Avidbank Holdings, Inc.

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2012 AND 2011
AND FOR THE YEARS ENDED
DECEMBER 31, 2012, 2011 AND 2010
AND
INDEPENDENT AUDITOR'S REPORT

INDEPENDENT AUDITOR'S REPORT

AVIDBANK HOLDINGS, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
December 31, 2012 and 2011

	2012	2011
ASSETS		
Cash and due from banks	$ 21,492,778	$ 12,376,758
Federal funds sold	85,510,000	33,660,000
Total cash and cash equivalents	107,002,778	46,036,758
Available-for-sale investment securities (Notes 2 and 16)	55,343,000	82,178,000
Loans, less allowance for loan losses of $4,479,813 in 2012 and $4,375,754 in 2011 (Notes 3,4,9,10 and 16)	242,788,866	203,588,739
Federal Home Loan Bank stock	1,497,300	1,285,300
Property and equipment, net (Note 5)	1,291,306	696,270
Cash surrender value of Bank-owned life insurance policies (Note 6)	3,419,645	3,311,651
Accrued interest receivable and other assets	4,378,185	5,107,813
Total assets	$ 415,721,080	$ 342,204,531
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	$ 105,517,676	$ 73,277,353
Interest bearing (Note 7)	269,476,235	233,412,492
Total deposits	374,993,911	306,689,845
Accrued interest payable and other liabilities	2,864,270	1,819,743
Total liabilities	377,858,181	308,509,588
Commitments and contingencies (Note 10)		
Shareholders' equity (Notes 11 and 12):		
Preferred stock - no par value; $1,000 liquidation preference; 5,000,000 shares authorized, 6,000 shares issued and outstanding at December 31, 2012 and 2011	5,951,578	5,906,336
Common stock - no par value; 5,000,000 shares authorized; 2,614,655 and 2,602,276 shares issued and outstanding at December 31, 2012 and 2011, respectively	27,618,879	27,618,879
Additional paid-in capital	1,936,976	1,627,042
Retained earnings (deficit)	1,171,133	(1,228,339)
Accumulated other comprehensive Income (loss), net of taxes (Note 2)	1,184,333	(228,975)
Total shareholders' equity	37,862,899	33,694,943
Total liabilities and shareholders' equity	$ 415,721,080	$ 342,204,531

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

AVIDBANK HOLDINGS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
For the Years Ended December 31, 2012, 2011 and 2010

	2012	2011	2010
Interest income:			
Interest and fees on loans	$ 14,786,643	$ 12,850,434	$ 13,914,915
Interest on Federal funds sold	142,420	97,648	115,571
Interest on investment securities	2,080,576	1,903,203	1,687,911
Total interest income	17,009,639	14,851,285	15,718,397
Interest expense:			
Interest on deposits (Note 7)	1,840,233	2,278,969	3,421,824
Net interest income	15,169,406	12,572,316	12,296,573
Provision for loan losses (Note 4)	480,000	435,260	824,211
Net interest income after provision for loan losses	14,689,406	12,137,056	11,472,362
Non-interest income:			
Service charges, fees and other income	359,422	251,046	204,783
Appreciation in cash surrender value of insurance contracts (Note 6)	107,595	107,335	106,247
Other income	-	216,948	-
Gain on sale of investment securities (Note 2)	336,565	68,168	171,028
Total non-interest income	803,582	643,497	482,058
Non-interest expenses:			
Salaries and employee benefits (Notes 3 and 13)	6,289,430	5,274,301	4,729,700
Occupancy and equipment (Notes 5 and 10)	1,881,693	1,571,452	1,756,853
Write down of other real estate owned	-	-	515,429
Other (Note 15)	2,519,151	2,670,497	2,545,893
Total other expenses	10,690,274	9,516,250	9,547,875
Income before provision for income taxes	4,802,714	3,264,303	2,406,545
Provision for (benefit from) income taxes (Note 8)	2,058,000	(572,400)	183,000
Net income	$ 2,744,714	$ 3,836,703	$ 2,223,545
Preferred stock dividends and discount accretion	$ 345,242	$ 555,242	$ 179,092
Net income available to common shareholders	$ 2,399,472	$ 3,281,461	$ 2,044,453
Basic income per common share (Note 11)	$ 0.92	$ 1.26	$ 0.79
Diluted income per common share (Note 11)	$ 0.91	$ 1.26	$ 0.79

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

AVIDBANK HOLDINGS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Years Ended December 31, 2012, 2011 and 2010

	2012	2011	2010
Net Income	$ 2,744,714	$ 3,836,703	$ 2,223,545
Other Comprehensive Income:			
Unrealized gains (losses) on securities:			
Unrealized holdings gains (losses)	2,692,080	(285,214)	134,343
Less: reclassification for net gains included in net income	(336,565)	(68,168)	(171,028)
Other comprehensive income, before tax	2,355,515	(353,382)	(36,685)
Tax effect	(942,207)	141,354	14,673
Other comprehensive income (loss)	1,413,308	(212,028)	(22,012)
Total Comprehensive Income	$ 4,158,022	$ 3,624,675	$ 2,201,533

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

AVIDBANK HOLDINGS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY
For the Years Ended December 31, 2012, 2011 and 2010

	Preferred Stock		Common Stock		Additional	Retained Earnings	Accumulated Other Comprehensive Income (Loss),	Total Shareholders'
	Shares	Amount	Shares	Amount	Paid-in Capital	(Deficit)	Net of Tax	Equity
Balance, December 31, 2009	6,000	$ 5,815,852	2,602,276	$ 27,618,879	$ 1,132,683	$ (6,554,253)	$ 5,065	$ 28,018,226
Net income						2,223,545		2,223,545
Other comprehensive loss:							(22,012)	(22,012)
Preferred stock dividends and accretion		45,242				(179,092)		(133,850)
Stock based compensation (Notes 1 and 11)					268,349			268,349
Balance, December 31, 2010	6,000	$ 5,861,094	2,602,276	$ 27,618,879	$ 1,401,032	$ (4,509,800)	$ (16,947)	$ 30,354,258
Net income						3,836,703		3,836,703
Other comprehensive loss:							(212,028)	(212,028)
Preferred stock dividends and accretion		45,242				(555,242)		(510,000)
Stock based compensation (Notes 1 and 11)					226,010			226,010
Balance, December 31, 2011	6,000	$ 5,906,336	2,602,276	$ 27,618,879	$ 1,627,042	$ (1,228,339)	$ (228,975)	$ 33,694,943
Net income						2,744,714		2,744,714
Other comprehensive income:							1,413,308	1,413,308
Preferred stock dividends and accretion		45,242				(345,242)		(300,000)
Stock options exercised			12,379		78,266			78,266
Stock based compensation (Notes 1 and 11)					231,668			231,668
Balance, December 31, 2012	6,000	$ 5,951,578	2,614,655	$ 27,618,879	$ 1,936,976	$ 1,171,133	$ 1,184,333	$ 37,862,899

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

AVIDBANK HOLDINGS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2012, 2011 and 2010

	2012	2011	2010
Cash flows from operating activities:			
Net income	$ 2,744,714	$ 3,836,703	$ 2,223,545
Adjustments to reconcile net income to net cash provided by operating activities:			
Loss on disposal of equipment	-	-	1,081
Gain on sale of investment securities	(336,565)	(68,168)	(171,028)
Provision for loan losses	480,000	435,260	824,211
Depreciation, amortization and accretion	952,799	964,602	544,497
Increase in deferred loan origination fees, net	12,337	271,974	141,340
Write down of other real estate owned	-	-	515,429
Earnings on bank-owned life insurance policies	(107,994)	(107,335)	(106,247)
Stock option compensation expense	231,670	226,010	268,349
Change in deferred income taxes	425,000	(1,915,000)	(214,000)
(Increase) decrease in accrued interest receivable and other assets	(638,550)	384,778	781,036
Increase in accrued interest payable and other liabilities	1,044,522	166,995	526,867
Net cash provided by operating activities	4,807,933	4,195,819	5,335,080
Cash flows used in investing activities:			
Purchase of available-for-sale investment securities	(28,218,176)	(80,979,524)	(51,007,267)
Proceeds from sales or calls of available-for-sale investment securities	57,067,040	56,922,387	25,485,547
Proceeds from principal payments on available-for-sale investment securities	40,235	122,771	1,071,203
Net decrease in interest bearing deposits in other banks	-	-	6,000,000
Purchase of Federal Home Loan Bank stock	(212,000)	(289,000)	(179,500)
Proceeds from sale of other real estate owned	-	-	2,081,275
Net increase in loans	(39,692,462)	(174,780)	(5,796,306)
Purchase of premises and equipment	(908,882)	(174,220)	(537,111)
Net cash used in investing activities	(11,924,245)	(24,572,366)	(22,882,159)
Cash flows from financing activities:			
Net increase in demand, interest bearing and savings deposits	65,055,057	23,401,741	3,998,867
Net increase (decrease) in time deposits	3,249,009	(1,399,785)	2,370,928
Net proceeds from exercise of stock options	78,266	-	-
Cash dividends paid	(300,000)	(558,942)	(300,000)
Net cash provided by financing activities	68,082,332	21,443,014	6,069,795
Increase (decrease) in cash and cash equivalents	60,966,020	1,066,467	(11,477,284)
Cash and cash equivalents at beginning of period	46,036,758	44,970,291	56,447,575
Cash and cash equivalents at end of year	$ 107,002,778	$ 46,036,758	$ 44,970,291
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest expense	$ 1,840,233	$ 2,278,805	$ 3,402,478
Income taxes	$ 1,685,000	$ 1,285,000	$ 279,500

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

Avidbank Holdings, Inc. (the "Company", formerly known as Peninsula Bank Holding Co.) was incorporated on December 17, 2007 and subsequently obtained approval from the Board of Governors of the Federal Reserve System to operate as a bank holding company. On April 2, 2008, Avidbank (the "Bank", formerly known as The Private Bank of the Peninsula) consummated a merger with the Company effected through the exchange of one share of the Company's stock for each share of the Bank's stock. The reorganization represented an exchange of shares between entities under common control, and, as a result, assets and liabilities of the Bank were recognized at their carrying amounts in the accounts of the Company. Subsequent to the reorganization, the Bank continued its operations as previously conducted, but as a wholly-owned subsidiary of the Company. On April 1, 2011, the Bank changed its name to Avidbank. The Company changed its name to Avidbank Holdings, Inc. on August 1, 2011.

The Bank is a California state-chartered institution and provides financial products and services to customers who are predominately small and middle-market businesses, professionals and individuals residing in San Mateo and Santa Clara Counties.

We have considered all events occurring from December 31, 2012 through March 26, 2013, the date the consolidated financial statements were available for issuance, and no subsequent events occurred requiring recognition or disclosure.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and the accounts of its wholly-owned subsidiary, the Bank. All significant intercompany balances and transactions have been eliminated. The accounting and reporting policies of the Company conform with accounting principles generally accepted in the United States of America and prevailing practices within the banking industry.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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, deferred tax assets, and fair values of financial instruments are particularly subject to change.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Cash and Cash Equivalents

For the purpose of the statement of cash flows, cash and cash equivalents consist of cash and due from banks and Federal funds sold. Generally, Federal funds are sold for one day periods. On the statement of cash flows, net cash flows are reported for customer loan and deposit transactions.

Investment Securities

Investment securities are classified into the following categories:

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

- Held-to-maturity securities, which management has the positive intent and ability to hold, reported at amortized cost, adjusted for the accretion of discounts and amortization of premiums, which are recognized as adjustments to interest income.

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. At December 31, 2012 and 2011, all of the Company's securities were classified as available-for-sale and there were no transfers between categories during those years.

Gains and losses on the sale of securities are computed using the specific identification method on the trade date. Interest earned on investment securities is reported in interest income, net of applicable adjustments for accretion of discounts and amortization of premiums which are accounted for on the level-yield method without anticipation of prepayment. In addition, unrealized losses, if any, that are determined by management to be other than temporary are recognized in earnings in accordance with the methodology described below.

An investment security is impaired when its carrying value is greater than its fair value. Impaired investment securities are evaluated 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 fair value is other than temporary. Management utilizes criteria such as the magnitude and duration of the decline and the intent and ability of the Company 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 the decline is permanent, but indicates the prospects for a near-term recovery of value are not necessarily favorable, or there is a lack of decline in value is determined to be other than temporary, and management does not intend to sell the security or it is more likely than not the Company will not be required to sell the security before recovery, only the portion of the impairment loss representing credit exposure is recognized as a charge to earnings, with the balance recognized as a charge to other comprehensive income. If management intends to sell the security or it is more likely than not the Company will be required to sell the security before recovering its forecasted cost, the entire impairment loss is recognized as a charge to earnings.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Investment in Federal Home Loan Bank Stock

As a member of the Federal Home Loan Bank System, the Company is required to maintain an investment in the capital stock of the Federal Home Loan Bank (FHLB). The investment is carried at cost. At December 31, 2012 and 2011, FHLB stock totaled $1,497,300 and $1,285,300, respectively. Both cash and stock dividends are reported as income.

Loans

Loans are stated at principal balances outstanding net of deferred loan fees and costs, and an allowance for loan losses. Interest is accrued daily based upon outstanding loan balances. However, when, a loan is past due 90 days or 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 accrued but unpaid is charged against income. Payments received on loans on nonaccrual status 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. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (including both principal and interest) in accordance with the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, the structure and nature of collateral, if any, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and the payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. The amount of impairment, if any, on an impaired loan is measured based on the present value of expected future cash flows discounted at the loan's effective rate, except that as a practical expedient, impairment may be measured based upon the loan's observable market price or the fair value of collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral.

Allowance for Loan Losses

The allowance for loan losses is an estimate of credit losses inherent in the Company's loan portfolio that have been incurred as of the balance sheet date. The allowance is established through a provision for loan losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses (Continued)

allowance. The overall allowance consists of two primary components: specific reserves related to impaired loans which are individually evaluated for impairment and general reserves for inherent losses related to loans that are collectively evaluated for impairment.

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

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

The Company determines a separate allowance for each portfolio segment (loan type). These portfolio segments include commercial, construction (including land and development loans), residential real estate (including home equity lines of credit), commercial real estate, asset based loans and consumer loans. The allowance for loan losses attributable to each portfolio segment, which includes both loans individually evaluated for impairment and loans that are collectively evaluated for impairment, are combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

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

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

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses (Continued)

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

Substandard-Impaired – A substandard loan is impaired when, based on current information and known or anticipated events, it is probable that the lender will be unable to collect all amounts due according to the terms of the original loan agreement. These loans are typically on nonaccrual and have many of the same weaknesses as substandard non-impaired loans.

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

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

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

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

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

Residential real estate (including home equity lines of credit) – Residential real estate loans are loans made with a residence serving as collateral. These are not typical mortgage loans and may have a variety of reasons for the borrowing including providing funding to a business or paying for large personal expenditures. These loans generally possess a lower inherent risk of loss than commercial real estate and construction loans and are often situations where the borrower is the occupant of the residence. The degree of risk in home equity loans depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses (Continued)

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

Asset based – Asset based loans are advances generally made against receivables to companies generating consistent sales but who have not yet reached consistent profitability. These companies are subjected to an audit of their receivables and ineligible accounts are excluded from the borrowing base. The Company controls the entire receivables cash flow of the company and advances are made on a portion of eligible receivable balances. Receivables are monitored daily and borrowing capacity is calculated based upon contractual formulas. As a result of these controls, asset based lending loans typically possess less risk than unsecured commercial loans.

Consumer – Consumer loans are primarily loans to individuals that may be unsecured or secured by collateral other than real estate. The unsecured loans are generally revolving personal lines of credit to established clients. The Company also offers demand deposit lines of credit to certain checking account clients. The high quality of the clients who are offered these products has historically caused this loan product to have less risk of loss than commercial loan products.

Although management believes the allowance to be appropriate, ultimate losses may vary from its estimates. At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's primary regulators, the Federal Reserve Bank, the FDIC and the California Department of Financial Institutions, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations. The allowance for loan losses at December 31, 2012 and 2011 reflects management's estimate of probable losses in the portfolio.

Reserve for Undisbursed Loan Commitments

The Company maintains a separate reserve for losses related to undisbursed loan commitments. Management estimates the amount of probable losses by applying the loss factors used in the allowance for loan loss methodology to an estimate of the expected usage of undisbursed lines of credit. This reserve totaled $304,204 and $238,754 at December 31, 2012 and 2011, respectively, and is included in accrued interest payable and other liabilities on the consolidated balance sheet.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Property and Equipment

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

Rental Income

The Company subleases space to tenants in vacated former branch and administrative offices. Rental income is recorded when earned as a component of "Occupancy and Equipment" expense. All leases are operating leases, as further discussed in Note 10.

Bank-Owned Life Insurance

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

Income Taxes

Deferred tax assets and liabilities are recognized for the tax consequences of temporary differences between the reported amount of assets and liabilities and their tax bases. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. The determination of the amount of deferred income tax assets which are more likely than not to be realized is primarily dependent on projections of future earnings, which are subject to uncertainty and estimates that may change given economic conditions and other factors. The recognition of deferred income tax assets is assessed and a valuation allowance is recorded if it is "more likely than not" that all or a portion of the deferred tax assets will not be realized. "More likely than not" is defined as greater than a 50% chance. All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed.

The Company considers all tax positions recognized in its financial statements for the likelihood of realization. When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Taxes (Continued)

is more than fifty percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above, if any, is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest expense and penalties associated with unrecognized tax benefits, if any, are included in the provision for income taxes in the statement of operations. The Company did not have any uncertain income tax positions and has not accrued for any interest or penalties as of December 31, 2012 and 2011.

The Company uses a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return. A tax position is recognized as a benefit only if it is "more likely than not" 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.

Stock-Based Compensation

The Company records compensation cost for all share-based payments based on the estimated grant date fair values of the options issued. Compensation cost is recognized over the required service period, generally defined as the vesting period. A Black-Scholes model is utilized to estimate the fair value of stock options.

The Company reports the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for options (excess tax benefits) as a cash flow from financing in the statement of cash flows. There were no excess tax benefits for the years ended December 31, 2012, 2011 and 2010.

Earnings Per Common Share

Basic earnings per share (EPS) is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options, result in the issuance of common stock which shares in the earnings of the Company. The treasury stock method is applied to determine the dilutive effect of stock options in computing diluted EPS. However, conversion is not assumed when a net loss occurs because the conversion of potential common stock would be antidilutive.

Comprehensive Income

Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of other comprehensive income that historically has not been recognized in the calculation of net income. Unrealized gains and losses on the Company's available-for-sale investment securities are included in other comprehensive income. The components of accumulated other comprehensive income are presented in the statement of changes in shareholders' equity.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Adoption of New Financial Accounting Standards

In June 2011, the FASB amended existing guidance and eliminated the option to present the components of other comprehensive income as part of the statement of changes in shareholder's equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in two separate consecutive statements. The amendments in this guidance are effective for annual reporting periods ending after December 15, 2012, and interim and annual periods thereafter. The adoption of this amendment changed the presentation of the components of comprehensive income for the Company as part of the consolidated statement of shareholder's equity.

In May 2011, the FASB issued an amendment to achieve common fair value measurement and disclosure requirements between U.S. and International accounting principles. Overall the guidance is consistent with existing U.S. accounting principles; however, there are some amendments that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The amendments in this guidance are effective for annual reporting periods beginning after December 15, 2011. The effect of adopting this standard did not have a material effect on the Company's operating results or financial condition.

2. AVAILABLE-FOR-SALE INVESTMENT SECURITIES

The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2012 and 2011 consisted of the following:

	2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
U.S. Agencies	$ 6,177,541	$ 56,459	$ -	$ 6,234,000
U.S. Govt. Sponsored Agencies	9,721,474	227,526	-	9,949,000
Residential Mortgage-Backed Securities	6,401,625	24,375	-	6,426,000
Corporate Debt Securities	31,068,471	1,665,529	-	32,734,000
Total debt securities	$ 53,369,111	$ 1,973,889	$ -	$ 55,343,000

	2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
U.S. Govt. Sponsored Agencies	$ 49,871,478	$ 326,025	$ (10,503)	$ 50,187,000
Corporate Debt Securities	32,688,148	352,621	(1,049,769)	31,991,000
Total debt securities	$ 82,559,626	$ 678,646	$ (1,060,272)	$ 82,178,000

Unrealized gains on available-for-sale investment securities totaling $1,973,889 were recorded as accumulated other comprehensive income, net of taxes of $789,556 within shareholders' equity at December 31, 2012. Net unrealized losses on available-for-sale investment securities totaling ($381,626) were recorded as accumulated other comprehensive income, net of taxes of ($152,651) within shareholders' equity at December 31, 2011.

Proceeds from the sale or call of available-for-sale investment securities totaled $57,067,040, $56,922,387 and $25,485,547 for the years ended 2012, 2011 and 2010, respectively, with gross recognized gains of $336,565 in 2012, $68,168 in 2011, and $171,028 in 2010.

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

There were no investment securities with unrealized losses at December 31, 2012. Investment securities with unrealized losses at December 31, 2011 are summarized and classified according to the duration of the loss period as follows:

	2011					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-Sale Debt Securities						
U.S. Govt. Sponsored Agencies	$ 9,495,000	$ (10,503)	$ -	$ -	$ 9,495,000	$ (10,503)
Corporate Debt Securities	20,891,000	(1,049,769)	-	-	20,891,000	(1,049,769)
	$30,386,000	$ (1,060,272)	$ -	$ -	$ 30,386,000	$ (1,060,272)

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

The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2012 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.

	2012	
	Amortized Cost	Estimated Fair Value
Through five years:	$ 33,035,480	$ 34,529,000
After five years through ten years:	7,755,036	8,154,000
After ten years:	12,578,595	12,660,000
	$ 53,369,111	$ 55,343,000

Investment securities with amortized costs totaling $4,024,687 and fair values of $4,138,797 were pledged to secure public deposits at December 31, 2012. Securities with amortized costs totaling $31,509,881 and fair values of $32,759,580 were pledged to the Federal Reserve for discount window borrowing at December 31, 2012. Investment securities with amortized costs totaling $6,034,926 and fair values of $6,146,177 were pledged to secure public deposits at December 31, 2011. Securities with amortized costs totaling $19,688,696 and fair values of $19,715,775 were pledged to the Federal Reserve for discount window borrowing at December 31, 2011.

3. LOANS

Outstanding loans are summarized below:

	December 31,	
	2012	2011
Commercial	$ 48,700,979	$ 38,495,857
Construction	59,086,969	42,386,584
Residential Real Estate	16,683,348	20,989,233
Commercial Real Estate	88,713,709	84,459,789
Asset based	31,925,512	19,158,347
Consumer	2,938,218	3,242,403
Total outstanding loans	248,048,735	208,732,213
Deferred loan origination fees, net	(780,057)	(767,720)
Allowance for loan losses	(4,479,813)	(4,375,754)
Total loans net of allowance for loan losses	$ 242,788,865	$ 203,588,739

3. LOANS (Continued)

Salaries and employee benefits totaling $502,533, $396,711 and $363,699 have been deferred as loan origination costs for the years ended December 31, 2012, 2011 and 2010, respectively.

From time to time, the Bank pledges loans as collateral under a short-term borrowing arrangement through the Discount Window of the Federal Reserve Bank. At December 31, 2012, there were no loans pledged. (Note 9) The Bank has entered into a blanket lien agreement providing for the pledging of Call Report loan categories for borrowing capacity with the Federal Home Loan Bank. The bank has pledged a total of $82,915,600 of loans for borrowing capacity of $73,297,605 at December 31, 2012.

4. ALLOWANCE FOR LOAN LOSSES

Changes in the allowance for loan losses during the years ended December 31, 2012, 2011 and 2010 were as follows:

	2012	2011	2010
Balance, beginning of year	$ 4,375,754	$ 4,420,964	$ 4,313,218
Provision charged to operations	480,000	435,260	824,211
Losses charged to allowance	(622,724)	(598,143)	(1,101,849)
Recoveries	246,783	117,673	385,384
Balance, end of year	$ 4,479,813	$ 4,375,754	$ 4,420,964

4. ALLOWANCE FOR LOAN LOSSES (Continued)

Allocation of the Allowance for Loan Losses by Portfolio Segment and Impairment Methodology as of and for the years ended December 31, 2012 and 2011:

	Commercial	Construction	Residential Real Estate	Commercial Real Estate	Asset Based	Consumer	Unallocated	Total
Allowance for loan losses:								
Balance at December 31, 2010	$ 409,423	$ 1,437,073	$ 157,595	$ 1,270,894	$ 664,904	$ 39,075	$ 442,000	$ 4,420,964
Provision for loan losses	330,957	(196,637)	57,732	372,497	(175,900)	45,509	1,102	435,260
Loans charged-off	(20,363)	(574,969)	-	-	-	(2,811)		(598,143)
Recoveries	18,187	99,465	-	-	-	21		117,673
Balance, at December 31, 2011	$ 738,204	$ 764,932	$ 215,327	$ 1,643,391	$ 489,004	$ 81,794	$ 443,102	$ 4,375,754
Provision for loan losses	(297,453)	253,825	189,018	(134,187)	568,249	(39,950)	(59,502)	480,000
Loans charged-off	(19,557)	-	(173,457)	-	(429,710)	-		(622,724)
Recoveries	237,019	-	8,500	-	1,234	30		246,783
Balance, at December 31, 2012	$ 658,213	$ 1,018,757	$ 239,388	$ 1,509,204	$ 628,777	$ 41,874	$ 383,600	$ 4,479,813

4. ALLOWANCE FOR LOAN LOSSES (Continued)

December 31, 2012	Commercial	Construction	Residential Real Estate	Commercial Real Estate	Asset Based	Consumer	Unallocated	Total
Allowance for loan losses:								
Ending balance	$ 658,213	$ 1,018,757	$ 239,388	$ 1,509,204	$ 628,777	$ 41,874	$ 383,600	$ 4,479,813
Ending balance: individually evaluated for impairment	$ -	$ -	$ -	$ 81,000	$ -	$ -	$ -	$ 81,000
Ending balance: collectively evaluated for impairment	$ 658,213	$ 1,018,757	$ 239,388	$ 1,428,204	$ 628,777	$ 41,874	$ 383,600	$ 4,398,813
Loans:								
Ending balance	$ 48,700,979	$ 59,086,969	$ 16,683,348	$ 88,713,709	$ 31,925,512	$ 2,938,218		$ 248,048,735
Ending balance: individually evaluated for impairment	$ -	$ -	$ -	$ 875,905	$ -	$ -		$ 875,905
Ending balance: collectively evaluated for impairment	$ 48,700,979	$ 59,086,969	$ 16,683,348	$ 87,837,804	$ 31,925,512	$ 2,938,218		$ 247,172,830

4. ALLOWANCE FOR LOAN LOSSES (Continued)

December 31, 2011	Commercial	Construction	Residential Real Estate	Commercial Real Estate	Asset Based	Consumer	Unallocated	Total
Allowance for loan losses:								
Ending balance	$ 738,204	$ 764,932	$ 215,327	$ 1,643,391	$ 489,004	$ 81,794	$ 443,102	$ 4,375,754
Ending balance: individually evaluated for impairment	$ 31,028	$ -	$ -	$ -	$ -	$ 28,802	$ -	$ 59,830
Ending balance: collectively evaluated for impairment	$ 707,176	$ 764,932	$ 215,327	$ 1,643,391	$ 489,004	$ 52,992	$ 443,102	$ 4,315,924
Loans:								
Ending balance	$ 38,495,857	$ 42,386,584	$ 20,989,233	$ 84,459,789	$ 19,158,347	$ 3,242,403		$ 208,732,213
Ending balance: individually evaluated for impairment	$ 62,057	$ 855,000	$ -	$ -	$ -	$ 57,602		$ 974,659
Ending balance: collectively evaluated for impairment	$ 38,433,800	$ 41,531,584	$ 20,989,233	$ 84,459,789	$ 19,158,347	$ 3,184,801		$ 207,757,554

4. ALLOWANCE FOR LOAN LOSSES (Continued)

Commercial Credit Exposure
Credit Risk Profile by Internally Assigned Grade as of December 31, 2012

	Commercial	Construction	Residential Real Estate	Commercial Real Estate	Asset Based	Consumer	Total
Grade:							
Pass	$ 47,147,069	$ 56,127,978	$ 16,059,684	$ 85,688,126	$ 31,002,282	$ 2,938,218	$238,963,357
Special Mention	542,333	2,958,991	-	-	923,230	-	4,424,554
Substandard-Non-Impaired	1,011,577	-	623,664	2,149,678	-	-	3,784,919
Substandard-Impaired	-	-	-	875,905	-	-	875,905
Total	$ 48,700,979	$ 59,086,971	$ 16,683,348	$ 88,713,709	$ 31,925,512	$ 2,938,218	$248,048,735

Commercial Credit Exposure
Credit Risk Profile by Internally Assigned Grade as of December 31, 2011

	Commercial	Construction	Residential Real Estate	Commercial Real Estate	Asset Based	Consumer	Total
Grade:							
Pass	$ 35,852,177	$ 40,523,064	$ 20,989,233	$ 80,718,532	$ 17,588,789	$ 3,184,801	$198,856,596
Special Mention	919,185	370,000	-	-	502,211	-	1,791,396
Substandard-Non-Impaired	1,662,438	638,520	-	3,741,257	1,067,347	-	7,109,562
Substandard-Impaired	62,057	855,000	-	-	-	57,602	974,659
Total	$ 38,495,857	$ 42,386,584	$ 20,989,233	$ 84,459,789	$ 19,158,347	$ 3,242,403	$208,732,213

4. ALLOWANCE FOR LOAN LOSSES (Continued)

Past Due and Nonaccrual Loan Detail as of December 31, 2012

	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total
Commercial	$ -	$ -	$ -	$ -	$ 48,700,979	$ 48,700,979
Construction	-	-	-	-	59,086,971	59,086,971
Residential Real Estate	-	-	-	-	16,683,348	16,683,348
Commercial Real Estate	-	-	875,905	875,905	87,837,804	88,713,709
Asset Based	-	-	-	-	31,925,512	31,925,512
Consumer	-	-	-	-	2,938,218	2,938,218
Total	$ -	$ -	$ 875,905	$ 875,905	$ 247,172,832	$ 248,048,737

Past Due and Nonaccrual Loan Detail as of December 31, 2011

	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total
Commercial	$ 131,491	$ -	$ 62,057	$ 193,548	$ 38,302,309	$ 38,495,857
Construction	-	-	855,000	855,000	41,531,584	42,386,584
Residential Real Estate	-	-	-	-	20,989,233	20,989,233
Commercial Real Estate	331,549	-	-	331,549	84,128,240	84,459,789
Asset Based	-	-	-	-	19,158,347	19,158,347
Consumer	-	-	57,602	57,602	3,184,801	3,242,403
Total	$ 463,040	$ -	$ 974,659	$ 1,437,699	$ 207,294,514	$ 208,732,213

4. ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired Loan Detail with a Related Allowance as of December 31, 2012

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on a Cash Basis
Commercial Real Estate	$ 875,905	$ 875,905	$ 81,000	$ 889,299	$ -	$ -
Total	$ 875,905	$ 875,905	$ 81,000	$ 889,299	$ -	$ -

Impaired Loan Detail with a Related Allowance as of December 31, 2011

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on a Cash Basis
Construction	$ 864,405	$ 864,405	$ -	$ 855,000	$ -	$ -
Commercial	62,714	62,714	31,028	74,907	-	-
Consumer	58,001	58,001	28,802	61,581	-	-
Total	$ 985,120	$ 985,120	$ 59,830	$ 991,488	$ -	$ -

As of December 31, 2011, there was one $864,405 construction loan where a related allowance was not deemed unnecessary.

The recorded investment in loans includes accrued interest receivable and loan origination fees, net. For purposes of this disclosure, the unpaid principal balance is not reduced for any related loan loss allowance.

As of December 31, 2012 and 2011, the Company has a recorded investment in troubled debt restructurings of $875,905 and $62,714, respectively. The Company has allocated $81,000 and $31,028 of specific reserves for those loans at December 31, 2012 and 2011, respectively. The Company has not committed to lend any additional amounts on loans identified as troubled debt restructurings.

During the years ending December 31, 2012 and 2011, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

4. ALLOWANCE FOR LOAN LOSSES (Continued)

The following table presents loans by class modified as troubled debt restructurings that occurred during the year ending December 31, 2012:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
Commercial Real Estate	1	$ 875,905	$ 875,905

The troubled debt restructuring described above increased the allowance for loan losses by $81,000 and resulted in no charge-offs during the year ending December 31, 2012.

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

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
Commercial	1	$ 62,714	$ 62,714

The troubled debt restructuring described above increased the allowance for loan losses by $0 and resulted in no charge-offs during the year ending December 31, 2011.

There were no troubled debt restructurings which defaulted within twelve months following the modification during the years ended December 31, 2012 or 2011.

5. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following:

	December 31, 2012	December 31, 2011
Furniture and equipment	$ 926,909	$ 408,341
Leasehold improvements	594,506	453,435
Computer equipment	1,653,039	1,403,796
Gross property and equipment	3,174,454	2,265,572
Less accumulated depreciation and amortization	1,883,148	1,569,302
Property and equipment, net	$ 1,291,306	$ 696,270

Depreciation included in occupancy and equipment expense totaled $313,846, $291,881 and $338,637 for the years ended December 31, 2012, 2011 and 2010, respectively.

6. CASH SURRENDER VALUE OF LIFE INSURANCE POLICIES

The Bank owns single-premium life insurance policies on the lives of two former key executives. Income earned on these policies, net of expenses, totaled $107,595, $107,335 and $106,247 for the years ended December 31, 2012, 2011 and 2010, respectively.

7. INTEREST-BEARING DEPOSITS

Interest-bearing deposits consisted of the following:

	December 31, 2012	December 31, 2011
NOW accounts	$ 17,292,527	$ 16,008,049
Savings	17,390,604	8,816,381
Money market	168,273,166	145,317,133
Time, $100,000 or more	62,025,136	57,753,359
Other time	4,494,802	5,517,570
Total interest-bearing deposits	$ 269,476,235	$ 233,412,492

7. INTEREST-BEARING DEPOSITS (Continued)

Aggregate annual maturities of time deposits are as follows:

Year Ending December 31,	
2013	$ 60,112,000
2014	2,084,500
2015	503,602
2016	1,453,525
2017	2,366,311
Total time deposits	$ 66,519,938

Interest expense recognized on interest-bearing deposits for the years ended December 31, 2012, 2011 and 2010 consisted of the following:

	2012	2011	2010
NOW accounts	$ 38,934	$ 44,378	$ 53,055
Savings	75,456	60,124	22,659
Money market	1,001,157	1,381,294	1,984,749
Time, $100,000 or more	669,082	712,196	1,246,624
Other time	55,604	80,977	114,737
Total interest expense	$ 1,840,233	$ 2,278,969	$ 3,421,824

At December 31, 2012 and 2011, the Company had no deposit relationships that exceeded 5% of total deposits.

8. INCOME TAXES

The provision for (benefit from) income taxes for the years ended December 31, 2012, 2011 and 2010 consisted of the following:

2012	Federal	State	Total
Current	$ 1,449,000	$ 184,000	$ 1,633,000
Deferred	64,000	361,000	425,000
Provision for income taxes	$ 1,513,000	$ 545,000	$ 2,058,000

2011	Federal	State	Total
Current	$ 978,200	$ 364,400	$ 1,342,600
Deferred	55,000	5,000	60,000
Valuation allowance	(1,217,000)	(758,000)	(1,975,000)
Benefit from income taxes	$ (183,800)	$ (388,600)	$ (572,400)

2010	Federal	State	Total
Current	$ 136,000	$ 247,000	$ 383,000
Deferred	580,000	19,000	599,000
Valuation allowance	(703,000)	(96,000)	(799,000)
Provision for income taxes	$ 13,000	$ 170,000	$ 183,000

8. INCOME TAXES (Continued)

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

	2012	2011
Deferred tax assets:		
Net operating losses	$ -	$ 218,000
Allowance for loan losses	1,299,000	1,451,000
State tax	63,000	119,000
Property and equipment	-	-
Accrued expenses	151,000	82,000
Other	145,000	125,000
Unrealized loss on available for sale investment securities	-	153,000
Share-base compensation	429,000	390,000
Total deferred tax assets	2,087,000	2,538,000
Deferred tax liabilities:		
Other	(45,000)	(27,000)
Property and equipment	(108,000)	(52,000)
Loan origination costs	(241,000)	(188,000)
Unrealized gain on available for sale investment securities	(790,000)	-
Total deferred tax liabilities	(1,184,000)	(267,000)
Net deferred tax asset	$ 903,000	$ 2,271,000

8. INCOME TAXES (Continued)

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

	Years Ended December 31,					
	2012		2011		2010	
	Amount	Rate %	Amount	Rate %	Amount	Rate %
Federal income tax expense, at statutory rate	$ 1,633,000	34.0	$ 1,110,000	34.0	$ 818,000	34.0
State franchise tax expense, net of Federal tax expense	121,000	2.5	240,000	7.4	163,000	6.8
Share-based compensation	40,000	0.8	42,000	1.3	32,000	1.3
Deferred tax valuation allowance	-	-	(1,975,000)	(60.5)	(799,000)	(33.2)
Tax-exempt income from life insurance policies	(37,000)	(0.8)	(36,400)	(1.1)	(36,000)	(1.5)
Meals and Entertainment	31,000	0.6	-	-	-	-
Other	270,000	5.8	47,000	1.4	5,000	0.2
Total income tax (benefit) expense	$ 2,058,000	42.9	$ (572,400)	(17.5)	$ 183,000	7.6

The total amount of unrecognized tax benefits, related to potentially uncertain tax positions, including interest and penalties, at December 31, 2012, is not considered material for disclosure purposes. The amount of tax benefits that would impact the effective rate, if recognized, is not expected to be material. The Company does not anticipate any significant changes with respect to unrecognized tax benefits within the next twelve months.

Status of Open Tax Years

The Company is subject to U.S. Federal income tax as well as California state income tax. Federal income tax returns for 2009 through 2012 and California income tax returns for 2008 through 2012 are currently open for Federal or state income tax examinations.

9. SHORT-TERM BORROWING ARRANGEMENTS

The Company had unsecured Federal Funds lines of credit totaling $10 million with its correspondent banks at December 31, 2012 and at December 31, 2011. There were no borrowings outstanding under these agreements at December 31, 2012 and 2011.

The Company has a short-term borrowing arrangement with the Federal Reserve Bank through the Discount Window. The Company has pledged certain securities to secure borrowings. The borrowing capacity under the agreement varies depending on the amount and type of securities pledged. There were no borrowings outstanding under the agreement at December 31, 2012 or 2011, and the Company had $31,152,913 of readily available borrowing capacity at December 31, 2012 based on currently pledged investments.

As a member of the Federal Home Loan Bank (FHLB) of San Francisco, the Bank is eligible to use the FHLB's facilities for short and long term borrowing. Borrowing capacity is based on the amount of stock ownership in the FHLB and all borrowings are based on pledged assets or a blanket lien against Call Report loan categories. There were no borrowings outstanding from the FHLB at December 31, 2012 or 2011. The borrowing capacity at December 31, 2012 was $73.3 million based upon a blanket lien against Call Report loan categories.

10. COMMITMENTS

Operating Leases

The Company leases its branch and its administrative offices under a noncancellable operating lease. The lease expires in 2018 and has two five-year renewal options. The Company also leases office space for loan production offices in Redwood City and San Jose, California. The Redwood City loan production office lease expires in 2019 and has one three-year renewal option. The San Jose loan production office lease expires in 2016 and has one three-year renewal option The Company also leases space related to former branch and administrative office locations which are subleased and for which the lease and sublease agreements expire in 2013.

The following is a schedule by year of future minimum rental payments required under operating leases and total minimum sublease rental income to be received that have initial or remaining noncancellable lease terms in excess of one year as of December 31, 2012:

Year Ending December 31,	Leases	Subleases
2013	$ 1,338,190	$ (251,672)
2014	1,127,110	-
2015	1,165,153	-
2016	1,154,554	-
2017	1,173,140	-
Thereafter	1,106,391	-
	$ 7,064,538	$ (251,672)

10. COMMITMENTS (Continued)

Operating Leases (continued)

Net rent expense included in occupancy and equipment expense totaled $837,578, $749,181 and $842,436 for the years ended December 31, 2012, 2011, and 2010, respectively. Sublease income totaled $408,022, $419,464 and $461,426 for the years ended December 31, 2012, 2011 and 2010, respectively.

Management has determined that the liability for future minimum rental payments due on abandoned leased premises, reduced by the estimated sublease income to be received, is $7,381 as of December 31, 2012. The future minimum rental payments required under operating leases and estimated sublease income for these locations are included in the preceding schedule.

Federal Reserve Requirements

Banks are required to maintain reserves with the Federal Reserve Bank equal to a percentage of their reservable deposits. The amount of such reserve balances required at December 31, 2012 was $4.9 million.

Financial Instruments With Off-Balance-Sheet Risk

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

The Company'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 Company uses the same credit policies in making commitments and standby letters of credit as it does for loans included on the balance sheet.

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

	December 31,	
	2012	2011
Commitments to extend credit	$ 115,953,149	$ 88,943,141
Standby letters of credit	$ 1,515,517	$ 574,390

Commitments to extend credit consist primarily of unfunded single-family residential and commercial real estate construction loans and commercial revolving lines of credit. Construction loans are established under standard underwriting guidelines and policies and are secured by deeds of trust, with disbursements made over the course of construction. Commercial revolving lines of credit have a high degree of industry diversification. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

10. COMMITMENTS (Continued)

Financial Instruments With Off-Balance-Sheet Risk (continued)

Standby letters of credit are generally secured and are issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loans to customers. The fair value of the liability related to these standby letters of credit, which represents the fees received for issuing the guarantees, was not significant at December 31, 2012 and 2011. The Company recognizes these fees as revenue over the term of the commitment or when the commitment is used.

At December 31, 2012, most loan commitments were for real estate mortgage and commercial loans and were generally secured by real estate with a loan-to-value ratio not to exceed 80%. In addition, the majority of the Company's loan commitments had variable interest rates.

Significant Concentrations of Credit Risk

The Company grants real estate mortgage, real estate construction, commercial and consumer loans primarily to customers in the California counties of San Mateo and Santa Clara. Although the Company has a diversified loan portfolio, a substantial portion of its portfolio is secured by commercial and residential real estate. Management believes the loans within this concentration have no more than the normal risk of collectability, however, a substantial decline in real estate values in the Company's primary market area could have an adverse impact on the collectability of these loans. Personal and business income represent the primary sources of repayment for a majority of these loans and management believes the risks presented by the concentration is further mitigated by diversification of property types within the Company's real estate portfolio and by conservative underwriting.

At December 31, 2012, in management's judgment, a concentration of loans existed in construction and real estate related loans. At that date, approximately 66.3% of the Company's loans were construction and real estate related, representing 23.8% and 42.5% of total outstanding loans, respectively.

At December 31, 2011, in management's judgment, a concentration of loans existed in construction and real estate related loans. At that date, approximately 69.1% of the Company's loans were construction and real estate related, representing 20.3% and 48.8% of total outstanding loans, respectively.

Correspondent Banking Agreements

The Company maintains funds on deposit with other federally-insured financial institutions under correspondent banking agreements. Some of those insured financial institutions elected to participate in the FDIC-sponsored Transaction Account Guarantee Program. Under that program, through December 31, 2010, all noninterest-bearing transaction accounts were fully guaranteed by the FDIC for the entire amount in the account. Coverage under the Transaction Account Guarantee Program was in addition to and separate from the coverage available under the FDIC's general deposit insurance rules. This coverage was continued under the Dodd Frank Act through December 31, 2012, and has now since expired. Deposits over $250,000 that were covered by insurance totaled $4.9 million and $7.4 million at December 31, 2012 and 2011, respectively, while $4.8 million and $4.1 million of interest-bearing deposits were uninsured at December 31, 2012 and 2011, respectively.

10. COMMITMENTS (Continued)

Contingencies

The Company 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 consolidated financial position or results of operations of the Company.

11. SHAREHOLDERS' EQUITY

Dividends

The Company's ability to pay cash dividends is dependent on dividends paid to it by the Bank and limited by California law. Under California law, the holders of common stock of the Company are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available, subject to certain restrictions. California General Corporation Law prohibits the Company from paying dividends on its common stock unless: (i) its retained earnings, immediately prior to the dividend payment, equals or exceeds the amount of the dividend or (ii) immediately after giving effect to the dividend, the sum of the Company's assets (exclusive of goodwill and deferred charges) would be at least equal to 125% of its liabilities (not including deferred taxes, deferred income and other deferred liabilities) and the current assets of the Company would be at least equal to its current liabilities, or, if the average of its earnings before taxes on income and before interest expense for the two preceding fiscal years was less than the average of its interest expense for the two preceding fiscal years, at least equal to 125% of its current liabilities.

Dividends paid from the Bank to the Company are restricted under certain Federal laws and regulations governing banks. In addition, the California Financial Code restricts the total dividend payment of any bank in any one year to the lesser of (1) the bank's retained earnings or (2) the bank's net income for its last three fiscal years, less distributions made to shareholders during the same three-year period, without the prior approval of the California Department of Financial Institutions. At December 31, 2012, $1.17 million was free of such restrictions.

Participation in the TARP Program

On January 30, 2009, the Company entered into a Letter Agreement (the "Purchase Agreement") with the United States Department of the Treasury ("Treasury"), pursuant to which the Company issued and sold 6,000 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the "Series A Preferred Stock") and (ii) a warrant (the "Warrant") to purchase 81,670 shares of the Company's common stock, no par value (the "Common Stock"), for an aggregate purchase price of $6 million in cash.

The Series A Preferred Stock qualifies as Tier 1 capital and pays cumulative dividends quarterly at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Series A Preferred Stock may be redeemed by the Company after three years. Prior to the end of three years, the Series A Preferred Stock may be redeemed by the Company only with proceeds from the sale of qualifying equity securities of the Company (a "Qualified Equity Offering").

The Warrant has a 10-year term and is immediately exercisable upon its issuance, with an exercise price, subject to antidilution adjustments, equal to $11.02 per share of the Common Stock. At December 31, 2012, the Warrant had no intrinsic value.

11. SHAREHOLDERS' EQUITY (Continued)

Participation in the TARP Program (Continued)

Pursuant to the Purchase Agreement, Treasury has agreed not to exercise voting power with respect to any shares of Common Stock issued upon exercise of the Warrant.

The Series A Preferred Stock and the Warrant were issued in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended. Neither the Series A Preferred Stock nor the Warrant will be subject to any contractual restrictions on transfer.

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

If dividends on the Series A Preferred Stock are not paid in full for six quarterly dividend periods, whether or not consecutive, the holders of the Series A Preferred Stock will have the right to elect two directors. The right to elect directors will end when full dividends have been paid for four consecutive quarterly dividend periods. As of December 31, 2012, the Company has paid quarterly dividends to the Treasury for eleven consecutive quarters.

In the Purchase Agreement, the Company agreed that, until such time as Treasury ceases to own any debt or equity securities of the Company acquired pursuant to the Purchase Agreement, the Company will take all necessary action to ensure that its benefit plans with respect to its senior executive officers comply with Section 111(b) of the Emergency Economic Stabilization Act of 2008 (the “EESA”) as implemented by any guidance or regulation under the EESA that has been issued and is in effect as of the date of issuance of the Series A Preferred Stock and the Warrant, and has agreed to not adopt any benefit plans with respect to, or which cover, its senior executive officers that do not comply with the EESA, and the applicable executives have consented to the foregoing. Furthermore, the Purchase Agreement allows Treasury to unilaterally amend the terms of the agreement.

With respect to dividends on the Company’s common stock and preferred stock issues that are subordinate to the Treasury's position, Treasury’s consent shall be required for any increase in common dividends per share until the third anniversary of the date of its investment unless prior to such third anniversary the Series A Preferred Stock is redeemed in whole or the Treasury has transferred all of the Senior Preferred Series A Preferred Stock to third parties. Furthermore, for as long as any Series A Preferred Stock is outstanding, no dividends may be declared or paid on junior preferred shares, preferred shares ranking pari passu with the Series A Preferred Stock, or common shares (other than in the case of pari passu preferred shares, dividends on a pro rata basis with the Series A Preferred Stock), nor may the Company repurchase or redeem any junior preferred shares, preferred shares ranking pari passu with the Series A Preferred Stock or common shares, unless all accrued and unpaid dividends for all past dividend periods on the Series A Preferred Stock are fully paid.

The Company allocated the proceeds received between the Series A Preferred Stock and the Warrant based on the estimated relative fair value of each. The fair value of the Warrant was estimated based on a Black-Scholes model and totaled $190,827. The discount recorded on the Series A Preferred Stock is being accreted using a straight-line method over 5 years.

11. SHAREHOLDERS' EQUITY (Continued)

Earnings Per Common Share

A reconciliation of the numerators and denominators of the basic and diluted earnings per common share computations for the years ended December 31, 2012, 2011 and 2010 is shown below:

	Net Income	Less Preferred Stock Dividends and Accretion	Net Income Available to Common Shareholders	Weighted Average Number of Shares Outstanding	Per Share Amount
December 31, 2012					
Basic income per common share	$ 2,744,714	$ (345,242)	$ 2,399,472	2,610,998	$ 0.92
Effect of dilutive options				19,086	-
Diluted income per common share	$ 2,744,714	$ (345,242)	$ 2,399,472	2,630,084	$ 0.91
December 31, 2011					
Basic income per common share	$ 3,836,703	$ (555,242)	$ 3,281,461	2,602,276	$ 1.26
Effect of dilutive options				3,310	-
Diluted income per common share	$ 3,836,703	$ (555,242)	$ 3,281,461	2,605,586	$ 1.26
December 31, 2010					
Basic income per common share	$ 2,223,545	$ (179,092)	$ 2,044,453	2,602,276	$ 0.79
Effect of dilutive options				-	-
Diluted income per common share	$ 2,223,545	$ (179,092)	$ 2,044,453	2,602,276	$ 0.79

There were 580,566 and 448,522 options excluded from the calculation of diluted earnings per share in 2012 and 2011, respectively, because they were anti-dilutive. All options outstanding at December 31, 2010 were excluded from the calculation of diluted earnings per share because they were anti-dilutive.

11. SHAREHOLDERS' EQUITY (Continued)

Regulatory Capital

The Company and Bank are subject to certain regulatory capital requirements administered by the Board of Governors of the Federal Reserve System and the FDIC. Failure to meet these minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated 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 Company's and 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 Company and 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 Company and the Bank met all their capital adequacy requirements as of December 31, 2012 and 2011.

11. SHAREHOLDERS' EQUITY (Continued)

Regulatory Capital (Continued)

As of December 31, 2012, the most recent notification from the FDIC categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category. To be categorized as well-capitalized, under the regulatory framework for prompt corrective actions, the Company and the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table below:

	2012		2011	
	Amount	Ratio	Amount	Ratio
Leverage Ratio				
Avidbank Holdings, Inc.	$ 36,678,966	8.88%	$ 27,923,816	10.37%
Minimum regulatory requirement	$ 16,523,649	4.00%	$ 13,091,157	4.00%
Avidbank	$ 36,582,200	8.86%	$ 33,897,816	10.36%
Minimum requirement for "Well-Capitalized" institution	$ 20,654,561	5.00%	$ 16,363,946	5.00%
Minimum regulatory requirement	$ 16,523,649	4.00%	$ 13,091,157	4.00%
Tier 1 Risk-Based Capital Ratio				
Avidbank Holdings, Inc.	$ 36,678,966	10.78%	$ 33,923,816	11.51%
Minimum regulatory requirement	$ 13,607,409	4.00%	$ 11,791,261	4.00%
Avidbank	$ 36,582,200	10.75%	$ 33,897,816	11.50%
Minimum requirement for "Well-Capitalized" institution	$ 20,411,114	6.00%	$ 17,686,892	6.00%
Minimum regulatory requirement	$ 13,607,409	4.00%	$ 11,791,261	4.00%
Total Risk-Based Capital Ratio				
Avidbank Holdings, Inc.	$ 40,931,281	12.03%	$ 37,847,339	12.84%
Minimum regulatory requirement	$ 27,214,818	8.00%	$ 23,582,522	8.00%
Avidbank	$ 40,834,515	12.00%	$ 37,821,339	12.83%
Minimum requirement for "Well-Capitalized" institution	$ 34,018,523	10.00%	$ 29,478,153	10.00%
Minimum regulatory requirement	$ 27,214,818	8.00%	$ 23,582,522	8.00%

12. SHARE-BASED PAYMENT

Stock Options

Under the Company's 2008 Stock Option Plan, 780,000 shares of common stock are reserved for issuance to employees and Directors under incentive or nonstatutory agreements, of which 96,154 shares of common stock have been issued to date. The plan requires that the option price may not be less than the fair market value of the stock at the date the option is granted, and that the stock must be paid for in full at the time the option is exercised. All options expire on a date determined by the Board of Directors, but not later than five years from the date of grant, unless grant was a replacement grant in a value for value exchange whereby the expiration date of such grants was extended by two years from the original expiration date. Upon grant, options vest ratably over a four year period.

There were 213,000 new options granted in 2012, and 436,500 new options granted in 2011. As of December 31, 2012, there were 18,094 remaining options available to be granted under the plan.

12. SHARE-BASED PAYMENT (Continued)

Stock Options (Continued)

A summary of option activity under the Plan for the years ended December 31, 2012 and 2011 follows:

	Number of Stock Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Options outstanding at December 31, 2010	176,254	$ 10.85	2.73 years	$ 5,400
Options granted	436,500	$ 6.68		
Options forfeited	(40,922)	$ 10.98		
Options outstanding at December 31, 2011	571,832	$ 7.66	3.70 years	$ 5,400
Options granted	213,000	$ 8.49		
Options exercised	(12,379)	$ 6.32		
Options forfeited	(106,701)	$ 11.23		
Options outstanding at December 31, 2012	665,752	$ 7.38	3.49 years	$ 1,628,432
Options vested or expected to vest at December 31, 2012	523,986	$ 7.37	3.43 years	$ 1,292,028
Options exercisable at December 31, 2012	161,600	$ 7.20	2.73 years	$ 453,178

The Company determines the fair value of options on the date of grant using a Black-Scholes option pricing model that uses assumptions based on expected option life, the level of estimated forfeitures, expected stock volatility and the risk-free interest rate. Stock volatility is based on the historical volatility of the Company's stock. The risk-free rate is based on the U.S. Treasury yield curve and the expected term of the options. For options granted, historical data was used based on the actual term the Company's options were held to estimate the expected term of the stock option grants.

12. SHARE-BASED PAYMENT (Continued)

Stock Options (Continued)

The fair value of each option is estimated on the date of grant using the following assumptions:

	2012	2011	2010
Dividend Yield	N/A	N/A	N/A
Expected volatility	31.83%	35.90%	36.17%
Risk-free interest rate	0.42%	0.84%	1.23%
Expected option life	3.2 years	3.2 years	3.8 years

The weighted-average grant-date fair value of options granted during 2012, 2011 and 2010 was $1.93, $1.76 and $1.60, respectively.

12,379 options were exercised in 2012 with cash proceeds received of $78,266. No options were exercised in 2011 or 2010. The intrinsic value of options exercised in 2012 was $29,972. The tax benefit recognized from stock option exercises in 2012 was not significant.

A summary of the status of the Company's non-vested shares as of January 1, 2012 and changes during the year ended December 31, 2012, is presented below:

Non-vested Shares	Shares	Weighted Average Exercise Price
Non-vested at January 1, 2012	461,113	$ 6.74
New options granted	213,000	8.43
Vested	(118,058)	6.87
Forfeited	(51,402)	6.86
Non-vested at December 31, 2012	504,653	$ 7.43

As of December 31, 2012, the unrecognized compensation cost related to non-vested stock option awards totaled $525,828. That cost is expected to be amortized on a straight-line basis over a weighted average period of seventeen months. The total fair value of vested options was $329,088 at December 31, 2012. The expensed cost of vested options was $216,353, $226,010 and $268,349 in 2012, 2011 and 2010, respectively.

13. EMPLOYEE 401(k) PROFIT SHARING PLAN

The Bank adopted The Private Bank of the Peninsula 401(k) Profit Sharing Plan and Trust, effective October 28, 2003. All employees 21 years of age or older become eligible to participate in the plan on the first day of the month following employment with the Bank. Eligible employees may elect to make tax deferred contributions of their salary up to the maximum amount allowed by law. The Bank may make additional contributions to the plan at the discretion of the Board of Directors. Bank contributions vest at a rate of 25% annually for all employees. Bank contributions for the years ended December 31, 2012, 2011 and 2010 totaled $120,844, $57,497 and $25,958, respectively.

14. RELATED PARTY TRANSACTIONS

During the normal course of business, the Company enters into transactions with related parties, including Directors and officers. The following is a summary of the aggregate activity involving related party borrowers during 2012:

Balance, January 1, 2012	$ 7,290,177
Additions	744,696
Amounts repaid	(2,786,950)
Balance, December 31, 2012	$ 5,247,923
Undisbursed commitments to related parties, December 31, 2012	$ 5,000

The Company's Chairman provided consulting services related to marketing, real estate and employee related matters prior to his becoming CEO on March 1, 2012. These services were provided under an annually renewable, fixed fee arrangement, approved by the Board of Directors. Payments under the arrangement totaled $35,667, $221,000 and $84,000 for the years ended December 31, 2012, 2011 and 2010, respectively.

15. OTHER EXPENSES

Other expenses for the years ended December 31, 2012, 2011and 2010 consisted of the following:

	2012	2011	2010
Data processing	$ 358,451	$ 320,236	$ 311,425
Advertising and marketing	220,717	254,782	282,670
Supplies and printing	37,605	49,025	77,778
Professional fees	271,697	420,862	264,556
Legal fees	94,484	134,004	287,948
Director's fees	117,750	159,750	157,850
Insurance and bonding	70,604	79,161	80,100
FDIC and DFI assessments	408,292	594,181	569,322
Credit reports and appraisals	11,218	22,465	12,006
Correspondent bank charges	262,314	168,217	159,573
Other real estate owned expenses	-	-	55,206
Off-balance sheet loss provision	65,450	50,278	(14,906)
Other	600,569	417,536	302,365
Total other expenses	$ 2,519,151	$ 2,670,497	$ 2,545,893

16. FAIR VALUE

The Company discloses the fair value of financial instruments for which it is practicable to estimate that value. Although management uses its best judgment in estimating fair value, there are inherent weaknesses in any estimates that are made at a discrete point in time based on relevant market data, information about the financial instruments, and other factors. Estimates of fair value of instruments without quoted market prices are subjective in nature and involve various assumptions and estimates that are matters of judgment. Changes in the assumptions used could significantly affect these estimates.

Fair Value Hierarchy

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

Level 1 - Quoted market prices for identical instruments traded in active exchange markets.

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

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

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

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

Methods and assumptions used to estimate the fair value of each major classification of financial instruments were:

Cash and cash equivalents and Federal Funds sold: The current carrying amount approximates estimated fair value resulting in a Level 1 classification.

FHLB stock: It is not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

Available-for-sale investment securities and interest-bearing deposits in other banks: For available-for-sale investment securities and interest-bearing deposits in other banks, fair values are based on quoted market prices, where available (Level 1 classification). If quoted market prices are not available, fair values are estimated using quoted market prices for similar securities and deposits and indications of value provided by brokers (Level 2 classification).

16. FAIR VALUE (Continued)

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

The carrying amounts of accrued interest receivable and payable are consistent with the asset/liability they are associated with.

Customer deposits: The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. The carrying amounts of variable rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date resulting in a Level 2 classification Fair values for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.The intangible value of long term relationships with depositors is not taken into account in estimating the fair values disclosed. Management believes that the Bank's non-term accounts, as a continuing source of less costly funds, provide significant additional value to the Bank that is not reflected below. The fair value of deposits with a stated maturity is based on the present value of contractual cash flows discounted by the replacement rates for securities with similar remaining maturities.

Commitments to extend credit: The majority of the Bank's commitments to extend credit carry current market interest rates if converted to loans. Because these commitments are generally unassignable by either the Bank or the borrower, they have value only to the Bank and the borrower. The estimated fair value of the Bank's commitments to extend credit, including letters of credit, approximates the recorded deferred fee amounts and was not material at December 31, 2012 or 2011.

16. FAIR VALUE (Continued)

The carrying amounts and estimated fair values of financial instruments, at December 31, 2012 and December 31, 2011 are as follows:

	Carrying Amount	Fair Value Measurements at 12/31/2012 Using: Level 1	Level 2	Level 3	Total
Financial assets:					
Cash and due from banks	$ 21,492,778	$ 21,492,778	$ -	$ -	$ 21,492,778
Federal funds sold	85,510,000	85,510,000	-	-	85,510,000
Available-for-sale investment securities	55,343,000	-	55,343,000	-	55,343,000
Loans	242,788,866	-	-	248,649,099	248,649,099
Federal Home Loan Bank stock	1,497,300	NA	NA	NA	NA
Accrued interest receivable	1,203,932	-	434,974	768,958	1,203,932
Financial liabilities:					
Deposits	$ 374,993,911	$ 308,473,973	$ 66,911,604	$ -	$ 375,385,578
Accrued interest payable	59,743	6	59,737	-	59,743

	Carrying Amount	Fair Value at 12/31/2011
Financial assets:		
Cash and due from banks	$ 12,376,758	$ 12,376,758
Federal funds sold	33,660,000	33,660,000
Available-for-sale investment securities	82,178,432	82,178,432
Loans	203,588,739	208,145,586
Federal Home Loan Bank stock	1,285,300	NA
Accrued interest receivable	1,384,327	1,384,327
Financial liabilities:		
Deposits	$ 306,715,845	$ 306,550,064
Accrued interest payable	44,875	44,875

16. FAIR VALUE (Continued)

Assets Recorded at Fair Value

The following tables present information about the company's assets and liabilities measured at fair value on a recurring and nonrecurring basis as of December 31, 2012 and December 31, 2011:

Recurring Basis

The Company is required or permitted to record the following assets at fair value on a recurring basis as follows:

	2012			
Description	Fair Value	Level 1	Level 2	Level 3
U.S. Agencies	$ 6,234,000	$ -	$ 6,234,000	$ -
U.S. Govt. Sponsored Agencies	9,949,000	-	9,949,000	-
Residential Mortgage-Backed Securities	6,426,000	-	6,426,000	-
Corporate Debt Securities	32,734,000	-	32,734,000	-
Available-for-sale securities	$ 55,343,000	$ -	$ 55,343,000	$ -

	2011			
Description	Fair Value	Level 1	Level 2	Level 3
U.S. Sponsored Agencies	$ 50,187,000	$ -	$ 50,187,000	$ -
Corporate Debt Securities	31,991,000	-	31,991,000	-
Available-for-sale securities	$ 82,178,000	$ -	$ 82,178,000	$ -

Fair values for available-for-sale investment securities are based on quoted market prices for similar securities (Level 2). During the years ended December 31, 2012 and December 31, 2011, there were no significant transfers in or out of Levels 1,2 or 3.

16. FAIR VALUE (Continued)

Non-recurring Basis

The Company may be required, from time to time, to measure certain assets and liabilities at fair value on a non-recurring basis. Collateral dependent loans at fair value as of December 31, 2011 are presented below:

	2011			
Description	Total	Level 1	Level 2	Level 3
Impaired loans				
Commercial	$ 31,029	$ -	$ -	$ 31,029
Consumer	28,800			28,800
Total impaired loans	$ 59,829	$ -	$ -	$ 59,829

At December 31, 2012, the fair value of the single impaired loan was based on a discounted cash flow analysis, as the loan was determined to not be collateral dependent. At December 31, 2011, the impaired loans were determined to be collateral dependent and categorized as Level 3. The fair value was based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

The Company did not identify any liabilities that are required to be presented at fair value at December 31, 2012 or 2011.

17. PARENT ONLY CONDENSED FINANCIAL STATEMENTS

PARENT ONLY BALANCE SHEET
December 31, 2012 and 2011

ASSETS	2012	2011
Cash and cash equivalents	$ 104,366	$ 26,100
Investment in Bank subsidiary	37,758,533	33,668,843
Total assets	$ 37,862,899	$ 33,694,943
LIABILITIES AND SHAREHOLDERS' EQUITY		
Preferred stock	$ 5,951,578	$ 5,906,336
Common stock	27,618,879	27,618,879
Additional paid-in capital	1,936,976	1,627,042
Retained earnings (deficit)	1,171,133	(1,228,339)
Accumulated other comprehensive income (loss), net of taxes	1,184,333	(228,975)
Total shareholders' equity	37,862,899	33,694,943
Total liabilities and shareholders' equity	$ 37,862,899	$ 33,694,943

PARENT ONLY STATEMENT OF OPERATIONS
For the years ending December 31, 2012 and 2011

	2012	2011
INCOME		
Dividends declared by subsidiary - eliminated in consolidation	$ 300,000	$ 559,000
Other income	-	26,000
Total income	300,000	585,000
EXPENSES	-	-
Income before undistributed net income of subsidiary	300,000	585,000
Equity in undistributed net income of subsidiary	2,444,714	3,251,703
Net income	$ 2,744,714	$ 3,836,703

17. PARENT ONLY CONDENSED FINANCIAL STATEMENTS (Continued)

PARENT ONLY STATEMENT OF CASH FLOWS
For the Years Ended December 31, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Net income	$ 2,744,714	$ 3,836,703
Adjustments to reconcile net income to net cash provided by operating activities:		
Undistributed net income of subsidiary	(2,444,714)	(3,251,703)
Net cash provided by operating activities	300,000	585,000
Cash flows from financing activities:		
Exercise of employee stock options	78,266	-
Cash dividends paid	(300,000)	(559,000)
Net cash used in by financing activities	(221,734)	(559,000)
Increase in cash and cash equivalents	78,266	26,000
Cash and cash equivalents at beginning of period	26,100	100
Cash and cash equivalents at end of year	$ 104,366	$ 26,100

OFFICERS and DIRECTORS

OFFICERS

Mark D. Mordell
Chairman and Chief Executive Officer

Kenneth D. Brenner
President

Ronald E. Oliveira
Executive Vice President & Chief Credit Officer

Steve Leen
Executive Vice President & Chief Financial Officer

Scott J. Chamberlin
Executive Vice President - Corporate Finance

Dori Hamilton
Executive Vice President - Corporate Banking

Michael V. Hansen
Executive Vice President - Corporate Finance

Mark V. Schoenstein
Executive Vice President, Manager - Construction Lending

Nicole L. Bader
Senior Vice President - Senior Loan Officer

Lisa O. Felleman
Senior Vice President & Controller

Jeffrey Javier
Senior Vice President - Relationship Manager

Jon Krogstad
Senior Vice President - Relationship Manager

Joe Maleti
Senior Vice President - Commercial Real Estate Lending

Fergal J. O'Boyle
Senior Vice President - Construction Lending

Patrick K. Pierce
Senior Vice President - Credit Administration

Margaret Rotzin
Senior Vice President - Relationship Manager

Gina Stephens
Senior Vice President - BSA Officer

Susan J. Wells
Senior Vice President - Relationship Manager

Sarah Wesner
Senior Vice President - Corporate Banking

DIRECTORS

Mark D. Mordell, Chairman

Kenneth D. Brenner

Kristofer W. Biorn

David V. Campbell

Lisa B. Hendrickson

Bryan C. Polster

Roxy H. Rapp

Daniel P. Vetras

Avidbank Holdings, Inc., headquartered in Palo Alto, California offers innovative financial solutions and services. We specialize in the following markets: commercial & industrial, corporate finance, asset-based lending, real estate construction and commercial real estate lending, and real estate bridge financing.

Avidbank advances the success of our clients by providing them with financial opportunities and serving them as we wish to be served - with mutual effort, ingenuity and trust - creating long-term banking relationships.

Avidbank Holdings, Inc.