Redwood Capital Bancorp

Audited Financial Statements

December 31, 2012

Redwood Capital Bancorp

April 10, 2013

Dear Shareholders,

"*Plan your work and work your plan*" has been a motto used throughout the history of Redwood Capital Bank. As with every year, we started 2012 with specific goals and objectives and ended the year meeting most of those objective while building on our already strong balance sheet. Our Board of Directors and management team have never been more optimistic about Redwood Capital Bank's long-term future and success.

In 2012 the company's net income after taxes was $1.21 million, or $0.68 cents per common share. The company's earnings were driven by growing the earning assets of the bank faster than deposits. Total loans grew by $11.28 million in 2012. The company's balance sheet is supported by a Tier One Capital Ratio of 14.70% which far exceeds the regulatory minimum of 4.00%. Overall, the balance sheet is very strong and well positioned for growth in the years to come.

I am pleased to report that despite another challenging year for the banking industry, Redwood Capital Bank maintained Bauer Financial Inc.'s *Five Star* rating, the highest rating possible from one of the nation's most respected independent bank rating firms.

Maximizing shareholder returns remains a top priority for our Board of Directors and management team. On June 1, 2012, Redwood Capital Bank paid its first cash dividend. Over the course of 2012, Redwood Capital Bank paid quarterly cash dividends totaling $0.15 per common share, representing a return to our shareholders of 2.59% based on the $5.80 closing price of the company's common stock as of December 30, 2011. As of March 28, 2013, our stock's closing price was $7.85, representing a 35% increase on stock price since the beginning of last year.

We look forward to 2013, our tenth year, with continued enthusiasm. We are pleased and excited to announce our expansion into the Arcata market later this year. This expansion is marked by a unique partnership with Humboldt State University and the Museum of Natural History. This partnership provides Redwood Capital Bank with an excellent facility in which to serve the Arcata community while ensuring the future of the museum, which has become a rich source of historical and scientific instruction for the youth in our communities.

On behalf of the staff, management, Advisory Board and Board of Directors, I would like to personally thank you, our valued shareholders, for your continued support, loyalty and confidence. We enter 2013 with a tremendous amount of momentum, a strong balance sheet and great optimism for expansion. Every member of our team is committed to the realization of our strategic objectives and our team approaches each new day with passion, conviction and an unrelenting quest to deliver long-term "shareholder value" while serving the communities we call home.

Sincerely,

REDWOOD CAPITAL BANCORP

John E. Dalby
President & CEO

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INDEPENDENT AUDITOR'S REPORT

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

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Redwood Capital Bancorp and Subsidiary, which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

The Shareholders and
Board of Directors
Redwood Capital Bancorp and Subsidiary

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Redwood Capital Bancorp and Subsidiary, as of December 31, 2012 and 2011, and the results of their operations, comprehensive income, and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Richardson & Company

March 25, 2013

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

December 31, 2012 and 2011

	2012	2011
ASSETS		
Cash and due from banks	$ 9,777,807	$ 7,969,140
Federal funds sold	12,390,000	37,755,000
Interest-bearing deposits in other financial institutions	21,433,169	18,979,172
Cash and cash equivalents	43,600,976	64,703,312
Investment securities available-for-sale, at fair value	30,845,712	21,176,774
Mortgages held for sale	3,026,410	2,897,277
Loans, net	153,126,498	141,491,678
Premises and equipment, net	4,216,158	4,097,547
Foreclosed real estate	366,335	522,586
Cash surrender value of life insurance	2,694,251	2,597,987
Accrued interest receivable and other assets	3,512,359	4,030,035
Mortgage servicing rights, at fair value	301,470	237,832
TOTAL ASSETS	$ 241,690,169	$ 241,755,028
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Deposits		
Non interest-bearing	$ 40,889,168	$ 36,576,193
Interest-bearing	174,108,164	180,203,282
Total deposits	214,997,332	216,779,475
Borrowings	2,576,546	2,842,593
Accrued interest payable and other liabilities	2,070,076	1,089,521
TOTAL LIABILITIES	219,643,954	220,711,589
Commitments and contingencies (see accompanying notes)		
SHAREHOLDERS' EQUITY		
Preferred stock, Series A, B, and C, no par value; 10,000,000 shares authorized; 7,310 shares of Series C issued and outstanding in 2012 and 2011	7,283,990	7,283,990
Common stock, no par value; 30,000,000 shares authorized; 1,792,632 and 1,761,887 shares issued and outstanding in 2012 and 2011	12,195,212	11,926,862
Additional paid-in capital	509,998	588,470
Retained earnings	1,601,011	853,948
Accumulated other comprehensive income	456,004	390,169
TOTAL SHAREHOLDERS' EQUITY	22,046,215	21,043,439
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 241,690,169	$ 241,755,028

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, 2012 and 2011

	2012	2011
INTEREST INCOME		
Interest and fees on loans	$ 8,623,311	$ 8,563,068
Interest on taxable investment securities	704,525	696,818
Dividend income	14,617	2,624
Interest on federal funds sold	65,182	70,263
Interest on deposits in banks	73,704	59,462
Total interest income	9,481,339	9,392,235
INTEREST EXPENSE		
Interest on deposits	1,093,899	1,634,085
Interest on other borrowings	128,984	129,898
Total interest expense	1,222,883	1,763,983
NET INTEREST INCOME	8,258,456	7,628,252
Provision for loan losses	995,000	300,000
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	7,263,456	7,328,252
OTHER INCOME		
Service charges and fees	487,360	469,987
Mortgage banking revenue, net	720,747	542,732
Other income	182,271	158,964
Total other income	1,390,378	1,171,683
OTHER EXPENSES		
Salaries and employee benefits	3,573,992	3,328,849
Foreclosed real estate	204,143	141,974
Occupancy and equipment	593,540	545,688
Other	2,283,660	2,199,656
Total other expenses	6,655,335	6,216,167
Income before provision for income taxes	1,998,499	2,283,768
Provision for income taxes	785,132	574,931
NET INCOME	$ 1,213,367	$ 1,708,837
NET INCOME PER SHARE	$ 0.68	$ 0.97
NET INCOME PER SHARE – ASSUMING DILUTION	$ 0.67	$ 0.94

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

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Years Ended December 31, 2012 and 2011

	2012	2011
NET INCOME	$ 1,213,367	$ 1,708,837
Other comprehensive income, net of tax		
Available for sale securities		
Unrealized gains (losses) arising during the year, net of tax expense of $46,034 and $255,343 as of 2012 and 2011, respectively	65,835	322,284
COMPREHENSIVE INCOME	$ 1,279,202	$ 2,031,121

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, 2012 and 2011

	Preferred Stock	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
Balance at January 1, 2011	$ 3,862,206	1,746,799	$ 11,791,633	$ 581,230	$ (539,358)	$ 67,885	$ 15,763,596
Dividends on preferred stock					(187,734)		(187,734)
Amortization/Accretion of preferred stock, net	22,162				(22,162)		
Redemption of preferred stock and warrants, net of costs	(3,884,368)				(105,635)		(3,990,003)
Issuance of preferred stock, net of costs	7,283,990						7,283,990
Redemption and retirement of stock		(1,680)	(9,324)				(9,324)
Stock option and restricted stock expense				151,793			151,793
Restricted stock vested		16,768	144,553	(144,553)			
Net income					1,708,837		1,708,837
Other comprehensive income, net of taxes						322,284	322,284
Balance at December 31, 2011	7,283,990	1,761,887	11,926,862	588,470	853,948	390,169	21,043,439
Cash dividends on common stock ($0.15 per share)					(267,779)		(267,779)
Dividends on preferred stock					(198,525)		(198,525)
Redemption and retirement of stock		(2,799)	(18,460)				(18,460)
Stock options exercised and related tax benefits		14,812	120,580	(74,043)			46,537
Restricted stock expense				161,801			161,801
Restricted stock vested		18,732	166,230	(166,230)			
Net income					1,213,367		1,213,367
Other comprehensive income, net of taxes						65,835	65,835
Balance at December 31, 2012	$ 7,283,990	1,792,632	$ 12,195,212	$ 509,998	$ 1,601,011	$ 456,004	$ 22,046,215

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, 2012 and 2011

	2012	2011
OPERATING ACTIVITIES		
Net income	$ 1,213,367	$ 1,708,837
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	995,000	300,000
Deferred loan origination fees and costs, net	(118,176)	21,926
Gain on disposal of premises	(40,281)	
Realized (gain) loss on sale of foreclosed real estate	(15,080)	2,366
Provision for losses on foreclosed real estate	200,750	90,051
Depreciation and amortization	549,996	477,569
Change in mortgage servicing rights carried at fair value	(63,638)	(237,832)
Stock-based compensation expense	161,801	151,793
Net increase in loans held for sale	(129,133)	(2,897,277)
Earnings on in cash surrender value of life insurance	(96,264)	(99,267)
Net change in accrued interest receivable and other assets	424,983	329,253
Net change in accrued interest payable and other liabilities	983,294	(43,818)
NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	4,066,619	(196,399)
INVESTING ACTIVITIES		
Purchase of available-for-sale investment securities	(18,361,557)	(6,533,465)
Proceeds from maturity of available-for-sale investment securities	4,990,000	4,043,636
Proceeds from paydowns on mortgage-backed securities	3,547,038	2,574,130
Proceeds from sale of foreclosed real estate	665,984	46,234
Purchase of Federal Home Loan Bank stock	(5,600)	(100,300)
Net increase in loans	(13,207,047)	(1,275,267)
Proceeds from sale of premises and equipment	327,317	
Purchases of premises and equipment	(688,193)	(162,541)
NET CASH USED BY INVESTING ACTIVITIES	(22,732,058)	(1,407,573)
FINANCING ACTIVITIES		
Net (decrease) increase in deposits	(1,782,143)	23,329,570
Repurchase of restricted stock	(18,460)	(9,324)
Proceeds from exercise of stock options	98,796	
Proceeds from issuance of preferred stock		7,283,990
Repurchase of preferred stock		(3,990,003)
Repayments of borrowings	(266,047)	(255,267)
Dividends paid on common stock	(267,779)	
Dividends paid on preferred stock	(201,264)	(173,192)
NET CASH (USED) PROVIDED BY FINANCING ACTIVITIES	(2,436,897)	26,185,774
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(21,102,336)	24,581,802
Cash and cash equivalents at beginning of year	64,703,312	40,121,510
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 43,600,976	$ 64,703,312

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

For the Years Ended December 31, 2012 and 2011

	2012	2011
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for:		
Interest	$ 1,237,493	$ 1,759,405
Income taxes	$ 548,000	$ 510,000
SUPPLEMENTAL DISCLOSURES OF NONCASH ACTIVITIES		
Net change in unrealized gains/losses on available-for-sale investment securities	$ 111,869	$ 547,627
Net change in deferred income taxes on unrealized gains and losses on securities available-for-sale	$ (46,034)	$ (225,343)
Loans transferred to foreclosed real estate	$ 695,403	$ 661,237

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

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business: Redwood Capital Bancorp (the Company), formed in 2007, is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiary, Redwood Capital Bank (the Bank). The Bank was incorporated on November 3, 2003 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 Company are prepared in conformity with generally accepted accounting principles and general practices 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, residential and personal credit and other banking services through its branches located in Eureka and Fortuna, 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.

Mortgages Held for Sale: Mortgages held for sale consist of one-to-four family residential loans originated for sale in the secondary market and are carried at the lower of cost or estimated fair value determined on an aggregate basis. The long-term, fixed rate loans are sold to investors on a best efforts basis such that the Company does not absorb the interest rate risk involved in the loans. The fair value of loans held for sale is determined by reference to quoted prices for loans with similar coupon rates and terms.

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.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 other liabilities. 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 collectability of the recorded balance is doubtful, collections of interest and principal are generally applied as a reduction to the principal outstanding. When the future collectability 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.

Foreclosed Real Estate: Foreclosed real estate includes both formally foreclosed property and in-substance foreclosed property. In-substance foreclosed properties are those properties for which the Company has taken physical possession, regardless of whether formal foreclosure proceedings have taken place. At the time of foreclosure, foreclosed real estate is recorded at fair value less cost to sell, which becomes the property's new basis. Any write-downs based on the asset's fair value at date of acquisition are charged to the allowance for loan losses. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of their new cost basis or fair value minus estimated costs to sell. Revenue and expenses from operations and subsequent adjustments to the carrying amount are included in other non-interest expenses.

Investment in Federal Home Loan Bank Stock: As a member of the Federal Home Loan Bank (FHLB) System, the Bank is required to maintain an investment in capital stock of the FHLB. The investment exceeds the minimum requirement at December 31, 2012 and 2011. The investment is stated at cost in the accompanying balance sheets and is reported as part of other assets.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Mortgage Servicing Rights: Servicing rights resulting from the sale or securitization of loans originated (asset transfers) are initially measured at fair value at the date of transfer and the changes in fair value, primarily due to changes in valuation inputs and assumptions and to the collection/realization of expected cash flows, are reported in noninterest income in the period in which the change occurs. The rights to service mortgage loans for others, or mortgage servicing rights, are recognized as assets whether purchased or resulting from an asset transfer.

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 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 N. The Company applies the fair value recognition provisions of FASB ASC 718, *Accounting for Stock-Based Compensation*. Accordingly, compensation cost for stock options is measured based on the grant-date fair value and is recognized in the income statement. Awards under the Company's plan generally vest over five years.

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" and "interest-bearing deposits in other financial institutions."

Subsequent events: The Company evaluated all events or transactions that occurred after December 31, 2012 and up to March 25, 2013, the date the financial statements were issued. During this period, the Company did not have any recognizable or nonrecognizable subsequent events.

NOTE B – 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, 2012				
Securities Available-for-Sale				
U.S. government agency securities	$ 6,987,964	$ 219,622		$ 7,207,586
Small Business Adminstration Securities	3,062,535	575	$ (8,600)	3,054,510
Mortgage-backed securities	3,591,449	130,638		3,722,087
Municipal securities	7,307,506	154,068	(44,898)	7,416,676
Collateralized mortgage obligations	9,121,400	324,237	(784)	9,444,853
Total	$ 30,070,854	$ 829,140	$ (54,282)	$ 30,845,712
December 31, 2011				
Securities Available-for-Sale				
U.S. government agency securities	$ 6,008,674	$ 117,038		$ 6,125,712
Mortgage-backed securities	2,343,643	105,108		2,448,751
Municipal securities	2,381,196	54,434		2,435,630
Collateralized mortgage obligations	9,780,272	397,523	$ (11,114)	10,166,681
Total	$ 20,513,785	$ 674,103	$ (11,114)	$ 21,176,774

The maturities of investment securities at December 31, 2012 were as follows:

	Available-for-Sale	
	Amortized Cost	Fair Value
Due from one year to five years	$ 2,112,483	$ 2,142,576
Due from five years to ten years	10,351,474	10,690,957
Due after ten years	17,606,897	18,012,179
	$ 30,070,854	$ 30,845,712

The amortized cost and fair value of mortgage-backed securities and collateralized mortgage obligations 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.

Investment securities with an amortized cost of $15,757,367 and a fair value of $16,490,840 at December 31, 2012 were pledged to secure public deposits. Investment securities with an amortized cost of $10,926,800 and a fair value of $11,368,067 at December 31, 2011 were pledged to secure public deposits.

NOTE B – INVESTMENT SECURITIES (Continued)

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, 2012 and 2011.

	2012		2011	
	Less than 12 Months		Less than 12 Months	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Small Business Administration Securities	$ 1,974,681	$ (8,600)		
Municipal securities	2,331,965	(44,898)		
Collateralized mortgage obligations	429,598	(784)	$ 971,288	$ (11,114)
	$ 4,736,244	$ (54,282)	$ 971,288	$ (11,114)

There were two small business administration securities, two municipal securities, and one collateralized mortgage obligation that were in a loss position as of December 31, 2012. There was one collateralized mortgage obligation that was in a loss position as of December 31, 2011. 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, 2012 and 2011.

NOTE C – LOANS, NET

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

	2012	2011
Commercial real estate	$ 80,011,682	$ 66,748,334
Commercial loans	20,390,135	18,962,831
Construction and land loans	7,672,156	9,189,331
Residential real estate	19,713,032	21,360,379
Loans to individuals	26,764,274	27,945,688
Agricultural	1,286,076	347,636
	155,837,355	144,554,199
Net deferred loan fees and costs	78,056	(40,120)
Allowance for loan losses	(2,788,913)	(3,022,401)
	$ 153,126,498	$ 141,491,678

The Company receives fees for servicing retained on loans sold. Loans being serviced by the Company for others totaled approximately $53,590,702 and $27,813,431 for the years ended December 31, 2012 and 2011, respectively.

NOTE C – LOANS, NET (Continued)

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

	2012	2011
Fixed rate loan maturities		
Three months or less	$ 1,006,689	$ 1,694,925
Over three months to twelve months	730,230	2,310,597
Over one year to five years	10,086,638	8,987,572
Over five years to fifteen years	4,778,553	4,779,943
Over fifteen years	1,791,191	2,757,410
Floating rate loans repricing		
Quarterly or more frequently	57,703,599	62,112,633
Quarterly to annual frequency	8,235,476	8,123,249
One to five years frequency	57,170,723	50,069,277
Five to fifteen years frequency	11,440,766	2,869,553
Over fifteen years frequency		1,164
Non-accrual loans	2,893,490	847,876
	$ 155,837,355	$ 144,554,199

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY

The Company's methodology for assessing the appropriateness of the allowance consists of three key elements, which include the general allowance, the specific allowance and an allowance for changing environmental factors. These various components are factored into a single allowance analysis.

General Allowance: The determination of general allowance is based on estimates made by management, including but not limited to, consideration of historical losses by portfolio segment, peer bank losses, analysis of the economy, market rate environment, underwriting standards and other criteria as identified by the credit administrator. The portfolio segments include commercial real estate, construction, single family residential, home equity lines of credit, agricultural land, commercial, agricultural loans/lines and consumer. In addition, the Company segregates each of these segments into local and out-of-area loans. Local refers to properties located in Humboldt, Del Norte and Trinity counties, and out-of-area refers to properties located outside of the tri-county area. Peer bank loss information is used for loans that are out-of-area. The general allowance consists of reserve factors that are based on charge-off history and management's assessment of each portfolio segment. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

Commercial Real Estate—These loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except construction loans. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Residential Real Estate—The loans consist of single family residential loans and home equity lines of credit. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

Construction and Land—Construction and land loans generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Commercial—Commercial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Agriculture—Loans secured by agricultural land and production are especially vulnerable to two risk factors that are largely outside the control of the Company and borrowers, commodity prices and weather conditions.

Installment and other loans to individuals—The installment loan portfolio is comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for purchase of heavy equipment or industrial vehicles may also be included.

Specific Allowance: Regular credit reviews of the portfolio also identify loans that are considered potentially impaired. A loan is considered impaired when, based on current information and events, the Company determines that they will probably not be able to collect all amounts due according to the loan contract, including scheduled interest payments. When the Company identifies a loan as impaired, they measure the impairment using discounted cash flows, except when the sole remaining source of repayment for the loans is the liquidation of the collateral. In these cases, they use the current fair value of the collateral, less selling costs. If the Company determines that the value of the impaired loan is less than the recorded investment in the loan, they either recognize an impairment reserve as a specific allowance to be provided for in the allowance or charge-off the impaired balance on collateral dependent loans if it is determined that such amount represents a confirmed loss. Loans determined to be impaired with a specific allowance are excluded from the general allowance so as not to double-count the loss exposure.

Qualitative factors: This component of the allowance is management's best estimate of the probable impact that various qualitative factors may have on the loan portfolio. It is not allocated to specific loans or groups of loans, but rather is intended to absorb losses caused by several factors, including changes in the nature and volume of the portfolio, changes in the terms of loans, changes in lending policies and procedures, underwriting collection practices, changes in international, national, regional, and local economic and business conditions, changes in the experience and ability of lending management and staff, changes in the volume and severity of past due loans, changes in the volume of non-accrual loans, changes in the volume and severity of adversely classified or graded loans, changes in the quality of the Company's loan review system, changes in the value of underlying collateral, the existence and effect of any concentrations of credit, changes in the level of concentrations of credit and the effect of other external factors such as competition and legal and regulatory requirements.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. The Board of Directors review the adequacy of the allowance quarterly, including consideration of current economic conditions, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, or past loan experience and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's primary regulators, the FDIC and the DFI, review the adequacy of the allowance as an integral part of their examination process. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

The following table summarizes activity related to the allowance for loan losses by loan portfolio segment and the allocation of the allowance for loan losses by loan portfolio segment and by impairment methodology for the years ended December 31, 2012 and 2011:

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Unallocated and Qualitative Factors	Total
2012								
Allowance for credit losses:								
Beginning balance	$ 1,146,513	$ 361,614	$ 216,998	$ 277,673	$ 585,687	$ 4,415	$ 429,501	$ 3,022,401
Charge-offs	(245,557)	(22,706)	(589,424)	(128,292)	(280,773)			(1,266,752)
Recoveries	32,224	1,000			5,040			38,264
Provision	222,475	(22,713)	547,350	141,641	305,370	11,675	(210,798)	995,000
Ending balance	$ 1,155,655	$ 317,195	$ 174,924	$ 291,022	$ 615,324	$ 16,090	$ 218,703	$ 2,788,913
Ending balance: Individually evaluated for impairment	$ 32,845	$ 23,387	$ 25,603	$ 1,518	$ 210,046	$ -	$ -	$ 293,399
Ending balance: Collectively evaluated for impairment	$ 1,122,810	$ 293,808	$ 149,321	$ 289,504	$ 405,278	$ 16,090	$ 218,703	$ 2,495,514
Loans:								
Ending balance	$ 80,011,682	$ 20,390,135	$ 7,672,156	$ 19,713,032	$ 26,764,274	$ 1,286,076		$ 155,837,355
Ending balance: Individually evaluated for impairment	$ 856,452	$ 130,614	$ 1,710,645	$ 511,549	$ 210,046			$ 3,419,306
Ending balance: Collectively evaluated for impairment	$ 79,155,230	$ 20,259,521	$ 5,961,511	$ 19,201,483	$ 26,554,228	$ 1,286,076	$	$ 152,418,049

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Unallocated and Qualitative Factors	Total
2011								
Allowance for credit losses:								
Beginning balance	$ 989,183	$ 371,164	$ 227,907	$ 297,634	$ 570,595	$ 4,107	$ 307,637	$ 2,768,227
Charge-offs					(73,615)			(73,615)
Recoveries		23,699			4,090			27,789
Provision	157,330	(33,249)	(10,909)	(19,961)	84,617	308	121,864	300,000
Ending balance	$ 1,146,513	$ 361,614	$ 216,998	$ 277,673	$ 585,687	$ 4,415	$ 429,501	$ 3,022,401
Ending balance: Individually evaluated for impairment	$ 206,559	$ 120,361	$ 63,117	$ 4,636	$ 184,278	$ -	$ -	$ 578,951
Ending balance: Collectively evaluated for impairment	$ 939,954	$ 241,253	$ 153,881	$ 273,037	$ 401,409	$ 4,415	$ 429,501	$ 2,443,450
Loans:								
Ending balance	$ 66,748,334	$ 18,962,831	$ 9,189,331	$ 21,360,379	$ 27,945,688	$ 347,636		$ 144,554,199
Ending balance: Individually evaluated for impairment	$ 897,924	$ 617,286	$ 2,204,316	$ 144,136	$ 184,278			$ 4,047,940
Ending balance: Collectively evaluated for impairment	$ 65,850,410	$ 18,345,545	$ 6,985,015	$ 21,216,243	$ 27,761,410	$ 347,636	$	$ 140,506,259

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

Credit Quality of Loans

The Company assigns a risk rating to loans over a certain threshold and periodically performs detailed reviews of all such loans to identify credit risks and to assess the overall collectability of the portfolio. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. These risk ratings can be grouped into the following major categories, defined as follows:

Pass: A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Watch List: A watch list loan has significant weaknesses resulting from performance trends or management concerns.

Special Mention: A special mention loan is currently protected, but is weak due to negative trends in the financial statements of the borrower and current cash flow problems, among other criteria. Special mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard: A substandard loan has well-defined weaknesses where a payment default and/or a loss is possible, but not yet probable. Cash flow is insufficient to service the debt, with prospects that the condition is permanent. Loans classified as substandard are inadequately protected by the current net worth and repayment capacity of the borrower and there is a likelihood that collateral will have to be liquidated and/or guarantor called upon to repay the debt.

Doubtful: Loans classified as doubtful have characteristics of those classified as substandard but available information suggests it is unlikely that the loan will be repaid in its entirety. Cash flow is insufficient to service the debt. If the current material adverse trends continue, it is unlikely the borrower will have the ability to meet the terms of the loan agreement. It may be difficult to project the exact amount of loss, but the probability of some loss is greater than 50%.

Loss: Loans classified as loss have characteristics those classified as of doubtful but the loan will not be repaid in full. Debt service coverage clearly reflects the borrower's inability to service the debt. The borrower cannot generate sufficient cash flow to cover fixed charges. All near-term and long-term trends concerning cash flow and earnings are negative. Collateral and guarantees provide no support.

The following table shows the loan portfolio allocated by management's internal risk ratings at December 31, 2012 and 2011:

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Total
2012							
Grade:							
Pass	$ 72,100,273	$ 15,789,367	$ 6,821,738	$ 17,451,032	$ 25,671,277	$ 305,331	$ 138,139,018
Watch	4,255,927	2,305,042	120,518	1,750,451	863,189		9,295,127
Special Mention	375,880	658,258					1,034,138
Substandard	3,279,602	1,637,468	729,900	511,549	229,808	980,745	7,369,072
Doubtful							
Total	$ 80,011,682	$ 20,390,135	$ 7,672,156	$ 19,713,032	$ 26,764,274	$ 1,286,076	$ 155,837,355

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Total
2011							
Grade:							
Pass	$ 60,739,453	$ 12,482,312	$ 6,758,569	$ 19,331,125	$ 26,908,236	$ 347,636	$ 126,567,331
Watch	4,207,857	1,607,848	130,941	1,885,118	806,727		8,638,491
Special Mention	632,578	2,319,133	982,870				3,934,581
Substandard	809,787	2,461,435	1,316,951	144,136	230,725		4,963,034
Doubtful	358,659	92,103					450,762
Total	$ 66,748,334	$ 18,962,831	$ 9,189,331	$ 21,360,379	$ 27,945,688	$ 347,636	$ 144,554,199

The following table summarizes the Company's past due loans and non-accrual loans by loan portfolio segment as of December 31, 2012 and 2011:

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
2012							
Commercial real estate					$ 68,306	$ 79,943,376	$ 80,011,682
Commercial					471,708	19,918,427	20,390,135
Construction and land					729,900	6,942,256	7,672,156
Residential	$ 789,126	$ 130,112		$ 919,238	511,549	18,282,245	19,713,032
Individual	198,891			198,891	131,282	26,434,101	26,764,274
Agriculture					980,745	305,331	1,286,076
Total	$ 988,017	$ 130,112	$ -	$ 1,118,129	$ 2,893,490	$ 151,825,736	$ 155,837,355

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
2011							
Commercial real estate					$ 329,937	$ 66,418,397	$ 66,748,334
Commercial	$ 31,257	$ 12,179		$ 43,436	177,856	18,741,539	18,962,831
Construction and land	1,062,280			1,062,280	59,355	8,067,696	9,189,331
Residential	421,964			421,964	138,335	20,800,080	21,360,379
Individual	159,113	36,081		195,194	142,393	27,608,101	27,945,688
Agriculture						347,636	347,636
Total	$ 1,674,614	$ 48,260	$ -	$ 1,722,874	$ 847,876	$ 141,983,449	$ 144,554,199

There were no accruing loans past due 90 days or more at December 31, 2012 and 2011.

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

The following table shows information related to impaired loans by loan portfolio segment as of December 31, 2012 and 2011:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
2012					
With no related allowance recorded:					
Commercial real estate	$ 527,506	$ 525,216		$ 791,872	$ 43,306
Commercial	22,013	21,597		536,268	16,828
Construction and land	1,002,703	980,745		1,000,811	-
Residential	385,663	383,806		361,311	5,239
Individual				87,756	1,966
With an allowance recorded:					
Commercial real estate	333,897	331,236	$ 32,845	55,992	4,800
Commercial	108,044	109,017	23,387	148,256	6,919
Construction and land	736,024	729,900	25,603	980,825	4,208
Residential	128,162	127,743	1,518	136,359	7,493
Individual	111,521	210,046	210,046	132,603	4,479
Total:					
Commercial real estate	861,403	856,452	32,845	847,864	48,106
Commercial	130,057	130,614	23,387	684,524	23,747
Construction and land	1,738,727	1,710,645	25,603	1,981,636	4,208
Residential	513,825	511,549	1,518	497,670	12,732
Individual	111,521	210,046	210,046	220,359	6,445
Total	$ 3,355,533	$ 3,419,306	$ 293,399	$ 4,232,053	$ 95,238
2011					
With no related allowance recorded:					
Commercial real estate	$ 543,369	$ 539,265		$ 548,309	$ 42,177
Commercial	278,495	273,481		244,304	10,160
Construction and land	998,918	982,899		125,327	2,002
Residential				14,229	
With an allowance recorded:					
Commercial real estate	362,926	358,659	$ 206,559	365,409	12,862
Commercial	345,452	343,805	120,361	153,166	8,193
Construction and land	1,225,625	1,221,417	63,117	50,980	2,028
Residential	144,555	144,136	4,636	145,524	
Individual	185,545	184,278	184,278	190,258	3,445
Total:					
Commercial real estate	906,295	897,924	206,559	913,718	55,039
Commercial	623,947	617,286	120,361	397,470	18,353
Construction and land	2,224,543	2,204,316	63,117	176,307	4,030
Residential	144,555	144,136	4,636	159,753	-
Individual	185,545	184,278	184,278	190,258	3,445
Total	$ 4,084,885	$ 4,047,940	$ 578,951	$ 1,837,506	$ 80,867

NOTE E – PREMISES AND EQUIPMENT

Premises and equipment consisted of the following at December 31:

	2012	2011
Land	$ 902,528	$ 800,000
Building and improvements	4,178,233	3,971,720
Furniture, fixtures and equipment	1,387,281	1,341,761
	6,468,042	6,113,481
Less: Accumulated depreciation	(2,251,884)	(2,015,934)
	$ 4,216,158	$ 4,097,547

Depreciation and amortization included in occupancy expense totaled $308,913 and $282,358 in 2012 and 2011, respectively.

NOTE F – MORTGAGE SERVICING RIGHTS

The following table presents the changes in the Bank's mortgage servicing rights for the year ended December 31, 2012:

	2012	2011
Fair value, beginning of year	$ 237,832	
Additions for new mortgage servicing rights capitalized	156,517	$ 237,832
Change in fair value due to changes in model inputs and assumptions	(92,879)	
Fair value, end of year	$ 301,470	$ 237,832
Balance of loans serviced for others	$ 50,814,335	$ 23,962,462
Mortgage servicing rights as a percentage of serviced loans	0.59%	0.99%

The amounts of contractually specified servicing fees, late fees and ancillary fees earned, recorded in mortgage banking revenue on the consolidated statements of operations, were $97,240 and $37,776 for the years ended December 31, 2012 and 2011, respectively. Changes in fair value are also included in mortgage banking revenue on the consolidated statements of operations.

The fair value of mortgage servicing rights are determined using a discounted cash flow model. In order to determine the fair value of the mortgage servicing rights, the present value of expected future cash flows is estimated. Assumptions used include market discount rates, anticipated prepayment speeds, delinquency and foreclosure rates, and ancillary fee income. Key assumptions used in measuring the fair value of mortgage servicing rights as of December 31, 2012 and 2011 include a discount rate of 11%. A proprietary market implied prepayment model is used by the independent valuation group.

The expected life of the loans can vary from management's estimates due to prepayments by borrowers, especially when rates fall. Prepayments in excess of management's estimates would negatively impact the recorded value of the mortgage servicing rights. The value of the mortgage servicing rights is also dependent upon the discount rate used in the model, which is based on current market rates. A significant increase in the discount rate would reduce the value of mortgage servicing rights.

NOTE G – INTEREST-BEARING DEPOSITS

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

	2012	2011
Negotiable order of withdrawal (NOW)	$ 41,000,067	$ 40,114,534
Savings and money markets	79,947,926	72,085,472
Time, $100,000 and over	26,016,121	34,217,468
Other time	27,144,050	33,785,808
	$ 174,108,164	$ 180,203,282

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

	2012	2011
Negotiable order of withdrawal (NOW)	$ 164,303	$ 320,042
Savings and money markets	408,835	650,991
Time, $100,000 and over	334,919	387,315
Other time	185,842	275,737
	$ 1,093,899	$ 1,634,085

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

	2012	2011
Three months or less	$ 15,181,516	$ 21,651,721
Over three months through twelve months	29,310,767	33,364,368
Over one year through three years	8,319,047	12,690,660
Over three years	348,841	296,527
	$ 53,160,171	$ 68,003,276

NOTE H – LENDING AGREEMENTS

The Company has federal funds line of credit agreements with other banks. The maximum borrowings available under these lines amount to $16,000,000 at December 31, 2012 and 2011. There were no borrowings outstanding under these agreements at December 31, 2012 and 2011.

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, 2012 totaled $241,542,951, resulting in a limit on borrowings of $36,231,443. Assets pledged under the agreement at December 31, 2011 totaled $241,508,990, resulting in a limit on borrowings of $36,226,349. The Company also maintains a letter of credit with the Federal Home Loan Bank of $10,500,000, as of December 31, 2012 and 2011, which serves as collateral for public and other deposits and is collateralized by a portion of the loans discussed above. No amounts were outstanding under this agreement as of December 31, 2012 and 2011.

The Company has an agreement to borrow from the Federal Reserve Bank by obtaining advances or discounting eligible paper to the extent of pledged collateral. Promissory notes and deeds of trust on the Bank's loans totaling $6,189,821 and $6,468,766 for 2012 and 2011, respectively, were held by the Federal Reserve Bank as collateral. There were no borrowings outstanding under this agreement at December 31, 2012 and 2011.

NOTE H – LENDING AGREEMENTS (Continued)

The Company has an agreement to borrow from another financial institution for $3,100,000. Interest on the outstanding balance is calculated at a variable rate equal to the prime rate. The interest rate at December 31, 2012 and 2011 was 3.25%. Consecutive interest payments are required for 24 months beginning February 5, 2009 through February 5, 2011, after which principal and interest payments of $31,845 are due monthly through January 5, 2021. The outstanding principal balance at December 31, 2012 was $2,576,546 and at December 31, 2011 was $2,864,092.

NOTE I – OTHER EXPENSES

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

	2012	2011
Data processing	$ 453,718	$ 405,968
Professional fees	384,579	318,456
Marketing and promotion	280,069	275,490
Director and shareholder	270,511	241,943
Loan and collection expense	204,419	98,427
Operating expense	188,221	187,973
Insurance expense	175,971	367,667
Postage and delivery	67,535	61,608
Stationary and forms	61,331	76,527
Miscellaneous employee expense	54,301	50,484
Operational losses	47,030	18,046
Telephone expense	45,171	44,171
Dues and memberships	29,939	35,895
Subscriptions	11,065	11,017
Security expense	5,861	4,474
Other non-interest expense	3,939	1,510
	$ 2,283,660	$ 2,199,656

NOTE J – PREFERRED STOCK

On July 21, 2011, the Company completed the issuance of $7,310,000 of Series C preferred stock under the U.S. Department of Treasury's Small Business Lending Fund and issued 7,310 shares of Series C preferred stock. A portion of the proceeds were used to redeem the Series A and B preferred stock issued under the U.S. Department of Treasury's Capital Purchase Program. The Series C preferred stock has a cumulative dividend for the first two and a half years of 1 to 5% per annum, which is dependent on the amount of loans to small businesses. After two and a half years, the dividend rate can increase to 7% if lending to small businesses has not increased. The rate increases to 9% for all banks after 4.5 years. The liquidation amount is $1,000 per share. The Preferred Stock has no maturity date and ranks senior to the Company's common stock with respect to the payment of dividends and distributions and amounts payable upon liquidation, dissolution and winding up of the Company. The Preferred Stock is generally non-voting, other than class voting on certain matters that could adversely affect the Preferred Stock. Preferred stock dividends totaled $198,525 and $187,734 in 2012 and 2011, respectively.

NOTE K – 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 $90,500 and $89,000 during 2012 and 2011, respectively.

The Company has single premium life insurance policies in connection with the 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, 2012 and 2011, the cash surrender value of these policies totaled $2,694,251 and $2,597,987, respectively.

The Company has a retirement plan that is unfunded, which provides for the Company to pay the officers specified amounts for specified periods after retirement and allow them to defer a portion of current compensation in exchange for the Company's commitment to pay a deferred benefit at retirement. Directors are also eligible to participate in the deferred compensation plan. 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. Deferred compensation is vested as to the amounts deferred. Liabilities are recorded for the estimated present value of future salary continuation benefits. At December 31, 2012 and 2011, the liability recorded for the executive officer supplemental retirement plan totaled $191,451 and $157,259, respectively. The amount of expense related to this plan for 2012 and 2011 was $34,192 and $44,838, respectively. At December 31, 2012 and 2011, the liability recorded for the deferred compensation plan totaled $134,320 and $84,808, respectively.

NOTE L – INCOME TAXES

The provision for income taxes for 2012 and 2011 is comprised of the following:

	2012	2011
Current		
Federal	$ 508,473	$ 798,208
State	57,492	95,253
	565,965	893,461
Deferred		
Federal	84,756	(93,177)
State	134,411	(28,071)
	219,167	(121,248)
Change in valuation allowance		(197,282)
Provision (benefit) for income taxes	$ 785,132	$ 574,931

NOTE L – INCOME TAXES (Continued)

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:

	2012	2011
Income benefit at the Federal statutory rate	$ 679,284	$ 776,481
State franchise tax benefit, less Federal income tax effect	142,937	163,390
Valuation allowance change		(197,282)
Interest on enterprise zone loans exempt from State tax	(58,668)	(82,923)
Earnings on cash surrender value of life insurance	(39,617)	(40,853)
Tax exempt municipal securities	(31,131)	(12,314)
Nondeductible expenses and other	92,327	(31,568)
Net provision for income taxes	$ 785,132	$ 574,931

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:

	2012	2011
Deferred tax assets:		
Allowance for loan losses	$ 753,095	$ 881,639
Net operating loss and contribution carryforwards	114,304	181,473
Salary continuation accrual	78,791	64,719
Nonstatutory stock option expense	72,849	128,662
Accrued vacation	64,977	64,977
Non-qualified restricted stock	66,588	61,556
Non-accrual interest	64,518	
Depreciation	35,671	
Allowance for loan commitments	24,693	24,693
Foreclosed real estate		26,141
Organizational costs	7,784	8,618
State taxes	544	44,284
Other	281	
Total deferred tax assets	1,284,095	1,486,762
Deferred tax liabilities:		
Available for sale securities	(318,854)	(272,820)
Mortgage servicing rights	(124,068)	(97,878)
Federal Home Loan Bank dividends	(24,940)	(24,940)
Depreciation		(7,756)
Discount accretion		(579)
Other		(1,355)
Total deferred tax liabilities	(467,862)	(405,328)
Net deferred tax assets	$ 816,233	$ 1,081,434

NOTE L – 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. As of December 31, 2012 and 2011, the Company had income tax receivable of $184,501 and $239,906, respectively.

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 2009 and 2008, respectively.

FASB ASC 740-10 clarifies the accounting for income taxes, by prescribing a minimum recognition threshold a tax position taken or expected to be taken in a tax return is required to meet before being recognized in the financial statements. The Company adopted provisions of FASB ASC 740-10, on January 1, 2007. There have been no adjustments identified for unrecognized tax benefits requiring an adjustment to the income statement since this pronouncement was implemented. The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. The Company has recognized no interest or penalties since this pronouncement was implemented.

The California Franchise Tax Board (FTB) is currently auditing the Company's 2010 and 2009 franchise tax returns and has asserted that enterprise zone loan net interest deductions totaling approximately $791,000 were improperly taken during these tax years. The Company and several other financial institutions have disputed the position taken by the FTB. The Company, if it does not prevail, could be required to pay the assessed franchise taxes of approximately $72,000 plus penalties and interest on the amount assessed. The Company accrued $82,000 as a potential settlement at December 31, 2012. However, the ultimate resolution of this matter could differ from management's estimate and could result in additional franchise tax being expensed or credited, which would affect the Company's effective tax rate. The Company expects the exam to be completed during the next twelve months.

The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2012 and 2011, the Company recognized no interest and penalties.

As of December 31, 2012, the Company had state net operating loss carryforwards available to reduce future taxable income as follows:

	Net Operating Loss Carryforward	Expiration Date
State	$ 817,961	2018
	520,003	2019
	120,860	2020
	138,844	2031
	$ 1,597,668	

As of December 31, 2012 and 2011, the Company also had state contribution carryforwards of $38,152, which expire in 2012 through 2016.

NOTE M– EARNINGS PER SHARE

The following is a computation of basic and diluted earnings per share for the years ended December 31, 2012 and 2011.

	2012	2011
Basic:		
Net income	$ 1,213,367	$ 1,708,837
Weighted-average common shares outstanding	1,780,677	1,758,775
Earnings per share	$ 0.68	$ 0.97
Diluted:		
Net income	$ 1,213,367	$ 1,708,837
Weighted-average common shares outstanding	1,780,677	1,758,775
Net effect of dilutive stock options - based on the Treasury stock method using average market price	19,782	67,836
Weighted-average common shares outstanding and common stock equivalents	1,800,459	1,826,611
Earnings per share - assuming dilution	$ 0.67	$ 0.94

Options to purchase 24,000 shares of common stock at $13.33 to $14.67 per share and 46,726 shares of restricted stock were outstanding during 2012 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. Options to purchase 24,000 shares of common stock at $13.33 to $14.67 per share and 64,254 shares of restricted stock were outstanding during 2011 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 N – 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 nonvested options expire.

NOTE N – STOCK OPTION PLAN (Continued)

A summary of stock option activity follows for the years ended December 31:

	Stock Options			
	2012		2011	
	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares
Shares under option at beginning of year	$ 7.37	249,080	$ 7.37	249,080
Options exercised		(14,812)		-
Shares under option at end of year	7.42	234,268	7.37	249,080
Options exercisable at end of year		234,268		249,080

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

	Stock Options	
	2012	2011
Intrinsic value:		
Outstanding shares	$ 91,109	
Exercisable shares	91,109	
Weighted-average remaining contractual term:		
Outstanding shares	1.29 years	2.29 years
Exercisable shares	1.30 years	2.29 years

Upon the exercise of stock options, new shares are issued. The total amount of cash received from the exercise of stock options during 2012 was $98,796. The tax benefits realized for the tax deductions from stock options exercised during 2012 was $21,784. No stock options were exercised in 2011.

The total fair value of shares vested during the year ended December 31, 2011, was $2,637, for 577 shares. There were no shares vested during the year ended December 31, 2012. There was no unrecognized compensation cost related to nonvested stock options as of December 31, 2012 and 2011.

NOTE N – STOCK OPTION PLAN (Continued)

A summary of restricted stock activity follows for the years ended December 31:

	Restricted Stock					
	2012			2011		
	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	64,254	$ 8.29		81,722	$ 8.45	
Granted	1,304	6.50				
Shares vested and issued	(18,732)	8.87		(16,768)	8.62	
Forfeited	(100)	12.00		(700)	12.50	
Nonvested at end of year	46,726	8.10	$ 323,279	64,254	8.29	$ 372,673

As of December 31, 2012 and 2011, there was $231,408 and $377,302 of total unrecognized compensation cost related to nonvested restricted stock. That cost is expected to be recognized over a weighted-average period of 2.46 and 3.13 years, respectively.

Total compensation cost for all share-based payments recognized in net income for 2012 and 2011 totaled $161,801 and $151,793, respectively. A tax benefit of $66,581 and $62,463 was recognized during 2012 and 2011, respectively, related to this compensation cost.

NOTE O – 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 $5,855,915 and $6,278,062 at December 31, 2012 and 2011, respectively. At December 31, 2012 and 2011, commitments to related parties of $3,135,096 and $2,414,970, respectively, were undisbursed. The Company has received deposits from directors and officers and their related interests totaling $4,991,032 and $6,084,880 at December 31, 2012 and 2011, respectively.

The Company entered into a lease agreement with a director's business as the landlord for two office spaces. The total rent paid for 2012 was $19,803 and for 2011 was $31,827. In 2012, the Bank sold the office space to the director's business for $327,317. The director's business paid the Bank $2,149 for common area maintenance in 2012 after the sale.

NOTE P – 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, 2012 and 2011 are as follows:

	Contractual Amounts	
	2012	2011
Commitments to extend credit	$ 39,817,121	$ 37,398,325
Standby letters of credit	272,599	272,599

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 2012 and 2011.

NOTE Q – 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 C. Approximately 92% 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.

NOTE Q – CONCENTRATIONS OF CREDIT RISK (Continued)

The concentrations by type of investment security are set forth in Note B. The Company places its investments primarily in financial instruments backed by the U.S. Government and its agencies. At December 31, 2012, the Bank has $12,390,000 in federal funds sold to four correspondent banks, which represents 51% of the Bank's net worth. Deposits with two correspondent banks were in excess of federally insured limits by $4,692,056 at December 31, 2012. While management recognizes the inherent risks involved in such concentrations, this concentration provides the Bank with an effective and cost efficient means of managing its liquidity position and item processing needs. Management closely monitors the financial condition of their correspondent banks on a continuous basis. The Bank also maintains additional deposit accounts with other correspondent banks should management determine that a change in its correspondent banking relationship would be appropriate.

NOTE R – 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, 2012, $4,958,839 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, 2012, that the Company meets all capital adequacy requirements to which it is subject.

NOTE R – REGULATORY MATTERS (Continued)

As of December 31, 2012, 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, 2012						
Total Capital (to Risk Weighted Assets)	$ 25,612	15.95%	≥ $ 14,847	≥ 8.00%	≥ $ 16,058	≥ 10.00%
Tier I Capital (to Risk Weighted Assets)	$ 23,607	14.70%	≥ $ 6,423	≥ 4.00%	≥ $ 9,635	≥ 6.00%
Tier I Capital (to Average Assets)	$ 23,607	9.66%	≥ $ 9,776	≥ 4.00%	≥ $ 12,220	≥ 5.00%
As of December 31, 2011						
Total Capital (to Risk Weighted Assets)	$ 24,919	16.37%	≥ $ 12,177	≥ 8.00%	≥ $ 15,221	≥ 10.00%
Tier I Capital (to Risk Weighted Assets)	$ 23,000	15.11%	≥ $ 6,089	≥ 4.00%	≥ $ 9,133	≥ 6.00%
Tier I Capital (to Average Assets)	$ 23,000	9.52%	≥ $ 9,666	≥ 4.00%	≥ $ 12,082	≥ 5.00%

NOTE S – FAIR VALUE MEASUREMENT

The following tables present information about financial instruments, whether or not recognized or recorded at fair value in the balance sheet. 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.

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.

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

NOTE S – FAIR VALUE MEASUREMENT (Continued)

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.

The carrying amount and estimated fair values of the Company's financial instruments are as follows:

	Carrying Amount	Level 1	Level 2	Level 3	Total
December 31, 2012					
Financial assets:					
Cash and due from banks	$ 9,777,807	$ 9,777,807			$ 9,777,807
Federal funds sold	12,390,000	12,390,000			12,390,000
Interest-bearing deposits in other banks	21,433,169	21,433,169			21,433,169
Investment securities available-for-sale	30,845,712		$ 30,845,712		30,845,712
Mortgages held for sale	3,026,410		3,100,740		3,100,740
Loans, net	153,126,498			$ 157,594,217	157,594,217
Cash surrender value of life insurance	2,694,251	2,694,251			2,694,251
Federal Home Loan Bank and Pacific Coast Bankers Bank Stock	1,206,300		1,206,300		1,206,300
Accrued interest receivable	658,475	658,475			658,475
Mortgage servicing rights	301,470			301,470	301,470
Financial liabilities:					
Deposits					
Non-interest bearing	40,889,168	40,889,168			40,889,168
Interest bearing	174,108,164	120,947,993	52,876,569		173,824,562
Borrowings	2,576,546		2,576,546		2,576,546
Accrued interest payable	44,224	44,224			44,224

NOTE S – FAIR VALUE MEASUREMENT (Continued)

	Carrying Amount	Level 1	Level 2	Level 3	Total
December 31, 2011					
Financial assets:					
Cash and due from banks	$ 7,969,140	$ 7,969,140			$ 7,969,140
Federal funds sold	37,755,000	37,755,000			37,755,000
Interest-bearing deposits in other banks	18,979,172	18,979,172			18,979,172
Investment securities available-for-sale	21,176,774		$ 21,176,774		21,176,774
Mortgages held for sale	2,897,277		2,939,842		2,939,842
Loans, net	141,491,678			$ 147,474,985	147,474,985
Cash surrender value of life insurance	2,597,987	2,597,987			2,597,987
Federal Home Loan Bank and Pacific Coast Bankers Bank Stock	1,200,700		1,200,700		1,200,700
Accrued interest receivable	689,205	689,205			689,205
Mortgage servicing rights	237,832			237,832	237,832
Financial liabilities:					
Deposits					
Non-interest bearing	36,576,193	36,576,193			36,576,193
Interest bearing	180,203,282	112,200,006	67,989,878		180,189,884
Borrowings	2,842,593		2,842,593		2,842,593
Accrued interest payable	58,834	58,834			58,834

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 financial institutions: The carrying amount approximates fair value and is classified as level 1.

Investment securities: Fair values for investment securities are based on quoted market prices, where available, and are classified as level 1. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments and indications of value provided by brokers and are classified as level 2. The carrying amount of accrued interest receivable approximates its fair value and is classified as level 1.

Mortgages held for sale: The fair value for mortgages held for sale are based on the actual selling price, if available or quoted market prices of comparable loans, which are classified as level 2.

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, resulting in a level 3 classification. 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, resulting in a level 3 classification. 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 and is classified as level 1.

Cash surrender value of life insurance: The carrying amount approximates fair value and is classified as level 1.

FHLB and PCBB Stock: For FHLB and PCBB stock, the carrying amount is equal to the par value at which the stock may be sold back to FHLB or PCBB, which approximates fair value and is classified as level 1.

NOTE S – FAIR VALUE MEASUREMENT (Continued)

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), resulting in a level 1 classification. 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, resulting in a level 2 classification. The carrying amount of accrued interest payable approximates fair value and is classified as level 1.

Borrowings: The carrying amount approximates fair value and is classified as level 1.

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring and nonrecurring basis as of December 31, 2012 and 2011, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value.

	Fair Value	Level 1	Level 2	Level 3	Total Losses
December 31, 2012:					
Measured at fair value on a recurring basis					
Investment securities	$ 30,845,712		$ 30,845,712		
Mortgage servicing rights	301,470			$ 301,470	
Total recurring	$ 31,147,182	$ -	$ 30,845,712	$ 301,470	$ -
Measured at fair value on a nonrecurring basis					
Impaired loans	$ 3,125,907			$ 3,125,907	$ (293,399)
Foreclosed real estate	366,335			366,335	(200,750)
Total nonrecurring	$ 3,492,242	$ -	$ -	$ 3,492,242	$ (494,149)
December 31, 2011:					
Measured at fair value on a recurring basis					
Investment securities	$ 21,176,774		$ 21,176,774		
Mortgage servicing rights	237,832			$ 237,832	
Total recurring	$ 21,414,606	$ -	$ 21,176,774	$ 237,832	$ -
Measured at fair value on a nonrecurring basis					
Impaired loans	$ 3,468,989			$ 3,468,989	$ (578,952)
Foreclosed real estate	522,586			522,586	(26,532)
Total nonrecurring	$ 3,991,575	$ -	$ -	$ 3,991,575	$ (605,484)

NOTE S – FAIR VALUE MEASUREMENT (Continued)

The following methods were used to estimate the fair value of each class of financial instrument above:

Securities Available-for-Sale: To value securities available-for-sale, 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.

Mortgage Servicing Rights: Mortgage servicing rights do not trade in an active market with readily observable prices. Accordingly, the Company determines the fair value of mortgage servicing rights using a valuation model that calculates the present value of estimated future net servicing income. Fair value measurements of the mortgage servicing rights use significant unobservable inputs and, accordingly, are classified as Level 3. Total gains recognized in earnings during 2012 and 2011 were $63,638 and $237,832, respectively, which are reflected in mortgage banking revenue, on the consolidated statements of operations.

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. 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. Management typically reduces the appraisal value by 10% to determine the fair value of the collateral.

Foreclosed Real Estate: Foreclosed real estate is held for sale and is initially recorded at fair value less estimated costs of disposition at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or estimated fair value less costs of disposition. The fair value of foreclosed real estate is determined using various valuation techniques which are not readily observable in the market place, including consideration of appraised values and other pertinent real estate market data. Management typically reduces the appraisal value by 10% to determine the fair value of the property.

No amounts were transferred among level 1, level 2 or level 3 during 2012 or 2011.

NOTE T – CONDENSED FINANCIAL INFORMATION OF THE PARENT COMPANY

Condensed balance sheets as of December 31, 2012 and 2011 and the related condensed statement of operations and cash flows for the years then ended for Redwood Capital Bancorp (parent company only) are presented as follows:

Condensed Balance Sheets
December 31, 2012 and 2011

	2012	2011
Assets		
Cash	$ 127,322	$ 112,001
Other assets	147,218	198,833
Intercompany receivable	45,356	244,599
Investment in subsidiary	24,364,620	23,389,853
	$ 24,684,516	$ 23,945,286
Liabilities and shareholders' equity		
Accrued interest payable and other liabilities	$ 61,755	$ 59,254
Borrowings	2,576,546	2,842,593
Preferred stock	7,283,990	7,283,990
Common stock	12,195,212	11,926,862
Additional paid-in capital	509,998	588,470
Retained earnings (deficit)	2,057,015	1,244,117
	$ 24,684,516	$ 23,945,286

Condensed Statements of Operations
For the years ended December 31, 2012 and 2011

	2012	2011
Interest expense	$ (116,579)	$ (126,948)
Other expenses	(440,743)	(382,245)
Loss before equity in undistributed income of subsidiary and income taxes	(557,322)	(509,193)
Equity in undistributed net income of subsidiary	1,558,933	1,774,323
Income tax benefit	211,756	443,707
	$ 1,213,367	$ 1,708,837

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

Condensed Statements of Cash Flows
For the years ended December 31, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Net income	$ 1,213,367	$ 1,708,837
Adjustments to reconcile net income to net cash used by operating activities:		
Equity in undistributed income of subsidiary	(1,558,933)	(1,774,323)
Dividends from subsidiary	650,000	
Stock-based compensation expense	161,801	151,793
Change in other assets	(644)	(198,558)
Change in intercompany receivable	199,243	510,699
Change in interest payable and other liabilities	5,241	(20,386)
Net cash provided by operating activities	670,075	378,062
Cash flows from investing activities:		
Capital infusion		(4,000,000)
Net cash provided (used) by investing activities		(4,000,000)
Cash flows from financing activities:		
Repurchase of restricted stock	(18,460)	(9,324)
Proceeds from exercise of stock options	98,796	
Proceeds from issuance of preferred stock		7,283,990
Repurchase of preferred stock		(3,990,003)
Repayments of borrowings	(266,047)	(255,267)
Dividends paid on common stock	(267,779)	
Dividends paid on preferred stock	(201,264)	(173,192)
Net cash (used) provided by financing activities	(654,754)	2,856,204
Net decrease in cash	15,321	(765,734)
Cash at beginning of year	112,001	877,735
CASH AT END OF YEAR	$ 127,322	$ 112,001

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