

VALLEY REPUBLIC BANK

Local. Responsive. Reliable.

2013 ANNUAL REPORT

BOARD OF DIRECTORS



Eugene (Gene) Voiland

Retired President and CEO of Aera Energy LLC. He has a long history in the energy industry, having worked over 28 years for Shell as an engineer and manager throughout the United States. Mr. Voiland is on a number of boards, is president of Orion California LP, and is a consultant to the oil industry. He is Chairman of the Board of the Bank and has served in that capacity since 2008.



Greg Bynum

Served as a member of the Bank's Board of Directors since 2008. Mr. Bynum is the owner and CEO of Gregory D. Bynum and Associates, Inc., a full-service real estate development, management, brokerage, and appraisal/analysis firm headquartered in Bakersfield, California. His firm was established in 1981.



Annette Davis

Served as a member of the Bank's Board of Directors since 2008. Mrs. Davis is the president of Adavco, Inc., one of the main land development companies in Bakersfield. Mrs. Davis co-founded the company in 1982.



Bruce Jay

Served as the Bank's President and Chief Executive Officer and as a member of its Board of Directors since 2008. Mr. Jay is a veteran banker with 22 years of executive management experience with Bank of Stockdale and its successor, Valley Independent Bank, as well as three years of de novo bank experience at Bank of Santa Clarita. Mr. Jay is a CPA and is a member of the American Institute of CPAs and the Colorado Society of CPAs.



Anthony Leggio

Served as a member of the Bank's Board of Directors since 2008. Mr. Leggio is a business attorney. From 1977 to 2001, Mr. Leggio was an attorney with the Bakersfield law firm of Clifford & Brown, where he served as Principal/Managing Partner. He was instrumental in establishing the firm's business department. Mr. Leggio served as Vice-President/ General Counsel of Wm. Bolthouse Farms from 2001-2005. Mr. Leggio currently serves as the president of Bolthouse Properties, LLC.



Angelo Mazzei

Served as a member of the Bank's Board of Directors since 2008. Mr. Mazzei is the founder and CEO of Mazzei Injector Corporation, in Bakersfield, California. Founded in 1978, the company manufactures and distributes patented high-efficiency venturi injectors and related equipment. The products are distributed worldwide for a variety of uses in agricultural irrigation, recreational waters, industrial and municipal drinking water treatment, and wastewater management.

BOARD OF DIRECTORS



Willy Reyneveld

Served as a member of the Bank's Board of Directors since 2008. Mr. Reyneveld is the President/CEO of W. Reyneveld Construction Inc., which he founded in 1994. The company specializes in super flat concrete floors for warehouses. In addition, Mr. Reyneveld has developed several industrial real estate projects in Bakersfield.



Carlos Sanchez

Served as a member of the Bank's Board of Directors since 2008. Mr. Sanchez is a realtor in Kern County, with over 20 years of experience in real estate sales. He has worked for Realty World Skyway, RE/MAX Golden Empire and, for the past 20 years, has been working for Coldwell Banker Preferred Realtors.



Shawn Shambaugh, M.D.

Served as a member of the Bank's Board of Directors since 2008. Dr. Shambaugh has been a physician specializing in oncology for over 20 years. He is also the Diagnostic Laboratory Director with Comprehensive Blood and Cancer Center, and serves as the Medical Director of the Houchin Community Blood Bank. He is a director of another community bank headquartered in Los Angeles County.



James Shuler, M.D.

Served as a member of the Bank's Board of Directors since 2008. Dr. Shuler was the founder and president of Empire Eye and Laser Center in Bakersfield from 1998-2007. Dr. Shuler also founded and served as the Medical Director of Empire Surgery Center, specializing in ophthalmic and orthopedic surgery. Dr. Shuler retired from eye surgery in 2008 and currently is a consultant for Anthem Blue Cross of California.



Robert Stine

Served as a director of the Bank since 2008. He is a director, and the retired President and Chief Executive Officer of Tejon Ranch Company. Previously, Mr. Stine was President and Chief Executive Officer of Collins Development Company in San Diego. Mr. Stine was a director of *The Bakersfield Californian,* and currently serves as a director of a bank holding company headquartered in Los Angeles County.



Warner Williams

Served as a member of the Bank's Board of Directors since 2008. He is Vice President of Chevron North America Exploration and Production, in charge of Chevron's operations in Louisiana, and Alabama. He has worked for over 35 years in the energy industry in both domestic and international locations. He holds a MS degree in Petroleum Engineering and serves on the Board of Councilors for the University of Southern California Viterbi School of Engineering.

EXECUTIVES AND MANAGEMENT





Executives

(From left to right)

Stephen M. Annis, CRP
Executive Vice President
Chief Financial Officer

Philip McLaughlin
Executive Vice President

Jack Smith
Executive Vice President
Chief Credit Officer

Bruce Jay
President and CEO

Management

(Standing, left to right)

Cindy Talley
VP-Compliance Manager

Brian Sabin
VP-Loans

Roxana Chavez
VP-Loan Servicing Manager

John Etchison
SVP-Agribusiness

Marcy Unruh
VP-Administration

Cathy Davies
VP-Operations

Garth Corrigan
VP-Controller

Pritesh Patel
VP-Branch Manager

(Seated, left to right)

Doris Depew
AVP-Relationship Manager

Stan Newman
VP-Loans

Janet Hepp
VP-Loans

Joel Askew
AVP-Loans

REPORT TO SHAREHOLDERS

Dear Shareholders and Friends:

Enclosed is the 2013 annual report for Valley Republic Bank ("VRB" or the "Bank"). The Bank opened for business on February 2, 2009 and just completed its fifth year of operation.

Before discussing results for 2013, it's a good time to reflect on the exceptional performance and growth VRB has achieved during its first five years of operation. The Bank's success began almost immediately after opening for business in February, 2009. Within 18 months of operation, the Bank grew to over $200 million in assets and became profitable, remaining profitable on a monthly basis since that date. Earnings have continued to improve each year and surpassed $2 million in 2013. Cumulative earnings have offset all start-up costs and provided a positive Retained Earnings balance of approximately $750,000. The Bank has grown to approximately $400 million in assets while maintaining superior asset quality. These results have exceeded our original plans and expectations and are substantially higher than the historical performance of de novo banks in California. With typical "start-up" risks behind us and a solid foundation in place, VRB is well positioned for the future.

Looking specifically at performance during 2013, continued growth and record earnings were achieved. Pre-tax earnings increased 59% to $2,915,000 as compared to $1,837,000 in 2012. In 2013, the Bank began recording income tax expense after utilizing start-up costs and expenses incurred in 2009 and 2010 (loss carry forwards). Net income for 2013 was $2,057,000, an increase of $220,000, or 12%, which included income tax expense of $858,000. This compared to net income of $1,837,000 for 2012 – which had zero income tax expense. We are pleased with the performance of the Bank in the midst of a very competitive environment. Continued growth of the loan portfolio and diligent control of costs were the primary drivers of earnings during 2013.

Total assets grew by 12% during the year to $395 million at December 31, 2013, compared to $353 million the prior year. Core (local) deposits grew 13% to $356 million compared to $314 million at the end of the prior year.

Our mission as a local bank is to re-invest these deposits into the community by making loans. The loan portfolio increased over $47 million (35%) from $137 million in 2012 to approximately $184 million at year end 2013. This growth accomplishment was exceptional in light of the current economic environment and strong competition among banks for new loans. Loans in the Kern County agribusiness sector, which we entered in late 2011, continued to grow. We have been diligent in underwriting and approving loans to maintain a high quality portfolio.

At December 31, 2013, there were no loan payments delinquent more than 30 days.

In September, we hired John (Jack) Smith to fill the vacant position of Executive Vice President-Chief Credit Officer due to the retirement of Grady Buck. Jack has over 25 years of commercial and agribusiness lending experience in the local market. The experience Jack gained working at a national bank is proving vital as VRB increases the size and complexity of our loan portfolio.

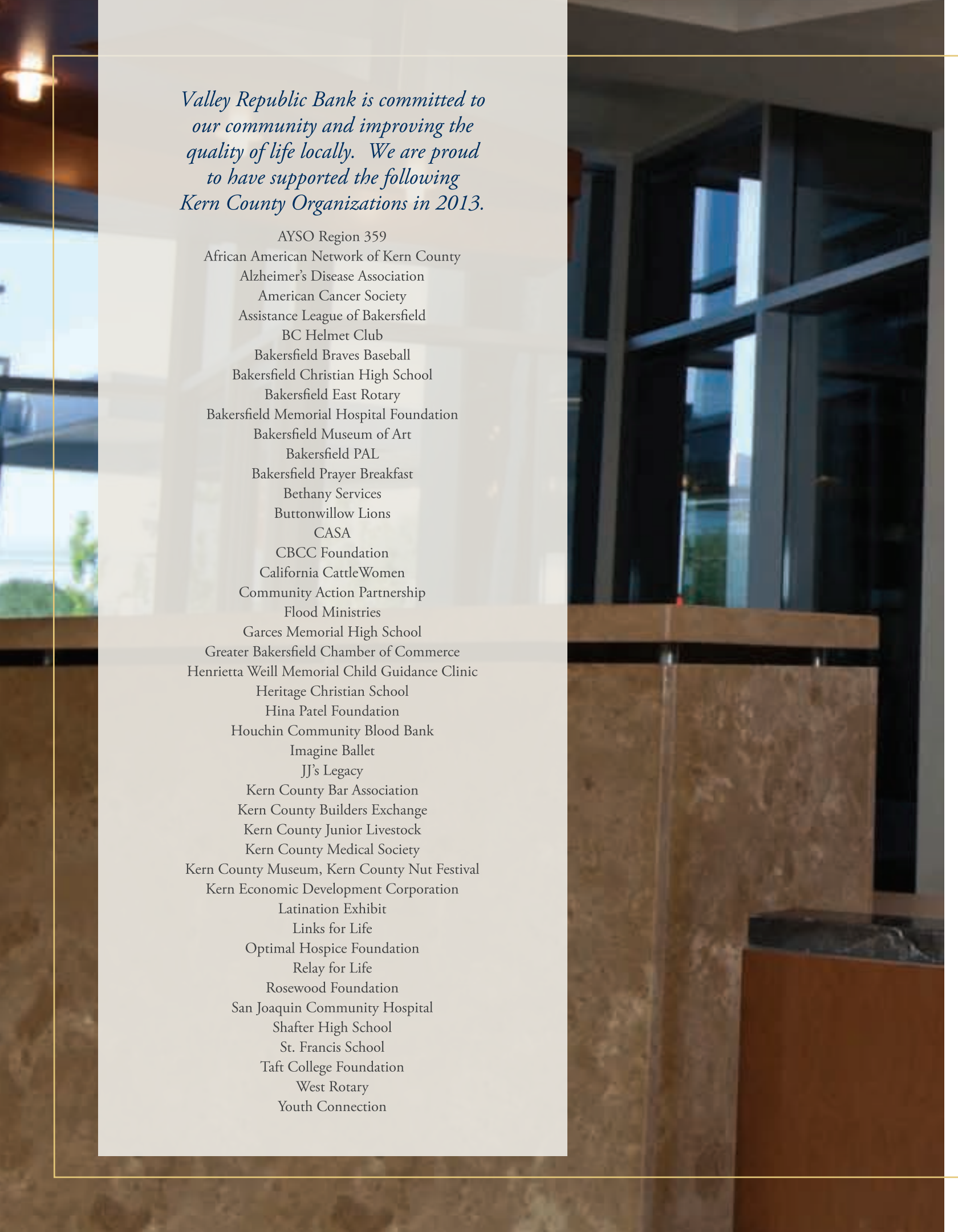
Prior to 2013, the financial statements (per accounting rules) did not reflect either a benefit or expense for federal and state income taxes. In addition to costs incurred prior to opening the Bank, VRB recorded an operating loss of approximately $2.5 million in 2009, followed by a small loss of $76,000 in 2010. These prior period losses, called "loss carry forwards", were utilized to offset taxable income generated by the Bank since becoming profitable in mid-2010. By March, 2013, the majority of these loss carry forwards had been absorbed which required an accrual entry for state and federal income tax expense. This was approximately $858,000 for 2013.

We are proud of the continued growth and progress of the Bank. There are several reasons for our success. Having the right people is critical! Since our inception just five years ago, we have hired, and continue to hire quality talent in every new position. Banking remains a "people" business and we have assembled an exceptional team at VRB. This team is focused on providing "uncommon" service to our customers on a consistent basis. As a result we have created a competitive advantage by providing exceptionally safe, reliable and responsive service to our customers. Our customers have confidence that their loan applications and general banking needs will be processed and completed in a timely manner.

Thanks to the overwhelming support of the community and the hard work and dedication of our Board of Directors, management and staff, VRB has achieved significant success during the first five years of operation. We thank each Shareholder for investing in our Bank, banking with us and referring friends and business associates.

We are fulfilling our commitment to building a safe, reliable and responsive bank that provides "uncommon" service to our customers. Together, we will achieve the coveted status as Bakersfield's premier bank.

BRUCE JAY, *President & CEO*
EUGENE (GENE) VOILAND, *Chairman of the Board*
Valley Republic Bank



Valley Republic Bank is committed to our community and improving the quality of life locally. We are proud to have supported the following Kern County Organizations in 2013.

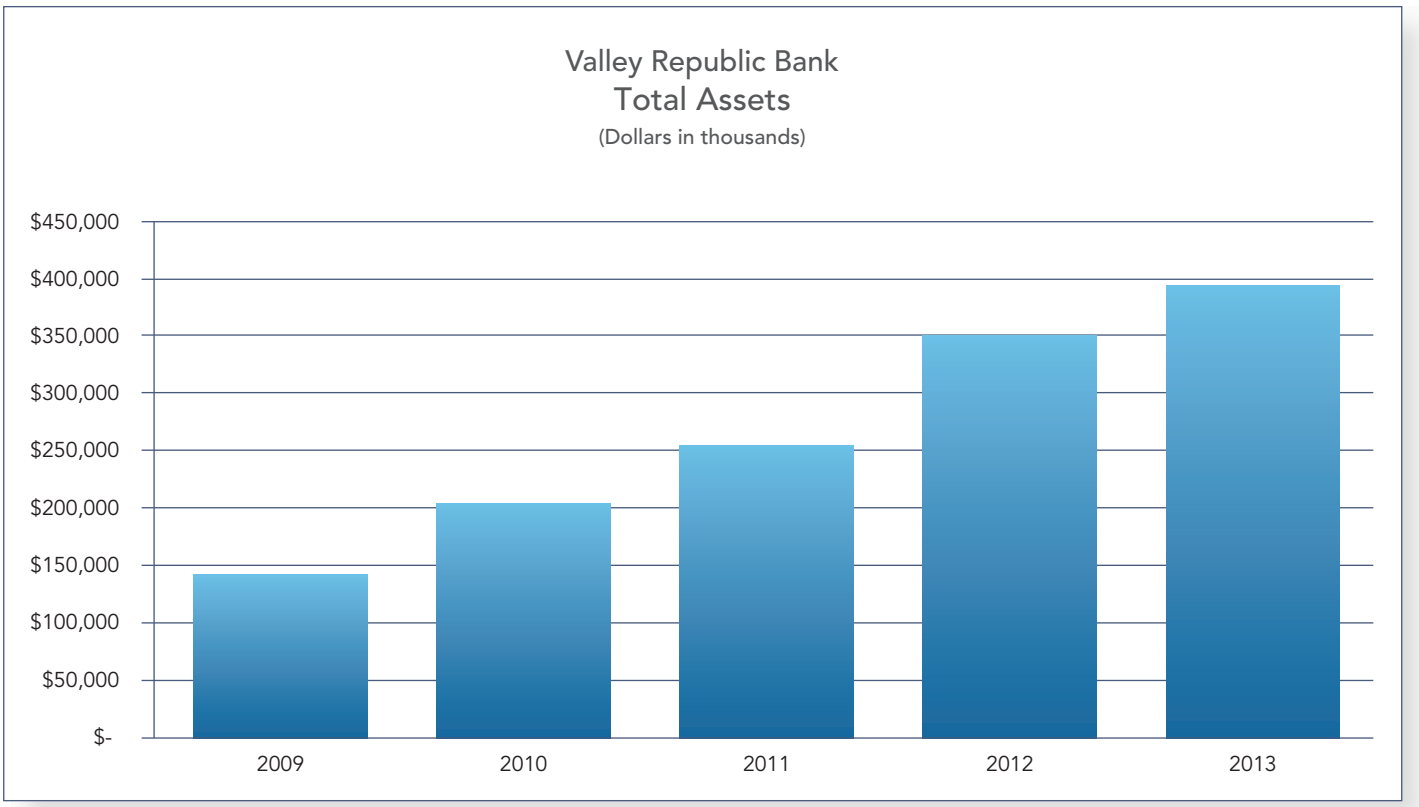
AYSO Region 359
African American Network of Kern County
Alzheimer's Disease Association
American Cancer Society
Assistance League of Bakersfield
BC Helmet Club
Bakersfield Braves Baseball
Bakersfield Christian High School
Bakersfield East Rotary
Bakersfield Memorial Hospital Foundation
Bakersfield Museum of Art
Bakersfield PAL
Bakersfield Prayer Breakfast
Bethany Services
Buttonwillow Lions
CASA
CBCC Foundation
California CattleWomen
Community Action Partnership
Flood Ministries
Garces Memorial High School
Greater Bakersfield Chamber of Commerce
Henrietta Weill Memorial Child Guidance Clinic
Heritage Christian School
Hina Patel Foundation
Houchin Community Blood Bank
Imagine Ballet
JJ's Legacy
Kern County Bar Association
Kern County Builders Exchange
Kern County Junior Livestock
Kern County Medical Society
Kern County Museum, Kern County Nut Festival
Kern Economic Development Corporation
Latination Exhibit
Links for Life
Optimal Hospice Foundation
Relay for Life
Rosewood Foundation
San Joaquin Community Hospital
Shafter High School
St. Francis School
Taft College Foundation
West Rotary
Youth Connection

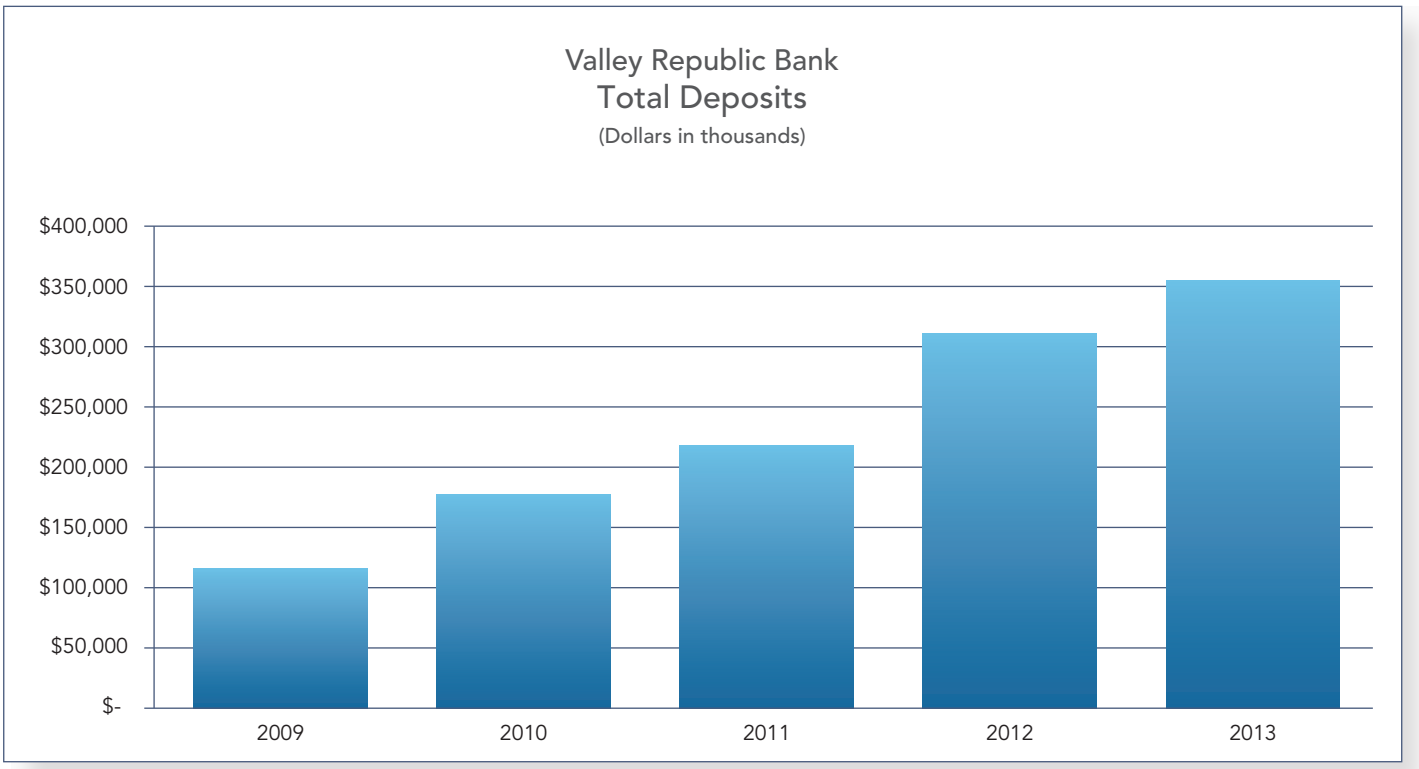


Jon Van Boening

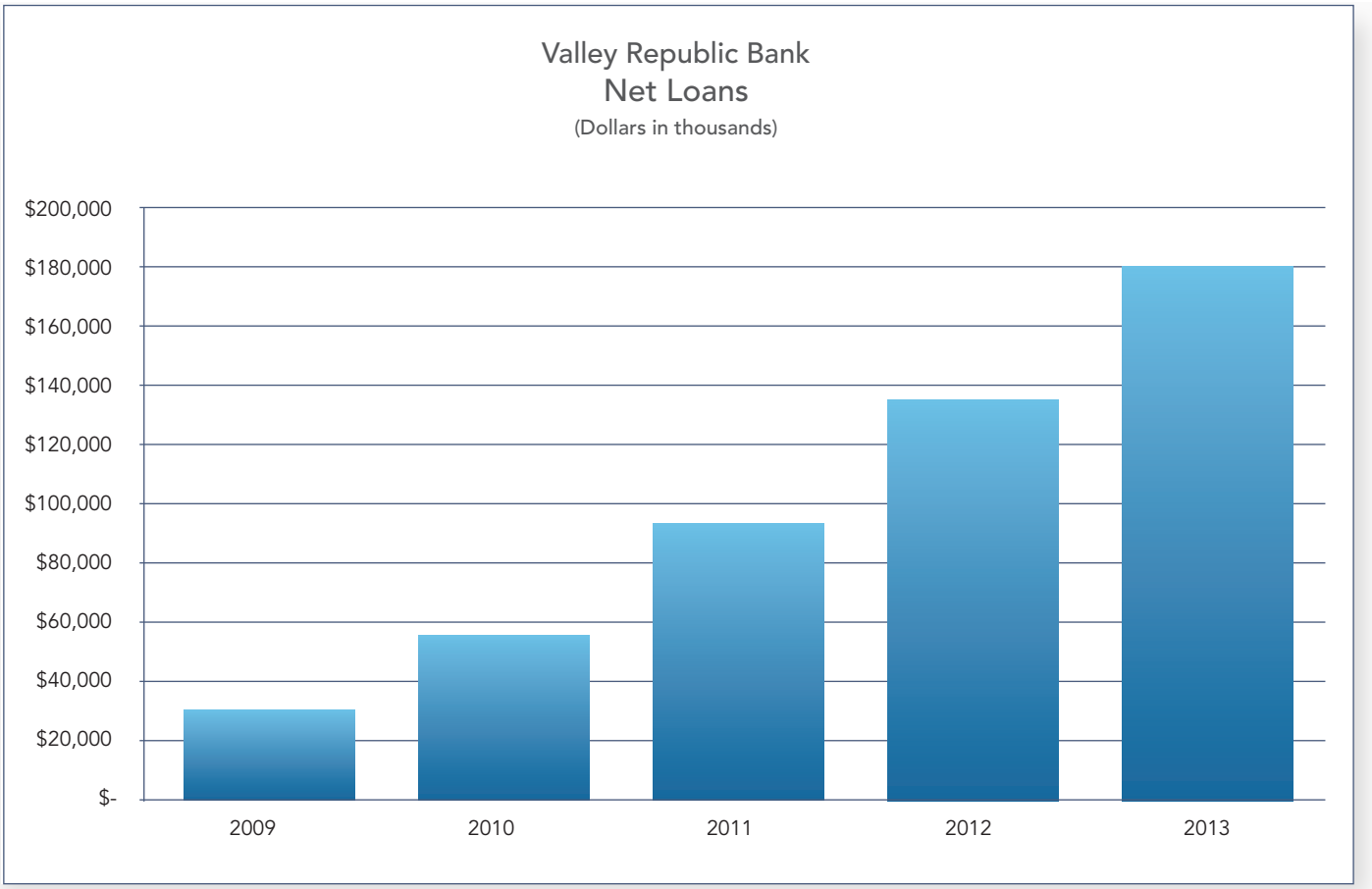
President and Chief Executive Officer
Memorial Hospital

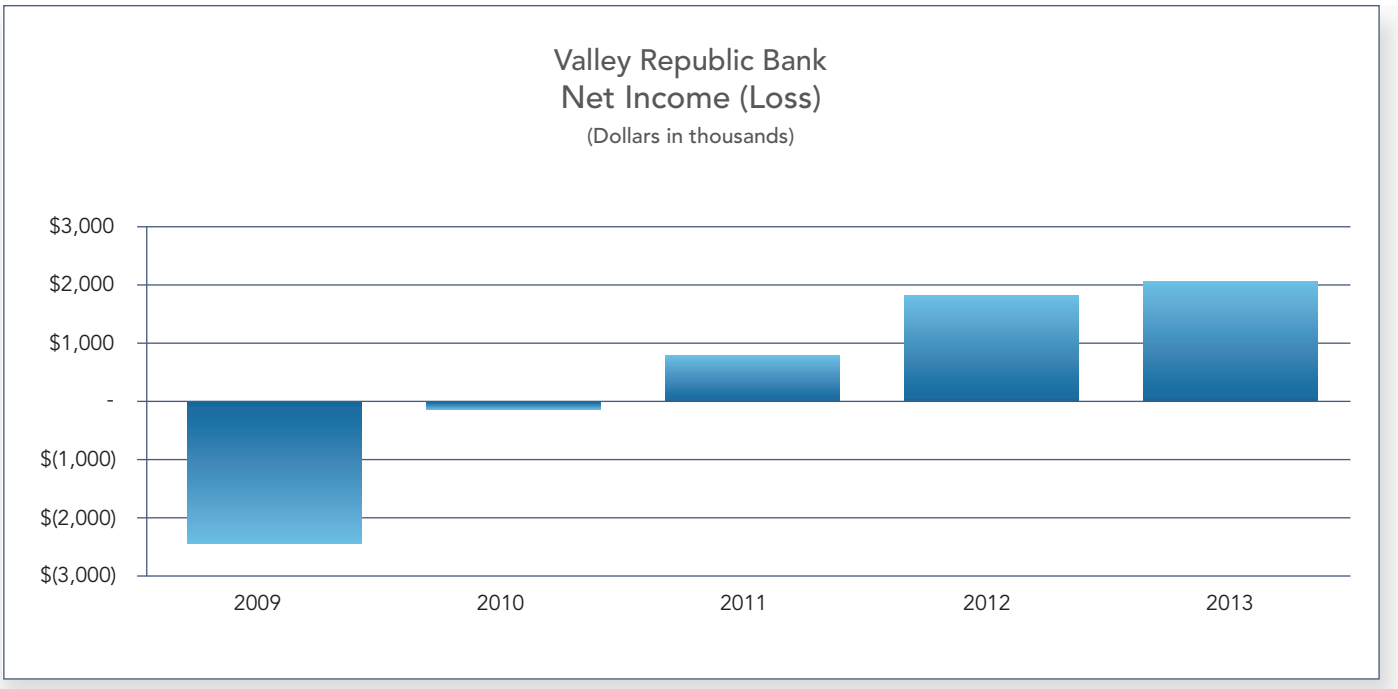
FINANCIAL HIGHLIGHTS





FINANCIAL HIGHLIGHTS







"Our local team understands this valley's agribusiness needs."

John Etchison

SVP - Agribusiness

Kern County agribusiness needs are unique – and so are the needs of your business. The success of your farm, ranch, dairy, vineyard, orchard or other agricultural entity depends on good, timely advice from local bankers who understand and care. Whether you're purchasing, refinancing, looking for a line of credit or funding for facilities expansion, Valley Republic Bank can help. We also originate and service Farmer Mac loans.

Left to right: Timothy Hay, Eliza Hernandez, John Etchison, Davin Jensen



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INDEPENDENT AUDITOR'S REPORT

Board of Directors and Shareholders of
Valley Republic Bank

Report on Financial Statements

We have audited the accompanying financial statements of Valley Republic Bank, which are comprised of the statements of financial condition as of December 31, 2013 and 2012, and the related statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these 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 from material misstatement.

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Valley Republic Bank as of December 31, 2013 and 2012, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Vavrinek, Trine, Day & Co., LLP

Laguna Hills, California
February 18, 2014

VALLEY REPUBLIC BANK

STATEMENTS OF FINANCIAL CONDITION
December 31, 2013 and 2012

	2013	2012
ASSETS		
Cash and Due from Banks	$ 5,617,000	$ 7,540,000
Interest-Bearing Deposits in Other Banks	19,890,000	42,165,000
Total Cash and Cash Equivalents	25,507,000	49,705,000
Time Deposits in Other Banks	6,367,000	12,665,000
Held-to Maturity Securities (Fair Value of $65,806,000 at December 31, 2013)	66,274,000	-
Available-for-Sale Securities	98,437,000	151,609,000
Total Investment Securities	164,711,000	151,609,000
Loans, Net of Deferred Fees and Costs	184,235,000	136,753,000
Allowance for Loan Losses	(2,827,000)	(2,355,000)
Net Loans	181,408,000	134,398,000
Premises and Equipment	1,248,000	1,306,000
Federal Home Loan Bank Stock, at Cost	1,954,000	1,611,000
Bank Owned Life Insurance	9,126,000	-
Accrued Interest and Other Assets	4,354,000	1,602,000
TOTAL ASSETS	$ 394,675,000	$ 352,896,000
LIABILITIES AND SHAREHOLDER'S EQUITY		
Deposits:		
Noninterest-Bearing	$ 117,332,000	$ 113,935,000
Interest-Bearing	238,786,000	200,175,000
Total Deposits	356,118,000	314,110,000
Accrued Interest and Other Liabilities	848,000	790,000
TOTAL LIABILITIES	356,966,000	314,900,000
Commitments and Contingencies - Note D and K		
Shareholders' Equity:		
Common Stock - No par value, 50,000,000 Shares Authorized,		
Shares Issued and Outstanding - 3,487,416 and 3,458,265 in 2013 at	36,706,000	36,433,000
Additional Paid-in Capital	1,783,000	1,723,000
Retained Earning (Deficit)	734,000	(1,323,000)
Accumulated Other Comprehensive Income (Loss) - Net Unrealized		
Gain (Loss) on Investment Securities, Net of Tax		
of $1,058,000 and $813,000 in 2013 and 2012, Respectively	(1,514,000)	1,163,000
TOTAL SHAREHOLDERS' EQUITY	37,709,000	37,996,000
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 394,675,000	$ 352,896,000

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

STATEMENTS OF INCOME

For the years ended December 31, 2013 and 2012

	2013	2012
ASSETS		
Interest and Fees on Loans	$ 7,436,000	$ 6,029,000
Interest on Investment Securities	2,376,000	2,426,000
Interest on Federal Funds Sold and Other	148,000	152,000
Total Interest Income	9,960,000	8,607,000
INTEREST EXPENSE		
Interest on Savings, NOW, and Money Market Accounts	785,000	682,000
Interest on Time Deposits	30,000	28,000
Total Interest Expense	815,000	710,000
Net Interest Income	9,145,000	7,897,000
Provision for Loan Losses	472,000	670,000
Net Interest Income After Provision for Loan Losses	8,673,000	7,227,000
NONINTEREST INCOME		
Service Charge and Fees on Deposit Accounts	230,000	171,000
Net Gain on Sales of Available-for-Sale Securities	103,000	316,000
Fees on Brokered Loans	171,000	45,000
Earnings on Bank Owned Life Insurance	154,000	-
Other Noninterest Income	219,000	40,000
Total Noninterest Income	877,000	572,000
NONINTEREST EXPENSE		
Salaries and Employee Benefits	3,809,000	3,223,000
Occupancy and Equipment Expense	698,000	614,000
Other Expenses	2,128,000	2,125,000
Total Noninterest Expense	6,635,000	5,962,000
Income Before Income Taxes	2,915,000	1,837,000
Income Taxes	858,000	-
NET INCOME	$ 2,057,000	$ 1,837,000
NET INCOME PER SHARE - BASIC	$ 0.59	$ 0.53
NET INCOME PER SHARE - DILUTED	$ 0.57	$ 0.52

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

VALLEY REPUBLIC BANK

STATEMENTS OF COMPPREHENSIVE INCOME
For the years ended December 31, 2013 and 2012

	2013	2012
Net Income	$ 2,057,000	$ 1,837,000
OTHER COMPREHENSIVE INCOME (LOSS):		
Unrealized Gain and Loss on Securites Available for Sale:		
Change in Net Unrealized Gain (Loss)	(4,445,000)	1,278,000
Reclassification of Gain Recognized in Net Income	(103,000)	(316,000)
	(4,548,000)	962,000
Income Tax Expense (Benefit):		
Change in Net Unrealized Gain (Loss)	(1,829,000)	462,000
Reclassification of Gain Recognized in Net Income	(42,000)	(114,000)
	(1,871,000)	348,000
TOTAL OTHER COMPREHENSIVE INCOME (LOSS)	(2,677,000)	614,000
TOTAL COMPREHENSIVE INCOME (LOSS)	$ (620,000)	$ 2,451,000

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



STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

For the years ended December 31, 2013 and 2012

	Common Stock				Accumulated	
	Number of Shares	Amount	Additional Paid-in Capital	Retained Earnings (Deficit)	Other Comprehensive Income (Loss)	Total
Balance January 1, 2012	3,458,265	$36,433,000	$1,237,000	$(3,160,000)	$ 549,000	$ 35,059,000
Net Income				1,837,000		1,837,000
Stock-based Compensation			486,000			486,000
Change in Other Comprehensive Income, Net of Taxes					614,000	614,000
Balance at December 31, 2012	3,458,265	36,433,000	1,723,000	(1,323,000)	1,163,000	37,996,000
Net Income				2,057,000		2,057,000
Stock-based Compensation			271,000			271,000
Vested Stock Awards	6,133	92,000	(92,000)			-
Exercise of Stock Options, Including Tax Benefits of $49,000	23,018	181,000	(119,000)			62,000
Change in Other Comprehensive Income, Net of Taxes					(2,677,000)	(2,677,000)
Balance at December 31, 2013	3,487,416	$36,706,000	$1,783,000	$ 734,000	$(1,514,000)	$ 37,709,000

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

VALLEY REPUBLIC BANK

STATEMENTS OF CASH FLOWS
For the years ended December 31, 2013 and 2012

	2013	2012
OPERATING ACTIVITIES		
Net Income	$ 2,057,000	$ 1,837,000
Adjustments to Reconcile Net Income to Net Cash		
From Operating Activities:		
Depreciation	215,000	190,000
Stock-based Compensation	271,000	486,000
Provision for Loan Losses	472,000	670,000
(Gain) Loss on Sale of Securities	(103,000)	(316,000)
Net Amortization of Premium on Securities	1,420,000	1,209,000
Net Increase in Bank Owned Life Insurance	(126,000)	-
Deferred Income Taxes	(381,000)	(799,000)
Other Items	(293,000)	(280,000)
Total Adjustments	1,475,000	1,160,000
Net Cash From Operating Activities	3,532,000	2,997,000
INVESTING ACTIVITIES		
Net (Increase) Decrease in Time Deposits in Other Banks	6,298,000	(401,000)
Net Increase in Loans to Customers	(47,631,000)	(47,345,000)
Purchase of Investment Securities	(56,189,000)	(66,873,000)
Maturities and Sales of Investment Securities	37,222,000	46,000,000
Purchase of Bank Owned Life Insurance	(9,000,000)	-
Purchase of Federal Home Loan Bank Stock	(343,000)	(257,000)
Purchase of Premises and Equipment	(157,000)	(626,000)
Net Cash From Investing Activities	(69,800,000)	(69,502,000)
FINANCING ACTIVITIES		
Net Increase in Demand Deposits and Savings Accounts	42,489,000	92,283,000
Net Increase (Decrease) in Time Deposits	(481,000)	1,567,000
Proceeds from Exercise of Stock Options including Tax Benefits	62,000	-
Net Cash From Financing Activities	42,070,000	93,850,000
Net Increase (Decrease) in Cash and Cash Equivalents	(24,198,000)	27,345,000
Cash and Cash Equivalents at Beginning of Period	49,705,000	22,360,000
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 25,507,000	$ 49,705,000
Supplemental Disclosures of Cash Flow Information:		
Interest Paid	$ 815,000	$ 712,000
Taxes Paid	$ 1,375,000	$ 915,000



NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

The Bank was incorporated in the State of California and organized as a single operating segment that operates two full-service branches in Bakersfield, California. The Bank's primary source of revenue is providing loans to customers, who are predominately small and middle-market businesses and individuals located primarily in Kern County, California.

Subsequent Events

The Bank has evaluated subsequent events for recognition and disclosure through February 18, 2014, which is the date the financial statements were available to be issued.

Use of Estimates in the Preparation of Financial Statements

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, 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.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash, due from banks and federal funds sold. Generally, federal funds are sold for periods of less than ninety days.

Cash and Due from Banks

Banking regulations require that banks maintain a percentage of their deposits as reserves in cash or on deposit with the Federal Reserve Bank. The Bank was in compliance with its reserve requirements as of December 31, 2013 and 2012.

The Bank maintains amounts due from banks, which may exceed federally insured limits. The Bank has not experienced any losses in such accounts.

Investment Securities

Bonds, notes, and debentures for which the Bank has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using the interest method over the period to maturity.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Investment Securities - Continued

Investments not classified as trading securities nor as held to maturity securities are classified as available-for-sale securities and recorded at fair value. Unrealized gains or losses on available-for-sale securities are excluded from net income and reported as an amount, net of taxes, as a separate component of other comprehensive income included in shareholders' equity. Premiums or discounts on held-to-maturity and available-for-sale securities are amortized or accreted into income using the interest method. Realized gains or losses on sales of held-to-maturity or available-for-sale securities are recorded using the specific identification method.

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: OTTI related to credit loss, which must be recognized in the income statement, and OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

Loans

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding unpaid principal balances reduced by any charge-offs or specific valuation accounts and net of deferred fees or costs on originated loans, or unamortized premiums or discounts on purchased loans. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan. Amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. The accrual of interest on loans is discontinued when principal or interest is past due 90 days based on the contractual terms of the loan or when, in the opinion of management, there is reasonable doubt as to collectibility. When loans are placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period interest income. Income on nonaccrual loans is subsequently recognized only to the extent that cash is received and the loan's principal balance is deemed collectible. Interest accruals are resumed on such loans only when they are brought current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectible as to all principal and interest.



NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Allowance for Loan Losses

The allowance for loan losses is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off. Amounts are charged-off when available information confirms that specific loans or portions thereof, are uncollectible. This methodology for determining charge-offs is consistently applied to each segment.

The Bank determines a separate allowance for each portfolio segment. The allowance consists of specific and general reserves. Specific reserves relate to loans that are individually classified as impaired. A loan is impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status, collateral value, and the probability of collecting all amounts when due. Measurement of impairment is based on the expected future cash flows of an impaired loan, which are to be discounted at the loan's effective interest rate, or measured by reference to an observable market value, if one exists, or the fair value of the collateral for a collateral-dependent loan. The Bank selects the measurement method on a loan-by-loan basis except that collateral-dependent loans for which foreclosure is probable are measured at the fair value of the collateral.

The Bank recognizes interest income on impaired loans based on its existing methods of recognizing interest income on nonaccrual loans. Loans, for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired with measurement of impairment as described above.

If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral.

General reserves cover non-impaired loans and are based on historical loss rates for each portfolio segment, adjusted for the effects of qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the portfolio segment's historical loss experience. Qualitative factors include consideration of the following: changes in lending policies and procedures; changes in economic conditions, changes in the nature and volume of the portfolio; changes in the experience, ability and depth of lending management and other relevant staff; changes in the volume and severity of past due, nonaccrual and other adversely graded loans; changes in the loan review system; changes in the value of the underlying collateral for collateral-dependent loans; concentrations of credit and the effect of other external factors such as competition and legal and regulatory requirements.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Allowance for Loan Losses - Continued

Portfolio segments identified by the Bank include real estate, commercial and industrial, agriculture and consumer loans. Relevant risk characteristics for these portfolio segments generally include debt service coverage, loan-to-value ratios and financial performance on non-consumer loans and debt-to income, collateral type and loan-to-value ratios for consumer loans.

Premises and Equipment

Premises and equipment are carried at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives, which ranges from three to seven years for furniture and equipment. Leasehold improvements are amortized using the straight-line method over the estimated useful lives of the improvements or the remaining lease term, whichever is shorter. Expenditures for betterments or major repairs are capitalized and those for ordinary repairs and maintenance are charged to operations as incurred.

Federal Home Loan Bank Stock ("FHLB")

The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on the ultimate recovery of par value. Both cash and stock dividends are reported as income.

Federal Agriculture Mortgage Association Stock ("Farmer Mac")

The Bank participates in the Farmer Mac I program. Participation in the program requires that lenders own a certain amount of stock based on the asset size of the Bank. Farmer Mac stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on the ultimate recovery of par value. Both cash and stock dividends are reported as income.

Bank Owned Life Insurance

Bank owned life insurance is recorded at the amount that can be realized under insurance contracts at the date of the statement of financial condition, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Advertising Costs

The Bank expenses the costs of advertising in the period incurred.



NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Income Taxes

Deferred income taxes are computed using the asset and liability method, which recognizes a liability or asset representing the tax effects, based on current tax law, of future deductible or taxable amounts attributable to events that have been recognized in the financial statements. A valuation allowance is established to reduce the deferred tax asset to the level at which it is "more likely than not" that the tax asset or benefits will be realized. Realization of tax benefits of deductible temporary differences and operating loss carryforwards depends on having sufficient taxable income of an appropriate character within the carryforward periods.

The Bank has adopted guidance issued by the Financial Accounting Standards Board ("FASB") that clarifies the accounting for uncertainty in tax positions taken or expected to be taken on a tax return and provides that the tax effects from an uncertain tax position can be recognized in the financial statements only if, based on its merits, the position is more likely than not to be sustained on audit by the taxing authorities. Interest and penalties related to uncertain tax positions are recorded as part of income tax expense.

Comprehensive Income

Changes in unrealized gains and losses on investment securities is the only component of accumulated other comprehensive income for the Bank. The amount reclassified out of other accumulated comprehensive income relating to realized gains on securities available for sale was $103,000 and $316,000 for 2013 and 2012, with the related tax effect of $42,000 and $114,000, 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, commercial letters of credit, and standby letters of credit as described in Note K. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

Stock-Based Compensation

The Bank recognizes the cost of employee services received in exchange for awards of stock options, or other equity instruments, based on the grant-date fair value of those awards. This cost is recognized over the period which an employee is required to provide services in exchange for the award, generally the vesting period. See Note M for additional information on the Bank's stock option plan.

Earnings Per Share ("EPS")

Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Reclassifications

Certain reclassifications have been made in the 2012 financial statements to conform to the presentation used in 2013. These reclassifications had no impact on the Bank's previously reported financial statements.

Fair Value Measurement

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Current accounting guidance establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance describes three levels of inputs that may be used to measure fair value:

> Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
>
> Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
>
> Level 3: Significant unobservable inputs that reflect a Bank's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

See Note N for more information and disclosures relating to the Bank's fair value measurements.

Adoption of New Accounting Standards

In February 2013, the Financial Accounting Standards Board issued Accounting Standards Update 2013-02, *Comprehensive Income* ("Topic 220") - *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income* ("ASU 2013-02"). This ASU requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under Generally Accepted Accounting Principles ("GAAP") to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under GAAP that provide additional detail about those amounts. ASU 2013-02 is effective prospectively for annual and interim periods beginning after December 15, 2012 for public entities and annual periods beginning after December 15, 2013 for nonpublic entities. The adoption of this ASU did not have a material impact on the Bank's financial position, results of operations, or cash flows.

NOTE B - INVESTMENT SECURITIES

Debt and equity securities have been classified in the balance sheet according to management's intent. The amortized cost of securities and their approximate fair values at December 31 were as follows:

December 31, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held-to-Maturity Securities				
U.S. Government and Agency Securities	$ 47,894,000	$ -	$ -	$ 47,894,000
Municipal Securities	18,380,000	26,000	(494,000)	17,912,000
Total Held-to-Maturity Securities	66,274,000	26,000	(494,000)	65,806,000
Available-for-Sale Securities:				
Mortgaged-Backed Securities	93,846,000	489,000	(964,000)	93,371,000
Corporate Securities	5,060,000	18,000	(12,000)	5,066,000
Total Available-for-Sale Securities	98,906,000	507,000	(976,000)	98,437,000
Total Investments Securities	$ 165,180,000	$ 533,000	$(1,470,000)	$ 164,243,000

December 31, 2012				
Available-for-Sale Securities:				
U.S. Government and Agency Securities	$ 25,000,000	$ 22,000	$(14,000)	$ 25,008,000
Mortgaged-Backed Securities	121,492,000	2,001,000	(48,000)	123,445,000
Corporate Securities	3,141,000	15,000	-	3,156,000
	$ 149,633,000	$ 2,038,000	$(62,000)	$ 151,609,000

As of December 31, 2013 the Bank reclassified its U.S. Government and Agency securities from available-for-sale to held-to-maturity. At the time of the reclassification the amortized cost was $49,997,000 with a fair value of $47,894,000.

NOTE B - INVESTMENT SECURITIES - Continued

The amortized cost and estimated fair value of all investment securities as of December 31, 2013 by expected maturities are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value
Held-to-Maturity Securities		
Due within One Year	$ 21,643,000	$ 21,643,000
Due from One to Five Years	19,155,000	19,082,000
Due from Five to Ten Years	23,196,000	22,857,000
Due after Ten Years	2,280,000	2,224,000
Total Held-to-Maturity Securities	66,274,000	65,806,000
Available-for-Sale Securities		
Due within One Year	$ 21,491,000	$ 21,517,000
Due from One to Five Years	47,318,000	47,289,000
Due from Five to Ten Years	27,728,000	27,262,000
Due after Ten Years	2,369,000	2,369,000
Total Available-for-Sale Securities	98,906,000	98,437,000
Total Investment Securities	$ 165,180,000	$ 164,243,000

NOTE B - INVESTMENT SECURITIES - Continued

At December 31, 2013 and 2012, the Company had fifty-eight and seven securities with unrealized losses, respectively. The following table presents information pertaining to these securities aggregated by investment category and length of time that individual securities have been in a continuous loss position:

	Less than Twelve Months		Twelve Months or More		Total	
December 31, 2013	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value
U.S. Government and Agency Securities	$(2,103,000)	$ 47,894,000	$ -	$ -	$(2,103,000)	$ 47,894,000
Mortgaged-Backed Securities	(753,000)	39,136,000	(211,000)	8,018,000	(964,000)	47,154,000
Corporate Securites	(12,000)	1,988,000	-	-	(12,000)	1,988,000
Municipal Securities	(494,000)	15,815,000	-	-	(494,000)	15,815,000
	$(3,362,000)	$ 104,833,000	$(211,000)	$ 8,018,000	$(3,573,000)	$ 112,851,000
December 31, 2012						
U.S. Government and Agency Securities	$(14,000)	$ 7,486,000	$ -	$ -	$(14,000)	$ 7,486,000
Mortgaged-Backed Securities	(48,000)	14,970,000	-	-	(48,000)	14,970,000
	$(62,000)	$ 22,456,000	$ -	$ -	$(62,000)	$ 22,456,000

As of December 31, 2013, the Bank had fifty-eight securities where the estimated fair value had decreased 3.1% from the Bank's amortized cost. The decrease in price is due to changes in interest rates and does not have any credit components or other loss components. Management has the intent and ability to retain its investment for a period of time sufficient to allow for any anticipated recovery. The fair value is expected to recover as the bonds approach maturity.

Gross realized gains and losses on sales of available-for-sale securities were $126,000 and $(23,000) in 2013, respectively. Proceeds from the sales of available-for-sale securities during 2013 were $8,051,000.

Gross realized gains and (losses) on sales of available-for-sale securities were $316,000 and $0 in 2012, respectively. Proceeds from the sales of available-for-sale securities during 2012 were $11,698,000.

The Bank has pledged investment securities with a market value of $28,178,000 as collateral for a line of credit with FHLB. See Note F for more information and disclosures relating to this borrowing line.

NOTE C - LOANS

The Bank's loan portfolio consists primarily of loans to borrowers within Kern County. Although the Bank seeks to avoid concentrations of loans to a single industry or based upon a single class of collateral, real estate and real estate associated businesses are among the principal industries in the Bank's market area and, as a result, the Bank's loan and collateral portfolios are, to some degree, concentrated in those industries.

At December 31, the composition of the loan portfolio is as follows:

	2013	2012
Real Estate:		
Construction and Land Development	$ 11,717,000	$ 5,646,000
1-4 Family Residential	24,409,000	15,626,000
Multifamily Residential	1,358,000	300,000
Secured by Farm Land	15,038,000	9,537,000
Commerical Real Estate	75,135,000	57,169,000
Total Real Estate Loans	127,657,000	88,278,000
Commerical and Industrial	42,375,000	38,342,000
Agriculture	12,324,000	7,467,000
Consumer and Other	1,891,000	2,529,000
Total Loans	184,247,000	136,616,000
Deferred Loan Fees, Net of Costs	(12,000)	137,000
Loans, Net of Deferred Fees and Costs	184,235,000	136,753,000
Allowance for Loan Losses	(2,827,000)	(2,355,000)
Net Loans	$ 181,408,000	$ 134,398,000

A summary of the changes in the allowance for loan losses as of December 31 follows:

	2013	2012
Balance at Beginning of Year	$ 2,355,000	$ 1,685,000
Additions to the Allowance Charged to Expense	472,000	670,000
Recoveries on Loans Charged Off	-	-
	2,827,000	2,355,000
Less Loans Charged Off	-	-
	$ 2,827,000	$ 2,355,000



NOTE C - LOANS - Continued

The following table presents the activity in the allowance for loan losses for the year 2013 and 2012, and the recorded investment in loans and impairment method as of December 31, 2013 and 2012 by portfolio segment:

December 31, 2013	Real Estate	Commercial and Industrial	Agriculture	Consumer	Total
Allowance for Loan Losses					
Beginning of Year	$ 1,268,000	$ 904,000	$ 123,000	$ 60,000	$ 2,355,000
Provisions	483,000	5,000	(1,000)	(15,000)	472,000
Charge-offs	-	-	-	-	-
Recoveries	-	-	-	-	-
End of Year	$ 1,751,000	$ 909,000	$ 122,000	$ 45,000	$ 2,827,000
Reserves:					
Specific	$ -	$ -	$ -	$ -	$ -
General	1,751,000	909,000	122,000	45,000	2,827,000
	$ 1,751,000	$ 909,000	$ 122,000	$ 45,000	$ 2,827,000
Loans Evaluated for Impairment:					
Individually	$ 264,000	$ -	$ -	$ -	$ 264,000
Collectively	127,393,000	42,375,000	12,324,000	1,891,000	183,983,000
	$ 127,657,000	$ 42,375,000	$ 12,324,000	$ 1,891,000	$ 184,247,000
December 31, 2012					
Allowance for Loan Losses					
Beginning of Year	$ 818,000	$ 851,000	$ 4,000	$ 12,000	$ 1,685,000
Provisions	450,000	53,000	119,000	48,000	670,000
Charge-offs					
Recoveries					
End of Year	$ 1,268,000	$ 904,000	$ 123,000	$ 60,000	$ 2,355,000
Reserves:					
Specific	$ -	$ -	$ -	$ -	$ -
General	1,268,000	904,000	123,000	60,000	2,355,000
	$ 1,268,000	$ 904,000	$ 123,000	$ 60,000	$ 2,355,000
Loans Evaluated for Impairment:					
Individually	$ 270,000	$ -	$ -	$ -	$ 270,000
Collectively	88,008,000	38,342,000	7,467,000	2,529,000	136,346,000
	$ 88,278,000	$ 38,342,000	$ 7,467,000	$ 2,529,000	$ 136,616,000

NOTE C - LOANS - Continued

The Bank categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as current financial information, historical payment experience, collateral adequacy, credit documentation, and current economic trends, among other factors. The Bank analyzes loans individually by classifying the loans as to credit risk. This analysis typically includes larger, non-homogeneous loans such as commercial real estate and commercial and industrial loans. This analysis is performed on an ongoing basis as new information is obtained. The Bank uses the following definitions for risk ratings:

Pass - Loans classified as pass include loans not meeting the risk ratings defined below.

Special Mention - Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

Substandard - Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Impaired - A loan is considered impaired, when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Additionally, all loans classified as troubled debt restructurings are considered impaired.

The risk category of loans by class of loans was as follows as of December 31, 2013:

December 31, 2013	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
Construction and Land Development	$ 11,717,000	$ -	$ -	$ -	$ 11,717,000
1-4 Family Residential	24,145,000	-	-	264,000	24,409,000
Multifamily Residential	1,358,000	-	-	-	1,358,000
Secured by Farm Land	15,038,000	-	-	-	15,038,000
Commercial Real Estate	75,135,000	-	-	-	75,135,000
Commerical and Industrial	42,074,000	301,000	-	-	42,375,000
Agriculture	12,324,000	-	-	-	12,324,000
Consumer and Other	1,891,000	-	-	-	1,891,000
	$ 183,682,000	$ 301,000	$ -	$264,000	$ 184,247,000



NOTE C - LOANS - Continued

The risk category of loans by class of loans was as follows as of December 31, 2012:

December 31, 2012	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
Construction and Land Development	$ 5,646,000	$ -	$ -	$ -	$ 5,646,000
1-4 Family Residential	15,356,000	-	-	270,000	15,626,000
Multifamily Residential	300,000	-	-	-	300,000
Secured by Farm Land	9,537,000	-	-	-	9,537,000
Commercial Real Estate	57,169,000	-	-	-	57,169,000
Commerical and Industrial	38,342,000	-	-	-	38,342,000
Agriculture	7,467,000	-	-	-	7,467,000
Consumer and Other	2,529,000	-	-	-	2,529,000
	$136,346,000	$ -	$ -	$270,000	$136,616,000

Past due and nonaccrual loans presented by loan class were as follows as of December 31, 2013:

	Still Accruing			
December 31, 2013	30-59 Days Past Due	60-89 Days Past Due	Over 90 Days Past Due	Nonaccrual
Real Estate:				
Construction and Land Development	$ -	$ -	$ -	$ -
1-4 Family Residential	-	-	-	264,000
Multifamily Residential	-	-	-	-
Secured by Farm Land	-	-	-	-
Commercial Real Estate	-	-	-	-
Commerical and Industrial	-	-	-	-
Agriculture	-	-	-	-
Consumer	-	-	-	-
	$ -	$ -	$ -	$ 264,000

NOTE C - LOANS - Continued

Past due and nonaccrual loans presented by loan class were as follows as of December 31, 2012:

December 31, 2012	Still Accruing 30-59 Days Past Due	60-89 Days Past Due	Over 90 Days Past Due	Nonaccrual
Real Estate:				
Construction and Land Development	$ -	$ -	$ -	$ -
1-4 Family Residential	-	-	-	270,000
Multifamily Residential	-	-	-	-
Secured by Farm Land	-	-	-	-
Commercial Real Estate	-	-	-	-
Commerical and Industrial	-	-	-	-
Agriculture	-	-	-	-
Consumer	-	-	-	-
	$ -	$ -	$ -	$ 270,000

Information relating to individually impaired loans presented by class of loans was as follows as of December 31, 2013:

December 31, 2013	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
With No Allowance Recorded					
Real Estate:					
Construction and Land Development	$ -	$ -	$ -	$ -	$ -
1-4 Family Residential	278,000	264,000	-	267,000	12,000
Multifamily Residential	-	-	-	-	-
Secured by Farm Land	-	-	-	-	-
Commercial Real Estate	-	-	-	-	-
Commerical and Industrial	-	-	-	-	-
Agriculture	-	-	-	-	-
Consumer	-	-	-	-	-
	$ 278,000	$ 264,000	$ -	$ 267,000	$ 12,000



NOTE C - LOANS - Continued

Information relating to individually impaired loans presented by class of loans was as follows as of December 31, 2012:

December 31, 2012	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
With No Allowance Recorded					
Real Estate:					
Construction and Land Development	$ -	$ -	$ -	$ -	$ -
1-4 Family Residential	283,000	270,000	-	274,000	-
Multifamily Residential	-	-	-	-	-
Secured by Farm Land	-	-	-	-	-
Commercial Real Estate	-	-	-	-	-
Commerical and Industrial	-	-	-	-	-
Agriculture	-	-	-	-	-
Consumer	-	-	-	-	-
	$ 283,000	$ 270,000	$ -	$ 274,000	$ -

The Bank has no allocated specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2013 and 2012. The Bank has committed to lend no additional amounts to customers with outstanding loans that are classified as troubled debt restructurings as of December 31, 2013.

No loans have been modified during 2013. During the year ended December 31, 2012, the terms of a certain loan were modified as a troubled debt restructuring. The modification of the terms of this loan included an extension of the maturity date at a reduced stated rate of interest that was lower than the current market rate for new debt with similar risk. At the date of restructuring, the new loan had a stated final maturity of five years and an amortization period of twenty years, with principal and interest due monthly. The restructuring also involved converting the loan from an unsecured commercial extension of credit to a loan secured by 1-4 family real estate. While the restructured loan also resulted in an additional extension of credit to the borrower, this was done in order to pay off another loan that was secured by the real estate collateral so that the bank would have a first lien against the property. Management believes that the restructured terms improve the loan's probability of repayment. Since the restructuring, the loan has been performing in accordance with its modified terms.

There were no troubled debt restructurings for which there was a payment default within twelve months following the modification during the period ended December 31, 2013 and 2012. A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms.

NOTE C - LOANS - Continued

The following table presents loans by class modified as troubled debt restructurings that occurred during the period ended December 31, 2012:

	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Real Estate:			
Construction and Land Development	-	$ -	$ -
1-4 Family Residential	1	244,000	287,000
Multifamily Residential	-	-	-
Secured by Farm Land	-	-	-
Commercial Real Estate	-	-	-
Commerical and Industrial	-	-	-
Agriculture	-	-	-
Consumer	-	-	-
	1	$ 244,000	$ 287,000

NOTE D - PREMISES AND EQUIPMENT

A summary of premises and equipment as of December 31 follows:

	2013	2012
Furniture, Fixtures, and Equipment	$ 1,084,000	$ 952,000
Leasehold Improvements	1,128,000	1,103,000
	2,212,000	2,055,000
Less Accumulated Depreciation and Amortization	(964,000)	(749,000)
	$ 1,248,000	$ 1,306,000

The Bank has entered into two leases for its main office and additional suite, which will expire in February 2018 and November 2016, respectively. These leases include provisions for periodic rent increases as well as payment by the lessee of certain operating expenses. These leases also include provisions for options to extend the lease. The Bank has leased a branch location from a Limited Liability Company which includes a director as a member. The lease commenced in 2012 and will expire ten years after the commencement of the lease. Refer to Note I – Related Party Transactions, for additional information regarding this lease. Rental expense relating to these leases and other short term rentals was approximately $330,000 and $300,000 for the years ended December 31, 2013 and 2012, respectively.



NOTE D - PREMISES AND EQUIPMENT - Continued

At December 31, 2013, the future lease rental payable under noncancellable operating lease commitments for the Bank's main office and additional suite was as follows:

	Related Party	Other
2014	$ 77,000	$ 268,000
2015	77,000	280,000
2016	77,000	281,000
2017	80,000	194,000
2018	89,000	32,000
Thereafter	332,000	-
	$ 732,000	$ 1,055,000

The minimum rental payments shown above are given for the existing lease obligation and are not a forecast of future rental expense.

NOTE E - DEPOSITS

Deposits consist of the following at December 31:

	2013	2012
Deposits:		
Noninterest-bearing Demand	$ 117,332,000	$ 113,935,000
Savings, NOW and Money Market Accounts	233,263,000	194,171,000
Time Deposits Under $100,000	532,000	1,022,000
Time Deposits $100,000 and Over	4,991,000	4,982,000
Total Deposits	$ 356,118,000	$ 314,110,000

At December 31, 2013, the scheduled maturities of time deposits are as follows:

2014	$ 3,998,000
2015	777,000
2016	613,000
2017	135,000
	$ 5,523,000

NOTE E - DEPOSITS - Continued

The Bank's ten largest deposit relationships represent approximately 36.8% of the total outstanding deposits of the Bank. Within this group, the five largest relationships represent approximately 27.2% of the Bank's total deposits.

Banks are required to maintain reserves with the Federal Reserve Bank equal to a specified percentage of their reservable deposits, less vault cash. The reserve balances maintained at the Federal Reserve Bank at December 31, 2013 and 2012, were $4,952,000 and $3,824,000, respectively.

NOTE F - OTHER BORROWINGS

The Bank may borrow up to $25,000,000 overnight on an unsecured basis from two correspondent banks. As of December 31, 2013 and 2012, no amounts were outstanding under these arrangements.

As of December 31, 2013, the Bank had an available line of credit with the Federal Home Loan Bank of San Francisco ("FHLB") secured by the assets of the Bank. Under this line, the Bank may borrow up to $26,769,000 subject to providing adequate collateral and continued compliance with the Advances and Security Agreement and other eligibility requirements established by the FHLB. The Bank has pledged investment securities with a market value of $28,178,000 as collateral for this line. As of December 31, 2013 no advances were outstanding under this arrangement.

NOTE G - INCOME TAXES

The provision for income taxes for the years ended December 31, consists of the following:

	2013	2012
Current:		
Federal	$ 919,000	$ 718,000
State	320,000	81,000
	1,239,000	799,000
Deferred	(381,000)	(799,000)
	$ 858,000	$ -



NOTE G - INCOME TAXES - Continued

Deferred taxes are a result of differences between income tax accounting and generally accepted accounting principles with respect to income and expense recognition. The following is a summary of the components of the net deferred tax asset accounts recognized in the accompanying statement of financial condition at December 31:

	2013	2012
Deferred Tax Assets:		
Pre-Opening Expenses	$ 342,000	$ 376,000
Allowance for Loan Losses Due to Tax Limitations	854,000	660,000
Market Value Adjustment on Investment Securities	1,058,000	-
Stock-Based Compensation	432,000	413,000
Other Assets and Liabilities	253,000	257,000
	2,939,000	1,706,000
Valuation Allowance	-	(262,000)
Deferred Tax Liabilities:		
Depreciation Differences	(150,000)	(152,000)
Market Value Adjustment on Investment Securites	-	(813,000)
Other Assets and Liabilites	(375,000)	(317,000)
	(525,000)	(1,282,000)
Net Deferred Tax Assets (Liabilities)	$ 2,414,000	$ 162,000

In 2012, the valuation allowance was established because the Bank had not reported earnings sufficient enough to support the full recognition of the deferred tax assets. The Bank does not expect the total amount of unrecognized tax benefits to significantly increase or decrease within the next twelve months.

The Bank is subject to federal income tax and franchise tax of the state of California. Income tax returns for the years ending after December 31, 2009 and 2008 are open to audit by the federal and state authorities, respectively.

The Bank realized benefits from the use of net operating loss carryforwards in the amount of $441,000 during 2012.

NOTE G - INCOME TAXES - Continued

A comparison of the federal statutory income tax rates to the Bank's effective income tax rates follows:

	2013		2012	
	Amount	Rate	Amount	Rate
Deferred Tax Assets:	$ 991,000	34.0%	$ 625,000	34.0%
State Tax, Net of Federal Benefit	203,000	7.0%	149,000	8.1%
Valuation Allowance	(262,000)	(9.0%)	(857,000)	(46.6%)
Tax Free Income	(95,000)	(3.3%)	-	-
Stock-Based Compensation	40,000	1.4%	80,000	4.4%
Other Items, Net	(19,000)	(0.7%)	3,000	0.1%
	$ 858,000	29.4%	$ -	0.0%

NOTE H - OTHER EXPENSES

Other expenses as of December 31 are comprised of the following:

	2013	2012
Professional Fees	$ 265,000	$ 266,000
Data Processing	533,000	517,000
Stock Bases Compensation	139,000	157,000
Office Expenses	181,000	168,000
Marketing and Business Promotion	240,000	309,000
Insurance	139,000	117,000
Other Expenses	631,000	591,000
	$ 2,128,000	$ 2,125,000

NOTE I - RELATED PARTY TRANSACTIONS

In the ordinary course of business, the Bank has extended credit to and received deposits from certain members of its Board of Directors and Executive Officers and companies in which they have an interest. These related parties had outstanding deposits at the Bank approximating $25,758,000 and $16,836,000, and outstanding loans of $7,616,000 and $7,640,000, at December 31, 2013 and 2012, respectively.

With regard to the lease for the branch, as discussed in Note D, independent counsel represented the Bank in the lease negotiations and the director's involvement was made known to the Board of Directors. The director abstained from the discussions regarding the branch lease as well as the vote on the lease. The Board believes that the terms of the lease are no less favorable to the Bank than could have been obtained from an independent third party.



NOTE J - EARNINGS PER SHARE ("EPS")

The following is a reconciliation of net income and shares outstanding to the income and number of shares used to compute EPS:

	2013		2012	
	Income	Shares	Income	Shares
Net Income as Reported	$ 2,057,000		$ 1,837,000	
Weighted Average Shares Outstanding During the Year		3,472,277		3,458,265
Used in Basic EPS	2,057,000	3,472,277	1,837,000	3,458,265
Dilutive Effect of Outstanding Stock Options and Stock Grants		157,307		83,625
Used in Dilutive EPS	$ 2,057,000	3,629,584	$ 1,837,000	3,541,890

At December 31, 2013 and 2012 there were 10,000 and 46,000 stock options, respectively, that could potentially dilute earnings per share in the future that were not included in the computation of diluted earnings per share because to do so would have been antidilutive.

NOTE K - COMMITMENTS

In the ordinary course of business, the Bank enters into financial commitments to meet the financing needs of its customers. Those instruments involve, to varying degrees, elements of credit and interest rate risk not recognized in the Bank's financial statements.

The Bank's exposure to loan loss in the event of nonperformance on commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments as it does for loans reflected in the financial statements.

As of December 31, 2013 and 2012, the Bank had the following outstanding financial commitments whose contractual amount represents credit risk:

	2013	2012
Commitments to Extend Credit	$ 63,428,000	$ 45,639,000

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. Since many of the commitments are expected to expire without being drawn upon, the total amounts do not necessarily represent future cash requirements. The Bank evaluates each client's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank, is based on management's credit evaluation of the customer. The majority of the Bank's commitments to extend credit and standby letters of credit are secured by real estate, equipment, or personal property.

NOTE K - COMMITMENTS - Continued

During 2013 the Bank entered into deferred compensation agreements with certain key officers. Under these agreements the Bank is obligated to provide, upon retirement a 15 year benefit to the officers. The annual benefits range from $75,000 to $100,000. The Bank expenses annually an amount sufficient to accrue the present value of the benefits to be paid to the officer. The expense associated with these agreements was approximately $137,000 in 2013.

NOTE L - EMPLOYEE BENEFIT PLAN

The Bank adopted a 401(k) Plan for its employees in 2010. Under the plan, eligible employees may defer a portion of their salaries. The plan also provides for a matching contribution by the Bank. The Bank made contributions of $71,000 and $65,000 for 2013 and 2012, respectively.

NOTE M - STOCK-BASED COMPENSATION

The Bank's 2008 Stock Option Plan was approved by its shareholders in February 2009. Under the terms of the 2008 Stock Option Plan, officers and key employees may be granted both nonqualified and incentive stock options and directors and organizers, who are not also an officer or employee, may only be granted nonqualified stock options. The Plan provides for options to purchase 737,937 shares of common stock at a price not less than 100% of the fair market value of the stock on the date of the grant. Stock options expire no later than ten years from the date of the grant and generally vest over three to five years. The Plan provides for accelerated vesting if there is a change of control, as defined in the Plan.

During 2013 the Board of Directors adopted the Valley Republic 2013 Restricted Share Plan ("Restricted Share Plan"). Under the terms of the Restricted Share Plan, awards of restricted stock may be granted to employees and directors of the Bank. The Restricted Share Plan provides for 299,542 shares of common stock that may be awarded. The shares will be issued upon vesting of the award. The awards generally will vest after the passage of time or performance criteria. The Restricted Share Plan provides for accelerated vesting if there is a change of control as defined in the Plan. The Restricted Share Plan expires in 2023.

The Bank recognized stock-based compensation expense of $271,000 and $486,000 in 2013 and 2012, respectively. The Bank also recognized income tax benefits related to stock-based compensation of $62,000 in 2013 and $103,000 in 2012.



NOTE M – STOCK-BASED COMPENSATION - Continued

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model with the weighted-average assumptions presented below:

	2012
Expected Volatility	25.6%
Expected Term	6.25 Yrs
Expected Dividends	None
Risk Free Rate	1.19%
Weighted-Average Grant Date Fair Value	$ 3.77

Since the Bank has a limited amount of historical stock activity the expected volatility is based on the historical volatility of similar banks that have a longer trading history. The expected term represents the estimated average period of time that the options remain outstanding. Since the Bank does not have sufficient historical data on the exercise of stock options, the expected term is based on the "simplified" method that measures the expected term as the average of the vesting period and the contractual term. The risk free rate of return reflects the grant date interest rate offered for zero coupon U.S. Treasury bonds over the expected term of the options.

A summary of the status of the Bank's stock option plan as of December 31, 2013 and changes during the period ended thereon is presented below:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at Beginning of Year	650,100	$ 10.56		
Granted	-	$ -		
Exercised	(56,625)	$ 10.04		
Forfeited	(3,875)	$ 12.86		
Outstanding at End of Year	589,600	$ 10.60	5.58 Years	$ 3,361,000
Options Exercisable	538,350	$ 10.41	5.42 Years	$ 3,169,000

As of December 31, 2013, there was $145,000 of total unrecognized compensation cost related to the outstanding stock options that will be recognized over a weighted-average period of approximately 1.4 years. The intrinsic value of stock options exercised during 2013 amounted to $367,000.

NOTE M – STOCK-BASED COMPENSATION - Continued

A summary of the Bank's nonvested stock grant activity under the Bank's 2013 Restricted Share Plan as of December 31, 2013 and changes during the year then ended are as follows:

	Shares	Weighted-Average Grant Date Fair Value
Nonvested at Beginning of Year	-	$ -
Restricted Stock Awards	9,133	$ 15.43
Shares Vested and Issued	(6,133)	$ 15.00
Shares Forfeited	-	$ -
Nonvested at End of Year	3,000	$ 16.30

As of December 31, 2013 there was $48,000 of total unrecognized compensation cost related to nonvested stock grants that will be recognized over a weighted average period of 2.5 years. The total fair value of shares vested during the year ended December 31, 2013 was approximately $94,000.

NOTE N - FAIR VALUE MEASUREMENT

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value:

Securities: The fair values of securities available for sale are determined by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2).

The following table provides a hierarchy and fair value for each major category of assets and liabilities measured at fair value at December 31:

	Fair Value Measurements Using			
December 31, 2013	Level 1	Level 2	Level 3	Total
Assets measured at fair value on a recurring basis				
Available-for-Sale Securities	$ -	$ 98,437,000	$ -	$ 98,437,000
December 31, 2012				
Assets measured at fair value on a recurring basis				
Available-for-Sale Securities	$ -	$ 151,609,000	$ -	$ 151,609,000



NOTE O - FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of a financial instrument is the amount at which the asset or obligation could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the entire holdings of a particular financial instrument. Because no market value exists for a significant portion of the financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature, involve uncertainties and matters of judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on financial instruments both on and off the balance sheet without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Additionally, tax consequences related to the realization of the unrealized gains and losses can have a potential effect on fair value estimates and have not been considered in many of the estimates.

The following methods and assumptions were used to estimate the fair value of significant financial instruments not previously presented:

Cash and Cash Equivalents

The carrying amounts of cash and short term instruments approximate fair values.

Time Deposits in Other Banks

Fair values for time deposits with other banks are estimated using discounted cash flow analyses, using interest rates currently being offered with similar terms.

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 all other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

Federal Home Loan Bank Stock and Other Bank Stock

The fair value of Federal Home Loan Bank Stock and other Bank stock is not readily determinable due to the lack of its transferability.

NOTE O - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued

Deposits

The fair values disclosed for demand deposits, including interest and non-interest demand accounts, savings, and certain types of money market accounts are, by definition based on carrying value. Fair value for fixed-rate certificates of deposit is estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregate expected monthly maturities on time deposits. Early withdrawal of fixed-rate certificates of deposit is not expected to be significant

Accrued Interest Receivable and Payable

The fair value of accrued interest receivable and payable approximate their carrying amounts.

Off-Balance Sheet Financial Instruments

The fair value of commitments to extend credit and standby letters of credit is estimated using the fees currently charged to enter into similar agreements. The fair value of these financial instruments is not material.

The fair value hierarchy level and estimated fair value of financial instruments at December 31, 2013 and 2012 are summarized as follows:

		2013		2012	
	Fair Value Hierarchy	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial Assets:					
Cash and Due From Banks	Level 1	$ 5,617,000	$ 5,617,000	$ 7,540,000	$ 7,540,000
Interest-Bearing Deposits in Other Banks	Level 1	19,865,000	19,865,000	42,165,000	42,165,000
Time Deposits in Other Banks	Level 1	6,392,000	6,392,000	12,665,000	12,665,000
Investment Securities	Level 2	164,711,000	164,243,000	151,609,000	151,609,000
Loans, net	Level 2	181,408,000	178,506,000	134,398,000	134,967,000
Federal Home Loan and Other Bank Stock	N/A	1,954,000	N/A	1,611,000	N/A
Accrued Interest Receivable	Level 2	1,301,000	1,301,000	955,000	955,000
Financial Liabilities:					
Deposits	Level 2	356,118,000	356,127,000	314,110,000	314,132,000
Accrued Interest Payable	Level 2	2,000	2,000	2,000	2,000



NOTE P - REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by the federal banking 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. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2013 and 2012, that the Bank meets all capital adequacy requirements.

As of December 31, 2013 and 2012, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action (there are no conditions or events since that notification that management believes have changed the Bank's category). To be categorized as well capitalized, the Bank must maintain minimum ratios as set forth in the table below.

The following table also sets forth the Bank's actual capital amounts and ratios:

	Actual		Amount of Capital Required: For Capital Adequacy Purposes		Amount of Capital Required: To Be Well-Capitalized Under Prompt Corrective Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2013:						
Total Capital (to Risk-Weighted Assets)	$42,064,000	18.2%	$18,468,000	8.0%	$23,085,000	10.0%
Tier 1 Capital (to Risk-Weighted Assets)	$39,223,000	17.0%	$9,234,000	4.0%	$13,851,000	6.0%
Tier 1 Capital (to Average Assets)	$39,223,000	9.9%	$15,812,000	4.0%	$19,765,000	5.0%
As of December 31, 2012:						
Total Capital (to Risk-Weighted Assets)	$38,962,000	23.0%	$13,538,000	8.0%	$16,923,000	10.0%
Tier 1 Capital (to Risk-Weighted Assets)	$36,833,000	21.8%	$6,769,000	4.0%	$10,154,000	6.0%
Tier 1 Capital (to Average Assets)	$36,833,000	10.7%	$13,792,000	4.0%	$17,241,000	5.0%

The California Financial Code provides that a bank may not make a cash distribution to its shareholders in excess of the lesser of the bank's undivided profits or the bank's net income for its last three fiscal years less the amount of any distribution made to the bank's shareholders during the same period.

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