

**BUSINESS BANK  
BURLINGTON, WASHINGTON  
AUDITED FINANCIAL STATEMENTS**

**DECEMBER 31, 2008 AND 2007**

**BUSINESS BANK**

**C O N T E N T S**

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## INDEPENDENT AUDITOR'S REPORT

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To the Board of Directors  
of Business Bank  
Burlington, Washington

We have audited the accompanying balance sheets of Business Bank as of December 31, 2008 and 2007, and the related statements of operations, changes in shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Business Bank as of December 31, 2008 and 2007, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

*Stovall, Grandey & Allen, LLP*

STOVALL, GRANDEY & ALLEN, L.L.P.  
Fort Worth, Texas  
March 31, 2009

**BUSINESS BANK  
BALANCE SHEETS  
DECEMBER 31, 2008 AND 2007**

	<u>2008</u>	<u>2007</u>
<b>ASSETS</b>		
Cash and due from banks	\$ 2,597,832	\$ 1,667,098
Interest-bearing deposits with financial institutions	89,072	38,642
Federal funds sold	-	390,000
	<hr/>	<hr/>
Cash and cash equivalents	2,686,904	2,095,740
Investment securities - Note 3	5,463,806	4,862,089
Federal Home Loan Bank stock, at cost - Note 2	1,010,000	80,000
Pacific Coast Bankers' Bank stock, at cost - Note 2	190,000	190,000
Loans held-for-sale	65,500	935,750
Loans receivable, net of allowance for loan losses and deferred loan fees - Note 4	111,173,825	98,194,210
Other real estate owned	434,544	-
Premises and equipment, net - Note 5	3,220,106	2,732,283
Accrued interest receivable	414,562	448,128
Federal income tax refund receivable - Note 7	597,867	-
Deferred tax asset - Note 7	455,379	373,338
Other assets	99,452	120,339
	<hr/>	<hr/>
<b>Total Assets</b>	<b>\$125,811,945</b>	<b>\$110,031,877</b>
	<hr/> <hr/>	<hr/> <hr/>
<b>LIABILITIES</b>		
Deposits - Note 6	\$ 88,635,383	\$ 85,697,598
Federal Home Loan Bank borrowings - Note 9	23,000,000	9,000,000
Short-term borrowings - Note 10	440,000	-
Accrued interest payable	224,044	253,998
Federal income tax payable	-	105,732
Other liabilities	151,065	118,288
	<hr/>	<hr/>
<b>Total Liabilities</b>	<b>112,450,492</b>	<b>95,175,616</b>
	<hr/> <hr/>	<hr/> <hr/>
Commitments and contingencies - Notes 10, 11 and 12		
<b>SHAREHOLDERS' EQUITY - Notes 13, 14 and 15</b>		
Common stock, no par value; 5,000,000 shares authorized; 1,395,163 shares outstanding at December 31, 2008 and 1,383,508 shares outstanding at December 31, 2007	14,987,056	14,803,886
Additional paid-in capital	44,262	19,040
Accumulated deficit	(1,780,028)	(5,958)
Accumulated other comprehensive income, net of tax	110,163	39,293
	<hr/>	<hr/>
<b>Total Shareholders' Equity</b>	<b>13,361,453</b>	<b>14,856,261</b>
	<hr/> <hr/>	<hr/> <hr/>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$125,811,945</b>	<b>\$110,031,877</b>

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

**BUSINESS BANK**  
**STATEMENTS OF OPERATIONS**  
**FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007**

	<u>2008</u>	<u>2007</u>
<b>Interest income</b>		
Interest and fees on loans	\$ 7,849,245	\$ 7,413,849
Interest on investment securities	328,460	139,546
Interest on federal funds sold	51,068	105,590
Total interest income	<u>8,228,773</u>	<u>7,658,985</u>
<b>Interest expense</b>		
On deposits	3,281,707	2,966,338
On borrowed funds	546,017	335,564
Total interest expense	<u>3,827,724</u>	<u>3,301,902</u>
Net interest income	4,401,049	4,357,083
Provision for loan losses - Note 4	<u>2,839,435</u>	<u>546,600</u>
Net interest income after provision for loan losses	<u>1,561,614</u>	<u>3,810,483</u>
<b>Non-interest income</b>		
Service charges on deposit accounts	83,527	80,801
Loss on sale of preferred stock	(470,994)	-
Gain on sale of loans	281,296	295,235
Total non-interest income	<u>(106,171)</u>	<u>376,036</u>
<b>Non-interest expense</b>		
Salaries and employee benefits	2,250,935	2,381,431
Occupancy and equipment	572,683	378,169
Data processing fees	145,851	114,388
Professional fees	83,644	102,993
Advertising and marketing expenses	73,311	59,267
Other expense	607,852	494,942
Total non-interest expense	<u>3,734,276</u>	<u>3,531,190</u>
Income (loss) before income taxes	(2,278,833)	655,329
Federal income tax (benefit)	<u>(504,763)</u>	<u>223,644</u>
<b>Net Income (Loss)</b>	<u>\$ (1,774,070)</u>	<u>\$ 431,685</u>

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

**BUSINESS BANK**  
**STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
**FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007**

	<u>Shares of Common Stock</u>	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Accumulated Deficit</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Total</u>
<b>Balance at January 1, 2007</b>	1,112,484	\$ 11,058,173	\$ 3,613	\$ (437,643)	\$ -	\$ 10,624,143
Vesting of restricted common stock		20,000				20,000
Stock-based compensation, stock options			15,427			15,427
Sales of common stock	268,024	3,695,713				3,695,713
Exercise of stock options	3,000	30,000				30,000
Net income for the year ended December 31, 2007				431,685		431,685
Unrealized gain on available-for- sale securities					39,293	39,293
Comprehensive income						470,978
<b>Balance at December 31, 2007</b>	1,383,508	14,803,886	19,040	(5,958)	39,293	14,856,261
Vesting of restricted common stock		20,000				20,000
Stock-based compensation, stock options			25,222			25,222
Sales of common stock	11,655	163,170				163,170
Net loss for the year ended December 31, 2008				(1,774,070)		(1,774,070)
Unrealized gain on available-for- sale securities					70,870	70,870
Comprehensive loss						(1,703,200)
<b>Balance at December 31, 2008</b>	<u>1,395,163</u>	<u>\$ 14,987,056</u>	<u>\$ 44,262</u>	<u>\$ (1,780,028)</u>	<u>\$ 110,163</u>	<u>\$ 13,361,453</u>

The accompanying notes are an integral part of these financial statements

**BUSINESS BANK**  
**STATEMENTS OF CASH FLOWS**  
**FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007**

	<u>2008</u>	<u>2007</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ (1,774,070)	\$ 431,685
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	254,215	195,756
Provision for loan losses	2,839,435	546,600
Writedown on other real estate owned	35,000	-
Loss on sale of FNMA and FHLMC stock	470,994	-
Deferred federal income tax benefit	(118,549)	(98,742)
Net discount accretion on investment securities	(12,606)	(8,261)
Stock-based compensation - restricted stock	20,000	20,000
Stock-based compensation - stock options	25,222	15,427
(Increase) decrease in loans held-for-sale	870,250	(560,750)
Increase in federal income tax refund receivable	(597,867)	-
(Increase) decrease in other assets	54,453	(237,569)
Increase (decrease) in other liabilities	(138,659)	158,479
Total adjustments	<u>3,701,888</u>	<u>30,940</u>
<b>Net Cash Provided by Operating Activities</b>	<u>1,927,818</u>	<u>462,625</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of available-for-sale securities	(3,004,168)	(3,644,905)
Purchases of held-to-maturity securities	(250,000)	(500,000)
Proceeds from maturities of held-to-maturity securities	1,250,000	250,000
Proceeds from sale of FNMA and FHLMC stock	540,168	-
Principal payments on available-for-sale securities	511,274	79,454
Purchase of FHLB stock	(930,000)	(5,000)
Net increase in loans receivable	(16,252,845)	(43,315,505)
Purchases of furniture and equipment	(742,038)	(107,493)
<b>Net Cash Used by Investing Activities</b>	<u>(18,877,609)</u>	<u>(47,243,449)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in deposits	2,937,785	40,283,785
Proceeds from FHLB borrowings	27,000,000	21,000,000
Payments on FHLB borrowings	(13,000,000)	(17,500,000)
Net increase in short-term borrowings	440,000	-
Proceeds from exercise of stock options	-	30,000
Net proceeds from common stock issued	163,170	3,695,713
<b>Net Cash Provided by Financing Activities</b>	<u>17,540,955</u>	<u>47,509,498</u>
<b>Net increase in cash and cash equivalents</b>	591,164	728,674
<b>Cash and cash equivalents at beginning of year</b>	<u>2,095,740</u>	<u>1,367,066</u>
<b>Cash and cash equivalents at end of year</b>	<u>\$ 2,686,904</u>	<u>\$ 2,095,740</u>
<b>SUPPLEMENTAL SCHEDULE:</b>		
Cash paid for interest	\$ 3,857,678	\$ 3,160,278
Income taxes paid	317,385	284,389
Other real estate acquired through foreclosure	469,545	-

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

**BUSINESS BANK  
NOTES TO FINANCIAL STATEMENTS  
DECEMBER 31, 2008 AND 2007**

**Note 1 Description of Business**

Business Bank (the "Bank") is a commercial bank chartered in the State of Washington. The Bank began operations April 11, 2005 and has four locations: Burlington, Bellingham, Lynden and Mt. Vernon, Washington. The Bank provides loan and deposit services to customers who are predominantly small and middle-market businesses and individuals in and around Skagit and Whatcom counties. The Bank operates under a state bank charter and is subject to regulation by the State of Washington Department of Financial Institutions and the Federal Deposit Insurance Corporation (FDIC).

**Note 2 Summary of Significant Accounting Policies**

Financial Statement Presentation

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and practices within the banking industry.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 Bank's loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Bank 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. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Bank to recognize additional losses based on their judgments about information available to them at the time of their examination. 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.

Cash and Cash Equivalents

Cash and due from banks consists of vault cash, cash items in the process of collection, and noninterest-bearing deposits with financial institutions. For purposes of the statement of cash flows, the Bank considers cash and cash equivalents to include cash, due from banks, investments with an original maturity of three months or less, and federal funds sold.

**BUSINESS BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008 AND 2007**

**Note 2      Summary of Significant Accounting Policies, continued**

Restrictions on Cash and Due From Banks

Business Bank is required to maintain reserve funds in cash or on deposit with Pacific Coast Bankers' Bank. The required reserve at December 31, 2008 was \$10,000.

Investment Securities

The Bank accounts for investment securities according to Statement of Financial Accounting Standards No. 115, "*Accounting for Certain Investments in Debt and Equity Securities*" (SFAS 115). Under the provisions of SFAS 115, debt securities that management has the ability and intent to hold to maturity are classified as held-to-maturity and carried at amortized cost. The amortization of premiums and accretion of discounts are recognized in interest income using methods approximating the interest method over the period to maturity.

Debt securities not classified as held-to-maturity are classified as available-for-sale. Securities available-for-sale are carried at fair value with unrealized gains and losses reported in other comprehensive income. Realized gains (losses) on securities available-for-sale are included in other income and, when applicable, are reported as a reclassification adjustment, net of tax (benefit), in other comprehensive income. Gains and losses on sales of securities are determined on the specific-identification method.

Declines in the fair value of individual held-to-maturity and available-for-sale securities below their amortized cost that are other than temporary result in write-downs of the individual securities to their fair value. The related write-downs are included in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Federal Home Loan Bank and Pacific Coast Bankers' Bank Stock

The Bank's investment in Federal Home Loan Bank (FHLB) stock is a restricted investment carried at par value (\$100 per share), which reasonably approximates its fair value. As a member of the FHLB system, the Bank is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding FHLB advances. The Bank may request redemption at par value of any stock in excess of the amount the Bank is required to hold. Stock redemptions are at the discretion of the FHLB.

The Bank owns stock in Pacific Coast Bankers' Bank (PCBB). The investment in PCBB stock is a restricted investment carried at par value (\$475 per share), which reasonably approximates its fair value. As a holder of PCBB stock, the Bank is allowed to borrow at a lower interest rate than a non-holder and to receive dividends.

Loans Held-for-Sale

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by aggregate outstanding commitments from investors or current investor yield requirements. Net unrealized losses are recognized through a valuation allowance by charges to income.

**BUSINESS BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008 AND 2007**

**Note 2      Summary of Significant Accounting Policies, continued**

Loans Held-for-Sale, continued

Mortgage loans held-for-sale are generally sold with the mortgage servicing rights released by the Bank. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.

Loans

Loans that management has the intent and ability to hold for the foreseeable future are stated at the principal amount outstanding, net of allowance for loan losses and deferred fees. Interest on loans is calculated using the simple interest method based on the daily balance of principal amount outstanding and is credited to income when earned. Interest is accrued as earned unless management doubts the collectibility of interest or principal, at which time the loan is placed on nonaccrual status and accrued but unpaid interest is charged against income in that period. Any loan delinquent 90 days or more is placed on nonaccrual. Accrual of interest income is resumed when the borrower demonstrates the ability to make scheduled payments of both principal and interest.

Management considers loans impaired when it is probable the Bank will not be able to collect all amounts as scheduled under a loan agreement. Impaired loans are measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Changes in these values will be reflected in income and as adjustments to the allowance for possible loan losses.

The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due, unless the loan is well secured and in the process of collection. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received, or payment is considered certain.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level believed to be sufficient to absorb potential losses in the portfolio. The allowance for specific loan losses is provided on loans, which are considered impaired when full collectibility may not be assured. The allowance is established by a charge against operations in the period the loss is identified. General loan loss reserves are established to provide for inherent risks in the portfolio. The reserves are based on management's continuing evaluation of the pertinent factors underlying the credit quality of the loan portfolio, including changes in the size and composition of the loan portfolio, actual loan loss experience, and current and anticipated economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available. Additionally, loans are subject to examinations by state and federal regulators, who, based upon their judgment, may require the Bank to make additional provisions or adjustments to its allowance for loan losses. Past due status is determined based on contractual terms.

**BUSINESS BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008 AND 2007**

**Note 2      Summary of Significant Accounting Policies, continued**

Loan Originations Fees

During 2008, the Bank fully implemented Statement of Financial Accounting Standards No. 91, "Accounting for Nonrefundable Fees and Costs" (SFAS 91), by properly deferring both loan fee income and loan origination costs. In 2007, the Bank began deferring loan fee income over the term of the related loans; however, did not implement cost deferral until 2008. Deferred loan origination costs of \$371,763 are included as a reduction in Salaries and Employee Benefits in 2008. Loan fee income for 2008 was reduced by \$190,845, due to deferral of loan origination costs. Net deferred fees of \$223,416 and \$227,416 are included in total loans at December 31, 2008 and, 2007, respectively.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Premises and Equipment

Property, equipment and leasehold improvements are recorded at cost, net of accumulated depreciation and amortization. Gains and losses on dispositions are reflected in operations. Expenditures for improvements and major renewals are capitalized, and ordinary maintenance, repairs, and small purchases are charged to operations as incurred.

Depreciation and Amortization

Property, equipment and leasehold improvements are depreciated or amortized over the estimated useful life of the related asset, three to thirty-nine years. The Bank uses the straight-line method of recognizing depreciation and amortization expenses. Leasehold improvements are amortized over lease terms on a straight-line basis.

Other Real Estate

Other real estate is foreclosed property held pending disposition and is initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. At foreclosure, if the fair value of the real estate acquired less estimated selling costs is less than the Bank's recorded investment in the related loan, a writedown is recognized through a charge to the allowance for loan losses. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Valuations are periodically performed by management, and any subsequent writedowns are recorded as a charge to income, if necessary, to reduce the carrying value of the property to its fair value less estimated selling costs. Sales of other real estate are accounted for according to Statement of Financial Accounting Standards No. 66, "Accounting for Sales of Real Estate."

**BUSINESS BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008 AND 2007**

**Note 2      Summary of Significant Accounting Policies, continued**

Income Taxes

Income taxes are provided for the tax effects of the transactions reported in the financial statements and consist of taxes currently due plus deferred taxes related primarily to differences between the tax and financial reporting of the allowance for loan losses, accumulated depreciation, organization costs, and conversion from accrual to cash basis.

The deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense (benefit) is the income tax payable (receivable) for the year and the change during the year in deferred tax assets and liabilities.

Advertising Costs

The Bank expenses advertising costs as they are incurred. Total advertising expense was \$73,311 and \$59,267 for the years ended December 31, 2008 and 2007, respectively.

Stock-Based Employee Compensation

The Bank has a stock-based compensation plan described more fully in Note 15. Prior to January 1, 2006, the Bank accounted for share-based employee compensation under the measurement and recognition provisions of Accounting Principles Board Opinions (APB) No. 25, "*Accounting for Stock Issued to Employees*" (APB 25) while disclosing under the provisions of Statement of Financial Accounting Standards (SFAS) No. 123, "*Accounting for Stock-Based Compensation*" (SFAS 123).

Effective January 1, 2006, the Bank adopted SFAS No. 123R, "*Share-Based Payment*," (SFAS 123R). Under the prospective method of adoption, which is required for private companies that previously used the minimum value method under SFAS 123, the Bank recognizes compensation expense for all share-based payments granted on or after January 1, 2006 based on the grant date fair value in accordance with the provisions of SFAS 123R.

For share-based payments granted prior to January 1, 2006, the Bank will continue to apply the measurement and recognition provisions of Accounting APB No. 25. See Note 15 for information about the Bank's stock-based compensation plan and the assumptions used to calculate the fair value of share-based employee compensation.

The Bank's statements of operations include \$25,222 and \$15,427 of compensation expense related to stock-based compensation for options for the years ended December 31, 2008 and 2007, respectively.

Financial Instruments

In the ordinary course of business, the bank has entered into off-balance-sheet financial instruments consisting of commitments to extend credit and commercial letters of credit. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

**BUSINESS BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008 AND 2007**

**Note 2      Summary of Significant Accounting Policies, continued**

Fair Values of Financial Instruments

The Bank implemented Statement of Financial Accounting Standards No. 107, “*Disclosures about Fair Value of Financial Instruments*” (SFAS 107), as of December 31, 2007 when its total assets exceeded \$100 million. SFAS 107 requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Statement No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Bank.

The following methods and assumptions were used by the Bank in estimating its fair value disclosures for financial instruments:

Cash and cash equivalents: The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets’ fair values.

Investment securities: Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

FHLB stock and PCBB stock: These are restricted investments carried at cost which approximates fair value.

Loans: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts. The fair values for other loans (for example, fixed rate commercial real estate and rental property mortgage loans and commercial and industrial loans) are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics.

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

Long-Term Borrowings: The fair values of the Bank’s long-term borrowings are estimated using discounted cash flow analyses based on the Bank’s current incremental borrowing rates for similar types of borrowing arrangements.

Short-Term Borrowings: The carrying amount of short-term borrowings approximates their fair values.

Accrued Interest: The carrying amount of accrued interest approximates its fair value.

**BUSINESS BANK**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2008 AND 2007**

**Note 2 Summary of Significant Accounting Policies, continued**

Reclassifications

Certain reclassifications have been made to the 2007 financial statements to conform with current year presentations. Such reclassifications have had no effect upon previously reported net income.

New Accounting Standards

On January 1, 2008, the Bank adopted Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements." SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. See Note 18 – Fair Value Measurements.

FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," clarifies FASB Statement No. 109, "Accounting for Income Taxes," by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements. Additionally, this Interpretation provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The effective date of Interpretation No. 48 has been deferred until January 1, 2009 with the issuance of FIN 48-3.

**Note 3 Investment Securities**

The amortized cost and fair values of investment securities at December 31, 2008 are as follows:

	<b>December 31, 2008</b>			
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
<b>Securities held-to-maturity:</b>				
U.S. Government agency securities	\$ 250,000	\$ 1,614	\$ -	\$ 251,614
Total held-to-maturity	<u>250,000</u>	<u>1,614</u>	<u>-</u>	<u>251,614</u>
<b>Securities available-for-sale:</b>				
U.S. Government agency securities	521,250	-	(926)	520,324
U.S. Government agency mortgage-backed securities	4,149,241	156,650	-	4,305,891
Collateralized mortgage obligations	<u>376,402</u>	<u>11,189</u>	<u>-</u>	<u>387,591</u>
Total available-for-sale	<u>5,046,893</u>	<u>167,839</u>	<u>(926)</u>	<u>5,213,806</u>
Totals – All Securities	<u>\$ 5,296,893</u>	<u>\$ 169,453</u>	<u>\$ (926)</u>	<u>\$ 5,465,420</u>

The balance sheet as of December 31, 2008 reflects the amortized cost of held-to-maturity securities of \$250,000 and the fair value of available-for-sale securities of \$5,213,806 for a total of \$5,463,806. A net unrealized gain of \$166,913 is in the available-for-sale investment securities balance. The unrealized gain, net of tax, is included in shareholders' equity.

**BUSINESS BANK**  
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**Note 3 Investment Securities, continued**

The amortized cost and fair values of investment securities at December 31, 2007 are as follows:

	<b>December 31, 2007</b>			
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
<b>Securities held-to-maturity:</b>				
U.S. Government agency securities	\$ 1,244,216	\$ 8,167	\$ (1,496)	\$ 1,250,887
Total held-to-maturity	<u>1,244,216</u>	<u>8,167</u>	<u>(1,496)</u>	<u>1,250,887</u>
<b>Securities available-for-sale:</b>				
U.S. Government agency mortgage-backed securities	2,613,888	58,952	-	2,672,840
Collateralized mortgage obligations	431,571	583	-	432,154
FHLMC stock	<u>512,879</u>	<u>-</u>	<u>-</u>	<u>512,879</u>
Total available-for-sale	<u>3,558,338</u>	<u>59,535</u>	<u>-</u>	<u>3,617,873</u>
Totals – All Securities	<u>\$ 4,802,554</u>	<u>\$ 67,702</u>	<u>\$ (1,496)</u>	<u>\$ 4,868,760</u>

The balance sheet as of December 31, 2007 reflects the amortized cost of held-to-maturity securities of \$1,244,216 and the fair value of available-for-sale securities of \$3,617,873 for a total of \$4,862,089. A net unrealized gain of \$59,535 is in the available-for-sale investment securities balance. The unrealized gain, net of tax, is included in shareholders' equity.

The amortized cost and fair values of held-to-maturity and available-for-sale securities by contractual maturity at December 31, 2008 are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations, with or without call or pre-payment penalties. Mortgage-backed securities and collateralized mortgage obligations are shown separately since they are not due at a single maturity date.

	<b>Available-for-Sale</b>		<b>Held-to-Maturity</b>	
	<b>Amortized Cost</b>	<b>Fair Value</b>	<b>Amortized Cost</b>	<b>Fair Value</b>
Amounts maturing:				
After one year through five years	\$ 521,250	\$ 520,324	\$ 250,000	\$ 251,614
Mortgage-backed securities	4,149,241	4,305,891	-	-
Collateralized mortgage obligations	<u>376,402</u>	<u>387,591</u>	<u>-</u>	<u>-</u>
Totals	<u>\$ 5,046,893</u>	<u>\$ 5,213,806</u>	<u>\$ 250,000</u>	<u>\$ 251,614</u>

During 2008, there were proceeds from sales of available-for-sale investment securities in the amount of \$540,168 which resulted in gross realized losses of \$470,994. There were no sales of investment securities during 2007.

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**Note 3 Investment Securities, continued**

Securities with carrying amounts of \$1,244,668 and \$1,244,216 at December 31, 2008 and 2007, respectively, were pledged to secure public deposits and for other purposes as required or permitted by law.

Information pertaining to securities with gross unrealized losses at December 31, 2008 and 2007, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	<u>Less Than 12 Months</u>		<u>12 Months or Greater</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>
December 31, 2008:						
Federal agencies	\$ 520,130	\$ (926)	\$ -	\$ -	\$ 520,130	\$ (926)
Totals	\$ 520,130	\$ (926)	\$ -	\$ -	\$ 520,130	\$ (926)
December 31, 2007:						
Federal agencies	\$ -	\$ -	\$ 497,295	\$ (1,496)	\$ 497,295	\$ (1,496)
Totals	\$ -	\$ -	\$ 497,295	\$ (1,496)	\$ 497,295	\$ (1,496)

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issue for a period of time sufficient to allow for any anticipated recovery in fair value.

Certain investment securities shown above currently have fair values less than amortized cost and therefore contain unrealized losses. At December 31, 2008, there is one investment security with an unrealized loss of less than 1.0% from its amortized cost. The Bank has evaluated this security and has determined that the decline in value is temporary and is related to the change in market interest rates since purchase. The decline in value is not related to any company or industry specific event. The Bank anticipates full recovery of amortized cost with respect to this security at maturity or sooner in the event of a more favorable market interest rate. As management has the ability to hold debt securities until maturity, or for the foreseeable future if classified as available-for-sale, no declines are deemed to be other-than-temporary.

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**NOTES TO FINANCIAL STATEMENTS**  
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**Note 4    Loans Receivable and Allowance for Loan Losses**

The composition of loans receivable at December 31 is as follows:

	<b>2008</b>	<b>2007</b>
Commercial	\$ 15,967,903	\$ 11,859,899
Real Estate	91,114,333	82,110,820
Agriculture	5,474,403	4,834,206
Consumer	743,532	652,101
Overdrafts	36,151	2,128
	113,336,322	99,459,154
Less allowance for loan losses	(2,162,497)	(1,264,944)
Loans, net	<b>\$ 111,173,825</b>	<b>\$ 98,194,210</b>

Transactions in the allowance for loan losses are summarized as follows:

	<b>2008</b>	<b>2007</b>
Balance at beginning of year	\$ 1,264,944	\$ 721,350
Provision charged to expense	2,839,435	546,600
Loans charged-off	(1,912,130)	(3,006)
Recoveries of loans previously charged-off	6,000	-
Reclassify off-balance sheet reserve	(35,752)	-
Balance at end of year	<b>\$ 2,162,497</b>	<b>\$ 1,264,944</b>

At December 31, 2008 and 2007, total nonaccrual loans were \$5,842,606 and \$745,771, respectively. At December 31, 2008 and 2007, the approximate recorded investment in impaired loans as defined in Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan," is as follows:

	<b>2008</b>	<b>2007</b>
Balance of impaired loans with no allocated allowance	\$ 4,348,366	\$ -
Balance of impaired loans with an allocated allowance	4,257,276	-
Total recorded investment in impaired loans	<b>\$ 8,605,642</b>	<b>\$ -</b>
Amount of the allowance allocated to impaired loans	<b>\$ 804,865</b>	<b>\$ -</b>

The average recorded investment in impaired loans amounted to approximately \$3,547,000 and \$-0- for the years ended December 31, 2008 and 2007, respectively. No interest income was recognized on these loans during 2008 and 2007. The Bank has no commitments to loan additional funds to borrowers whose loans are impaired. There were no loans past due 90 days or more and still accruing interest at December 31, 2008 or 2007.

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**Note 5 Premises and Equipment**

The components of premises and equipment at December 31 are as follows:

	<u>2008</u>	<u>2007</u>
Land	\$ 604,771	\$ 604,771
Building	1,732,318	1,643,245
Leasehold improvements	420,890	207,382
Equipment, furniture, and fixtures	902,218	624,822
Construction in process	167,499	5,438
Total cost	<u>3,827,696</u>	<u>3,085,658</u>
Less accumulated depreciation	<u>607,590</u>	<u>353,375</u>
Total	<u>\$ 3,220,106</u>	<u>\$ 2,732,283</u>

Depreciation and amortization charged against operations for the years ended December 31, 2008 and 2007 was \$254,215 and \$195,756, respectively.

The Bank leases its branch facilities in Bellingham, Lynden and South Mount Vernon under operating leases with initial lease terms of five years. These leases include renewal options and provide for rate adjustment based on changes in various economic indicators. Gross rental expense was \$120,951 for 2008 and \$40,807 for 2007 which is included in occupancy and equipment expense.

Minimum gross rental commitments under non-cancellable leases having an original or remaining term of more than one year are as follows at December 31, 2008:

2009	\$ 162,640
2010	164,775
2011	150,470
2012	127,256
2013	<u>63,217</u>
Total	<u>\$ 668,358</u>

**Note 6 Deposits**

The composition of deposits at December 31 is as follows:

	<u>2008</u>	<u>2007</u>
Noninterest checking	\$ 8,962,135	\$ 8,237,603
Interest-bearing checking and money market accounts	18,834,492	14,837,126
Savings deposits	403,153	230,026
Time deposits, less than \$100,000	44,762,899	11,584,861
Time deposits, \$100,000 or more	<u>15,672,704</u>	<u>50,807,982</u>
Total deposits	<u>\$ 88,635,383</u>	<u>\$ 85,697,598</u>

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**Note 6 Deposits, continued**

Included in time deposits are brokered deposits of \$34,088,000 at December 31, 2008. The scheduled maturities of time deposits at December 31, 2008 are as follows:

2009	\$ 57,106,423
2010	2,791,489
2011	431,564
2012	56,127
2013	50,000
	<u>\$ 60,435,603</u>

**Note 7 Federal Income Taxes**

Income taxes are comprised of the following for the years ended December 31:

	<u>2008</u>	<u>2007</u>
Provision for income tax:		
Current (benefit)	\$ (386,214)	\$ 322,386
Deferred benefit	(118,549)	(98,742)
Total income tax provision (benefit)	<u>\$ (504,763)</u>	<u>\$ 223,644</u>

The following reconciliation is between the statutory and the effective federal income tax rate for the years ended December 31:

	<u>2008</u>		<u>2007</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Federal income tax at statutory rate	\$ (774,803)	(34.0)%	\$ 222,814	34.0 %
Increase (decrease) resulting from:				
Disallowed expenses	3,112	.1%	3,264	.5 %
Stock-based compensation	8,575	.4%	5,245	.8 %
Other	(1,867)	(.1)%	(7,679)	(1.2)%
Valuation allowance	260,220	11.4%	-	-
Total income tax (benefit)	<u>\$ (504,763)</u>	<u>(22.2)%</u>	<u>\$ 223,644</u>	<u>34.1 %</u>

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**Note 7 Federal Income Taxes, continued**

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities at December 31 are:

	<b>2008</b>	<b>2007</b>
<b>Deferred tax assets:</b>		
Organizational expenditures	\$ 83,539	\$ 111,502
Net operating loss carryover	260,220	-
Allowance for possible loan losses in excess of tax reserves	594,600	394,067
Basis difference on other real estate owned	11,900	-
Off-balance sheet liability	12,156	-
Other	2,096	20,568
Total deferred tax asset	964,511	526,137
<b>Deferred tax liabilities:</b>		
Unrealized gain on available-for-sale securities	56,750	20,242
Accrual to cash adjustment	46,781	54,024
Premises and equipment	113,612	75,708
Other	31,769	2,825
Total deferred tax liability	248,912	152,799
Less Valuation Allowance	(260,220)	-
<b>Net deferred tax asset</b>	<b>\$ 455,379</b>	<b>\$ 373,338</b>

During 2008, the Bank incurred a net operating loss for tax purposes of approximately \$1,861,000, of which \$1,095,000 will be carried back to prior tax years to obtain a refund of taxes previously paid of \$365,482. The remainder of the net operating loss may be carried forward for a period of fifteen years. Realization of the future tax benefits of the net operating loss is dependent upon the Bank's ability to generate future taxable income. Due to the uncertainty of future earnings, management is unable to predict whether the deferred tax asset will be realized and therefore has recorded a valuation allowance of \$260,220 as of December 31, 2008. A federal income tax refund receivable of \$597,867 has been recorded at December 31, 2008 for current year income tax payments of \$232,385 plus the refund of amounts paid in prior years.

**Note 8 Related Party Transactions**

During 2008 and 2007, Business Bank had transactions made in the ordinary course of business with certain of its officers, directors and principal shareholders. All loans included in such transactions were made on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with other persons, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features.

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**Note 8 Related Party Transactions, continued**

A summary of these transactions follows:

	<u>Balance Beginning of Year</u>	<u>Additions</u>	<u>Amounts Collected</u>	<u>Balance End of Year</u>
For the year ended December 31, 2008	\$ 3,720,127	\$ 1,441,818	\$ (1,447,053)	\$ 3,714,892
For the year ended December 31, 2007	\$ 1,478,468	\$ 3,062,497	\$ (820,838)	\$ 3,720,127

The Bank also had unfunded commitments to executive officers, directors and principal shareholders of approximately \$1,041,000 at December 31, 2008.

The Bank held related-party deposits of \$2,761,878 and \$2,709,447 at December 31, 2008 and 2007, respectively, which includes deposits held for directors, executive officers, principal shareholders, and related business entities.

**Note 9 Federal Home Loan Bank Borrowings**

Business Bank is a member of the Federal Home Loan Bank (FHLB) of Seattle, which entitles it to certain benefits including a variety of borrowing options. The FHLB borrowings at December 31, 2008 consist of a warehouse securities credit line (securities line), which also allows for advances with interest rates fixed at the time of borrowing, a warehouse cash management advance line (CMA line), which allows daily advances at variable interest rates, and a putable advance option, in which the borrower is "paid" for selling the options embedded in the advance, which enables the Bank to borrow at rates below those for regular fixed-rate advances. It also has a "Bermudin" option, which means that the option is exercisable at June 1, 2008 and every quarter thereafter. Credit capacity is primarily determined by the value of assets collateralized at the FHLB, funds on deposit at the FHLB, and stock owned by the Bank. Credit is limited to 10% of the Bank's total assets. Total collateral pledged to the FHLB as of December 31, 2008 and 2007 consisted of loans of \$28,592,000 and \$9,228,000, respectively. The Bank has available borrowing capacity of an additional \$5,592,000 at December 31, 2008.

Advances on these lines at December 31, 2008 were as follows:

Securities line:	
Putable advance, interest rate 3.28%	\$ 3,000,000
Putable advance, interest rate 4.61%	2,000,000
Putable advance, interest rate 2.38%	4,000,000
Adjustable interest rate of 2.36%	3,000,000
Fixed interest rate of 3.72%	<u>11,000,000</u>
Total	<u>\$ 23,000,000</u>

**BUSINESS BANK  
NOTES TO FINANCIAL STATEMENTS  
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**Note 9 FHLB Borrowings, continued**

At December 31, 2008, scheduled maturities of the advances are as follows:

<u>Years Ending December 31,</u>	<u>Amount</u>
2009	\$ 10,000,000
2010	4,000,000
2011	-
2012	-
2013	4,000,000
Thereafter	<u>5,000,000</u>
Total	<u>\$ 23,000,000</u>

**Note 10 Lines of Credit**

The Bank has credit available through Pacific Coast Banker's Bank under a \$5 million unsecured federal funds line of credit. Pricing is based upon Pacific Coast Banker's Bank's rates at the time of the borrowing. This facility is not a committed facility and can be cancelled by either party. In addition, the Bank has credit available through Silverton Bank under a \$3 million federal funds line of credit.

There were outstanding advances of \$440,000 on these lines at December 31, 2008. There were no outstanding balances at December 31, 2007.

**Note 11 Commitments and Contingent Liabilities**

In the normal course of business, the Bank has outstanding commitments and contingent liabilities, such as commitments to extend credit, which are not included in the accompanying financial statements. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit is represented by the contractual or notional amount of those instruments. The Bank uses the same credit policies in making such commitments as it does for instruments that are included in the balance sheet.

Commitments to extend credit and possible credit risk were as follows:

	<u>2008</u>	<u>2007</u>
Commitments to extend credit	\$ 9,569,000	\$ 26,850,000
Commercial letters of credit	3,327,000	-
Standby letters of credit	171,000	25,000

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**Note 11 Commitments and Contingent Liabilities, continued**

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

The Bank has not been required to perform on any financial guarantees nor incurred any losses on its commitments during 2008 or 2007.

The Bank is subject to claims and lawsuits which arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the financial position of the Bank.

The Bank participates in the Washington State Public Depository program. Under the Public Depository Protection Act, financial institutions that participate in this program are part of the collateral pool that was established to protect public deposits. As a participating bank, the Bank is responsible for its pro rata share of restoring the public deposit funds for any uninsured public deposits held in a failed financial institution. The Bank is unaware of any material liabilities under this program at December 31, 2008; thus, no such liability is recorded in the financial statements at December 31, 2008.

**Note 12 Concentrations of Credit Risk**

The Bank maintains its cash accounts with several correspondent banks. Generally, accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000 per bank. Uninsured deposits amounted to approximately \$338,000 at December 31, 2008. Furthermore, federal funds sold are essentially uncollateralized loans to other financial institutions. Management regularly evaluates the credit risk associated with the counterparties to these transactions and believes that the Bank is not exposed to any significant credit risks on cash and cash equivalents.

The Bank grants agribusiness, commercial, consumer, and real estate loans to customers within Skagit and Whatcom Counties, Washington and the surrounding areas. Concentrations of credit by loan type are set forth in Note 4.

**Note 13 Regulatory Matters**

The Bank is subject to various regulatory capital requirements administered by the federal regulatory agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices.

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**Note 13 Regulatory Matters, continued**

The capital amounts and classification are also subject to qualitative judgments by regulators about components, risk weightings, and other factors. Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets, and of Tier I capital to average assets. Management believes, as of December 31, 2008 and 2007, that the Bank meets all capital adequacy requirements to which it is subject.

The Bank's actual and required capital amounts and ratios are as follows:

	<u>Actual</u>		<u>Minimum Required for Capital Adequacy Purposes</u>		<u>Required to be Well Capitalized under the Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<b>As of December 31, 2008:</b>						
Tier 1 Capital (to Adjusted Total Average Assets)	\$ 13,251	10.47%	\$ 5,065	4.00%	\$ 6,331	5.00%
Tier 1 Capital (to Risk- weighted Assets)	\$ 13,251	11.64%	\$ 4,554	4.00%	\$ 6,832	6.00%
Total Risk-based Capital (to Risk-weighted Assets)	\$ 14,683	12.90%	\$ 9,109	8.00%	\$ 11,386	10.00%
<b>As of December 31, 2007:</b>						
Tier 1 Capital (to Adjusted Total Average Assets)	\$ 14,817	13.92%	\$ 4,257	4.00%	\$ 5,322	5.00%
Tier 1 Capital (to Risk- weighted Assets)	\$ 14,817	14.00%	\$ 4,233	4.00%	\$ 6,350	6.00%
Total Risk-based Capital (to Risk-weighted Assets)	\$ 16,082	15.20%	\$ 8,467	8.00%	\$ 10,583	10.00%

**Note 14 Equity Transactions**

The Bank had a secondary stock offering during 2008 and 2007. During 2008, an additional 11,655 shares of stock were sold for total proceeds of \$163,170. During 2007, 258,024 shares of stock were sold under this offering at \$14.00 per share raising additional capital of \$3,582,000, net of stock issuance costs of approximately \$30,000. An additional 10,000 shares of stock were sold prior to the offering at \$11.35 per share for total proceeds of \$113,500.

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**Note 15 Stock-Based Compensation**

Stock Option Plan

In June 2005, the Board of Directors approved the adoption for the 2005 Stock Option Plan (“2005 Plan”), whereby, the Bank may grant awards to employees and directors of shares of common stock such as Incentive and Non-Qualified Stock Options as determined by the Administrator at the time of grant. The total number of options reserved for grant under the Plan was increased from 165,000 to 250,000 options in May 2008. At December 31, 2008, 104,750 shares of common stock were reserved for future grants. The Plan does not stipulate any terms or conditions for the awards to be granted. The options granted in 2008 and 2007 were granted at a price not less than market value at the date of the grant, vest over five years, and have a term of ten years, and are all Incentive Stock Options.

The Bank uses the Black-Scholes option pricing model to estimate the fair value of each option grant on the date of grant or modification. The Bank amortizes the estimated fair value to stock compensation expense using the straight-line method over the vesting period of the option. Following, is a description of the significant assumptions used in the option-pricing model:

**Expected Term** – The expected term is the period of time that granted options are expected to be outstanding. The Bank estimates the expected term based on historical patterns of option exercises, as well as potential future events that may increase liquidity. These factors are believed to reflect future exercise behavior.

**Expected Volatility** – Because the Bank’s stock is not traded in an active market, the Bank calculates volatility by using the historical stock prices of similar banks going back over the estimated life of the option and averaging the volatilities of these banks.

**Risk-Free Interest Rate** – The Bank bases the risk-free interest rate used in the Black-Scholes option valuation model on the market yield in effect at the time of the option grant provided from the Federal Reserve Board’s Statistical Releases and Historical publications from the Treasury constant maturities rates for the equivalent remaining terms.

**Dividends** – The Bank does not have plans to pay cash dividends in the future. Therefore, the Bank uses an expected dividend yield of zero in the Black-Scholes option valuation model.

The following assumptions were used to estimate the value of options granted for the years ended December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Average expected term	7.0 years	7.0 years
Expected stock price volatility	20.00%	20.00%
Risk free interest rate	3.47%	4.85%
Expected dividends	Zero	Zero

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**Note 15 Stock-Based Compensation, continued**

Option activity under the Plan for the years ended December 31, 2008 and 2007 is summarized as follows:

<u>Options</u>	<u>Shares</u>	<u>Weighted- Average Exercise Price</u>	<u>Weighted- Average Remaining Contractual Term</u>
Outstanding at January 1, 2007	131,250	\$ 10.10	
Granted	26,250	13.81	
Exercised	(3,000)	10.00	
Forfeited or expired	<u>(12,000)</u>	10.00	
Outstanding at December 31, 2007	<u>142,500</u>	10.75	7.85
Exercisable and vested, December 31, 2007	<u>44,300</u>	10.03	8.19
Outstanding at January 1, 2008	142,500	\$ 10.75	
Granted	5,750	13.57	
Exercised	-	-	
Forfeited or expired	<u>(6,000)</u>	10.67	
Outstanding at December 31, 2008	<u>142,250</u>	10.85	6.94
Exercisable and vested, December 31, 2008	<u>74,750</u>	10.29	6.57

The weighted-average grant-date fair value of options granted during the years ended December 31, 2008 and 2007, respectively, were \$4.23 and \$4.77. There were no options exercised during the year ended December 31, 2008. There were 3,000 options exercised during the year ended December 31, 2007 for total proceeds of \$30,000.

A summary of the status of the Bank's nonvested shares as of December 31, 2008, and changes during the year ended December 31, 2008, is presented below:

<u>Nonvested Shares</u>	<u>Shares</u>	<u>Weighted- Average Grant-Date Fair Value</u>
<b>Nonvested at January 1, 2008</b>	98,200	\$ 4.60
Granted	5,750	4.23
Vested	(31,450)	4.58
Forfeited	<u>(5,000)</u>	4.43
<b>Nonvested at December 31, 2008</b>	<u>67,500</u>	4.54

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**Note 15 Stock-Based Compensation, continued**

As of December 31, 2008, there was \$122,749 of total unrecognized compensation cost related to non-vested stock options granted under the Plan. Total unrecognized compensation costs will be adjusted for future changes in estimated forfeitures. The Bank expects to recognize that cost over a period of approximately 4.67 years.

The following table summarizes information concerning currently outstanding and exercisable options:

<u>Exercise Prices</u>	<u>Number Outstanding</u>	<u>Weighted Average Remaining Contractual Life (Years)</u>	<u>Number Exercisable</u>
\$ 10.00	105,250	6.38	67,150
10.50	2,000	7.45	600
11.35	5,000	7.73	2,000
13.00	5,000	8.30	1,000
14.00	20,000	8.64	4,000
13.50	5,000	9.47	-
Total	<u>142,250</u>		<u>74,750</u>

Restricted Stock

The Bank grants employees restricted stock with a graded vesting period over five years. The Bank provided for 10,000 shares of restricted common stock to an employee in April 2005. There were no grants of restricted common stock during 2008 or 2007. At December 31, 2008, 7,333 shares of restricted common stock were vested. The Bank's statements of operations include \$20,000 of compensation expense related to restricted stock-based compensation for the years ended December 31, 2008 and 2007. As of December 31, 2008, the remaining amount of unrecognized compensation for restricted common stock is \$26,667, which will be recognized over a period of 1.2 years.

**Note 16 Employee Benefit Plan**

The Bank has a 401(k) profit sharing plan (the "Plan") covering substantially all of its employees. Employees are eligible to participate in the Plan if they are 21 years of age and have completed three months of service. Eligible employees may contribute through payroll deductions and are 100% vested at all times in their deferral contributions account. The Bank is allowed to make annual matching contributions and/or employer "non-elective" contributions at its discretion. Participants are 100% vested in employer contributions after five years of service. Total 401(k) expense was \$36,694 and \$23,921 for the years ended December 31, 2008 and 2007, respectively.

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**Note 17 Fair Values of Financial Instruments**

The estimated fair values of the Bank's financial instruments are as follows:

	2008		2007	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>				
Cash and due from banks	\$ 2,597,832	\$ 2,597,832	\$ 1,667,098	\$ 1,667,098
Interest-bearing deposits with financial institutions	89,072	89,072	38,642	38,642
Federal funds sold	-	-	390,000	390,000
Investment securities	5,463,806	5,465,420	4,862,089	4,868,760
Federal Home Loan Bank stock	1,010,000	1,010,000	80,000	80,000
Pacific Coast Bankers' Bank stock	190,000	190,000	190,000	190,000
Loans held-for-sale	65,500	65,500	935,750	935,750
Loans, net	111,173,825	111,294,038	98,194,210	98,286,792
Interest receivable	414,562	414,562	448,128	448,128
<b>Financial liabilities:</b>				
Deposits	88,635,383	88,200,051	85,697,598	86,005,916
FHLB borrowings	23,000,000	23,843,868	9,000,000	8,348,762
Short-term borrowings	440,000	440,000	-	-
Interest payable	224,044	224,044	253,998	253,998

The carrying amounts in the preceding table are included in the balance sheet under the applicable captions.

**Note 18 Fair Value Measurements**

Effective January 1, 2008, the Bank adopted the provisions of SFAS No. 157, "*Fair Value Measurements*," for financial assets and financial liabilities. In accordance with Financial Accounting Standards Board Staff Position (FSP) No. SFAS 157-2, "*Effective Date of FASB Statement No. 157*," the Bank will delay application of SFAS 157 for non-financial assets and non-financial liabilities, until January 1, 2009. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The application of SFAS 157 in situations where the market for a financial asset is not active was clarified by the issuance of FSP No. SFAS 157-3, "*Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*," in October 2008. FSP No. SFAS 157-3 became effective for the Bank's financial statements as of December 31, 2008 and did not significantly impact the methods by which the Bank determines the fair values of its financial assets.

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**Note 18 Fair Value Measurements, continued**

SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

SFAS 157 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, SFAS 157 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- *Level 1 Inputs* – Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- *Level 2 Inputs* – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.
- *Level 3 Inputs* – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Bank's financial assets and financial liabilities carried at fair value effective January 1, 2008.

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**Note 18 Fair Value Measurements, continued**

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Bank's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Bank's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Bank's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

*Securities Available-for-Sale* – U.S. Treasury securities are reported at fair value utilizing Level 1 inputs. Other securities classified as available-for-sale are reported at fair value utilizing Level 2 inputs. For these securities, the Bank obtains fair value measurements from an independent pricing service. The fair value measurements consider 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.

*Impaired Loans* – Certain impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria.

The following table summarizes financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2008, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure the fair value:

	<u>Level 1 Inputs</u>	<u>Level 2 Inputs</u>	<u>Level 3 Inputs</u>	<u>Total Fair Value</u>
Available-for-Sale Securities	\$ -	\$ 5,213,806	\$ -	\$ 5,213,806

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). During the year ended December 31, 2008, certain impaired loans were remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for possible loan losses based upon the fair value of the underlying collateral. Impaired loans with a carrying value of \$8,605,642 were reduced by specific valuation allowance allocations totaling \$804,865 to a total reported fair value of \$7,800,777 based on collateral valuations utilizing Level 3 valuation inputs.

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**Note 18 Fair Value Measurements, continued**

Certain non-financial assets and non-financial liabilities measured at fair value on a recurring basis include reporting units measured at fair value in the first step of a goodwill impairment test. Certain non-financial assets measured at fair value on a non-recurring basis include non-financial assets and non-financial liabilities measured at fair value in the second step of a goodwill impairment test, as well as intangible assets and other non-financial long-lived assets measured at fair value for impairment assessment. As stated above, SFAS 157 will be applicable to these fair value measurements beginning January 1, 2009.