





2013 ANNUAL REPORT

FIRST MOUNTAIN BANK

To Our Shareholders

We are pleased to present this annual report to you, our valued shareholders. Many important events occurred during 2013, not the least of which was a nearly $1.9 million turnaround in pre-tax earnings between 2012 and 2013. In January we completed the merger of the holding company back into the Bank. In July we consolidated our Interlaken Big Bear office into the Main Big Bear office, resulting in significant cost savings. Throughout the year we focused on asset quality improvement and ended the year with no foreclosed properties on our books. We also became more capable and efficient at finding, originating, and selling loans guaranteed through the Small Business Administration (SBA) and the United States Department of Agriculture (USDA). Thanks to the efforts of our lending staff, we reported net gains in excess of $900,000 through these sales, up from $200,000 in 2012. During the year we also attempted to raise additional capital for some planned expansion. However, we found that the level at which investors were willing to invest was too dilutive to our current shareholders, so we have shelved the capital raise and expansion plans for the time being.

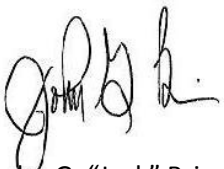
Strong capital levels provide banks with the ability to weather tough economic times. In spite of the "Great Recession" of these past few years, our capital has provided the cushion needed to weather the losses and financial strains that have impacted the Bank and our customers. At December 31, 2013, our Tier 1 and Total Risk-based Capital ratios place us in the category of a "Well Capitalized" bank under regulatory guidelines. Capital preservation and growth continue to be important elements of our future plans for the Bank.

Financial Highlights

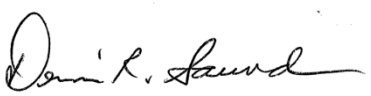
The Bank reported net income of $680,149 for the year ended December 31, 2013, or $0.43 per basic share, compared to a net loss of $2,899,196, or $1.85 loss per share for the year ended December 31, 2012. The 2012 loss included a $1.7 million valuation allowance established against the Bank's net deferred tax assets. With continued profitability, the valuation allowance on the Bank's net deferred tax assets could be reversed and added back to augment both earnings and capital. Total shareholders' equity was $12,059,062 at December 31, 2013, representing a Tier 1 Leverage Capital ratio of 9.2%, well above the regulatory guidelines for a "Well Capitalized" designation. Book value per share was $7.71 at year end, based upon 1,564,926 outstanding shares.

Future Opportunities

We see many signs of an improving economy in our local market areas. Our very liquid balance sheet provides opportunities to extend credit through competitive loan products to local entrepreneurs as their businesses expand. Improving property values have strengthened our existing loan portfolio and also will open new lending opportunities for real estate secured loans in the future. We have technology advances coming in 2014 that will allow us to provide "big bank" account products and services without sacrificing our small bank personal touch. We look forward to the future with great optimism. We are proud to serve you and appreciate your continued support.



John G. "Jack" Briner
Chairman and CEO



Dennis R. Saunders
President and CFO

First Mountain Bank

Consolidated Financial Statements

as of December 31, 2013 and 2012,

and for the Years Then Ended

and

Independent Auditor's Report

Crowe Horwath.

Crowe Horwath LLP
Independent Member Crowe Horwath International

INDEPENDENT AUDITOR'S REPORT

The Shareholders and
Board of Directors
First Mountain Bank
Big Bear Lake, California

Report on the Financial Statements

We have audited the accompanying financial statements of First Mountain Bank, which comprise the balance sheets as of December 31, 2013 and 2012, and the related statements of operations, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these 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 First Mountain 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.

Crowe Horwath LLP

Crowe Horwath

Sacramento, California
March 17, 2014

FIRST MOUNTAIN BANK

BALANCE SHEETS

December 31, 2013 and 2012

	2013	2012
ASSETS		
Cash and due from banks	$ 25,374,284	$ 30,771,031
Federal funds sold	468,594	466,985
Total cash and cash equivalents	25,842,878	31,238,016
Interest-bearing deposits in other financial institutions	625,278	625,202
Available-for-sale investment securities (Notes 2, 3 and 8)	12,031,000	7,762,000
Loans, less allowance for loan losses of $2,814,762 in 2013 and $2,860,700 in 2012 (Notes 2, 4, 8, 10 and 14)	87,898,486	90,741,365
Premises and equipment, net (Notes 6 and 10)	2,314,750	2,220,780
Cash surrender value of life insurance policies (Note 16)	3,639,525	3,531,797
Other real estate (Notes 2 and 5)	—	492,200
Accrued interest receivable and other assets (Note 9)	2,045,253	1,860,756
Total assets	$ 134,397,170	$ 138,472,116
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	$ 40,505,902	$ 42,232,580
Interest bearing (Note 7)	80,758,375	83,666,628
Total deposits	121,264,277	125,899,208
Accrued interest payable and other liabilities (Note 16)	1,073,831	976,588
Total liabilities	122,338,108	126,875,796
Commitments and contingencies (Notes 10 and 11)		
Shareholders' equity (Notes 12 and 13):		
Preferred stock - no par value; 10,000,000 shares authorized; no shares issued or outstanding at December 31, 2013 and 2012		
Common stock - no par value; 10,000,000 shares authorized; issued and outstanding – 1,564,926 shares in 2013 and 2012	12,081,356	12,060,998
Retained earnings/(accumulated deficit)	153,751	(526,398)
Accumulated other comprehensive (loss) income, net of taxes (Note 3)	(176,045)	61,720
Total shareholders' equity	12,059,062	11,596,320
Total liabilities and shareholders' equity	$ 134,397,170	$ 138,472,116

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

FIRST MOUNTAIN BANK

STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2013 and 2012

	2013	2012
Interest income:		
Interest and fees on loans	$ 5,136,248	$ 5,904,105
Interest on investment securities:		
Taxable	207,871	139,432
Exempt from Federal income taxes	26,506	57,355
Interest on Federal funds sold	1,185	2,925
Interest on deposits in banks	67,339	45,379
Total interest income	5,439,149	6,149,196
Interest expense:		
Interest on deposits (Note 7)	312,076	434,916
Net interest income before provision for loan losses	5,127,073	5,714,280
Provision for loan losses (Note 4)	45,000	566,000
Net interest income after provision for loan losses	5,082,073	5,148,280
Non-interest income:		
Service charges	857,817	908,008
Net gains on sales of loans	900,488	200,248
Earnings on cash surrender value of life insurance policies (Note 16)	107,728	124,217
Net (loss) gain on sale of other real estate (Note 5)	(27,978)	24,025
Other	55,344	101,976
Total non-interest income	1,893,399	1,358,474
Other expenses:		
Salaries and employee benefits (Notes 4 and 16)	3,171,352	3,305,727
Occupancy and equipment (Notes 6 and 10)	673,136	714,159
Other real estate (Note 5)	27,184	1,093,814
Other (Note 15)	2,423,651	2,582,250
Total other expenses	6,295,323	7,695,950
Income (loss) before income taxes	680,149	(1,189,196)
Provision for income taxes (Note 9)	—	1,710,000
Net income (loss)	$ 680,149	$ (2,899,196)
Basic earnings (loss) per share (Note 12)	$ 0.43	$ (1.85)
Diluted earnings per share (Note 12)	$ 0.43	

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

FIRST MOUNTAIN BANK

STATEMENTS OF COMPREHENSIVE INCOME

For the Years Ended December 31, 2013 and 2012

	2013	2012
Net income (loss)	$ 680,149	$ (2,899,196)
Other comprehensive loss:		
Unrealized losses on investment securities:		
Unrealized holding loss arising during the period	(396,353)	(8,126)
Tax effect	158,588	2,966
Total other comprehensive loss	(237,765)	(5,160)
Comprehensive income (loss)	$ 442,384	$ (2,904,356)

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

FIRST MOUNTAIN BANK

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the Years Ended December 31, 2013 and 2012

	Common Stock		Retained Earnings/ (Accumulated Deficit)	Accumulated Other Compre-hensive Income (loss), Net of Taxes	Total Shareholders' Equity
	Shares	Amount			
Balance, January 1, 2012	1,564,926	$ 12,073,465	$ 2,372,798	$ 66,880	$ 14,513,143
Net loss			(2,899,196)		(2,899,196)
Other comprehensive loss, net of taxes				(5,160)	(5,160)
Share-based compensation expense, net of cancellation benefit (Note 13)		(12,467)			(12,467)
Balance, December 31, 2012	1,564,926	$ 12,060,998	$ (526,398)	$ 61,720	$ 11,596,320
Net income			680,149		680,149
Other comprehensive loss, net of taxes				(237,765)	(237,765)
Share-based compensation expense (Note 13)		20,358			20,358
Balance, December 31, 2013	1,564,926	$ 12,081,356	$ 153,751	$ (176,045)	$ 12,059,062

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

FIRST MOUNTAIN BANK

STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2013 and 2012

	2013	2012
Cash flows from operating activities:		
Net income (loss)	$ 680,149	$ (2,899,196)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Loss on disposition of equipment	947	—
Loss (gain) on sale of other real estate	27,978	(24,025)
Net gains on sales of loans	(900,488)	(200,248)
Provision for loan losses	45,000	566,000
Impairment charges on other real estate	—	1,042,587
Depreciation, amortization and accretion, net	351,940	300,946
Increase (decrease) in deferred loan origination fees, net	277,879	(49,171)
Origination of loans held for sale	(4,195,175)	(3,078,549)
Proceeds from loans held for sale	9,311,891	3,882,563
Increase in cash surrender value of life insurance policies, net	(107,728)	(111,247)
Share-based compensation expense (benefit)	20,358	(12,467)
(Decrease) increase in accrued interest receivable and other assets	(80,630)	132,903
Increase in accrued interest payable and other liabilities	97,243	87,780
Change in deferred taxes	—	1,710,000
Net cash provided by operating activities	5,529,364	1,347,876
Cash flows from investing activities:		
Increase in interest-bearing deposits in banks, net	(76)	(500,075)
Purchase of available-for-sale investment securities	(7,558,159)	(5,228,452)
Proceeds from called and matured investment securities	1,750,000	3,335,000
Principal repayments received from government-guaranteed residential mortgage-backed securities	1,100,927	757,493
Net (increase) decrease in loans	(1,992,469)	8,531,769
Purchases of premises and equipment	(214,656)	(199,353)
Purchase of FHLB stock	—	(36,900)
Proceeds from FHLB stock redemption	25,400	—
Proceeds from sale of other real estate	599,462	1,352,176
Other real estate improvements capitalized	—	(24,505)
Net cash (used in) provided by investing activities	(6,289,571)	7,987,153

(Continued)

FIRST MOUNTAIN BANK

STATEMENTS OF CASH FLOWS
(Continued)
For the Years Ended December 31, 2013 and 2012

	2013	2012
Cash flows from financing activities:		
Net (decrease) increase in demand, interest bearing and savings deposits	(2,214,791)	6,351,666
Net decrease in time deposits	(2,420,140)	(5,253,688)
Net cash (used in) provided by financing activities	(4,634,931)	1,097,978
(Decrease) increase in cash and cash equivalents	(5,395,138)	10,433,007
Cash and cash equivalents, beginning of year	31,238,016	20,805,009
Cash and cash equivalents, end of year	$ 25,842,878	$ 31,238,016
Supplemental disclosure of cash flow information:		
Cash paid during the year for:		
Interest expense	$ 315,595	$ 438,222
Non-cash investing activities:		
Loans transferred to other real estate	$ 296,240	$ 2,592,372
Loans transferred from portfolio loans to loans held for sale	$ 4,216,229	$ 603,766
Loans provided for sales of other real estate	$ —	$ 1,444,250
Other real estate transferred to bank premises	$ 161,000	$ —

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

The Balance Sheet as of December 31, 2012 and Statement of Operations, Statement of Comprehensive Income, Statement of Shareholders' Equity and Statement of Cash Flows for the year ended December 31, 2012, include the consolidated information of First Mountain Bancorp (the "Holding Company") and its wholly-owned subsidiary, First Mountain Bank (the "Bank"). The Bank was a wholly-owned subsidiary of the Holding Company from September 5, 2006 until January 24, 2013. Effective January 24, 2013, the Holding Company was merged into the Bank with the Bank as the surviving corporation. On the effective date, the directors and officers of the Bank immediately prior to the effective date remained the directors and officers of the surviving corporation. Upon the merger becoming effective, each share of common stock of the Holding Company issued and outstanding immediately prior to the effective date was automatically converted into one share of fully paid and non-assessable common stock of the Bank as the surviving corporation. The Statement of Operations for the year ended December 31, 2013, includes an insignificant amount of consolidated expenses through January 24, 2013, with the remaining revenues and expenses for the year representing the merged operations of the Bank. The Balance Sheet and Statement of Operations of the Bank, as the surviving corporation, at December 31, 2013, are considered comparable in all material respects with the Consolidated Balance Sheets and Consolidated Statements of Operations reported for prior periods.

The Bank is a state chartered financial institution with its main office in Big Bear Lake, California, and two additional branches in the surrounding area. Our deposits are insured up to applicable legal limits by the Federal Deposit Insurance Corporation (the "FDIC"), which also regulates the Bank together with the California Department of Business Oversight (the "CDBO").

We provide traditional banking services which include accepting demand, savings and time deposits and making commercial, installment and real estate loans. Our primary source of revenue is providing loans to customers who are predominantly small and middle-market businesses and individuals.

Our accounting and reporting policies conform to accounting principles generally accepted in the United States of America and prevailing practices within the banking industry.

Subsequent Events

We have reviewed all events occurring from December 31, 2013, through March 17, 2014, the date the financial statements were available to be issued.

Reclassifications

Some items in the prior year financial statements were reclassified to conform to the current presentation. Reclassifications had no effect on prior year net income or shareholders' equity.

Segment Information

Management has determined that since all of the banking products and services offered by the Bank are available in each branch of the Bank, all branches are located within the same economic environment and management does not allocate resources based on the performance of different lending or transaction activities, it is appropriate to aggregate the Bank branches and report them as a single operating segment. No customer accounts for more than 10 percent of the revenues of the Bank.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements, the reported amounts of revenues and expenses during the reporting period and the related disclosures therein. Actual results could differ from these estimates. The allowance for loan losses, deferred tax assets and the related valuation allowance, and fair values of assets and liabilities are estimates which are particularly subject to change.

Cash and Cash Equivalents

For the purpose of the statement of cash flows, cash and due from banks, deposits at other financial institutions with original maturities less than 90 days and Federal funds sold are considered to be cash equivalents. Generally, Federal funds are sold for one day periods. Net cash flows are reported for customer loan and deposit transactions, interest bearing deposits in other financial institutions, and federal funds purchased.

Interest-bearing Deposits in Other Financial Institutions

Interest-bearing deposits in other financial institutions represent interest-bearing deposits with original maturities greater than ninety days.

Investment Securities

Investment securities are classified into the following categories:

- Available-for-sale securities, reported at fair value, with unrealized gains and losses excluded from earnings and reported, net of taxes, as accumulated other comprehensive income (loss) within shareholders' equity.

- Held-to-maturity securities, which we have both the positive intent and ability to hold to maturity, reported at amortized cost, adjusted for the accretion of discounts and amortization of premiums.

We determine the appropriate classification of our investments at the time of purchase and may only change the classification in certain limited circumstances. All transfers between categories are accounted for at fair value. At December 31, 2013 and 2012, all securities are classified as available-for-sale and there were no transfers between categories.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Investment Securities (Continued)

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 whether 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: 1) OTTI related to credit loss, which must be recognized in the statement of operations and 2) 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 Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Loans held for sale are generally sold with servicing rights retained. The carrying value of loans sold is reduced by the amount allocated to the servicing right. Gains and losses on sales of loans are based on the difference between the selling price and the carrying value of the related loan sold.

Loans

All classes of loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at principal balances outstanding adjusted for unamortized discounts and premiums and net of deferred loan origination fees and costs, write-downs and the allowance for loan losses. Interest is accrued daily based upon outstanding loan balances.

Loan origination fees, commitment fees, direct loan origination costs and purchase premiums and discounts on loans are deferred and are amortized into interest income and recognized as an adjustment of yield using the level-yield method over the contractual term of the loan. The unamortized balance of deferred fees and costs is reported in net loans.

Interest income on all loan classes is discontinued at the time the loan is 90 days delinquent unless the loan is well-secured and in process of collection. Consumer and credit card loans are typically charged off no later than 120 days past due. For all portfolio classes, past due status is based on the contractual terms of the loan. In all cases, loans in all loan classes are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. For all portfolio classes, a loan is moved to non-accrual status in accordance with the Bank's policy, typically after 90 days of non-payment.

For all portfolio classes, all interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. For all portfolio classes, loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses

The allowance for loan losses is a valuation allowance for probable incurred credit losses in the Bank's loan portfolio. The allowance is established through a provision for loan losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of two primary components, specific reserves related to impaired loans and general reserves for probable losses related to loans that are collectively evaluated for impairment.

For all portfolio classes 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, including principal and interest, according to the contractual terms of the original agreement. Loans determined to be impaired are individually evaluated for impairment. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower’s prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

When a loan is impaired, the Bank measures impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the sale or operation of the underlying collateral.

A restructuring of a debt constitutes a troubled debt restructuring (TDR) if the Bank for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment as described above. For troubled debt restructurings that subsequently default, the Bank determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The determination of the general reserve for loans that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio class over the most recent twelve quarters, internal asset classifications, and qualitative factors to include economic trends in the Bank's service areas, industry trends, geographic concentrations, estimated collateral values, the Bank's underwriting policies, the character of the loan portfolio, and probable losses inherent in the portfolio taken as a whole.

The Bank determines a separate allowance for each portfolio class. These portfolio classes include commercial & industrial, real estate-construction (including land and development loans), real estate-commercial, real estate-residential (including home equity loans), and consumer. The allowance for loan losses attributable to each portfolio class, which includes both impaired loans and loans that are collectively evaluated for impairment, is combined to determine the Bank's overall allowance for loan losses, which is included on the balance sheets and available for all loss exposures.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses (Continued)

The Bank assigns a risk rating to all loans except pools of homogeneous loans and typically performs detailed reviews on a quarterly basis of all such loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by independent specialists engaged by the Bank and the Bank's regulators. During the Bank's internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. The risk ratings can be grouped into five major categories, defined as follows:

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

Watch/Special Mention – A watch/special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Bank's credit position at some future date. Watch/Special Mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.

Substandard – A substandard loan is not adequately protected by the current sound worth and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well defined weaknesses include inadequate cash flow or collateral support, a project's lack of marketability, failure to complete construction on time or a project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss – Loans classified as loss are considered uncollectible and charged off immediately.

The general reserve component of the allowance for loan losses also consists of reserve factors that are based on management's assessment of the following for each portfolio class: (1) inherent credit risk, (2) historical losses and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio class described below.

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

Real estate - construction – Real estate construction loans generally possess a higher inherent risk of loss than other real estate portfolio classes. A major risk arises from the necessity to complete projects within specified costs and timelines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses (Continued)

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

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

Consumer – Consumer loans include credit card receivables, overdraft protection lines, and installment loans. Credit card receivables and overdraft lines generally have a higher rate of default than all other portfolio classes and are also impacted by weak economic conditions and trends. Our installment loan portfolio is comprised of a larger number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for the purchase of heavy equipment or industrial vehicles may also be included. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Bank's primary regulators, the FDIC and CDBO, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

Allowance for Off Balance-Sheet Commitments

The Bank also maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance-sheet commitments is included in accrued interest payable and other liabilities on the balance sheets.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Sales of Loans

The Bank accounts for the transfer of financial assets based on the financial assets it controls and liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. At the time of sale, servicing assets are recognized and measured at fair value, and the previous carrying amount of the sold loan is allocated between the sold portion of the loan and the interests that continue to be held by the Bank based on their relative fair values at the date of sale. Gains or losses resulting from sales of loans are recorded at the time of sale and are determined by the difference between: (i) the net sales proceeds plus the interests that continue to be held, and (ii) the original carrying value of the loan sold. The difference between the subsequent fair value of the interests that continue to be held and their original carrying value is amortized to interest and fees on loans over the estimated remaining life of the associated loans using the interest method. The fair value of any interests that continue to be held by the Bank is periodically evaluated for impairment, with any shortfall in estimated fair value versus carrying amount being charged against interest and fees on loans.

Servicing Rights

When Small Business Administration loans are sold with servicing retained, servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sales of loans. Fair value is based on market prices for comparable mortgage servicing contracts, when available or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. All classes of servicing assets are subsequently measured using the amortization method which requires servicing rights to be amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans. Servicing rights are evaluated for impairment based upon the fair value of the rights as compared to carrying amount. Impairment is determined by stratifying rights into groupings based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual grouping, to the extent that fair value is less than the carrying amount. If the Bank later determines that all or a portion of the impairment no longer exists for a particular grouping, a reduction of the allowance may be recorded as an increase to income.

Servicing fee income is reported on the Statements of Operations as other non-interest income. The fees are based on a contractual percentage of the outstanding principal and are recorded as income when earned. The amortization of servicing rights is netted against loan servicing fee income. Servicing fees were not material in the years ended December 31, 2013 and 2012.

The Bank serviced loans for others in the amount of $10,291,875 and $2,513,395 at December 31, 2013 and 2012, respectively. Net servicing assets were $295,406 and $66,198 at December 31, 2013 and 2012, respectively.

Premises and Equipment

Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation. Depreciation is determined using the straight-line method over the estimated useful lives of the related assets. The useful lives of furniture, fixtures and equipment are estimated to be three to ten years. Leasehold improvements are amortized over the life of the asset or the term of the related lease, whichever is shorter. When assets are sold or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred. We evaluate premises and equipment for financial impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Cash Surrender Value of Life Insurance Policies

The Bank has purchased life insurance policies on certain key executives and former executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Other Real Estate

Other real estate includes real estate acquired in full or partial settlement of loan obligations. Other real estate is initially recorded at fair value less costs to sell, and any excess of our recorded loan balance and accrued interest income over the estimated fair market value of the property less costs to sell is charged against the allowance for loan losses. A valuation allowance for losses on other real estate is maintained to provide for temporary declines in value. The allowance is established through a provision for losses on other real estate which is included in other expenses. Subsequent gains or losses on sales or writedowns resulting from permanent impairments are recorded in other income or expense as incurred.

Investment in Bank Stocks

Federal Home Loan Bank Stock

As a member of the Federal Home Loan Bank of San Francisco, the Bank is required to maintain an investment in the capital stock of the Federal Home Loan Bank (FHLB) based on the level of borrowings and other factors. The Bank may invest in additional amounts as required by the FHLB. The investment is carried at cost and is periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income. At December 31, 2013 and 2012, FHLB stock totaled $550,200 and $575,600, respectively, and is included on the balance sheets in accrued interest receivable and other assets.

Pacific Coast Bankers Bank Stock

The Bank maintains an investment in the capital stock of Pacific Coast Bankers Bank (PCBB). The investment is carried at cost and is periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income. At December 31, 2013 and 2012, PCBB stock totaled $507,500 and is included on the balance sheets in accrued interest receivable and other assets.

Income Taxes

Prior to the year ended December 31, 2013 the Holding Company filed income taxes on a consolidated basis with the Bank. For the year ended December 31, 2013 the provision for income taxes represents Bank-only income. The allocation of income tax expense represents each entity's share of the consolidated provision for income taxes. Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities.

The determination of the amount of deferred tax assets which are more likely than not to be realized is primarily dependent on projections of future earnings, which are subject to uncertainty and estimates that may change given economic conditions and other factors. The realization of deferred tax assets is assessed and a valuation allowance is recorded if it is "more likely than not" that all or a portion of the deferred tax asset will not be realized. "More likely than not" is defined as greater than a 50% chance. All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Taxes (Continued)

Based upon our analysis of available evidence, we have determined that it is not “more likely than not” that the Bank will be able to utilize all of its deferred tax assets and has recorded a full valuation allowance at December 31, 2013 and 2012.

The Bank recognizes interest and/or penalties related to income tax matters in income tax expense.

Accounting for Uncertainty in Income Taxes

We use a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

Retirement Plans

Employee 401(k) plan expense represents the amount of matching contributions. Deferred compensation and salary continuation plan expense allocates the benefits over years of service.

Earnings (loss) Per Share

Basic earnings (loss) per share (EPS), which excludes dilution, is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if contracts to issue common stock, such as stock options and restricted stock, result in the issuance of common stock which shares in the earnings of the Bank. The treasury stock method is applied to determine the dilutive effect of stock options and restricted stock in computing diluted EPS. However, diluted earnings per share is not presented when a net loss occurs because the conversion of potential common stock is anti-dilutive. All data used in computing earnings per share is retroactively adjusted to reflect stock dividends and splits.

Share-Based Compensation

We record compensation cost for all share-based payments based on the estimated grant date fair value for stock options or the fair value of the restricted stock on the grant date.

Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

We measure the fair value of stock options on the date of grant using a Black-Scholes option pricing model that is based on expected option life, expected stock volatility and the risk-free interest rate. Stock volatility is based on the historical volatility of the Bank's stock. The risk-free rate is based on the U.S. Treasury yield curve in effect with substantially the same expected term as the options. The expected dividend yield was not considered in the option pricing formula because we have not paid cash dividends historically and had no plans to do so at the grant dates. The expected term of our stock options is based on the Bank’s historical data.

Excess tax benefits are classified as a cash flow from financing in the statement of cash flows.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Comprehensive Income (loss)

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale and is also recognized as a separate component of shareholders' equity.

Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there are currently any such matters that will have a material effect on the financial statements.

Loan Commitments and Related Financial Instruments

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Restrictions on Cash

Cash on hand or on deposit with the Federal Reserve Bank is required to meet regulatory reserve and clearing requirements.

Dividend Restrictions

Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to shareholders.

Fair Value of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Footnote 2. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect these estimates.

2. FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (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.

Fair Value Hierarchy

We group our assets and liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. Valuations within these levels are based upon:

Level 1 – Quoted market prices (unadjusted) for identical instruments traded in active exchange markets which the Bank has the ability to access at the measurement date.

Level 2 – Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are supported by market data.

Level 3 – Model-based techniques that use at least one significant assumption not supported by market data. These assumptions reflect our estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include our judgment and estimation which may be significant.

We monitor the availability of observable market data to assess the appropriate classification of assets and liabilities measured at fair value within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of assets and liabilities from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

We evaluate the significance of transfers between levels based upon the nature of the asset and liability and size of the transfer relative to total assets, total liabilities or total earnings.

We used the following methods and significant assumptions to estimate fair value:

Investment Securities: The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities and model-based valuation techniques in which all significant assumptions are observable (Level 2).

Impaired Loans: The fair value of collateral dependent impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

2. FAIR VALUE (Continued)

Fair Value Hierarchy (Continued)

Real Estate Owned: Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Real estate owned properties are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Appraisals for both collateral-dependent impaired loans and real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Bank. Once received, a member of the Loan Department reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. On an annual basis, the Bank compares the actual selling price of collateral that has been sold to the most recent appraised values to determine what, if any, additional adjustments should be made to the appraisal values to arrive at fair value.

2. FAIR VALUE (Continued)

Fair Value Measurements

Assets and Liabilities Recorded at Fair Value

The following tables present information about the Bank's assets and liabilities measured at fair value on a recurring and nonrecurring basis as of December 31, 2013 and 2012:

Recurring Basis

	Fair Value Measurements at December 31, 2013 Using:			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Available-for-sale investment securities				
Debt securities:				
U.S. Government sponsored entities and agencies	$ —	$ 5,883,000	$ —	$ 5,883,000
Obligations of states and political subdivisions	—	425,000	—	425,000
Residential mortgage-backed securities issued by U.S. Government sponsored agencies	—	5,723,000	—	5,723,000
Total assets measured at fair value on a recurring basis	$ —	$ 12,031,000	$ —	$ 12,031,000

	Fair Value Measurements at December 31, 2012 Using:			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Available-for-sale investment securities				
Debt securities:				
U.S. Government sponsored entities and agencies	$ —	$ 3,506,000	$ —	$ 3,506,000
Obligations of states and political subdivisions	—	1,186,000	—	1,186,000
Residential mortgage-backed securities issued by U.S. Government sponsored agencies	—	3,070,000	—	3,070,000
Total assets measured at fair value on a recurring basis	$ —	$ 7,762,000	$ —	$ 7,762,000

During the year ended December 31, 2013, there were no transfers in or out of Levels 1, 2 or 3.

There were no liabilities recorded at fair value on a recurring basis at December 31, 2013 and 2012.

2. FAIR VALUE (Continued)

Fair Value Measurements (Continued)

Assets and Liabilities Recorded at Fair Value (Continued)

Non-recurring basis

Assets measured at fair value on a non-recurring basis as of December 31, 2013 and 2012, are summarized below:

	Fair Value Measurements at December 31, 2013 Using:			
	Significant Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired loans				
Real estate – residential	$ —	$ —	$ 81,500	$ 81,500
Total assets measured at fair value on a non-recurring basis	$ —	$ —	$ 81,500	$ 81,500

	Fair Value Measurements at December 31, 2012 Using:			
	Significant Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired loans				
Real estate – residential	$ —	$ —	$ 565,753	$ 565,753
Other real estate				
Commercial	—	—	492,200	492,200
Total assets measured at fair value on a non-recurring basis	$ —	$ —	$ 1,057,953	$ 1,057,953

If we determine that the fair value of an impaired loan is less than the recorded investment in the loan, the carrying value is adjusted through a charge-off or additional specific loan loss provisions recorded through the allowance for loan losses. Impaired loans evaluated under the discounted cash flow method are excluded from the table above. The discounted cash flow method as prescribed by topic 310 is not a fair value measurement since the discount rate utilized is the loan's effective interest rate which is not a market rate. Total losses of $2,242 and $181,200 were recognized on the above loans during the years ended December 31, 2013 and 2012, respectively, related to impaired loans.

2. FAIR VALUE (Continued)

Fair Value Measurements (Continued)

Assets and Liabilities Recorded at Fair Value (Continued)

Non-recurring basis (continued)

Other real estate has been adjusted to estimated fair value, less estimated selling costs. At the time of foreclosure, assets are recorded at the lower of the carrying amount of the loan or the estimated fair value less estimated selling costs. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, management periodically obtains updated valuations of the foreclosed assets and, if additional impairments are deemed necessary, the impairment is recorded in other real estate expenses on the statements of operations. No losses were recognized in 2013, and $72,911 was recognized on the above properties during the year ended December 31, 2012, related to other real estate held at December 31, 2012.

There were no liabilities recorded at fair value on a non-recurring basis at December 31, 2013 or 2012.

Fair Value of Financial Instruments

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

		Fair Value Measurements at December 31, 2013 Using:			
	Carrying Amount	(Level 1)	(Level 2)	(Level 3)	Total
Financial assets:					
Cash and due from banks	$ 25,374,284	$ 3,568,487	$ 21,805,797	$ —	$ 25,374,284
Federal funds sold	468,594	—	468,594	—	468,594
Interest bearing deposits in other financial institutions	625,278	—	625,278	—	625,278
Investment securities	12,031,000	—	12,031,000	—	12,031,000
Loans	87,898,486	—	—	87,856,905	87,856,905
FHLB stock	550,200	—	—	—	N.A.
PCBB stock	507,500	—	—	—	N.A.
Accrued interest receivable	260,319	—	35,805	224,514	260,319
Financial liabilities:					
Deposits	$ 121,264,277	$ 86,534,268	$ 34,875,276	$ —	$ 121,409,544
Accrued interest payable	12,306	2,914	9,392	—	12,306

		Fair Value Measurements at December 31, 2012 Using:			
	Carrying Amount	(Level 1)	(Level 2)	(Level 3)	Total
Financial assets:					
Cash and due from banks	$ 30,771,031	$ 4,299,675	$ 26,471,356	$ —	$ 30,771,031
Federal funds sold	466,985	—	466,985	—	466,985
Interest bearing deposits in other financial institutions	625,202	—	625,202	—	625,202
Investment securities	7,762,000	—	7,762,000	—	7,762,000
Loans	90,741,365	—	—	90,699,013	90,699,013
FHLB stock	575,600	—	—	—	N.A.
PCBB stock	507,500	—	—	—	N.A.
Accrued interest receivable	241,059	—	36,142	204,917	241,059
Financial liabilities:					
Deposits	$ 125,899,208	$ 88,749,059	$ 37,237,886	$ —	$ 125,986,945
Accrued interest payable	15,825	1,279	14,546	—	15,825

2. FAIR VALUE (Continued)

Fair Value of Financial Instruments (Continued)

These estimates do not reflect any premium or discount that could result from offering our entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of these estimates.

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

(a) Cash and Cash Equivalents

The carrying amounts of cash, short-term instruments, and Federal Funds sold approximate fair values and are classified as either Level 1 or Level 2. Cash on hand and non-interest due from bank accounts are Level 1 classification whereas interest bearing due from bank accounts and fed funds sold are considered Level 2.

(b) FHLB and PCBB Stock

It is not practical to determine the fair value of FHLB or PCBB stock due to restrictions placed on their transferability.

(c) Loans

Fair values of loans are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

(d) Deposits

The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. The carrying amounts of variable rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date resulting in a Level 1 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

(e) Accrued Interest Receivable/Payable

The carrying amounts of accrued interest approximate fair value and are classified consistent with the level of the related asset or liability.

(f) Off-balance Sheet Instruments

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material, and therefore is not included in the above table.

3. AVAILABLE-FOR-SALE INVESTMENT SECURITIES

The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2013 and 2012 consisted of the following:

	2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
U.S. Government sponsored entities and agencies	$ 5,992,778	$ 1,588	$ (111,366)	$ 5,883,000
Obligations of states and political subdivisions	407,810	17,190	—	425,000
Residential mortgage-backed securities guaranteed by U.S. Government sponsored agencies	5,923,424	34,960	(235,384)	5,723,000
	$ 12,324,012	$ 53,738	$ (346,750)	$ 12,031,000

Net unrealized losses on available-for-sale investment securities totaling $293,012 were recorded, net of 116,967 in tax liabilities, as accumulated other comprehensive income (loss) within shareholders' equity at December 31, 2013. There were no sales or transfers of available-for-sale investment securities for the year ended December 31, 2013.

	2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
U.S. Government sponsored entities and agencies	$ 3,499,094	$ 6,906	$ —	$ 3,506,000
Obligations of states and political subdivisions	1,159,084	26,916	—	1,186,000
Residential mortgage-backed securities guaranteed by U.S. Government sponsored agencies	3,000,481	69,519	—	3,070,000
	$ 7,658,659	$ 103,341	$ —	$ 7,762,000

Net unrealized gains on available-for-sale investment securities totaling $103,341 were recorded, net of $41,621 in tax liabilities, as accumulated other comprehensive income within shareholders' equity at December 31, 2012. There were no sales or transfers of available-for-sale investment securities for the year ended December 31, 2012.

3. AVAILABLE-FOR-SALE INVESTMENT SECURITIES (Continued)

The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2013, by contractual maturity are shown below. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
After one year through five years	$ 6,400,588	$ 6,308,000
Investment securities not due at a single maturity date:		
Residential mortgage-backed securities guaranteed by U.S. Government sponsored agencies	5,923,424	5,723,000
	$ 12,324,012	$ 12,031,000

The following table shows gross unrealized losses and estimated fair values, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2013. No securities were in an unrealized loss position at December 31, 2012.

	2013					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Debt securities:						
U.S. Government sponsored entities and agencies	$ 5,382,000	$ (111,366)	$ —	$ —	$ 5,382,000	$ (111,366)
Residential mortgage-backed securities guaranteed by U.S. government sponsored agencies	4,699,000	(235,384)	—	—	4,699,000	(235,384)
	$ 10,081,000	$ (346,750)	$ —	$ —	$ 10,081,000	$ (346,750)

U.S. Government Sponsored entities and Agencies: At December 31, 2013, the Bank held twelve U.S. Government sponsored entities and agency securities of which eleven were in a loss position for less than 12 months and none were in a loss position or had been in a loss position for 12 months or longer. The unrealized losses on the Banks's investments in U.S. Government sponsored entities and agencies were caused by interest rate changes. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Bank does not intend to sell, and it is more likely than not that it will not be required to sell those investments until a recovery of fair value, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2013.

3. AVAILABLE-FOR-SALE INVESTMENT SECURITIES (Continued)

Residential Mortgage-Backed Securities Guaranteed by U.S. Government Sponsored Agencies: At December 31, 2013, the Bank held twenty Residential Mortgage-Backed Securities Guaranteed by U.S. Government Sponsored Agencies securities of which seven were in a loss position for less than 12 months and none were in a loss position or had been in a loss position for 12 months or longer. The unrealized losses on the Bank's investments in Residential Mortgage-Backed Securities Guaranteed by U.S. Government Sponsored Agencies were caused by interest rate changes. The contractual cash flows of those investments are guaranteed or supported by an agency or sponsored entity of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Bank's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Bank does not intend to sell, and it is more likely than not that it will not be required to sell those investments until a recovery of fair value, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2013.

Investment securities with amortized costs of $6,052,370 and $4,002,529 and estimated market values of $5,973,000 and $4,019,000 were pledged to secure treasury, tax and loan accounts, local agency deposits, and a federal funds credit facility at December 31, 2013 and 2012, respectively (see Note 8).

4. LOANS AND THE ALLOWANCE FOR LOAN LOSSES

Outstanding loans are summarized below:

	December 31,	
	2013	2012
Commercial & industrial	$ 14,945,080	$ 14,951,466
Real estate - construction	1,951,536	697,200
Real estate - commercial	63,533,594	66,085,299
Real estate - residential	8,946,849	11,046,046
Consumer	1,691,943	899,929
	91,069,002	93,679,940
Deferred loan origination fees, net	(355,754)	(77,875)
Allowance for loan losses	(2,814,762)	(2,860,700)
	$ 87,898,486	$ 90,741,365

Salaries and employee benefits totaling $134,500 and $145,175 were deferred as loan origination costs during the years ended December 31, 2013 and 2012, respectively.

Loans with fair values of approximately $46,035,000 and $57,029,000 were pledged to secure borrowing arrangements at December 31, 2013 and 2012, respectively (see Note 8).

4. LOANS AND THE ALLOWANCE FOR LOAN LOSSES (Continued)

The following table presents the activity in the allowance for loan losses by portfolio class for the years ended December 31, 2013 and 2012:

	Commercial & Industrial	Real Estate – Construction	Real Estate – Commercial	Real Estate – Residential	Consumer	Unallocated	Total
December 31, 2013:							
Allowance for Loan Losses:							
Beginning balance	$ 693,000	$ 44,000	$ 1,743,700	$ 359,000	$ 21,000	$ —	$ 2,860,700
Provision charge to operations	(152,268)	(17,753)	(141,030)	183,291	7,998	164,762	45,000
Losses charged to allowance	(16,281)	—	(23,670)	(82,188)	(26,293)	—	(148,432)
Recoveries	1,549	21,753	—	17,897	16,295	—	57,494
Total ending allowance balance	$ 526,000	$ 48,000	$ 1,579,000	$ 478,000	$ 19,000	$ 164,762	$ 2,814,762
December 31, 2012:							
Allowance for Loan Losses:							
Beginning balance	$ 407,000	$ 42,000	$ 1,713,000	$ 247,000	$ 27,000	$ 16,630	$ 2,452,630
Provision charge to operations	300,623	(19,600)	80,464	222,029	(886)	(16,630)	566,000
Losses charged to allowance	(23,677)	—	(77,912)	(116,951)	(8,034)	—	(226,574)
Recoveries	9,054	21,600	28,148	6,922	2,920	—	68,644
Total ending allowance balance	$ 693,000	$ 44,000	$ 1,743,700	$ 359,000	$ 21,000	$ —	$ 2,860,700

4. LOANS AND THE ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio class and based on impairment method as of December 31, 2013 and 2012:

	Commercial & Industrial	Real Estate – Construction	Real Estate – Commercial	Real Estate – Residential	Consumer	Unallocated	Total
December 31, 2013:							
Allowance for Loan Losses:							
Ending allowance balance attributable to loans:							
Individually evaluated for impairment	$ 9,000	$ —	$ 356,000	$ 258,000	$ —	$ —	$ 623,000
Collectively evaluated for impairment	517,000	48,000	1,223,000	220,000	19,000	164,762	2,191,762
Total ending allowance balance	$ 526,000	$ 48,000	$ 1,579,000	$ 478,000	$ 19,000	$ 164,762	$ 2,814,762
Loans:							
Individually evaluated for Impairment	$ 431,915	$ —	$ 9,341,452	$ 1,085,759	$ 16,850	$ —	$ 10,875,976
Collectively evaluated for Impairment	14,513,165	1,951,536	54,192,142	7,861,090	1,675,093	—	80,193,026
Total ending loans balance	$ 14,945,080	$ 1,951,536	$ 63,533,594	$ 8,946,849	$ 1,691,943	$ —	$ 91,069,002
December 31, 2012:							
Allowance for Loan Losses:							
Ending allowance balance attributable to loans:							
Individually evaluated for impairment	$ 2,000	$ —	$ 220,000	$ 126,000	$ —	$ —	$ 348,000
Collectively evaluated for impairment	691,000	44,000	1,523,700	233,000	21,000	—	2,512,700
Total ending allowance balance	$ 693,000	$ 44,000	$ 1,743,700	$ 359,000	$ 21,000	$ —	$ 2,860,700
Loans:							
Individually evaluated for Impairment	$ 198,363	$ —	$ 8,010,528	$ 2,272,426	$ 17,770	$ —	$ 10,499,087
Collectively evaluated for Impairment	14,753,103	697,200	58,074,771	8,773,620	882,159	—	83,180,853
Total ending loans balance	$ 14,951,466	$ 697,200	$ 66,085,299	$ 11,046,046	$ 899,929	$ —	$ 93,679,940

4. LOANS AND THE ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables show the loan portfolio allocated by management's internal risk ratings at December 31, 2013 and 2012:

	Pass	Watch/ Special Mention	Substandard	Doubtful	Total
December 31, 2013:					
Commercial & industrial	$ 12,998,150	$ 1,205,464	$ 741,466	$ —	$ 14,945,080
Real estate – construction	1,951,536	—	—	—	1,951,536
Real estate - commercial	50,786,526	2,630,799	10,116,269	—	63,533,594
Real estate - residential	6,961,570	678,157	1,307,122	—	8,946,849
Consumer	1,675,093	—	16,850	—	1,691,943
Total	$ 74,372,875	$ 4,514,420	$ 12,181,707	$ —	$ 91,069,002
December 31, 2012:					
Commercial & industrial	$ 12,555,161	$ 1,579,935	$ 816,370	$ —	$ 14,951,466
Real estate – construction	697,200	—	—	—	697,200
Real estate - commercial	51,667,088	4,010,587	10,407,624	—	66,085,299
Real estate - residential	7,233,094	816,481	2,996,471	—	11,046,046
Consumer	868,098	913	30,918	—	899,929
Total	$ 73,020,641	$ 6,407,916	$ 14,251,383	$ —	$ 93,679,940

The following tables present information related to impaired loans by class of loans as of and for the years ended December 31, 2013 and 2012:

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
December 31, 2013:						
With no related allowance recorded:						
Commercial & industrial	$ 318,047	$ 299,097	$ —	$ 312,000	$ 2,347	$ —
Real estate – construction	—	—		—	—	—
Real estate – commercial	3,770,922	3,630,199	—	3,739,345	15,216	58,365
Real estate – residential	161,344	161,344	—	161,982	—	4,147
Consumer	16,850	16,850	—	17,000	—	—
Subtotal	4,267,163	4,107,490	—	4,230,327	17,563	62,512
With an allowance recorded:						
Commercial & industrial	142,662	132,818	9,000	138,804	9,576	—
Real estate – construction	—	—	—	—	—	—
Real estate – commercial	6,424,604	5,711,253	356,000	5,847,295	210,045	—
Real estate – residential	957,312	924,415	258,000	941,707	18,744	—
Subtotal	7,524,578	6,768,486	623,000	6,927,806	238,365	—
Total	$ 11,791,741	$ 10,875,976	$ 623,000	$ 11,158,133	$ 255,928	$ 62,512
December 31, 2012:						
With no related allowance recorded:						
Commercial & industrial	$ 116,886	$ 115,402	$ —	$ 117,553	$ 5,947	$ 2,736
Real estate – construction	—	—	—	—	—	—
Real estate – commercial	2,386,077	2,284,202	—	2,293,106	16,174	119,163
Real estate – residential	2,058,647	1,630,258	—	1,663,992	—	—
Consumer	17,770	17,770	—	19,244	472	—
Subtotal	4,579,380	4,047,632	—	4,093,895	22,593	121,899
With an allowance recorded:						
Commercial & industrial	82,961	82,961	2,000	85,276	—	—
Real estate – construction	—	—	—	—	—	—
Real estate – commercial	5,931,812	5,726,326	220,000	5,884,168	84,183	—
Real estate – residential	642,168	642,168	126,000	646,871	15,520	—
Subtotal	6,656,941	6,451,455	348,000	6,616,315	99,703	—
Total	$ 11,236,321	$ 10,499,087	$ 348,000	$ 10,710,210	$ 122,296	$ 121,899

4. LOANS AND THE ALLOWANCE FOR LOAN LOSSES (Continued)

Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The following tables present the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2013 and December 31, 2012:

	Nonaccrual	Past Due Over 90 Days Still Accruing
December 31, 2013:		
Commercial & industrial	$ 294,169	$ —
Real estate – commercial	8,473,243	—
Real estate – residential	731,751	—
Consumer	149	—
Total	$ 9,499,312	$ —
December 31, 2012:		
Commercial & industrial	$ 356,750	$ —
Real estate – commercial	13,205,744	—
Real estate – residential	2,120,755	—
Consumer	11,470	2,401
Total	$ 15,694,719	$ 2,401

During the years ended December 31, 2013 and 2012, the Bank had $384,673 and $291,170 of interest income foregone from loans on nonaccrual status.

The following tables present the ageing of the recorded investment in past due loans as of December 31, 2013 and 2012, by class of loans:

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Loans Not Past Due	Total
December 31, 2013:						
Commercial & industrial	$ —	$ —	$ —	$ —	$ 14,945,080	$ 14,945,080
Real estate - construction	—	—	—	—	1,951,536	1,951,536
Real estate - commercial	—	—	5,326	5,326	63,528,268	63,533,594
Real estate - residential	—	—	—	—	8,946,849	8,946,849
Consumer	44,850	—	—	44,850	1,647,093	1,691,943
Total	$ 44,850	$ —	$ 5,326	$ 50,176	$ 91,018,826	$ 91,069,002
December 31, 2012:						
Commercial & industrial	$ —	$ —	$ —	$ —	$ 14,951,466	$ 14,951,466
Real estate - construction	—	—	—	—	697,200	697,200
Real estate - commercial	—	—	—	—	66,085,299	66,085,299
Real estate – residential	161,040	170,978	474,720	806,738	10,239,308	11,046,046
Consumer	10,903	—	2,401	13,304	886,625	899,929
Total	$ 171,943	$ 170,978	$ 477,121	$ 820,042	$ 92,859,898	$ 93,679,940

4. LOANS AND THE ALLOWANCE FOR LOAN LOSSES (Continued)

Troubled Debt Restructurings

During the year ended December 31, 2013, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or interest-only payments for a period of time.

Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from two years to five years. Modifications involving an extension of the maturity date were for periods ranging from two years to five years.

The following table presents loans by class modified as troubled debt restructurings that occurred during the years ended December 31, 2013 and 2012:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
December 31, 2013:			
Troubled Debt Restructurings:			
Commercial & industrial	4	$ 257,891	$ 257,891
Real estate - commercial	1	354,529	354,529
Real estate – residential	2	184,156	184,156
Total	7	$ 796,576	$ 796,576
December 31, 2012:			
Troubled Debt Restructurings:			
Commercial & industrial	1	$ 18,585	$ 18,585
Real estate – commercial	2	220,775	220,775
Real estate – residential	3	530,692	530,692
Consumer	1	8,876	8,876
Total	7	$ 778,928	$ 778,928

The troubled debt restructurings described above increased the allowance for loan losses by $59,000 and $118,000 during the years ended December 31, 2013 and 2012, respectively.

Included in the impaired and nonaccrual loans above are 28 and 30 loans in the amounts of $9,079,233 and $10,013,070 that were considered to be troubled debt restructurings at December 31, 2013 and 2012, respectively. The Bank has allocated $470,000 and $348,000 of specific reserves to loans whose terms have been modified in troubled debt restructurings as of December 31, 2013 and 2012, respectively. Outstanding commitments to lend additional funds to one of these borrowers at December 31, 2013 were not significant.

4. LOANS AND THE ALLOWANCE FOR LOAN LOSSES (Continued)

Troubled Debt Restructurings (Continued)

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the years ended December 31, 2013 and 2012:

Troubled Debt Restructurings
That Subsequently Defaulted:

	Number of Loans	Recorded Investment
2013:		
Commercial & industrial	2	$ 195,859
Real estate – commercial	1	354,529
Real estate – residential	1	104,312
Total	4	$ 654,700
2012:		
Commercial & industrial	1	$ 18,585
Real estate - commercial	1	140,713
Total	2	$ 159,298

A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms, or the loan has been placed on nonaccrual status.

The troubled debt restructurings that subsequently defaulted described above did not directly increase the allowance for loan losses.

The terms of certain other loans were modified during the year ended December 31, 2013 that did not meet the definition of a troubled debt restructuring. These loans have a total recorded investment as of December 31, 2013 of $11,698,250. The modification of these loans involved either a modification of the terms of a loan to borrowers who were not experiencing financial difficulties or a delay in a payment that was considered to be insignificant.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Bank's internal underwriting policy.

5. OTHER REAL ESTATE

At December 31, 2013 and 2012, the Bank had $0 and $492,200 respectively, invested in properties acquired through foreclosure. The properties are described in the following paragraph. These properties are carried at the lower of cost or fair value, less estimated costs to sell. Fair value is based on recently obtained third-party appraisals or recent offers on like properties, less disposition costs. The table below provides a summary of the change in other real estate (OREO) balances for the years ended December 31, 2013 and 2012.

	2013	2012
Beginning balance	$ 492,200	$ 1,690,311
Additions	296,240	2,592,372
Capitalized improvements	—	24,505
Dispositions	(760,462)	(2,796,426)
Impairment charges	—	(1,042,587)
Net (loss) gain on disposition	(27,978)	24,025
Ending balance	$ —	$ 492,200

At December 31, 2013, the Bank had no OREO.

During 2013 one of the two properties held at year-end 2012 was sold and the other property held at year-end 2012 was converted to Bank use in September 2013 with the net carrying value of $161,000 transferred to bank premises. One additional property acquired during 2013 was sold. Total sales proceeds were $599,462 with a net loss of $27,978.

During 2012 three of the four properties held at year-end 2011 were sold, and five additional properties acquired during 2012 were sold. Total sales proceeds were $2,796,426, with a net gain of $24,025.

Expenses related to OREO consisted of the following for the years ended December 31, 2013 and 2012:

	2013	2012
Impairment charges	$ —	$ 1,042,587
Operating expenses, net of rental income	27,184	51,227
Total	$ 27,184	$ 1,093,814

6. PREMISES AND EQUIPMENT

Premises and equipment consisted of the following:

	December 31,	
	2013	2012
Land	$ 695,904	$ 695,904
Buildings	2,090,482	1,905,930
Furniture, fixtures and equipment	1,389,188	1,456,722
Leasehold improvements	463,409	1,474,173
Company automobiles	188,428	188,428
	4,827,411	5,721,157
Less accumulated depreciation and amortization	(2,512,661)	(3,500,377)
	$ 2,314,750	$ 2,220,780

Depreciation and amortization included in occupancy and equipment expense totaled $280,739 and $246,539 for the years ended December 31, 2013 and 2012, respectively.

7. INTEREST-BEARING DEPOSITS

Interest-bearing deposits consisted of the following:

	December 31,	
	2013	2012
Savings	$ 18,566,515	$ 19,155,773
Money market	14,802,680	14,397,872
NOW	12,659,171	12,962,834
Time, $100,000 or more	19,340,882	20,212,546
Other time	15,389,127	16,937,603
	$ 80,758,375	$ 83,666,628

Aggregate annual maturities of time deposits are as follows:

Year Ending December 31,	
2014	$ 24,114,668
2015	5,657,312
2016	1,700,818
2017	2,195,875
2018	1,061,336
	$ 34,730,009

7. INTEREST-BEARING DEPOSITS (Continued)

Interest expense recognized on interest-bearing deposits consisted of the following:

	Year Ended December 31,	
	2013	2012
Savings	$ 22,613	$ 22,111
Money market	27,155	27,368
NOW	6,517	5,529
Time, $100,000 or more	152,858	222,589
Other time	102,933	157,319
	$ 312,076	$ 434,916

8. BORROWING ARRANGEMENTS

We have a $3,000,000 borrowing arrangement secured by certain investment securities with one of our correspondent banks to meet short-term liquidity needs. There were no borrowings outstanding under this arrangement at December 31, 2013 and 2012.

We have a borrowing arrangement with the Federal Home Loan Bank (FHLB) under which short-term or long-term advances are secured by certain loans in the loan portfolio and all FHLB stock we own. Our credit limit varies according to our total assets and the amount and composition of the loan portfolio pledged as collateral. At December 31, 2013, amounts pledged and available to borrow under such limits were approximately $46,035,000 and $23,490,000, respectively. At December 31, 2012, amounts pledged and available to borrow under such limits were approximately $57,029,000 and $25,365,000, respectively. There were no borrowings outstanding under this arrangement at December 31, 2013 and 2012.

9. INCOME TAXES

The provision for income taxes for the years ended December 31, 2013 and 2012, consisted of the following:

	Federal	State	Total
2013			
Current	$ —	$ —	$ —
Deferred	162,000	46,000	208,000
	162,000	46,000	208,000
Change in valuation allowance	(162,000)	(46,000)	(208,000)
Provision for income taxes	$ —	$ —	$ —
2012			
Current	$ (76,000)	$ 2,000	$ (74,000)
Deferred	(395,000)	(141,000)	(536,000)
	(471,000)	(139,000)	(610,000)
Change in valuation allowance	1,605,000	715,000	2,320,000
Provision for income taxes	$ 1,134,000	$ 576,000	$ 1,710,000

9. INCOME TAXES (Continued)

Deferred tax assets (liabilities) are included in accrued interest receivable and other assets on the balance sheets and consisted of the following:

	December 31, 2013	December 31, 2012
Deferred tax assets:		
Net operating loss	$ 1,382,000	$ 1,755,000
Allowance for loan losses	832,000	821,000
Deferred compensation	285,000	239,000
Premises and equipment	236,000	205,000
Non-accrual loan interest	172,000	—
Unrealized loss on available-for-sale investment securities	117,000	—
Other real estate	—	36,000
Reserve for off balance sheet credit losses	26,000	26,000
Share-based compensation	34,000	22,000
Alternative minimum tax credits	18,000	—
Charitable contributions	—	19,000
Future benefit of State tax liability	—	1,000
Deferred tax assets before valuation allowance	3,102,000	3,124,000
Valuation allowance	(2,409,000)	(2,617,000)
Total deferred tax assets	693,000	507,000
Deferred tax liabilities:		
Future liability of State deferred tax assets	(246,000)	(268,000)
Deferred loan origination costs	(242,000)	(150,000)
Prepaid expenses	(61,000)	(64,000)
Unrealized gain on available-for-sale investment securities	—	(42,000)
Federal Home Loan Bank stock	(27,000)	(25,000)
Total deferred tax liabilities	(576,000)	(549,000)
Net deferred tax assets (liabilities)	$ 117,000	$ (42,000)

As of December 31, 2013, we performed an evaluation of our ability to utilize all of our deferred tax assets or to reverse all or a portion of the 100% valuation allowance previously established against the net deferred tax assets considering the following negative and positive evidence. The negative evidence we considered was: (1) the Bank experienced cumulative three year losses through 2012; (2) non-accrual loans remain at high levels with a continuing negative impact on current and future earnings potential; (3) core earnings, before gains on sales of loans, were negative in 2013. The positive evidence we considered included: (1) the Bank reported taxable income in 2013; (2) the Bank is projecting increased earnings for 2014 through 2016; (3) the Bank has a pipeline of potential new SBA guaranteed loans that can be sold for significant gains in the future; and (4) the Bank had no foreclosed properties at year end and management believes classified loans have been written down to their realizable values. As a result of our evaluation, management concluded the negative evidence outweighed the positive evidence and that the 100% valuation allowance should remain in place at December, 31 2013, exclusive of the deferred tax asset associated with the market value of available-for-sale investment securities.

9. INCOME TAXES (Continued)

At December 31, 2013, we had Federal net operating loss carry-forwards (NOLs) of $2,728,000 and California State NOLs of $4,190,000. The Federal NOLs begin to expire in 2030 and the California State NOLs begin to expire in 2029.

The benefit for income taxes differs from amounts computed by applying the statutory Federal income tax rate of 34% to the loss before income taxes. The effects of these differences are as follows:

	Year Ended December 31,	
	2013	2012
Federal income tax expense (benefit), at statutory rate	$ 234,000	$ (404,000)
State franchise tax expense (benefit), net of Federal tax effect	49,000	(83,000)
Interest on obligations of states and political subdivisions	(9,000)	(19,000)
Tax-exempt income from life insurance policies	(44,000)	(46,000)
Valuation allowance	(208,000)	2,320,000
Other	(22,000)	(58,000)
Total income tax expense	$ —	$ 1,710,000

We are subject to U.S. Federal income tax as well as California state franchise tax. There are currently no pending examinations by those taxing authorities. Federal tax returns for the years from 2012 to 2010 and California tax returns for the years from 2012 to 2009 are currently open for examination.

There are no unrecognized tax benefits for uncertain tax positions and the Bank has not accrued for any interest or penalties at December 31, 2013 and 2012.

10. COMMITMENTS

Operating Leases

We lease one branch office under a non-cancelable operating lease. The lease expires in February 2019 with one additional five year renewal option.

Future minimum lease payments are as follows:

Year Ending December 31,	
2014	$ 35,400
2015	36,000
2016	36,000
2017	36,000
2018	36,000
2019	6,000
	$ 185,400

10. COMMITMENTS (Continued)

Operating Leases (Continued)

Rental expense included in occupancy and equipment expense totaled $97,625 and $152,575 for the years ended December 31, 2013 and 2012, respectively.

Financial Instruments with Off-Balance-Sheet Risk

We are party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of our customers and to reduce our own exposure to fluctuations in interest rates. These financial instruments consist of commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the balance sheet.

Our exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. We use the same credit policies in making commitments and standby letters of credit as we do for loans included on the balance sheet.

The following financial instruments represent off-balance-sheet credit risk:

	December 31,	
	2013	2012
Commitments to extend credit	$ 7,985,000	$ 7,451,000
Standby letters of credit	$ —	$ 130,000

Commitments to extend credit are agreements to lend to a customer as long as they adhere to the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if we deem necessary upon extension of credit, is based on our credit evaluation of the borrower. Collateral held varies, but may include accounts receivable, inventory, and deeds of trust on residential real estate, land held for development and income-producing commercial properties.

Financial Instruments with Off-Balance-Sheet Risk (Continued)

Standby letters of credit are conditional commitments we issue to guarantee the performance or financial obligation of a customer to a third party. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loans to customers. The fair value of the liability related to these standby letters of credit, which represents the fees received for issuing the guarantees, was not significant at December 31, 2013 and 2012. We recognize these fees as revenue over the term of the commitment or when the commitment is used.

At December 31, 2013, real estate loan commitments represented approximately 76% of total commitments and are generally secured by property with a loan-to-value ratio not to exceed 75%. Commercial lines of credit, personal lines of credit and other commitments represented the remaining 24% of total commitments. In addition, the majority of our loan commitments have variable interest rates.

10. COMMITMENTS (Continued)

Significant Concentrations of Credit Risk

We grant real estate mortgage, real estate construction, commercial and installment loans to customers in our geographic service area. In our judgment, a concentration exists in real estate related loans which represented approximately 82% and 83% of the Bank's loan portfolio at December 31, 2013 and 2012, respectively. A continued decline in the economy in general, a continuation of current economic conditions for an extended period of time, or additional declines in real estate values in our primary market area in particular, could have an adverse impact on collectability of these loans. Personal and business income represent the primary source of repayment for a majority of these loans.

Correspondent Banking Agreements

We maintain funds on deposit with other federally insured financial institutions under correspondent banking agreements. Uninsured deposits were estimated to be $684,520 at December 31, 2013.

Federal Reserve Requirement

Banks are required to maintain reserves with the Federal Reserve Bank equal to a percentage of their reservable deposits less vault cash. Our vault cash fulfilled our reserve requirement at December 31, 2013.

11. CONTINGENCIES

Because of the nature of our activities, we are subject to pending, threatened and filed legal actions which arise in the ordinary course of business. In our opinion, liabilities arising from these claims, if any, will not have a significant effect on our financial position or results of operations.

12. SHAREHOLDERS' EQUITY

Dividends

Our ability to pay cash dividends is limited by California law. Under California law, the holders of common stock of the Bank are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available, subject to certain restrictions. California General Corporation Law prohibits us from paying dividends on our common stock unless:

(1) our retained earnings, immediately prior to the dividend payment, equals or exceeds the amount of the dividend or
(2) immediately after giving effect to the dividend,
    - the sum of our assets (exclusive of goodwill and deferred charges) would be at least equal to 125% of our liabilities (not including deferred taxes, deferred income and other deferred liabilities) and
    - our current assets would be at least equal to our current liabilities, or, if the average of our earnings before taxes on income and before interest expense for the two preceding fiscal years was less than the average of our interest expense for the two preceding fiscal years, at least equal to 125% of our current liabilities.

The California Financial Code restricts the total dividend payment of any bank in any one year to the lesser of:

(1) the bank's retained earnings or
(2) the bank's net income for its last three fiscal years, less distributions made to shareholders during the same three-year period.

At December 31, 2013, no retained earnings were free of such restrictions.

12. SHAREHOLDERS' EQUITY (Continued)

Earnings (Loss) Per Share

A reconciliation of the numerators and denominators of the basic and diluted loss per share computations for the years ended December 31, 2013 and 2012, is shown below.

	Net Income/(Loss)	Weighted Average Number of Shares Outstanding	Per Share Amount
December 31, 2013			
Basic earnings per share	$ 680,149	1,564,926	$ 0.43
Effect of dilutive stock options	—	19,818	
Diluted earnings per share	$ 680,149	1,584,744	$ 0.43
December 31, 2012			
Basic loss per share	$ (2,899,196)	1,564,926	$ (1.85)

Outstanding options of 59,194 were not factored into the calculation of dilutive stock options at December 31, 2013 because they were anti-dilutive.

At December 31, 2012, diluted earnings per share is not presented because the conversion of potential common stock is anti-dilutive when a loss occurs.

Regulatory Capital

The Bank is subject to certain regulatory capital requirements administered by the FDIC. Failure to meet these minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on our financial statements.

Under capital adequacy guidelines, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. These quantitative measures are established by regulation and require that minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets (leverage ratio) be maintained. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

We are also subject to additional capital guidelines under the regulatory framework for prompt corrective action. To be categorized as well capitalized, we must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. The Bank maintained capital levels at December 31, 2013 and 2012, that fall within the category of well-capitalized under the framework for prompt corrective action. During 2011 the Bank entered into an agreement with the FDIC to maintain a minimum leverage ratio of 9.0%. The Bank had a leverage ratio of 9.2% at December 31, 2013, which is above the required level. Management believes as of December 31, 2013, the Bank meets all capital adequacy requirements to which it is subject.

12. SHAREHOLDERS' EQUITY (Continued)

Regulatory Capital (Continued)

In addition, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth below. There are no conditions or events since that notification that management believes have changed the Bank's category.

	December 31,			
	2013		2012	
	Amount	Ratio	Amount	Ratio
Leverage Ratio				
First Mountain Bank	$ 12,206,000	9.2%	$ 11,511,000	8.5%
Minimum requirement for "Well-Capitalized" institution under prompt corrective action provisions	$ 6,666,000	5.0%	$ 6,788,000	5.0%
Minimum regulatory requirement	$ 5,333,000	4.0%	$ 5,431,000	4.0%
Tier 1 Risk-Based Capital Ratio				
First Mountain Bank	$ 12,206,000	12.3%	$ 11,511,000	11.2%
Minimum requirement for "Well-Capitalized" institution under prompt corrective action provisions	$ 5,971,000	6.0%	$ 6,145,000	6.0%
Minimum regulatory requirement	$ 3,981,000	4.0%	$ 4,097,000	4.0%
Total Risk-Based Capital Ratio				
First Mountain Bank	$ 13,470,000	13.5%	$ 12,811,000	12.5%
Minimum requirement for "Well-Capitalized" institution under prompt corrective action provisions	$ 9,952,000	10.0%	$ 10,241,000	10.0%
Minimum regulatory requirement	$ 7,962,000	8.0%	$ 8,193,000	8.0%

13. SHARE-BASED COMPENSATION

In February 2011 the Holding Company adopted the 2011 Equity Compensation Plan (the “Plan”). The Plan provides for the issuance of up to 215,000 shares of the Bank’s common stock through exercises of stock option awards or grants of restricted common stock. The 2011 Plan replaces the First Mountain Bancorp 2001 Stock Option Plan and the 2009 Restricted Stock Award Plan so that no future grants may be made from the prior plans. Under the 2011 Plan, stock options or restricted stock awards may be granted to certain key officers and directors of the Bank at the discretion of the Board of Directors or a designated committee of the Board. The Plan became effective February 22, 2011, and will terminate 10 years after its effective date. The Plan does not provide for the settlement of awards in cash, and new shares are issued upon option exercise and the vesting of restricted stock.

In addition, all outstanding options issued from the 2001 Stock Option Plan were assumed by the 2011 Equity Compensation Plan.

On January 24, 2013, the Holding Company was merged with and into the Bank. As of that date, the Bank adopted and assumed all of the Holding Company’s rights and obligations under the Plan and under each outstanding stock option agreement evidencing an option or other equity right previously granted under the Plan or any other predecessor plan.

13. SHARE-BASED COMPENSATION (Continued)

Stock Options

The Plan requires that the option price may not be less than the fair market value of the stock at the date the option is granted, and that the stock must be paid in full at the time the option is exercised. The options expire on a date determined by the Board of Directors, but not later than ten years from the date of grant. The vesting period is determined by the Board of Directors and is generally over five years.

There are 59,194 shares remaining as reserved for issuance for options already granted to employees and directors under incentive and nonstatutory agreements.

For the years ended December 31, 2013 and 2012, the compensation cost recognized for share-based compensation related to stock options was $1,935 and $6,581, respectively.

A summary of the stock option activity for the years ended December 31, 2012 and 2013 follows:

	Number of Stock Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)
Options outstanding at January 1, 2012	86,496	$ 12.58	
Options expired	(19,115)	$ 6.36	
Options outstanding at December 31, 2012	67,381	$ 14.35	
Options expired	(8,187)	$ 11.29	
Options outstanding at December 31, 2013	59,194	$ 14.39	2.99
Options vested or expected to vest at December 31, 2013	59,194	$ 14.39	2.99
Options exercisable at December 31, 2013	59,194	$ 14.39	2.99

There were no options granted during the years ended December 31, 2013 and 2012. There were no options exercised during the years ended December 31, 2013 and 2012. There was no intrinsic value associated with options outstanding, vested or expected to vest at December 31, 2013.

As of December 31, 2013, there was no unrecognized compensation cost related to non-vested stock option share-based compensation arrangements. Total fair value of options vesting during the years ended December 31, 2013 and 2012 were $1,935 and $6,581 respectively.

13. SHARE-BASED COMPENSATION (Continued)

Restricted Common Stock Awards

Restricted stock awards are grants of shares of the Bank's common stock that are subject to forfeiture until specific conditions or goals are met. Conditions may be based on continuing employment or service and/or achieving specified performance goals. During the period of restriction, Plan participants holding restricted share awards have no voting or cash dividend rights. The restrictions lapse in accordance with a schedule or with other conditions determined by the Board of Directors as reflected in each award agreement. Upon the vesting of each restricted stock award, the Bank issues the associated common shares from its inventory of authorized common shares. All outstanding awards under the Plan immediately vest in the event of a change in control of the Bank. The shares associated with any awards that fail to vest become available for re-issuance under the Plan. No restricted shares were granted in 2013 and 2012.

In February 2011, the Bank granted 25,500 shares of restricted common stock to selected officers and directors, which had a fair market value of $3.25 per share on the date of grant. These restricted common stock awards vest over three years based on performance measures as defined by the Board of Directors.

In April 2009, the Bank granted 14,000 shares of restricted common stock to selected officers, which had a fair market value of $6.05 per share on the date of grant. These restricted common stock awards vest over three years based on performance measures as defined by the Board of Directors. There were no restricted shares granted or outstanding prior to April 20, 2009.

On April 20, 2010, 4,664 shares of restricted stock vested and were issued to four executive officers of the Bank. As of December 31, 2013, 22,500 shares of restricted stock are unissued, nonvested and expected to vest. Compensation cost for restricted stock awards was $18,423 for the year ended December 31, 2013. During 2012 the Bank canceled 9,336 nonvested restricted shares granted in 2009 because it was not probable that performance goals would be met. As a result of the cancelation, the Bank recorded a net compensation benefit of $19,048 for the year ended December 31, 2012. There were no tax benefits recognized in the statements of operations for restricted stock awards for the years ended December 31, 2013 or 2012. At December 31, 2013, the total compensation cost related to nonvested restricted common stock not yet recognized was $4,128. Restricted stock compensation expense is recognized based on the probability of the performance criteria being achieved for all grants of restricted stock with performance-based vesting terms. This cost is expected to be recognized over a weighted average remaining period of approximately two months and will be adjusted for subsequent changes in estimated forfeitures. No restricted stock vested during the years ending December 31, 2013 and 2012.

The following table summarizes restricted common stock activity during the year ended December 31, 2013:

	Shares
Nonvested restricted stock grants at December 31, 2012	25,500
Shares canceled	(3,000)
Nonvested restricted stock grants at December 31, 2013	22,500

14. RELATED PARTY TRANSACTIONS

During the normal course of business, we enter into transactions with related parties, including directors and executive officers. The following is a summary of the aggregate activity involving related party borrowers during 2013:

Balance, January 1, 2013	$ 2,626,259
Disbursements	1,034,761
Amounts repaid	(892,346)
Balance, December 31, 2013	$ 2,768,674
Undisbursed commitments to related parties, December 31, 2013	$ 304,588

15. OTHER EXPENSES

Other expenses for the years ended December 31, 2013 and 2012 consisted of the following:

	2013	2012
Data processing	$ 670,248	$ 620,023
Other professional fees	343,770	327,055
Legal fees and litigation costs	260,002	275,418
FDIC insurance and assessments	182,402	183,589
Debit card expenses	141,248	120,760
Communications and postage	132,846	180,021
Insurance	124,877	133,211
Advertising and promotion	95,426	95,753
Stationery and supplies	68,094	68,373
Directors' expenses	62,269	91,633
Repossession and collection expenses	—	140,315
Other operating expenses	342,469	346,099
	$ 2,423,651	$ 2,582,250

16. RETIREMENT PLANS

Savings Plans and Employee Stock Ownership Plan

We had a combination Employee Stock Ownership Plan (ESOP) and salary deferral 401(k) plan for the benefit of our employees. Under the plan, eligible employees were able to defer a selected percentage of their annual compensation. We were able to, at our discretion, make matching contributions to the employee salary deferrals or to the ESOP portion of the plan. The ESOP plan was frozen, and all participants were fully vested in any employer contributions. The ESOP was terminated and merged into the existing 401(k) plan during 2012. There were no contributions to the ESOP during 2012.

In 2001, we established a new salary deferral 401(k) plan for the benefit of our employees. Under the plan, employees meeting certain service requirements may defer a selected percentage of their annual compensation. The Bank may make a discretionary contribution that is determined annually by the Board of Directors under which the Bank will match a percentage of each participant's contribution.

There were no employer matching contributions for the years ended December 31, 2013 and 2012.

16. RETIREMENT PLANS (Continued)

Salary Continuation Program and Bank Owned Life Insurance

The Bank maintains a salary continuation plan for a key executive. Under this plan, the Bank is obligated to provide the executive with annual benefits for 15 years after retirement. In addition, under a split dollar benefit added to this program, the Bank has effectively agreed to maintain life insurance policies on the executive during the related postretirement period, under which the executive's beneficiaries will receive designated proceeds from split dollar life insurance policies at his death. The estimated present value of these future benefits will be accrued over the period from the effective date of the program until the participant's effective retirement date.

Liabilities accrued in connection with the salary continuation program totaled $474,113 and $389,799 at December 31, 2013 and 2012, respectively. Expense recognized totaled $84,314 and $76,884 for the years ended December 31, 2013 and 2012, respectively.

A liability at December 31, 2013 and 2012, has been accrued in the amounts of $63,615 and $52,323, respectively, representing the present value of the costs to maintain the life insurance policies during the post-retirement period.

The Bank maintains life insurance policies on the executive noted above, as well as on other former Bank executives. Cash surrender values related to these life insurance policies totaled $3,639,525 and $3,531,797 at December 31, 2013 and 2012, respectively. Income on these policies, net of expense, totaled $107,728 and $124,217 for the years ended December 31, 2013 and 2012, respectively.

Director Deferred Compensation Program

During 1994, a deferred compensation program was established for certain members of the Board of Directors. The program provided for annual cash payments to the Directors for a period not to exceed ten years, beginning after ten years of deferment. In the event of death prior to normal retirement age, annual cash payments would be made to beneficiaries for a period of ten years following the date of death. Liabilities accrued in connection with this program totaled $50,265 and $95,216 at December 31, 2013 and 2012, respectively. Expense recognized totaled $1,908 and $3,221 for the years ended December 31, 2013 and 2012, respectively.



BOARD OF DIRECTORS

John G. (Jack) Briner, *Chairman of the Board*

David M. LeRoy, *Vice Chairman, Assistant Secretary*

Walter J. Con

Russell D. Jeter

Dennis R. Saunders

G. Vincent Smith

OFFICERS

EXECUTIVE OFFICERS

John G. (Jack) Briner, Chief Executive Officer
Dennis R. Saunders, President/Chief Financial Officer
Debbie M. Seaman, Executive Vice President/Chief Operating Officer
Michael J. Curran, Executive Vice President/Chief Credit Officer

BANK OFFICERS

Kathleen Bauch
Central Operations

Terisa Bonito
Branch Manager

Paula Collier
Construction Lending

Marlene Fuller
Branch Manager

Michael Gonet
Credit Administration

Shirley Hartwick
Controller

Tracy Howe
Branch Manager

James Lloyd
IT Manager

Richard Miller
Compliance Officer

Nancy Planellas
Note Department Manager

Scottie Rood
Human Resources Manager

Diane Versaggi
Corporate Secretary



BANKING OFFICES

BIG BEAR LAKE
40865 Big Bear Blvd.
Big Bear Lake, California 92315
(909) 866-5861

LUCERNE VALLEY
32946 Highway 18, Suite D
Lucerne Valley, California 92356
(760) 248-2717

RUNNING SPRINGS
2625 Whispering Pines Dr.
Running Springs, California 92382
(909) 867-4242