 and $82,917 of total unrecognized compensation cost related to nonvested restricted stock. That cost is expected to be recognized over a weighted-average period of 3.65 and 4 years, respectively.

Total compensation cost for all share-based payments recognized in net income for 2008 and 2007 totaled $152,958 and $136,241, respectively. No tax benefit was recognized related to this compensation cost.

NOTE M – RELATED PARTY TRANSACTIONS

During the normal course of business, the Company 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 $2,950,094 and $971,946 at December 31, 2008 and 2007, respectively. At December 31, 2008 and 2007, commitments to related parties of $398,416 and $1,842,084, respectively, were undisbursed. The Company has received deposits from directors and officers and their related interests totaling $4,230,850 and $6,116,840 at December 31, 2008 and 2007, respectively.

NOTE N – CONTINGENT LIABILITIES AND COMMITMENTS

Financial Instruments with Off-Balance-Sheet Risk: The Company'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 Company's commitments and contingent liabilities at December 31, 2008 and 2007 are as follows:

	Contractual Amounts	
	2008	2007
Commitments to extend credit	$ 38,141,119	$ 30,957,892
Standby letters of credit	777,807	750,079

Commitments to extend credit and standby letters of credit include exposure to some credit loss in the event of nonperformance of the customer. The Company'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 Company.

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 Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company 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 Company 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 Company did not incur any losses on its commitments in 2008 and 2007.

Lease Commitments: The Company leases two sites under noncancelable operating leases expiring in October 2009 and September 2011. The lease expiring September 2011 includes an option to renew for two additional five-year terms, with the monthly rental being adjusted to $400 per month at the beginning of the first option period and to $500 per month at the beginning of the second option period.

As of December 31, 2008, future minimum lease payments under noncancelable operating leases are as follows:

Year ended December 31:	Lease Commitment
2009	$ 21,900
2010	3,900
2011	2,925
Total minimum lease commitments	$ 28,725

Rent expense for the year ended December 31, 2008 totaled $30,560.

NOTE O – CONCENTRATIONS OF CREDIT RISK

Most of the Company's business activity is with customers located within the State of California, primarily in and around the City of Eureka. Most of the Company's loans have been granted to customers in the Company'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 Company 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 Company's access to this collateral is through judicial procedures.

The concentrations of credit by type of loan are set forth in Note D. Approximately 81% of the Company's loans are collateralized by real estate in the Company'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 Company to 15% of the sum of the Company's equity capital plus the allowance for loan losses, subject to certain adjustments. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company, 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 Company places its investments primarily in financial instruments backed by the U.S. Government and its agencies. In addition, at December 31, 2007, the Company had deposits in federally insured banks in excess of federally insured limits by $10,391. There were no deposits in excess of federally insured limit at December 31, 2008. At December 31, 2008, the Bank has $4,986,000 in federal funds sold to two correspondent banks, which represents 46% of the Bank's net worth.

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, 2008, $1,697,991 was available for cash dividend distribution without prior approval.

The Company 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 Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company'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 Company 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, 2008, that the Company meets all capital adequacy requirements to which it is subject.

NOTE P – REGULATORY MATTERS (Continued)

As of December 31, 2008, the most recent notification from the FDIC categorized the Company as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Company 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 Company's category. The Company'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, 2008						
Total Capital						
(to Risk Weighted Assets)	$ 14,635	10.90%	≥ $ 10,743	≥ 8.00%	≥ $ 12,429	≥ 10.00%
Tier I Capital						
(to Risk Weighted Assets)	$ 13,043	9.71%	≥ $ 5,371	≥ 4.00%	≥ $ 8,057	≥ 6.00%
Tier I Capital						
(to Average Assets)	$ 13,043	8.61%	≥ $ 6,061	≥ 4.00%	≥ $ 1,577	≥ 5.00%
As of December 31, 2007						
Total Capital						
(to Risk Weighted Assets)	$ 12,269	10.93%	≥ $ 8,980	≥ 8.00%	≥ $ 11,224	≥ 10.00%
Tier I Capital						
(to Risk Weighted Assets)	$ 10,879	9.69%	≥ $ 4,490	≥ 4.00%	≥ $ 6,735	≥ 6.00%
Tier I Capital						
(to Average Assets)	$ 10,879	8.36%	≥ $ 5,208	≥ 4.00%	≥ $ 6,509	≥ 5.00%

NOTE Q – FAIR VALUES OF FINANCIAL INSTRUMENTS

SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. SFAS No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company as a whole. The estimated fair values of the Company's financial instruments are as follows at December 31, 2008:

NOTE Q – FAIR VALUES OF FINANCIAL INSTRUMENTS (Continued)

	2008		2007	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and due from banks	$ 5,582,425	$ 5,582,425	$ 3,458,835	$ 3,458,835
Federal funds sold	9,615,000	9,615,000	435,000	435,000
Interest-bearing deposits in other banks			3,900,000	3,900,000
Investment securities available-for-sale	10,253,071	10,253,071	9,304,983	9,304,983
Loans, net	127,841,123	130,360,832	102,840,519	102,263,544
Cash surrender value of life insurance	2,298,540	2,298,540	2,193,628	2,193,628
Accrued interest receivable	607,919	607,919	594,219	594,219
Financial liabilities:				
Deposits	147,436,018	147,446,268	116,830,665	116,834,391
Borrowings	3,000,000	3,000,000	1,315,000	1,315,000
Accrued interest payable	115,405	115,405	201,455	201,455

The carrying amounts in the preceding table are included in the balance sheet under the applicable captions. The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash and due from banks, federal funds sold and interest-bearing deposits in other banks: The carrying amount is a reasonable estimate of fair value.

Investment securities: Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. The carrying amount of accrued interest receivable approximates its fair value.

Loans, net: For variable-rate loans that reprice frequently and fixed rate loans that mature in the near future, with no significant change in credit risk, fair values are based on carrying amounts. The fair values for other fixed rate loans are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics and are adjusted for the allowance for loan losses. The carrying amount of accrued interest receivable approximates its fair value.

Cash surrender value of life insurance: The carrying amount approximates fair value.

Deposits: The fair values disclosed for demand deposits (for example, interest-bearing checking, money market and savings accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on the certificates to a schedule of aggregated contractual maturities on such time deposits. The carrying amount of accrued interest payable approximates fair value.

Borrowings: The carrying amount approximates fair value.

NOTE Q – FAIR VALUES OF FINANCIAL INSTRUMENTS (Continued)

Statement of Financial Accounting Standards (SFAS) No. 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurement. Effective January 1, 2008, the Company adopted SFAS No. 157, which enhances the disclosures about financial instruments carried at fair value. The adoption of SFAS No. 157 did not have an impact on the Company's financial condition or results of operations.

Fair value is a market-based measure considered from the perspective of a market participant who holds the asset or owes the liability rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, the Company's own assumptions are set to reflect those that market participants would use in pricing the asset or liability at the measurement date. The Company uses prices and inputs that are current as of the measurement date, including during periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or Level 2 to Level 3.

In general, fair values are determined by:

Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access.

Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any market activity for the asset or liability.

Assets measured at fair value on a recurring basis consist of securities available-for-sale with a fair value of $10,253,071, all of which are valued using Level 2 inputs. The following methods were used to estimate the fair value of securities available-for-sale.

Securities available-for-sale – For investment securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurement considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions among other things.

The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Assets measured at fair value on a nonrecurring basis include impaired loans with a fair value of $2,465,120, all of which utilized Level 2 inputs.

Impaired loans – The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At December 31, 2008, all of the impaired loans were evaluated based on the fair value of the collateral. In accordance with SFAS 157, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraisal value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring level 3.

NOTE R – CONDENSED FINANCIAL INFORMATION OF THE PARENT COMPANY

Condensed balance sheets as of December 31, 2008 and 2007 and the related condensed statement of operations and cash flows for the year and eight months then ended for Redwood Capital Bancorp (parent company only) are presented as follows:

Condensed Balance Sheets
December 31, 2008 and 2007

	2008	2007
Assets		
Cash	$ 453,685	$ 402,239
Other assets		10,625
Intercompany receivable	800	
Investment in subsidiary	13,471,576	10,919,950
	$ 13,926,061	$ 11,332,814
Liabilities and shareholders' equity		
Accrued interest payable and other liabilities	$ 93,938	$ 67,382
Other borrowings	3,000,000	1,315,000
Common stock	11,611,403	11,211,107
Additional paid-in capital	455,759	393,890
Retained earnings (deficit)	(1,235,039)	(1,654,565)
	$ 13,926,061	$ 11,332,814

Condensed Statements of Operations
For the year ended December 31, 2008 and eight months ended December 31, 2007

	2008	2007
Dividends from subsidiary		$ 30,000
Interest expense	$ (115,313)	(48,114)
Other expenses	(330,987)	(249,315)
Loss before equity in undistributed income of subsidiary and income taxes	(446,300)	(267,429)
Equity in undistributed net income of subsidiary	640,457	669,302
Income tax expense	(800)	(800)
	$ 193,357	$ 401,073

NOTE R – CONDENSED FINANCIAL INFORMATION OF THE PARENT COMPANY (Continued)

Condensed Statements of Cash Flows
For the year ended December 31, 2008 and eight months ended December 31, 2007

	2008	2007
Cash flows from operating activities:		
Net income	$ 193,357	$ 401,073
Adjustments to reconcile net income to net cash used by operating activities:		
Equity in undistributed income of subsidiary	(640,457)	(669,302)
Dividends from subsidiary		(30,000)
Stock options and restricted granted	152,958	98,711
Change in other assets	10,625	(10,625)
Change in intercompany receivable	(800)	
Change in interest payable and other liabilities	26,556	67,382
Net cash used by operating activities	(257,761)	(142,761)
Cash flows from investing activities		
Capital infusion	(1,685,000)	(800,000)
Dividends from subsidiary		30,000
Net cash used by investing activities	(1,685,000)	(770,000)
Cash flows from financing activities:		
Proceeds from other borrowings	1,685,000	1,315,000
Proceeds from exercise of stock options	309,207	
Net cash provided by financing activities	1,994,207	1,315,000
Net increase in cash	51,446	402,239
Cash at beginning of year	402,239	
CASH AT END OF YEAR	$ 453,685	$ 402,239

NOTE S – SUBSEQUENT EVENTS

On January 16, 2009, the Company entered into a letter agreement with the United States Department of the Treasury pursuant to the Troubled Asset Relief Program Capital Purchase Program. Under the terms of the Letter Agreement, the Company issued to the Treasury 3,800 shares of perpetual preferred stock and a warrant to acquire up to 190.0019 shares of a separate series of perpetual preferred stock for an aggregate purchase price of $3,800,000, pursuant to the standard Capital Purchase Program terms and conditions for non-public companies. These proceeds were used to repay the line of credit described in Note G. A new line of credit was obtained on January 5, 2009 totaling $3,100,000 with interest at the Wall Street Journal prime rate that can be drawn upon over a two-year period, after which the balance will amortize over 10 years. No borrowings have been made on this line as of the date of this report.