BUSINESS BANK
BURLINGTON, WASHINGTON

AUDITED FINANCIAL STATEMENTS

DECEMBER 31, 2011 AND 2010

C O N T E N T S

Stovall Grandey & Allen LLP

500 W. 7th Street
Suite 900
Fort Worth, Texas
76102-4702

Phone 817-632-2500
Fax 817-632-2598

www.sga-cpas.com

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
of Business Bank
Burlington, Washington

We have audited the accompanying balance sheets of Business Bank as of December 31, 2011 and 2010, 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Bank is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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, 2011 and 2010, 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
April 9, 2012

BUSINESS BANK
BALANCE SHEETS
DECEMBER 31, 2011 AND 2010

	2011	2010
ASSETS		
Cash and due from banks - Note 3	$ 1,548,751	$ 1,064,974
Interest-bearing deposits with financial institutions	5,474,647	10,207,438
Cash and cash equivalents	7,023,398	11,272,412
Investment securities - Note 4	7,732,286	8,939,794
Federal Home Loan Bank stock, at cost - Note 3	1,106,500	1,106,500
Pacific Coast Bankers' Bank stock, at cost - Note 3	190,000	190,000
Loans receivable, net of allowance for loan losses and deferred loan fees - Note 5	63,335,202	59,709,372
Other real estate owned	4,195,215	4,291,658
Premises and equipment, net - Note 6	4,533,584	2,562,806
Accrued interest receivable	222,927	225,126
Other assets	190,807	279,002
Total Assets	$ 88,529,919	$ 88,576,670
LIABILITIES		
Deposits - Note 7	$ 73,181,956	$ 73,762,246
Federal Home Loan Bank borrowings - Note 10	9,750,000	9,000,000
Accrued interest payable	82,906	107,092
Other liabilities	287,429	252,117
Total Liabilities	83,302,291	83,121,455
Commitments and contingencies - Notes 6, 10, 11, 12 and 13		
SHAREHOLDERS' EQUITY - Notes 14, 15 and 16		
Common stock, no par value; authorized: 10,000,000 shares Issued and outstanding: 4,423,656 and 3,279,609 shares at December 31, 2011 and 2010, respectively	20,124,624	18,308,449
Additional paid-in capital	113,775	92,600
Retained deficit	(15,030,982)	(12,909,229)
Accumulated other comprehensive income (loss)	20,211	(36,605)
Total Shareholders' Equity	5,227,628	5,455,215
Total Liabilities and Shareholders' Equity	$ 88,529,919	$ 88,576,670

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

BUSINESS BANK
STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2011 AND 2010

	2011	2010
Interest income		
Interest and fees on loans	$ 3,243,767	$ 4,176,638
Interest on investment securities	176,439	390,574
Interest on interest-bearing deposits with financial institutions	11,545	17,522
Total interest income	3,431,751	4,584,734
Interest expense		
On deposits	800,274	1,302,880
On borrowed funds	281,712	382,953
Total interest expense	1,081,986	1,685,833
Net interest income	2,349,765	2,898,901
Provision for loan losses - Note 5	-	2,893,797
Net interest income after provision for loan losses	2,349,765	5,104
Non-interest income		
Service charges on deposit accounts	127,089	119,042
Net gain on sale of investments	-	352,473
Net loss on sales of loans	-	(1,048)
Loss on sales of fixed assets	-	(180,200)
Net loss on sales of other real estate owned	(68,985)	(136,654)
Other	71,849	25,410
Total non-interest income	129,953	179,023
Non-interest expense		
Salaries and employee benefits	1,693,078	1,766,167
Occupancy and equipment	451,297	628,212
Data processing fees	168,781	186,030
Professional fees	180,620	97,676
Prepayment penalties	-	123,393
FDIC assessment	172,980	319,074
OREO expense and writedowns	1,135,513	1,216,241
Unreimbursed loan expense	240,610	270,628
Directors and officers insurance	168,235	230,730
Other expense	390,357	425,612
Total non-interest expense	4,601,471	5,263,763
Net Loss	(2,121,753)	(5,079,636)

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, 2011 AND 2010

	Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Deficit	Accumulated Other Comprehensive Income (Loss)	Total
Balance at January 1, 2010	1,577,014	$ 15,551,344	$ 69,782	$ (7,829,593)	$ 141,372	$ 7,932,905
Vesting of restricted common stock		6,666				6,666
Stock-based compensation, stock options			22,818			22,818
Sales of common stock	1,702,595	2,750,439				2,750,439
Net loss for the year ended December 31, 2010				(5,079,636)		(5,079,636)
Unrealized loss on available-for-sale securities					(177,977)	(177,977)
Comprehensive loss						(5,257,613)
Balance at December 31, 2010	3,279,609	18,308,449	92,600	(12,909,229)	(36,605)	5,455,215
Stock-based compensation, stock options			21,175			21,175
Sales of common stock	1,144,047	1,816,175				1,816,175
Net loss for the year ended December 31, 2011				(2,121,753)		(2,121,753)
Unrealized gain on available-for-sale securities					56,816	56,816
Comprehensive loss						(2,064,937)
Balance at December 31, 2011	4,423,656	$ 20,124,624	$ 113,775	$ (15,030,982)	$ 20,211	$ 5,227,628

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

BUSINESS BANK
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2011 AND 2010

	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (2,121,753)	$ (5,079,636)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	211,001	292,305
Provision for loan losses	-	2,893,797
Writedown on other real estate owned	527,746	823,037
Net gain on sales of investments	-	(352,473)
Net loss on sales of loans	-	1,048
Loss on sales of fixed assets	-	180,200
Net loss on sales of other real estate owned	68,985	136,654
Net amortization on investment securities	67,833	60,039
Stock-based compensation	21,175	29,484
Proceeds from sales of loans held-for-sale	-	206,952
Decrease in other assets	36,683	60,598
Increase (decrease) in other liabilities	11,126	(140,134)
Total adjustments	944,549	4,191,507
Net Cash Used by Operating Activities	(1,177,204)	(888,129)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available-for-sale securities	-	(8,432,733)
Proceeds from maturities of available-for-sale securities	-	500,000
Proceeds from sales of available-for-sale securities	-	15,259,208
Principal payments on available-for-sale securities	1,130,260	1,728,039
Purchases of FHLB stock	-	(32,200)
Net (increase) decrease in loans receivable	(8,788,757)	14,481,802
Cash proceeds from sales of other real estate owned	2,971,798	4,885,157
Capitalized costs of other real estate owned	(342,927)	-
Purchases of furniture and equipment	(81,779)	(47,386)
Net Cash Provided (Used) by Investing Activities	(5,111,405)	28,341,887
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net decrease in deposits	(526,580)	(19,136,686)
Proceeds from FHLB borrowings	850,000	3,605,000
Payments on FHLB borrowings	(100,000)	(13,605,000)
Net proceeds from common stock issued	1,816,175	2,750,439
Net Cash Provided (Used) by Financing Activities	2,039,595	(26,386,247)
Net increase (decrease) in cash and cash equivalents	(4,249,014)	1,067,511
Cash and cash equivalents at beginning of year	11,272,412	10,204,901
Cash and cash equivalents at end of year	$ 7,023,398	$ 11,272,412
SUPPLEMENTAL SCHEDULE OF OPERATING AND INVESTING ACTIVITIES:		
Cash paid for interest	$ 1,106,172	$ 1,833,607
Other real estate acquired through foreclosure	3,658,064	5,205,566
Bank financed sales of other real estate owned	360,000	232,750
Noncash acquisition of bank premises and land	2,100,000	-

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

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 had three locations as of December 31, 2011: Burlington, Bellingham 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 Retained Deficit and Management Plans

The Bank experienced net operating losses during the last three years which attributed to a retained deficit balance of $15,030,982 at December 31, 2011. In addition, the Bank is operating under provisions of a Cease and Desist Order (Order) issued by the FDIC and the Washington Department of Financial Institutions in September 2009. The Board of Directors is working diligently to comply with all aspects of the Order. Under new management in 2010 and 2011 the Board of Directors raised $4.57 million in additional capital. In addition, a revised Capital Restoration Plan (Plan) has been put in place which outlines specific steps and timeframes to achieve and maintain specific capital levels. The Bank experienced a profitable month in December of 2011 and the Plan calls for a return to sustainable profitability in the latter half of 2012. Management and the Board continue to pursue additional sources of capital (refer to Note 19 – Subsequent Events).

Note 3 Summary of Significant Accounting Policies

<u>Financial Statement Presentation</u>

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.

<u>Estimates</u>

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.

Note 3 Summary of Significant Accounting Policies, continued

Estimates, continued

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 non-interest-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.

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, 2011 and 2010 was $250,000.

Investment Securities

The Bank accounts for investment securities according to authoritative guidance issued by the Financial Accounting Standards Board (FASB). Under the provisions of the FASB authoritative guidance, 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 writedowns of the individual securities to their fair value. The related writedowns 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.

Note 3 Summary of Significant Accounting Policies, continued

<u>Federal Home Loan Bank and Pacific Coast Bankers' Bank Stock</u>

The Bank's investment in Federal Home Loan Bank (FHLB) stock is a restricted investment carried at cost ($100 per share par value), 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 cost, 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.

<u>Loans Held-for-Sale</u>

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.

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.

<u>Loans</u>

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 loan 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.

Note 3 Summary of Significant Accounting Policies, continued

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.

Loan Origination Fees

The Bank has adopted authoritative guidance issued by the FASB regarding deferral of loan fee income and loan origination costs. Deferred loan origination costs of $245,777 and $184,027 are included as a reduction in Salaries and Employee Benefits in 2011 and 2010, respectively. Loan fee income for 2011 and 2010 was reduced by $171,314 and $190,221, respectively, due to amortization of deferred loan origination costs. Net deferred fees of $27,292 and $12,062 are included in total loans at December 31, 2011 and 2010, 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, which ranges from 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.

Note 3 Summary of Significant Accounting Policies, continued

Other Real Estate Owned

Other real estate owned 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 owned are accounted for according to authoritative guidance issued by the FASB.

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.

In accordance with authoritative guidance issued by the FASB, the Bank performed an evaluation to determine if there were any uncertain tax positions that would have an impact on the financial statements. No uncertain tax positions were identified. The December 31, 2008 through December 31, 2011 tax years remain subject to examination by the Internal Revenue Service. The Bank does not believe that any reasonably possible changes will occur within the next 12 months which will have a material impact on the financial statements. The Bank records incurred penalties and interest in other non-interest expense. There were no penalties and interest assessed by taxing authorities during 2011 or 2010.

Advertising Costs

The Bank expenses advertising costs as they are incurred. Total advertising expense was $19,057 and $20,028 for the years ended December 31, 2011 and 2010, respectively.

Stock-Based Employee Compensation

The Bank has a stock-based compensation plan described more fully in Note 16. The Bank was required to adopt authoritative guidance issued by the FASB regarding stock compensation effective January 1, 2006. As permitted by this guidance, the Bank accounts for stock option awards using the calculated value method.

Note 3 Summary of Significant Accounting Policies, continued

Stock-Based Employee Compensation, continued

The provisions of this guidance are applicable to stock options awarded by the Bank and the Bank is required to recognize compensation expense for options granted in 2006 and thereafter. The Bank used the modified prospective application transition method in adopting this new FASB guidance. Under the modified prospective method, 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 FASB guidance. See Note 16 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 $21,175 and $22,818 of compensation expense related to stock-based compensation for options for the years ended December 31, 2011 and 2010, respectively. The financial statements also include $6,666 in stock-based compensation for 2010, related to a Restricted Stock Plan which is described in Note 16.

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.

Reclassifications

Certain reclassifications have been made to the 2010 financial statements to conform with current year presentations. Such reclassifications have had no effect upon previously reported net loss.

Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before the financial statements are available to be issued. The Bank recognizes in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing the financial statements. The Bank's financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date and before the financial statements are available to be issued. The Bank has evaluated subsequent events from December 31, 2011 through April 9, 2012 the date the financial statements were available to be issued. Refer to Note 19 for subsequent events identified for disclosure.

Note 3 Summary of Significant Accounting Policies, continued

New Accounting Standards

Accounting Standards Update (ASU) No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures About Fair Value Measurements*, requires expanded disclosures related to fair value measurements including (i) the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers, (ii) the reasons for transfer of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately, (iii) the policy for determining when transfers between levels of the fair value hierarchy are recognized and (iv) for recurring fair value measurements of assets and liabilities in Level 3 of the fair value hierarchy, a gross presentation of information about purchases, sales, issuances and settlements. ASU 2010-06 further clarifies that (i) fair value measurement disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities within a line item in the statement of financial position and (ii) companies should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The disclosures related to the gross presentation of purchases, sales, issuances and settlements of assets and liabilities included in Level 3 of the fair value hierarchy became effective for the Bank on January 1, 2011. The remaining disclosure requirements and clarifications made by ASU 2010-06 became effective for the Bank on January 1, 2010. See Note 18 – Fair Value Measurements.

ASU No. 2010-20, *Receivables (Topic 310) – Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, requires entities to provide disclosures designed to facilitate financial statement users' evaluation of (i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for loan losses and (iii) the changes and reasons for those changes in the allowance for loan losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for loan losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a rollforward of the allowance for loan losses as well as information about modified, impaired, nonaccrual and past due loans and credit quality indicators. ASU 2010-20 was effective for the Bank's financial statements as of December 31, 2011, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period became effective for the Bank's financial statements on January 1, 2011. Certain disclosures related to troubled debt restructurings were temporarily deferred by ASU 2011-01, *Receivables (Topic 310) – Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*, and will be effective January 1, 2012 as required by ASU No. 2011-02, *Receivables (Topic 310) – A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*, as further discussed on the next page. See Note 5 – Loans and Allowance for Loan Losses.

ASU No. 2010-28, *Intangibles – Goodwill and Other (Topic 350) – When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts*, modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist such as if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. ASU 2010-28 is effective for periods beginning on or after December 15, 2011 and is not expected to have a significant impact on the Bank's financial statements.

Note 3 Summary of Significant Accounting Policies, continued

New Accounting Standards, continued

ASU No. 2011-02, *Receivables (Topic 310) – A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*, clarifies when loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-02, that both of the following exist: (a) the restructuring constitutes a concession and (b) the debtor is experiencing financial difficulties. ASU 2011-02 is effective for annual periods ending on or after December 15, 2012 and will be applied retrospectively to restructurings occurring on or after January 1, 2012 and is not expected to have a significant impact on the Bank's financial statements.

ASU 2011-04, *Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRS*, amends Topic 820, *Fair Value Measurements and Disclosures*, to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 is effective for annual periods beginning after December 15, 2011 and is not expected to have a significant impact on the Bank's financial statements.

ASU 2011-05, *Comprehensive Income (Topic 220) – Presentation of Comprehensive Income*, amends Topic 220, *Comprehensive Income*, to require that all non-owner changes in shareholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in shareholders' equity was eliminated. ASU 2011-05 is effective for annual periods ending after December 15, 2012; however, certain provisions related to the presentation of reclassification adjustments have been deferred by ASU 2011-12, *Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*, as further discussed on the next page. ASU 2011-05 is not expected to have a significant impact on the Bank's financial statements.

ASU 2011-08, *Intangibles – Goodwill and Other (Topic 350) – Testing Goodwill for Impairment*, amends Topic 350, *Intangibles – Goodwill and Other*, to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. ASU 2011-08 is effective for annual and interim impairment tests beginning after December 15, 2011, and is not expected to have a significant impact on the Bank's financial statements.

Note 3 Summary of Significant Accounting Policies, continued

New Accounting Standards, continued

ASU 2011-12, *Comprehensive Income (Topic 220) – Deferral of Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05,* defers changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments to allow the FASB time to redeliberate whether to require presentation of such adjustments on the face of the financial statements to show the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income. ASU 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. All other requirements in ASU No. 2011-05 are not affected by ASU No. 2011-12. ASU 2011-12 is effective for annual periods ending after December 15, 2012 and is not expected to have a significant impact on the Bank's financial statements.

Note 4 Investment Securities

The amortized cost and fair values of investment securities at December 31, 2011 are as follows:

	December 31, 2011			
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Available-for-Sale:				
U.S. Government agency mortgage-backed securities	$ 2,880,152	$ 38,259	$ (5,007)	$ 2,913,404
Collateralized mortgage obligations	458,957	2,726	-	461,683
SBA pools	4,372,966	11,064	(26,831)	4,357,199
Totals	$ 7,712,075	$ 52,049	$ (31,838)	$ 7,732,286

The balance sheet as of December 31, 2011 reflects the fair value of available-for-sale securities of $7,732,286. A net unrealized gain of $20,211 is in the available-for-sale investment securities balance. The unrealized gain is included in shareholders' equity.

Note 4 Investment Securities, continued

The amortized cost and fair values of investment securities at December 31, 2010 are as follows:

	December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale:				
U.S. Government agency mortgage-backed securities	$ 3,586,825	$ 16,195	$ (11,760)	$ 3,591,260
Collateralized mortgage obligations	511,820	-	(5,343)	506,477
SBA pools	4,877,754	4,730	(40,427)	4,842,057
Totals	$ 8,976,399	$ 20,925	$ (57,530)	$ 8,939,794

The balance sheet as of December 31, 2010 reflects the fair value of available-for-sale securities of $8,939,794. A net unrealized loss of $36,605 is in the available-for-sale investment securities balance. The unrealized loss is included in shareholders' equity.

The Bank's investment securities consist only of mortgage-backed securities, collateralized mortgage obligations and SBA pools which are not due at a single maturity date; therefore, a schedule of contractual maturities is not presented.

There were no sales of investment securities in 2011. During 2010, there were proceeds from sales of available-for-sale investment securities in the amount of $15,259,208 which resulted in gross realized gains of $359,221 and gross realized losses of $6,748.

Securities with carrying amounts of $3,009,848 and $2,126,205 at December 31, 2011 and 2010, respectively, were pledged to secure public deposits and for other purposes as required or permitted by law.

Note 4 Investment Securities, continued

Information pertaining to securities with gross unrealized losses at December 31, 2011 and 2010 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2011:						
U.S. Government agency mortgage-backed securities	$ 74,604	$ (641)	$1,713,193	$ (4,366)	$ 1,787,797	$ (5,007)
SBA pools	-	-	1,901,363	(26,831)	1,901,363	(26,831)
Totals	$ 74,604	$ (641)	$3,614,556	$ (31,197)	$ 3,689,160	$ (31,838)
December 31, 2010:						
U.S. Government agency mortgage-backed securities	$ 2,706,309	$ (11,760)	$ -	$ -	$ 2,706,309	$ (11,760)
Collateralized mortgage obligations	506,476	(5,343)	-	-	506,476	(5,343)
SBA pools	3,574,207	(40,427)	-	-	3,574,207	(40,427)
Totals	$ 6,786,992	$ (57,530)	$ -	$ -	$ 6,786,992	$ (57,530)

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 issuer 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, 2011, there are fourteen investment securities with an unrealized loss of less than 1% from their amortized cost. The Bank has evaluated these securities 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 these securities 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.

Note 5 Loans Receivable and Allowance for Loan Losses

An analysis of loan categories at December 31, 2011 and 2010 is as follows:

		2011	2010
Commercial and agricultural loans		$ 12,260,596	$ 7,262,367
Real estate (RE) loans:			
Construction, land and land development		16,976,337	24,731,111
Residential 1-4 family		13,870,944	10,770,622
Commercial RE		22,406,976	20,702,256
Consumer and other loans		860,817	408,393
Overdrafts		31,155	1,760
		66,406,825	63,876,509
Less:	Deferred loan fees	(27,292)	(12,062)
	Allowance for loan losses	(3,044,331)	(4,155,075)
	Loans, net	$ 63,335,202	$ 59,709,372

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

	Commercial and Agricultural	Construction, Land and Land Development	Residential 1-4 Family	Commercial RE	Consumer and Other	Unallocated	2011 Total	2010 Total
Allowance for Loan Losses:								
Balance, beginning of year	$ 342,054	$ 2,060,592	$ 929,156	$ 518,104	$ 23,872	$ 281,297	$ 4,155,075	$ 2,825,208
Provisions, charged (credited) to income	297,378	(343,334)	(632,815)	396,792	(8,374)	290,353	-	2,893,797
	639,432	1,717,258	296,341	914,896	15,498	571,650	4,155,075	5,719,005
Loans charged-off	(107,692)	(839,694)	(82,365)	(348,888)	(424)	-	(1,379,063)	(1,686,921)
Recoveries of loans previously charged-off	-	23,815	232,682	11,315	507	-	268,319	122,991
Net (charge offs) recoveries	(107,692)	(815,879)	150,317	(337,573)	83	-	(1,110,744)	(1,563,930)
Balance, end of year	$ 531,740	$ 901,379	$ 446,658	$ 577,323	$ 15,581	$ 571,650	$ 3,044,331	$ 4,155,075
Amounts allocated to: Individually evaluated for impairment	$ 212,488	$ 536,550	$ 89,510	$ 68,720	$ -	$ -	$ 907,268	$ 1,997,430
Amounts allocated to: Collectively evaluated for impairment	319,252	364,829	357,148	508,603	15,581	571,650	2,137,063	2,157,645
Balance, end of year	$ 531,740	$ 901,379	$ 446,658	$ 577,323	$ 15,581	$ 571,650	$ 3,044,331	$ 4,155,075
Loans:								
Individually evaluated for impairment	$ 588,570	$ 8,705,337	$ 759,263	$ 2,938,307	$ -		$ 12,991,477	$ 19,057,308
Collectively evaluated for impairment	11,672,026	8,271,000	13,111,681	19,468,669	891,972		53,415,348	44,819,201
Ending balance total loans	$ 12,260,596	$ 16,976,337	$ 13,870,944	$ 22,406,976	$ 891,972		$ 66,406,825	$ 63,876,509

Note 5 Loans and Allowance for Loan Losses, continued

Federal regulations require that the Bank periodically evaluate the risks inherent in its loan portfolio. In addition, the Bank's regulatory agencies have authority to identify problem loans and, if appropriate, require them to be reclassified. There are three classifications for problem loans: Substandard, Doubtful and Loss. Substandard loans have one or more defined weaknesses and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Doubtful loans have the weaknesses of loans classified as "Substandard," with additional characteristics that suggest the weaknesses make collection or recovery in full after liquidation of collateral questionable on the basis of currently existing facts, conditions and values. There is a high possibility of loss in loans classified as "Doubtful." A loan classified as "Loss" is considered uncollectible and of such little value that continued classification of the credit as a loan is not warranted. If a loan or a portion thereof is classified as "Loss," it must be charged-off, meaning the amount of the loss is charged against the allowance for loan losses, thereby reducing that reserve. The Bank also classifies some loans as "Watch" or "Other Loans Especially Mentioned" ("OLEM"). Loans classified as Watch are performing assets and classified as pass credits but have elements of risk that require more monitoring than other performing loans. Loans classified as OLEM are assets that continue to perform but have shown deterioration in credit quality and require close monitoring.

Loans by credit quality risk rating at December 31, 2011 are as follows:

	Pass	Other Loans Especially Mentioned	Sub-Standard	Doubtful	Total
Commercial and agricultural loans	$ 10,625,347	$ -	$ 1,635,249	$ -	$ 12,260,596
Real estate (RE) loans:					
Construction, land and land development	12,228,496	16,003	4,731,838	-	16,976,337
Residential 1-4 family	12,913,974	-	956,970	-	13,870,944
Commercial RE	19,306,203	361,109	2,739,664	-	22,406,976
Consumer and other loans	876,042	2,014	13,916	-	891,972
Less: Deferred loan fees	-	-	-	-	(27,292)
Total loans	$ 55,950,062	$ 379,126	$ 10,077,637	$ -	$ 66,379,533

An analysis of nonaccrual loans by category at December 31, 2011 and 2010 is as follows:

	2011	2010
Commercial and agricultural loans	$ 306,489	$ 33,722
Real estate (RE) loans:		
Construction, land and land development	2,551,395	2,480,032
Residential 1-4 family	558,536	1,285,094
Commercial RE	771,544	2,787,196
Consumer and other loans	-	12,845
Total nonaccrual loans	$ 4,187,964	$ 6,598,889

Note 5 Loans and Allowance for Loan Losses, continued

At December 31, 2011 and 2010, a summary of information pertaining to impaired loans is as follows:

	Unpaid Contractual Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2011:							
Commercial and agricultural loans	$ 627,099	$ 59,445	$ 529,125	$ 588,570	$ 212,488	$ 1,038,074	$ 29,992
Real estate (RE) loans:							
Construction, land and land development	9,353,797	3,196,021	5,509,316	8,705,337	536,550	9,362,946	464,933
Residential 1-4 family	763,811	181,062	578,201	759,263	89,510	1,724,308	21,415
Commercial RE	3,164,048	779,227	2,159,080	2,938,307	68,720	3,917,005	42,987
Total	$ 13,908,755	$ 4,215,755	$ 8,775,722	$ 12,991,477	$ 907,268	$ 16,042,333	$ 559,327
December 31, 2010:							
Commercial and agricultural loans	$ 1,487,577	$ 828,692	$ 658,885	$ 1,487,577	$ 180,931	$ 1,039,169	$ 29,007
Real estate (RE) loans:							
Construction, land and land development	10,020,555	1,414,710	8,605,845	10,020,555	1,169,761	9,344,974	241,999
Residential 1-4 family	2,689,354	1,612,470	1,076,884	2,689,354	384,845	3,773,119	62,879
Commercial RE	4,895,704	2,613,622	2,282,082	4,895,704	261,893	3,451,088	121,053
Total	$ 19,093,190	$ 6,469,494	$ 12,623,696	$ 19,093,190	$ 1,997,430	$ 17,608,350	$ 454,938

The Bank has no commitments to loan additional funds to borrowers whose loans are impaired.

Troubled Debt Restructurings – The restructuring of a loan is considered a "troubled debt restructuring" if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Troubled debt restructurings during 2011 are set forth in the following table:

	Number of Contracts	Balance at Restructuring Date	Balance at December 31, 2011
Real estate (RE) loans:			
Construction, land and land development	2	$ 442,759	$ 436,783
Residential – 1-4 family	2	196,874	191,039
Commercial RE	6	2,330,447	2,128,603
Total troubled debt restructurings	10	$ 2,970,080	$ 2,756,425

Concessions granted on these loans include reduction in interest rate and restructuring payments to match borrower's cash flow. At December 31, 2011, two commercial RE loans totaling $316,111 were not in compliance with the loan's modified terms.

Note 5 Loans and Allowance for Loan Losses, continued

The following table illustrates an age analysis of past due loans as of December 31, 2011:

	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	Recorded Investment 90 Days or More and Still Accruing
Commercial and agricultural loans	$ 346,441	$ -	$ 346,441	$ 11,914,155	$ 12,260,596	$ -
Real estate (RE) loans:						
Construction, land and land development	1,269,192	2,551,395	3,820,587	13,155,750	16,976,337	-
Residential 1-4 family	55,188	438,116	493,304	13,377,640	13,870,944	-
Commercial RE	-	779,227	779,227	21,627,749	22,406,976	779,227
Consumer and other loans	-	-	-	891,972	891,972	-
Less: Deferred loan fees	-	-	-	-	(27,292)	-
Total	$ 1,670,821	$ 3,768,738	$5,439,559	$ 60,967,266	$ 66,379,533	$ 779,227

At December 31, 2010, there were no loans past due ninety days or more and still accruing interest.

Loans totaling approximately $35,259,000 and $37,933,000 were pledged to secure borrowings at December 31, 2011 and 2010, respectively. Refer to Notes 10 and 11.

Note 6 Premises and Equipment

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

	2011	2010
Land	$ 1,024,771	$ 604,771
Buildings	3,412,318	1,732,318
Leasehold improvements	351,665	351,665
Equipment, furniture and fixtures	1,006,376	926,417
Total cost	5,795,130	3,615,171
Less accumulated depreciation	(1,261,546)	(1,052,365)
Total	$ 4,533,584	$ 2,562,806

Depreciation and amortization charged against operations for the years ended December 31, 2011 and 2010 was $211,001 and $292,305, respectively.

The Bank leases its branch facilities in Bellingham under an operating lease with initial lease term of five years. The lease includes renewal options and provides for rate adjustments based on changes in various economic indicators. This lease was renewed in July 2011 for an additional three-year term.

Note 6 Premises and Equipment, continued

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, 2011:

Year Ending December 31,		
2012	$	38,988
2013		39,994
Total	$	78,982

Gross rental expense was $90,035 for 2011 and $180,740 for 2010, which is included in occupancy and equipment expense.

In August 2011, the Bank acquired the land and building where the South Mount Vernon branch is located for $2,100,000. This property was financed by the Bank; therefore, the Bank agreed to pay the building owner by reducing his debt by the purchase price. There are two tenants in this building obligated under operating leases which expire in 2015. Future minimum rental income under these leases is as follows:

Year Ending December 31,		
2012	$	86,536
2013		87,346
2014		88,181
2015		26,966
Total	$	289,029

Rental income of $28,691 was received during 2011 under these lease agreements and is recorded in other non-interest income in the accompanying financial statements.

Note 7 Deposits

The composition of deposits at December 31 is as follows:

	2011	2010
Non-interest checking	$ 11,134,762	$ 7,806,755
Interest-bearing checking and money market	19,051,344	15,424,693
Savings deposits	3,106,688	977,203
Time deposits, less than $100,000	36,257,167	46,272,900
Time deposits, $100,000 or more	3,631,995	3,280,695
Total deposits	$ 73,181,956	$ 73,762,246

Note 7 Deposits, continued

Included in time deposits are brokered deposits of $-0- and $6,714,872 at December 31, 2011 and 2010, respectively. The scheduled maturities of time deposits at December 31, 2011 are as follows:

Year Ending December 31,	
2012	$ 25,515,813
2013	4,729,539
2014	1,192,043
2015	6,687,349
2016	1,764,418
Total	$ 39,889,162

Note 8 Federal Income Taxes

No income tax expense or benefit was recorded on the Bank's books during 2011 or 2010 due to net operating losses incurred.

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

	2011	**2010**
Deferred tax assets:		
Organizational expenditures	$ 40,683	$ 45,199
Net operating loss carryover	4,446,685	3,281,356
Allowance for possible loan losses in excess of tax reserves	624,668	1,045,555
Basis difference on other real estate owned	107,963	145,063
Off-balance-sheet liability	4,316	4,892
Other	2,117	1,786
Total deferred tax asset	5,226,432	4,523,851
Deferred tax liabilities:		
Accrual to cash adjustment	(3,454)	(5,351)
Premises and equipment	(82,522)	(76,347)
Other	(268)	(14,119)
Total deferred tax liability	(86,244)	(95,817)
Net Deferred Tax Asset	5,140,188	4,428,034
Less Valuation Allowance	(5,140,188)	(4,428,034)
Net deferred tax asset	$ -	$ -

The Bank incurred a net operating loss of approximately $2,122,000 for financial reporting purposes and a taxable loss of approximately $3,427,000 for the year ended December 31, 2011. As of December 31, 2011, the Bank has net operating losses of approximately $13,078,000 which may be carried forward a period of twenty years to offset future taxable income. These losses begin to expire in 2028.

Note 8 Federal Income Taxes, continued

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 $5,140,188 and $4,428,034 as of December 31, 2011 and 2010, respectively.

Note 9 Related Party Transactions

During 2011 and 2010, the 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.

A summary of these transactions follows:

	Balance Beginning of Year	Additions	Amounts Collected	Balance End of Year
For the year ended: December 31, 2011	$ 2,745,929	$ 587,497	$ (1,878,697)	$ 1,454,729
For the year ended: December 31, 2010	$ 2,956,971	$ 61,246	$ (272,288)	$ 2,745,929

The Bank also had unfunded commitments to executive officers, directors and principal shareholders of approximately $98,500 and $334,000 at December 31, 2011 and 2010, respectively.

At December 31, 2011 and 2010, the Bank held related party deposits of approximately $2,148,000 and $1,581,000, respectively, which includes deposits held for directors, executive officers, principal shareholders and related business entities.

Note 10 Federal Home Loan Bank Borrowings

The 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, 2011 and 2010 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 12% of the Bank's total assets.

Collateral pledged to the FHLB as of December 31, 2011 and 2010 included loans with outstanding balances of approximately $32,299,000 and $31,206,000, respectively. The Bank has available borrowing capacity of an additional $15,000 at December 31, 2011. The Bank was charged a prepayment penalty of $123,393 in May 2010 for prepayment of a $10,000,000 FHLB advance.

Note 10 Federal Home Loan Bank Borrowings, continued

Advances on these lines at December 31, 2011 were as follows:

Securities line:	
Fixed rate advance, interest rate 0.28%	$ 750,000
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
Total	$ 9,750,000

At December 31, 2011, scheduled maturities of the advances are $750,000 due in 2012, $4,000,000 due in 2013 and $5,000,000 due in 2017, for a total of $9,750,000.

Note 11 Lines of Credit

At December 31, 2011 and 2010, the Bank had available a collateralized line of credit with the Federal Reserve Bank of San Francisco (FRB). Loans with outstanding balances of $2,700,915 and $6,728,052 were pledged to the FRB for available borrowings of $1,292,418 and $2,617,395 at December 31, 2011 and 2010, respectively. There were no outstanding borrowings on this line as of December 31, 2011 or 2010.

Note 12 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 approximately as follows:

	2011	2010
Commitments to extend credit	$ 5,168,000	$ 3,447,000
Standby letters of credit	150,000	-

Note 12 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 2011 or 2010.

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 which requires institutions to collateralize uninsured public deposits at 100 percent. At December 31, 2011 and 2010, the Bank had pledged $45,513 and $667,497, respectively, to secure public deposits. Refer to Note 4 – Investment Securities.

Note 13 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. In addition, the FDIC insurance coverage has temporarily increased to 100% for non-interest-bearing checking accounts. There were no uninsured deposits at December 31, 2011 or December 31, 2010. 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 5 – Loans and Allowance for Loan Losses.

Note 14 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.

Note 14 Regulatory Matters, continued

On September 1, 2009, the Bank entered into an Order to Cease and Desist (Consent Agreement) with the FDIC and Washington Department of Financial Institutions. The Agreement requires the Bank to take certain actions to strengthen board oversight, strengthen credit risk management, reduce loan concentrations, improve asset quality, adopt and implement a comprehensive policy for determining the adequacy of the allowance for loan losses, achieve and maintain a primary liquidity ratio of at least 15%, and maintain specified capital levels. The Agreement requires the Bank to have and thereafter maintain Tier 1 Capital to Total Assets Ratio to equal or exceed 10% and Total Risk-Based Capital Ratio to equal or exceed 13%. At December 31, 2011 and 2010, the Bank is in substantial compliance with all provisions of the Order with the exception of capital ratios and loan concentration levels. Although concentration of Commercial Real Estate (CRE) and Acquisition, Development and Construction (ADC) loans have been significantly reduced since September 2009, the percentages have not decreased due to the decrease in the Bank's assets and capital.

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. The Bank's actual and required capital amounts and ratios are as follows (in thousands):

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required under the Cease and Desist Order	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
As of December 31, 2011:						
Tier 1 Capital (to Adjusted Total Average Assets)	$ 5,208	6.13%	$ 3,399	4.00%	$ 8,497	10.00%
Tier 1 Capital (to Risk-weighted Assets)	$ 5,208	7.46%	$ 2,794	4.00%	$ 4,191	6.00%
Total Risk-based Capital (to Risk-weighted Assets)	$ 6,115	8.76%	$ 5,588	8.00%	$ 9,081	13.00%
As of December 31, 2010:						
Tier 1 Capital (to Adjusted Total Average Assets)	$ 5,492	6.34%	$ 3,465	4.00%	$ 8,663	10.00%
Tier 1 Capital (to Risk-weighted Assets)	$ 5,492	8.45%	$ 2,601	4.00%	$ 3,901	6.00%
Total Risk-based Capital (to Risk-weighted Assets)	$ 6,347	9.76%	$ 5,201	8.00%	$ 8,452	13.00%

Note 15 Equity Transactions

The Bank's Articles of Incorporation were amended during 2010 to increase the authorized shares of common stock from 5,000,000 to 10,000,000. The Bank had secondary stock offerings during 2011 and 2010. During 2010, an additional 1,702,595 shares of stock were sold for total proceeds of $2,796,703. During 2011, an additional 1,144,047 shares of stock were sold for total proceeds of $1,830,475. Stock proceeds were offset by stock issuance costs of $14,300 and $46,264 for the years ended December 31, 2011 and 2010, respectively.

Note 16 Stock-Based Compensation

Stock Option Plan

In June 2005, the Board of Directors approved the adoption of 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, 2011, 162,750 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 2009 were granted at a price not less than market value at the date of the grant, vest over five years, 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.

Note 16 Stock-Based Compensation, continued

Stock Option Plan, continued

Option activity under the Plan for the years ended December 31, 2011 and 2010 is summarized as follows:

Options	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term
Outstanding at January 1, 2010	131,750	$ 10.55	
Granted	-	-	
Exercised	-	-	
Forfeited or expired	(46,250)	10.09	
Outstanding at December 31, 2010	85,500	$ 10.80	5.11
Vested or expected to vest at December 31, 2010	85,500	$ 10.80	5.11
Exercisable at December 31, 2010	74,750	$ 10.58	4.86
Outstanding at January 1, 2011	85,500	$ 10.80	
Granted	-	-	
Exercised	-	-	
Forfeited or expired	(1,250)	10.00	
Outstanding at December 31, 2011	84,250	$ 10.81	4.14
Vested or expected to vest at December 31, 2011	84,250	$ 10.81	4.14
Exercisable at December 31, 2011	78,800	$ 10.73	4.00

There were no options granted during the years ended December 31, 2011 and 2010. There were no options exercised during the years ended December 31, 2011 or 2010.

A summary of the status of the Bank's nonvested shares as of December 31, 2011, and changes during the year ended December 31, 2011, is presented below:

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2011	10,750	$ 2.06
Granted	-	-
Vested	(5,300)	4.12
Forfeited	-	-
Nonvested at December 31, 2011	5,450	$ 1.98

Note 16 Stock-Based Compensation, continued

Stock Option Plan, continued

As of December 31, 2011, there was $16,222 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 2.25 years.

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

Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Number Exercisable
$ 10.00	57,750	4.44	57,750
10.50	2,000	5.48	1,800
11.35	5,000	5.76	5,000
14.00	14,750	6.66	11,800
13.50	2,750	7.55	1,650
5.88	2,000	8.18	800
Total	84,250		78,800

Restricted Stock

In April 2005, the Bank granted to an employee 10,000 shares of restricted common stock with a graded vesting period over 5 years. There have been no additional grants of restricted common stock since. The Bank's statements of operations include $6,666 of compensation expense related to restricted stock-based compensation for the year ended December 31, 2010. As of December 31, 2011, there was no remaining unrecognized compensation for restricted common stock.

Stock Warrants

In June 2005, the Board of Directors authorized the granting of stock warrants to the Bank's organizers in exchange for providing $700,000 in seed capital which funded the organizational expenses of the Bank. Each Director (8) received 8,750 warrants that entitles the holder to purchase one share of common stock at a price of $10.00 per share on or before May 31, 2015. All 70,000 warrants remain outstanding as of December 31, 2011 and 2010.

Note 17 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. There was no employer match in 2011 or 2010.

Note 18 Fair Value Measurements

The Bank has adopted authoritative guidance issued by the FASB regarding fair value measurements for financial assets and financial liabilities. The authoritative guidance defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements.

The authoritative guidance issued by the FASB 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.

The authoritative guidance issued by the FASB 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, the authoritative guidance 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.

Note 18 Fair Value Measurements, continued

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.

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.

Other Real Estate: Other real estate represents foreclosed assets that are reported at the fair value less estimated selling costs of the underlying property. The fair values are estimated using Level 2 inputs based on observable market data or Level 3 inputs based on information obtained from customized discounting criteria.

Note 18 Fair Value Measurements, continued

The following table summarizes financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2011 and 2010, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure the fair value:

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
December 31, 2011:				
Available-for-Sale				
U.S. Government agency mortgage-backed securities	$ -	$ 2,913,404	$ -	$ 2,913,404
Collateralized mortgage obligations	-	461,683	-	461,683
SBA pools	-	4,357,199	-	4,357,199
Totals	$ -	$ 7,732,286	$ -	$ 7,732,286
December 31, 2010:				
Available-for-Sale				
U.S. Government agency mortgage-backed securities	$ -	$ 3,591,260	$ -	$ 3,591,260
Collateralized mortgage obligations	-	506,477	-	506,477
SBA pools	-	4,842,057	-	4,842,057
Totals	$ -	$ 8,939,794	$ -	$ 8,939,794

Certain financial assets are measured at fair value on a non-recurring 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). Financial assets measured at fair value on a non-recurring basis include certain impaired loans 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.

Note 18 Fair Value Measurements, continued

The following table summarizes financial assets measured at fair value on a non-recurring basis as of December 31, 2011 and 2010, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure the fair value:

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
December 31, 2011:				
Impaired loans	$ -	$ 8,666,043	$ 4,325,434	$ 12,991,477
Less specific valuation allowance for possible loan losses	-	(555,032)	(352,236)	(907,268)
Impaired loans, net	$ -	$ 8,111,011	$ 3,973,198	$ 12,084,209
December 31, 2010:				
Impaired loans	$ -	$ 14,983,230	$ 4,074,078	$ 19,057,308
Less specific valuation allowance for possible loan losses	-	(1,633,766)	(363,664)	(1,997,430)
Impaired loans, net	$ -	$ 13,349,464	$ 3,710,414	$ 17,059,878

Certain nonfinancial assets are measured at fair value on a non-recurring basis. Nonfinancial assets measured at fair value on a non-recurring basis include other real estate owned which, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for loan losses and certain other real estate owned, which subsequent to their initial recognition, were remeasured at fair value through a writedown included in other non-interest expense. The fair value of other real estate owned is estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. At December 31, 2011 and 2010, the Bank had other real estate owned totaling $4,195,215 and $4,291,658, respectively. Fair values were determined using Level 2 measurements. There were $113,504 and $117,542 in charge-offs included in the allowance for loan losses and $527,746 and $823,037 in subsequent writedowns included in other non-interest expense for impairment on other real estate owned at December 31, 2011 and 2010, respectively.

Note 19 Subsequent Events

On March 28, 2012, the Bank commenced a $4,500,000 Offering of up to 2,571,429 shares of common stock at $1.75 per share. Each purchaser will receive a stock warrant to purchase one additional share of common stock for each two shares acquired through the Offering. Each warrant allows the holder to purchase one share of common stock at $2.00 per share within the next three years. The minimum investment for persons who are not currently Bank shareholders is 2,857 shares ($5,000.00). There is no minimum investment for current Bank shareholders. The Offering will terminate on June 29, 2012, unless terminated earlier or extended by the Bank.