# 2010
# Annual Report

Lighthouse Bank

# Lighthouse Bank

*Lighthouse Bank is a locally owned and operated independent bank serving Santa Cruz County. Our Bank was founded in October 2007 by approximately 350 local residents, professionals and small business owners. Our core business operations are conducted entirely in Santa Cruz County and we are committed to success, driven by the economic health and prosperity of our community and local ownership.*

*Lighthouse Bank offers a full array of loan and deposit products to professionals, small to medium-sized businesses and non-profit organizations in our community. We specialize in developing relationships that are tailored to meet the individual needs of each client. Our local headquarters and management give us the ability to respond to your needs quickly. Simply put, we believe in consistently delivering competitive products with a level of personalized, professional and highly-responsive service that is unmatched.*

*We value the trust our owners and clients place in us and recognize that they make our business possible. We invite you to visit us and experience premier local banking at Lighthouse Bank.*

**From the first moment we walked in the door we knew Lighthouse Bank was different from other banks. They welcomed us with genuine interest, listened to our vision for our business and have supported us every step of the way.**

Chef Kendra L. Baker
Zachary E. Davis
Owners, The Penny Ice Creamery

Cover Photo: Yeazell Design

# A Letter To Our Owners

To our Owners, Employees, Clients and Community,

ON BEHALF of the Board of Directors and Management of Lighthouse Bank, we present our financial results for the fiscal year ended December 31, 2010.

John C. Burroughs
*Chairman of the Board*

Richard G. Hofstetter
*President and CEO*

2010 was an incredibly good year for Lighthouse Bank. The year began with our economy still in the midst of a severe recession. Despite these conditions our Bank achieved profitability and increased earnings each successive quarter during our second full year of operation. While there were some signs of economic recovery for the economy in 2010, the signs were small and the progress slow. In spite of this environment, our Bank experienced good growth in both loans and deposits. This performance put our Bank head and shoulders above the majority of industry peers, even those with considerably longer histories of operation.

Lighthouse Bank experienced a number of first time achievements during the year. Our Bank's net profit of $647 thousand for the fiscal year ended December 31, 2010 represented our first full year of profitable operations. Shareholders' equity, which began increasing in early 2009, grew by $906 thousand to $17.3 million. Total assets surpassed the $100 million mark, growing $25.7 million over the prior year to $117 million. In September of 2010, our Bank was granted Preferred Lender (PLP) status by the Small Business Administration. As a Preferred Lender, we are permitted to make decisions on behalf of the SBA, which significantly shortens the loan process for our clients.

We continued to focus on achieving growth and profitability through a deliberate and controlled process. We view growth as desirable, but only to the extent that it adds to profitability and equity and does not dilute the interests of our owners. With this in mind, we intend to continue to grow our Bank organically. We do not plan to engage in asset purchases or other activities that would require additional stock sales resulting in ownership dilution. Fortunately, Lighthouse Bank has an extremely high leverage capital ratio, which at 15.2% is far and away the strongest of any bank or credit union doing business in Santa Cruz County. This capital is more than adequate to support the considerable growth we foresee over the next few years. This bodes well for the future of our company.

Critical to our Bank's economic success in 2010 was our ability to control expenses and maintain a high quality level in our loan portfolio. While loan losses are an inevitable part of lending, we have been fortunate in not having experienced a loan loss since opening in 2007. Notwithstanding, we maintain a conservative reserve to support any future losses that may occur. That reserve was in excess of $1.9 million at year end. In the area of expense control, the Bank continues to operate with considerable

**Our Mission Statement**

**Lighthouse Bank is committed to providing superior personalized banking products and services in Santa Cruz County. We are dedicated to creating financial benefit for our clients, professional growth for our employees and financial prosperity for our owners and community.**

# A Letter To Our Owners

efficiency. As with most of the industry, employee related costs represent well over 50% of total non-interest expenses. At year end our Bank employed a full-time staff of eighteen. Benchmark efficiency ratios, of assets per employee and deposits per employee, place Lighthouse Bank well ahead of our peers. Overall costs remain under tight control driven by an emphasis to beneficially invest in our community. In concert with our search of prudent investments is our aversion to committing resources to unproductive or excessive undertakings that are commonplace within our industry.

On a more personal note, it is with considerable sadness that we recognize the passing of Lighthouse Bank Director Dr. Ritu Meister last spring. Dr. Meister's unique cultural and professional perspectives will be missed by the entire organization. In addition, Director Doug Austin elected to retire from the Board in January 2011. Doug was an extremely valuable asset to the Bank, particularly in regard to our formation and receipt of initial regulatory approvals. Doug's many years as a Director with Coast Commercial Bank proved invaluable to our efforts. We will seek to fill both directorship openings during 2011.

*Lighthouse Bank volunteers at the Habitat for Humanity project on Frederick Street.*

Moving further into 2011, we are confident that Lighthouse Bank will outperform in the industry regardless of the economic climate. At the foundation of our success is our committed and talented staff; most of whom have been with us since the day our Bank opened, our dedicated Board of Directors, and our extraordinarily supportive owners, the vast majority of whom are also clients.

As always, we ask you to refer your friends, relatives and business associates our way. It is crucial that you support your Bank and your investment by letting others know that Lighthouse Bank is here to serve our clients and our community. Our Bank continues to build a tradition of involvement in the community by supporting local charitable organizations, such as Habitat for Humanity, Big Brothers Big Sisters, the United Way and a long list of other worthy local organizations. Our employees and directors are proud of their affiliations with these organizations. Do not hesitate to contact us at any time to discuss our Bank or any questions that you may have. Together we look forward to continued success in and with Santa Cruz County.

Please join us at our annual owners meeting at the Museum of Art and History at the McPherson Center on Thursday May 19, 2011 at 4:00 P.M.

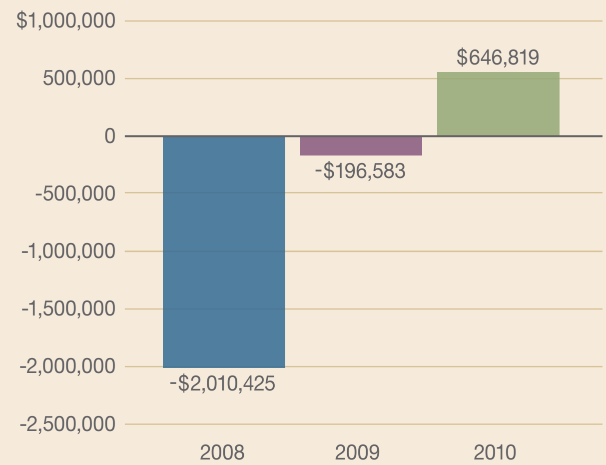
Sincerely,

**John C. Burroughs**
*Chairman of the Board*

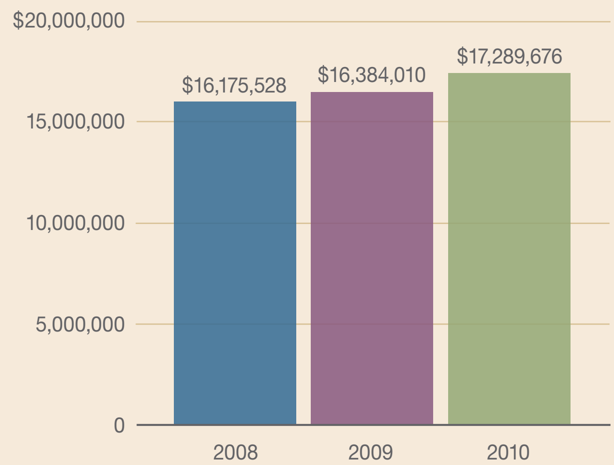
**Richard G. Hofstetter**
*President and CEO*

# Financial Summary

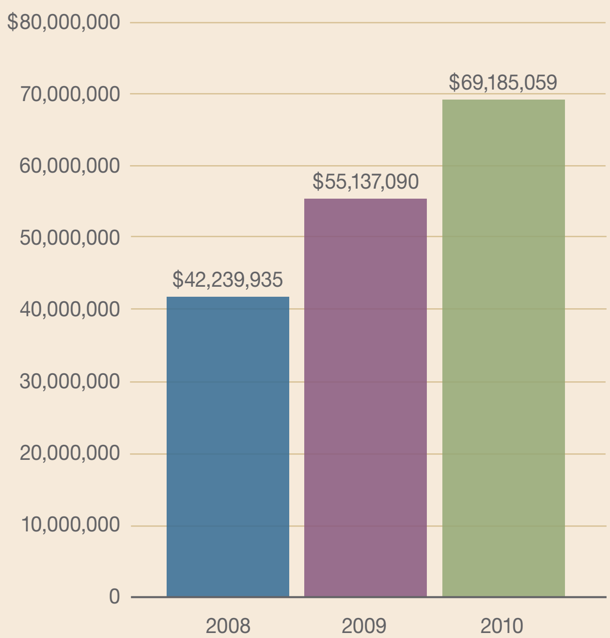
**Net Income After Tax**



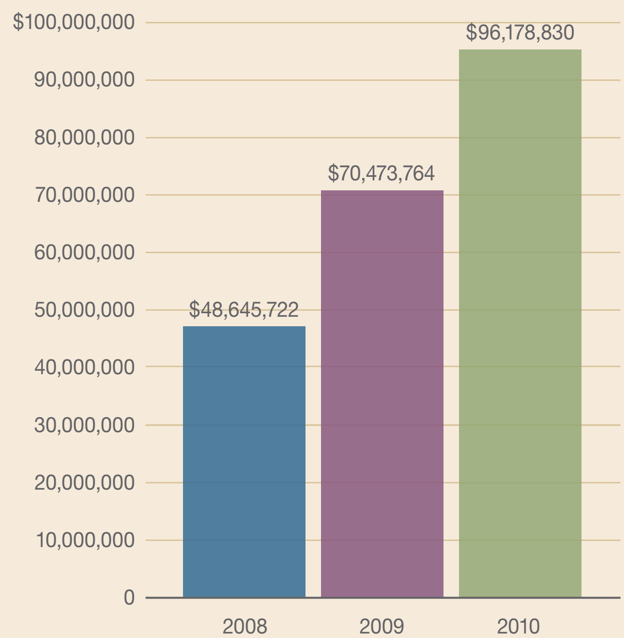

**Total Shareholders' Equity**




**Total Gross Loans**




**Total Deposits**



VAVRINEK, TRINE, DAY
& COMPANY, LLP
*Certified Public Accountants*
www.vtdcpa.com

VALUE THE DIFFERENCE

## INDEPENDENT AUDITOR'S REPORT

The Board of Directors
Lighthouse Bank

We have audited the balance sheets of Lighthouse Bank as of December 31, 2010, and 2009 and the related statements of operations, changes in stockholders' equity and other comprehensive income, and cash flows for each of the years in the three year period ended December 31, 2010. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Lighthouse Bank as of December 31, 2010 and 2009 and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

Vavrinek Trine Day + Co. LLP

Palo Alto, California
March 8, 2011

260 Sheridan Avenue, Suite 440 Palo Alto, CA 94306 Tel: 650.462.0400 Fax: 650.462.0500 www.vtdcpa.com

FRESNO ◆ LAGUNA HILLS ◆ PALO ALTO ◆ PLEASANTON ◆ RANCHO CUCAMONGA

# Statements of Condition

| | December 31, 2010 | December 31, 2009 |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | $ 17,455,690 | $ 8,797,559 |
| Federal funds sold | 576,000 | 4,106,000 |
| Total cash and cash equivalents | 18,031,690 | 12,903,559 |
| Interest bearing deposits in other financial institutions | 24,698,574 | 16,482,000 |
| Investment securities: | | |
| Securities available-for-sale, at estimated fair value | 2,719,871 | 2,759,425 |
| Total investment securities | 2,719,871 | 2,759,425 |
| Loans receivable: | | |
| Gross loans | 69,185,059 | 55,137,090 |
| less deferred loan fees, net of costs | 405,218 | 274,869 |
| less reserve for loan losses | 1,925,000 | 1,384,000 |
| Net loans | 66,854,841 | 53,478,221 |
| Premises and equipment, net | 257,076 | 433,479 |
| Accrued interest receivable | 320,781 | 229,264 |
| Federal Home Loan Bank and bankers' bank stock, at cost | 581,373 | 464,274 |
| Other real estate owned | 2,548,244 | 3,882,387 |
| Other assets | 817,179 | 522,009 |
| **Total Assets** | $116,829,629 | $91,154,618 |
| **Liabilities and Shareholders' Equity** | | |
| **Liabilities:** | | |
| Deposits: | | |
| Noninterest-bearing demand deposits | $ 20,258,708 | $12,454,194 |
| Interest-bearing demand deposits | 7,523,211 | 2,886,908 |
| Savings and money market deposits | 46,168,868 | 32,722,861 |
| Time deposits | 22,228,043 | 22,409,801 |
| Total deposits | 96,178,830 | 70,473,764 |
| Other liabilities: | | |
| Accrued interest payable | 11,950 | 16,426 |
| Borrowings | 3,000,000 | 4,100,000 |
| Other liabilities | 349,173 | 180,418 |
| Total liabilities | 99,539,953 | 74,770,608 |
| **Shareholders' Equity:** | | |
| Common stock, no par value, 10,000,000 shares authorized: issued and outstanding; 1,853,028 shares at December 31, 2010 and at December 31, 2009 | 18,484,627 | 18,484,627 |
| Additional paid-in-capital | 1,098,165 | 843,113 |
| Accumulated (deficit) | (2,397,297) | (3,044,116) |
| Accumulated other comprehensive income | 104,181 | 100,386 |
| Total shareholders' equity | 17,289,676 | 16,384,010 |
| **Total Liabilities and Shareholders' Equity** | $116,829,629 | $91,154,618 |

*See accompanying notes to the Financial Statements*

## Statements of Operations

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2010 | 2009 | 2008 |
| **Interest Income:** | | | |
| Interest and fees on loans | $4,746,339 | $3,785,073 | $ 2,297,636 |
| Investment securities | 452,692 | 525,172 | 99,042 |
| Federal funds sold and other interest income | 28,845 | 14,278 | 365,449 |
| Total interest income | 5,227,876 | 4,324,523 | 2,762,127 |
| **Interest Expense:** | | | |
| Deposits and other borrowed funds | 699,979 | 768,035 | 630,879 |
| Net interest income before provision for loan losses | 4,527,897 | 3,556,488 | 2,131,248 |
| Provision for loan losses | 541,000 | 413,000 | 891,000 |
| Net interest income after provision for loan losses | 3,986,897 | 3,143,488 | 1,240,248 |
| **Non-Interest Income:** | | | |
| Service charges on deposit accounts | 256,384 | 102,555 | 42,801 |
| Other non-interest income | 83,552 | 32,749 | 16,120 |
| Total non-interest income | 339,936 | 135,304 | 58,921 |
| **Non-Interest Expense:** | | | |
| Salaries and employee benefits | 2,168,383 | 2,141,394 | 2,183,656 |
| Occupancy | 259,686 | 257,463 | 273,049 |
| Furniture and equipment | 223,455 | 229,033 | 232,989 |
| Marketing and business development | 58,468 | 52,475 | 59,321 |
| Item and data processing | 160,431 | 156,107 | 98,615 |
| Professional services | 123,499 | 90,679 | 83,571 |
| Other operating expenses | 730,828 | 547,424 | 377,593 |
| Total non-interest expense | 3,724,750 | 3,474,575 | 3,308,794 |
| Income (loss) before income taxes | 602,083 | (195,783) | (2,009,625) |
| Income tax expense (benefit) | (44,736) | 800 | 800 |
| **Net income** (loss) | $ 646,819 | $ (196,583) | $ (2,010,425) |
| Earnings (loss) per share: | | | |
| Basic | $ 0.35 | $ (0.11) | $ (1.08) |
| Diluted | $ 0.35 | $ (0.11) | $ (1.08) |

*See accompanying notes to the Financial Statements*

## Statement of Shareholders' Equity

**For the three years ended December 31, 2010**

| | Common Shares | Amount | Additional Paid-In Capital | Accumulated Deficit | Other Comprehensive Income | Total Shareholders' Equity |
|---|---|---|---|---|---|---|
| **Balance at January 1, 2008** | 1,853,028 | $18,484,627 | $ 121,148 | $ (837,108) | $ – | $ 17,768,667 |
| Stock-based compensation | – | – | 366,708 | – | – | 366,708 |
| Net loss | – | – | – | (2,010,425) | – | (2,010,425) |
| Unrealized gain on securities available-for-sale, net of tax of $0 | – | – | – | – | 50,578 | 50,578 |
| **Balance at December 31, 2008** | 1,853,028 | 18,484,627 | 487,856 | (2,847,533) | 50,578 | 16,175,528 |
| Stock-based compensation | – | – | 355,257 | – | – | 355,257 |
| Net loss | – | – | – | (196,583) | – | (196,583) |
| Unrealized gain on securities available-for-sale, net of tax of $0 | – | – | – | – | 49,808 | 49,808 |
| **Balance at December 31, 2009** | 1,853,028 | 18,484,627 | 843,113 | (3,044,116) | 100,386 | 16,384,010 |
| Stock-based compensation | – | – | 255,052 | – | – | 255,052 |
| Net income | – | – | – | 646,819 | – | 646,819 |
| Unrealized gain on securities available-for-sale, net of tax of $0 | – | – | – | – | 3,795 | 3,795 |
| **Balance at December 31, 2010** | 1,853,028 | $18,484,627 | $ 1,098,165 | $ (2,397,297) | $ 104,181 | $ 17,289,676 |

*See accompanying notes to the Financial Statements*

## Statements of Cash Flows

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2010 | 2009 | 2008 |
| **Operating Activities:** | | | |
| Net income (loss) | $646,819 | $(196,583) | $(2,010,425) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization of premises and equipment | 179,820 | 185,995 | 173,853 |
| Provision for loan losses | 541,000 | 413,000 | 891,000 |
| Deferred income tax benefit | (477,942) | – | – |
| Net amortization/accretion of investment discounts and premiums | 5,697 | 12,219 | 1,490 |
| Increase in deferred loan fees, net of costs | 130,349 | 23,543 | 191,109 |
| Stock-based compensation | 255,052 | 355,257 | 366,708 |
| Net (increase) decrease in: | | | |
| Accrued interest receivable | (91,517) | (40,237) | (167,543) |
| Other assets | 182,772 | (391,958) | (32,378) |
| Net increase (decrease) in: | | | |
| Accrued interest payable | (4,476) | (7,079) | 21,436 |
| Other liabilities | 168,755 | 69,521 | 64,812 |
| Net cash provided by (used in) operating activities | 1,536,329 | 423,678 | (499,938) |
| **Investing Activities:** | | | |
| Held-to-maturity securities: | | | |
| Principal repayments | – | – | 100,000 |
| Purchases | – | – | – |
| Available-for-sale securities: | | | |
| Principal repayments | 1,043,589 | 950,050 | 36,118 |
| Purchases | (1,005,938) | – | (3,658,736) |
| Net (increase) in Federal Home Loan Bank stock | (115,400) | (184,000) | (8,700) |
| Purchase of bankers' bank stock | (1,698) | (1,574) | (270,000) |
| Net (increase) in time deposits with other banks | (7,971,000) | (4,277,000) | (12,205,000) |
| Net (increase) in other interest-bearing deposits with other banks | (245,574) | – | – |
| Net (increase) in loans | (12,713,826) | (16,779,542) | (35,848,122) |
| Purchase of premises and equipment | (3,672) | (25,501) | (84,112) |
| Disposal of equipment | 255 | – | 1,736 |
| Net cash used in investing activities | (21,013,264) | (20,317,567) | (51,936,816) |
| **Financing Activities:** | | | |
| Increase (decrease) in: | | | |
| Demand deposits | 12,440,817 | 2,551,847 | 9,538,962 |
| Savings and money market deposits | 13,446,007 | 10,454,830 | 17,745,195 |
| Time deposits | (181,758) | 8,821,365 | 12,384,305 |
| Other borrowings | (1,100,000) | 4,100,000 | – |
| Net cash provided by financing activities | 24,605,066 | 25,928,042 | 39,668,462 |
| Net (decrease) increase in cash and cash equivalents | 5,128,131 | 6,034,153 | (12,768,292) |
| Cash and cash equivalents at beginning of period | 12,903,559 | 6,869,406 | 19,637,698 |
| Cash and cash equivalents at end of period | $18,031,690 | $12,903,559 | $ 6,869,406 |
| **Supplemental Disclosures of Cash Flow Information** | | | |
| Total interest paid | $704,455 | $775,114 | $609,443 |
| Total income taxes paid | 380,800 | 800 | 800 |
| Transfer of loans to other real estate owned | 706,024 | 3,882,387 | – |

*See accompanying notes to the Financial Statements*

## Note 1. Summary of Significant Accounting Policies

**Description of the Business** — Lighthouse Bank (the Bank) is a California state chartered bank which offers a full range of commercial and personal banking services to residents and businesses in Santa Cruz County, California, through its office in Santa Cruz, California. The Bank was incorporated on June 13, 2007 as Lighthouse Bank (In Organization) and commenced banking operations on October 29, 2007 (inception), upon receipt of final approval from the California Department of Financial Institutions and the issuance of deposit insurance by the Federal Deposit Insurance Corporation. The Bank is subject to competition from other financial institutions. Additionally, the Bank is subject to regulations by the above referenced regulatory agencies and undergoes periodic examinations by those agencies.

The majority of the Bank's business is done with customers located in Northern California, specifically in Santa Cruz and adjacent counties. The Bank has 78 credit arrangements that are collateralized by real estate. Generally, the Bank maintains loan-to-value ratios no greater than 70 percent on commercial and multi-family real estate loans and no greater than 70 percent on single-family residential real estate loans. At December 31, 2010, the Bank had loans outstanding of approximately $60,313,000 that were collateralized by real estate. There were no other significant loan concentrations.

**Subsequent Events** — The Bank has evaluated subsequent events for recognition and disclosure through March 8, 2011, which is the date the financial statements were available to be issued.

**Summary of Significant Accounting Policies** — The accounting and reporting policies of the Bank conform to generally accepted accounting principles in the United States of America and prevailing practices within the banking industry. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported accounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The following is a summary of significant policies used in the preparation of the accompanying financial statements.

**Cash and Cash Equivalents** — For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and highly liquid debt instruments with an original maturity of 90 days or less. The Bank had a net cash reserve requirement of $24,000 at December 31, 2010 and no net cash reserve requirement at December 31, 2009.

**Use of Estimates in the Preparation of Financial Statements** — The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Investment Securities** — Marketable investment securities have consisted of U.S. Government Agency and Agency mortgage-backed securities. At the time of purchase, the Bank designates securities as either "held-to-maturity" or "available-for-sale" based on its investment objectives, operational needs and intent. The Bank does not engage in securities trading activities.

Held-to-maturity securities are recorded at amortized cost, adjusted for amortization or accretion of premiums or discounts. Available-for-sale securities are recorded at fair value with unrealized holding gains and losses, net of the related tax effect, reported as a separate component of shareholders' equity until realized. During the year ended December 31, 2010, there were no transfers between classifications. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. Dividend and interest income are recognized on an accrual basis. Realized gains and losses for securities classified as available-for-sale and held-to-maturity are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

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

**Loans** — Loans are stated at the amount of unpaid principal, net of deferred fees, and reduced by an allowance for loan losses. Accrual of interest is discontinued on loans which are more than 90 days delinquent or when Management believes, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of interest is doubtful unless the loans are well-secured and in the process of collection. When a loan is placed on non-accrual status, all interest previously accrued but not collected is charged against current period income. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. Generally, a non-accrual loan will be restored to an accrual status when none of its principal and interest is past due, when prospects for future contractual payments are no longer in doubt and when the loan becomes well-secured and in the process of collection.

Non-refundable fees and estimated loan origination costs are deferred net and are amortized to income over the expected life of the loan using a method that approximates the level yield method.

**Impaired Loans** — The Bank considers a loan to be impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement, including scheduled interest payments. Generally, the Bank identifies loans to be reported as impaired when such loans are in non-accrual status or are considered troubled debt restructurings due to the granting of a below-market rate of interest or a partial forgiveness of indebtedness on an existing loan. Any allowance on impaired loans is generally based on one of three methods. 1) present value of expected future cash flows discounted at the loan's effective interest rate or, 2) as a practical expedient, at the loan's observable market price or 3) the fair value of the collateral if the loan is collateral dependent. Income recognition on impaired loans is consistent with the policy for income recognition on non-accrual loans described above.

**Allowance for Loan Losses** — The allowance for loan losses is established through periodic provisions for possible loan losses. Loans are charged against the allowance for loan losses when Management believes that the collectability of the principal is unlikely. The allowance is a reserve to provide for possible losses on existing loans that may become uncollectable, based on evaluations of the collectability of loans and prior loan loss experience. The evaluations include consideration of changes in the nature and volume of the loan portfolio, overall portfolio quality, a review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay.

Management believes that the allowance for loans losses is adequate. While Management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review Bank's allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on their judgment of information available to them at the time of their examination.

**Premises & Equipment** — Premises and equipment are stated at cost less accumulated depreciation and amortization and include additions that materially extend the useful lives of existing premises and equipment. All other maintenance and repair expenditures are expensed as incurred.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, three to five years, and are expensed to non-interest expense. Leasehold improvements are amortized over the initial term of the lease.

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

**Other Real Estate Owned** — Other real estate owned represents real estate acquired through foreclosure and is carried at the lower of the recorded investment on the property or its fair value. Prior to foreclosure, the value of the underlying loan is written down to the fair market value of the real estate to be acquired by a charge to the allowance for credit losses, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of related income are included in other expenses.

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

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

This guidance has been applied to all tax positions of the Bank as of inception. The adoption of this guidance has not had a material impact on the Bank’s financial position, results of operations or cash flows for the periods presented.

**Stock-Based Compensation** — The Bank recognizes the cost of employee services received in exchange for awards of stock options, or other equity instruments, based on the grant-date fair value of those awards. This cost is recognized over the period which an employee is required to provide services in exchange for the award, generally the vesting period. See Note 8 for additional information on the Bank’s stock option plan.

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

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

*See Note 12 for more information and disclosures relating to the Bank’s fair value measurements.*

**Earnings (Loss) Per Share** — Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. Due to the operating losses incurred during 2009 and 2008 there were no potentially dilutive securities at December 31, 2009 or December 31, 2008. The weighted average shares outstanding were 1,853,028 at each of the periods ended December 31, 2010, 2009 and 2008. In addition, in 2010 there were no potentially dilutive securities outstanding.

**Comprehensive Income** — Changes in unrealized gains and losses on available-for-sale securities is the only component of accumulated other comprehensive income for the Bank. The Bank had accumulated other comprehensive income totaling $3,795, $49,808 and $50,578 at December 31, 2010, December 31, 2009 and December 31, 2008, respectively.

| | 2010 | 2009 | 2008 |
|---|---|---|---|
| Net Income (loss) | $ 646,819 | $ (196,583) | $(2,010,425) |
| Unrealized gain on securities available for sale | 3,795 | 49,808 | 50,578 |
| Total comprehensive profit (loss) | $ 650,614 | $ (146,775) | $(1,959,847) |

**Adoption of New Accounting Standards**

In June 2009, accounting standards were amended to clarify when a transferor has surrendered control over transferred financial assets and thus is entitled to account for the transfer as a sale. The amendments establish specific conditions for accounting for the transfer of a financial asset, or a portion of a financial asset, as a sale. This guidance was effective for transfers occurring on or after January 1, 2010 and impacted when a loan participation or SBA loan sale could be accounted for as a sale and the related transferred asset derecognized by the Bank. Adoption of the standard by the Bank in 2010 did not have a material impact on its balance sheet or statement of operations.

In July 2010, accounting standards were amended to require significantly more information about the credit quality of the Bank's loan portfolio. Although this statement addresses only disclosure and does not seek to change recognition or measurement, the disclosure represents a meaningful change in practice. New period-end related disclosures are reflected in these financial statements while new activity related disclosures will be effective in 2011.

## Note 2. Investment Securities

The following table summarizes Lighthouse Bank's securities available-for-sale at December 31, 2010, and December 31, 2009:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| **December 31, 2010** | | | | |
| **Securities available-for-sale** | | | | |
| U.S. Agency MBS's | $ 2,615,690 | $ 104,181 | $ – | $ 2,719,871 |
| Total securities available-for-sale | $ 2,615,690 | $ 104,181 | $ – | $ 2,719,871 |
| **December 31, 2009** | | | | |
| **Securities available-for-sale:** | | | | |
| U.S. Agency MBS's | $ 2,659,039 | $ 100,386 | $ – | $ 2,759,425 |
| Total securities available-for-sale | $ 2,659,039 | $ 100,386 | $ – | $ 2,759,425 |

The amortized cost and estimated fair value of investment securities at December 31, 2010 and December 31, 2009 by contractual maturity are shown below, except for mortgage-backed securities and other securities which are presented in total. Expected maturities on mortgage-backed securities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Securities available-for-sale | | Securities held-to-maturity | |
|---|---|---|---|---|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| **December 31, 2010** | | | | |
| Due in one year or less | $ – | $ – | $ – | $ – |
| Due after one year through five years | – | – | – | – |
| Due after five years through ten years | – | – | – | – |
| Mortgage-backed securities | 2,615,690 | 2,719,871 | – | – |
| Total | $ 2,615,690 | $ 2,719,871 | $ – | $ – |
| **December 31, 2009** | | | | |
| Due in one year or less | $ – | $ – | $ – | $ – |
| Due after one year through five years | – | – | – | – |
| Due after five years through ten years | – | – | – | – |
| Mortgage-backed securities | 2,659,039 | 2,759,425 | – | – |
| Total | $ 2,659,039 | $ 2,759,425 | $ – | $ – |

There are no investment securities in a temporary unrealized loss position as of December 31, 2010. There are no investment securities that have been in a temporary unrealized loss position for 12 months or longer. No investment securities were sold in 2010 or 2009. There were no investment securities required to be pledged to secure public deposits at December 31, 2010 and December 31, 2009, or for any other purposes, required or permitted by law. Investment securities pledged to secure Federal Home Loan Bank borrowings (note 7) at December 31, 2010 and December 31, 2009, were $1,000,000 and $700,000, respectively.

## Note 3. Loans

Loan maturity and rate sensitivity data (excluding loans on non-accrual) of the loan portfolio at December 31, 2010 and 2009 are as follows (in thousands):

| **December 31, 2010** | Within One Year | One to Five Years | After Five Years | Total |
|---|---|---|---|---|
| Loans secured by real estate, land and construction loans | $ 19,878 | $ 26,844 | $ 13,590 | $ 60,312 |
| Consumer and other loans | 41 | 6 | – | 47 |
| Commercial and revolving lines | 3,578 | 4,338 | 910 | 8,826 |
| | $ 23,497 | $ 31,188 | $ 14,500 | $ 69,185 |
| Loans at fixed interest rates | $ 20,390 | $ 22,364 | $ 12,705 | $ 55,459 |
| Loans at variable interest rates | 3,107 | 8,824 | 1,795 | 13,726 |
| | $ 23,497 | $ 31,188 | $ 14,500 | $ 69,185 |

| **December 31, 2009** | Within One Year | One to Five Years | After Five Years | Total |
|---|---|---|---|---|
| Loans secured by real estate, land and construction loans | $ 18,641 | $ 19,044 | $ 10,500 | $ 48,185 |
| Consumer and other loans | 338 | 9 | – | 347 |
| Commercial and revolving lines | 2,037 | 3,722 | 140 | 5,899 |
| | $ 21,016 | $ 22,775 | $ 10,640 | $ 54,431 |
| Loans at fixed interest rates | $ 20,305 | $ 13,026 | $ 9,612 | $ 42,943 |
| Loans at variable interest rates | 711 | 9,749 | 1,028 | 11,488 |
| | $ 21,016 | $ 22,775 | $ 10,640 | $ 54,431 |

**Changes in the allowance for loan losses were as follows:**

| | December 31, | | |
|---|---|---|---|
| | 2010 | 2009 | 2008 |
| Balance at beginning of year | $1,384,000 | $ 971,000 | $ 80,000 |
| Provision for loan losses | 541,000 | 413,000 | 891,000 |
| Loan charge-offs | – | – | – |
| Recoveries of loan charge-offs | – | – | – |
| Balance at year end | $1,925,000 | $1,384,000 | $ 971,000 |
| Net loan (recoveries) charge-offs as a percentage of average total loans | N/A | N/A | N/A |

**The following table presents the balance in the allowance for loan losses and the recorded investment in loans by impairment method as of December 31, 2010:**

| | Evaluated for Impairment | | |
|---|---|---|---|
| | Collectively | Individually | Total |
| **Allowance for Loan Losses** | | | |
| Construction and land | $ 254,971 | $ 298,779 | $ 553,750 |
| Commercial real estate | 561,720 | 426,371 | 988,091 |
| Residential real estate | 77,990 | – | 77,990 |
| Commercial and industrial | 288,929 | 2,333 | 291,262 |
| Small Business Administration | 13,228 | – | 13,228 |
| Other | 679 | – | 679 |
| | $ 1,197,517 | $ 727,483 | $ 1,925,000 |
| **Loans** | | | |
| Construction and land | $13,057,919 | $2,987,788 | $16,045,707 |
| Commercial real estate | 26,397,043 | 6,574,038 | 32,971,081 |
| Residential real estate | 4,673,072 | – | 4,673,072 |
| Commercial and industrial | 13,908,763 | 46,667 | 13,955,430 |
| Small Business Administration | 1,484,578 | – | 1,484,578 |
| Other | 55,191 | – | 55,191 |
| | $59,576,566 | $9,608,493 | $69,185,059 |

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

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

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

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

Loans listed as pass include larger non-homogeneous loans not meeting the risk rating definitions above and smaller, homogeneous loans not assessed on an individual basis.

Based on the most recent analysis performed, the approximate amount of loans by risk category and class of loans is as follows as of December 31, 2010:

| | Pass | Special Mention | Substandard | Impaired | Total |
|---|---|---|---|---|---|
| **Loans:** | | | | | |
| Construction and land | $ 13,057,919 | $ – | $ 2,987,788 | – | $16,045,707 |
| Commercial real estate | 26,397,043 | 5,597,352 | 976,686 | – | 32,971,081 |
| Residential real estate | 4,673,072 | – | – | – | 4,673,072 |
| Commercial and industrial | 13,908,763 | 46,667 | – | – | 13,955,430 |
| Small Business Administration | 1,484,578 | – | – | – | 1,484,578 |
| Other | 55,191 | – | – | – | 55,191 |
| | $59,576,566 | $ 5,644,019 | $ 3,964,474 | $ – | $69,185,059 |

In general, the Bank would not recognize any interest income on loans that are classified as impaired. The following is a summary of the investment in impaired loans as of December 31, 2010 and 2009, including the related allowance for loan losses and cash-basis income recognized. Also shown are loans on non-accrual and those that are past due and still accruing interest:

| | December 31, | | |
|---|---|---|---|
| | 2010 | 2009 | 2008 |
| **Impaired Loans:** | | | |
| Recorded investment in impaired loans | $ – | $ 706,024 | $ 2,857,976 |
| Related allowance for loan losses | – | – | – |
| Average recorded investment in impaired loans | 148,942 | 2,715,495 | 894,521 |
| Interest income recognized for cash payments while impaired | – | – | – |
| Total loans on non-accrual | – | 706,024 | 2,857,976 |
| Total loans past due 90 days or more and still accruing interest | 1,863,656 | – | – |

## Note 4. Premises and Equipment

The following presents the cost of premises and equipment including leasehold improvements and the related accumulated depreciation and amortization at December 31, 2010 and December 31, 2009:

| | December 31, 2010 | December 31, 2009 |
|---|---|---|
| Leasehold improvements | $ 294,469 | $ 294,469 |
| Furniture, fixtures and equipment | 210,817 | 210,213 |
| Software and capitalized data & item processing | 145,660 | 145,660 |
| Computer equipment | 151,585 | 149,026 |
| Automobile | 20,282 | 20,282 |
| Construction-in-progress | – | – |
| Total premises and equipment | 822,813 | 819,650 |
| Less accumulated depreciation and amortization | 565,737 | 386,171 |
| Premises and equipment, net | $ 257,076 | $ 433,479 |

Depreciation and amortization expense of premises and equipment aggregated $179,820, $185,995 and $173,853 for the years ended December 31, 2010, December 31, 2009 and December 31, 2008, respectively.

## Note 5. Income Taxes

Deferred income taxes are the result of differences between income tax accounting and accounting principles generally accepted in the United States of America, with respect to income and expense recognition. The following is a summary of the components of the net deferred tax asset accounts as of December 31, 2010:

| | |
|---|---|
| Pre-opening expenses | $ 86,000 |
| Stock-based compensation | 164,000 |
| OREO expenses | 100,000 |
| Loan loss reserve | 743,000 |
| Other | 72,000 |
| | 1,165,000 |
| Valuation allowance | (687,000) |
| Net deferred tax asset | $ 478,000 |

During the 2010 year, the Bank demonstrated the ability to maintain a consistent level of profitability such that a 100% reserve against the net deferred tax assets is no longer necessary. Therefore, the valuation allowance has been adjusted downward by $337,000 from the prior year. The deferred tax asset before any valuation allowance has increased by $141,000 during the year resulting in a net deferred tax asset of $478,000 being reflected in the accompanying 2010 Statement of Condition. The Bank's effective income tax rate for the year ended December 31, 2010 was a negative 7.43%. The main reason for the variance between an expected rate using statutory federal and State income tax rates, and the actual rate was the recognition deferred tax assets that were generated in prior years, but which were recognized in the current year.

| | 2010 | 2009 | 2008 |
|---|---|---|---|
| **Current:** | | | |
| Federal | $ 376,584 | $ – | $ – |
| State | 56,622 | 800 | 800 |
| Total current | 433,206 | 800 | 800 |
| **Deferred:** | | | |
| Federal | 432,360 | – | – |
| State | 45,582 | – | – |
| Total deferred | 477,942 | – | – |
| Total provision | $ (44,736) | $ 800 | $ 800 |

The Bank's Federal and State income tax returns for the three years ended December 31, 2009, are open to audit by Federal and California State taxing authorities.

## Note 6. Time Deposits

The aggregate amount of time deposit accounts equal to or greater than $100,000 was $15,064,544 and $16,624,183 at December 31, 2010 and December 31, 2009, respectively. At December 31, 2010 the scheduled maturities for time deposits were as follows (in thousands):

| | |
|---|---|
| Due in 2011 | $ 17,677 |
| Due in 2012 | 4,031 |
| Due in 2013 | 406 |
| Due in 2014 | 104 |
| Due in 2015 | 10 |
| | $22,228 |

Interest expense on time deposits of $100,000 or more was $233,531, $287,864 and $194,514 in 2010, 2009 and 2008, respectively.

## Note 7. Borrowed Funds

The Bank has obtained federal funds borrowing guidance lines with its correspondent banks in an aggregate amount of $9.5 million on an unsecured basis. The only usage of these guidance lines was to successfully test their availability. Additionally, the Bank has established a secured borrowing facility with the Federal Home Loan Bank of San Francisco. Total FHLB borrowings at December 31, 2010, and December 31, 2009, were $3,000,000 and $4,100,000 with a weighted average maturity of 53 days and 153 days and a weighted average cost of 0.42% and 0.83%, respectively. At December 31, 2010, the Bank had a total available borrowing capacity of $26,148,744 which included $16,648,744 in secured borrowing capacity from the FHLB.

## Note 8. Stock Options

The Bank has adopted a qualified stock option plan (the Plan) for employees, non-employee directors and Bank founders, under which a maximum of 555,908 shares of Bank's common stock may be issued. The Plan calls for the exercise prices of the options to be equal to or greater than the fair market value of the stock at the time of grant. Options granted to Bank founders who are not also Bank directors or Bank officers were fully vested upon the date of grant. All other options shares granted have annual vesting over the first three years of the option contract. All option contracts for founders who are not also Bank directors or Bank officers have expiration dates of ten years from the date of grant. All director and employee option contracts have expiration dates on the earlier of termination of service or 10 years from the date of grant.

**The following is a summary of required disclosures relating to the Bank's stock option plan for the periods presented:**

| | Options Outstanding | Weighted Average Exercise Price |
|---|---|---|
| Balance at December 31, 2007 | 444,500 | $ 10.00 |
| Granted 2008 | 5,000 | 11.80 |
| Exercised 2008 | – | – |
| Cancelled 2008 | (12,500) | 10.00 |
| Balance at December 31, 2008 | 437,000 | 10.02 |
| Granted 2009 | 6,000 | 9.88 |
| Exercised 2009 | – | – |
| Cancelled 2009 | (3,000) | 10.00 |
| Balance at December 31, 2009 | 440,000 | 10.02 |
| Granted 2010 | 3,000 | 7.15 |
| Exercised 2010 | – | – |
| Cancelled 2010 | (18,000) | 9.53 |
| Balance at December 31, 2010 | 425,000 | $ 10.02 |

| | Options Outstanding | | | Options Exercisable | | |
|---|---|---|---|---|---|---|
| | Number | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number | Weighted Average Contractual Life | Weighted Average Exercise Price |
| December 31, 2009: | 440,000 | 7.78 years | $ 10.02 | 295,327 | 7.75 years | $ 10.01 |
| December 31, 2010: | 425,000 | 6.78 years | $ 10.02 | 419,334 | 6.75 years | $ 10.01 |

There was no aggregate intrinsic value of stock option awards outstanding and exercisable at December 31, 2010.

**The number and weighted average grant date fair value of options granted is as follows for the years ended December 31, 2010, December 31, 2009 and December 31, 2008:**

| | Number | Weighted Average Grant Date Fair Value |
|---|---|---|
| 2008 | 5,000 | $2.77 |
| 2009 | 6,000 | $2.43 |
| 2010 | 3,000 | $3.99 |

**The weighted average assumptions used for 2010, 2009 and 2008 in determining the fair value of options granted are as follows:**

| | 2010 | 2009 | 2008 |
|---|---|---|---|
| Expected life (yrs.) | 6 | 6 | 6 |
| Volatility | 57.04% | 5.00% | 1.56% |
| Risk free rate of return | 2.96% | 3.46% | 3.85% |
| Dividend yield | 0.00% | 0.00% | 0.00% |

As of December 31, 2010, there was $10,817 unrecognized stock compensation expense that will be recognized through December 31, 2012.

## Note 9. 401(k) Employee Benefit Plan

All employees of the Bank are immediately, upon employment, eligible to participate in the Bank's 401(k) Plan which is a tax-deferred savings plan designed to assist employees in preparing for their retirement years. Employees may contribute to the Plan up to certain limits prescribed by the Internal Revenue Service. The Bank does not match employee contributions.

## Note 10. Related Party Transactions

In the ordinary course of business, Bank policies allow the making of loans to directors, officers, principal shareholders and their associates on substantially the same terms, including interest rates, origination and commitment fees, and collateral, as comparable transactions with unaffiliated persons, and such loans do not involve more than the normal risk of collectability. The Bank had no loans and/or extensions of credit made to or guaranteed by the Bank's directors and officers and their related companies at December 31, 2010, and December 31, 2009.

## Note 11. Restrictions, Commitments, Contingencies and Other Disclosures

**Restrictions on Cash and Due from Banks.** Lighthouse Bank is subject to Federal Reserve Act Regulation D which requires banks to maintain average reserve balances with the Federal Reserve Bank. Reserve requirements are offset by usable cash reserves. As of December 31, 2010, Lighthouse Bank had a net reserve requirement of $24,000. As of December 31, 2009, the Bank had no net reserve requirement.

As compensation for check clearing and other services, compensating balances of approximately $400,000 and $345,000 were maintained with correspondent banks at December 31, 2010 and December 31, 2009, respectively.

**Building Lease Commitments.** The current operating lease for the Bank's 111 Mission Street office in Santa Cruz expires November 30, 2012, with an option to extend for three additional 5 year periods. The monthly lease payment for the Santa Cruz Office is presently $11,700 plus triple net expenses for taxes, insurance and maintenance and the lease payment is fixed at this amount during the initial term.

Minimum rental payments for future years under this lease are as follows at December 31, 2010:

| | |
|---|---|
| 2011 | $140,400 |
| 2012 | 128,700 |
| | $269,100 |

Building rent expense was $140,400 for each of the years ended December 31, 2010, December 31, 2009, and December 31, 2008.

**Loan Commitments.** The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

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

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

**Financial instruments whose contract amounts represent credit risk at December 31, 2010 and December 31, 2009 are as follows:**

| | December 31, | |
|---|---|---|
| | 2010 | 2009 |
| Commitments to extend credit | $13,232,312 | $6,716,372 |
| Total unfunded financial commitments | $13,232,312 | $6,716,372 |

**Legal Matters.** At December 31, 2010, the Bank was not subject to or knows of any claims and/or lawsuits that could have a material financial impact on the operations of the Bank.

## Note 12. Fair Value of Financial Instruments

In accordance with applicable accounting guidance, the Bank groups its financial assets and financial 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. These levels are:

- **Level 1**: Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Level 1 also includes U.S. Treasury, other U.S. government and agency mortgage-backed securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
- **Level 2**: Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities.
- **Level 3**: Valuations for assets and liabilities that are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

The only assets or liabilities measured at fair value on a recurring basis on the Bank's balance sheet at December 31, 2010 and 2009 are the investment securities classified as available for sale totaling $2,719,871 and $2,759,425, respectively. Fair value for this group is based on the Level 2 assumption. Assets measured at fair value on a non-recurring basis at December 31, 2010, and December 31, 2009, consist solely of other real estate owned of $2,548,244 and $3,882,387, having a fair value assertion based on the Level 3 assumption.

As of December 31, 2010, 2009 and 2008, specific allocated reserves on OREO properties as well as write-downs on such properties aggregated $87,603, $0 and $0.

The were no changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the year ended December 31, 2010.

The following table presents the carrying amounts and estimated fair values of the Bank's financial instruments at December 31, 2010 and December 31, 2009. The fair value of financial instruments does not represent actual amounts that may be realized upon any sale or liquidation of the related assets or liabilities. In addition, these values do not give effect to discounts to fair value which may occur when financial instruments are sold in larger quantities. The fair values presented represent the Bank's best estimate of fair value using the methodologies discussed below.

The respective carrying values of certain on-balance-sheet financial instruments approximated their fair values. These financial instruments include cash and cash equivalents, interest-bearing deposits in other banks, banker's bank and Federal Home Loan Bank stock and demand and savings deposits. Carrying values were assumed to approximate fair values for these financial instruments as they are short term in nature and their recorded amounts approximate fair values or are receivable or payable on demand. The Bank does not use derivative financial instruments.

| | December 31, 2010 | | December 31, 2009 | |
|---|---|---|---|---|
| | Amount | Value | Amount | Value |
| **Financial Assets:** | | | | |
| Cash and cash equivalents | $ 18,031,690 | $ 18,031,690 | $ 12,903,559 | $ 12,903,559 |
| Interest-bearing deposits in other banks | 24,698,574 | 24,698,574 | 16,482,000 | 16,482,000 |
| Securities available-for-sale | 2,719,871 | 2,719,871 | 2,759,425 | 2,759,425 |
| Bankers' bank and Federal Home Loan Bank stock | 581,373 | 581,373 | 464,274 | 464,274 |
| Loans, net | 66,854,841 | 66,382,096 | 53,478,221 | 53,186,924 |
| **Financial Liabilities:** | | | | |
| Noninterest-bearing demand deposits | $ 20,258,708 | $ 20,258,708 | $ 12,454,194 | $ 12,454,194 |
| Interest-bearing demand deposits | 7,523,211 | 7,523,211 | 2,886,908 | 2,886,908 |
| Money market deposits | 43,843,032 | 43,843,032 | 31,428,955 | 31,428,955 |
| Time certificates of deposit | 22,228,043 | 22,228,304 | 22,409,801 | 22,409,298 |
| Savings account deposits | 2,325,836 | 2,325,836 | 1,293,906 | 1,293,906 |
| Borrowings | 3,000,000 | 3,000,000 | 4,100,000 | 4,100,000 |

The following methods and assumptions were used to estimate the fair value of other classes of financial instruments:

**Securities:** The fair values of securities classified as available-for-sale and held-to-maturity are based on quoted market prices at the reporting date for those or similar investments.

**Loans:** The fair value of fixed rate loans is determined as the present value of expected future cash flows discounted at the interest rate currently offered by the Bank, which approximates rates currently offered by local lending institutions for loans of similar terms to companies with comparable credit risk. Variable rate loans which re-price frequently with changes in approximate market rates were valued using the outstanding principal balance. The estimated fair value of loan commitments and contingent liabilities at December 31, 2010 and December 31, 2009 approximate current book values.

**Deposits:** The fair values of demand deposits, savings deposits, and money market deposits without defined maturities were the amounts payable on demand. For substantially all deposits with defined maturities, the fair values were calculated using discounted cash flow models based on market interest rates for different product types and maturity dates. For variable rate deposits where the Bank has the contractual right to change rates, carrying value was assumed to approximate fair value. The discount rates used were based on rates for comparable deposits.

## Note 13. Other Operating Income and Expense

The following is a breakdown of other non-interest income and non-interest expense in the Statement of Operations:

| | 2010 | 2009 | 2008 |
|---|---|---|---|
| **Other non-interest income:** | | | |
| Gain on sale of assets | $ 51,412 | $ – | $ – |
| Wire transfer fees | 5,655 | 3,855 | 2,130 |
| Merchant card processing | 5,131 | 4,082 | 1,497 |
| Imprinted check sales | 3,324 | 2,830 | 3,214 |
| Internet banking fees | 3,255 | 2,545 | 1,047 |
| Safe deposit fees | 2,450 | 1,950 | 1,400 |
| Other non-interest income | 12,325 | 17,487 | 6,832 |
| Total other non-interest income | $ 83,552 | $ 32,749 | $ 16,120 |
| **Other operating expense:** | | | |
| Other real estate owned expense | $ 173,138 | $ 10,368 | $ – |
| Regulatory assessments | 201,967 | 108,680 | 18,925 |
| Directors' & organizers' stock-based compensation expense | 94,250 | 113,100 | 113,100 |
| Correspondent bank charges | 82,256 | 93,694 | 45,691 |
| Stationery, supplies and printing | 26,653 | 23,217 | 25,117 |
| Shareholder related expense | 26,330 | 15,267 | 23,885 |
| Insurance and security | 25,591 | 26,061 | 30,293 |
| Telephone, postage and electronic communications | 21,732 | 20,197 | 19,637 |
| Director fees | 16,666 | – | – |
| Loan and collection expense | 10,263 | 91,030 | 23,440 |
| Armored car and messenger | 6,892 | 3,283 | 2,682 |
| ATM surcharge fees | 6,600 | 4,661 | 3,003 |
| Publications and subscriptions | 6,027 | 6,844 | 4,073 |
| Meetings, conferences, education & training | 3,944 | 2,199 | 12,507 |
| Human resources administration fees | 3,867 | 10,403 | 30,401 |
| Dues and memberships | 1,579 | 3,770 | 2,183 |
| Customer checks and stamps | 1,563 | 1,109 | 3,331 |
| Other non-interest expenses | 21,510 | 13,541 | 19,325 |
| Total other operating expenses | $ 730,828 | $ 547,424 | $ 377,593 |

## Note 14. Capital Adequacy

The Bank is subject to various regulatory capital adequacy requirements administered by the banking regulatory agencies. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) required that the federal regulatory agencies adopt regulations defining five capital tiers for depository institutions: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, would have a direct material effect on the Bank's financial statements.

Quantitative measures, established by the regulators to ensure capital adequacy, require that the Bank maintain minimum ratios (set forth in the following table) of capital to risk-weighted assets and average assets. Management believes that, as of December 31, 2010, the Bank met all capital adequacy requirements to which they were subject.

The most recent notification from the FDIC categorized the Bank as well capitalized under the FDICIA regulatory framework for prompt corrective action. To be categorized as well capitalized; the institution must maintain a total risk-based capital ratio as set forth in the following table and not be subject to a capital directive order (such as a Formal Agreement). There are no conditions or events since that notification that Management believes has changed the Bank's risk-based category.

| (Dollars in thousands) | Actual | | For Capital Adequacy Purposes: | | For Regulatory Adequacy Purposes (first three years) | | To Be Well Capitalized Under the FDICIA Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **As of December 31, 2010** | | | | | | | | |
| Total capital (to risk-weighted assets) | $18,232 | 22.01% | $ 6,627 | 8.00% | $ 8,283 | 10.00% | $ 8,283 | 10.00% |
| Tier 1 capital (to risk-weighted assets) | $17,185 | 20.75% | $ 3,313 | 4.00% | $ 4,970 | 6.00% | $ 4,970 | 6.00% |
| Tier 1 capital (to average assets) leverage ratio | $17,185 | 15.22% | $ 4,517 | 4.00% | $ 9,033 | 8.00% | $ 5,646 | 5.00% |
| **As of December 31, 2009** | | | | | | | | |
| Total capital (to risk-weighted assets) | $17,115 | 25.95% | $ 5,276 | 8.00% | $ 6,595 | 10.00% | $ 6,595 | 10.00% |
| Tier 1 capital (to risk-weighted assets) | $16,284 | 24.69% | $ 2,638 | 4.00% | $ 3,957 | 6.00% | $ 3,957 | 6.00% |
| Tier 1 capital (to average assets) leverage ratio | $16,284 | 18.46% | $ 3,529 | 4.00% | $ 7,058 | 8.00% | $ 4,411 | 5.00% |
| **As of December 31, 2008** | | | | | | | | |
| Total capital (to risk-weighted assets) | $16,766 | 32.89% | $ 4,078 | 8.00% | $ 5,098 | 10.00% | $ 5,098 | 10.00% |
| Tier 1 capital (to risk-weighted assets) | $16,125 | 31.63% | $ 2,039 | 4.00% | $ 3,059 | 6.00% | $ 3,059 | 6.00% |
| Tier 1 capital (to average assets) leverage ratio | $16,125 | 25.12% | $ 2,567 | 4.00% | $ 5,134 | 8.00% | $ 3,209 | 5.00% |

The leverage ratio consists of Tier 1 capital divided by quarterly average assets, excluding intangible assets and certain other items. The minimum leverage ratio guideline is 4% for banking organizations that do not anticipate significant growth and that have well-diversified risk, excellent asset quality, high liquidity, good earnings and, in general, are considered top-rated, strong banking organizations. Throughout its first seven years of operation, the Bank is required to maintain a Tier 1 Leverage Ratio of not less than 8%.

### Note 15. Regulatory Matters

Under the terms of approval of deposit insurance by the Federal Deposit Insurance Corporation, the Bank's Tier 1 capital-to-assets leverage ratio (as defined in the appropriate capital regulation and guidance from the Bank's primary federal regulator) shall be maintained at not less than 8% throughout the first seven years of operation. Additionally, the FDIC's approval requires that the Bank operate within the parameters of its original business plan, submitted as part of the Bank's application for deposit insurance, during the first three years of operation and its extended de novo business plan, during years four through seven, and that any major deviation or material changes from the plans be submitted 60 days before consummating the change.

# Board of Directors

(In order from left to right)

**William R. Slakey**
*Chief Financial Officer*
*LiveOps, Inc.*

**John C. Burroughs, Chairman**
*Certified Financial Planner*
*Burroughs Financial Services*

*Vice Chairman*
*Foothill Securities, Inc.*

**Michael P. Dunn, D.O.**
*Physician*
*Watsonville Community Hospital*

**Richard G. Hofstetter**
*President and*
*Chief Executive Officer*
*Lighthouse Bank*

**Bruce A. McPherson**
*California's 30th Secretary of State*
*Past California State Senator,*
*15th District*

**James L. Weisenstein**
*President*
*Graystone Consulting, LLC.*

**Craig A. French**
*Managing Director and*
*Chief Operating Officer*
*Redtree Properties, LP.*

(Not pictured)

**Stephen D. Pahl**
*Chairman and*
*Chief Executive Officer*
*Pahl & McCay,*
*a Professional Law Corporation*

**The service at Lighthouse Bank is fabulous and the business stays local.**

Alan Heit, D.D.S.

# Senior Management

(In order from left to right)

**Kimberly M. Raynal**
*Senior Vice President*
*Chief Operating Officer*

**Donald H. Soman**
*Executive Vice President*
*Chief Financial Officer*

**Lane S. Lawson, Jr.**
*Executive Vice President*
*Chief Credit Officer*

**Jon P. Sisk**
*Senior Vice President*
*Senior Lending Officer*

**Richard G. Hofstetter**
*President*
*Chief Executive Officer*

**Lighthouse Bank's friendly, knowledgeable staff always makes us feel welcome. They know us by name and treat every client like a VIP.**

Kurt Grutzmacher and Joe Miller
Hillcrest Terrace Winery

# STAFF

(Front row left to right)

**Brianna Carabba**
*Assistant Vice President*
*Executive Administrator*

**Michelle Cole**
*Assistant Vice President*
*Note Department Manager*

**Wendy Matlick**
*Assistant Vice President*
*Service Manager*

**Dara Harris**
*Loan Support Officer*

**Claudia Morales**
*Client Service Representative*

**Judy Spellerberg**
*Senior Client Service Representative*

**Lisa Ratliff**
*Loan Servicing Specialist*

**Jamie Ganly**
*Vice President*
*Commercial Real Estate and Construction Loan Officer*

**Kimberly Raynal**
*Senior Vice President*
*Chief Operating Officer*

(Back row left to right)

**Lane Lawson, Jr.**
*Executive Vice President*
*Chief Credit Officer*

**Robert Dennis**
*Vice President*
*SBA/Commercial Relationship Manager*

**Jon Sisk**
*Senior Vice President*
*Senior Lending Officer*

**Matty Sinnott**
*Client Service Representative*

**Joey Garcia**
*Senior Client Service Representative*

**Richard Hofstetter**
*President*
*Chief Executive Officer*

**Donald Soman**
*Executive Vice President*
*Chief Financial Officer*

**Marshall Delk**
*Vice President*
*Business Development Officer*

**Ivan Ditmars**
*Accounting Officer*

**Lighthouse Bank consistently goes out of its way to make us happy. We also love the convenience of their courier service.**

Dean Schwartz and Larry Johnson
Owners, Lloyds Tire Service

# Advisory Board

**Christen Allaman, M.D.**
*President and Medical Director Eye Care Medical Group, Inc.*
*President and Medical Director Cypress Outpatient Surgical Center*

**Charlene Atack**
*Atack & Penrose, LLP*

**Kenneth Bergman**
*President*
*Scotts Valley Realty*

**Blaine Brokaw**
*Senior Vice President*
*Thoits Insurance Service, Inc.*

**Linda Burroughs**
*Linda Burroughs Real Estate*

**Bruce Dunn, M.D.**

**Peter Gaarn**
*Peter Gaarn & Associates*

**Deidre Hamilton**
*Hamilton Swift & Associates*

**Alan Heit, D.D.S.**

**Sandra Hill**
*Sandra Hill Fiduciary Services*

**David Jacobs, C.P.A.**
*Chiorini, Hunt & Jacobs*

**Larry Kerr, D.V.M., D.A.C.V.R.**
*President*
*Veterinary Radiology Specialists*

**Bill McDermott, C.P.A.**
*Fournier, McDermott & Lamb*

**Bruce McGuire, S.R.A.**
*President*
*Western Appraisal Services*

**Matt Shelton**
*Owner/Broker*
*J.R. Parrish Commercial Real Estate*

**Sam Storey**
*Chief Executive Officer*
*Community Bridges*

**Ken Whiting**
*President*
*Whiting's Foods, Inc.*

**Lawrence Wolfsen**
*Owner*
*Wolfsen Properties*

# Shareholder Relations and Information

**Stock Listing**
Lighthouse Bank's stock is listed on the Over-the-Counter Bulletin Board (OTCBB) and trades under the ticker symbol LGHT.OB.

**Market Maker**
Lisa Gallo
Wedbush Morgan Securities,
Lafayette, CA
Phone: (866) 491-7828
Email: lisa.gallo@wedbush.com

Shareholders with questions regarding their stockholder account, stock transfer, lost certificates or changes of address should contact their broker. In the event that certificates are held directly, shareholders should contact the Bank's stock transfer agent:

**Registrar & Transfer Company**
Attn: Investor Relations
10 Commerce Drive
Cranford, NJ 07016
Phone: (800) 368-5948

For assistance with other stock related matters or to change your contact information for periodic shareholder communications sent directly from the Bank, shareholders should contact:

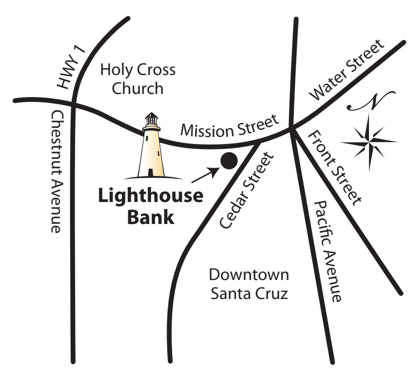
**Brianna Carabba**
Lighthouse Bank
111 Mission Street
Santa Cruz, CA 95060
Phone: (831) 600-4007

For financial information beyond that shown in this report, shareholders should contact:

**Donald H. Soman**
Chief Financial Officer
Lighthouse Bank
111 Mission Street
Santa Cruz, CA 95060
Phone: (831) 600-4009

LIGHTHOUSE BANK

111 Mission Street
Santa Cruz, CA 95060
(831) 600-4000
www.lighthousebank.net




EQUAL HOUSING LENDER
Member FDIC

LIGHTHOUSE BANK

## ORGANIZERS

- Douglas & Jo-Ann Austin
- Don & Barbara Bargiacchi
- Gary & Valerie Benito
- Ken & Debra Bergman
- Chip & Suzie Bogaard
- Blaine & Connie Brokaw
- William Brooks
- John & Linda Burroughs
- Marshall & Sabrina Delk
- Dr. Michael & Julie Dunn
- Craig & Mimi French
- Peter & Nancy Port-Gaarn
- Doak & Jeri Gintert
- Russell & Alana Gross
- Richard G. Hofstetter
- Larry Kerr & Jennifer Antrim
- Gary & Lynn Marietti
- Lido & Marie Marietti
- Bill & Julie McDermott
- Bruce & Mary McPherson
- Dr. Ritu & Robert Meister
- Herman Mondo
- Richard Murphy
- Jesse & Christine Nickell
- Tom & Lisa O'Rourke
- Stephen & Louise Pahl
- Rowland & Pat Rebele
- Hans Schroeder
- Jon & Margie Sisk
- William & Peggy Slakey
- James & Carol Weisenstein
- Whiting's Foods
- Peter & Jackie Whiting
- Tim & Ann Williams
- Andy Zehnder

Marcos Weiss
*Pacific Avenue*
www.marcosweiss.com