



PRESIDIO
BANK

FINANCIAL STATEMENTS

December 31, 2012 and 2011

PRESIDIO BANK
San Francisco, California

FINANCIAL STATEMENTS
December 31, 2012 and 2011

CONTENTS

| | |
|-----------------------------------------------------|---|
| INDEPENDENT AUDITOR'S REPORT | 1 |
| FINANCIAL STATEMENTS | |
| BALANCE SHEETS | 2 |
| STATEMENTS OF INCOME | 3 |
| STATEMENTS OF COMPREHENSIVE INCOME | 4 |
| STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY | 5 |
| STATEMENTS OF CASH FLOWS..... | 6 |
| NOTES TO FINANCIAL STATEMENTS | 7 |

INDEPENDENT AUDITOR'S REPORT

The Shareholders and
Board of Directors
Presidio Bank
San Francisco, California

Report on the Financial Statements

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Presidio Bank as of December 31, 2012 and 2011, 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 LLP

San Francisco, California
March 18, 2013

PRESIDIO BANK
BALANCE SHEETS
December 31, 2012 and 2011

| | <u>2012</u> | <u>2011</u> |
|------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|-----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 66,538,893 | \$ 71,432,528 |
| Other overnight deposits | <u>10,055,000</u> | <u>10,005,000</u> |
| Total cash and cash equivalents | 76,593,893 | 81,437,528 |
| Available-for-sale investment securities, at fair value (Note 3) | 10,228,804 | - |
| Held-to-maturity investment securities, at amortized cost (Note 3) | 672,376 | 676,213 |
| Federal Reserve Bank stock, at cost | 1,364,250 | 1,314,150 |
| Federal Home Loan Bank stock, at cost | 1,180,000 | 1,138,700 |
| Loans, less allowance for loan losses of \$4,945,316 in 2012 and \$4,944,316 in 2011 (Notes 4, 5, 10 and 13) | 309,046,670 | 265,453,295 |
| Premises and equipment, net (Note 6) | 1,220,657 | 1,314,172 |
| Deferred tax assets, net (Note 8) | 3,324,000 | 4,186,000 |
| Accrued interest receivable and other assets | <u>1,840,568</u> | <u>1,829,864</u> |
| Total assets | <u>\$ 405,471,218</u> | <u>\$ 357,349,922</u> |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits: | | |
| Non-interest bearing | \$ 131,437,855 | \$ 89,208,889 |
| Interest bearing (Note 7) | <u>225,935,589</u> | <u>221,551,348</u> |
| Total deposits | 357,373,444 | 310,760,237 |
| Accrued interest payable and other liabilities | <u>2,209,223</u> | <u>1,898,732</u> |
| Total liabilities | <u>359,582,667</u> | <u>312,658,969</u> |
| Commitments and contingencies (Note 10) | | |
| Shareholders' equity (Notes 11 and 12): | | |
| Preferred stock, no par value; 10,000,000 shares authorized: | | |
| Series A, noncumulative, \$1,000 per share liquidation preference; 10,800 shares issued and outstanding | 10,677,222 | 10,612,222 |
| Series B, noncumulative, \$1,000 per share liquidation preference; 325 shares issued and outstanding | 325,000 | 325,000 |
| Common stock, no par value; 30,000,000 shares authorized; 4,123,064 and 4,092,212 shares issued and outstanding in 2012 and 2011, respectively | 42,809,380 | 42,317,701 |
| Accumulated deficit | (7,904,890) | (8,563,970) |
| Accumulated other comprehensive loss, net of tax | <u>(18,161)</u> | <u>-</u> |
| Total shareholders' equity | <u>45,888,551</u> | <u>44,690,953</u> |
| Total liabilities and shareholders' equity | <u>\$ 405,471,218</u> | <u>\$ 357,349,922</u> |

See accompanying notes to financial statements.

PRESIDIO BANK
STATEMENTS OF INCOME
Years Ended December 31, 2012 and 2011

| | <u>2012</u> | <u>2011</u> |
|---------------------------------------------------------|---------------------|---------------------|
| Interest and dividend income: | | |
| Interest and fees on loans | \$ 14,415,483 | \$ 14,465,823 |
| Interest on due from banks and other overnight deposits | 295,162 | 118,904 |
| Interest on investment securities | 31,380 | 27,151 |
| Dividend income | <u>92,005</u> | <u>75,516</u> |
| Total interest and dividend income | 14,834,030 | 14,687,394 |
| Interest expense: | | |
| Interest on deposits (Note 7) | 880,268 | 1,068,112 |
| Interest on borrowings | <u>-</u> | <u>91,916</u> |
| Total interest expense | 880,268 | 1,160,028 |
| Net interest income | 13,953,762 | 13,527,366 |
| Provision for loan losses (Note 5) | <u>-</u> | <u>841,381</u> |
| Net interest income after provision for loan losses | <u>13,953,762</u> | <u>12,685,985</u> |
| Non-interest income: | | |
| Service charges and fees | 458,805 | 361,848 |
| Other non-interest income | <u>68,839</u> | <u>54,184</u> |
| Total non-interest income | <u>527,644</u> | <u>416,032</u> |
| Non-interest expenses: | | |
| Salaries and employee benefits (Notes 5 and 14) | 7,515,898 | 6,613,007 |
| Occupancy and equipment (Notes 6 and 10) | 1,661,839 | 1,467,635 |
| Other (Note 15) | <u>3,029,337</u> | <u>3,062,754</u> |
| Total non-interest expenses | <u>12,207,074</u> | <u>11,143,396</u> |
| Income before income taxes | 2,274,332 | 1,958,621 |
| Provision for (benefit from) income taxes (Note 8) | <u>981,000</u> | <u>(4,087,000)</u> |
| Net income | <u>\$ 1,293,332</u> | <u>\$ 6,045,621</u> |
| Dividends on preferred stock | <u>569,252</u> | <u>1,130,593</u> |
| Net income available for common shareholders | <u>\$ 724,080</u> | <u>\$ 4,915,028</u> |
| Basic and diluted earnings per share | <u>\$ 0.18</u> | <u>\$ 1.22</u> |
| Weighted average basic shares outstanding | <u>4,117,878</u> | <u>4,033,260</u> |
| Weighted average diluted shares outstanding | <u>4,119,991</u> | <u>4,033,260</u> |

See accompanying notes to financial statements.

PRESIDIO BANK
STATEMENTS OF COMPREHENSIVE INCOME
Years Ended December 31, 2012 and 2011

| | <u>2012</u> | <u>2011</u> |
|-----------------------------------------------------|---------------------|---------------------|
| Net income | \$ 1,293,332 | \$ 6,045,621 |
| Other comprehensive loss: | | |
| Unrealized losses on available-for-sale securities: | | |
| Unrealized holding loss arising during the period | (30,863) | - |
| Tax effect | <u>12,702</u> | <u>-</u> |
| Total other comprehensive loss | <u>(18,161)</u> | <u>-</u> |
| Comprehensive income | <u>\$ 1,275,171</u> | <u>\$ 6,045,621</u> |

See accompanying notes to financial statements.

PRESIDIO BANK
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years Ended December 31, 2012 and 2011

| | <u>Preferred Stock – Series A</u> | | <u>Preferred Stock – Series B</u> | | <u>Common Stock</u> | | <u>Accumulated Deficit</u> | <u>Accumulated Other Comprehensive Loss</u> | <u>Total Shareholders' Equity</u> |
|------------------------------------------------------|-----------------------------------|----------------------|-----------------------------------|-------------------|---------------------|----------------------|----------------------------|---------------------------------------------|-----------------------------------|
| | <u>Shares</u> | <u>Amount</u> | <u>Shares</u> | <u>Amount</u> | <u>Shares</u> | <u>Amount</u> | | | |
| Balance, January 1, 2011 | 10,800 | \$ 10,547,222 | 325 | \$ 325,000 | 4,036,099 | \$ 41,930,154 | \$ (13,413,998) | \$ - | \$ 39,388,378 |
| Amortization of discount on Series A Preferred stock | - | 65,000 | - | - | - | - | (65,000) | - | - |
| Preferred dividends | - | - | - | - | - | - | (1,130,593) | - | (1,130,593) |
| Restricted stock granted | - | - | - | - | 57,510 | - | - | - | - |
| Restricted stock forfeited | - | - | - | - | (1,397) | - | - | - | - |
| Share-based compensation expense | - | - | - | - | - | 387,547 | - | - | 387,547 |
| Net Income | - | - | - | - | - | - | 6,045,621 | - | 6,045,621 |
| Balance, December 31, 2011 | 10,800 | 10,612,222 | 325 | 325,000 | 4,092,212 | 42,317,701 | (8,563,970) | - | \$ 44,690,953 |
| Amortization of discount on Series A Preferred stock | - | 65,000 | - | - | - | - | (65,000) | - | - |
| Preferred dividends | - | - | - | - | - | - | (569,252) | - | (569,252) |
| Restricted stock granted | - | - | - | - | 30,852 | - | - | - | - |
| Share-based compensation expense | - | - | - | - | - | 491,679 | - | - | 491,679 |
| Net Income | - | - | - | - | - | - | 1,293,332 | - | 1,293,332 |
| Other comprehensive loss | - | - | - | - | - | - | - | (18,161) | (18,161) |
| Balance, December 31, 2012 | <u>10,800</u> | <u>\$ 10,677,222</u> | <u>325</u> | <u>\$ 325,000</u> | <u>4,123,064</u> | <u>\$ 42,809,380</u> | <u>\$ (7,904,890)</u> | <u>\$ (18,161)</u> | <u>\$ 45,888,551</u> |

See accompanying notes to financial statements.

PRESIDIO BANK
STATEMENTS OF CASH FLOWS
Years Ended December 31, 2012 and 2011

| | <u>2012</u> | <u>2011</u> |
|-----------------------------------------------------------------------------------|----------------------|----------------------|
| Cash flows from operating activities: | | |
| Net income | \$ 1,293,332 | \$ 6,045,621 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | - | 841,381 |
| Amortization of discounts on investment securities | (25,798) | (27,151) |
| Depreciation and amortization | 563,805 | 427,138 |
| (Gain) loss on disposal of equipment | (1,750) | 14,963 |
| Deferred loan origination fees, net | 203,861 | 68,405 |
| Share-based compensation expense | 491,679 | 387,547 |
| Deferred income taxes | 874,000 | 666,000 |
| Change in valuation allowance on deferred tax assets | - | (4,852,000) |
| (Increase) decrease in accrued interest receivable and other assets | (10,002) | 218,697 |
| Increase in accrued interest payable and other liabilities | <u>310,491</u> | <u>129,671</u> |
| Net cash provided by operating activities | <u>3,699,618</u> | <u>3,920,272</u> |
| Cash flows from investing activities: | | |
| Purchases of available-for-sale investment securities | (10,260,870) | - |
| Proceeds from principal payments on held-to-maturity investment securities | 30,838 | 30,839 |
| Purchase of Federal Reserve Bank stock | (50,100) | (147,500) |
| Purchase of FHLB stock | (41,300) | (115,100) |
| Net increase in loans | (43,797,236) | (12,662,509) |
| Purchases of premises and equipment | (470,290) | (250,394) |
| Proceeds from sale of premises and equipment | <u>1,750</u> | <u>-</u> |
| Net cash used in investing activities | <u>(54,587,208)</u> | <u>(13,144,664)</u> |
| Cash flows from financing activities: | | |
| Net increase in demand, interest-bearing and savings deposits | 45,746,207 | 60,586,848 |
| Net increase in time deposits | 867,000 | 2,806,272 |
| Repayments of FHLB advances | - | (3,000,000) |
| Payment of dividends on preferred stock | <u>(569,252)</u> | <u>(1,130,593)</u> |
| Net cash provided by financing activities | <u>46,043,955</u> | <u>59,262,527</u> |
| (Decrease) increase in cash and cash equivalents | (4,843,635) | 50,038,135 |
| Cash and cash equivalents at beginning of year | <u>81,437,528</u> | <u>31,399,393</u> |
| Cash and cash equivalents at end of year | <u>\$ 76,593,893</u> | <u>\$ 81,437,528</u> |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest expense | \$ 896,590 | \$ 1,205,578 |
| Cash paid for income taxes | \$ 105,195 | \$ 74,000 |

See accompanying notes to financial statements.

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 1 – THE BUSINESS OF PRESIDIO BANK

Presidio Bank (the "Bank") was approved as state-chartered bank on July 24, 2006 and is a member of the Federal Reserve System (the "Fed"). The Bank is subject to regulation by the Fed, the California Department of Financial Institutions (the "DFI"), and the Federal Deposit Insurance Corporation (the "FDIC"). The Bank's deposits are insured by the FDIC up to applicable legal limits.

Through December 31, 2012, all noninterest-bearing transaction accounts are fully guaranteed by the FDIC; however, this additional guarantee lapsed on January 1, 2013. All accounts are insured up to \$250,000 per depositor under the FDIC's general deposit insurance rules.

The Bank is headquartered in San Francisco, California and also has branch offices in Walnut Creek, San Rafael, and Palo Alto, California. The Bank provides traditional commercial banking services to its target market throughout Northern California, consisting of small to medium sized businesses, along with the owners and executives of those firms.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General: The accounting and reporting policies of the Bank conform with accounting principles generally accepted in the United States of America and prevailing practices within the banking industry.

Subsequent Events: Management has reviewed all events occurring from December 31, 2012 through March 18, 2013, the date the financial statements were available to be issued.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The allowance for loan losses, deferred tax assets and the fair value of financial instruments are particularly subject to change. Actual results could differ from these estimates.

Operating Segments: While the Bank's executive officers monitor the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Bank-wide basis. Operating results are not reviewed by senior management to make resource allocation or performance decisions. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable operating segment.

Reclassifications: Certain reclassifications have been made to the prior year's balances in order to conform to the classifications used in the current year.

Cash and Cash Equivalents: For the purpose of the statement of cash flows, cash and cash equivalents consist of cash and due from banks as well as other overnight deposits.

Federal Reserve Bank Stock and Federal Home Loan Bank Stock: As a member of both the Federal Reserve Bank (the "FRB") and the Federal Home Loan Bank (the "FHLB"), the Bank is required to maintain a minimum level of investment in the capital stocks of the FRB and FHLB. These investments are considered restricted equity securities and are carried at par value. The Bank may request redemption at par value in excess of the amount required to be held. Stock redemptions are made at the discretion of the FRB and FHLB. Both cash and stock dividends are reported as income.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 management has the positive intent and ability to hold, reported at amortized cost, adjusted for the accretion of discounts and amortization of premiums.

Management determines the appropriate classification of its 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. There were no transfers between categories during the years ended December 31, 2012 or 2011.

Gains or losses on the sale of investment securities are computed using the specific identification method. Interest earned on investment securities is reported in interest income, net of applicable adjustments for accretion of discounts and amortization of premiums.

An investment security is impaired when its carrying value is greater than its fair value. Investment securities that are impaired are evaluated on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether such a decline in their fair value is other than temporary. Management utilizes criteria such as the magnitude and duration of the decline and the intent and ability of the Bank to retain its investment in the securities for a period of time sufficient to allow for an anticipated recovery in fair value, in addition to the reasons underlying the decline, to determine whether the loss in value is other than temporary. The term "other than temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other than temporary, and management does not intend to sell the security or it is more likely than not that the Bank will not be required to sell the security before recovery, only the portion of the impairment loss representing credit exposure is recognized as a charge to earnings, with the balance recognized as a charge to other comprehensive income. If management intends to sell the security or it is more likely than not that the Bank will be required to sell the security before recovering its forecasted cost, the entire impairment loss is recognized as a charge to earnings.

Loans: Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are recorded at the principal balances outstanding, net of deferred loan origination fees and costs and the allowance for loan losses. Interest is accrued daily based upon outstanding loan balances. However, when in the opinion of management, loans are considered to be impaired and the future collectibility of interest and principal is in serious doubt, loans are placed on nonaccrual status and the accrual of interest income is suspended. Any interest accrued but unpaid is charged against income. Payments received are applied to reduce principal to the extent necessary to ensure collection. Subsequent payments on these loans, or payments received on nonaccrual loans for which the ultimate collectibility of principal is not in doubt, are applied first to earned but unpaid interest and then to principal. Generally, loans are placed on non-accrual status when they are 90 days past due. Past due status is based on the contractual terms of the loan. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. The Bank's policy for placing loans on nonaccrual status, recording payments received on nonaccrual loans resuming accrual of interest and determining past due or delinquency status does not differ by portfolio segment.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

All loans are evaluated and considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due (including both principal and interest) in accordance with the contractual terms of the loan agreement. The policy for recognizing interest on impaired loans is the same as the policy described above and does not differ by portfolio segment.

Substantially all loan origination and commitment fees, net of direct loan origination costs, and purchase premiums and discounts on loans are deferred and recognized as an adjustment of yield, to be amortized to interest income over the contractual term of the loan. The unamortized balance of deferred fees and costs is reported as a component of net loans.

The Bank services loans that have been participated to other financial institutions totaling approximately \$23,065,000 and \$17,351,000 at December 31, 2012 and 2011, respectively.

Allowance for Loan Losses: The allowance for loan losses is an estimate of credit losses inherent in the Bank's loan portfolio that have been incurred as of the balance-sheet date. 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 policy for charging off loans and recording recoveries on previously charged off loans does not differ by portfolio segment. The overall allowance consists of two primary components, specific reserves related to impaired loans and general reserves for inherent losses related to loans that are not impaired.

Loans determined to be impaired are individually evaluated for impairment. 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 underlying collateral. The policy for measuring impaired loans does not differ by portfolio segment.

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.

The determination of the general reserve for loans that are not impaired is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, and qualitative factors to include economic trends in the Bank's service areas, industry experience and 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 maintains a separate allowance for each portfolio segment (loan type). These portfolio segments include commercial, construction and land development, commercial real estate and consumer loans. The allowance for loan losses attributable to each portfolio segment, which includes both impaired loans and loans that are not impaired, is combined to determine the Bank's overall allowance, which is included on the balance sheet.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The Bank assigns a risk rating to all loans and periodically performs detailed reviews 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 these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. The risk ratings can be grouped into five major categories, defined as follows:

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

Special Mention – A 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. 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 a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the 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 segment: (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 segment described below.

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

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

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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 FRB and DFI 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 Credit Losses on Off-Balance-Sheet Credit Exposures: 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 sheet.

Bank Premises and Equipment: Bank premises and equipment are carried at cost. 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 3 to 7 years. Leasehold improvements are amortized over the lesser of the respective lease term (including renewal periods that are reasonably assured) or their useful lives, which are generally 7 to 10 years.

Certain operating leases contain scheduled and specified rent increases or incentives in the form of tenant improvement allowances or credits. The scheduled rent increases are recognized on a straight-line basis over the lease term as an increase in the amount of rental expense recognized each period. Lease incentives are capitalized at the inception of the lease and amortized on a straight-line basis over the lease term as a reduction of rental expense. Amounts accrued in excess of amounts paid related to the scheduled rent increases are included in accrued interest payable and other liabilities on the balance sheet.

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.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Taxes: Deferred tax assets and liabilities are recognized for the tax consequences of temporary differences between the reported amount of assets and liabilities and their tax basis. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. A valuation allowance is recognized if, based on the weight of available evidence, management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized.

At December 31, 2012 and 2011, the Bank did not have a reserve for uncertain tax positions. The Bank uses 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. Interest expense and penalties associated with unrecognized tax benefits, if any, are classified as income tax expense in the statement of operations. The Bank has not accrued for any interest or penalties as of December 31, 2012 or December 31, 2011 because it does not have any unrecognized tax benefits.

Earnings Per Share: Basic earnings per share, which excludes dilution, is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options, result in the issuance of common stock which share in the earnings of the Bank. The treasury stock method is applied to determine the dilutive effect of stock options in computing diluted earnings per share. For the years ended December 31, 2012 and 2011 substantially all of the Bank's stock options and restricted stock were excluded from the calculation of diluted earnings per share because they were considered anti-dilutive in that the assumed proceeds from exercise price, tax benefits and average future compensation were greater than the average price of the Bank's common stock.

Share-Based Compensation: The Bank has one share-based compensation plan, the Presidio Bank 2006 Stock Option Plan (the "Plan"), which has been approved by its shareholders and permits the grant of stock options and restricted stock for up to 1,200,000 shares of the Bank's common stock, of which 60,236 shares were available for future grant at December 31, 2012. The Plan is designed to attract and retain employees and directors. The amount, frequency, and terms of share-based awards may vary based on competitive practices, the Bank's operating results and government regulations. New shares are issued upon option exercise of stock options and vesting of restricted stock. The Plan does not provide for the settlement of awards in cash. 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 Bank has issued four types of awards under the plan: Organizer options, which were granted to founders and organizers and were fully vested upon the granting of the award; service-based options, which are granted to employees and Directors and that will generally vest over a five year period; performance-based options, which are granted to employees and Directors and will vest only if the Bank meets or exceeds certain pre-determined financial goals and objectives; and restricted stock, which generally vest quarterly over a two year period.

The Bank accounts for share-based compensation using a fair-value based method that requires that share-based compensation expense be recorded for all stock options and restricted stock that are ultimately expected to vest as the requisite service is rendered.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Management estimates the fair value of each option award as of the date of grant using a Black-Scholes-Merton option pricing formula. Expected volatility is based on historical volatility of similar entities over a preceding period commensurate with the expected term of the option because the Bank's common stock has been publicly traded for a shorter period than the expected term for the options. The "simplified" method described in the Securities and Exchange Commission's Staff Accounting Bulletin No. 110 is used to determine the expected term of option awards. The risk-free rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Expected dividend yield was not considered in the option pricing formula because the Bank has not paid dividends and has no current plans to do so in the future. The fair value of restricted stock awards is determined using the fair value of the underlying shares on the date of the grant. In addition to the assumptions discussed above, management makes estimates regarding pre-vesting forfeitures that will impact total compensation expense recognized under the Plan.

Adoption of New Financial Accounting Standards: In June 2011, the FASB amended existing guidance and eliminated the option to present the components of other comprehensive income as part of the statement of changes in shareholder's equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in two separate consecutive statements. The adoption of this amendment changed the presentation of the components of comprehensive income for the Bank as part of the statement of changes in shareholders' equity.

In May 2011, the FASB issued an amendment to achieve common fair value measurement and disclosure requirements between U.S. and International accounting principles. Overall, the guidance is consistent with existing U.S. accounting principles; however, there are some amendments that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The effect of adopting this standard did not have a material effect on the Bank's operating results or financial condition.

NOTE 3 – INVESTMENT SECURITIES

Available-for-Sale Investment Securities: The Bank held no available-for-sale investment securities at December 31, 2011. The following table summarizes the amortized cost and fair value of available-for-sale investment securities at December 31, 2012 and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income (loss):

| | 2012 | | | |
|--------------------------------------------|-------------------|------------------------------|-------------------------------|----------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Debt securities: | | | | |
| Mortgage-backed securities- residential | \$ 5,222,229 | \$ - | \$ (30,863) | \$ 5,191,366 |
| Asset-backed securities- student loan | 5,037,438 | - | | 5,037,438 |
| | \$ 10,259,667 | \$ - | \$ (30,863) | \$ 10,228,804 |

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 3 – INVESTMENT SECURITIES (Continued)

Unrealized losses on available-for-sale investment securities totaling \$30,863 were recorded as net of a related tax benefit of \$12,702 as accumulated other comprehensive loss at December 31, 2012. There were no sales or transfers of available-for-sale investment securities during the year ended December 31, 2012. Available-for-sale residential mortgage-based securities mature in 2019. Available-for-sale student loan asset-backed securities mature in 2035. Expected maturities may differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations.

Held-to-Maturity Investment Securities: The following table summarizes the amortized cost and fair value of held-to-maturity investment securities at December 31, 2012 and 2011 and the corresponding amounts of gross unrecognized gains and losses:

| | 2012 | | | |
|--------------------------------------------|-------------------|--------------------------------|---------------------------------|----------------------------|
| | Amortized Cost | Gross Unrecognized Gains | Gross Unrecognized Losses | Estimated Fair Value |
| Debt securities: | | | | |
| Mortgage-backed securities- residential | \$ 672,376 | \$ - | \$ (205) | \$ 672,171 |

| | 2011 | | | |
|--------------------------------------------|-------------------|--------------------------------|---------------------------------|----------------------------|
| | Amortized Cost | Gross Unrecognized Gains | Gross Unrecognized Losses | Estimated Fair Value |
| Debt securities: | | | | |
| Mortgage-backed securities- residential | \$ 676,213 | \$ - | \$ (213) | \$ 676,000 |

Held-to-maturity investment securities are recorded at amortized cost, adjusted for the amortization of premiums or accretion of discounts. There were no sales, calls or transfers of held-to-maturity investment securities for the years ended December 31, 2011 and 2010. Held-to-maturity investment securities mature in 2019.

At December 31, 2012, the mortgage-backed securities held by the Bank were issued by a U.S. government-sponsored entity, Fannie Mae, an institution which the government has affirmed its commitment to support. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Bank does not have the intent to sell these mortgage-backed securities and it is likely that it will not be required to sell the securities before their anticipated recovery, the Bank does not consider these securities to be other-than-temporarily impaired at December 31, 2012.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 4 – LOANS

Outstanding loans are summarized below:

| | December 31, | |
|-------------------------------------|-----------------------|-----------------------|
| | <u>2012</u> | <u>2011</u> |
| Commercial | \$ 94,579,375 | \$ 91,952,011 |
| Construction and land development | 28,390,769 | 18,010,433 |
| Commercial real estate | 147,033,665 | 124,651,640 |
| Consumer and other | 44,544,780 | 36,136,269 |
| | 314,548,589 | 270,750,353 |
| Deferred loan origination fees, net | (556,603) | (352,742) |
| Allowance for loan losses | (4,945,316) | (4,944,316) |
| | <u>\$ 309,046,670</u> | <u>\$ 265,453,295</u> |

Salaries and employee benefits totaling \$686,908 and \$635,398 were deferred as loan origination costs for the years ended December 31, 2012 and 2011, respectively.

NOTE 5 – ALLOWANCE FOR LOAN LOSSES

Changes in the allowance for loan losses for the year ended December 31, 2012 and 2011 were as follows:

| | <u>2012</u> | <u>2011</u> |
|---------------------------------|---------------------|---------------------|
| Balance, beginning of year | \$ 4,944,316 | \$ 4,911,720 |
| Provision for loan losses | - | 841,381 |
| Losses charged to the allowance | - | (830,232) |
| Recoveries | 1,000 | 21,447 |
| Balance, end of year | <u>\$ 4,945,316</u> | <u>\$ 4,944,316</u> |

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 5 – ALLOWANCE FOR LOAN LOSSES (Continued)

The following table shows the allocation of the allowance for loan losses at and for the years ended December 31, 2012 and 2011 and for the year ended December 31, 2012 by portfolio segment and by impairment methodology:

| | <u>Commercial</u> | <u>Construction and Land Development</u> | <u>Commercial Real Estate</u> | <u>Consumer and Other</u> | <u>Total</u> |
|-------------------------------------------------------|-----------------------------|--------------------------------------------------|---------------------------------------|-----------------------------------|-----------------------------|
| <u>Allowance for Loan Losses</u> | | | | | |
| <u>2012</u> | | | | | |
| Beginning balance allocated to portfolio segments | \$ 2,758,773 | \$ 551,652 | \$ 1,291,547 | \$ 342,344 | \$ 4,944,316 |
| Provision for loan losses | (360,496) | 265,949 | (105,798) | 200,345 | - |
| Losses charged to allowance | - | - | - | - | - |
| Recoveries | - | - | - | 1,000 | 1,000 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Ending balance allocated to portfolio segments | <u>\$ 2,398,277</u> | <u>\$ 817,601</u> | <u>\$ 1,185,749</u> | <u>\$ 543,689</u> | <u>\$ 4,945,316</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 135,139</u> | <u>\$ -</u> | <u>\$ 23,100</u> | <u>\$ -</u> | <u>\$ 158,239</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 2,263,138</u> | <u>\$ 817,601</u> | <u>\$ 1,162,649</u> | <u>\$ 543,689</u> | <u>\$ 4,787,077</u> |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| | <u>Commercial</u> | <u>Construction and Land Development</u> | <u>Commercial Real Estate</u> | <u>Consumer and Other</u> | <u>Total</u> |
| <u>Allowance for Loan Losses</u> | | | | | |
| <u>2011</u> | | | | | |
| Beginning balance allocated to portfolio segments | \$ 2,393,722 | \$ 409,501 | \$ 1,585,495 | \$ 523,002 | \$ 4,911,720 |
| Provision for loan losses | 357,336 | 142,151 | 30,052 | 311,842 | 841,381 |
| Losses charged to allowance | (6,232) | - | (324,000) | (500,000) | (830,232) |
| Recoveries | 13,947 | - | - | 7,500 | 21,447 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Ending balance allocated to portfolio segments | <u>\$ 2,758,773</u> | <u>\$ 551,652</u> | <u>\$ 1,291,547</u> | <u>\$ 342,344</u> | <u>\$ 4,944,316</u> |
| Ending balance: individually evaluated for impairment | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 181,699</u> | <u>\$ -</u> | <u>\$ 181,699</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 2,758,773</u> | <u>\$ 551,652</u> | <u>\$ 1,109,848</u> | <u>\$ 342,344</u> | <u>\$ 4,762,617</u> |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 5 – ALLOWANCE FOR LOAN LOSSES (Continued)

The following table shows the loan portfolio at December 31, 2012 and 2011 by portfolio segment and impairment methodology:

| <u>Loans</u> | <u>Commercial</u> | <u>Construction and Land Development</u> | <u>Commercial Real Estate</u> | <u>Consumer and Other</u> | <u>Total</u> |
|----------------------------------------------------------|----------------------|--------------------------------------------------|---------------------------------------|-----------------------------------|-----------------------|
| <u>2012</u> | | | | | |
| Ending balance | <u>\$ 94,579,375</u> | <u>\$ 28,390,769</u> | <u>\$147,033,665</u> | <u>\$ 44,544,780</u> | <u>\$ 314,548,589</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 201,989</u> | <u>\$ -</u> | <u>\$ 1,581,894</u> | <u>\$ -</u> | <u>\$ 1,783,883</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 94,377,386</u> | <u>\$ 28,390,769</u> | <u>\$145,451,771</u> | <u>\$ 44,544,780</u> | <u>\$ 312,764,706</u> |
| <u>2011</u> | | | | | |
| Ending balance | <u>\$ 91,952,011</u> | <u>\$ 18,010,433</u> | <u>\$124,651,640</u> | <u>\$ 36,136,269</u> | <u>\$ 270,750,353</u> |
| Ending balance: individually evaluated for impairment | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 1,699,020</u> | <u>\$ -</u> | <u>\$ 1,699,020</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 91,952,011</u> | <u>\$ 18,010,433</u> | <u>\$122,952,620</u> | <u>\$ 36,136,269</u> | <u>\$ 269,051,333</u> |

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

| | <u>Credit Risk Profile by Internally Assigned Grade</u> | | | | <u>Total</u> |
|-----------------|---------------------------------------------------------|--------------------------------------------------|-----------------------------------|-----------------------------------|-----------------------|
| | <u>Commercial</u> | <u>Construction and Land Development</u> | <u>Commercial Real Estate</u> | <u>Consumer and Other</u> | |
| <u>2012</u> | | | | | |
| Grade: | | | | | |
| Pass | \$ 84,797,680 | \$ 26,932,440 | \$ 141,229,067 | \$ 43,744,779 | \$ 296,703,966 |
| Special Mention | 6,672,870 | 1,458,330 | 1,943,236 | 800,000 | 10,874,436 |
| Substandard | <u>3,108,824</u> | <u>-</u> | <u>3,861,362</u> | <u>-</u> | <u>6,970,186</u> |
| Total | <u>\$ 94,579,375</u> | <u>\$ 28,390,769</u> | <u>\$ 147,033,665</u> | <u>\$ 44,544,779</u> | <u>\$ 314,548,589</u> |
| <u>2011</u> | | | | | |
| Grade: | | | | | |
| Pass | \$ 81,556,917 | \$ 14,992,900 | \$ 118,988,983 | \$ 36,136,269 | \$ 251,675,069 |
| Special Mention | 5,330,828 | 3,017,533 | 1,623,006 | - | 9,971,367 |
| Substandard | <u>5,064,266</u> | <u>-</u> | <u>4,039,651</u> | <u>-</u> | <u>9,103,917</u> |
| Total | <u>\$ 91,952,011</u> | <u>\$ 18,010,433</u> | <u>\$ 124,651,640</u> | <u>\$ 36,136,269</u> | <u>\$ 270,750,353</u> |

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 5 – ALLOWANCE FOR LOAN LOSSES (Continued)

The following table shows an aging analysis of the loan portfolio by the time past due at December 31, 2012 and 2011:

| | 30-89 Days Past Due | Nonaccrual | Total Past Due and Nonaccrual | Current | Total |
|--------------------------------------|-----------------------------|-----------------------------|-------------------------------------|-----------------------------|-----------------------------|
| <u>2012</u> | | | | | |
| Commercial: | | | | | |
| Commercial | \$ 280,308 | \$ 201,989 | \$ 482,297 | \$ 94,097,078 | \$ 94,579,375 |
| Construction and land development | - | - | - | 28,390,769 | 28,390,769 |
| Commercial real estate | - | 1,581,893 | 1,581,893 | 145,451,772 | 147,033,665 |
| Consumer and other | - | - | - | 44,544,780 | 44,544,780 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total | <u>\$ 280,308</u> | <u>\$ 1,783,882</u> | <u>\$ 2,064,190</u> | <u>\$ 312,484,399</u> | <u>\$ 314,548,589</u> |
| <u>2011</u> | | | | | |
| Commercial: | | | | | |
| Commercial | \$ - | \$ - | \$ - | \$ 91,952,011 | \$ 91,952,011 |
| Construction and land development | - | - | - | 18,010,433 | 18,010,433 |
| Commercial real estate | - | 1,699,020 | \$ 1,699,020 | 122,952,620 | 124,651,640 |
| Consumer and other | - | - | - | 36,136,269 | 36,136,269 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total | <u>\$ -</u> | <u>\$ 1,699,020</u> | <u>\$ 1,699,020</u> | <u>\$ 269,051,333</u> | <u>\$ 270,750,353</u> |

The Bank had allocated \$135,139 and \$181,699 of specific reserves to customers whose loan terms had been modified in troubled debt restructurings as of December 31, 2012 and 2011, respectively. The Bank did not have commitments to lend additional funds to borrowers with loans whose terms had been modified in troubled debt restructurings as of December 31, 2012.

During the year ending December 31, 2011, the terms of one loan were modified as a troubled debt restructuring. The modification of the terms included 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; and a permanent reduction of the recorded investment in the loan. The modifications involving a reduction of the stated interest rate of the loan and an extension of maturity were for a period through July 2018.

The following table shows loans by class modified as troubled debt restructurings that occurred during the year ending December 31, 2011:

| | <u>Number of Loans</u> | <u>Pre-Modification Outstanding Recorded Investment</u> | <u>Post-Modification Outstanding Recorded Investment</u> |
|------------------------|------------------------|-----------------------------------------------------------------|------------------------------------------------------------------|
| Commercial real estate | <u>1</u> | <u>\$2,393,887</u> | <u>\$2,143,887</u> |

The Bank had no loans modified as troubled debt restructurings that occurred during the year ending December 31, 2012. The Bank had no loans that had been modified as troubled debt restructurings during the previous twelve months that defaulted during the years ended December 31, 2012 and 2011.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 6 – PREMISES AND EQUIPMENT

Premises and equipment consisted of the following:

| | December 31, | |
|------------------------------------------------|---------------------|---------------------|
| | <u>2012</u> | <u>2011</u> |
| Furniture, fixtures and equipment | \$ 2,275,256 | \$ 2,158,556 |
| Leasehold improvements | <u>1,108,972</u> | <u>776,835</u> |
| | 3,384,228 | 2,935,391 |
| Less accumulated depreciation and amortization | <u>(2,163,571)</u> | <u>(1,621,219)</u> |
| | <u>\$ 1,220,657</u> | <u>\$ 1,314,172</u> |

Depreciation and amortization included in occupancy and equipment expense totaled \$542,352 and \$427,138 for the years ended December 31, 2012 and 2011.

NOTE 7 – INTEREST BEARING DEPOSITS

Interest-bearing deposits consisted of the following:

| | December 31, | |
|----------------------------------|-----------------------|-----------------------|
| | <u>2012</u> | <u>2011</u> |
| Savings | \$ 3,502,631 | \$ 1,384,781 |
| Money market | 125,735,242 | 122,787,227 |
| Interest-bearing demand accounts | 53,779,803 | 55,328,427 |
| Time, \$100,000 or more | 41,212,962 | 40,497,506 |
| Other time | <u>1,704,951</u> | <u>1,553,407</u> |
| | <u>\$ 225,935,589</u> | <u>\$ 221,551,348</u> |

Aggregate annual maturities of time deposits are as follows:

| Year Ending December 31, | |
|-----------------------------|----------------------|
| 2013 | \$ 27,143,986 |
| 2014 | 5,321,673 |
| 2015 | 9,109,873 |
| 2016 | 203,101 |
| 2017 | <u>1,139,280</u> |
| | <u>\$ 42,917,913</u> |

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 7 – INTEREST BEARING DEPOSITS (Continued)

Interest expense recognized on interest-bearing deposits for the years ended December 31, 2012 and 2011 consisted of the following:

| | December 31, | |
|----------------------------------|--------------|--------------|
| | <u>2012</u> | <u>2011</u> |
| Savings | \$ 3,637 | \$ 4,078 |
| Money market | 334,786 | 412,649 |
| Interest-bearing demand accounts | 185,927 | 277,612 |
| Time, \$100,000 or more | 343,535 | 356,511 |
| Other time | 12,383 | 17,262 |
| | \$ 880,268 | \$ 1,068,112 |

NOTE 8 – INCOME TAXES

Income taxes for the years ended December 31, 2012 and 2011 consisted of the following:

| | <u>Federal</u> | <u>State</u> | <u>Total</u> |
|-------------------------------|----------------|----------------|----------------|
| <u>2012</u> | | | |
| Current | \$ 49,000 | \$ 58,000 | \$ 107,000 |
| Deferred | 681,000 | 193,000 | 874,000 |
| Income tax expense | \$ 730,000 | \$ 251,000 | \$ 981,000 |
| <u>2011</u> | | | |
| Current | \$ 51,000 | \$ 48,000 | \$ 99,000 |
| Deferred | 635,000 | 31,000 | 666,000 |
| Change in valuation allowance | (3,381,000) | (1,471,000) | (4,852,000) |
| Income tax benefit | \$ (2,695,000) | \$ (1,392,000) | \$ (4,087,000) |

The provision for income taxes differs from amounts computed by applying the statutory Federal income tax rate to income before income taxes. The items comprising these differences consisted of the following for the years ended December 31, 2012 and 2011:

| | 2012 | | 2011 | |
|----------------------------------------------|---------------|-------------|----------------|-------------|
| | <u>Amount</u> | <u>Rate</u> | <u>Amount</u> | <u>Rate</u> |
| Federal income tax expense at statutory rate | \$ 773,273 | 34.0% | \$ 665,931 | 34.0% |
| State franchise tax, net of Federal benefit | 167,640 | 7.4% | 52,140 | 2.7% |
| Compensation for incentive stock options | 54,305 | 2.4% | 28,084 | 1.4% |
| Change in valuation allowance - Federal | - | 0.0% | (3,381,000) | (172.6)% |
| Change in valuation allowance – state | - | 0.0% | (1,471,000) | (75.1)% |
| Other | (14,218) | (0.7)% | 18,845 | 0.9% |
| Income tax expense (benefit) | \$ 981,000 | 43.1% | \$ (4,087,000) | (208.7)% |

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 8 – INCOME TAXES (Continued)

Deferred tax assets (liabilities) at December 31, 2012 and 2011 consisted of the following:

| | <u>2012</u> | <u>2011</u> |
|--------------------------------|---------------------|---------------------|
| Deferred tax assets: | | |
| Net operating losses | \$ 272,000 | \$ 1,827,000 |
| Organizational costs | 322,000 | 359,000 |
| Allowance for loan losses | 2,018,000 | 2,032,000 |
| Share-based compensation | 173,000 | 131,000 |
| Accrued expenses | 444,000 | 90,000 |
| Other | <u>398,000</u> | <u>255,000</u> |
| Total deferred tax assets | <u>3,727,000</u> | <u>4,694,000</u> |
| Deferred tax liabilities: | | |
| Depreciation and amortization | (44,000) | (165,000) |
| FHLB stock dividends | (5,000) | (5,000) |
| Prepaid expenses | (45,000) | (57,000) |
| Deferred loan costs | <u>(309,000)</u> | <u>(281,000)</u> |
| Total deferred tax liabilities | <u>(403,000)</u> | <u>(508,000)</u> |
| Net deferred tax assets | <u>\$ 3,324,000</u> | <u>\$ 4,186,000</u> |

The determination of the amount of deferred income 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 income 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. Based upon its analysis of available evidence, including recent profitability and the ability to realize net operating losses in the near term, management has determined that it is "more likely than not" that the Bank's deferred income tax assets as of December 31, 2012 will be fully realized and therefore no valuation allowance was recorded.

At December 31, 2012, the Bank had no Federal net operating loss carryforwards (NOLs) and State NOLs of approximately \$3,803,000. The State NOLs begin to expire in 2016. The Bank files income tax returns in the United States and California jurisdictions. There are currently no pending Federal, state or local income tax examinations by tax authorities. Federal and California tax returns are currently open for examination for tax years since 2008 and 2007, respectively. The total amount of unrecognized tax benefits, including interest and penalties, at December 31, 2012 was not material. The amount of tax benefits that would impact the effective rate, if recognized, is not expected to be material. The Bank does not anticipate any significant changes with respect to unrecognized tax benefits within the next 12 months.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 9 – BORROWING ARRANGEMENTS

Lines of Credit: The Bank has unsecured Federal funds lines of credit with two of its correspondent banks under which it can borrow up to an aggregate of \$10,000,000. There were no borrowings outstanding under these arrangements at December 31, 2012 or 2011.

FRB: The Bank has a borrowing arrangement with the Federal Reserve Bank of San Francisco secured by certain of the Bank's loans. At December 31, 2012, the amounts pledged and borrowing capacity under this arrangement totaled \$14,939,805 and \$13,334,304, respectively. There were no borrowings outstanding under this arrangement at December 31, 2012 or 2011.

FHLB: The Bank has a borrowing arrangement with FHLB under which short-term and long term advances are secured by the Bank's loan portfolio. The Bank's credit limit varies according to the amount and composition of loans pledged as collateral. At December 31, 2012, the loans pledged and borrowing capacity under such limits were approximately \$97,634,000 and \$42,143,000, respectively. At December 31, 2011, the loans pledged and borrowing capacity under such limits were approximately \$102,582,000 and \$47,747,000, respectively.

At December 31, 2012 and 2011, the Bank had no borrowings outstanding under these arrangements.

NOTE 10 – COMMITMENTS AND CONTINGENCIES

Operating Leases: The Bank leases its San Francisco headquarters and Walnut Creek, San Rafael and Palo Alto branch offices under non-cancelable operating leases. The leases expire on May 31, 2016, March 31, 2016, February 28, 2013 and January 31, 2020 respectively. The leases include annual rent adjustments of approximately 2.6%, 2.0%, 3% and 3%, respectively, each year during the initial lease terms. The San Francisco lease has two five year renewal options, the Walnut Creek, San Rafael and Palo Alto leases each have one five year renewal option.

Approximate future minimum lease payments are as follows:

| <u>Year Ending December 31,</u> | <u>Operating Leases</u> |
|-------------------------------------|-----------------------------|
| 2013 | \$ 880,200 |
| 2014 | 950,456 |
| 2015 | 975,918 |
| 2016 | 708,263 |
| 2017 | 546,622 |
| Thereafter | <u>1,842,499</u> |
| | <u>\$ 5,903,957</u> |

Rental expense included in occupancy and equipment expense totaled \$993,869 and \$959,194 for years ended December 31, 2012 and 2011, respectively.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 10 – COMMITMENTS AND CONTINGENCIES (Continued)

Financial Instruments With Off-Balance-Sheet Risk: The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments consist of the following:

| | <u>December 31,</u> | |
|------------------------------|---------------------|----------------|
| | <u>2012</u> | <u>2011</u> |
| Commitments to extend credit | \$ 128,774,000 | \$ 105,512,000 |
| Standby letters of credit | \$ 4,886,000 | \$ 6,531,000 |

The Bank's exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments as it does for loans included on the balance sheet.

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

Standby letters of credit are conditional commitments issued to guarantee the performance of a client 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 clients. 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, 2012. The Bank recognizes these fees as revenue over the term of the commitment or when the commitment is used.

Commercial loan commitments represent approximately 61% of total commitments and are generally unsecured or secured by collateral other than real estate and have variable interest rates. Consumer loan commitments represent approximately 4% of total commitments and are generally unsecured or secured by collateral other than real estate and have variable interest rates. Real estate loan commitments represent approximately 23% of total commitments and are generally secured by property with a loan-to-value ratio not to exceed 75%. The majority of real estate commitments also have variable interest rates. Letters of credit represent 4% of total commitments. Home equity lines of credit represent the remaining 8% of total commitments and are generally secured by residential real estate and have both variable and fixed interest rates.

Concentrations of Credit Risk: The Bank grants real estate mortgage, real estate construction and commercial loans to customers in San Francisco and surrounding counties. A substantial portion of its portfolio is secured by commercial and residential real estate at December 31, 2012 and 2011.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 10 – COMMITMENTS AND CONTINGENCIES (Continued)

In management's judgment, a concentration of loans exists in real estate related loans with approximately 65% of the Bank's loans being real estate related. Although management believes the loans within this concentration have no more than the normal risk of collectibility, a substantial decline in the performance of the economy in general or a decline in real estate values in the Bank's primary market area, in particular, could have an adverse impact on the collectibility of these loans. Personal and business income represent the primary source of repayment for a majority of these loans.

Correspondent Banking Agreements: Bank maintains funds on deposit with other federally insured financial institutions under correspondent banking agreements. Through December 31, 2012, all noninterest-bearing transaction accounts are fully guaranteed by the FDIC for the entire amount in the account. Coverage through December 31, 2012 on certain transaction accounts is in addition to the coverage of \$250,000 per depositor available under the FDIC's general deposit insurance rules.

NOTE 11 – SHARE-BASED COMPENSATION

Stock Option Awards: Stock option activity for the years ended December 31, 2012 and 2011 is summarized as follows:

| | Number of Stock Options <u>Outstanding</u> | Weighted Average Exercise <u>Prices</u> | Weighted Average Remaining Contractual <u>Life</u> |
|-------------------------------------|--------------------------------------------------|--------------------------------------------------|----------------------------------------------------------------|
| Outstanding at January 1, 2011 | 975,800 | \$ 9.93 | |
| Granted | 58,500 | \$ 6.69 | |
| Cancelled or expired | <u>(181,200)</u> | \$ 9.81 | |
| Outstanding at December 31, 2011 | 853,100 | \$ 9.74 | |
| Granted | 164,300 | \$ 6.95 | |
| Cancelled or expired | <u>(700)</u> | \$ 7.39 | |
| Outstanding at December 31, 2012 | <u>1,016,700</u> | \$ 9.29 | 5.2 years |
| Exercisable at December 31, 2012 | <u>760,200</u> | \$ 9.93 | 4.1 years |
| Additional options expected to vest | <u>207,116</u> | \$ 7.39 | 8.5 years |

The intrinsic value of stock options outstanding, exercisable or expected to vest at December 31, 2012 and 2011 was \$112,475.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 11 – SHARE-BASED COMPENSATION (Continued)

The weighted average exercise price and weighted average remaining contractual term of these awards was as follows at December 31, 2012:

| | <u>Shares</u> | <u>Weighted Average Exercise Price</u> | <u>Weighted Average Remaining Contractual Term</u> |
|-----------------------|---------------|----------------------------------------------------|--------------------------------------------------------------------|
| Organizer options | 180,000 | \$ 10.00 | 3.5 years |
| Service-based options | 836,700 | \$ 9.13 | 5.5 years |

All of the Bank's performance-based options were forfeited in 2012 because the performance criteria required for vesting did not occur. The Bank had no performance-based options outstanding at December 31, 2012.

The unrecognized compensation cost related to non-vested service-based options totaled \$173,039 as of December 31, 2012. That cost is expected to be amortized on an accelerated basis over a weighted average period of 2.3 years and will be adjusted for subsequent changes in estimated forfeitures.

The following stock option information for service-based options is for the years ended December 31, 2012 and 2011:

| | <u>2012</u> | <u>2011</u> |
|---------------------------------------------------------------------|-------------|-------------|
| Weighted average grant date fair value per share of options granted | \$1.91 | \$2.01 |
| Significant fair value assumptions: | | |
| Expected term in years | 6.5 years | 6.5 years |
| Expected annual volatility | 22.83% | 21.80% |
| Expected annual dividend yield | 0% | 0% |
| Risk-free interest rate | 2.0% | 3.1% |
| Total compensation cost (included in operating expenses) | \$211,131 | \$108,600 |

Restricted Stock Awards: The following restricted stock information is for the years ended December 31, 2012 and 2011.

| | <u>2012</u> | | <u>2011</u> | |
|------------------------------|-----------------------------|-------------------------------------------------------------------------|-----------------------------|-------------------------------------------------------------------------|
| | <u>Number of Shares</u> | <u>Weighted Average Grant Date Fair Value Per Share</u> | <u>Number of Shares</u> | <u>Weighted Average Grant Date Fair Value Per Share</u> |
| Nonvested, beginning of year | 34,347 | \$6.26 | 18,045 | \$6.20 |
| Granted | 30,852 | \$7.32 | 57,510 | \$6.26 |
| Vested | (27,886) | \$6.56 | (39,811) | \$6.23 |
| Forfeited | - | - | (1,397) | \$6.26 |
| Nonvested, end of year | <u>37,313</u> | \$6.91 | <u>34,347</u> | \$6.26 |

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 11 – SHARE-BASED COMPENSATION (Continued)

Compensation cost associated with the restricted stock totaled \$280,548 and \$278,947 for the years ended December 31, 2012 and 2011, respectively. As of December 31, 2012 the unrecognized compensation cost related to the nonvested restricted stock totaled approximately \$129,659. The unrecognized compensation cost at December 31, 2012 is expected to be amortized on a straight-line basis over a weighted average period of one year and will be adjusted for subsequent changes in estimated forfeitures.

NOTE 12 – SHAREHOLDERS' EQUITY

Preferred Stock: On November 20, 2009, the Bank entered into a Letter Agreement (the "Purchase Agreement") with the United States Department of the Treasury (the "Treasury"), pursuant to which the Bank issued and sold (i) 10,800 shares of Fixed Rate Non-cumulative Perpetual Preferred Stock, Series A (the "Series A Preferred Stock") for a purchase price of \$10,800,000 and (ii) a warrant to purchase 325 shares of Fixed Rate Non-cumulative Perpetual Preferred Stock, Series B stock, (the "Warrant Preferred") for \$0.01 per share for an aggregate exercise price of \$3.25. The Treasury exercised the warrant immediately upon issuance. On December 11, 2012, the Treasury sold at auction all 10,800 shares of the Series A Preferred and all 325 shares of the Series B Preferred to private investors.

The Series A Preferred Stock qualifies as Tier 1 capital and pays non-cumulative dividends quarterly at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Warrant Preferred pays non-cumulative dividends at a rate of 9% per annum until redemption. Either series may be redeemed by the Bank after three years; however, the Warrant Preferred may not be redeemed until after all the Series A Preferred Stock has been redeemed. Prior to the end of three years, the Series A Preferred Stock and the Warrant Preferred may be redeemed by the Bank only with proceeds from the sale of qualifying equity securities (a "Qualified Equity Offering").

The Series A Preferred Stock and the Warrant Preferred were issued in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended. Neither the Series A Preferred Stock nor the Warrant Preferred will be subject to any contractual restrictions on transfer, except that the Treasury and its transferees shall not effect any transfer of the Series A or Series B Preferred Stock which would require the bank to become subject to the periodic reporting requirements of Section 13 or 15(d) of the Exchange Act.

The Series A Preferred and Warrant Preferred shall be non-voting, other than class voting rights on (i) any authorization or issuance of shares ranking senior to the Series A Preferred and Warrant Preferred, (ii) any amendment to the rights of the Series A Preferred and Warrant Preferred, or (iii) any merger, exchange or similar transaction which would adversely affect the rights of the Series A Preferred and Warrant Preferred.

If dividends on the Series A Preferred and Warrant Preferred are not paid in full for six dividend periods, whether or not consecutive, the holders of the Series A Preferred and Warrant Preferred will have the right to elect 2 directors. The right to elect directors will end when full dividends have been paid for all prior dividend periods.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 12 – SHAREHOLDERS' EQUITY (Continued)

Furthermore, for as long as any Series A Preferred Stock or Warrant Preferred is outstanding, no dividends may be declared or paid on junior preferred shares, preferred shares ranking pari passu with the Series A Preferred Stock or Warrant Preferred, or common shares (other than in the case of pari passu preferred shares or dividends on a pro rata basis with the Series A Preferred Stock or Warrant Preferred), nor may the Bank repurchase or redeem any junior preferred shares, preferred shares ranking pari passu with the Series A Preferred Stock or Warrant Preferred, unless the full dividend for the latest completed dividend period has been declared and paid in full.

The Bank recorded a discount on the Series A Preferred Stock at approximately the liquidation preference of the Warrant Preferred. The discount recorded on the Series A Preferred Stock will be amortized on the level-yield method over five years.

Dividends: Upon declaration by the Board of Directors, all shareholders of record will be entitled to receive dividends. The California Financial Code restricts the total dividend payment of any state banking association in any calendar 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, 2011, no amounts were free of such restrictions. During 2011, the Bank received approval to pay dividends on the Series A Preferred and the Warrant Preferred from more than two-thirds of its shareholders as required under Federal Reserve Regulation H. After also receiving approval from the Bank's state and federal banking regulators, the Board of Directors of the Bank approved the payment of \$569,252 and \$1,130,593 of dividends on the Series A Preferred and the Warrant Preferred shares in 2012 and 2011 respectively. The current dividend rate will result in an ongoing annual Series A Preferred dividend of \$540,000 and a Warrant Preferred dividend of \$29,250.

Regulatory Capital: The Bank is subject to certain regulatory capital requirements administered by the FRB and 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 the Bank's financial statements.

Under capital adequacy guidelines, the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. 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 be maintained. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The Bank is also subject to additional capital guidelines 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 in the table on the following page. As of December 31, 2012 and 2011, the most recent notification from the FDIC categorized the Bank as well capitalized under these guidelines. There are no conditions or events since that notification that management believes have changed the Bank's category.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 12 – SHAREHOLDERS' EQUITY (Continued)

Management believes that the Bank met all of its capital adequacy requirements as of December 31, 2012 and 2011.

| | <u>2012</u> | | <u>2011</u> | |
|--------------------------------------------------------|---------------|--------------|---------------|--------------|
| | <u>Amount</u> | <u>Ratio</u> | <u>Amount</u> | <u>Ratio</u> |
| <u>Leverage Ratio</u> | | | | |
| Presidio Bank | \$ 44,607,000 | 10.8% | \$ 41,691,000 | 12.0% |
| Minimum requirement for "Well-Capitalized" institution | \$ 20,663,000 | 5.0% | \$ 17,385,000 | 5.0% |
| Minimum regulatory requirement | \$ 16,530,400 | 4.0% | \$ 13,908,000 | 4.0% |
| <u>Tier 1 Risk-Based Capital Ratio</u> | | | | |
| Presidio Bank | \$ 44,607,000 | 12.5% | \$ 41,690,953 | 13.7% |
| Minimum requirement for "Well-Capitalized" institution | \$ 21,441,180 | 6.0% | \$ 18,210,000 | 6.0% |
| Minimum regulatory requirement | \$ 14,294,120 | 4.0% | \$ 12,140,000 | 4.0% |
| <u>Total Risk-Based Capital Ratio</u> | | | | |
| Presidio Bank | \$ 49,088,000 | 13.7% | \$ 45,504,000 | 15.00% |
| Minimum requirement for "Well-Capitalized" institution | \$ 35,735,300 | 10.0% | \$ 30,349,000 | 10.0% |
| Minimum regulatory requirement | \$ 28,588,240 | 8.0% | \$ 24,280,000 | 8.0% |

NOTE 13 – RELATED PARTY TRANSACTIONS

During the normal course of business, the Bank enters into transactions with related parties, including Directors, executive officers and affiliates. The following is a summary of the aggregate activity involving related party borrowers during the years ended December 31, 2012 and 2011:

| | <u>2012</u> | <u>2011</u> |
|--------------------------------------------|---------------------|---------------------|
| Beginning balance | \$ 1,740,000 | \$ 1,977,000 |
| Disbursements | 2,263,000 | 6,024,000 |
| Amounts repaid | <u>(3,615,000)</u> | <u>(6,261,000)</u> |
| Ending balance | <u>\$ 388,000</u> | <u>\$ 1,740,000</u> |
| Undisbursed commitments to related parties | <u>\$ 1,068,000</u> | <u>\$ 865,000</u> |

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 14 – EMPLOYEE BENEFIT PLANS

Profit Sharing Plan: In 2006, the Bank adopted the Presidio Bank 401(k) Profit Sharing Plan and Trust. All employees 21 years of age or older are eligible to participate in the plan. Eligible employees may elect to make tax deferred contributions up to the maximum amount allowed by law. The Bank may make additional contributions to the plan at the discretion of the Board of Directors. Bank contributions vest at a rate of 20% annually for all employees. The Bank made contributions to the Plan totaling approximately \$193,000 and \$191,000 for the years ended December 31, 2012 and 2011, respectively.

NOTE 15 – OTHER EXPENSES

Other expenses for the years ended December 31, 2012 and 2011 consisted of the following:

| | <u>2012</u> | <u>2011</u> |
|---------------------------------------------|---------------------|---------------------|
| Data processing | \$ 859,655 | \$ 776,517 |
| Regulatory and insurance | 335,736 | 513,847 |
| Professional fees | 380,648 | 488,814 |
| Provision for unfunded loan commitments | 209,607 | - |
| Advertising and promotions | 159,292 | 213,444 |
| Stationery and supplies | 158,052 | 197,698 |
| Travel and entertainment | 184,624 | 197,489 |
| Correspondent bank charges | 161,130 | 147,838 |
| Directors fees and share-based compensation | 192,939 | 134,000 |
| Telephone | 120,896 | 125,068 |
| Other | <u>266,758</u> | <u>268,039</u> |
| | <u>\$ 3,029,337</u> | <u>\$ 3,062,754</u> |

NOTE 16 – FAIR VALUE MEASUREMENTS

Fair Value Hierarchy: The Bank groups its 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 for identical instruments traded in active exchange markets.

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 observable or can be corroborated by observable market data.

Level 3 – Model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect the Bank's estimates of assumptions that market participants would use on pricing the asset or liability. Valuation techniques include management judgment and estimation which may be significant.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 16 – FAIR VALUE MEASUREMENTS (Continued)

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period. Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

Fair Value of Financial Instruments: The estimated carrying and fair values of the Bank's financial instruments are as follows:

Fair Value Measurements at December 31, 2012 using:

| | <u>Carrying Amount</u> | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> |
|-------------------------------|----------------------------|----------------|----------------|----------------|--------------|
| Financial assets | | | | | |
| Cash and cash equivalents | 76,593,893 | 76,593,893 | | | 76,593,893 |
| Securities available-for-sale | 10,228,804 | | 10,228,804 | | 10,228,804 |
| Securities held-to-maturity | 672,376 | | | 672,171 | 672,171 |
| FRB and FHLB Stock | 2,544,250 | N/A | N/A | N/A | N/A |
| Loans, net | 309,046,670 | | | 316,719,206 | 316,719,206 |
| Accrued interest receivable | 797,326 | | | 797,326 | 797,326 |
| Financial liabilities | | | | | |
| Deposits | 357,373,444 | 311,918,770 | 42,884,035 | | 354,802,805 |
| Accrued interest payable | 58,042 | 214 | 57,828 | | 58,042 |

| | <u>December 31, 2011</u> | |
|----------------------------------------|----------------------------|-------------------------------------|
| | <u>Carrying Amount</u> | <u>Estimated Fair Value</u> |
| Financial assets: | | |
| Cash and due from banks | \$ 81,437,528 | \$ 81,437,528 |
| Held-to-maturity investment securities | 676,213 | - |
| FRB and FHLB stock | 2,452,850 | N/A |
| Loans, net | 265,453,295 | 268,566,962 |
| Accrued interest receivable | 861,383 | 861,383 |
| Financial liabilities: | | |
| Deposits | \$ 310,760,237 | \$ 308,383,012 |
| Accrued interest payable | 74,364 | 74,364 |

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 16 – FAIR VALUE MEASUREMENTS (Continued)

These estimates do not reflect any premium or discount that could result from offering the Bank's 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 following methods and assumptions were used to estimate the fair value of financial instruments. For cash and cash equivalents, variable-rate loans and leases, accrued interest receivable and payable, demand deposits and short-term borrowings, the carrying amount is estimated to be fair value. For investment securities, fair values are based on quoted market prices, quoted market prices for similar securities and indications of value provided by brokers. It was not practicable to determine the fair value of FRB and FHLB stock due to restrictions placed on their transferability. The fair values for fixed-rate loans and leases are estimated using discounted cash flow analyses, using interest rates currently being offered at each reporting date for loans with similar terms to borrowers of comparable creditworthiness.

Fair values for fixed-rate certificates of deposit are estimated using discounted cash flow analyses using interest rates offered at each reporting date by the Bank for certificates with similar remaining maturities. The fair value of long term borrowings are estimated using discounted cash flow analyses using interest rates offered at each reporting date by FHLB for advances with similar remaining maturities. The fair values of commitments are estimated using the fees currently charged to enter into similar agreements and are not significant and, therefore, not included in the above table.

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 and short-term instruments approximate fair values and are classified as Level 1.

(b) *FRB and FHLB Stock* – It is not practical to determine the fair value of FRB and FHLB stock due to restrictions placed on its transferability.

(c) *Investment Securities* – The fair value of investment securities available-for-sale is based on quoted market prices for identical securities in markets that are not active. The fair value for investment securities held-to-maturity is based on a discounted cash flow model.

(d) *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.

(e) *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. 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.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 16 – FAIR VALUE MEASUREMENTS (Continued)

(f) *Accrued Interest Receivable/Payable* – The carrying amounts of accrued interest approximate fair value resulting in Level 3 for accrued interest receivable on loans and Level 1 for accrued interest payable on deposits.

(g) *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.

Assets 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:

Recurring Basis

The Bank had no assets or liabilities measured at fair value on a recurring basis at December 31, 2011. The Bank is required or permitted to record the following assets at fair value on a recurring basis at December 31, 2012:

| <u>Description</u> | <u>Fair Value</u> | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> |
|-------------------------------------------------------------|----------------------|----------------|----------------------|----------------|
| <u>December 31, 2012</u> | | | | |
| Available-for-sale investment securities: | | | | |
| Debt securities: | | | | |
| Mortgage backed securities | | | | |
| residential | \$ 5,191,366 | \$ - | \$ 5,191,366 | \$ - |
| Asset backed securities | | | | |
| Student loans | <u>5,037,438</u> | <u>-</u> | <u>5,037,438</u> | <u>-</u> |
| Total assets measured at fair value on a recurring basis | <u>\$ 10,228,804</u> | <u>\$ -</u> | <u>\$ 10,228,804</u> | <u>\$ -</u> |

During the year ended December 31, 2012, there were no transfers in or out of Level 1 or Level 2 categories.

(Continued)

PRESIDIO BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2012 and 2011

NOTE 16 – FAIR VALUE MEASUREMENTS (Continued)

Non-recurring Basis

The Bank may be required, from time to time, to measure certain assets at fair value on a non-recurring basis. These include assets that are measured at the lower of cost or market value that were recognized at fair value which was below cost at the reporting date.

| <u>Description</u> | <u>Fair Value</u> | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> |
|-----------------------------------------------------------------|---------------------|----------------|----------------|---------------------|
| <u>December 31, 2012</u> | | | | |
| Impaired loans: | | | | |
| Commercial real estate | \$ 1,581,893 | \$ - | \$ - | \$ 1,581,893 |
| Commercial | <u>201,989</u> | <u>-</u> | <u>-</u> | <u>201,989</u> |
| Total assets measured at fair value on a non-recurring basis | <u>\$ 1,783,882</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 1,783,882</u> |
| <u>December 31, 2011</u> | | | | |
| Impaired loans – commercial real estate | <u>\$ 1,517,321</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 1,517,321</u> |

The fair value of impaired loans is based on the fair value of the collateral for all collateral dependent loans and for other impaired loans is estimated using a discounted cash flow model. Impaired loans were categorized as Level 3 with unobservable inputs and assumptions in fair value measurements. There were no losses on the above impaired loans for the year ended December 31, 2012. Losses on the above impaired loans totaled and \$191,562 for the year ended December 31, 2011. The Bank had no liabilities measured at fair value on a non-recurring basis at December 31, 2012 or 2011.