



# **SUMMIT STATE BANK**

**2008 REPORT ON 10-K**

To our Shareholders and Friends;

2008 proved to be a turning point in the history of Summit State Bank.

Despite the sharp economic downturn and its negative impact on many banks, we have been able to perform in 2008 by maintaining our asset quality and achieving core earnings growth. This resulted from continued sound underwriting, including retreating from spec home construction lending in late 2006, measured loan growth, disciplined loan pricing, targeted cost of funds management to better position the Bank both in the short term and long term, and gaining greater efficiencies in our overhead structure.

Perhaps the most exciting development in 2008 was the recognition of Summit's value in the local community, which resulted in the Bank being named the *Top Rated Bank in Sonoma County* by the various bank rating services, namely *Bauer Financial* and *Thestreet.com*. As other banks struggled, we were able to continue to lend. We are beginning to see an inflow of new customers seeking a safer bank for the current economic environment.

Summit did not escape 2008 without being impacted by the current economic downturn. The Bank had net income of \$1,009,000 or \$0.21 per common share for 2008, which was down from net income in 2007 of \$1,942,000 or \$0.40 per common share primarily due to impairment write-downs on investment securities. Although the securities' write-downs were disappointing, we substantially increased the net interest margin to 3.78% for the 2008 year and 3.95% in the fourth quarter compared to 3.49% for all of 2007. Summit's margin increased while many banks' margins decreased in 2008.

The margin expansion was, in part, the result of a shift in our funding philosophy by increasing brokered deposits while targeting our historical challenge of building core deposits, thus avoiding deposit rate competition with a few large national banks that had funding pressures. We believe there is more opportunity to further increase the net interest margin and to better position the Bank for eventual higher interest rates.

We have focused and improved our future operating efficiency. The increase in operating expenses in 2008 was partially due to a conversion to a new data processing vendor and severance costs related to increasing staffing efficiency. With these expenses behind us, we enter 2009 with a well-controlled expense structure.

Finally, we accepted and are beginning to make use of preferred stock capital obtained from the U.S. Treasury under the TARP program. We did not need the additional capital as we are one of the highest capitalized banks in our market, but after careful consideration we accepted these funds, to be best prepared for an even tougher economy in the next year, and to safeguard our shareholders' investment. This preferred capital positions the Bank to withstand the impact of the current recession, while also giving us a strong base to pursue opportunities to gain new customers as other banks deal with their problems in this economic downturn.



John C. Lewis  
Chairman



Thomas Duryea  
CEO and President

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Attorney  
DeMeo DeMeo & West

**Michael J. Donovan**  
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President & Chief Executive Officer  
Summit State Bank

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Chief Financial Officer  
Champion Industries, Inc.

**Allan J. Hemphill**  
President  
Hemphill and Associates

**John C. Lewis**  
Chairman  
Summit State Bank

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**Marshall T. Reynolds**  
Chairman and Chief Executive Officer  
Champion Industries, Inc.

**Robert B. St. Clair**  
Executive  
Clover Stornetta Farms, Inc.

**Eugene W. Traverso**  
Owner  
Traverso's Gourmet Foods & Liquors

**Executive Officers:**

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President & Chief Executive Officer  
Summit State Bank

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**Guy C. Dana**  
Senior Vice President & Chief Credit Officer

**Linda Bertauche**  
Senior Vice President & Chief Operating Officer

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**SUMMIT STATE BANK  
ANNUAL REPORT ON FORM 10-K**

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## Selected Financial Data

Year Ended December 31

(in thousands except per share data)

	2008	2007	2006	2005	2004
<b>Income statement data:</b>					
Interest income	\$ 21,554	\$ 22,755	\$ 20,454	\$ 16,668	\$ 12,450
Net interest income	12,343	10,851	11,031	10,386	8,968
Provision for loan losses	685	749	253	444	444
Total non-interest income	(1,303)	1,196	1,321	1,859	1,338
Total non-interest expense	8,639	7,993	7,238	6,481	5,328
Income before income taxes	1,716	3,305	4,861	5,320	4,534
Income taxes	707	1,363	2,053	2,189	1,866
Net income	\$ 1,009	\$ 1,942	\$ 2,808	\$ 3,131	\$ 2,668

### Selected balance sheet data:

Assets	\$ 364,580	\$ 340,193	\$ 312,950	\$ 345,788	\$ 247,772
Loans, net	299,645	267,067	252,860	236,208	200,184
Earning assets	347,786	321,154	289,581	330,833	229,652
Deposits	252,763	249,019	232,974	301,754	189,337
Federal Home Loan Bank advances	55,420	42,600	31,460	15,200	32,200
Shareholders' equity	55,547	47,715	47,812	27,043	25,386
Balance sheet data - average					
Assets	\$ 343,403	\$ 329,457	\$ 303,800	\$ 294,615	\$ 234,341
Loans, net	279,140	268,310	248,539	222,011	189,052
Earning assets	326,496	310,636	284,906	275,919	215,435
Deposits	242,587	238,721	235,553	242,329	181,503
Federal Home Loan Bank advances	52,233	41,180	28,557	23,747	26,664
Shareholders' equity	47,655	48,219	36,768	26,396	24,504

### Selected per common share data:

Earnings per common share - basic	\$ 0.21	\$ 0.40	\$ 0.70	\$ 0.93	\$ 0.79
Earnings per common share - diluted	\$ 0.21	\$ 0.40	\$ 0.69	\$ 0.93	\$ 0.79
Weighted average shares used to calculate earnings per common share - basic	4,745	4,831	4,030	3,361	3,361
Weighted average shares used to calculate earnings per common share - diluted	4,745	4,834	4,074	3,378	3,361
Common shares outstanding at year end	4,745	4,745	4,795	3,361	3,361
Cash dividends per share	\$ 0.36	\$ 0.36	\$ 0.36	\$ 0.36	\$ 0.30
Book value per common share	9.92	10.06	9.97	8.05	7.55
Tangible book value per common share	9.05	9.19	9.11	6.82	6.33

### Selected ratios:

Return on average equity	2.12%	4.03%	7.64%	11.86%	10.89%
Return on average tangible equity	2.32%	4.40%	8.60%	14.05%	13.09%
Return on average assets	0.29%	0.59%	0.92%	1.06%	1.14%
Common dividend payout ratio	169.95%	89.75%	52.21%	38.65%	37.78%
Net interest margin	3.78%	3.49%	3.87%	3.76%	4.16%
Efficiency ratio (noninterest expenses to net interest income and noninterest income)	78.25%	66.35%	58.60%	52.93%	51.70%
Average equity to average assets	13.88%	14.64%	12.10%	8.96%	10.46%
Leverage capital ratio	14.76%	12.98%	14.29%	6.72%	9.24%
Nonperforming assets to total assets	0.30%	0.14%	0.76%	0.21%	0.09%
Nonperforming loans to total loans	0.34%	0.17%	0.93%	0.30%	0.11%
Net charge-offs to average loans	0.10%	0.32%	0.05%	0.00%	0.05%
Allowance for loan losses to total loans	1.32%	1.34%	1.46%	1.51%	1.56%

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion provides additional information about the financial condition of Summit State Bank ("the Bank") at December 31, 2008 and 2007 and results of operations for the years ended December 31, 2008, 2007 and 2006. The following analysis should be read in conjunction with the consolidated financial statements of the Bank and the notes thereto prepared in accordance with accounting principles generally accepted in the United States.

All references to Common Shares and per share information have been adjusted for the 2-for-1 stock split issued in June 2006.

This discussion contains certain forward-looking information about us (See "DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS" on page 60).

***Critical Accounting Policies.*** The discussion and analysis of the Bank's results of operations and financial condition are based upon financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Bank's management to make estimates and judgments that affect the reported amounts of assets and liabilities, income and expense, and the related disclosures of contingent assets and liabilities at the date of these financial statements.

The Bank believes these estimates and assumptions to be reasonably accurate; however, actual results may differ from these estimates under different assumptions or circumstances. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses, consideration of goodwill impairment and consideration of "other than temporary impairment" of investment securities.

The allowance for loan losses is determined first and foremost by promptly identifying potential credit weaknesses that could jeopardize repayment. The Bank's process for evaluating the adequacy of the allowance for loan losses includes determining estimated loss percentages for each credit based on the Bank's historical loss experience and other factors in the Bank's credit grading system and accompanying risk analysis for determining an adequate level of the allowance. The risks are assessed by rating each account based upon paying habits, loan to value ratio, financial condition and level of classifications. The allowance for loan losses was \$4,016,000 at December 31, 2008 compared to \$3,621,000 at December 31, 2007.

### ***Valuation of Goodwill***

We assess the carrying value of our goodwill at least annually in order to determine if this intangible asset is impaired. In reviewing the carrying value of our goodwill, we assess the recoverability of such assets by evaluating the fair value of the related business unit. If the carrying amount of goodwill exceeds its fair value, an impairment loss is recognized for the amount of the excess and the carrying value of goodwill is reduced accordingly. Any impairment would be required to be recorded during the period identified.

Statement of Financial Accounting Standard (SFAS) No. 142, "Accounting for Goodwill and Other Intangible Assets," establishes standards for the amortization of acquired intangible assets and impairment assessment of goodwill. SFAS No. 142 requires an annual evaluation of

goodwill for impairment using various estimates and assumptions. The market price at the close of business on December 31, 2008 was \$4.51 per common share compared to a book value of \$9.92 per common share. The Bank believes the lower market price in relation to book value is due to the overall decline in the financial industry sector and is not specific to the Bank. Further, the Bank engaged an independent third party specialist to perform an impairment test of its goodwill. The evaluation included three approaches: 1) Multiple of tangible book value, based on recent bank acquisitions in California 2) Multiple of equity return and 3) Premium on deposits. The Bank took an average of these approaches and also considered their excess capital levels above the required leverage capital ratio. The impairment test was performed as of November 30, 2008 based on June 30, 2008 data and resulted in an implied fair value for the Bank sufficiently above the book value to support the current carrying value of goodwill. As the Bank's stock price per common share is currently less than its book value per common share, it is reasonably possible that management may conclude that goodwill, totaling \$4.1 million at December 31, 2008, is impaired as a result of a future assessment. If our goodwill is determined to be impaired, the related charge to earnings could be material.

We are obligated to assess, at each reporting date, whether there is an "other-than-temporary" impairment to our investment securities. Such impairment must be recognized in current earnings rather than in other comprehensive income or loss, net of tax. We examine all individual securities that are in an unrealized loss position at each reporting date for other-than-temporary impairment. Specific investment level factors we examine to assess impairment include the severity and duration of the unrealized loss, the nature, financial condition and results of operations of the issuers of the securities and whether there has been any cause for default on the securities or any adverse change in the rating of the securities by the various rating agencies. Additionally, we reexamine our financial resources and our overall intent and ability to hold the securities until their fair values recover. During 2008, we recognized other than temporary impairment charges of \$2,457,000 on government sponsored agency preferred stocks, corporate bonds and a pooled trust preferred security. We do not believe that we had any other investment securities with material unrealized losses that would be deemed to be "other-than-temporarily impaired" as of December 31, 2008. Investment securities are discussed in more detail under "Investment Portfolio" on page 12.

## **Overview**

The Bank is a community bank serving Sonoma, Napa, San Francisco and Marin Counties in California. It operates through five offices located in Santa Rosa, Petaluma, Rohnert Park and Windsor. The Bank was founded as a savings and loan in 1982 under the name Summit Savings. On January 15, 1999, the Bank converted its charter to a California state-chartered commercial bank and thereby became subject to regulation, supervision and examination by the California Department of Financial Institutions and the FDIC.

## **Results of Operations**

### ***Years Ended December 31, 2008, 2007 and 2006***

The Bank's primary source of income is net interest income, which is the difference between interest income and fees derived from earning assets and interest paid on liabilities which fund those assets. Net interest income, expressed as a percentage of total average interest earning assets, is referred to as the net interest margin. The Bank's net interest income is affected by changes in the volume and mix of interest earning assets and interest bearing liabilities. It is also affected by changes in yields earned on interest earning assets and rates paid on interest bearing deposits and other borrowed funds. The Bank also generates noninterest income, including transactional fees, service charges, office lease income, gains and losses on investment securities and gains on sold SBA guaranteed loans originated by the Bank. Noninterest expenses consist primarily of employee compensation and benefits, occupancy and equipment expenses and other operating expenses. The Bank's results of operations are also affected by its provision for loan losses. Results of operations may also be significantly affected by other factors including general economic and competitive conditions, mergers and acquisitions of other financial institutions within the Bank's market area, changes in market interest rates, government policies, and actions of regulatory agencies.

### **Net Income**

For the year ended December 31, 2008, net income was \$1,009,000, or \$0.21 per diluted common share, and return on average assets was 0.29%. This compares with net income of \$1,942,000, or \$0.40 per diluted common share, for the year ended December 31, 2007 and a return on average assets of 0.59%. The decline in year-over-year earnings amounts was \$933,000, or 48%. The Bank experienced a decline in net income in 2008 when compared to 2007, primarily due to other than temporary impairment charges (OTTI) recorded on investment securities of \$2,457,000; expenses related to conversion to a new data processor of approximately \$311,000; and employee termination expense of \$268,000.

Net income for 2007 declined by \$866,000, or 31%, as compared to the year ended December 31, 2006, which had net income of \$2,808,000, or \$0.69 per diluted common share and a return on average assets of 0.92%. The decline in net income was attributable to a decline in net interest income and noninterest income, an increase in operating expenses including the opening of the Petaluma office, and increased provision for loan losses.

### **Net Interest Income and Net Interest Margin**

For the year ended December 31, 2008, net interest income was \$12,343,000 and the net interest margin was 3.78%. This was an increase of \$1,492,000 or 14% over 2007. For the year ended December 31, 2007, net interest income was \$10,851,000 and the net interest margin was 3.49%. Net interest income was \$11,031,000 for the year ended December 31, 2006 and the net interest margin was 3.87%. At December 31, 2008, approximately 82% of the Bank's assets were comprised of net loans and 11% of investment securities compared to 79% of net loans, 12% of investment securities and 2% in Federal Funds sold at December 31, 2007.

The yield on average interest earning assets declined from 2007 to 2008 and increased from 2006 to 2007. The yield on average interest earning assets was 6.60% for the year ended December 31, 2008, 7.33% for the year ended December 31, 2007 and 7.18% for the year ended December 31, 2006. The changes in the overall yield on average earning assets between the years was primarily attributable to the changes in general economic interest rates with the changes in rates impacting the repricing of the Bank's variable rate loan portfolio.

The decline in interest income resulting from lower yields was partially offset by an increase in the average earning assets over the two years ending December 31, 2008. The growth rate of average earning assets for the two years ended December 31, 2008 was 9% and for average loans was 9%.

For the year ended December 31, 2008, the cost of average interest bearing liabilities was 3.26% compared with a cost of average interest bearing liabilities of 4.44% for the year ended December 31, 2007 and 3.73% for the year ended December 31, 2006. The changes in the cost of funds have been driven by the changing market interest rates during 2006 through 2008. In 2008, the cost of funds was lowered, in part by utilizing brokered deposits and FHLB advances as an alternative to local time deposits as these alternative sources had a lower cost.

The following tables present condensed average balance sheet information for the Bank, together with interest rates earned and paid on the various sources and uses of its funds for each of the periods presented. Average balances are based on daily average balances. Nonaccrual loans are included in loans with any interest collected reflected on a cash basis.

## Average Balance Sheets and Analysis of net Interest Income

Year Ended December 31,									
	2008			2007			2006		
(in thousands)	Average Balance	Interest Income/ Expense	Average Rate	Average Balance	Interest Income/ Expense	Average Rate	Average Balance	Interest Income/ Expense	Average Rate
<b>Assets</b>									
Interest earning assets:									
Interest bearing deposits in banks	\$ 26	\$ 1	3.85%	\$ 203	\$ 7	3.45%	\$ 832	\$ 28	3.37%
Taxable investment securities	45,336	2,636	5.81%	41,982	2,415	5.75%	28,856	1,622	5.62%
Federal funds sold	1,994	69	3.46%	141	6	4.26%	6,679	297	4.45%
Loans, net of unearned income	279,140	18,848	6.75%	268,310	20,327	7.58%	248,539	18,507	7.45%
Total earning assets/interest income	<u>326,496</u>	<u>21,554</u>	6.60%	<u>310,636</u>	<u>22,755</u>	7.33%	<u>284,906</u>	<u>20,454</u>	7.18%
Nonearning assets	20,720			22,268			22,599		
Allowance for loan losses	(3,813)			(3,447)			(3,705)		
Total assets	<u>\$ 343,403</u>			<u>\$ 329,457</u>			<u>\$ 303,800</u>		
<b>Liabilities and Shareholders' Equity</b>									
Interest bearing liabilities:									
Deposits:									
Interest-bearing demand deposits	\$ 13,066	102	0.78%	\$ 12,530	94	0.75%	\$ 13,438	60	0.45%
Savings and money market	37,919	854	2.25%	49,838	1,666	3.34%	80,669	2,298	2.85%
Time deposits	179,728	6,376	3.55%	164,356	8,109	4.93%	129,636	5,682	4.38%
Securities sold under repurchase agreements	-	-	0.00%	87	2	2.30%	578	13	2.25%
FHLB advances	52,233	1,879	3.60%	41,180	2,033	4.94%	28,557	1,370	4.80%
Total interest bearing liabilities/interest expense	<u>282,946</u>	<u>9,211</u>	3.26%	<u>267,991</u>	<u>11,904</u>	4.44%	<u>252,878</u>	<u>9,423</u>	3.73%
Noninterest bearing deposits	11,874			11,997			11,810		
Other liabilities	928			1,250			2,344		
Total liabilities	<u>295,748</u>			<u>281,238</u>			<u>267,032</u>		
Shareholders' equity	47,655			48,219			36,768		
Total liabilities and shareholders' equity	<u>\$ 343,403</u>			<u>\$ 329,457</u>			<u>\$ 303,800</u>		
Net interest income and margin (2)		<u>\$ 12,343</u>	3.78%		<u>\$ 10,851</u>	3.49%		<u>\$ 11,031</u>	3.87%
Net interest spread (3)			3.34%			2.89%			3.45%

- (1) The net amortization of deferred fees and costs on loans included in interest income was \$284,000, \$228,000 and \$172,000 for the years ended December 31, 2008, 2007 and 2006, respectively.
- (2) Net interest margin is computed by dividing net interest income by average total earning assets.
- (3) Net interest spread is the difference between the average rate earned on average total earning assets and the average rate paid on average total interest bearing liabilities.

The following table shows the change in interest income and interest expense and the amount of change attributable to variances in volume and rates. The unallocated change in rate or volume variance has been allocated between the rate and volume variances in proportion to the absolute dollar amount in the change of each.

## Volume and Yield/Rate Variances

(in thousands)	2008 Compared to 2007			2007 Compared to 2006		
	Change Due to			Change Due to		
	Volume	Rate	Net	Volume	Rate	Net
Interest bearing deposits in banks	\$ (7)	\$ 1	\$ (6)	\$ (22)	\$ 1	\$ (21)
Taxable investment securities	195	26	221	754	39	793
Federal funds sold	64	(1)	63	(279)	(12)	(291)
Loans, net of unearned income	796	(2,275)	(1,479)	377	1,443	1,820
Total interest income	1,048	(2,249)	(1,201)	830	1,471	2,301
Interest-bearing demand deposits	4	4	8	(4)	38	34
Savings and money market	(343)	(469)	(812)	(983)	351	(632)
Time deposits	705	(2,438)	(1,733)	1,652	775	2,427
Securities sold under repurchase agreements	(2)	-	(2)	(11)	-	(11)
FHLB advances	472	(626)	(154)	622	41	663
Total interest expense	836	(3,529)	(2,693)	1,276	1,205	2,481
Increase (decrease) in net interest income	\$ 212	\$ 1,280	\$ 1,492	\$ (446)	\$ 266	\$ (180)

### Provision for Loan Losses

The Bank maintains an allowance for loan losses for losses that are expected to occur as an incidental part of the banking business. Write-offs of loans are charged against the allowance for loan losses, which is adjusted periodically to reflect changes in the volume of outstanding loans and estimated losses due to deterioration in the financial condition of borrowers or the value of property securing nonperforming loans, or changes in general economic conditions and other qualitative factors. Additions to the allowance for loan losses are made through a charge against income referred to as the “provision for loan losses.”

The Bank’s loan policy provides procedures designed to evaluate and assess the credit risk factors associated with its loan portfolio, to enable management to assess such credit risk factors prior to granting new loans and to evaluate the sufficiency of the allowance for loan losses. The Bank conducts an assessment of the allowance for loan losses on a monthly basis and undertakes a more critical evaluation quarterly. At the time of the quarterly review, the Board of Directors examines and formally approves the adequacy of the allowance. The quarterly evaluation includes an assessment of the following factors: any external loan review and regulatory examination, estimated potential loss exposure on each pool of loans, concentrations of credit, value of collateral, the level of delinquent and non-accruals loans, trends in loan volume, effects of any changes in the lending policies and procedures, changes in lending personnel, current economic conditions at the local, state and national level, and a migration analysis of historical losses and recoveries for the prior eight quarters.

At December 31, 2008, the Bank’s allowance for loan losses totaled \$4,016,000, or 1.32% of outstanding loans, compared with an allowance for loan losses of \$3,621,000, or 1.34% of outstanding loans, at December 31, 2007 and \$3,736,000, or 1.46% of outstanding loans, at December 31, 2006. There were \$290,000 in net loans charged-off to the allowance for loan losses during 2008, and \$864,000 of net charge-offs in 2007 and \$134,000 was charged-off to the

allowance in 2006. For the year ended December 31, 2008, the provision for loan losses amounted to \$685,000, and for the years ended December 31, 2007 and 2006, the provision for loan losses amounted to \$749,000 and \$253,000, respectively. The provision for loan losses is dependent on the increase in loans outstanding, the mix of types of loans within the portfolio, net charge-offs recorded against the allowance, the volumes of loans past due or on nonaccrual status and economic factors. See “Allowance for Loan Losses” below.

## Noninterest Income

Noninterest income is comprised primarily of service charges and other fees on deposit accounts, gains on sales of SBA guaranteed loans and office lease income. In 2008, noninterest income was decreased by other than temporary impairment write downs on investment securities (OTTI).

The following table summarizes noninterest income recorded for the years indicated.

(in thousands)	Year Ended December 31,		
	2008	2007	2006
Service charges	\$ 404	\$ 352	\$ 337
Office leases	669	699	658
Gains on sales of loans	-	41	99
Securities impairment	(2,457)	-	-
Loan servicing, net	46	65	65
Other income	35	39	162
Total non-interest income	<u><u>\$ (1,303)</u></u>	<u><u>\$ 1,196</u></u>	<u><u>\$ 1,321</u></u>

Service charges on deposit accounts were \$404,000 for the year ended December 31, 2008, compared to \$352,000 and \$337,000 for the years ended December 31, 2007 and 2006, respectively. The increase in service charge income was primarily the result of new fee schedules implemented and granting fewer fee waivers during 2007 and 2008.

The Bank built and owns its headquarters building with approximately half of the office space leased to nonaffiliated tenants. The building was occupied in 2004 and fully leased in 2005. Lease income from this office building was \$669,000, \$699,000 and \$658,000 for the years ended December 31, 2008, 2007 and 2006, respectively. The leases have annual rent increases. One lease expired at the end of 2008 and the new lease terms will result in a lower initial rent for 2009. Additionally, one lease expires in September 2009 and is not expected to renew.

Management does an analysis quarterly in determining the credit quality and expected cash flows from its investment securities to determine if other than temporary impairment should be recognized. The volatile bond market and uncertainties of the financial condition of various corporate entities resulted in OTTI write downs of \$2,457,000 during 2008. The write downs consisted of \$1,256,000 on the value of government sponsored agencies’ preferred stocks, \$970,000 on corporate securities and \$231,000 on a security backed by trust preferred securities

of financial institutions and insurance companies. The remaining net book value of the written down securities at December 31, 2008 was \$305,000.

## Noninterest Expenses

The following table summarizes noninterest expenses recorded for the years indicated.

(in thousands)	Year Ended December 31,		
	2008	2007	2006
Salaries and employee benefits	\$ 4,343	\$ 3,974	\$ 3,675
Occupancy and equipment	1,735	1,624	1,350
Other expenses	2,561	2,395	2,213
Total	<u>\$ 8,639</u>	<u>\$ 7,993</u>	<u>\$ 7,238</u>

For the year ended December 31, 2008, noninterest expenses were \$8,639,000, or 2.5% of average assets and 64% of total revenue (total revenue is defined as net interest income plus noninterest income, excluding securities impairment). This was an 8% increase over 2007 noninterest expenses of \$7,993,000. The Bank incurred \$311,000 of expenses in 2008 in connection with its conversion to a new data processor and \$268,000 in employee termination expenses. Without these expenses, the total noninterest expense would have been \$8,060,000 for 2008 and would have been relatively unchanged compared to the amount recorded in 2007.

Noninterest expenses increased 10% to \$7,993,000 in 2007 compared to noninterest expenses of \$7,238,000 in 2006. Noninterest expenses were 2.4% of average assets and 66% of total revenue in 2007 and 2.4% of average assets and 59% of total revenue in 2006. The increase in expenses in 2007 over 2006 included the opening of an additional branch location in Petaluma.

Salaries and employee benefits expense increased 9% in 2008 compared to 2007 and 8% in 2007 compared to 2006. In 2008, salaries and employee benefits expense included \$268,000 in employee termination expenses. Without these termination expenses, 2008 would have increased 3% over 2007. The increase in 2007 was primarily attributable to the increased staffing for the new Petaluma office.

Occupancy and equipment expenses increased 7% in 2008 compared to 2007 and 20% in 2007 compared to 2006. The increase in occupancy expenses in 2008 was primarily attributable to occupancy expenses for the new Petaluma office for the full year and the increase in 2007 was the opening of the Petaluma office in July of 2007.

The following table summarizes the categories of other expenses.

(in thousands)	Year Ended December 31,		
	2008	2007	2006
Data processing	\$ 949	\$ 578	\$ 526
Professional fees	412	319	268
Director fees and expenses	298	250	223
Advertising and promotion	206	289	382
Deposit and other insurance premiums	171	193	179
Telephone and postage	91	95	105
Other expenses	434	671	530
	<u>\$ 2,561</u>	<u>\$ 2,395</u>	<u>\$ 2,213</u>

Included in other expense are FDIC insurance premiums assessed. These premiums are assessed quarterly and were significantly offset by a one time credit during 2007 and 2008. No credit is available during 2009 and the FDIC has announced higher insurance premiums along with possible special assessments to rebuild the insurance fund. Without a special assessment, management estimates an increase in FDIC insurance premiums of approximately \$200,000 in 2009. Professional fees increased in 2008 as the Bank contracted with specialists to work with collection of various SBA guaranteed loans.

### Provision for Income Taxes

The Bank accrues income tax expense based on the anticipated tax rates during the financial period covered. The provision for income taxes for the years ended December 31, 2008, 2007 and 2006, was \$707,000, \$1,363,000 and \$2,053,000, respectively. The combined effective Federal and State corporate income tax rates for the years ended December 31, 2008, 2007 and 2006, were 41.2%, 41.2% and 42.2%, respectively.

### Investment Portfolio

Securities classified as available-for-sale for accounting purposes are recorded at their fair or market value on the balance sheet. Securities classified as held-to-maturity are recorded at amortized cost. At December 31, 2008, investment securities comprised 11% of total assets and 12% of interest earning assets. At December 31, 2007, investment securities comprised 12% of total assets and 13% of interest earning assets. At December 31, 2008 there were no investment securities classified as held-to-maturity and at December 31, 2007 there were \$5,000,000, with market values of \$5,000,000 of investment securities classified as held to maturity. Securities classified as available-for-sale were \$41,183,000 and \$35,426,000 for the 2008 and 2007 respective year ends. Changes in the fair market value of available-for-sale securities (e.g., unrealized holding gains or losses) are reported as "other comprehensive income (loss)," net of tax, and carried as accumulated other comprehensive income or loss within shareholders' equity until realized.

The Bank utilizes the investment portfolio to manage liquidity and attract funding that requires collateralization. At December 31, 2008, investment securities with a market value of

\$19,624,000, or 48% of the portfolio, were pledged to secure State of California deposits, this compares to \$19,771,000, or 49% of the portfolio pledged at December 31, 2007. At December 31, 2008 and 2007, securities with a par value of \$32,500,000 and \$33,760,000, respectively, were callable within one year.

### Investment Securities

(in thousands)	December 31,		
	2008	2007	2006
Available-for-sale securities:			
Government agencies	\$ 36,143	\$ 30,826	\$ 22,192
Mortgage-backed securities	2,464	2,642	2,869
Pooled trust preferred securities	18	233	250
Other debt securities	2,534	426	513
Government agencies' stock	24	1,299	5
	<u>41,183</u>	<u>35,426</u>	<u>25,829</u>
Held-to-maturity:			
Government agencies	-	5,000	5,000
Total	<u>\$ 41,183</u>	<u>\$ 40,426</u>	<u>\$ 30,829</u>

The composition of the investment portfolio by major category and contracted maturities or repricing of debt investment securities at December 31, 2008 are shown below.

### Contractual Maturity or Repricing Schedule and Weighted Average Yields of Securities As of December 31, 2008

(in thousands)	Within One Year		After One But Within Five Years		After Five But Within Ten Years		After Ten Years	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Available-for-sale:								
Government agencies	\$ -	-	\$ 529	4.30%	\$ -	0.00%	\$ 35,614	5.84%
Mortgage backed securities	-	-	-	-	-	0.00%	2,464	6.03%
Other debt securities	-	-	375	18.40%	1,693	4.79%	484	12.83%
	<u>\$ -</u>	-	<u>\$ 904</u>	10.15%	<u>\$ 1,693</u>	4.79%	<u>\$ 38,562</u>	5.94%

As of December 31, 2008 the Bank did not own securities of any single issuer (other than U.S. Government agencies and corporations) whose aggregate book value was in excess of 10% of the Bank's total equity at the time of purchase.

The Bank recorded other than temporary impairment charges of \$2,457,000 on investment securities during 2008. No impairment charges were recorded in 2007 or 2006. The securities with impairment charges had a market value of \$417,000 and an adjusted book value of \$305,000 at December 31, 2008. The securities with impairment charges were government sponsored agency preferred stocks, corporate securities and a pooled trust preferred security.

## Loan Portfolio

The following table shows the composition of the Bank's loan portfolio by amount and percentage of total loans for each major loan category at the dates indicated.

### Loans

(in thousands)	December 31,									
	2008		2007		2006		2005		2004	
Commercial & Agricultural	\$ 69,359	22.7%	\$ 54,846	20.2%	\$ 55,814	21.7%	\$ 41,064	17.1%	\$ 39,584	19.5%
Real Estate - Commercial	126,690	41.4%	101,919	37.6%	102,439	39.9%	92,198	38.4%	70,954	34.8%
Real Estate-Construction	6,800	2.2%	27,085	10.0%	30,937	12.0%	23,875	9.9%	20,567	10.1%
Real Estate - Single family units	53,375	17.4%	40,940	15.1%	31,451	12.2%	30,763	12.8%	35,072	17.2%
Real Estate - Land Loans	14,857	4.9%	12,856	4.7%	10,882	4.2%	8,895	3.7%	7,124	3.5%
Real Estate-Multifamily	23,159	7.6%	20,545	7.6%	14,116	5.5%	34,570	14.4%	23,667	11.6%
Consumer	5,253	1.7%	5,711	2.1%	4,977	1.9%	4,181	1.7%	4,273	2.1%
Lease Financing	6,305	2.1%	7,295	2.7%	6,538	2.6%	4,756	2.0%	2,471	1.2%
	<u>305,798</u>	<u>100%</u>	<u>271,197</u>	<u>100%</u>	<u>257,154</u>	<u>100%</u>	<u>240,302</u>	<u>100%</u>	<u>203,712</u>	<u>100%</u>
<b>LESS:</b>										
Allowance for Loan Losses	(4,016)		(3,621)		(3,736)		(3,617)		(3,173)	
Deferred Loan Fees	(2,137)		(509)		(558)		(477)		(355)	
Total Loans, Net	<u>\$ 299,645</u>		<u>\$ 267,067</u>		<u>\$ 252,860</u>		<u>\$ 236,208</u>		<u>\$ 200,184</u>	

At December 31, 2008, the Bank had approximately \$19,079,000 in undisbursed loan commitments, of which approximately \$6,524,000 related to real estate construction loans. This compares with undisbursed commitments of approximately \$40,437,000 at December 31, 2007, of which approximately \$10,669,000 related to real estate construction loans. At December 31, 2008 and 2007, there were \$197,000 and \$48,000, respectively, in standby letters of credit outstanding.

The following table shows the maturity distribution of Real Estate Construction and Commercial & Agriculture loans, including rate repricing intervals on variable rate loans, at December 31, 2008. In the following table, the term variable (generally referring to loans for which the interest rate will change immediately given a change in the underlying index) also includes loans with adjustable rates (loans for which the rate may change, but which are also limited in occurrence).

## Loan Portfolio Maturity Structure at December 31, 2008

(in thousands)	Within One Year	After One But Within Five Years	After Five Years	Total
Real Estate - Construction (1)	\$ 6,285	\$ -	\$ 515	\$ 6,800
Commercial & Agricultural	42,396	20,633	6,330	69,359
Total	<u>\$ 48,681</u>	<u>\$ 20,633</u>	<u>\$ 6,845</u>	<u>\$ 76,159</u>
Loans with:				
Fixed Interest Rates	\$ 10,551	\$ 17,166	\$ 6,213	\$ 33,930
Floating Interest Rates	38,130	3,467	632	42,229
Total	<u>\$ 48,681</u>	<u>\$ 20,633</u>	<u>\$ 6,845</u>	<u>\$ 76,159</u>

- (1) Construction loans with maturities over five years include loans that borrowers have paid fees for a rollover to permanent financing.

### Nonperforming Assets

Nonperforming assets consist of nonperforming loans, investment securities with deferred interest payments and other real estate owned. Nonperforming loans are those for which the borrower fails to perform under the original terms of the obligation and consist of nonaccrual loans, accruing loans past due 90 days or more and restructured loans, if applicable

In addition to the nonperforming loans discussed below for the respective periods, the Bank owns various security investments for which expected cash flows have deteriorated and an other than temporary impairment charge was recorded in 2008. No impairment charges were recorded in 2007 or 2006. Below are the investments in which impairment charges were taken in 2008:

Security	Book Value Prior To Impairment	Impairment Recorded	Adjusted Book Value	Fair Value at 12/31/08
Freddie Mac preferred stock	\$1,031,000	\$1,015,000	\$ 16,000	\$ 16,000
Fannie Mae preferred stock	250,000	242,000	8,000	8,000
Lehman Brothers bond	738,000	738,000	-	-
GMAC bond	499,000	236,000	263,000	375,000
ALESCO Preferred Funding IX class D-1 notes	244,000	226,000	18,000	18,000
Total impaired securities	<u>\$2,762,000</u>	<u>\$2,457,000</u>	<u>\$305,000</u>	<u>\$417,000</u>

Investments that have deferred or suspended payments in the above table are the ALESCO Preferred Funding IX class D-1 notes, the preferred stocks of Freddie Mac and Fannie Mae, and the Lehman Brothers bond. The adjusted book values are included in the nonperforming assets below.

The following are the nonperforming assets for the respective periods:

### Nonperforming Loans and Assets

(in thousands)	December 31,				
	2008	2007	2006	2005	2004
Nonaccrual loans	\$ 1,046	\$ 465	\$ 2,383	\$ 713	\$ 216
Accruing loans past due 90 days or more	-	-	-	-	-
Total nonperforming loans	1,046	465	2,383	713	216
Other real estate owned	-	-	-	-	-
Investment securities	42	-	-	-	-
Total nonperforming assets	<u>\$ 1,088</u>	<u>\$ 465</u>	<u>\$ 2,383</u>	<u>\$ 713</u>	<u>\$ 216</u>
Nonperforming loans to total loans	0.34%	0.17%	0.93%	0.30%	0.11%
Nonperforming assets to total assets	0.30%	0.14%	0.76%	0.21%	0.09%

Nonaccrual loans were \$1,046,000, or .34% of gross loans outstanding, at December 31, 2008. Nonaccrual loans included \$461,000 in balances guaranteed by the Small Business Administration, and all are secured by liens on real estate. At December 31, 2008 and 2007, there were \$15,710,000 and \$5,811,000 loans with respect to which management had concerns as to the ability of the borrower to comply with the present loan repayment terms that were not included in nonaccrual or nonperforming loans. These borrowers have exhibited some deterioration as of the respective year ends, but were current with the loan terms and management has assessed the ability to continue performance. These loans are predominantly secured by real estate.

### Loan Policies and Procedures

The Bank's underwriting practices include an analysis of the borrower's management, current economic factors, the borrower's ability to respond and adapt to economic changes outside its direct control and verification of primary and secondary sources of repayment. Risk within the loan portfolio is managed through the Bank's loan policies and underwriting. These policies are reviewed and approved annually by the Board of Directors.

- Management administers the loan policy, ensures proper loan documentation is maintained and develops the methodology for monitoring loan quality and the level of the allowance for loan losses and reports on these matters to the Board of Directors' Internal Asset Review Committee and the Board of Directors.
- The Board of Directors' Internal Asset Review Committee meets regularly to evaluate problem assets and the adequacy of the allowance for loan losses. The Committee also reviews and makes recommendations to the Board of Directors regarding the adequacy of the allowance for loan losses, and is responsible for ensuring that an independent third party reviews the loan portfolio at least annually. Resultant reports are sent to this Committee and to the Audit Committee.
- The Board of Directors' Loan Committee is responsible for enforcement of the loan

policy and has additional responsibilities which include approving loans or loan relationships for a customer that, when considered in the aggregate, exceed management's level of loan authority for that customer.

- The Board of Directors' Audit Committee also engages a third party to perform a review of management's asset and liability practices to ensure compliance with the Bank's policies.
- The Board of Directors retains overall responsibility for all loan functions and reviews material loan relationships.

Loan approvals are granted according to established policies, and lending officers are assigned approval authorities within their levels of training and experience. Interest rates reflect the risk inherent in loans and collateral is generally taken for purchase-money financing. Collateral may consist of accounts receivable, direct assignment of contracts, inventory, equipment and real estate. Unsecured loans may be made when warranted by the financial strength of the borrower. With the exception of single-family residential mortgage loans, the maximum rate adjusting period is generally five years. The Bank has approximately \$86 million in loans (28% of the loan portfolio at December 31, 2008) with fixed interest rates that mature in over 5 years. Guarantees are generally required to help assure repayment. Management believes that pricing is commensurate with risk for both new and existing customers.

### **Allowance for Loan Losses**

The Bank maintains the allowance for loan losses to provide for inherent losses in the loan portfolio. Additions to the allowance for loan losses are established through a provision charged to expense. All loans which are judged to be uncollectible are charged against the allowance while any recoveries are credited to the allowance. The Bank's policy is to charge off any known losses at the time of determination. Any unsecured loan more than 90 days delinquent in payment of principal or interest and not in the process of collection is charged off in total. Secured loans are evaluated on a case by case basis to determine the ultimate loss potential to us subsequent to the liquidation of collateral. In those cases where we believe we are inadequately protected, a charge-off will be made to reduce the loan balance to a level equal to the liquidation value of the collateral.

The Bank's loan policy provides procedures designed to evaluate and assess the credit risk factors associated with the loan portfolio, to enable the Bank to assess such credit risk factors prior to granting new loans and to evaluate the sufficiency of the allowance for loan losses. The Bank conducts an assessment of the allowance on a monthly basis and undertakes a more critical evaluation quarterly. At the time of the quarterly review, the Board of Directors will examine and formally approve the adequacy of the allowance. The quarterly evaluation includes an assessment of the following factors: any external loan review and any recent regulatory examination, estimated potential loss exposure on each pool of loans, concentrations of credit, value of collateral, the level of delinquent and non-accrual loans, trends in loan volume, effects of any changes in lending policies and procedures, changes in lending personnel, current economic conditions at the local, state and national level and historical losses and recoveries.

The following table sets forth an analysis of the allowance for loan losses and provision for loan losses for the periods indicated.

### Summary of Activity in the Allowance for Loan Losses

(in thousands)	Year Ended December 31,				
	2008	2007	2006	2005	2004
Balance at beginning of period	\$ 3,621	\$ 3,736	\$ 3,617	\$ 3,173	\$ 2,831
Charge-offs:					
Commerical and agricultural	431	331	134	-	102
Real estate--construction and land development	-	561	-	-	-
Real estate--mortgage	-	-	-	-	-
Installment loans to individuals	8	-	-	-	-
Leases	19	-	-	-	-
Total loans charged-off	<u>458</u>	<u>892</u>	<u>134</u>	<u>-</u>	<u>102</u>
Recoveries:					
Commerical and agricultural	168	28	-	-	-
Real estate--construction and land development	-	-	-	-	-
Real estate--mortgage	-	-	-	-	-
Installment loans to individuals	-	-	-	-	-
Leases	-	-	-	-	-
Total recoveries	<u>168</u>	<u>28</u>	<u>-</u>	<u>-</u>	<u>-</u>
Net loans charged-off	290	864	134	-	102
Provision for loan losses	685	749	253	444	444
Allowance for loan losses - end of period	<u>\$ 4,016</u>	<u>\$ 3,621</u>	<u>\$ 3,736</u>	<u>\$ 3,617</u>	<u>\$ 3,173</u>
Loans:					
Average loans outstanding during the period, net of unearned income	\$ 279,140	\$ 268,310	\$ 248,539	\$ 222,011	\$ 189,052
Total loans at end of period, net of unearned income	303,661	\$ 270,688	\$ 256,596	\$ 239,825	\$ 203,357
Ratios:					
Net loans charged-off to average net loans	0.10%	0.32%	0.05%	-	0.05%
Net loans charged-off to total loans	0.10%	0.32%	0.05%	-	0.05%
Allowance for loan losses to average net loans	1.44%	1.35%	1.50%	1.63%	1.68%
Allowance for loan losses to total loans	1.32%	1.34%	1.46%	1.51%	1.56%
Net loans charged-off to beginning allowance for loan losses	8.01%	23.13%	3.70%	-	3.60%
Net loans charged-off to provision for loan losses	42.34%	115.35%	52.96%	-	22.97%

The following table summarizes the allocation of the allowance for loan losses by loan category and the amount of loans in each category as a percentage of total loans in each category as of the end of each year presented. The allocated and unallocated portions of the allowance for loan losses are available to the entire portfolio.

## Allocation of Allowance for Loan Losses

	2008		2007		2006		2005		2004	
	Allowance Allocation	Loans to Total Loans								
(in thousands)										
Commercial & Agricultural	\$ 1,024	22.7%	\$ 450	20.2%	\$ 521	21.7%	\$ 1,013	17.1%	\$ 986	19.5%
Real Estate - Commercial	707	41.4%	1,156	37.6%	688	39.9%	680	38.4%	617	34.8%
Real Estate - Construction	398	2.2%	749	10.0%	450	12.0%	227	9.9%	416	10.1%
Real Estate - Single Family Units	88	17.4%	67	15.1%	58	12.2%	59	12.8%	64	17.2%
Real Estate - Land Loans	135	4.9%	108	4.7%	172	4.2%	206	3.7%	34	3.5%
Real Estate - Multifamily	328	7.6%	18	7.6%	99	5.5%	97	14.4%	83	11.6%
Consumer	259	1.7%	66	2.1%	36	1.9%	29	1.7%	20	2.1%
Lease Financing	63	2.1%	79	2.7%	69	2.6%	47	2.0%	29	1.2%
Other	735		756		1,117		934		828	
Unallocated	279		172		526		325		96	
Total	<u>\$ 4,016</u>	<u>100%</u>	<u>\$ 3,621</u>	<u>100%</u>	<u>\$ 3,736</u>	<u>100%</u>	<u>\$ 3,617</u>	<u>100%</u>	<u>\$ 3,173</u>	<u>100%</u>

The changes from year to year for the allocation by loan category are attributable to the growth of the category and managements assessment of the quality of the individual loans within the category. The other allocation represents various qualitative factors in the determination of the adequacy of the allowance for loan losses. Qualitative factors included the size of individual credits, concentrations and general economic conditions. Management also considers these qualitative factors in their evaluation of the adequacy of the allowance for loan losses.

The increase in allocation of the allowance for loan losses to the commercial and agricultural portfolio at December 31, 2008 compared to December 31, 2007, was primarily attributable to the changes in the economy and its effect on particular commercial borrowers. The decline in the allocation to commercial real estate was a result of management's analysis of this portfolio. Many of the Bank's commercial real estate loans are owner occupied which can be impacted less than speculative commercial real estate.

An unallocated allowance can arise from fluctuations in the amount of classified and nonperforming loans ("credit grades") between periods. The Internal Asset Review Committee reviews the amount and reasons for unallocated allowances and whether it has arisen due to periodic fluctuations in the credit grades or has arisen due to changes in qualitative factors or change in lending strategies. If the unallocated allowance has arisen from other than periodic fluctuations in credit grades, then the Internal Asset Review Committee may determine that a portion of the allowance for loan losses should be reversed. The unallocated allowance represents temporary changes in allocations resulting from changes in loan volumes, types and quality, as well as other factors. Management assesses the unallocated amount to determine if the amount is due to other than temporary changes in these factors.

In addition to the allowance for loan losses, the Bank maintains an allowance for losses for undisbursed loan commitments, which is reported in other liabilities on the consolidated balance sheets. This allowance was \$30,000 and \$50,000 at December 31, 2008 and 2007.

## Deposits

Deposits are the Bank's primary source of funds. The Bank employs business development officers to solicit commercial demand deposits. The Bank focuses on obtaining deposits from the communities it serves but occasionally may accept deposits from outside its market area or receive brokered deposits. Management concentrated on lowering its cost of funding by increasing its reliance on brokered deposits during 2008 compared to 2007. This enabled the Bank to avoid paying artificial high rates in the local market that were being set by troubled national financial institutions. These institutions were merged into other institutions toward the end of 2008 and the pricing pressures in the local market for deposits have declined. Management is concentrating on increasing demand deposits in the local market through the use of business development officers who call on small businesses.

At December 31, 2008, the Bank had a deposit mix of 76% in time deposits, 14% in money market and savings accounts, and 10% in interest bearing and noninterest bearing demand accounts. At December 31, 2007, the Bank's deposit mix was comprised of 74% in time deposits, 17% in money market and savings accounts, and 9% in interest bearing and noninterest bearing demand accounts.

The Bank offers local depositors with deposits in excess of \$100,000 and who are concerned with FDIC insurance limits, a deposit placement service through a program called CDARS. Through this program amounts in excess of \$100,000 can be placed in certificates of deposit at other institutions and the Bank receives reciprocal deposits from other institutions within the network. At December 31, 2008 and 2007, there were \$18,788,000 and \$2,740,000 in the CDARS program, respectively. Although the originating depositors are local customers of the Bank, this exchange of deposits for the purposes of FFIEC Call Reports, are classified as brokered deposits. In addition to the CDARS deposits, the Bank had \$47,615,000 and \$18,102,000 at December 31, 2008 and 2007 in brokered deposits.

Time deposits are received through a program run by the Treasurer of the State of California to place public deposits with community banks. At December 31, 2008 and 2007, the State of California had \$40,000,000 and \$38,000,000 in time deposits with the Bank with maturities of 3 to 6 months and collateralized by investment securities, mortgage loans or letters of credit issued by the Federal Home Loan Bank.

The following table sets forth the average balances by deposit category and the interest cost for the periods indicated.

### Average Deposit Balances and Rates Paid

(in thousands)	Year Ended December 31,					
	2008		2007		2006	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Non-interest-bearing demand deposits	\$ 11,874		\$ 11,997		\$ 11,810	
Interest-bearing demand deposits	13,066	0.78%	12,530	0.75%	13,438	0.45%
Saving and money market (1)	37,919	2.25%	49,838	3.34%	80,669	2.85%
Time certificates under \$100,000	79,009	2.46%	69,327	5.13%	55,504	3.91%
Time certificates \$100,000 or over	100,719	4.44%	95,029	4.79%	74,132	4.74%
Total deposits	<u>\$ 242,587</u>	3.02%	<u>\$238,721</u>	4.13%	<u>\$235,553</u>	3.41%

- (1) This includes the Bank's 1031 deposits which are volatile and generally do not remain on deposit for more than 180 days. These deposits were \$ -0-, \$624,000 and \$6,173,000 at December 31, 2008, 2007 and 2006.

The following table sets forth the maturities of time certificates of deposit of \$100,000 or more outstanding at December 31, 2008.

### Maturity of Time Deposits of \$100,000 or More

(in thousands)	December 31, 2008
Time deposits of \$100,000 or more maturing in:	
Three months or less	\$ 48,908
Over three though six months	17,295
Over six to twelve months	16,682
Over twelve months	1,866
Total time deposits of \$100,000 or more	<u>\$ 84,751</u>

### Borrowings

Borrowings were \$55,420,000 and \$42,600,000 at December 31, 2008 and 2007. Borrowings consisted of FHLB advances. At December 31, 2008 there was \$25,420,000 in overnight advances, \$19,000,000 due within one year, \$4,000,000 with maturities greater than one year but less than three years and \$7,000,000 due between four and five years. Management utilizes FHLB advances when the terms are deemed advantageous compared to raising time deposits and to manage over all liquidity.

## **Quantitative and Qualitative Disclosures about Market Risk**

The Bank constantly monitors earning asset and deposit levels, developments and trends in interest rates, liquidity, capital adequacy and marketplace opportunities. Management responds to all of these to protect and possibly enhance net interest income while managing risks within acceptable levels as set forth in the Bank's policies. In addition, alternative business plans and transactions are contemplated for their potential impact. This process is known as asset/liability management and is carried out by changing the maturities and relative proportions of the various types of loans, investments, deposits and borrowings in the ways described above.

The tool most commonly used to manage and analyze the interest rate sensitivity of a bank is known as a computer simulation model. To quantify the extent of risks in both the Bank's current position and in transactions it might make in the future, the Bank uses a model to simulate the impact of different interest rate scenarios on net interest income. The hypothetical impact of both sudden (generally, an immediate change in interest rates of +/- 2.00%) and smaller incremental interest rate changes are modeled at least quarterly, representing the primary means the Bank uses for interest rate risk management decisions.

The Bank is liability sensitive during a one year period meaning that during one year, more liabilities will reprice than loans. Liability sensitive banks would expect an increase in the net interest margin if interest rates decline and the net interest margin to decline when rates increase. However various factors influence the change in the Bank's margin when general economic interest rates change. These factors include, but are not limited to, the growth and mix of new assets, deposit liabilities and borrowings, the extension or contraction of maturities of new and renewed assets and liabilities, the particular shape of the general economic yield curve, and the general influence on pricing by competition in the local market for loans and deposits. Additionally, when economic rates change, there is an immediate impact from loans that are tied to a daily "prime lending rate." The repricing of liabilities to offset this change requires time for deposits to mature and renew. Based strictly on maturing time deposits and borrowings, and without the other factors listed above, it normally will take three months for the Bank to reprice liabilities to offset a prime rate change.

At December 31, 2008, the computer simulation model for a +2.00% interest rate shock, results in the Bank's net interest income for a twelve month period to decrease by a -36% or \$(1,113,000). As current interest rates are at low levels, no meaningful projection is made for a rate reduction. To lower exposure to rising interest rates, management has plans to lengthen the maturities of any new brokered deposits.

When preparing its modeling, the Bank makes significant assumptions about the lag in the rate of change in various asset and liability categories. The Bank bases its assumptions on past experience and comparisons with other banks, and tests the validity of its assumptions by reviewing actual results with projected expectations.

## Liquidity and Capital Resources

Maintenance of adequate liquidity requires that sufficient resources be available at all times to meet cash flow requirements of the Bank. Liquidity in a banking institution is required primarily to provide for deposit withdrawals and the credit needs of customers and to take advantage of lending and investment opportunities as they arise. A bank may achieve desired liquidity from both assets and liabilities. Cash and deposits held in other banks, Federal funds sold, other short term investments, maturing loans and investments, payments of principal and interest on loans and investments, and potential loan sales are sources of asset liquidity. Deposit growth and access to credit lines established with correspondent banks, primarily with the FHLB, and access to brokered certificates of deposits are sources of liability liquidity. The Bank reviews its liquidity position on a regular basis based upon its current position and expected trends of loans and deposits. Management believes that the Bank maintains adequate sources of liquidity to meet its liquidity needs.

The Bank's liquid assets, defined as cash, demand deposits with bank's, Federal funds sold and unpledged investment securities, totaled \$25,209,000 and \$33,443,000 at December 31, 2008 and December 31, 2007, respectively, and constituted 7% and 10%, respectively, of total assets on those dates.

At December 31, 2008, lines of credit with the FHLB and the Bank's correspondent banks totaled \$100 million, of which \$62 million was outstanding, which included \$7 million in letters of credit issued by the FHLB as collateral for State of California deposits. At December 31, 2007, lines of credit with the Federal Home Loan Bank and the Bank's correspondent banks totaled \$100 million, of which \$50 million was outstanding, which included \$7 million in letters of credit issued by the FHLB as collateral for State of California deposits.

The Board of Directors recognizes that a strong capital position is vital to growth, continued profitability, and depositor and investor confidence. The policy of the Board of Directors is to maintain sufficient capital at not less than the "well-capitalized" thresholds established by banking regulators.

Shareholders' equity also includes the Bank's accumulated other comprehensive income (loss), net of taxes of \$54,000 at December 31, 2008 and \$16,000 at December 31, 2007. Other comprehensive income (loss) reflects the fair value adjustment, net of tax, of investment securities classified as available-for-sale. This will fluctuate based on the amount of securities classified as available-for-sale and changes in market interest rates. Total shareholders' equity was \$55,547,000 at December 31, 2008, \$47,715,000 at December 31, 2007.

Federal regulations establish guidelines for calculating "risk-adjusted" capital ratios and minimum ratio requirements. Under these regulations, banks are required to maintain a total risk-based capital ratio of 8.0% and Tier 1 risk-based capital (primarily shareholders' equity) of at least 4.0% of risk-weighted assets. The Bank had total and Tier 1 risk-based capital ratios of 18.6% and 17.4%, respectively, at December 31, 2008, and was "well-capitalized" under the regulatory guidelines. The Bank's total and Tier 1 risk-based capital ratios were 16.4% and 15.1%, respectively, at December 31, 2007.

In addition, regulators have adopted a minimum leverage ratio standard for Tier 1 capital to average assets. The minimum ratio for top-rated institutions may be as low as 3%. However, regulatory agencies have stated that most institutions should maintain ratios at least 1 to 2 percentage points above the 3% minimum. As of December 31, 2008, the Bank's leverage ratio was 14.8%, while as of December 31, 2007, the Bank's leverage ratio was 13.0%. Capital levels for the Bank remain above established regulatory capital requirements.

The Bank increased Tier 1 capital by \$8,500,000 through issuance of preferred stock and common stock warrants to the U.S. Department of the Treasury under the TARP Capital Purchase Program in December 2008. See "Regulation and Supervision – Recent Developments."(page 65)

### **Impact of Inflation**

The primary impact of inflation on the Bank is its effect on interest rates. The Bank's primary source of income is net interest income, which is affected by changes in interest rates. The Bank attempts to limit the impact of inflation on its net interest margin through management of rate-sensitive assets and liabilities and analyses of interest rate sensitivity. The effect of inflation on premises and equipment as well as on noninterest expenses has not been significant for the periods presented.

**SUMMIT STATE BANK AND SUBSIDIARY**

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2008 AND 2007**

**AND FOR THE YEARS ENDED**

**DECEMBER 31, 2008, 2007 AND 2006**

**AND**

**REPORT OF INDEPENDENT REGISTERED PUBLIC  
ACCOUNTING FIRM**



Crowe Horwath LLP  
Member Horwath International

### Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders  
Summit State Bank:

We have audited the accompanying consolidated balance sheets of Summit State Bank and Subsidiary as of December 31, 2008 and 2007 and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ending December 31, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Summit State Bank and Subsidiary as of December 31, 2008 and 2007 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

*Crowe Horwath LLP*

Crowe Horwath LLP

South Bend, Indiana  
March 26, 2009

**SUMMIT STATE BANK AND SUBSIDIARY**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands except per share data)

	<b>December 31, 2008</b>	<b>December 31, 2007</b>
<b>ASSETS</b>		
Cash and due from banks	\$ 3,650	\$ 5,695
Federal funds sold	-	7,110
Total cash and cash equivalents	3,650	12,805
Time deposits in banks	-	80
Available-for-sale investment securities - amortized cost of \$41,088 in 2008 and \$35,404 in 2007	41,183	35,426
Held-to-maturity investment securities - market value of \$5,000 in 2007	-	5,000
Loans, less allowance for loan losses of \$4,016 in 2008 and \$3,621 in 2007	299,645	267,067
Bank premises and equipment, net	7,816	8,463
Investment in Federal Home Loan Bank stock, at cost	2,942	2,850
Goodwill	4,119	4,119
Accrued interest receivable and other assets	5,225	4,383
Total assets	\$ 364,580	\$ 340,193
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits:		
Demand - non interest-bearing	\$ 10,773	\$ 10,297
Demand - interest-bearing	13,597	12,421
Savings	10,068	12,460
Money market	26,123	29,858
Time deposits, \$100,000 and over	84,751	103,995
Other time deposits	107,451	79,988
Total deposits	252,763	249,019
Federal Home Loan Bank (FHLB) advances	55,420	42,600
Accrued interest payable and other liabilities	850	859
Total liabilities	309,033	292,478
Shareholders' equity		
Preferred stock (net); no par value; shares authorized - 20,000,000; shares issued and outstanding 8,500 in 2008 and none in 2007; per share redemption of \$1,000	7,868	-
Common stock, no par value; shares authorized - 30,000,000 shares issued and outstanding 4,744,720 in 2008 and 4,745,420 in 2007	36,251	36,244
Common stock warrants	622	-
Retained earnings	10,752	11,455
Accumulated other comprehensive income, net of taxes	54	16
Total shareholders' equity	55,547	47,715
Total liabilities and shareholders' equity	\$ 364,580	\$ 340,193

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

**SUMMIT STATE BANK AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF INCOME**

	<b>Year Ended December 31,</b>		
(In thousands except for share and earnings per share data)	<b>2008</b>	<b>2007</b>	<b>2006</b>
Interest income:			
Interest and fees on loans	\$ 18,848	\$ 20,327	\$ 18,507
Interest on Federal funds sold	69	6	297
Interest on investment securities and deposits in banks	2,523	2,293	1,536
Dividends on FHLB stock	114	129	114
Total interest income	21,554	22,755	20,454
Interest expense:			
Deposits	7,332	9,869	8,040
Securities sold under repurchase agreements	-	2	13
FHLB advances	1,879	2,033	1,370
Total interest expense	9,211	11,904	9,423
Net interest income before provision for loan losses	12,343	10,851	11,031
Provision for loan losses	685	749	253
Net interest income after provision for loan losses	11,658	10,102	10,778
Non-interest income:			
Service charges	404	352	337
Office leases	669	699	658
Gains on sales of loans	-	41	99
Securities impairment	(2,457)	-	-
Loan servicing, net	46	65	65
Other income	35	39	162
Total non-interest income	(1,303)	1,196	1,321
Non-interest expense:			
Salaries and employee benefits	4,343	3,974	3,675
Occupancy and equipment	1,735	1,624	1,350
Other expenses	2,561	2,395	2,213
Total non-interest expense	8,639	7,993	7,238
Income before provision for income taxes	1,716	3,305	4,861
Provision for income taxes	707	1,363	2,053
Net income	\$ 1,009	\$ 1,942	\$ 2,808
Less: Accretion of preferred discount	(4)	-	-
Net income available for common stock	\$ 1,005	\$ 1,942	\$ 2,808
Basic earnings per common share	\$ 0.21	\$ 0.40	\$ 0.70
Diluted earnings per common share	\$ 0.21	\$ 0.40	\$ 0.69
Basic weighted average shares of common stock outstanding	4,745	4,831	4,030
Diluted weighted average shares of common stock outstanding	4,745	4,834	4,074

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

SUMMIT STATE BANK AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

	Preferred Stock and Common Stock Warrants	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity	Total Comprehensive Income
	Amount	Shares Amount	Amount	Net of Tax	Equity	Income
(in thousands)						
Balance, January 1, 2006	\$ -	3,361 \$ 17,395	\$ 9,914	\$ (266)	\$ 27,043	
Comprehensive income						
Net income			2,808		2,808	\$ 2,808
Other comprehensive income, net of tax:						
Net change in unrealized gains (losses) on available-for-sale investment securities				124	124	124
Total comprehensive income			(1,466)		19,303	\$ 2,932
Stock issued		1,434 19,303			(1,466)	
Cash dividends - \$.36 per share						
Balance, December 31, 2006	-	4,795 36,698	11,256	(142)	47,812	
Comprehensive income:						
Net income			1,942		1,942	\$ 1,942
Other comprehensive income, net of tax:						
Net change in unrealized gains (losses) on available-for-sale investment securities				158	158	158
Total comprehensive income					3	\$ 2,100
Stock-based compensation expense					424	424
Stock issued, net of tax benefits		50 424			(881)	(881)
Stock purchases and retirements		(100) (881)			(1,743)	
Cash dividends - \$.36 per share						
Balance, December 31, 2007	-	4,745 36,244	11,455	16	47,715	
Comprehensive income:						
Net income			1,009		1,009	\$ 1,009
Other comprehensive income, net of tax:						
Net change in unrealized gains (losses) on available-for-sale investment securities				38	38	38
Total comprehensive income					13	\$ 1,047
Stock-based compensation expense					8,486	8,486
Preferred stock (9 shares) and warrants issued					(6)	(6)
Accretion of preferred stock discount					(1,708)	(1,708)
Stock purchases and retirements		4 (6)	(4)		-	-
Cash dividends - \$.36 per share						
Balance, December 31, 2008	\$ 8,490	4,745 \$ 36,251	\$ 10,752	\$ 54	\$ 55,547	\$ 1,047

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

**SUMMIT STATE BANK AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)	Year Ended December 31,		
	2008	2007	2006
Cash flows from operating activities:			
Net income	\$ 1,009	\$ 1,942	\$ 2,808
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	891	820	711
Other than temporary impairment on investment securities	2,457	-	-
Loss on disposal of bank premises and equipment	9	33	-
Net (decrease) increase in deferred loan fees	1,628	(49)	81
Net loss on sale of foreclosed real estate	-	4	-
Provision for loan losses	685	749	253
Gains on sales of loans	-	(41)	(99)
Loans originated for sale	-	(661)	(1,201)
Proceeds from sales of loans held for sale	-	702	1,281
Dividends on Federal Home Loan Bank stock	(143)	(119)	(98)
Net change in accrued interest receivable and other assets	(877)	(317)	(628)
Net change in accrued interest payable and other liabilities	(9)	412	(1,169)
Stock-based compensation expense	13	3	-
Net cash from operating activities	5,663	3,478	1,939
Cash flows from investing activities:			
Decrease in time deposits in banks	80	377	1,178
Purchases of available-for-sale investment securities	(24,731)	(14,671)	(15,015)
Proceeds from calls and maturities of available-for-sale investment securities	16,590	5,371	8,920
Proceeds from calls of held to maturity investment securities	5,000	-	-
Purchase of Federal Home Loan Bank stock	(4,106)	(2,335)	(1,118)
Proceeds from the redemption of Federal Home Loan Bank stock	4,157	1,303	968
Net change in loans	(34,891)	(15,828)	(16,987)
Purchases of bank premises and equipment, net	(253)	(1,141)	(234)
Proceeds from sale of foreclosed real estate	-	917	-
Net cash from investing activities	(38,154)	(26,007)	(22,288)

(Continued)

**SUMMIT STATE BANK AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)	Year Ended December 31,		
	2008	2007	2006
Cash flows from financing activities:			
Net increase (decrease) in demand, NOW, savings and money market deposits	(4,475)	(25,441)	(101,326)
Net change in certificates of deposit	8,219	41,486	32,546
Net change in securities sold under repurchase agreements	-	(257)	82
Net change in short term FHLB advances	25,420	(8,260)	3,260
Proceeds from long term FHLB advances	5,000	37,000	13,000
Repayment of long term FHLB advances	(17,600)	(17,600)	-
Gross proceeds from issuance of common stock	-	259	19,303
Repurchase of common stock	(6)	(881)	-
Tax benefit from exercise of stock options	-	165	-
Proceeds from issuance of preferred stock, net discount	7,864	-	-
Proceeds from issuance of common stock warrant	622	-	-
Dividends paid on common stock	(1,708)	(1,743)	(1,466)
Net cash from financing activities	23,336	24,728	(34,601)
Net change in cash and cash equivalents	(9,155)	2,199	(54,950)
Cash and cash equivalents at beginning of year	12,805	10,606	65,556
Cash and cash equivalents at end of period	\$ 3,650	\$ 12,805	\$ 10,606
Supplemental disclosure of cash flow information:			
Cash paid during the period for:			
Interest	\$ 9,292	\$ 11,718	\$ 10,311
Income taxes	\$ 510	\$ 1,453	\$ 2,495
Noncash investing activities:			
Transfer from loans to other real estate owned	\$ -	\$ 921	\$ -

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

## SUMMIT STATE BANK AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

##### General

On January 15, 1999, Summit State Bank (the "Bank") received authority to transact business as a California state-chartered commercial bank and is subject to regulation, supervision and examination by the California Department of Financial Institutions and the Federal Deposit Insurance Corporation. The Bank was organized under a charter granted by the Department of Savings and Loan of the State of California under the name Summit Savings. The Bank was incorporated on December 20, 1982. The Bank converted to a federal savings bank under a charter granted by the Office of Thrift Supervision on May 24, 1990. The Bank provides a variety of banking services to individuals and businesses in its primary service area of Sonoma County, California. The Bank's branch locations include Santa Rosa, Petaluma, Rohnert Park and Windsor. The Bank offers depository and lending services primarily to meet the needs of its business and individual clientele. These services include a variety of transaction, money market, savings and time deposit account alternatives. The Bank's lending activities are directed primarily towards commercial real estate, construction and business loans. The Bank utilizes its subsidiary Alto Service Corporation for its deed of trust services.

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

##### Principles of Consolidation

The consolidated financial statements include the accounts of Summit State Bank (the "Bank") and its wholly-owned subsidiary, Alto Service Corporation. All significant inter-company accounts and transactions have been eliminated in consolidation.

##### Use of Estimates

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

##### Cash and Cash Equivalents

For the purpose of the consolidated statement of cash flows, the Bank considers cash and due from banks under 90 days and Federal funds sold to be cash equivalents. Generally, Federal funds are sold for one-day periods. Net cash flows are reported for customer loan and deposit transactions, time deposits in banks and short-term borrowings with an original maturity of 90 days or less.

##### Time Deposits in Banks

Time deposits in banks are carried at cost.

## Investment Securities

Investments are classified into the following categories:

- Available-for-sale securities, reported at fair value, with unrealized gains and losses excluded from earnings and reported, net of taxes, as accumulated other comprehensive income (loss) within shareholders' equity.
- Held-to-maturity securities, which management has the positive intent and ability to hold to maturity, reported at amortized cost, adjusted for the accretion of discounts and amortization of premiums.

Management determines the appropriate classification of its investments at the time of purchase and may only change the classification in certain limited circumstances. All transfers between categories are accounted for at fair value.

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

Investment securities are evaluated for impairment on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether a decline in their value is other than temporary. Management utilizes criteria such as the magnitude and duration of the decline and the intent and ability of the Bank to retain its investment in the securities for a period of time sufficient to allow for an anticipated recovery in fair value, in addition to the reasons underlying the decline, to determine whether the loss in value is other than temporary. The term "other than temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other than temporary, the value of the security is reduced and a corresponding charge to earnings is recognized.

## Investment in Federal Home Loan Bank Stock

In order to borrow from the Federal Home Loan Bank of San Francisco (FHLB), the Bank is required to maintain an investment in the capital stock of the FHLB. The investment is carried at cost and is generally redeemable at par. Both cash and stock dividends are reported as income. The FHLB of San Francisco has suspended dividends beginning with the fourth quarter of 2008 to preserve capital and they have ceased redemptions of outstanding stock until further notice.

## Loans Held for Sale

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

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

## Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are stated at principal balances outstanding, net of deferred loan origination fees and costs and the allowance for loan losses, adjusted for accretion of discounts or amortization of premiums. Interest is accrued daily based upon outstanding loan balances. However, when, in the opinion of management, loans are considered to be impaired and the future collectability of interest and principal is in serious doubt, loans are

placed on nonaccrual status and the accrual of interest income is suspended. Any interest previously accrued, but unpaid, is charged against income. Payments received are applied to reduce principal to the extent necessary to ensure collection. Subsequent payments on these loans, or payments received on nonaccrual loans for which the ultimate collectability of principal is not in doubt, are applied first to earned but unpaid interest and then to principal.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due (including both principal and interest) in accordance with the contractual terms of the loan agreement. An impaired loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical matter, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent.

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

The Bank may purchase loans or acquire loans through a business combination for which differences exist between the contractual cash flows and the cash flows expected to be collected due, at least in part, to credit quality. When the Bank acquires such loans, the yield that may be accreted (accretible yield) is limited to the excess of the Bank's estimate of undiscounted cash flows expected to be collected over the Bank's initial investment in the loan. The excess of contractual cash flows over cash flows expected to be collected may not be recognized as an adjustment to yield, loss, or a valuation allowance. Subsequent increases in cash flows expected to be collected generally should be recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as impairment. The Bank may not "carry over" or create a valuation allowance in the initial accounting for loans acquired under these circumstances. At December 31, 2008, there were no loans being accounted for under this policy.

#### Allowance for Loan Losses

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

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors.

A loan is impaired when full payment under the loan terms is not expected. Commercial and commercial real estate 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 the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment, and accordingly, are not separately identified for impairment disclosures.

The Bank is subject to periodic examinations by its federal and state regulatory examiners and may be required by such regulators to recognize additions to the allowance for loan losses based on their assessment of credit information available to them at the time of their examinations. The process of assessing the adequacy of the allowance for loan losses is necessarily subjective. Further, and particularly in times of economic downturns, it is reasonably possible that future credit losses may exceed historical loss levels and may also exceed management's current estimates of incurred credit losses inherent within

the loan portfolio. As such, there can be no assurance that future charge-offs will not exceed management's current estimate of what constitutes a reasonable allowance for credit losses.

#### Loan Servicing

The Bank adopted Statement of Financial Accounting Standard No. 156 "Accounting for Servicing of Financial Assets" ("SFAS No. 156"), as of January 1, 2007. SFAS No. 156 requires separately recognized servicing assets and servicing liabilities to be initially measured at fair value and permits the Bank to elect to measure servicing assets and servicing liabilities at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur or to continue to amortize the servicing assets over the loan service period with periodic impairment assessment. The Bank has elected to continue to amortize its servicing assets. There was no cumulative effect upon the adoption of SFAS No. 156 and the effect on net income for the years ended December 31, 2008 and 2007 was not significant. The Bank's servicing assets at December 31, 2008 and 2007 were \$46,000 and \$56,000 respectively, and consist of the servicing of loans guaranteed by the Small Business Administration (SBA) totaling \$5,589,000 and \$7,761,000 at December 31, 2008 and 2007, respectively.

Servicing fee income which is reported on the income statement as loan servicing, net is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal; or a fixed amount per loan and are recorded as income when earned. The amortization of SBA loan servicing rights is netted against loan servicing fee income. Servicing fees, net of amortization of servicing asset totaled \$46,000, \$65,000, and \$65,000 for the years ended December 31, 2008, 2007 and 2006. Late fees and ancillary fees related to loan servicing are not material

#### Valuation of Goodwill

We assess the carrying value of our goodwill at least annually in order to determine if this intangible asset is impaired. In reviewing the carrying value of our goodwill, we assess the recoverability of such assets by evaluating the fair value of the related business unit. If the carrying amount of goodwill exceeds its fair value, an impairment loss is recognized for the amount of the excess and the carrying value of goodwill is reduced accordingly. Any impairment would be required to be recorded during the period identified.

Statement of Financial Accounting Standard (SFAS) No. 142, Accounting for Goodwill and Other Intangible Assets, establishes standards for the amortization of acquired intangible assets and impairment assessment of goodwill. SFAS No. 142 requires an annual evaluation of goodwill for impairment using various estimates and assumptions. The market price at the close of business on December 31, 2008 was \$4.51 per common share compared to a book value of \$9.92 per common share. The Bank believes the lower market price in relation to book value is due to the overall decline in the financial industry sector and is not specific to the Bank. Further, the Bank engaged an independent third party specialist to perform an impairment test of its goodwill. The evaluation included three approaches: 1) Multiple of tangible book value, based on recent bank acquisitions in California 2) Multiple of equity return and 3) Premium on deposits. The Bank took an average of these approaches and also considered their excess capital levels above the required leverage capital ratio. The impairment test was performed as of November 30, 2008 based on June 30, 2008 data and resulted in an implied fair value for the Bank sufficiently above the book value to support the current carrying value of goodwill. As the Bank's stock price per common share is currently less than its book value per common share, it is reasonably possible that management may conclude that goodwill, totaling \$4.1 million at December 31, 2008, is impaired as a result of a future assessment. If our goodwill is determined to be impaired, the related charge to earnings could be material.

#### Other Real Estate

Other real estate includes real estate acquired in full or partial settlement of loan obligations. When property is acquired, any excess of the Bank's recorded investment in the loan balance and accrued interest income over the estimated fair market value of the property, less costs to sell, is charged against the allowance for loan losses. A valuation allowance for losses on other real estate, if needed, is maintained to provide for declines in value. The allowance is established through a provision for losses on other real estate which is included in other expenses. Subsequent gains or losses on sales or write-downs resulting

from impairment are recorded in other income or expenses as incurred. There was no other real estate held at December 31, 2008 and 2007. Operating costs after acquisition are expensed.

#### Bank Premises and Equipment

Land is carried at cost. Buildings, furniture, fixtures, and equipment are carried at cost less accumulated depreciation. Depreciation is determined using the straight-line method over the estimated useful lives of the related assets. The useful lives of buildings are estimated to be 39 years and furniture, fixtures and equipment are estimated to be 3 to 15 years. Leasehold improvements are amortized over the estimated useful life of the asset or the term of the related lease, whichever is shorter. When assets are sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred.

The Bank evaluates premises and equipment for financial impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable.

#### Income Taxes

The Bank files its income taxes on a consolidated basis with its subsidiary. The allocation of income tax expense (benefit) represents each entity's proportionate share of the consolidated provision for income taxes. Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities.

Deferred tax assets and liabilities are recognized for the tax consequences of temporary differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized. On the consolidated balance sheet, net deferred tax assets are included in accrued interest receivable and other assets.

The Bank adopted FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes", ("FIN 48"), as of January 1, 2007. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The adoption had no effect on the Bank's consolidated financial statements.

The Bank recognizes interest and/or penalties related to income tax matters in income tax expense. The Bank has not accrued any potential interest and penalties as of December 31, 2008 and December 31, 2007 for uncertainties related to income taxes.

#### Stock Split

On May 22, 2006, the Board of Directors declared a two-for-one stock split for all common stock outstanding as of June 1, 2006 effected in the form of a stock dividend which was paid on June 14, 2006. All share and per share amounts have been retroactively adjusted for the stock split.

#### Earnings Per Common Share

Basic earnings per common share (EPS), which excludes dilution, is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if contracts to issue common stock, such as stock options, result in the issuance of common stock which shares in the earnings of the Bank. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issuance of the financial statements. Accordingly, all share and per share information reflects

the two-for-one stock split paid on June 14, 2006. Stock options for 55,666 and 50,663 shares of common stock and common stock warrants for 239,212 and 0 shares of common stock were not considered in computing diluted earnings per share for 2008 and 2007 because they were anti-dilutive.

The factors used in the earnings per common share computation follow:

(in thousands except earnings per share)	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Basic</b>			
Net income available for common shareholders	<u>\$ 1,005</u>	<u>\$ 1,942</u>	<u>\$ 2,808</u>
Weighted average common shares outstanding	<u>4,745</u>	<u>4,831</u>	<u>4,030</u>
Basic earnings per common share	<u>\$ 0.21</u>	<u>\$ 0.40</u>	<u>\$ 0.70</u>
<b>Diluted</b>			
Net income available for common shareholders	<u>\$ 1,005</u>	<u>\$ 1,942</u>	<u>\$ 2,808</u>
Weighted average common shares outstanding for basic earnings per common share	4,745	4,831	4,030
Add: Dilutive effects of assumed exercises of stock options	<u>-</u>	<u>3</u>	<u>44</u>
Average shares and dilutive potential common shares	<u>4,745</u>	<u>4,834</u>	<u>4,074</u>
Diluted earnings per common share	<u>\$ 0.21</u>	<u>\$ 0.40</u>	<u>\$ 0.69</u>

#### Comprehensive Income

Comprehensive income is reported in addition to net income for all periods presented. Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of other comprehensive income (loss) that historically has not been recognized in the calculation of net income. Unrealized gains and losses on the Bank's available-for-sale investment securities are included in other comprehensive income (loss), net of taxes. Total comprehensive income and the components of accumulated other comprehensive income (loss), net of taxes, are presented in the consolidated statements of changes in shareholders' equity.

Other comprehensive income (loss) net of related taxes were attributable to available for sale securities and were as follows:

	<u>Before Tax</u>	<u>Tax Benefit (Expense)</u>	<u>After Tax</u>
(in thousands)			
For the year ended December 31, 2008			
Other comprehensive income:			
Unrealized holding gains on available- for-sale investment securities	<u>\$ 73</u>	<u>\$ (35)</u>	<u>\$ 38</u>
For the year ended December 31, 2007			
Other comprehensive income:			
Unrealized holding gains on available- for-sale investment securities	<u>\$ 297</u>	<u>\$ (139)</u>	<u>\$ 158</u>
For the year ended December 31, 2006			
Other comprehensive income:			
Unrealized holding gains on available- for-sale investment securities	<u>\$ 187</u>	<u>\$ (63)</u>	<u>\$ 124</u>

#### Stock Based Compensation

Compensation cost is recognized for stock options granted to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

#### Adoption of New Accounting Standards

In September 2006, the FASB issued Statement No. 157, "*Fair Value Measurements*" ("SFAS No. 157"). This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The standard was effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued Staff Position 157-2 ("FSP"), "*Effective Date of FASB Statement No. 157*". This FSP delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The impact of adoption on January 1, 2008 was not material to the Bank's consolidated financial condition or results of operations. In October 2008, the FASB issued Staff Position (FSP) 157-3 "*Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*." This FSP clarifies the application of FAS No. 157 in a market that is not active. The impact of adoption was not material to the Bank's consolidated financial condition or results of operations.

In February 2007, the FASB issued Statement No. 159, "*The Fair Value Option for Financial Assets and Financial Liabilities*". The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The new standard was effective for the Bank on January 1, 2008. The Bank did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008.

On November 5, 2007, the SEC issued Staff Accounting Bulletin No. 109, "*Written Loan Commitments Recorded at Fair Value through Earnings*" ("SAB 109"). Previously, SAB 105, "*Application of Accounting Principles to Loan Commitments*", stated that in measuring the fair value of a derivative loan

commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 supersedes SAB 105 and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also indicated that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 became effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The impact of the adoption of this standard on January 1, 2008 was not material to the Bank's consolidated financial condition or results of operations.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4, "*Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*." This issue requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. This issue was effective for fiscal years beginning after December 15, 2007. The impact of adoption on January 1, 2008 was not material to the Bank's consolidated financial condition or results of operations.

In December 2007, the SEC issued SAB No. 110, which expresses the views of the SEC regarding the use of a "simplified" method, as discussed in SAB No. 107, in developing an estimate of expected term of "plain vanilla" share options in accordance with SFAS No. 123(R), "*Share-Based Payment*." The SEC concluded that a company could, under certain circumstances, continue to use the simplified method for share option grants after December 31, 2007. The Bank does not use the simplified method for share options and therefore the adoption of SAB No. 110 on January 1, 2008 had no impact on the Bank's consolidated financial statements.

Effect of Newly Issued But Not Yet Effective Accounting Standards:

In December 2007, the FASB issued FAS No. 141 (revised 2007), "*Business Combinations*" ("FAS 141(R)"), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. FAS No. 141(R) is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The impact of adoption of this standard is dependent on future business combinations that the Bank may enter into.

In December 2007, the FASB issued SFAS No. 160, "*Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB No. 51*" ("SFAS No. 160"), which will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of shareholders' equity within the consolidated balance sheets. FAS No. 160 is effective as of the beginning of the first fiscal year beginning on or after December 15, 2008. Earlier adoption is prohibited and the Bank does not expect the adoption of FAS No. 160 to have a significant impact on its consolidated results of operations or financial position.

In March 2008, the FASB issued SFAS No. 161, “*Disclosures about Derivative Instruments and Hedging Activities, an amendment of SFAS No. 133*”. FAS No. 161 amends and expands the disclosure requirements of SFAS No. 133 for derivative instruments and hedging activities. FAS No. 161 requires qualitative disclosure about objectives and strategies for using derivative and hedging instruments, quantitative disclosures about fair value amounts of the instruments and gains and losses on such instruments, as well as disclosures about credit-risk features in derivative agreements. FAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The adoption of this standard is not expected to have a material effect on the Bank’s consolidated results of operations or financial position.

#### Reclassifications

Certain reclassifications were made to the prior year’s presentation to conform to the current year’s presentation.

#### Operating segments

While the Bank’s chief decision makers monitor the revenue streams of the Bank’s various products and services, operations are managed and financial performance is evaluated on a bank-wide basis. Operating segments are aggregated into one segment as operating results for all segments are similar.

## 2. INVESTMENT SECURITIES

The amortized costs and estimated fair value of investment securities at December 31, 2008 and 2007 consisted of the following:

		2008		
(in thousands)	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities available -for-sale:				
Government agencies	\$ 35,998	\$ 145	\$ -	\$ 36,143
Mortgage-backed securities	2,376	88	-	2,464
Pooled trust preferred securities	18	-	-	18
Government agencies stock	24	-	-	24
Other	2,672	152	(290)	2,534
Total securities available -for-sale	<u>\$ 41,088</u>	<u>\$ 385</u>	<u>\$ (290)</u>	<u>\$ 41,183</u>
		2007		
(in thousands)	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities available -for-sale:				
Government agencies	\$ 30,760	\$ 75	\$ (9)	\$ 30,826
Mortgage-backed securities	2,612	30	-	2,642
Pooled trust preferred securities	250	-	(17)	233
Government agencies stock	1,284	15	-	1,299
Other	498	-	(72)	426
Total securities available -for-sale	<u>\$ 35,404</u>	<u>\$ 120</u>	<u>\$ (98)</u>	<u>\$ 35,426</u>
Securities held-to-maturity:				
Government agencies	<u>\$ 5,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,000</u>
Total securities held-to-maturity	<u>\$ 5,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,000</u>
	<u>\$ 40,404</u>	<u>\$ 120</u>	<u>\$ (98)</u>	<u>\$ 40,426</u>

Net unrealized gains (losses) on available-for-sale investment securities totaling \$95,000 and \$22,000 are recorded, net of \$41,000 and \$6,000 in tax expense, as accumulated other comprehensive income within shareholders' equity at December 31, 2008 and 2007, respectively. There were no sales or transfers of available-for-sale or held-to-maturity investment securities for the years ended December 31, 2008, 2007 and 2006.

Investment securities with unrealized losses at December 31, 2008 and 2007 are summarized and classified according to the duration of the loss period as follows:

		2008					
		Less than 12 Months		12 Months or More		Total	
(in thousands)		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Debt securities:							
Other		\$ 1,613	\$ (290)	\$ -	\$ -	\$ 1,613	\$ (290)
		<u>\$ 1,613</u>	<u>\$ (290)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,613</u>	<u>\$ (290)</u>
		2007					
		Less than 12 Months		12 Months or More		Total	
(in thousands)		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Debt securities:							
Government agencies		\$ -	\$ -	\$ 5,240	\$ (9)	\$ 5,240	\$ (9)
Other		659	(89)	-	-	659	(89)
		<u>\$ 659</u>	<u>\$ (89)</u>	<u>\$ 5,240</u>	<u>\$ (9)</u>	<u>\$ 5,899</u>	<u>\$ (98)</u>

At December 31, 2008, the Bank held 6 investment securities which were in a loss position for less than twelve months and none were in a loss position for twelve months or more. Management periodically evaluates each investment security for other than temporary impairment, relying primarily on industry analyst reports and observation of market conditions and interest rate fluctuations. The Bank recorded \$2,457,000 in other than temporary impairment losses (OTTI) in the consolidated statement of income in 2008 on its investments in preferred stocks of Freddie Mac and Fannie Mae, debt securities of various corporations and an investment in pooled trust preferred securities. No OTTI was recorded in 2007 or 2006.

The amortized cost and estimated fair value of investment securities at December 31, 2008 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

		Available for Sale	
		Amortized	Estimated
(in thousands)		Cost	Fair Value
Within one year		\$ -	\$ -
After one year through five years		763	904
After five years through ten years		1,910	1,693
After ten years		<u>36,015</u>	<u>36,098</u>
		38,688	38,695
Investment securities not due at a single maturity date:			
Government agencies stock		24	24
Mortgage-backed securities		<u>2,376</u>	<u>2,464</u>
		<u>\$ 41,088</u>	<u>\$ 41,183</u>

Investment securities with amortized costs totaling \$19,500,000 and \$19,760,000 and estimated fair values totaling \$19,624,000 and \$19,771,000 were pledged to secure State of California deposits at December 31, 2008 and 2007 (see Notes 5 and 6).

### 3. LOANS

Outstanding loans are summarized as follows:

(in thousands)	December 31,	
	2008	2007
Mortgage loans collateralized by:		
Real estate - single family units	\$ 53,375	\$ 40,940
Real estate - multi-family	23,159	20,545
Real estate - land	14,857	12,856
Real estate-commercial	126,690	101,919
Real estate-construction	6,800	27,085
Commercial & agricultural	69,359	54,846
Consumer	5,253	5,711
Lease financing	6,305	7,295
	<u>305,798</u>	<u>271,197</u>
Deferred loan fees	(2,137)	(509)
Allowance for loan losses	(4,016)	(3,621)
	<u>\$ 299,645</u>	<u>\$ 267,067</u>

Changes in the allowance for loan losses were as follows:

(in thousands)	Year Ended December 31,		
	2008	2007	2006
Balance, beginning of year	\$ 3,621	\$ 3,736	\$ 3,617
Provision charged to operations	685	749	253
Losses charged to allowance	(458)	(892)	(134)
Recoveries added to allowance	168	28	-
Balance, end of year	<u>\$ 4,016</u>	<u>\$ 3,621</u>	<u>\$ 3,736</u>

At December 31, 2008 and 2007, nonaccrual loans totaled \$1,046,000 and \$465,000 respectively. Interest foregone on nonaccrual loans totaled \$51,000, \$40,000 and \$111,000 for the years ended December 31, 2008, 2007 and 2006, respectively. Interest income recognized on nonaccrual loans was \$60,000, \$12,000 and \$139,000 for the years ended December 31, 2008, 2007 and 2006, respectively. At December 31, 2008 and 2007, there were no accruing loans past due 90 days or more.

The recorded investment in loans that were considered to be impaired totaled \$1,046,000 at December 31, 2008, with no specific loss allocations. There was \$465,000 considered to be impaired at December 31, 2007 with a related allowance of \$25,000. The average recorded investment in impaired loans for the years ended December 31, 2008, 2007 and 2006 was \$881,000, \$907,000 and \$923,000. The Bank recognized no interest income on a cash basis for such loans during December 31, 2008, 2007 and 2006.

Salaries and employee benefits totaling \$280,000, \$386,000 and \$393,000 have been deferred as loan origination costs for the years ended December 31, 2008, 2007 and 2006, respectively.

Mortgage loans totaling \$202,727,000 and \$183,953,000 were pledged to secure borrowings with the Federal Home Loan Bank or State of California time deposits at December 31, 2008 and 2007, respectively (see Notes 5 and 6).

#### 4. BANK PREMISES AND EQUIPMENT

Bank premises and equipment consisted of the following:

(in thousands)	December 31,	
	2008	2007
Land	\$ 1,184	\$ 1,184
Building	7,460	7,455
Furniture, fixtures and equipment	2,362	2,161
Leasehold improvements	817	804
	<u>11,823</u>	<u>11,604</u>
Less accumulated depreciation and amortization	<u>(4,007)</u>	<u>(3,141)</u>
	<u>\$ 7,816</u>	<u>\$ 8,463</u>

Depreciation and amortization included in occupancy and equipment expense totaled \$891,000, \$820,000 and \$711,000 for the years ended December 31, 2008, 2007 and 2006, respectively.

#### 5. INTEREST-BEARING DEPOSITS

The aggregate amount of maturities of all time deposits is as follows:

2009 - \$183,986,000; 2010 - \$7,048,000; 2011 - \$589,000; 2012 - \$30,000 and 2013 - \$549,000

Interest expense recognized on interest-bearing deposits were as follows:

(in thousands)	Year Ended December, 31		
	2008	2007	2006
Interest bearing demand	\$ 102	\$ 94	\$ 60
Savings	181	266	968
Money market	674	1,400	1,330
Time deposits	6,375	8,109	5,682
	<u>\$ 7,332</u>	<u>\$ 9,869</u>	<u>\$ 8,040</u>

As of December 31, 2008 and 2007, time deposits, \$100,000 and over included \$40,000,000 and \$38,000,000 of public deposits from the State of California with maturity terms of three to six months. Brokered deposits issued in denominations of less than \$100,000 and issued in denominations greater than \$100,000 and participated out by the broker in shares of \$100,000 or less are included in other time deposits and were \$66,403,000 and \$20,842,000 at December 31, 2008 and 2007.

## 6. BORROWINGS

### Borrowing Arrangements

The Bank has a total of \$16,000,000 in Federal funds lines of credit with three correspondent banks at December 31, 2008. The Bank also maintains a letter of credit facility totaling \$1,000,000 with a correspondent bank to guarantee international letters of credit issued to certain customers. There were guarantees of \$348,000 and \$577,000 under this facility as of December 31, 2008 and 2007, respectively. There were no borrowings outstanding under the Federal funds lines of credit as of December 31, 2008 or 2007.

In addition, the Bank can borrow from the Federal Home Loan Bank of San Francisco on either a short-term or long-term basis up to approximately \$83,256,000 and \$78,488,000 of which \$27,836,000 and \$35,888,000 was available as of December 31, 2008 and 2007, respectively. Various mortgage loans with a carrying value of \$177,707,000 and \$154,808,000 as of December 31, 2008 and 2007, respectively, secured the borrowing arrangement. Interest on advances is due monthly or quarterly and principal is due at maturity.

Fixed rate borrowings included the following advances from the Federal Home Loan Bank of San Francisco.

(in thousands)	Year Ended December 31,			
	2008		2007	
	Amount	Rate	Amount	Rate
<u>Maturity</u>				
FHLB overnight advances	\$ 25,420	0.05%	\$ -	
Total short-term borrowings	<u>25,420</u>		<u>-</u>	
2008	-		17,600	2.66% to 5.38%
2009	19,000	.37% to 4.87%	14,000	4.11% to 4.87%
2010	4,000	4.41% to 6.52%	4,000	4.11% to 6.52%
2012	7,000	4.67%	7,000	4.67%
Total long-term borrowings	<u>30,000</u>		<u>42,600</u>	
Total borrowings	<u>\$ 55,420</u>		<u>\$ 42,600</u>	

## 7. INCOME TAXES

The provision for income taxes for the years ended December 31, 2008, 2007 and 2006 consisted of the following:

(in thousands)			
<u>2008</u>	<u>Federal</u>	<u>State</u>	<u>Total</u>
Current	\$ 1,363	\$ 541	\$ 1,904
Deferred	(842)	(355)	(1,197)
Provision for income taxes	<u>\$ 521</u>	<u>\$ 186</u>	<u>\$ 707</u>
 <u>2007</u>	 <u>Federal</u>	 <u>State</u>	 <u>Total</u>
Current	\$ 1,146	\$ 429	\$ 1,575
Deferred	(142)	(70)	(212)
Provision for income taxes	<u>\$ 1,004</u>	<u>\$ 359</u>	<u>\$ 1,363</u>
 <u>2006</u>	 <u>Federal</u>	 <u>State</u>	 <u>Total</u>
Current	\$ 1,670	\$ 670	\$ 2,340
Deferred	(205)	(82)	(287)
Provision for income taxes	<u>\$ 1,465</u>	<u>\$ 588</u>	<u>\$ 2,053</u>

Deferred tax assets (liabilities) are comprised of the following:

(in thousands)	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
Deferred tax assets:		
Allowance for loan losses	\$ 1,539	\$ 1,612
Future benefit of state tax deduction	184	43
Bank premises and equipment	475	429
Other than temporary impairment	1,011	-
Other accruals	138	82
Total deferred tax assets	<u>3,347</u>	<u>2,166</u>
Deferred tax liabilities:		
Federal Home Loan Bank stock dividends	(131)	(148)
Future benefit of state tax deduction	-	-
Net unrealized gains on available-for-sale investment securities	(40)	(6)
Prepaid expenses and other	(98)	(97)
Total deferred tax liabilities	(269)	(251)
Valuation allowance	-	-
Net deferred tax assets	<u>\$ 3,078</u>	<u>\$ 1,915</u>

The provision for income taxes differs from amounts computed by applying the statutory Federal income tax rates to operating income before income taxes. The significant items comprising these differences for the years ended December 31, 2008, 2007 and 2006 consisted of the following:

(in thousands)	2008		2007		2006	
	Amount	Rate %	Amount	Rate %	Amount	Rate %
Federal income tax expense, at statutory rate	\$ 583	34.0%	\$ 1,124	34.0%	\$ 1,653	34.0%
State franchise tax expense, net of Federal tax effect	124	7.2%	239	7.2%	400	8.2%
Total income tax expense	<u>\$ 707</u>	<u>41.2%</u>	<u>\$ 1,363</u>	<u>41.2%</u>	<u>\$ 2,053</u>	<u>42.2%</u>

The Bank has not recorded any tax contingencies under FIN 48. The Bank does not expect to record any unrecognized tax benefits under FIN 48 in the next twelve months. The Bank and its subsidiary are subject to U.S. federal income tax as well as income tax of the State of California. The Bank is no longer subject to examination by federal taxing authorities for tax years 2004 and prior and by California taxing authorities for tax years 2003 and prior.

## 8. COMMITMENTS AND CONTINGENCIES

### Leases

The Bank leases various equipment and branch offices in Santa Rosa, Rohnert Park, Petaluma and Windsor under non-cancelable operating leases. These leases include various renewal and termination options and rental adjustment provisions. Rental expense included in occupancy and equipment expense totaled \$342,000, \$329,000 and \$212,000 for the years ended December 31, 2008, 2007 and 2006, respectively. Future minimum lease payments are as follows:

Year Ending December 31,	(in thousands)
2009	\$ 247
2010	187
2011	194
2012	175
2013	102
	<u>\$ 905</u>

The Bank entered into operating leases with third parties during 2008 and 2007 for office space in its building. The leases are for periods from five to seven years and contain a provision for one five year renewal option. Rental income totaled \$669,000, \$699,000 and \$658,000 for the years ended December 31, 2008, 2007 and 2006 respectively. Minimum future rental incomes from these operating leases are as follows:

Year Ending December 31,	(in thousands)
2009	\$ 521
2010	405
2011	415
2012	287
2013	224
	<u>\$ 1,852</u>

### Federal Reserve Requirements

Banks are required to maintain reserves with the Federal Reserve Bank equal to a percentage of their reservable deposits less vault cash. The reserve requirement was \$0 and \$360,000 as of December 31, 2008 and 2007 respectively.

### Financial Instruments With Off-Balance-Sheet Risk

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of its clients and to reduce its own exposure to fluctuations in interest rates. These financial instruments consist of commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the consolidated balance sheets.

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

The contractual amounts of financial instruments with off-balance-sheet risk at year end were as follows:

(in thousands)	December 31,			
	2008		2007	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commitments to make loans	\$ -	\$ -	\$ -	\$ 3,085
Unused lines of credit	6,210	12,869	10,334	27,018
Standby letters of credit	-	197	-	48

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

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a client to a third party. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loans to clients. The fair value of the liability related to these standby letters of credit, which represents the fees received for issuing the guarantees, was not significant at December 31, 2008 and 2007. The Bank recognizes these fees as revenue over the term of the commitment or when the commitment is used.

At December 31, 2008, real estate loan commitments represent 46% of total commitments and are generally secured by property with a loan-to-value ratio not to exceed 80%. Commercial loan commitments represent approximately 43% of total commitments and are generally secured by collateral other than real estate or are unsecured. Credit card and other unsecured commitments represent approximately 11% of total commitments. The majority of the Bank's commitments have variable interest rates.

### Concentrations of Credit Risk

The Bank's business activity is primarily with clients located within Northern California. Although the Bank has a diversified loan portfolio, a significant portion of its clients' ability to repay loans is dependent upon the real estate market and various economic factors within Sonoma County. Generally, loans are secured by various forms of collateral. The Bank's loan policy requires sufficient collateral be obtained as necessary to meet the Bank's relative risk criteria for each borrower. The Bank's collateral consists primarily of real estate, accounts receivable, inventory and other financial instruments.

### Correspondent Banking Agreements

The Bank maintains funds on deposit with other federally insured financial institutions under correspondent banking agreements. No deposits were uninsured at December 31, 2008.

### Contingencies

The Bank is subject to legal proceedings and claims which arise in the ordinary course of business. In the opinion of management, the amount of ultimate liability with respect to such actions will not materially affect the financial condition or results of operations of the Bank.

## **9. SHAREHOLDERS' EQUITY**

### Regulatory Capital

The Bank is subject to certain regulatory capital requirements administered by the Federal Deposit Insurance Corporation (FDIC). Failure to meet these minimum capital requirements can initiate certain mandatory and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. Each of these components is defined in the regulations. Management believes that the Bank met all its capital adequacy requirements as of December 31, 2008 and 2007.

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

The Bank's actual and required capital amounts and ratios consisted of the following:

(in thousands)	2008		2007	
	Amount	Ratio	Amount	Ratio
<u>Tier 1 Leverage Ratio</u>				
Summit State Bank	\$ 51,328	14.8%	\$43,524	13.0%
Minimum requirement for "Well-Capitalized" institution	\$ 17,388	5.0%	\$16,761	5.0%
Minimum regulatory requirement	\$ 13,910	4.0%	\$13,409	4.0%
<u>Tier 1 Risk-Based Capital Ratio</u>				
Summit State Bank	\$ 51,328	17.4%	\$43,524	15.1%
Minimum requirement for "Well-Capitalized" institution	\$ 17,722	6.0%	\$17,258	6.0%
Minimum regulatory requirement	\$ 11,815	4.0%	\$11,505	4.0%
<u>Total Risk-Based Capital Ratio</u>				
Summit State Bank	\$ 55,024	18.6%	\$47,127	16.4%
Minimum requirement for "Well-Capitalized" institution	\$ 29,537	10.0%	\$28,763	10.0%
Minimum regulatory requirement	\$ 23,629	8.0%	\$23,011	8.0%

#### Dividends

Upon declaration by the Board of Directors, all shareholders of record will be entitled to receive dividends. The California Financial Code restricts the total dividend payment of any bank in any calendar year without permission of the California Department of Financial Institutions, to the lesser of (1) the bank's retained earnings or (2) the bank's net income for its last three fiscal years, less distributions made to shareholders during the same three-year period. At December 31, 2008, retained earnings of \$842,000 were free of such restrictions. Further dividend restrictions are contained in the Preferred Stock purchase agreement as explained below.

#### Preferred Stock

On December 19, 2008, the Bank received \$8,500,000 and issued 8,500 shares of Fixed Rate Non-cumulative Perpetual Preferred Stock, Series A (the "Preferred Stock") and warrants representing the purchase rights to 239,212 shares of common stock (the "Warrant") to the United States Department of the Treasury (the "Treasury") as part of the Treasury's Capital Purchase Program (CPP). The Preferred Stock was recorded net of \$622,000 of value allocated to the Warrant and \$14,000 in issuance costs.

The Preferred Stock has a non-cumulative dividend rate of 5% per annum for 5 years and then increases to 9% per annum. The Preferred Stock may be redeemed at any time. The Warrant has a 10 year term and is immediately exercisable upon its issuance, with an exercise price of \$5.33 per share of common stock.

The Preferred Stock purchase agreement contains various restrictions for 3 years or until its redemption including prohibiting increasing common stock dividends in excess of historical levels without obtaining the prior approval of the Treasury, prohibiting the repurchase of common stock and limitations on executive compensation. Additionally the Bank cannot pay dividends on its common stock unless it has paid the most recent dividend accrued in the treasury's preferred stock.

## Stock Options

In 1999, the Bank established a stock option plan for which 100,000 shares of common stock are reserved for issuance to directors and officers under nonstatutory agreements. The plan requires that the option price may not be less than the fair market value of the stock at the date the option is granted, and the stock must be paid in full at the time the option is exercised. Payment in full for the option price must be made in cash or with Bank common stock previously acquired by the optionee and held by the optionee for a period of at least six months. The options expire on dates determined by the Board of Directors, but not later than ten years from the date of grant. Options vest over a three to five year period. The 1999 stock option plan has been cancelled with the adoption of the 2007 stock option plan, except for the current options that were granted under this plan, which totaled 25,666 shares at December 31, 2008 and 30,666 shares at December 31, 2007.

The Bank's 2007 Stock Option Plan (stock option plan or the Plan), which is shareholder-approved, permits the grant of share options to its employees for up to 150,000 shares of common stock. Option awards are generally granted with an exercise price equal to the market price of the Company's common stock at the date of grant; those option awards have vesting periods of 5 years unless otherwise approved by the Board of Directors and have 10-year contractual terms. As of December 31, 2008, 125,000 shares remain available for future grants under this plan.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities of an index consisting of financial institution stocks which should approximate the future volatility of the Bank's common stock. The Bank uses historical data to estimate option exercise and post-vesting termination behavior. Employee and management options are tracked separately. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

The fair value of options granted was determined using the following weighted-average assumptions as of the grant date.

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Risk-free interest rate	3.9%	5.0%	-
Expected term	7 years	7 years	-
Expected stock price volatility	45.51	26.63	-
Dividend yield	5.6%	3.3%	-

A summary of the activity in the stock option plan for 2008 follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of the year	50,666	\$ 8.70		
Granted	10,000	6.99		
Exercised	-	-		
Forfeited or expired	(5,000)	10.92		
Outstanding at the end of year	<u>55,666</u>	<u>\$ 8.20</u>	<u>6.5 years</u>	<u>\$ -</u>
Vested or expected to vest	<u>55,666</u>	<u>\$ 8.20</u>	<u>6.5 years</u>	<u>\$ -</u>
Exercisable at end of year	<u>34,416</u>	<u>\$ 7.65</u>	<u>6.5 years</u>	<u>\$ -</u>

Information related to the stock option plan during each year follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Intrinsic value of options exercised	\$ -	\$ 408,000	\$ -
Cash received from option exercises	-	259,000	-
Tax benefit realized from option exercises	-	165,000	-
Weighted average fair value of options granted	1.82	2.76	-

As of December 31, 2008, there was \$49,000 of total unrecognized compensation costs related to nonvested stock options granted under the Plan.

### Initial Public Offering

On July 13, 2006, the Bank commenced an underwritten initial public offering (IPO) and sold 1,432,700 shares of common stock at an offering price of \$15 per share. Net proceeds from the IPO after the underwriters discount and other expense was \$19,303,000. The common stock of the Bank is listed on the Nasdaq Global market under the trading symbol of SSBI.

## 10. OTHER EXPENSES

Other expenses consisted of the following:

(in thousands)	Year Ended December 31,		
	2008	2007	2006
Data processing	\$ 949	\$ 578	\$ 526
Professional fees	412	319	268
Director fees and expenses	298	250	223
Advertising and promotion	206	289	382
Deposit and other insurance premiums	171	193	179
Telephone and postage	91	95	105
Other expenses	434	671	530
	<u>\$ 2,561</u>	<u>\$ 2,395</u>	<u>\$ 2,213</u>

## 11. EMPLOYEE BENEFIT PLAN

### 401(k) Employee Savings Plan

The Bank has a 401(k) Employee Savings Plan (the "Plan"), qualified under the Internal Revenue Code (Code), whereby participants may defer a percentage of their compensation, but not in excess of the maximum allowed under the Code. Bank contributions, as determined by the Board of Directors, are discretionary and vest immediately. Contributions by the Bank totaled \$57,000, \$41,000 and \$61,000 for the years ended December 31, 2008, 2007 and 2006, respectively.

## 12. RELATED PARTY TRANSACTIONS

During the normal course of business, the Bank enters into loans with related parties, including executive officers and directors. The following is a summary of the aggregate activity involving related party borrowers during 2008:

	(in thousands)
Balance, January 1, 2008	\$ 444
New borrowings	-
Amounts repaid	(16)
Balance, December 31, 2008	<u>\$ 428</u>
Undisbursed commitments to related parties, December 31, 2008	<u>\$ 43</u>

A significant shareholder of the Bank is also a significant shareholder of three other banks ("affiliated banks"). During the years ended December 31, 2008 and 2007, the Bank purchased participations in loans originated by the affiliated banks. As of December 31, 2008 and 2007, the outstanding balances of these participations purchased were approximately \$12,146,000 and \$11,671,000 respectively. The Bank had no sold participation interests in loans to these affiliated banks as of December 31, 2008 or 2007.

### 13. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

Estimated fair values are disclosed for financial instruments for which it is practicable to estimate fair value. These estimates are made at a specific point in time based on relevant market data and information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering the Bank's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of these estimates.

Because no active market exists for a significant portion of the Bank's financial instruments, fair value estimates are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the fair values presented.

The following methods and assumptions were used by the Bank to estimate the fair value of its financial instruments at December 31, 2008 and 2007:

Cash and cash equivalents: For cash and cash equivalents consisting of cash, due from banks and federal funds sold, the carrying amount is estimated to be fair value.

Time deposits in banks: The fair value for time deposits in banks is estimated by discounting their future cash flows using interest rates being offered at each reporting date for instruments with similar remaining maturities.

Investment securities: As discussed in greater detail in Note 14, for investment securities, fair values are based on quoted market prices, where available. If quoted market prices are not available, fair values are estimated using quoted market prices for similar securities and indications of value provided by brokers. The carrying amount of accrued interest receivable approximates its fair value.

Loans, net of allowance: For variable-rate loans that reprice frequently with no significant change in credit risk, fair values are based on carrying values. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates being offered at each reporting date for loans with similar terms to borrowers of comparable creditworthiness (without considering widening credit spreads due to market illiquidity). The allowance for loan losses is considered to be a reasonable estimate of discount for credit risk. The carrying amount of accrued interest receivable approximates its fair value.

Federal Home Loan Bank stock: The fair value for Federal Home Loan Bank Stock is not determinable as there are restrictions on its transferability.

Deposits: The fair values for demand deposits are, by definition, equal to the amount payable on demand at the reporting date represented by their carrying amount. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis using interest rates being offered at each reporting date for certificates with similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

Short-term borrowings and long-term debt: The fair values of fixed rate borrowings are estimated using a discounted cash flow analysis that applies interest rates being offered on similar debt instruments. The fair values of variable rate borrowings are based on carrying value. The carrying amount of accrued interest payable approximates its fair value.

Commitments to fund loans/standby letters of credit: The fair values of commitments are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. The differences between the carrying value of commitments to fund loans or standby letters of credit and their fair value are not significant and, therefore, are not included in the following table.

(in thousands)	December 31, 2008		December 31, 2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and due from banks	\$ 3,650	\$ 3,650	\$ 5,695	\$ 5,695
Federal funds sold	-	-	7,110	7,110
Time deposits in banks	-	-	80	80
Investment securities	41,183	41,183	40,426	40,426
Loans, net of allowance	299,645	339,987	267,067	273,157
Investment in FHLB stock	2,942	N/A	2,850	N/A
Accrued interest receivable	2,050	2,050	1,827	1,827
Financial liabilities:				
Deposits	\$ 252,763	\$ 254,093	\$ 249,019	\$ 248,928
FHLB advances	55,420	56,664	42,600	42,096
Accrued interest payable	345	345	426	426

#### 14. FAIR VALUE

FASB Statement 157 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 standard 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 reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The fair values of most securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used to in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

## Assets Measured on a Recurring Basis

Assets measured at fair value on a recurring basis are summarized below:

### Fair Value Measurements at December 31, 2008 (In thousands)

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:			
Securities available for sale	\$ 2,558	\$ 38,625	\$ -

## 15. SUBSEQUENT EVENT

On January 26, 2009, the Board of Directors declared a \$.09 per common share cash dividend to shareholders of record at the close of business on February 12, 2009, to be paid on or about February 23, 2009 and a preferred stock dividend of \$66,000 payable on February 17, 2009.

## 16. QUARTERLY FINANCIAL DATA (Unaudited)

(in thousands except EPS data)	2008				
	Interest income	Net Interest Income	Net Income (Loss)	Earnings (Loss) Per Common Share	
				Basic	Common
First quarter	\$ 5,442	\$ 2,647	\$ 230 (1)	\$ 0.05	\$ 0.05
Second quarter	5,336	3,062	584	0.12	0.12
Third quarter	5,441	3,291	(569) (2)	(0.12)	(0.12)
Fourth quarter	5,335	3,343	764	0.16	0.16
	2007				
	Interest income	Net Interest Income	Net Income	Earnings Per Common Share	
Basic				Common	
First quarter	\$ 5,533	\$ 2,764	\$ 592	\$ 0.12	\$ 0.12
Second quarter	5,607	2,635	400	0.08	0.08
Third quarter	5,822	2,731	509	0.11	0.10
Fourth quarter	5,793	2,721	441	0.09	0.09

- (1) Net income for the first quarter of 2008 includes the impact of \$189,000 of expenses associated with senior officer changes and \$140,000 of expenses related to a core data processor change.
- (2) Net income for the third quarter of 2008 includes the impact of a \$2.3 million securities impairment charge.

**FEDERAL DEPOSIT INSURANCE CORPORATION**

Washington, D.C. 20429

**FORM 10-K**

- Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the Fiscal Year Ended December 31, 2008
- Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from  
\_\_\_ to \_\_\_.

FDIC Certificate Number 32203

**Summit State Bank**

(Exact name of registrant as specified in its charter)

California 94-2878925  
(State of incorporation) (I.R.S. Employee Identification No.)

500 Bicentennial Way, Santa Rosa, California 95403  
(Address of principal executive offices)  
(707) 568-6000  
(registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:  
Common Stock, no par value, registered on the NASDAQ Stock Market, LLC

Securities registered pursuant to Section 12(g) of the Act:  
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a no accelerated filer or smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act). (Check one)

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark if the registrant is a shell company, in Rule 12b(2) of the Exchange Act. Yes  No

The aggregate market value of the Common Stock held by nonaffiliated was approximately \$25,760,000 (based upon the closing price of shares of the registrant's Common Stock, no par value, as reported by the NASDAQ Stock Market, LLC on June 30, 2008.) The number of shares outstanding of the registrant's common stock (no par value) at the close of business March 26, 2009 was 4,744,720.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's Proxy Statement for the 2009 Annual Meeting of Shareholders to be filed within 120 days of the fiscal year ended December 31, 2008 are incorporated by reference into Part III.

**SUMMIT STATE BANK  
CROSS REFERENCE INDEX**

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**SUMMIT STATE BANK**  
**ANNUAL REPORT ON FORM 10-K**

**PART I**

**DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS**

This report contains certain statements that are forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Actual outcomes and results may differ materially from those expressed in, or implied by, our forward-looking statements. Words such as “expects,” “anticipates,” “believes,” “estimates” and other similar expressions or future or conditional verbs such as “will,” “should,” “would” and “could” are intended to identify such forward-looking statements. Readers of this annual report of the Summit State Bank (also referred to as we, us or our) should not rely solely on the forward-looking statements and should consider all uncertainties and risks throughout the report.

Forward-looking statements, by their nature, are subject to risks, uncertainties and assumptions. Our future results and shareholder values may differ significantly from those expressed in these forward-looking statements. You are cautioned not to put undue reliance on any forward-looking statement. The statements are representative only as of the date they are made, and we undertake no obligation to update any forward-looking statement. However, your attention is directed to any further disclosures made on related subjects in any subsequent reports we may file with the Federal Deposit Insurance Corporation (“FDIC”), including on Forms 10-K, 10-Q and 8-K, in the event we become required to make such filings.

**ITEM 1. BUSINESS**

**INFORMATION ABOUT SUMMIT STATE BANK**

**General**

Summit State Bank (the “Bank”) is a state-chartered commercial bank operating a traditional community banking business within our primary service area of Sonoma County in California. We operate through five offices located in Santa Rosa, Rohnert Park, Windsor and Petaluma.

The Bank was incorporated on December 20, 1982 and commenced operations as a California state-chartered savings and loan in 1982. On January 15, 1999, the Bank received authority to convert its charter to a California state-chartered commercial bank. On July 13, 2006, the Bank completed an underwritten initial public offering and listed its stock on the Nasdaq Global Market under the symbol SSBI. The Bank’s deposits are insured by the FDIC in accordance with the Federal Deposit Insurance Act and the related regulations.

We provide a broad array of financial services to small-to medium-sized businesses, and their owners and employees, professionals and professional associations, entrepreneurs, high net worth families, foundations, estates and to individual consumers. We believe that our principal

competitive advantages are personal service, flexibility and responsiveness to customer needs. Our lending activities are primarily focused on commercial real estate, construction, and business loans to our targeted clientele.

We emphasize relationship banking and we believe we offer our customers many of the management capabilities of a large financial institution, together with the resourcefulness and superior customer service of a community bank. Through our branches and the use of technology, we offer a broad array of deposit products and services for both commercial and consumer customers, including electronic banking, cash management services and electronic bill payment. We provide a comprehensive set of loan products, such as commercial loans and leases, lines of credit, commercial real estate loans, Small Business Administration, or SBA, loans, residential mortgage loans, home equity lines of credit and construction loans. We believe that local decision making ensures that our lending process is fast, efficient, and focused on maintaining our high credit quality and underwriting standards.

The Bank's only subsidiary is ALTO Service Corporation, which is a wholly owned subsidiary, incorporated in California. Its purpose is to act as trustee on the Bank's deeds of trust and perform reconveyances. The assets of ALTO Service Corporation consist exclusively of cash on deposit with the Bank. It has no employees and its operations and balance sheet are not material to the Bank's consolidated operating income or financial condition.

## **Services and Financial Products**

### ***Deposit Products***

The Bank offers a wide range of deposit accounts designed to attract commercial businesses, professionals, and residents in its primary service area. These accounts include personal and business checking accounts, money market accounts, time certificates of deposit, sweep accounts and specialized deposit accounts, including professional accounts, small business "packaged" accounts, and tiered accounts designed to attract larger deposits, and Keogh and IRA accounts.

### ***Lending Products***

The Bank also offers a full complement of lending products designed to meet the specialized needs of its customers, including commercial and industrial lines of credit and term loans, credit lines to individuals, equipment loans, real estate and construction loans, small business loans of which a portion may be guaranteed by the SBA, and business lines of credit. The Bank has the designation of "Preferred Lender" by the SBA, which allows for expedited loan approval and funding. The Bank also offers consumer loans, including auto loans, mortgage loans, home improvement loans, and home equity lines of credit. The Bank offers loans in amounts which exceed the Bank's lending limits through participation arrangements with correspondent banks. On a selective basis, the Bank also offers loans for accounts receivable and inventory financing, loans to agriculture-related businesses, and equipment and expansion financing programs.

### ***Brokered Deposits and CDARS***

The Bank will accept brokered deposits when it is determined to be advantageous over other time deposits through its branch system. The Bank is a member of a special network (Promontory Interfinancial Network) offering a time deposit product called CDARS. When a customer places a large deposit with the Bank as a network member, the Bank can place the funds into certificates of deposit issued by other banks in the network in increments of less than \$100,000, so that both principal and interest are eligible for complete FDIC protection. Other banks do the same thing with their customer funds. The network banks exchange deposits on a dollar-for-dollar basis, bringing the full amount of the original deposit back to the originating bank. Because the originating bank comes out “whole,” it can make the full amount of deposits received available for community lending purposes or other initiatives of its choosing. Deposits placed using CDARS meet the pass-through insurance coverage guidelines established by the FDIC and the depositor can obtain up to \$25 million in FDIC insurance coverage. The deposits received by the Bank from other network members in exchange for the Bank’s customers’ deposits placed in the program are reported as brokered deposits for FFIEC Call Report purposes. Deposit funding raised through the CDARS product can vary significantly between financial reporting periods. CDARS and other brokered deposits totaled \$66,403,000 or 26% of deposits at December 31, 2008, and \$20,842,000 or 8% of deposits at December 31, 2007.

### ***State of California Approved Depository***

The Bank is an approved depository for the deposit of funds of the State of California. These time deposits are placed by the Treasurer of the State of California and have maturities of three to six months, and are collateralized by investment securities, mortgage loans or letters of credit issued by the Federal Home Loan Bank (“FHLB”). These deposits totaled \$40,000,000 or 16% of deposits at December 31, 2008 and \$38,000,000 or 15% of deposits at December 31, 2007.

### ***Internet and Telephone Banking Services***

The Bank offers a computerized internet banking system, accessible on the Internet at the Bank’s website [www.summitstatebank.com](http://www.summitstatebank.com), that enables its customers to view account information, access cash management services (including the initiation of automated clearinghouse payments), make transfers between accounts, pay bills, make loan payments, pre-schedule deposit transfers and request loan draws, and view both the front and back of cleared deposit items. The Bank also offers telephone banking services that enable customers to obtain account information, make transfers between accounts, make stop payments, check cleared items, and pre-schedule deposit transfers and loan payments.

### ***Other Services***

Other services which the Bank offers include banking by appointment, online banking services, direct payroll and social security deposits, letters of credit, access to national automated teller machine networks, courier services, safe deposit boxes, night depository facilities, notary services, travelers checks, lockbox, and banking by mail.

Management evaluates the Bank’s services on an ongoing basis, and adds or discontinues services based upon customer needs, competitive factors, and the financial and other capabilities

of the Bank. Future services may also be significantly influenced by improvements and developments in technology and evolving state and federal regulations.

### **Sources of Business**

In marketing its services, the Bank capitalizes on its identity as a local, community bank, with officers, Directors and shareholders who have business and personal ties to the community. Small to medium-sized businesses are targeted, as well as accounting, insurance, legal and medical professionals.

The Bank competes with other financial institutions in its service area through localized promotional activities, personalized service, and personal contact with potential customers by Executive Officers, Directors, employees and shareholders. Promotional activities include direct mail, media advertising, community advisory groups and Executive Officer participation in community business and civic groups. Executive Officers and Directors are active members of the community who call personally on their business contacts and acquaintances in the Sonoma County area to become customers.

The Bank employs business development officers to solicit loans and deposits from local businesses and professionals.

### **Competition**

The banking business in California generally, and in the Bank's service area in particular, is highly competitive with respect to both loans and deposits and is dominated by a relatively small number of major banks that have offices operating over wide geographic areas. The Bank competes for deposits and loans with these banks as well as with savings and loan associations, credit unions, mortgage companies, money market funds, stock brokerage firms, insurance companies, and other traditional and non-traditional financial institutions.

Major financial institutions with offices in the service area include Bank of America, Wells Fargo Bank, and Washington Mutual Bank which is now operated by JP Morgan Chase. Regional and independent financial institutions with offices in our service area include, among others, Sonoma Bank (part of Sterling Savings Bank), Luther Burbank Savings, Exchange Bank, and Westamerica Bank.

The major banks and some of the other institutions have the ability to finance extensive advertising campaigns and to shift their resources to regions or activities of greater potential profitability. Many of the competing banks and other institutions offer diversified financial services which may not be directly offered by the Bank. The major banks also have substantially more capital and higher lending limits.

The Bank competes for customers' funds with governmental and private entities issuing debt or equity securities or other forms of investments which may offer different or higher yields than those available through bank deposits.

Existing and future state and federal legislation could significantly affect the Bank's cost of doing business, its range of permissible activities, and the competitive balance among major, regional and independent banks, and other financial institutions. Management cannot predict the impact these matters may have on commercial banking in general or on the business of the Bank in particular.

To compete with the financial institutions operating in the Bank's service area, the Bank relies upon its independent status to provide flexibility and personalized service to its customers. The Bank emphasizes personal contacts with potential customers by Executive Officers, Directors and employees, develops local promotional activities, and seeks to develop specialized or streamlined services for customers. To the extent customers desire loans in excess of its lending limits or services not offered by the Bank, the Bank attempts to assist customers in obtaining such loans or other services through participations with other banks or assistance from correspondent banks.

### **Our Address, Telephone Number and Internet Website**

Our principal executive offices are located at 500 Bicentennial Way, Santa Rosa, California 95403, and our telephone number is (707) 568-6000. Information about us is available at [www.summitstatebank.com](http://www.summitstatebank.com). The information on our website is not incorporated by reference into and does not form a part of this report.

## REGULATION AND SUPERVISION

### Overview

The Bank is extensively regulated by federal and state authorities. As a California state-chartered commercial bank with deposit accounts insured by the FDIC to the maximum amount permitted by law, the Bank is regulated, supervised and examined by the Commissioner and the FDIC. The Bank must also comply with certain regulations issued by the FRB. The regulations of the Commissioner, the FRB and the FDIC govern most aspects of the Bank's business, including the making of periodic reports by the Bank, as well as the Bank's activities relating to dividends, investments, loans, borrowings, capital requirements, certain check-clearing activities, branching, mergers and acquisitions, reserves against deposits, the issuance of securities and numerous other areas. The Bank is also subject to the requirements and restrictions of various consumer laws and regulations, as well as applicable provisions of California law, insofar as they do not conflict with and are not preempted by federal banking laws. Supervision, legal action and examination of the Bank by the regulatory agencies are generally intended to protect depositors and are not intended for the protection of shareholders.

Statutes, regulations and policies affecting the banking industry are frequently under review by the U.S. Congress and state legislatures, and by the federal and state agencies charged with supervisory and examination authority over banking institutions. Changes in the banking and financial services industry can be expected to occur in the future. Some of the changes may create opportunities for the Bank to compete in financial markets with less regulation. However, these changes also may create new competitors in geographic and product markets which have historically been limited by law to insured depository institutions such as the Bank. Changes in the statutes, regulations or policies that affect the Bank cannot be predicted and may have a material effect on the Bank's business and earnings. In addition, the regulatory agencies which have jurisdiction over the Bank have broad discretion in exercising their supervisory powers. For example, the FDIC has authority under federal law to prohibit a state bank from engaging in banking practices which it considers unsafe and unsound.

The laws of the State of California affect the Bank's business and operations. The California Financial Code provides that if the Commissioner believes that a bank is violating its articles of incorporation or state law, or is engaging in unsafe or injurious business practices, the Commissioner can order that bank to comply with the law or to cease the unsafe or injurious practices and has authority to impose civil money penalties. The Commissioner has the power to suspend or remove bank officers, directors and employees who violate any law or regulation relating to the business of the bank or breach any fiduciary duty to the bank, engage in any unsafe and unsound practices related to the business of the bank, or are charged with or convicted of a felony involving dishonesty or breach of trust. The Commissioner also has authority to take possession of and to liquidate a bank, to appoint a conservator for a bank and to appoint the FDIC as receiver for a bank.

The FDIC can pursue an enforcement action against a bank for unsafe and unsound practices in conducting its business, or for violations of any law, rule or regulation or provision, any consent order with any agency, any condition imposed in writing by the agency, or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or

receiver, cease-and-desist orders and written agreements, the termination of insurance of deposits, the imposition of civil money penalties and removal and prohibition orders against institution-affiliated parties.

In addition to the regulation and supervision outlined above, banks must be prepared for judicial scrutiny of their lending and collection practices. For example, some banks have been found liable for exercising remedies which their loan documents authorized upon the borrower's default. This has occurred in cases where the exercise of those remedies was determined to be inconsistent with the previous course of dealing between those banks and the borrowers. As a result, banks have had to exercise increased caution, incur greater expense and face increased exposure to liability when dealing with defaulting loans.

## **Recent Developments**

### **Troubled Asset Relief program and Related Measures**

On October 3, 2008, Congress adopted the Emergency Economic Stabilization Act ("EESA"), including a Troubled Asset Relief Program ("TARP"). TARP gave the United States Treasury Department ("Treasury") authority to deploy up to \$700 billion into the financial system for the purpose of improving liquidity in capital markets. On October 14, 2008, Treasury announced plans to direct \$250 billion of this authority into preferred stock investments in banks and bank holding companies through a Capital Purchase Program ("CPP"). The general terms of this CPP are as follows:

- Treasury's investment must be between 1% and 3% of the issuer's risk-weighted assets;
- Treasury's preferred stock earns 5% dividends for the first five years and 9% dividends thereafter; dividends on preferred stock issued by holding companies are cumulative; dividends on preferred stock issued by banks without holding companies are non-cumulative;
- No increase in common stock dividends for three years while Treasury is an investor;
- Treasury's consent is required for common stock repurchases;
- Treasury receives warrants for common stock equal to 15% of Treasury's total investment, with an exercise price based on the common stock's market price;
- Participating bank executives must agree to certain compensation restrictions and executive compensation above \$500,000 may not be claimed as a tax deduction;
- If an issuer fails to pay dividends for six quarters, whether or not consecutive, Treasury is entitled to appoint two persons to the issuer's board of directors.

For private companies whose stock is not traded on an exchange and companies that are Subchapter S corporations, the terms are similar to those set forth above with certain differences.

The Bank elected to participate in the CPP by issuing \$8,500,000 in non-cumulative preferred stock to Treasury and, upon Treasury's exercise of the warrant, 239,212 shares of common stock. The transaction was completed on December 19, 2008.

Under EESA, certain temporary increases in FDIC deposit insurance have also been approved.

From October 3, 2008, until December 31, 2009, the amount of deposit insurance provided by the FDIC is increased from \$100,000 to \$250,000. This temporary increase is automatic.

In addition, any depository institution will be able to provide full deposit insurance coverage until December 31, 2009, for non-interest bearing deposit transaction accounts, attorney trust accounts, and NOW accounts paying not more than 50 basis points of interest regardless of dollar amount. These accounts are mainly payment-processing accounts, such as payroll accounts used by businesses. Participants will be charged a 10-basis point surcharge to current insurance assessments for this additional coverage. The Bank is participating in this aspect of the program.

The transaction documents for the Capital Purchase Program give Treasury the unilateral right to change or add additional terms to the agreements. Congress and Treasury are currently contemplating possible changed or additional terms, with substantial focus on executive compensation, tracking the use of TARP funds received by financial institutions and possible foreclosure relief.

The American Recovery and Reinvestment Act of 2009 (“ARRA”) was signed into law on February 17, 2009. ARRA includes a wide variety of programs intended to stimulate the economy. In addition, ARRA imposes new executive compensation and expenditure limits on all previous and future TARP CPP recipients, such as the Bank, and expands the class of employees to whom the limits and restrictions apply. ARRA also provides the opportunity for additional repayment flexibility for existing TARP CPP recipients.

Among other things, ARRA prohibits the payment of bonuses, other incentive compensation and severance to certain of the company’s most highly paid employees (except in the form of restricted stock subject to specified limitations and conditions), and requires each TARP recipient to comply with certain other executive compensation related requirements. However, both the ARRA and the existing Treasury guidelines contemplate that the Secretary of the Treasury will adopt standards to provide additional guidance regarding how the executive compensation restrictions under the ARRA and EESA will be applied.

Treasury has announced a new program known as the Capital Assistance Program (“CAP”). The CAP provides for Treasury to invest additional capital in financial institutions in exchange for preferred stock that accrues cumulative dividends at 9%, is convertible to common stock at the issuer’s option at 90% of the average market price for the 20 trading days ending February 9, 2009 (subject to reduction if required shareholder approvals are not obtained timely) and automatically converts to common stock after seven years if not previously redeemed. CAP participants cannot pay quarterly dividends in excess of \$0.01 per share without Treasury’s approval. The executive compensation requirements that apply to TARP also apply to the CAP. Applicants for CAP assistance must submit a plan describing their intended use of CAP funds. The Bank does not expect to participate in the CAP.

## **Deposit Insurance Premiums**

The FDIC has developed a risk-based assessment system that provides that the assessment rate for an insured depository institution will vary according to the level of risk incurred in its activities. Through December 31, 2008, an institution's risk category was based upon whether the institution is well capitalized, adequately capitalized or less than adequately capitalized. The FDIC assigns each DIF member institution an annual FDIC assessment rate on insured deposits.

Effective January 1, 2009, banks pay from 12 basis points to 50 basis points on deposits annually for deposit insurance. The FDIC has proposed changes to the deposit insurance assessment system beginning with the second quarter of 2009 to make the increase in assessments fairer by requiring riskier institutions to pay a larger share. Institutions would be classified into one of four risk categories. Within each category, the FDIC will be able to assess higher rates to institutions with a significant reliance on secured liabilities, which generally raises the FDIC's loss in the event of failure without providing additional assessment revenue. The proposal also would assess higher rates for institutions with a significant reliance on brokered deposits but, for well-managed and well-capitalized institutions, only when accompanied by rapid asset growth. The proposal also would provide incentives in the form of a reduction in assessment rates for institutions to hold long-term unsecured debt and, for smaller institutions, high levels of Tier 1 capital. Together, the changes would improve the way the system differentiates risk among insured institutions and help ensure that the reserve ratio returns to at least 1.15 percent by the end of 2013.

In addition, on February 27, 2009, the FDIC announced a special emergency assessment of 20 basis points payable September 30, 2009, with the possibility of an additional emergency assessment.

## **Limitations on Dividends**

Under California law the holders of the Bank's common stock are entitled to receive dividends out of funds legally available for the payment of dividends when and as declared by the Board of Directors, provided the conditions described below are satisfied.

The payment of cash dividends by the Bank depends on various factors, including the earnings and capital requirements of the Bank and other financial conditions. California law provides that, as a state-licensed bank, the Bank may not make a cash distribution to its shareholders in excess of the lesser of the following: (a) the Bank's retained earnings or (b) the Bank's net income for its last three fiscal years, less the amount of any distributions made by the Bank to its shareholders during that period. However, a bank such as the Bank, with the prior approval of the Commissioner, may make a distribution to its shareholders of an amount not to exceed the greater of (1) the Bank's retained earnings, (2) the Bank's net income for its last fiscal year, or (3) the Bank's net income for the current fiscal year. If the Commissioner determines that the shareholders' equity of the Bank is inadequate or that the making of a distribution by the Bank would be unsafe or unsound, the Commissioner may order the Bank to refrain from making a proposed distribution.

The FDIC and the Commissioner have authority to prohibit a bank from engaging in business practices which are considered to be unsafe or unsound. Depending upon the financial condition of bank and upon other factors, the FDIC or the Commissioner could assert that payments of dividends or other payments by the Bank might be an unsafe or unsound practice.

Under the terms of the preferred stock issued to Treasury in its TARP transaction, the Bank cannot pay dividends on its common stock unless it has paid the most recent dividend accrued on Treasury's preferred stock.

### **Capital Adequacy Guidelines**

Federal bank regulatory agencies have adopted risk-based capital guidelines for insured banks. A bank's total qualifying capital consists of two types of capital components: "core capital elements," known as Tier 1 capital, and "supplementary capital elements," known as Tier 2 capital. The Tier 1 component of a bank's qualifying capital must represent at least 50% of total qualifying capital. Tier 1 capital consists of common equity, non-cumulative perpetual preferred stock and minority interests in the equity accounts of consolidated subsidiaries. Tier 1 capital excludes goodwill and other specified intangibles, as well as the equity impact of adjusting available-for-sale securities to market value. In addition to the Tier 1 capital components, total capital also includes cumulative perpetual preferred stock, trust preferred stock, limited-life preferred stock, mandatory convertible securities, subordinated debt and general loan loss reserves up to a limit of 1.25% of risk-weighted assets.

The guidelines make regulatory capital requirements sensitive to the differences in risk profiles among banking institutions, take off-balance-sheet items into account when assessing capital adequacy, and minimize disincentives to holding liquid low-risk assets.

These guidelines require a minimum total risk-based capital ratio of 8% of risk-weighted assets, with at least 4% in the form of Tier 1 capital. Federal banking regulators also have instituted minimum leverage ratio guidelines for financial institutions. The leverage ratio guidelines require maintenance of a minimum ratio of 3% Tier 1 capital to adjusted quarterly average assets for the most highly rated bank holding company organizations. Less highly rated institutions and institutions that are anticipating significant growth or that face other significant risks are required to maintain capital levels ranging from 1% to 2% above the 3% minimum. In addition, all banks are generally expected to maintain capital above these minimums.

Federal banking agencies, including the FDIC, have adopted regulations implementing a system of prompt corrective action under the Federal Deposit Insurance Corporation Improvement Act. The regulations establish five capital categories with the following characteristics: (1) "Well-capitalized," consisting of institutions with a total risk-based capital ratio of 10% or greater, a Tier 1 risk-based capital ratio of 6% or greater and a leverage ratio of 5% or greater and which are not operating under an order, written agreement, capital directive or prompt corrective action directive; (2) "Adequately capitalized," consisting of institutions with a total risk-based capital ratio of 8% or greater, a Tier 1 risk-based capital of 4% or greater and a leverage ratio of 4% or greater and which do not meet the definition of a "well-capitalized"

institution; (3) "Undercapitalized," consisting of institutions with a total risk-based capital ratio of less than 8%, a Tier 1 risk-based capital ratio of less than 4%, or a leverage ratio of less than 4%; (4) "Significantly undercapitalized," consisting of institutions with a total risk-based capital ratio of less than 6%, a Tier 1 risk-based capital ratio of less than 3%, or a leverage ratio of less than 3%; and (5) "Critically undercapitalized," consisting of institutions with a ratio of tangible equity to total assets that is equal to or less than 2%. Banks are subject to sanctions of increasing severity for failure to maintain capital ratios at well-capitalized or adequately-capitalized levels.

As of December 31, 2008, the Bank was well-capitalized and had a total risk-based capital ratio of 18.6%, a Tier-1 risk-based capital ratio of 17.4% and a leverage ratio of 14.8%.

### **Programs To Mitigate Identity Theft**

In November 2007, federal banking agencies together with the NCUA and FTC adopted regulations under the Fair and Accurate Credit Transactions Act of 2003 to require financial institutions and other creditors to develop and implement a written identity theft prevention program to detect, prevent and mitigate identity theft in connection with certain new and existing accounts. Covered accounts generally include consumer accounts and other accounts that present a reasonably foreseeable risk of identity theft. Each institution's program must include policies and procedures designed to: (i) identify indicators, or "red flags," of possible risk of identity theft based; (ii) detect the occurrence of red flags; (iii) respond appropriately to red flags that are detected; and (iv) ensure that the program is updated periodically as appropriate to address changing circumstances. The regulations include guidelines that each institution must consider and, to the extent appropriate, include in its program.

### **Legislation and Proposed Changes**

From time to time, legislation is enacted which has the effect of increasing the cost of doing business, limiting or expanding permissible activities or affecting the competitive balance between banks and other financial institutions. Proposals to change the laws and regulations governing the operations and taxation of banks, bank holding companies and other financial institutions are frequently made in Congress, in the California legislature and before various bank regulatory agencies. For example, from time to time Congress has considered various proposals to eliminate the federal thrift charter, create a uniform financial institutions charter, conform holding company regulation, and abolish the Office of Thrift Supervision. Typically, the intent of this type of legislation is to strengthen the banking industry. No prediction can be made as to the likelihood of any major changes or the impact that new laws or regulations might have on the Bank.

## **Employees**

As of December 31, 2008, the Bank employed a total of 49 full-time and 10 part-time employees in various capacities, all located in California. The Bank's employees are not represented by any union or covered by any collective bargaining agreement. The Bank considers its relationships with its employees to be good.

## **ITEM 1A. RISK FACTORS**

The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This report is qualified in its entirety by these risk factors.

### ***Current Market Developments May Adversely Affect Our Industry, Business and Results of Operations.***

Dramatic declines in the housing market during the prior year, with falling home prices and increasing foreclosures and unemployment, have resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities and major commercial and investment banks. These write-downs, initially of mortgage-backed securities but spreading to credit default swaps and other derivative securities, have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions and, in some cases, to fail. Many lenders and institutional investors, concerned about the stability of the financial markets generally and the strength of counterparties, have reduced or ceased to provide funding to borrowers, including other financial institutions. The resulting lack of available credit, lack of confidence in the financial sector, increased volatility in the financial markets and reduced business activity could materially and adversely affect our business, financial condition and results of operations.

### ***There Can Be No Assurance that the Recently Enacted Emergency Economic Stabilization Act of 2008 ("EESA") and American Recovery and Reinvestment Act ("ARRA") Will Help Stabilize the U.S. Financial System.***

The EESA evolved from the U.S. Treasury's initial proposal in response to the financial crises affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions. This was followed by the ARRA. The U.S. Treasury and banking regulators are implementing a number of programs under this legislation to address capital and liquidity issues in the banking system. There can be no assurance, however, as to the actual impact that the EESA or ARRA will have on the financial markets, including the extreme levels of volatility and limited credit availability currently being experienced. The failure of the EESA or ARRA to help stabilize the financial markets and a continuation or worsening of current financial market conditions could materially and adversely affect our business, financial condition, results of operations, access to credit or the trading price of our common stock.

### ***Premiums for Federal Deposit Insurance Will Increase and May Increase More.***

Recent failures have caused the FDIC's deposit insurance fund to fall below the minimum balance required by law, forcing the FDIC to consider action to rebuild the fund by raising the insurance premiums assessed member banks. The FDIC increased premiums by seven basis points in January 2009, with additional increases for institutions with greater risk profiles starting in the second quarter. It also announced an additional emergency assessment of 20 basis points on February 27, 2009, and the possibility of another emergency assessment in the future. Depending on the frequency and severity of bank failures, future increases in premiums or assessments could be significant and negatively affect our earnings.

### ***Our Share Price May Be Volatile***

As of December 31, 2008, there were 4,744,720 shares of our common stock issued and outstanding. The Bank's common stock is listed on the Nasdaq Global Market under the symbol "SSBI." Factors such as announcements of developments related to the Bank's business, announcements by competitors, fluctuations in its financial results, general conditions in the banking industry, economic conditions in the areas in which the Bank does business, fluctuations in interest rates, and other factors could cause the price of the Shares to fluctuate substantially. In addition, in recent years the stock market in general and the market for shares of small capitalization stocks and financial institutions in particular have experienced extreme price fluctuations, which have often been unrelated to the operating performance of affected companies. Such fluctuations could have a material adverse effect on the market price of the Shares.

### ***The Bank Is Highly Dependent on Real Estate and Events that Negatively Impact the Real Estate Market Could Hurt Our Business***

A significant portion of our loan portfolio is dependent on real estate. At December 31, 2008, real estate served as the principal source of collateral with respect to approximately 74% of our loan portfolio. Our financial condition may be adversely affected by a decline in the value of the real estate securing our loans and, while we presently hold no real estate acquired through foreclosure or other judicial proceeding, a decline in the value of real estate that may be owned by us, through foreclosure or otherwise, in the future could adversely impact our financial condition. In addition, acts of nature, including earthquakes, brush fires and floods, which may cause uninsured damage and other loss of value to real estate that secures these loans, may also negatively impact our financial condition. This is particularly significant in light of the fact that substantially all of the real estate that makes up the collateral of our real estate secured loans is located in Northern California, where earthquakes and brush fires are common.

### ***The Bank's Business Is Highly Competitive***

In California generally, and in the Bank's service area specifically, major banks and regional banks dominate the commercial banking market. By virtue of their larger capital bases, such institutions have substantially greater financial, marketing and operational resources than the Bank and offer diversified services that might not be directly offered by the Bank. The Bank

competes with these larger commercial banks and other financial institutions, such as savings and loan associations and credit unions, which offer services traditionally offered only by banks. In addition, the Bank competes with other institutions such as money market funds, brokerage firms, commercial finance companies, leasing companies, and even retail stores seeking to penetrate the financial services market. No assurance can be given, however, that the Bank's efforts to compete with other banks and financial institutions will continue to be successful. In addition, the costs of providing a high level of personal service could adversely affect the Bank's operating results. See "Information About Summit State Bank — Competition" on page 63.

### ***The Bank Depends on Loan Originations to Grow Its Business***

The Bank's success depends on, among other things, its ability to originate loans. The Bank's competitors may offer better terms or better service, or respond to changing capital and other regulatory requirements better than the Bank is able to do. Some of the Bank's competitors make loans on terms that the Bank is not willing to match. Success in competing for loans depends on such factors as:

- Quality of service to borrowers, especially the time it takes to process loans;
- Economic factors, such as interest rates;
- Terms of the loans offered, such as rate adjustment provisions, adjustment caps, loan maturities, loan-to-value ratios and loan fees; and
- Size of the loan.

### ***The Bank Is Subject to Lending Risks***

The Bank intends to engage primarily in commercial lending; however, other products such as consumer and real estate mortgage lending are offered as well. All lenders face the risk that some of their borrowers will not repay their loans. The ability of borrowers to repay their obligations can be adversely affected by factors beyond the control of the Bank, including local and general economic and market conditions. A substantial portion of the Bank's loans are secured by liens on real estate. These same factors may adversely affect the value of real estate taken as collateral. The Bank maintains the allowance for loan losses to reflect the level of losses determined by management to be inherent in the loan portfolio. Each increase made in the allowance for loan losses ("provision") results in a charge against the Bank's earnings in the financial period in which the increase is made. However, the level of the allowance for loan losses and the amount of the provision are estimates based on management's judgment, and there can be no assurance that actual losses incurred will not exceed the amount of the allowance or require substantial additional increases to the allowance. See "Information About Summit State Bank — Services and Financial Products" on page 61-63.

### ***The Bank's Business is Subject to Extensive Government Regulation and Legislation***

The Bank is subject to extensive state and federal regulation, supervision and legislation, and the laws that govern The Bank and its operations are subject to change from time to time. Applicable laws and regulations provide for the regular examination and supervision of institutions; affect the cost of funds through reserve requirements and assessments on deposits; limit or prohibit the payment of interest on demand deposits; limit the kinds of investments a bank or bank holding company can make and the kinds of activities in which it can engage; and grant the regulatory agencies broad enforcement authority in case of violations. The laws and regulations increase the cost of doing business and have an adverse impact on the ability of the Bank to compete efficiently with other financial services providers that are not similarly regulated. There can be no assurance that future regulation or legislation will not impose additional requirements and restrictions on the Bank in a manner that will adversely affect its results of operations, financial condition and prospects. See “Information About Summit State Bank — Competition” and “Regulation and Supervision” on pages 63-70.

### ***Limited Capital May Adversely Affect the Bank's Ability to Do Business***

Under applicable government regulations, the Bank is permitted to make unsecured loans to any single borrower or group of related borrowers in an amount that will not exceed 15% of its shareholders' equity, plus the allowance for loan losses, capital notes and debentures, and secured loans in an amount that, when combined with unsecured loans made to the same borrower or group of related borrowers, will not exceed 25% of its shareholders' equity, plus the allowance for loan losses, capital notes and debentures (the “Lending Limits”). Such Lending Limits make it more difficult for the Bank to attract borrowers who have lending requirements in excess of those Lending Limits and, as a result, the future success of the Bank depends on, among other things, its ability to increase capital (and thereby the amount of the loans it will be able to make to borrowers) by selling additional common stock or preferred stock, subordinated notes that are senior in priority to the shares and any preferred stock, but junior in priority to depositors and creditors of the Bank (which are known as “Capital Notes”), or certain other securities, such as trust preferred securities. The Bank has no plans at this time to sell any additional common stock, preferred stock or Capital Notes or other securities (except upon issuance of options to directors and employees under its stock option plan). However, if the need to do so should arise, there is no assurance that the Bank's efforts to raise such additional capital will be successful or that the sale of additional shares will not dilute the ownership of current investors. The Bank seeks the participation of other banks and lending institutions, as co-lenders with it, for loans that exceed the Bank's Lending Limits; however, there can be no assurance that other lending institutions will be interested in doing so.

### ***The Bank's Business May Be Adversely Affected By General Economic Conditions Including Conditions in California***

The banking business is affected by general economic and political conditions, both domestic and international, and by governmental monetary and fiscal policies. Conditions such as inflation, recession, unemployment, volatile interest rates, money supply, scarce natural

resources, weather, natural disasters such as earthquakes, international disorders, etc., and other factors beyond the Bank's control may adversely affect the profitability of the Bank.

A substantial majority of the Bank's assets and deposits are generated in Northern California. As a result, poor economic conditions in Northern California may cause the Bank to incur losses associated with higher default rates and decreased collateral values in its loan portfolio. Economic conditions in Northern California are subject to various uncertainties at this time, including the state's budget deficit and the appreciation of real estate. If economic conditions in Northern California decline further, the Bank recognizes that its level of problem assets could increase accordingly.

### ***Failure to Successfully Execute Our Strategy Could Adversely Affect Our Performance***

Along with the other factors listed herein, our financial performance and profitability depends on our ability to execute our corporate growth strategy. Continued growth may present operating and other problems that could adversely affect our business, financial condition and results of operations. Accordingly, there can be no assurance that we will be able to execute our growth strategy or maintain the level of profitability that we have recently experienced. Our strategy relies in part on the opening of new branches. Our intent is to lease our branches. However, there can be no assurance that we will be able to achieve lease terms which are favorable. In certain cases, we may not be able to lease appropriate space in locations which we believe to be favorable to the growth of the Bank's business or we may need to purchase real estate instead of entering into lease arrangements, which would involve a significantly larger capital expenditure than leasing property.

### ***Our Business is Subject to Liquidity Risk and Changes in Our Source of Funds May Affect Our Performance and Financial Condition***

Our ability to make loans is directly related to our ability to secure funding. In addition to local deposits, the Bank receives funding from FHLB advances, brokered deposits and State of California time deposits, when such alternatives are attractive compared to the cost of attracting additional local deposits. These alternative sources of funds, along with local time deposits, are sensitive to interest rates and can affect the cost of funds and net interest margin. Liquidity risk arises from the inability to meet obligations when they come due or to manage the unplanned decreases or changes in funding sources. Although we believe we can continue to successfully pursue a local deposit funding strategy, significant fluctuations in local deposit balances or if one of the alternative source of funds becomes unavailable, an adverse effect on our financial condition and results of operations may be experienced.

### ***The Bank's Business Is Subject to Interest Rate Sensitivity***

The income of the Bank depends to a great extent on the difference between the interest rates earned on its loans, securities and other interest-earning assets and the interest rates paid on its deposits and other interest-bearing liabilities. These rates are highly sensitive to many factors that are beyond the Bank's control, including general economic conditions and the policies of various governmental and regulatory agencies, in particular the Federal Reserve Board ("FRB").

A change in interest rates could have a material adverse effect on the Bank's results of operations, financial condition and prospects by reducing the spread between income on interest earning assets and interest paid on interest bearing liabilities. See "Management's Discussion and Analysis of Financial Condition and Results of Operations-Liquidity and Capital Resources" on page 23.

***We Are Exposed to Risk of Environmental and Other Liabilities with Respect to Properties to Which We Take Title***

In the course of our business, we may foreclose and take title to real estate, and could be subject to environmental or other liabilities with respect to these properties. We may be held liable to a governmental entity or to third persons for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or we may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, in the event we become the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our business, financial condition, liquidity and results of operations could be materially and adversely affected.

***The Bank's Ability to Declare Future Dividends Is Subject to Certain Limitations***

The Bank's ability to pay dividends is limited by law and regulation and by the financial condition of the Bank. There can be no assurance that the Bank will continue to pay dividends at the rate and frequency at which it has done so in the past, or that any dividends will be declared and paid in the future at all. See "Regulation and Supervision-Limitations on Dividends" on page 68-69. Additionally the preferred stock purchase agreement entered into with the United States Department of the Treasury prohibits the payment of common stock dividends in excess of historical levels without obtaining the prior approval of the Treasury and the Bank cannot pay dividends on its common stock unless it has paid the most recent dividend accrued on the Treasury's preferred stock.

***The Accuracy of the Bank's Judgments and Estimates about Financial and Accounting Matters Will Impact Operating Results and Financial Condition***

The Bank makes certain estimates and judgments in preparing its financial statements. The quality and accuracy of those estimates and judgments will have an impact on the Bank's operating results and financial condition. See "MANAGEMENT'S DISCUSSION AND ANALYSIS-Critical Accounting Policies" beginning on page 4.

### ***The Bank's Information Systems May Experience an Interruption or Breach in Security***

The Bank relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Bank's customer relationship management and systems. There can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately corrected by the Bank. The occurrence of any such failures, interruptions or security breaches could damage the Bank's reputation, result in a loss of customer business, subject the Bank to additional regulatory scrutiny, or expose the Bank to litigation and possible financial liability, any of which could have a material adverse effect on the Bank's financial condition and results of operations.

### ***The Bank's Controls and Procedures May Fail or Be Circumvented***

Management regularly reviews and updates the Bank's internal control over financial reporting, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls and procedures, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the Bank's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Bank's business, results of operations and financial condition.

## **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

## **ITEM 2. PROPERTIES**

The Bank owns its head office building located at 500 Bicentennial Way, Santa Rosa, California. The building has approximately 31,000 square feet of usable space. The Bank occupies approximately 13,000 square feet as its headquarters. The remaining 18,000 square feet are currently leased to 3 tenants, with lease terms maturing from 2009 to 2013. The Bank also leases spaces for branch offices in four shopping centers. These leases expire at various dates through 2012 and include renewal and termination options and rental adjustment provisions.

## **ITEM 3. LEGAL PROCEEDINGS**

The nature of our business causes us to be involved in routine legal proceedings from time to time. As of the date of this report, the Bank is not a party to any litigation of any kind nor is the Bank aware of any threats of any litigation or administrative proceedings affecting the Bank.

#### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

There was no submission of matters to a vote of securities holders during the quarter ended December 31, 2008.

#### **PART II**

#### **ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

The common stock started trading on the NASDAQ on July 14, 2006, under the symbol "SSBI." Prior to July 14, 2006, the common stock had no established public trading market. The quotations shown below reflect for the periods indicated the high and low closing sales prices for our common stock as reported by NASDAQ.

<b>For the quarter ended</b>	<b>High</b>	<b>Low</b>	<b>Cash dividends declared</b>
December 31, 2008	\$ 6.10	\$ 4.30	\$ 0.09
September 30, 2008	6.99	5.20	0.09
June 30, 2008	9.50	6.95	0.09
March 31, 2008	8.24	7.31	0.09
December 31, 2007	9.99	7.85	0.09
September 30, 2007	12.01	9.56	0.09
June 30, 2007	13.39	10.75	0.09
March 31, 2007	13.47	12.46	0.09

There were 208 common stock shareholders of record at December 31, 2008

There were no issuer purchases of equity securities for the three month period ended December 31, 2008.

## **ITEM 6. SELECTED FINANCIAL DATA**

Information regarding Selected Financial Data appears on page 3 under the caption “SELECTED FINANCIAL DATA” and is incorporated herein by reference.

## **ITEM 7. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Information regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations appears on pages 4 - 24 under the caption “MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS” and is incorporated herein by reference.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Information regarding Quantitative and Qualitative Disclosures About Market Risk appears on pages 22 under the caption “QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK” and is incorporated herein by reference.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Information regarding Financial Statements and Supplementary Data appears on pages 25 - 56 under the captions “REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM,” “CONSOLIDATED BALANCE SHEETS,” “CONSOLIDATED STATEMENTS OF INCOME,” “CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS’ EQUITY,” “CONSOLIDATED STATEMENTS OF CASH FLOWS” and “NOTES TO CONSOLIDATED FINANCIAL STATEMENTS” and is incorporated herein by reference.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None

## **ITEM 9A. CONTROLS AND PROCEDURES**

### **(A) Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2008. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934, means controls and other procedures of a Bank that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that

information required to be disclosed by a company in the reports that it files and submits under the Exchange Act is accumulated and communicated to the Bank's management, including its principal executive and principle financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of December 31, 2008, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective.

The Audit Committee of the Board of Directors, which is composed solely of independent directors, meets regularly with our independent registered public accounting firm, Crowe Horwath LLP, and representatives of management to review accounting, financial reporting, internal control and audit matters, as well as the nature and extent of the audit effort. The Audit Committee is responsible for the engagement of the independent auditors. The independent auditors have free access to the Audit Committee.

#### (B) Management's Annual Report on Internal Control over Financial Reporting

The Bank's management is responsible for establishing and maintaining adequate control over financial reporting for the Bank, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. Under the supervision and with the participation of the Bank's management, including our principal executive and principal financial officers, the Bank conducted an evaluation of the effectiveness of its internal control over financial reporting based on the framework in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO Framework"). Based on this evaluation under the COSO Framework, management concluded that its internal control over financial reporting was effective as of December 31, 2008.

(C) Changes in Internal Control over Financial Reporting

During the quarter ended December 31, 2008, the Registrant did not make any significant changes in, nor take any corrective actions regarding, its internal control over financial reporting or other factors that has materially affected, or is reasonably likely to materially affect the registrants' internal control over financial reporting.

(D) Attestation Report of the Independent Registered Public Accounting Firm

This annual report does not include an attestation report of the Bank's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Bank's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Bank to provide only management's report in this annual report.

**ITEM 9B. OTHER INFORMATION**

None.

**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

We intend to file a definitive proxy statement for the 2009 Annual Meeting of Shareholders (or "the Proxy Statement") with the FDIC within 120 days of December 31, 2008. Information regarding directors of Summit State Bank will appear under the caption —Proposal 1: "Election of Directors" in the Proxy Statement and is incorporated herein by reference. Information about Summit State Bank's Audit Committee Financial Expert will appear under the caption "The Committees of the Board—Audit Committee" and is incorporated herein by reference. The Bank has adopted a code of ethics applicable to all of our directors and employees, including the principal executive officer, principal financial officer and principal accounting officer.

**ITEM 11. EXECUTIVE COMPENSATION**

Information regarding executive compensation will appear under the captions "EXECUTIVE OFFICERS OF THE BANK," "EXECUTIVE COMPENSATION, EMPLOYMENT CONTRACTS" AND BOARD OF DIRECTS REPORT ON COMPENSATION," in the Proxy Statement and is incorporated herein by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The following table summarizes information as of December 31, 2008 relating to equity compensation plans of Summit State Bank pursuant to which grants of options, restricted stock, or other rights to acquire shares may be granted from time to time.

<b>Plan category</b>	<b>Number of securities to be issued upon exercise of outstanding options</b>	<b>Weighted average exercise price of outstanding options</b>	<b>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</b>
Equity compensation plans:			
Not approved by security holders	30,666	\$7.26	0
Approved by security holders	25,000	9.35	125,000

Information regarding security ownership of certain beneficial owners and management and related shareholder matters will appear under the caption “EQUITY COMPENSATION PLAN INFORMATION,” “SECURITY OWNERSHIP OF MANAGEMENT” AND “PRINCIPAL SHAREHOLDERS” in the Proxy Statement and is incorporated herein by reference.

### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

Information regarding certain relationships and related transactions will appear under the caption “TRANSACTIONS WITH RELATED PERSONS” in the Proxy Statement and is incorporated herein by reference.

### **ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Information regarding fees paid to our independent registered public accounting firm, will appear under the caption —Proposal 2. Ratification of Selection of Independent Public Accounts “FEES PAID TO INDEPENDENT PUBLIC ACCOUNTANTS” in the Proxy Statement and is incorporated herein by reference.

## PART IV

### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

#### (a) 1. *Financial Statements*

The following documents are filed as part of this report:

Report of Independent Registered Public Accounting Firm  
Consolidated Balance Sheets at December 31, 2008 and 2007  
Consolidated Statements of Income for each of the years in the three-year period ended  
December 31, 2008  
Consolidated Statements of Changes in Shareholders' Equity for each of the years in the three-  
year period ended December 31, 2008  
Consolidated Statements of Cash Flows for each of the years in the three-year period ended  
December 31, 2008  
Notes to Consolidated Financial Statements

#### 2. *Financial Statement Schedules*

Not applicable

#### 3. *Exhibits*

##### (b) *Exhibits Required by Item 601 of Regulation S-K*

Reference is made to the Exhibit Index on pages 86 through 87 for exhibits filed as part of this report.

##### (c) *Additional Financial Statements*

Not applicable.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Summit State Bank

By \_\_\_\_\_ */s/ Dennis E. Kelley* \_\_\_\_\_ March 26, 2009

**Dennis E. Kelley**  
**Senior Vice President and**  
**Chief Financial Officer**  
**(Principal Financial and Accounting Officer)**

Summit State Bank

By \_\_\_\_\_ */s/ Thomas M. Duryea* \_\_\_\_\_ March 26, 2009

**Thomas M. Duryea**  
**President and**  
**Chief Executive Officer**  
**(Principal Executive Officer)**

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

Dated: 03/25/09 \_\_\_\_\_  
*/s/ Thomas M. Duryea*  
Thomas M. Duryea  
President, Chief Executive Officer (Principal Executive Officer) and Director

Dated: \_\_\_\_\_  
John F. DeMeo, Director

Dated: 03/25/09 \_\_\_\_\_  
*/s/ Michael J. Donovan*  
Michael J. Donovan, Director

Dated: 03/25/09 \_\_\_\_\_  
*/s/ Richard A. Dorr*  
Richard A. Dorr, Director

Dated: 03/26/09 \_\_\_\_\_  
*/s/ Todd R. Fry*  
Todd R. Fry, Director

Dated: \_\_\_\_\_  
Allan J. Hemphill, Director

Dated: 03/26/09 \_\_\_\_\_  
*/s/ Dennis E. Kelley*  
Dennis E. Kelley  
Senior Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)

Dated: 03/26/09 \_\_\_\_\_  
*/s/ John C. Lewis*  
John C. Lewis  
Chairman of the Board and Director

Dated: 03/25/09 \_\_\_\_\_  
*/s/ Ronald A. Metcalfe*  
Ronald A. Metcalfe, Director

Dated: 03/26/09 \_\_\_\_\_  
*/s/ Marshall T. Reynolds*  
Marshall T. Reynolds

Dated: 03/25/09 \_\_\_\_\_  
*/s/ Nicholas J. Rado*  
Nicholas J. Rado, Director

Dated: \_\_\_\_\_  
Robert B. St. Clair, Director

Dated: 03/25/09 \_\_\_\_\_  
*/s/ Eugene W. Traverso*  
Eugene W. Traverso, Director

## EXHIBIT INDEX

<u>EXHIBIT</u> <u>NO.</u>	<u>EXHIBIT</u>
3.1	Articles of Incorporation of the registrant <sup>(1) (2) (3)</sup>
3.2	Certificate of determination of series a preferred stock <sup>(9)</sup>
3.3	By-laws of the registrant <sup>(1) (2) (3)</sup>
4.1	Specimen of the registrant's common stock certificate <sup>(1) (2) (3)</sup>
4.2	The total amount of the registrant's long-term debt does not exceed 10 percent of the total assets of the registrant and its subsidiaries on a consolidated basis. Pursuant to Item 601(b)(4)(iii)(A) of Regulation S-K, the registrant agrees to file any instrument with respect to such long-term debt upon request of the FDIC.
4.3	Warrant for purchase of shares of common stock <sup>(9)</sup>
10.1	Commercial property lease between the registrant and Countrywide Home Loans, Inc. dated June 2004 <sup>(1) (2) (3)</sup>
10.2	Commercial property lease between the registrant and Fidelity National Title Company dated August 19, 2003 <sup>(1) (2) (3)</sup>
10.3	Commercial property lease between the registrant and Kaiser foundation Hospitals dated September 2004 <sup>(1) (2) (3)</sup>
10.4	Lease between Montgomery Village Limited Partnership and the registrant dated May 28, 2002 <sup>(1) (2) (3)</sup>
10.5	Lease between Codding Enterprises and the registrant dated June 5, 2003, as amended <sup>(1) (2) (3)</sup>
10.6	Lease between Lakewood Conolly Associates and the registrant Dated June 14, 1991, as amended <sup>(1) (2) (3)</sup>
10.7	FPS Gold On-Line Computer Service Agreement between the registrant and DHI Computing, Inc. dated October 23, 2003, as amended <sup>(1) (2) (3)</sup>
10.8	1999 Non-qualified Stock Option Plan, as amended by First Amendment dated September 25, 2002 <sup>(1) (2) (3)</sup>
10.9	Lease between Parkway Plaza, LLC and the registrant dated September 20, 2007 <sup>(6)</sup>
10.10	2007 Stock Option Plan <sup>(7)</sup>
10.11	Letter agreement dated December 19, 2008, between the Company and the United States Department of the Treasury, with respect to issuance of preferred stock and the warrant <sup>(9)</sup>
14.1	Code of Ethics <sup>(8)</sup>
16.1	Letter regarding change in certifying accountant <sup>(5)</sup>
21.1	Subsidiaries of the registrant <sup>(1)</sup>
31.1	Rule 13a-14(a)/15d-14(a) Certification
31.2	Rule 13a-14(a)/15d-14(a) Certification
32.1	Section 1350 certifications

1. Incorporated by reference from Summit State Bank's Form 10 filed with the FDIC on June 19, 2006.
2. Incorporated by reference from Summit State Bank's Form 10/A Amendment No. 1 filed with the FDIC on July 12, 2006.
3. Incorporated by reference from Summit State Bank's Form 10/A Amendment No.2 filed with the FDIC on July 13, 2006.
4. Incorporated by reference from Summit State Bank's Form 8-K filed with the FDIC on July 13, 2006.
5. Incorporated by reference from Summit State Bank's Form 8-K filed with the FDIC on October 24, 2006.
6. Incorporated by reference from Summit State Bank's Form 10-Q filed with the FDIC on November 13, 2006.
7. Incorporated by reference from Summit State Bank's Definitive Proxy Statement filed with the FDIC on April 27, 2007.
8. Incorporated by reference from Summit State Bank's Form 10-K filed with the FDIC on March 28, 2007.
9. Incorporate by reference fro Summit state Bank's Form 8-K filed with the FDIC on December 23, 2008.

## **EXHIBIT 31.1**

### **Certification pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002.**

I, Thomas M. Duryea, Chief Executive Officer, certify that:

1. I have reviewed this annual report on Form 10-K of Summit State Bank (the Registrant);

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;

4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and

5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of Registrant's Board of Directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting, which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Dated: 3/26/09

*/s/ Thomas M. Duryea*  
Thomas M. Duryea  
Chief Executive Officer

## **EXHIBIT 31.2**

### **Certification pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002.**

I, Dennis E. Kelley, Chief Financial Officer, certify that:

1. I have reviewed this annual report on Form 10-K of Summit State Bank (the Registrant);

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;

4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and

5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of Registrant's Board of Directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting, which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Dated: 3/26/09

*/s/ Dennis E. Kelley*

Dennis E. Kelley

Chief Financial Officer

**EXHIBIT 32.1**  
**Certification pursuant to 18 U.S.C. §1350**

In connection with the annual report on Form 10-K of Summit State Bank (the Registrant) for the year ended December 31, 2008, as filed with the Federal Deposit Insurance Corporation, the undersigned hereby certify pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

- 1) such Form 10-K fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2) the information contained in such Form 10-K fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

Dated: 3/26/09

*/s/ Thomas M. Duryea*  
Thomas M. Duryea  
Chief Executive Officer

Dated: 3/26/09

*/s/ Dennis E. Kelley*  
Dennis E. Kelley  
Chief Financial Officer