2014

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.

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.

Artist's rendering of the future Lighthouse Bank headquarters located at 2020 North Pacific Avenure, Santa Cruz. Site improvements are underway and occupancy is anticipated in early 2016.

A Letter To Our Owners

John C. Burroughs *Chairman of the Board* Richard G. Hofstetter *President and CEO*

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, 2014.

A Year of Growth and Transition

Lighthouse Bank's string of financial records continued for the 7th consecutive year in 2014. The Bank posted record profitability of $2.4 million as well as strong growth in deposits, loans and shareholder equity.

On January 31, 2014 the Bank purchased the property located at 2020 North Pacific Avenue in downtown Santa Cruz (the former Bank of the West building next to the Town Clock), with the intention of moving our headquarters to that location. Major alterations and improvements to the building are planned and you will soon see the physical renovation progress begin. The site will provide 50 percent more space than our current location, with occupancy costs anticipated to be only modestly higher than we have at our current site. Everyone is excited about our new Headquarters, and we expect to occupy the location by early 2016.

Adding Shareholder Value

During the fourth quarter of 2014, your Board of Directors elected to grant our owners with a meaningful cash dividend of $.40 per share, which was distributed on January 2, 2015. The cash dividend was preceded by a 10% stock dividend in 2011 and a 5% stock dividend in 2013. With the two stock dividends plus the cash dividend, our initial shareholders now have a "breakeven" basis of $8.26 per share. The fluctuation of our stock price was kind to our owners in 2014, as the share price started the year at $10.90 and ended the year at $14.60, a rise of 34% for the year and a 77% increase since inception. We hope you are pleased with these results, but we ask you to view your investment in Lighthouse Bank not as just another stock investment; but rather, as a partner in a local bank that will make a difference in and have a positive impact on our community. We remain committed to a business model which rewards our shareholders, employees and community while building an organization that meets the financial needs of our marketplace and continually looks to develop new opportunities.

A Year of Awards

Our business model of combining highly personalized service and operational efficiency has served us well and is rapidly becoming the industry standard. During this past year the Bank received outstanding recognition from several bank rating agencies. We are rated by Bauer Financial as Five-Star "Superior" for strong financial performance, the top rating given by the independent bank rating firm. Lighthouse Bank is the only locally owned institution in Santa Cruz County with a Five-Star rating. The Findley Reports, a well known banking publication named the Bank as a "Super Premier" performing bank, their highest ranking, and FMC Consulting named us as the top rated state chartered bank on the Central Coast. Most recently, SNL Financial released their ranking of the 100 top-performing community banks in the United States with less than $500 million in assets, and we were ranked eighth of the over four-thousand banks in this category. The Bank has no financial relationship with any of these rating agencies.

We believe most of the credit for the recognition and awards belongs to our management team and staff. They put our clients first and are passionate about having a personal connection with them. They truly understand that the culture of community banking is about "Relationships."

In closing, our long-term success is predicated in large part on your continued support and referrals as a source of new business. If you are not yet a client of Lighthouse Bank, or you know someone that would benefit from our exceptional service, we would appreciate the opportunity to speak with you.

On behalf of the directors, officers and staff, please accept our appreciation for your investment and continued involvement. We would welcome the opportunity to tell you more about our accomplishments and our future plans at our annual owners meeting at the Museum of Art and History at the McPherson Center on Thursday, May 21, 2015 at 4:00 P.M.

Sincerely,

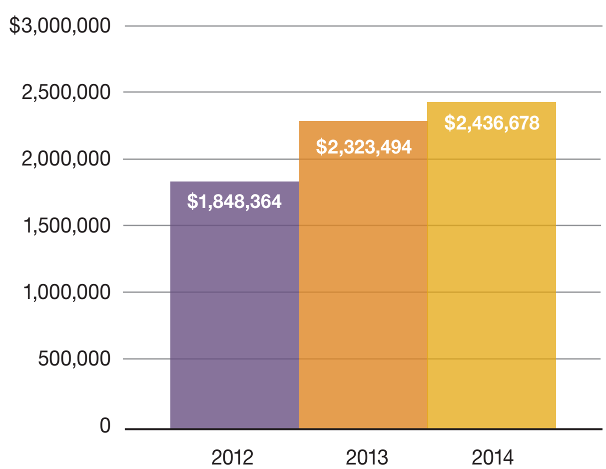
John C. Burroughs

John C. Burroughs, *Chairman of the Board*

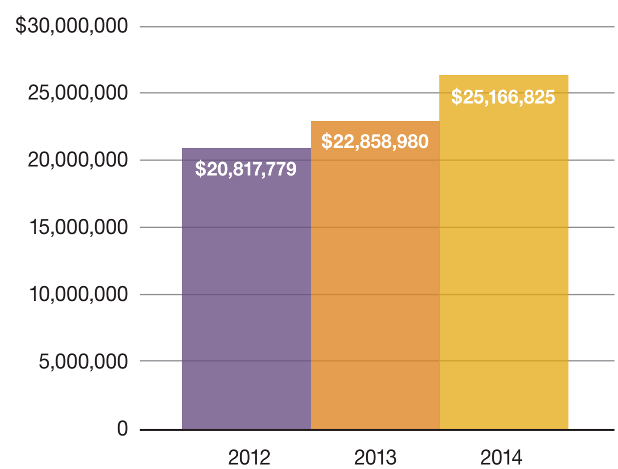
Richard G. Hofstetter, *President and CEO*

Financial Summary

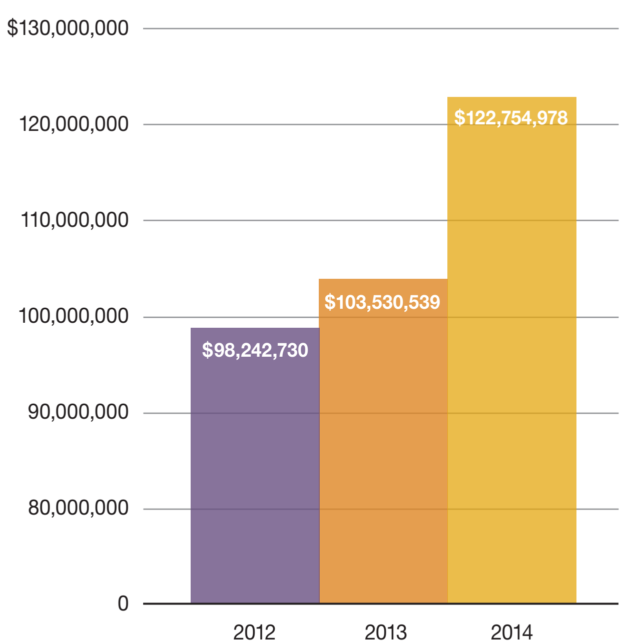
Net Income After Tax



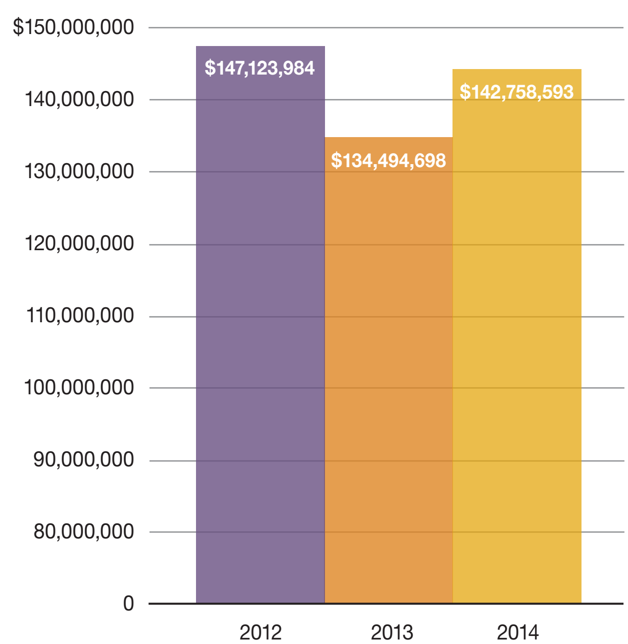
Total Shareholders' Equity



Total Gross Loans



Total Deposits



Vavrinek, Trine, Day & Co., LLP
Certified Public Accountants

VALUE THE DIFFERENCE

INDEPENDENT AUDITOR'S REPORT

Board of Directors
Lighthouse Bank

We have audited the accompanying financial statements of Lighthouse Bank, which are comprised of the statements of condition as of December 31, 2014 and 2013, and the related statements of operations, comprehensive income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2014, 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 Lighthouse Bank as of December 31, 2014 and 2013, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2014, in accordance with accounting principles generally accepted in the United States of America.

Vavrinek Trine Day + Co. LLP

Palo Alto, CA
March 15, 2015

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

Statements of Condition

	December 31, 2014	December 31, 2013
Assets		
Cash and due from banks	$ 3,426,947	$ 4,579,474
Interest-bearing deposits in other financial institutions	23,396,757	31,430,826
Investment securities:		
Securities held-to-maturity	7,739,678	7,760,636
Securities available-for-sale, at estimated fair value	5,641,305	6,414,050
Total investment securities	13,380,983	14,174,686
Loans receivable:		
Gross loans	122,754,978	103,530,539
Less deferred loan fees, net of costs	508,658	579,454
Less reserve for loan losses	3,164,031	2,874,031
Net loans	119,082,289	100,077,054
Premises and equipment, net	253,399	103,675
Accrued interest receivable	367,421	358,052
Federal Home Loan Bank and bankers' bank stock, at cost	802,360	825,752
Other real estate owned	–	348,750
Bank owned life insurance	4,400,425	4,269,543
Deferred income taxes	1,602,000	1,652,000
Other assets	1,621,472	154,714
Total Assets	$168,334,053	$ 157,974,526
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Noninterest-bearing demand deposits	$ 35,877,916	$ 30,290,175
Interest-bearing demand deposits	7,104,014	8,493,178
Savings and money market deposits	70,885,210	66,715,753
Time deposits	28,891,453	28,995,592
Total deposits	142,758,593	134,494,698
Other liabilities:		
Accrued interest payable	9,079	9,578
Other liabilities	399,556	611,270
Total liabilities	143,167,228	135,115,546
Shareholders' Equity:		
Common stock, no par value, 10,000,000 shares authorized: issued and outstanding; 2,206,482 shares at December 31, 2014 and 2,140,157 shares at December 31, 2013	21,713,397	21,138,517
Additional paid-in capital	1,286,157	1,179,338
Retained earnings	2,102,992	548,445
Accumulated other comprehensive income	64,279	(7,320)
Total shareholders' equity	25,166,825	22,858,980
Total Liabilities and Shareholders' Equity	$168,334,053	$ 157,974,526

See accompanying notes to the Financial Statements

Statements of Operations

	Year Ended December 31,		
	2014	2013	2012
Interest Income:			
Interest and fees on loans	$7,847,893	$7,044,668	$6,556,092
Investment securities	513,489	483,181	482,279
Federal funds sold and other interest income	13,131	36,345	64,640
Total interest income	8,374,513	7,564,194	7,103,011
Interest Expense:			
Deposits and other borrowed funds	378,965	427,030	579,993
Net interest income before provision for loan losses	7,995,548	7,137,164	6,523,018
Provision for loan losses	290,000	–	238,000
Net interest income after provision for loan losses	7,705,548	7,137,164	6,285,018
Non-Interest Income:			
Service charges on deposit accounts	98,090	123,714	145,916
Other non-interest income	243,138	224,603	206,730
Total non-interest income	341,228	348,317	352,646
Non-Interest Expense:			
Salaries and employee benefits	2,692,534	2,508,832	2,233,413
Occupancy	232,963	190,927	235,955
Furniture and equipment	203,295	180,378	192,806
Marketing and business development	87,981	65,454	57,207
Item and data processing	208,391	188,124	147,916
Professional services	265,472	159,204	139,145
Other operating expenses	438,549	494,186	621,047
Total non-interest expense	4,129,185	3,787,105	3,627,489
Income before income taxes	3,917,591	3,698,376	3,010,175
Income tax expense	1,480,913	1,374,882	1,161,811
Net income	$2,436,678	$2,323,494	$1,848,364
Earnings per share:			
Basic	$ 1.12	$ 1.09	$ 0.86
Diluted	$ 1.06	$ 1.06	$ 0.85

See accompanying notes to the Financial Statements

Statements of Comprehensive Income

	Year Ended December 31,		
	2014	2013	2012
Net income	$ 2,436,678	$ 2,323,494	$ 1,848,364
Other comprehensive income:			
Unrealized gains on securities:			
Unrealized holding gains (losses) arising during period	71,599	(341,184)	223,928
Plus: reclassification adjustment for losses included in net income	–	–	1,599
Other comprehensive income (loss):	71,599	(341,184)	225,527
Comprehensive income	$ 2,508,277	$ 1,982,310	$ 2,073,891

Statement of Shareholders' Equity

For the three years ended December 31, 2014

	Common Shares	Amount	Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance at December 31, 2011	2,038,324	$20,178,232	$ 1,108,323	$ (2,663,128)	$ 108,337	$ 18,731,764
Stock-based compensation	–	–	12,124	–	–	12,124
5% stock dividend	101,833	960,285	–	(960,285)	–	–
Net income	–	–	–	1,848,364	–	1,848,364
Unrealized gain on securities available-for-sale	–	–	–	–	225,527	225,527
Balance at December 31, 2012	2,140,157	21,138,517	1,120,447	(1,775,049)	333,864	20,817,779
Stock-based compensation	–	–	58,891	–	–	58,891
Net income	–	–	–	2,323,494	–	2,323,494
Unrealized (loss) on securities available-for-sale	–	–	–	–	(341,184)	(341,184)
Balance at December 31, 2013	2,140,157	21,138,517	1,179,338	548,445	(7,320)	22,858,980
Stock-based compensation	–	–	103,675	–	–	103,675
Stock options exercised	66,325	574,880	3,144	–	–	578,024
Dividends				(882,131)	–	(882,131)
Net income	–	–	–	2,436,678	–	2,436,678
Unrealized gain on securities available-for-sale	–	–	–	–	71,599	71,599
Balance at December 31, 2014	2,206,482	$21,713,397	$ 1,286,157	$ 2,102,992	$ 64,279	$ 25,166,825

See accompanying notes to the Financial Statements

Statements of Cash Flows

	Year Ended December 31,		
	2014	2013	2012
Operating Activities:			
Net income	$ 2,436,678	$ 2,323,494	$ 1,848,364
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization of premises and equipment	39,253	37,472	109,410
Provision for loan losses	290,000	–	238,000
Deferred income tax expense (benefit)	50,000	(12,468)	13,000
Net amortization/accretion of investment discounts and premiums	49,900	74,270	91,709
Decrease in deferred loan fees, net of costs	(70,796)	45,520	55,401
Bank Owned Life Insurance income	(130,883)	(145,854)	(123,688)
Stock-based compensation	103,675	58,891	12,124
Gain on sale of equipment	–	(250)	–
Loss on sale of AFS securities	–	–	1,599
Gain on sale of OREO	(2,088)	–	–
Writedown on foreclosed assets	–	21,250	26,000
Net (increase) decrease in:			
Accrued interest receivable	(9,369)	(12,762)	(15,695)
Other assets	(10,447)	54,117	54,419
Net increase (decrease) in:			
Accrued interest payable	(499)	(2,742)	380
Other liabilities	(249,246)	(199,817)	292,686
Net cash provided by operating activities	2,496,178	2,241,121	2,603,709
Investing Activities:			
Investment securities:			
Principal repayments	860,071	1,652,913	1,890,669
Purchases	–	(1,349,341)	(13,014,369)
Sales	–	–	3,468,957
Purchase of Federal Home Loan Bank stock	(5,400)	(95,300)	(133,900)
Redemptions of Federal Home Loan Bank stock	33,100	–	–
Purchase of bankers' bank stock	(4,308)	–	(1,955)
Purchase of Bank Owned Life Insurance	–	–	(4,000,000)
Net (increase) decrease in time deposits with other banks	8,034,940	(14,423,359)	11,275,000
Net (increase) in other interest-bearing deposits with other banks	(871)	(794)	(868)
Net (increase) in loans	(19,224,439)	(5,277,080)	(12,045,944)
Purchase of premises and equipment	(1,652,424)	(113,459)	(14,004)
Proceeds from sale of OREO	350,838	–	–
Net cash used in investing activities	(11,608,493)	(19,606,420)	(12,576,414)
Financing Activities:			
Cash dividends paid	(882,131)	–	–
Proceeds from exercise of stock options, including tax benefit	578,024	–	–
Increase (decrease) in:			
Demand deposits	4,198,577	(6,431,999)	3,715,321
Savings and money market deposits	4,169,457	(3,789,839)	16,777,959
Time deposits	(104,139)	(2,407,448)	2,748,496
Proceeds from Federal Home Loan Bank advances and other debt	21,215,000	–	–
Repayments on Federal Home Loan Bank advances and other debt	(21,215,000)	–	–
Net cash provided (used) by financing activities	7,959,788	(12,629,286)	23,241,776
Net increase (decrease) in cash and cash equivalents	(1,152,527)	(29,994,585)	13,269,071
Cash and cash equivalents at beginning of period	4,579,474	34,574,059	21,304,988
Cash and cash equivalents at end of period	$ 3,426,947	$ 4,579,474	$ 34,574,059
Supplemental Disclosures of Cash Flow Information			
Total interest paid	$ 379,464	$ 429,772	$ 579,613
Total income taxes paid	$ 1,661,000	$ 1,635,121	$ 1,137,577

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 Business Oversight 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 195 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, 2014, the Bank had loans outstanding of approximately $117,524,000 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 15, 2015, which is the date the financial statements were available to be issued.

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 $525,000 and $688,000 at December 31, 2014, and December 31, 2013, respectively.

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, Agency mortgage-backed securities, and bank-qualified municipal 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, 2014, 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 maintained to provide for losses related to impaired loans and other losses that can be expected to occur in the normal course of business. The determination of the allowance is based on estimates made by management, to include consideration of the character of the loan portfolio, specifically identified problem loans, potential losses inherent in the portfolio taken as a whole and economic conditions in the Bank's service area.

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

The allowance consists of specific and general reserves. Specific reserves relate to loans that are individually classified as impaired. A loan is impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status, collateral value and the probability of collecting all amounts when due. Loans, for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and are also classified as impaired.

Generally, large balance non-homogeneous loans are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at either the present value of estimated future cash flows using the loan's effective interest rate at inception or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment.

Management believes that the allowance for loan 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.

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 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. The weighted average shares outstanding have been adjusted to retroactively reflect the impact of the 10% stock dividend issued in 2011 and the 5% stock dividend issued on March 8, 2013. Weighted average shares outstanding for basic and diluted earnings per share are as follows for the years ended December 31:

	2014	2013	2012
Weighted average shares outstanding, basic	2,167,884	2,140,157	2,140,157
Weighted average shares outstanding, diluted	2,295,386	2,196,918	2,184,853

Recent Accounting Guidance, Not Yet Effective — In January 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-04, Receivables—*Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*, a consensus of the FASB Emerging Issues Task Force. This Update provides clarification as to when an in-substance repossession or foreclosure has occurred, i.e., the creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan and, therefore, the loan receivable should be derecognized and the real estate property should be recognized. Under ASU No. 2014-04, a creditor has received physical possession of residential real estate property collateralizing a consumer mortgage loan upon either (1) the creditor obtaining legal title to the property upon completion of a foreclosure or (2) the borrower conveying all interest in the property to the creditor to satisfy the loan through completion of a deed in lieu of foreclosure or a similar legal agreement. The Update also will require disclosure in annual and interim financial statements of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this Update are effective for interim and annual periods beginning after December 15, 2014. Adoption of this Update is not expected to have a material impact on the Bank's financial statements.

In May 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This Update requires an entity to recognize revenue as performance obligations are met, in order to reflect the transfer of promised goods or services to customers in an amount that reflects the consideration the entity is entitled to receive for those goods or services. The following steps are applied in the updated guidance: (1) identify the contract(s) with a customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when, or as, the entity satisfies a performance obligation. This Update is effective for interim and annual periods beginning after December 15, 2016 for public business entities and after December 15, 2017 for non-public business entities. Early adoption of this Update is not permitted. The Bank is currently in the process of evaluating the impact of the adoption of this Update, but does not expect a material impact on the Bank's financial statements.

Note 2. Investment Securities

The following table summarizes Lighthouse Bank's securities at December 31, 2014, and December 31, 2013:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2014				
Securities available-for-sale:				
U.S. Agency	$ 1,000,000	$ 9,180	$ –	$ 1,009,180
U.S. Agency MBSs	4,532,357	99,768	–	4,632,125
Total securities available-for-sale	$ 5,532,357	$ 108,948	$ –	$ 5,641,305
Securities held-to-maturity:				
Municipal Securities	$ 7,739,678	$ 77,498	$ (68,461)	$ 7,748,715
December 31, 2013				
Securities available-for-sale:				
U.S. Agency	$ 1,000,000	$ 9,590	$ –	$ 1,009,590
U.S. Agency MBSs	5,421,370	47,017	(63,927)	5,404,460
Total securities available-for-sale	$ 6,421,370	$ 56,607	$ (63,927)	$ 6,414,050
Securities held-to-maturity:				
Municipal Securities	$ 7,760,636	$ –	$ (377,500)	$ 7,383,136

The amortized cost and estimated fair value of investment securities at December 31, 2014 and December 31, 2013 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.

	Amortized Cost	Estimated Fair Value
December 31, 2014		
Due in one year or less	$ –	$ –
Due after one year through five years	1,244,350	1,267,136
Due after five years through ten years	3,156,192	3,152,872
Due after ten years	8,871,493	8,970,012
Total	$13,272,035	$13,390,020
December 31, 2013		
Due in one year or less	$ 8,032	$ 8,374
Due after one year through five years	1,382,381	1,416,789
Due after five years through ten years	2,262,551	2,172,212
Due after ten years	10,529,042	10,199,811
Total	$ 14,182,006	$ 13,797,186

Note 3. Loans

Loan maturity and rate sensitivity data of the loan portfolio at December 31, 2014 and 2013 are as follows (in thousands):

December 31, 2014	Matures Within One Year	Matures in One to Five Years	Matures After Five Years	Total
Loans secured by real estate, land and construction loans	$ 37,318	$ 27,025	$ 47,740	$ 112,083
Consumer and other loans	–	685	4,596	5,281
Commercial and revolving lines	4,725	548	118	5,391
	$ 42,043	$ 28,258	$ 52,454	$ 122,755
Loans at fixed interest rates	$ 29,264	$ 20,753	$ 41,767	$ 91,784
Loans at variable interest rates	12,779	7,505	10,687	30,971
	$ 42,043	$ 28,258	$ 52,454	$ 122,755

December 31, 2013	Matures Within One Year	Matures in One to Five Years	Matures After Five Years	Total
Loans secured by real estate, land and construction loans	$ 26,649	$ 24,124	$ 41,430	$ 92,203
Consumer and other loans	369	332	3,706	4,407
Commercial and revolving lines	5,051	1,237	633	6,921
	$ 32,069	$ 25,693	$ 45,769	$ 103,531
Loans at fixed interest rates	$ 26,268	$ 17,756	$ 33,165	$ 77,189
Loans at variable interest rates	5,801	7,937	12,604	26,342
	$ 32,069	$ 25,693	$ 45,769	$ 103,531

A summary of the changes in the allowance for loan losses for the years ended December 31:

	2014	2013	2012
Balance at beginning of year	$ 2,874,031	$ 2,863,302	$ 2,855,000
Provision for loan losses	290,000	–	238,000
Loan charge-offs	–	–	(256,686)
Unfunded commitment reclassification	–	(47,781)	(35,000)
Recoveries of loan charge-offs	–	58,510	61,988
Balance at year end	$ 3,164,031	$ 2,874,031	$ 2,863,302

The following table presents the activity in the allowance for loan losses for the years 2014 and 2013 and the recorded investment in loans and impairment method as of December 31, 2014 and 2013 by portfolio segment:

December 31, 2014	Commercial Real Estate	Residential Real Estate	Commercial	Consumer	Total
Allowance for Loan Losses:					
Beginning of Year	$ 2,418,114	$ 93,744	$ 350,952	$ 11,221	$ 2,874,031
Provisions	278,880	18,623	2,332	(9,835)	290,000
Charge-offs	–	–	–	–	–
Adjustments	–	–	–	–	–
Recoveries	–	–	–	–	–
End of Year	$ 2,696,994	$ 112,367	$ 353,284	$ 1,386	$ 3,164,031
Reserves:					
Specific	$ 91,387	$ 13,985	$ 15,303	$ –	$ 120,675
General	2,605,607	98,382	337,981	1,386	3,043,356
	$ 2,696,994	$ 112,367	$ 353,284	$ 1,386	$ 3,164,031
Loans Evaluated for Impairment:					
Individually	$ 1,827,754	$ 139,845	$ 252,547	$ –	$ 2,220,146
Collectively	100,376,853	5,090,721	15,016,585	50,673	120,534,832
	$ 102,204,607	$ 5,230,566	$ 15,269,132	$ 50,673	$ 122,754,978

December 31, 2013	Commercial Real Estate	Residential Real Estate	Commercial	Consumer	Total
Allowance for Loan Losses:					
Beginning of Year	$ 2,445,672	$ 44,696	$ 371,175	$ 1,759	$ 2,863,302
Provisions	–	–	–	–	–
Charge-offs	–	–	–	–	–
Adjustments	(27,558)	–	(20,223)	–	(47,781)
Recoveries	–	49,048	–	9,462	58,510
End of Year	$ 2,418,114	$ 93,744	$ 350,952	$ 11,221	$ 2,874,031
Reserves:					
Specific	$ 71,714	$ 13,985	$ 19,980	$ –	$ 105,679
General	2,346,400	79,759	330,972	11,221	2,768,352
	$ 2,418,114	$ 93,744	$ 350,952	$ 11,221	$ 2,874,031
Loans Evaluated for Impairment:					
Individually	$ 1,434,289	$ 139,847	$ 215,492	$ –	$ 1,789,628
Collectively	83,930,065	3,884,243	13,471,007	455,596	101,740,911
	$ 85,364,354	$ 4,024,090	$ 13,686,499	$ 455,596	$103,530,539

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

Pass — Loans classified as pass include loans not meeting any of the risk ratings defined below.

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

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

Doubtful & 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 doubtful or as troubled debt restructurings are considered impaired.

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, 2014 and 2013:

December 31, 2014	Pass	Special Mention	Substandard	Doubtful & Impaired	Total
Loans:					
Construction and land	$ 26,486,963	$ –	$ –	$ –	$ 26,486,963
Commercial real estate	73,889,890	1,827,754	–	–	75,717,644
Residential real estate	5,090,721	–	139,845	–	5,230,566
Commercial and industrial	12,354,962	199,037	53,510	–	12,607,509
Small Business Administration	2,661,623	–	–	–	2,661,623
Other	50,673	–	–	–	50,673
	$120,534,832	$ 2,026,791	$ 193,355	$ –	$ 122,754,978

December 31, 2013	Pass	Special Mention	Substandard	Doubtful & Impaired	Total
Loans:					
Construction and land	$ 20,082,780	$ 299,922	$ –	$ –	$ 20,382,702
Commercial real estate	63,847,285	1,134,367	–	–	64,981,652
Residential real estate	3,884,243	–	139,847	–	4,024,090
Commercial and industrial	11,599,102	31,384	184,108	–	11,814,594
Small Business Administration	1,871,905	–	–	–	1,871,905
Other	455,596	–	–	–	455,596
	$101,740,911	$ 1,465,673	$ 323,955	$ –	$103,530,539

In general, the Bank would not recognize any interest income on loans that are classified as impaired. The Bank had no loans considered impaired as of December 31, 2014 and 2013.

The Bank had no past due or nonaccrual loans as of December 31, 2014 and 2013.

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, 2014 and December 31, 2013:

	December 31, 2014	December 31, 2013
Leasehold improvements	$ 294,469	$ 294,469
Furniture, fixtures and equipment	214,541	213,764
Software and capitalized data & item processing	222,902	222,902
Computer equipment	212,461	179,805
Automobile	20,282	20,282
Construction-in-progress	99,347	8,697
Total premises and equipment	1,064,002	939,919
Less accumulated depreciation and amortization	810,603	836,244
Premises and equipment, net	$ 253,399	$ 103,675

Depreciation and amortization expense of premises and equipment aggregated $39,253, $37,472 and $109,410 for the years ended December 31, 2014, December 31, 2013 and December 31, 2012, respectively.

Note 5. Income Taxes

The components of income tax expense (benefit) are as follows for the years ended December 31:

	2014	2013	2012
Current:			
Federal	$ 1,031,873	$ 1,040,414	$ 841,587
State	399,040	346,936	307,224
Total current	1,430,913	1,387,350	1,148,811
Deferred:			
Federal	41,000	(252)	(64,000)
State	9,000	(12,216)	77,000
Total deferred	50,000	(12,468)	13,000
Total expense	$ 1,480,913	$ 1,374,882	$ 1,161,811

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, 2014, 2013 and 2012:

	2014	2013	2012
Pre-opening expenses	$ 65,000	$ 64,000	$ 71,000
Stock-based compensation	161,000	164,000	164,000
OREO expenses	–	105,000	94,000
Loan loss reserve	1,277,000	1,158,000	1,158,000
Other	99,000	161,000	177,000
	1,602,000	1,652,000	1,664,000
Valuation allowance	–	–	–
Net deferred tax asset	$ 1,602,000	$ 1,652,000	$ 1,664,000

The following is a reconciliation of the expected federal income tax rate to the actual rate for the years ended December 31:

	2014	2013	2012
Tax at statutory federal rate	34.00%	34.00%	34.00%
State tax net of federal benefit	7.15	7.15	7.15
Other	(3.35)	(3.95)	(2.55)
	37.8%	37.2%	38.6%

The Bank's Federal and State income tax returns are subject to review by Federal and State taxing authorities for the three and four year periods ending December 31, 2013, respectively.

Note 6. Time Deposits

The aggregate amount of time deposit accounts equal to or greater than $100,000 was $19,619,542 and $18,743,789 at December 31, 2014 and December 31, 2013, respectively. At December 31, 2014 the scheduled maturities for time deposits were as follows (in thousands):

Due in 2015	$ 20,634
Due in 2016	5,488
Due in 2017	1,865
Due in 2018	761
Due in 2019	143
	$ 28,891

Interest expense on time deposits of $100,000 or more was $125,135, $140,829 and $212,875 in 2014, 2013 and 2012, respectively.

Note 7. Borrowed Funds

The Bank has obtained federal funds borrowing guidance lines with its correspondent banks in an aggregate amount of $7.0 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 (FHLB). Total FHLB borrowings at December 31, 2014, and December 31, 2013 were $0 and $0, respectively. During the year ended December 31, 2014 and December 31, 2013, the bank had weighted average borrowings of $2,609,578 and $943 with weighted average costs of .12% and 1.15%, respectively. At December 31, 2014, the Bank had a total available borrowing capacity of $47,875,750 which included $40,875,750 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 642,074 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 maximum shares stated above and amounts in the succeeding tables, for all periods presented, reflect the 10% stock dividend of December 5, 2011 and the 5% stock dividend of March 8, 2013.

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, 2012	473,702	$ 8.65
Granted 2013	100,375	10.27
Exercised 2013	–	–
Cancelled 2013	(61,863)	8.83
Balance at December 31, 2013	512,214	$ 8.65
Granted 2014	102,550	11.82
Exercised 2014	(66,325)	8.67
Cancelled 2014	(53,845)	9.45
Balance at December 31, 2014	494,594	$ 9.95

	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, 2013:	512,214	4.97 years	$ 8.95	409,774	3.82 years	$ 8.65
December 31, 2014:	494,594	5.12 years	$ 9.95	346,294	3.18 years	$ 8.75

There was an aggregate intrinsic value of stock option awards outstanding and exercisable of $3,458,498 and $2,743,165, respectively, at December 31, 2014. The aggregate intrinsic value of stock options exercised was $310,305 for the year ended December 31, 2014. There were no stock options exercised in the year ended December 31, 2013.

The number and weighted average grant date fair value of options granted is as follows for the years ended December 31, 2014, December 31, 2013 and December 31, 2012:

	Number	Weighted Average Grant Date Fair Value
2012	11,300	$4.37
2013	100,375	$2.39
2014	102,550	$2.98

The weighted average assumptions used for 2014, 2013 and 2012 in determining the fair value of options granted are as follows:

	2014	2013	2012
Expected life (yrs.)	6	6	6
Volatility	18.21%	16.70%	48.31%
Risk free rate of return	2.52%	2.44%	1.72%
Dividend yield	0.00%	0.00%	0.00%

As of December 31, 2014, there was $329,534 unrecognized stock compensation expense that will be recognized through December 31, 2017.

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 made $25,661, $22,225 and $18,117 matching employee 401(k) contributions in 2014, 2013, and 2012, respectively.

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, 2014, and December 31, 2013.

Note 11. Restrictions, Commitments, Contingencies and Other Disclosures

Restrictions on Cash and Due from Banks. As compensation for check clearing and other services, compensating balances of approximately $2,000,000 was maintained with correspondent banks at both December 31, 2014 and December 31, 2013.

Building Lease Commitments. The original operating lease for the Bank's 111 Mission Street office in Santa Cruz, which had an expiration date of November 30, 2012 and an option to extend for three additional 5 year periods, was renegotiated January 13, 2012, effective January 1, 2012. The new monthly lease payment for the Santa Cruz Office is $12,600. This payment includes all building expenses for taxes, insurance and maintenance and the lease payment is fixed at this amount during the initial term through December 31, 2017, inclusive. Additionally, the new lease has an option to extend for two additional five-year periods.

Minimum rental payments for future years under this new lease are as follows:

2015	$ 151,200
2016	151,200
2017	151,200
	$453,600

Building rent expense was $151,200 for the three years ended December 31, 2014, December 31, 2013 and December 31, 2012.

Other Assets. In January 2014, the Bank purchased property at 2020 North Pacific Avenue, Santa Cruz, CA. Purchase price of the property was $1,508,447, and is included in other assets on these financial statements. The property is being developed and will serve as the Bank's main headquarters when the project is completed. Construction in progress, as of December 31, 2014, totaled $99,347 and is included in premises and equipment on these financial statements.

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, 2014 and December 31, 2013 are as follows:

	December 31,	
	2014	2013
Commitments to extend credit	$22,425,526	$33,424,921
Total unfunded financial commitments	$22,425,526	$33,424,921

Legal Matters. At December 31, 2014, 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, 2014 and 2013 are the investment securities classified as available for sale totaling $5,641,305 and $6,414,050, respectively. Fair value for this group is based on the Level 2 assumption. There were no assets measured at fair value on a non-recurring basis at December 31, 2014. Assets measured at fair value on a non-recurring basis at December 31, 2013, consist solely of other real estate owned of $348,750 having a fair value assertion based on the Level 3 assumption.

As of December 31, 2014 and 2013 specific allocated reserves on OREO properties as well as write-downs on such properties aggregated $0 and $21,250, respectively.

During the year ended December 31, 2014, the Bank sold all Level 3 assets. There were no changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the year ended December 31, 2013.

The following table presents the carrying amounts and estimated fair values of the Bank's financial instruments at December 31, 2014 and December 31, 2013. 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 on the following page.

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, 2014		December 31, 2013	
	Amount	Fair Value	Amount	Fair Value
Financial Assets:				
Cash and cash equivalents	$ 3,426,947	$ 3,426,947	$ 4,579,474	$ 4,579,474
Interest-bearing deposits in other banks	23,396,757	23,396,757	31,430,826	131,430,826
Securities available-for-sale	5,641,305	5,641,305	6,414,050	6,414,050
Securities held-to-maturity	7,739,678	7,748,715	7,760,636	7,383,136
Bankers' bank and Federal Home Loan Bank stock	802,360	802,360	825,752	825,752
Bank Owned Life Insurance	4,400,425	4,400,425	4,269,543	4,269,543
Loans, net	119,082,289	128,159,338	100,077,054	98,808,805
Accrued interest receivable	367,421	367,421	358,052	358,052
Financial Liabilities:				
Noninterest-bearing demand deposits	$ 35,877,916	$ 35,877,916	$ 30,290,175	$ 30,290,175
Interest-bearing demand deposits	7,104,014	7,104,014	8,493,178	8,493,178
Money market deposits	62,614,352	62,614,352	61,255,740	61,255,740
Time certificates of deposit	28,891,453	28,891,685	28,995,592	28,994,642
Savings account deposits	8,270,858	8,270,858	5,460,013	5,460,013
Accrued interest payable	9,079	9,079	9,578	9,578

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, 2014 and December 31, 2013 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:

	2014	2013	2012
Other non-interest income:			
Gain (loss) on sale of assets	$ 2,087	$ 250	$ (1,599)
Wire transfer fees	10,241	8,200	7,340
Merchant card processing	22,927	13,283	5,025
Imprinted check sales	4,172	4,533	4,027
Internet banking fees	6,713	6,310	5,620
Safe deposit fees	3,100	3,150	3,160
BOLI non-interest income	130,883	145,854	123,688
Other non-interest income	63,015	43,023	59,469
Total other non-interest income	$ 243,138	$ 224,603	$ 206,730
Other operating expense:			
Other real estate owned expense	$ 2,285	$ 27,250	$ 36,406
Regulatory assessments	117,856	91,171	180,580
Correspondent bank charges	41,779	56,248	59,443
Stationery, supplies and printing	23,350	31,360	25,559
Shareholder related expense	24,178	18,799	30,729
Insurance and security	31,256	26,394	26,384
Telephone, postage and electronic communications	21,119	21,237	22,154
Director fees	77,735	78,425	67,650
Loan and collection expense	17,364	15,005	21,965
Armored car and messenger	8,069	8,718	8,115
ATM surcharge fees	10,110	9,280	8,817
Publications and subscriptions	3,576	12,050	15,009
Meetings, conferences, education and training	10,553	9,600	8,800
Human resources administration fees	2,757	2,536	2,264
Dues and memberships	15,185	10,418	6,331
Customer checks and stamps	6,019	5,125	5,028
Other operating expenses	25,358	70,570	95,813
Total other operating expenses	$ 438,549	$ 494,186	$ 621,047

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, 2014, 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.

Notes to Financial Statements

December 31, 2014 and 2013

(Dollars in thousands)	Actual		For Capital Adequacy Purposes:		For Regulatory Adequacy Purposes (first seven years)		To Be Well Capitalized Under the FDICIA Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2014								
Total capital (to risk-weighted assets)	$26,941	18.49%	$11,655	8.00%	N/A	N/A	$14,569	10.00%
Tier 1 capital (to risk-weighted assets)	$25,103	17.23%	$ 5,827	4.00%	N/A	N/A	$ 8,741	6.00%
Tier 1 capital (to average assets) leverage ratio	$25,103	15.04%	$ 6,677	4.00%	N/A	N/A	$ 8,347	5.00%
As of December 31, 2013								
Total capital (to risk-weighted assets)	$24,545	18.45%	$10,640	8.00%	$ 13,300	10.00%	$13,300	10.00%
Tier 1 capital (to risk-weighted assets)	$22,866	17.19%	$ 5,320	4.00%	$ 7,980	6.00%	$ 7,980	6.00%
Tier 1 capital (to average assets) leverage ratio	$22,866	14.34%	$ 6,379	4.00%	$ 12,757	8.00%	$ 7,973	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 was required to maintain a Tier 1 Leverage Ratio of not less than 8%.

Board of Directors

IN ORDER FROM L TO R:

James L. Weisenstein
Chief Executive Officer
DayOne Solar, Inc.

Richard G. Hofstetter
President and Chief Executive Officer
Lighthouse Bank

Stephen D. Pahl
Senior Partner and Chairman
Pahl & McCay
a Professional Law Corporation

John C. Burroughs, Chairman
Certified Financial Planner
Founder and Owner
Burroughs Financial Services
Chairman
Foothill Securities, Inc.

Bruce A. McPherson
Fifth District Supervisor
Santa Cruz County

William R. Slakey
Executive Vice President and
Chief Financial Officer
Echelon Corporation

Michael P. Dunn, D.O.
Physician
Watsonville Emergency Medical Group
Santa Cruz Emergency Physicians

Craig A. French
President
French Resources Group, Inc.

Not pictured:
James R. Castellanos
President
Casco Property Management

Senior Management

IN ORDER FROM L TO R:

Donald H. Soman
Executive Vice President
Chief Financial Officer

Kimberly M. Raynal
Executive Vice President
Chief Operating Officer

Richard G. Hofstetter
President
Chief Executive Officer

Kristin Ditlevsen
Senior Vice President
Lending Group Manager

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

Staff

TOP ROW FROM L TO R:

Angela Henderson
Assistant Vice President
Controller

Matthew Sinnott
Assistant Vice President
Deposit Services Manager

Neil Santiago
Senior Vice President
SBA Lending

Joey Garcia
Assistant Vice President
Service Manager

NEXT ROW:

Brianna Carabba
Vice President
Human Resources &
Executive Administrator

Richard Harker
Assistant Vice President
Relationship Manager

Michele Bassi
Vice President
Business Development

Elliott Miller
Assistant Vice President
Relationship Manager

NEXT ROW:

Elsy Franco
Client Service Representative

Michelle Cole
Vice President
Loan Operations Manager

Chastain Sampson
Client Service Representative

Kia West
Loan Operations Specialist

Dara Harris
Assistant Vice President
Relationship Manager

BOTTOM ROW:

Judy Spellerberg
Deposit Services Specialist

Marva Andrews
Utility Representative

Kathryn Baumert
Client Service Representative

Ruby Stiga
Loan Operations Specialist

Advisory Board

Christen Allaman, M.D.
President and
Medical Director
Eye Care
Medical Group, Inc.

President and
Medical Director
Cypress Outpatient

Frank "Buzz" Anderson
Businessman

James Baker
Superintendent
Retired
Pajaro Valley Unified
School District

Kenneth Bergman
President
Scotts Valley Realty

Blaine Brokaw
Broker
ANB Insurance
Services

Linda Burroughs
Co-Chair

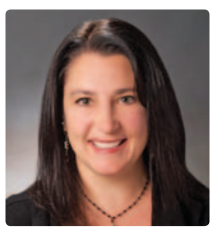
Owner/Broker
Linda Burroughs
Real Estate

Bruce Dunn, M.D.
Retired
Physician

Peter Gaarn
Co-Chair

Peter Gaarn & Associates

Russell E. Gross
President/Broker
Russell E. Gross
Real Estate, Inc.



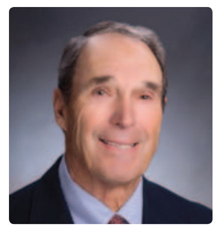
Brigid Heath
Branch Manager/
Escrow Officer
Old Republic
Title Company

Alan Heit, D.D.S.
Alan Heit
Family Dentistry

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

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

Gary Marietti, D.D.S.
Retired

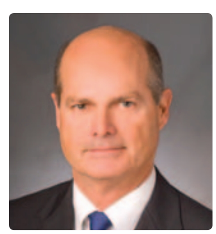


Hon. John A. Marlo
Retired

Mediator and Arbitrator
JAMS

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

Jesse L. Nickell III
Senior Vice President
Construction and
Development
Barry Swenson Builder



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

Shareholder Relations and Information

Stock Information

Lighthouse Bank's stock is listed and publicly traded over-the-counter under the ticker symbol LGHT.

Market Maker

Raymond James & Associates
John T. Cavender
(415) 616-8935
John.Cavender@RaymondJames.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:

Computershare Shareholder Services
P.O. Box 43078
Providence, RI 02940-3078
www.computershare.com/investor
(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
Vice President
Human Resources and Executive Administrator
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
Executive Vice President
Chief Financial Officer
Lighthouse Bank
111 Mission Street, Santa Cruz, CA 95060
Phone: (831) 600-4009

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
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- Herman Mondo
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- James & Carol Weisenstein
- Whiting's Foods
- Peter & Jackie Whiting
- Tim & Ann Williams
- Andy Zehnder

LIGHTHOUSE BANK

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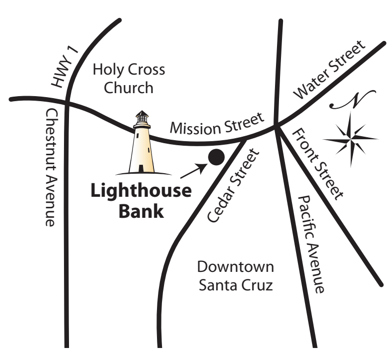

EQUAL HOUSING LENDER
Member FDIC

Supporting Our Community

Following is a list of some of the local organizations which the Bank, our Directors and Employees have generously supported:

- American Cancer Society
- American Red Cross
- Aptos Sports Foundation
- BALANCE4Kids
- Baymonte School
- Big Brothers Big Sisters of Santa Cruz
- Big Stick Surfing Association
- Bonny Doon Community School Foundation
- Boomerang Foundation
- Boys & Girls Club of Santa Cruz County
- Cabrillo College Foundation
- California State Parks Foundation
- CASA for Children of Santa Cruz County
- Clean Oceans Project
- Community Bridges
- Community Housing Land Trust
- Community Life Services
- Cultural Council of Santa Cruz County
- Dientes
- Digital Nest
- Dominican Hospital Foundation
- Ecology Action
- Family Service Agency of the Central Coast
- Freedom Rotary Foundation
- Friends of Olympia Station
- Friends of Santa Cruz Parks & Recreation
- Gateway School
- Grey Bears
- Habitat for Humanity
- Happy Valley Parent Club
- Harbor High School
- Health Improvement Partnership
- Helping Hands
- Homeless Services Center
- Hope Services
- Hospice of Santa Cruz County
- Human Care Alliance
- Imagine Supported Living Service
- Jacob's Heart
- Janus of Santa Cruz
- Jordan & Kyra Memorial Foundation
- Kids on Broadway
- Kuumbwa Jazz Center
- Life Lab Science Program
- Long Marine Lab
- Monte Foundation
- Mount Madonna School
- Muscular Dystrophy Association
- National Marine Sanctuary Foundation
- Omega Nu
- O'Neill Sea Odyssey
- Opening Doors to Community
- Organic Farming Research Foundation
- Pacific Collegiate School
- PAMF Office of Philanthropy
- Sanctuary Exploration Center
- Santa Cruz Art League
- Santa Cruz Ballet Theatre
- Santa Cruz Chamber of Commerce
- Santa Cruz City Youth Soccer Club
- Santa Cruz Community Counseling Center
- Santa Cruz County Bar Association
- Santa Cruz County Fair Heritage Foundation
- Santa Cruz County Symphony Association
- Santa Cruz County Trial Lawyers Association
- Santa Cruz Educational Foundation
- Santa Cruz High School Athletics
- Santa Cruz Host Lions Club
- Santa Cruz Little League
- Save Our Shores
- Scotts Valley Educational Foundation
- Scotts Valley Little League
- Second Harvest Food Bank
- Senior Citizens Legal Services
- Seniors Council
- ShelterBox USA
- Siena House
- SLVHS Athletics
- Soquel High Fund
- Sunrise Rotary Club of Santa Cruz
- Survivors Healing Center
- Tannery Arts Center
- Teen Kitchen Project
- The College of Botanical Healing
- The Daisy
- The Family Network
- The Museum of Art & History
- The Salvation Army
- United Way of Santa Cruz County
- Vine Hill Elementary School
- Vista Center for the Blind & Visually Impaired
- Walnut Avenue Women's Center

LIGHTHOUSE BANK

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