# 2012
# Annual Report

Lighthouse Bank

# LIGHTHOUSE BANK

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

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

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

## Supporting our Community

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

- American Cancer Society
- American Red Cross
- Aptos Sports Foundation
- Big Brothers Big Sisters
- Big Stick Surfing Association
- Boomerang Foundation
- Boys & Girls Club of Santa Cruz
- Cabrillo College Foundation
- California Grey Bears
- California State Parks Foundation
- Clean Oceans Project
- Community Bridges
- Cultural Council of Santa Cruz County
- Cystic Fibrosis Foundation
- Dientes
- Dominican Hospital Foundation
- Family Service Agency of the Central Coast
- Habitat for Humanity
- Happy Valley Elementary School
- Harbor High School
- Hope Services
- Human Care Alliance
- Imagine Supported Living Services
- Jacob's Heart
- Kids on Broadway
- Long Marine Lab
- Monte Foundation
- Mount Madonna School
- Muscular Dystrophy Association
- MAH @ the McPherson Center
- National Marine Sanctuary Foundation
- Omega Nu
- Opening Doors to Community
- Organic Farming Research
- Pacific Collegiate School
- Salvation Army Santa Cruz Corps
- Sanctuary Exploration Center
- Santa Cruz Art League
- Santa Cruz City Youth Soccer Club
- Santa Cruz Community Counseling Center
- Santa Cruz County Bar Association
- Santa Cruz County Soccer Fund
- Santa Cruz County Symphony
- Santa Cruz County Trial Lawyers Association
- Santa Cruz Education Foundation
- Santa Cruz Gals Softball
- Santa Cruz G-Ball
- Santa Cruz High Baseball
- Santa Cruz Little League
- Santa Cruz Sunrise Rotary Save our Shores
- Scotts Valley Educational Foundation
- Scotts Valley Little League
- Second Harvest Food Bank
- Senior Citizens Legal Services
- Tannery Arts Center
- United Way of Santa Cruz County
- Vine Hill Elementary School
- Vista Center for the Blind & Visually Impaired
- Volunteer Centers of Santa Cruz County
- Walnut Avenue Women's Center
- Your Future is Our Business

# A Letter To Our Owners

To our Owners, Employees, Clients and Community,

On behalf of the Board of Directors and Management of Lighthouse Bank, we present our financial results for the fiscal year ended December 31, 2012. In spite of lackluster economic conditions, 2012 proved to be a year of records for our Bank. Assets, loans, deposits and earnings all increased to record levels, up 18%, 14%, 19% and 29%, respectively, as compared to 2011 year-end results. Credit quality remained strong, as we experienced only a single loan loss for the year, representing less than one-quarter of one percent of the entire loan portfolio. At year-end, the Bank had no past-due loans over 30-days, although the loan portfolio was backed by a reserve for loan losses of nearly 3%. Our continued focus on expense control remained intact, with non-interest expenses increasing by a modest 2% for the year. As a result, net profit after tax for 2012 increased by 29%, to a record $1.85 million. Lighthouse Bank's return on equity for 2012, at 9.3% placed it among the top 25% of the 233 state chartered banks in California, notwithstanding factors of size and age.

The foundation of the Bank's success continues to be our people. Bank staff, as well as our owners and clients, remain uncommonly committed to the company and its ideal of providing tangible benefit to all stakeholders. Of our original eighteen employees in 2007, fifteen are still with the company today, providing both industry expertise and service continuity for our clients. These same staff members, together with an engaged and dedicated Board, continue to further Lighthouse Bank's mission of strong financial performance combined with material community involvement and support.

Our consistently strong financial performance was recognized throughout 2012 by numerous financial services rating firms throughout the country. Firms the likes of Bauer Financial, FMC Consulting, Moss Adams and the Findley Reports, place Lighthouse Bank among the top performers in the industry. Looking forward through 2013, prospects for the Bank are bright as we move forward in adding scale to our model of consistent and efficient growth.

Again, we would like to thank our clients, owners and staff for their continued confidence and support. As Lighthouse Bank's presence and place in the community continues to grow, your trust and advocacy will remain a significant factor in driving our future success.

Please join us at our annual owners meeting at 4pm on Thursday, May 16th at the Santa Cruz Museum of Art and History at the McPherson Center.

Sincerely,

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

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

John C. Burroughs
*Chairman of the Board*

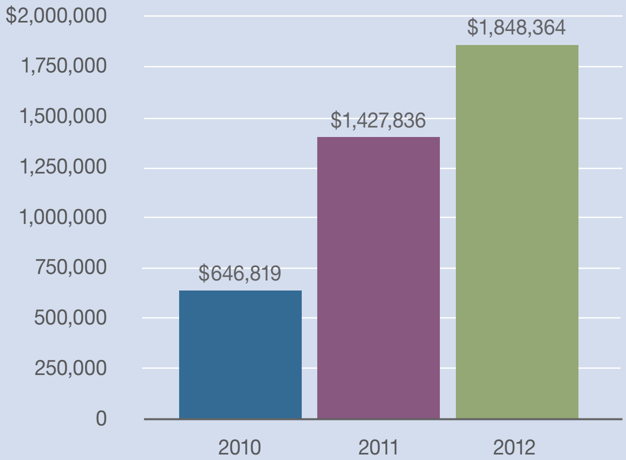
Richard G. Hofstetter
*President and CEO*

## Our Mission Statement

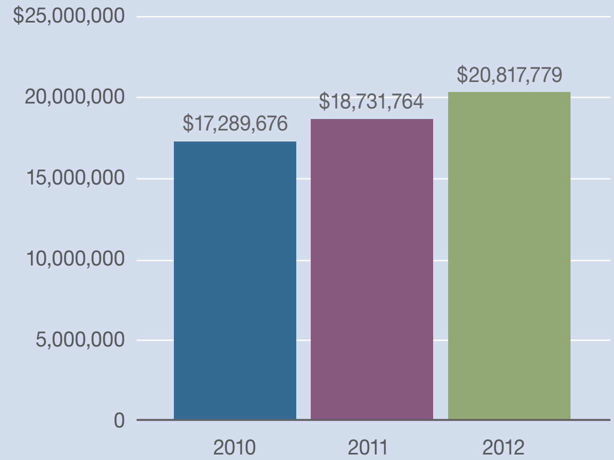
*Lighthouse Bank is committed to providing superior personalized banking products and services in Santa Cruz County. We are dedicated to creating financial benefit for our clients, professional growth for our employees and financial prosperity for our owners and community.*

# Financial Summary

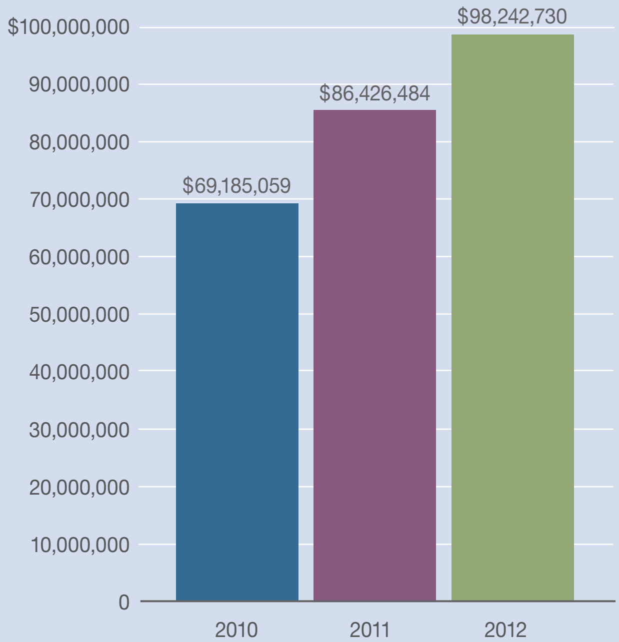
### Net Income After Tax



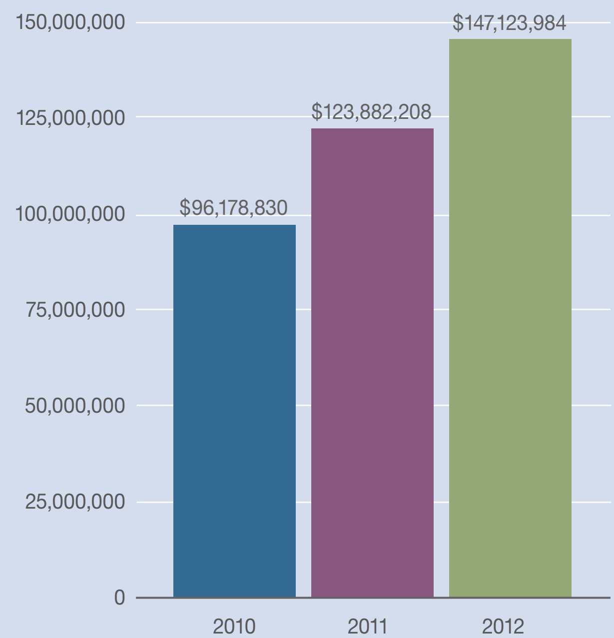

### Total Shareholders' Equity




### Total Gross Loans




### Total Deposits



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

VALUE THE DIFFERENCE

# INDEPENDENT AUDITOR'S REPORT

The Board of Directors
Lighthouse Bank

We have audited the accompanying financial statements of Lighthouse Bank, which are comprised of the statements of condition as of December 31, 2012 and 2011, and the related statements of operations, comprehensive income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2012, and the related notes to the financial statements.

*Management's Responsibility for the Consolidated Financial Statements*

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

*Auditor's Responsibility*

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

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

*Opinion*

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lighthouse Bank as of December 31, 2012 and 2011, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2012, in accordance with accounting principles generally accepted in the United States of America.

Vavrinek Trine Day + Co. LLP

Palo Alto, CA
March 19, 2013

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

# Statements of Condition

| | December 31, | |
|---|---|---|
| | 2012 | 2011 |
| **Assets** | | |
| Cash and due from banks | $ 33,714,059 | $ 21,254,988 |
| Federal funds sold | 860,000 | 50,000 |
| Total cash and cash equivalents | 34,574,059 | 21,304,988 |
| Interest-bearing deposits in other financial institutions | 17,006,673 | 28,280,805 |
| Investment securities: | | |
| Securities available-for-sale, at estimated fair value | 14,893,712 | 7,106,750 |
| Loans receivable: | | |
| Gross loans | 98,242,730 | 86,426,484 |
| Less deferred loan fees, net of costs | 533,934 | 478,533 |
| Less reserve for loan losses | 2,863,302 | 2,855,000 |
| Net loans | 94,845,494 | 83,092,951 |
| Premises and equipment, net | 27,438 | 122,844 |
| Accrued interest receivable | 345,290 | 329,595 |
| Federal Home Loan Bank and bankers' bank stock, at cost | 730,452 | 594,597 |
| Other real estate owned | 370,000 | 396,000 |
| Other assets | 5,972,052 | 1,915,783 |
| **Total Assets** | $ 168,765,170 | $ 143,144,313 |
| **Liabilities and Shareholders' Equity** | | |
| **Liabilities:** | | |
| Deposits: | | |
| Noninterest-bearing demand deposits | $ 37,314,565 | $ 31,366,553 |
| Interest-bearing demand deposits | 7,900,787 | 10,133,478 |
| Savings and money market deposits | 70,505,592 | 53,727,633 |
| Time deposits | 31,403,040 | 28,654,544 |
| Total deposits | 147,123,984 | 123,882,208 |
| Other liabilities: | | |
| Accrued interest payable | 12,320 | 11,940 |
| Borrowings | – | – |
| Other liabilities | 811,087 | 518,401 |
| Total liabilities | 147,947,391 | 124,412,549 |
| **Shareholders' Equity:** | | |
| Common stock, no par value, 10,000,000 shares authorized: issued and outstanding; 2,140,157 shares at December 31, 2012 and 2,038,324 shares at December 31, 2011 | 21,138,517 | 20,178,232 |
| Additional paid-in-capital | 1,120,447 | 1,108,323 |
| Accumulated (deficit) | (1,775,049) | (2,663,128) |
| Accumulated other comprehensive income | 333,864 | 108,337 |
| Total shareholders' equity | 20,817,779 | 18,731,764 |
| **Total Liabilities and Shareholders' Equity** | $ 168,765,170 | $ 143,144,313 |

*See accompanying notes to the Financial Statements*

## Statements of Operations

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| **Interest Income:** | | | |
| Interest and fees on loans | $6,556,092 | $5,846,845 | $4,746,339 |
| Investment securities | 482,279 | 323,924 | 452,692 |
| Federal funds sold and other interest income | 64,640 | 43,064 | 28,845 |
| Total interest income | 7,103,011 | 6,213,833 | 5,227,876 |
| **Interest Expense:** | | | |
| Deposits and other borrowed funds | 579,993 | 641,952 | 699,979 |
| Net interest income before provision for loan losses | 6,523,018 | 5,571,881 | 4,527,897 |
| Provision for loan losses | 238,000 | 930,000 | 541,000 |
| Net interest income after provision for loan losses | 6,285,018 | 4,641,881 | 3,986,897 |
| **Non-Interest Income:** | | | |
| Service charges on deposit accounts | 145,916 | 120,605 | 256,384 |
| Other non-interest income | 206,730 | 146,149 | 83,552 |
| Total non-interest income | 352,646 | 266,754 | 339,936 |
| **Non-Interest Expense:** | | | |
| Salaries and employee benefits | 2,233,413 | 2,126,370 | 2,168,383 |
| Occupancy | 235,955 | 259,000 | 259,686 |
| Furniture and equipment | 192,806 | 190,983 | 223,455 |
| Marketing and business development | 57,207 | 52,868 | 58,468 |
| Item and data processing | 147,916 | 159,656 | 160,431 |
| Professional services | 139,145 | 166,461 | 123,499 |
| Other operating expenses | 621,047 | 614,694 | 730,828 |
| Total non-interest expense | 3,627,489 | 3,570,032 | 3,724,750 |
| Income before income taxes | 3,010,175 | 1,338,603 | 602,083 |
| Income tax expense (benefit) | 1,161,811 | (89,233) | (44,736) |
| Net income | $1,848,364 | $ 1,427,836 | $ 646,819 |
| Earnings per share: | | | |
| Basic | $ 0.86 | $ 0.67 | $ 0.30 |
| Diluted | $ 0.85 | $ 0.67 | $ 0.30 |

*See accompanying notes to the Financial Statements*

## Statement of Shareholders' Equity

**For the three years ended December 31, 2012**

| | Common Shares | Amount | Additional Paid-In Capital | Accumulated Deficit | Other Comprehensive Income | Total Shareholders' Equity |
|---|---|---|---|---|---|---|
| **Balance at January 1, 2010** | $1,853,028 | $18,484,627 | $ 843,113 | $ (3,044,116) | $ 100,386 | $ 16,384,010 |
| Stock-based compensation | – | – | 255,052 | – | – | 255,052 |
| Net income | – | – | – | 646,819 | – | 646,819 |
| Unrealized gain on securities available-for-sale | – | – | – | – | 3,795 | 3,795 |
| **Balance at December 31, 2010** | 1,853,028 | 18,484,627 | 1,098,165 | (2,397,297) | 104,181 | 17,289,676 |
| Stock-based compensation | – | – | 10,158 | – | – | 10,158 |
| 10% stock dividend | 185,296 | 1,693,605 | – | (1,693,667) | – | (62) |
| Net income | – | – | – | 1,427,836 | – | 1,427,836 |
| Unrealized gain on securities available-for-sale | – | – | – | – | 4,156 | 4,156 |
| **Balance at December 31, 2011** | 2,038,324 | 20,178,232 | 1,108,323 | (2,663,128) | 108,337 | 18,731,764 |
| Stock-based compensation | – | – | 12,124 | – | – | 12,124 |
| 5% stock dividend | 101,833 | 960,285 | – | (960,285) | – | – |
| Net income | – | – | – | 1,848,364 | – | 1,848,364 |
| Unrealized gain on securities available-for-sale | – | – | – | – | 225,527 | 225,527 |
| **Balance at December 31, 2012** | $2,140,157 | $21,138,517 | $ 1,120,447 | $ (1,775,049) | $ 333,864 | $ 20,817,779 |

## Statements of Comprehensive Income

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| Net income | $ 1,848,364 | $ 1,427,836 | $ 646,819 |
| Other comprehensive income, net of tax: | | | |
| Unrealized gains on securities: | | | |
| Unrealized holding gains (losses) arising during period | 233,928 | 4,156 | 3,795 |
| Plus: reclassification adjustment for losses included in net income | 1,599 | – | – |
| Other comprehensive income, net of tax: | 225,527 | 4,156 | 3,795 |
| Comprehensive income | $ 2,073,891 | $ 1,431,992 | $ 650,614 |

*See accompanying notes to the Financial Statements*

## Statements of Cash Flows

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| **Operating Activities:** | | | |
| Net income | $ 1,848,364 | $ 1,427,836 | $ 646,819 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization of premises and equipment | 109,410 | 138,632 | 179,820 |
| Provision for loan losses | 238,000 | 930,000 | 541,000 |
| Deferred income tax expense (benefit) | 13,000 | (1,199,000) | (477,942) |
| Net amortization/accretion of investment discounts and premiums | 91,709 | 4,353 | 5,697 |
| Increase in deferred loan fees, net of costs | 55,401 | 73,315 | 130,349 |
| Bank Owned Life Insurance income | (123,688) | – | – |
| Stock-based compensation | 12,124 | 10,158 | 255,052 |
| Loss on disposal of equipment | – | 1,744 | 255 |
| Loss on sale of AFS securities | 1,599 | – | – |
| Gain on sale of OREO | – | (89,644) | (51,412) |
| Writedown on foreclosed assets | 26,000 | 80,680 | 87,603 |
| Net (increase) decrease in: | | | |
| Accrued interest receivable | (15,695) | (8,814) | (91,517) |
| Other assets | 54,419 | 100,396 | 95,169 |
| Net increase (decrease) in: | | | |
| Accrued interest payable | 380 | (10) | (4,476) |
| Other liabilities | 292,686 | 169,228 | 168,755 |
| Net cash provided by operating activities | 2,603,709 | 1,638,874 | 1,485,172 |
| **Investing Activities:** | | | |
| Available-for-sale securities: | | | |
| Principal repayments | 1,890,669 | 728,600 | 1,043,589 |
| Purchases | (13,014,369) | (5,115,676) | (1,005,938) |
| Sales | 3,468,957 | – | – |
| Purchase of Federal Home Loan Bank stock | (133,900) | (11,400) | (115,400) |
| Purchase of bankers' bank stock | (1,955) | (1,825) | (1,698) |
| Purchase of Bank Owned Life Insurance | (4,000,000) | – | – |
| Net (increase) decrease in time deposits with other banks | 11,275,000 | (3,581,000) | (7,971,000) |
| Net (increase) in other interest-bearing deposits with other banks | (868) | (1,231) | (245,574) |
| Net (increase) in loans | (12,045,944) | (17,241,425) | (14,047,969) |
| Purchase of premises and equipment | (14,004) | (6,205) | (3,672) |
| Proceeds from sale of OREO | – | 2,161,208 | 1,385,555 |
| Net cash used in investing activities | (12,576,414) | (23,068,954) | (20,962,107) |
| **Financing Activities:** | | | |
| Increase (decrease) in: | | | |
| Demand deposits | 3,715,321 | 13,718,112 | 12,440,817 |
| Savings and money market deposits | 16,777,959 | 7,558,765 | 13,446,007 |
| Time deposits | 2,748,496 | 6,426,501 | (181,758) |
| Other borrowings | – | (3,000,000) | (1,100,000) |
| Net cash provided by financing activities | 23,241,776 | 24,703,378 | 24,605,066 |
| Net increase in cash and cash equivalents | 13,269,071 | 3,273,298 | 5,128,131 |
| Cash and cash equivalents at beginning of period | 21,304,988 | 18,031,690 | 12,903,559 |
| Cash and cash equivalents at end of period | $34,574,059 | $21,304,988 | $ 18,031,690 |
| **Supplemental Disclosures of Cash Flow Information** | | | |
| Total interest paid | $ 579,613 | $ 641,962 | $ 704,455 |
| Total income taxes paid | $ 1,137,577 | $ 986,000 | $ 380,800 |
| Transfer of loans to other real estate owned | $ – | $ – | $ 706,024 |

*See accompanying notes to the Financial Statements*

## Note 1. Summary of Significant Accounting Policies

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

The majority of the Bank's business is done with customers located in Northern California, specifically in Santa Cruz and adjacent counties. The Bank has 151 credit arrangements that are collateralized by real estate. Generally, the Bank maintains loan-to-value ratios no greater than 70 percent on commercial and multi-family real estate loans and no greater than 70 percent on single-family residential real estate loans. At December 31, 2012, the Bank had loans outstanding of approximately $88,963,000 that were collateralized by real estate. There were no other significant loan concentrations.

**Subsequent Events** — The Bank has evaluated subsequent events for recognition and disclosure through March 19, 2013, which is the date the financial statements were available to be issued.

**Cash and Cash Equivalents** — For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and highly liquid debt instruments with an original maturity of 90 days or less. The Bank had a net cash reserve requirement of $768,000 and $563,000 at December 31, 2012, and December 31, 2011, respectively.

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

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

Held-to-maturity securities are recorded at amortized cost, adjusted for amortization or accretion of premiums or discounts. Available-for-sale securities are recorded at fair value with unrealized holding gains and losses, net of the related tax effect, reported as a separate component of shareholders' equity until realized. During the year ended December 31, 2012, there were no transfers between classifications. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. Dividend and interest income are recognized on an accrual basis. Realized gains and losses for securities classified as available-for-sale and held-to-maturity are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

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

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

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

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

**Allowance for Loan Losses** — The allowance for loan losses is established through periodic provisions for possible loan losses. Loans are charged against the allowance for loan losses when Management believes that the collectability of the principal is unlikely. The allowance is a reserve to provide for possible losses on existing loans that may become uncollectable, based on evaluations of the collectability of loans and prior loan loss experience. The evaluations include consideration of changes in the nature and volume of the loan portfolio, overall portfolio quality, a review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. Amounts are charged-off when available information confirms that specific loans or portions thereof, are uncollectible. This methodology for determining charge-offs is consistently applied to each segment. Factors considered in determining impairment include payment status, collateral value and the probability of collecting all amounts when due.

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

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

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

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

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

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

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

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

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

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

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

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

**Earnings (Loss) Per Share** — Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. The weighted average shares outstanding have been adjusted to retroactively reflect the impact of the 10% stock dividend issued in 2011 and the 5% stock dividend issued on March 8, 2013 (see Note 16). The weighted average shares outstanding for the basic earnings per share calculation were 2,140,157 for the years ended December 31, 2012, 2011 and 2010. The weighted average shares outstanding for diluted earnings per share for the year ended December 31, 2012 were 2,184,853. In 2011 and 2010 there were no potentially dilutive securities outstanding.

**Adoption of New Accounting Standards**
In April 2011, the Financial Accounting Standard Board ("FASB") amended existing guidance for assisting a creditor in determining whether a restructuring is a troubled debt restructuring ("TDR"). The amendments clarify the guidance for a creditor's evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. This guidance was effective for annual reporting periods ending after December 15, 2012, and was applied retrospectively to restructurings that occurred after January 1, 2012. The adoption of this standard in 2012 did not materially impact the Bank's accounting for TDR's.

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 periods beginning after December 15, 2011. New fair value related disclosures required by the new standard have been included in these financial statements.

In September 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 shareholders' equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in a two separate consecutive statement approach. The adoption of this amendment changed the presentation of the components of comprehensive income for the Bank as part of the consolidated statement of shareholders' equity. This amendment is effective for annual periods beginning after December 15, 2011 and the required presentation of other comprehensive income is included in these financial statements.

## Note 2. Investment Securities

**The following table summarizes Lighthouse Bank's securities available-for-sale at December 31, 2012, and December 31, 2011:**

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| **December 31, 2012** | | | | |
| **Securities available-for-sale:** | | | | |
| U.S. Agency | $ 1,000,000 | $ 19,240 | $ – | $ 1,019,240 |
| Municipal Securities | 6,431,567 | 98,340 | (18,041) | 6,511,866 |
| U.S. Agency MBSs | 7,128,281 | 234,325 | – | 7,362,606 |
| Total securities available-for-sale | $14,559,848 | $ 351,905 | $ (18,041) | $ 14,893,712 |
| **December 31, 2011** | | | | |
| **Securities available-for-sale:** | | | | |
| U.S. Agency | $ 1,000,000 | $ 530 | $ – | $ 1,000,530 |
| U.S. Agency MBSs | 5,998,413 | 112,048 | (4,241) | 6,106,220 |
| Total securities available-for-sale | $ 6,998,413 | $ 112,578 | $ (4,241) | $ 7,106,750 |

The amortized cost and estimated fair value of investment securities at December 31, 2012 and December 31, 2011 by contractual maturity are shown below, except for mortgage-backed securities and other securities in 2011 which are presented in total. Expected maturities on mortgage-backed securities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| **December 31, 2012** | | |
| Due in one year or less | $ 25,184 | $ 26,403 |
| Due after one year through five years | 1,049,526 | 1,069,302 |
| Due after five years through ten years | 2,079,993 | 2,166,565 |
| Due after ten years | 11,405,145 | 11,631,442 |
| Total | $14,559,848 | $14,893,712 |
| **December 31, 2011** | | |
| Due in one year or less | $ – | $ – |
| Due after one year through five years | 1,000,000 | 1,000,530 |
| Due after five years through ten years | – | – |
| Mortgage-backed securities | 5,998,413 | 6,106,220 |
| Total | $ 6,998,413 | $ 7,106,750 |

As of December 31, 2012 and 2011, there are no investment securities that have been in a temporary unrealized loss position for 12 months or longer. To reduce the Bank's market risk, investment securities with par values totaling $3,308,070 were sold at a combined net loss of $1,599 in 2012. No investment securities were sold in 2011. There are no investment securities required to be pledged to secure public deposits at December 31, 2012 and December 31, 2011, or for any other purposes, required or permitted by law. As of December 31, 2012 and 2011, there are no investment securities pledged to secure Federal Home Loan Bank borrowings (note 7).

## Note 3. Loans

**Loan maturity and rate sensitivity data of the loan portfolio at December 31, 2012 and 2011 are as follows (in thousands):**

| **December 31, 2012** | Within One Year | One to Five Years | After Five Years | Total |
|---|---|---|---|---|
| Loans secured by real estate, land and construction loans | $ 26,723 | $ 12,492 | $ 49,747 | $ 88,962 |
| Consumer and other loans | 102 | 9 | – | 111 |
| Commercial and revolving lines | 5,129 | 3,598 | 443 | 9,170 |
| | $ 31,954 | $ 16,099 | $ 50,190 | $ 98,243 |
| Loans at fixed interest rates | $ 25,057 | $ 10,305 | $ 38,538 | $ 73,900 |
| Loans at variable interest rates | 6,897 | 5,794 | 11,652 | 24,343 |
| | $ 31,954 | $ 16,099 | $ 50,190 | $ 98,243 |

| December 31, 2011 | Within One Year | One to Five Years | After Five Years | Total |
|---|---|---|---|---|
| Loans secured by real estate, land and construction loans | $ 24,059 | $ 22,672 | $ 29,157 | $ 75,888 |
| Consumer and other loans | 104 | – | – | 104 |
| Commercial and revolving lines | 4,987 | 4,395 | 1,052 | 10,434 |
| | $ 29,150 | $ 27,067 | $ 30,209 | $ 86,426 |
| Loans at fixed interest rates | $ 23,542 | $ 24,626 | $ 26,762 | $ 74,930 |
| Loans at variable interest rates | 5,608 | 2,441 | 3,447 | 11,496 |
| | $ 29,150 | $ 27,067 | $ 30,209 | $ 86,426 |

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

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| Balance at beginning of year | $ 2,855,000 | $ 1,925,000 | $ 1,384,000 |
| Provision for loan losses | 238,000 | 930,000 | 541,000 |
| Loan charge-offs | (256,686) | – | – |
| Unfunded commitment reclassification | (35,000) | – | – |
| Recoveries of loan charge-offs | 61,988 | – | – |
| Balance at year end | $ 2,863,302 | $ 2,855,000 | $ 1,925,000 |

**The following table presents the activity in the allowance for loan losses for the years 2012 and 2011 and the recorded investment in loans and impairment method as of December 31, 2012 and 2011 by portfolio segment:**

| December 31, 2012 | Commercial Real Estate | Residential Real Estate | Commercial | Consumer | Total |
|---|---|---|---|---|---|
| **Allowance for Loan Losses:** | | | | | |
| Beginning of Year | $ 2,346,323 | $ 83,499 | $ 425,097 | $ 81 | $ 2,855,000 |
| Provisions | 329,047 | (38,803) | (53,922) | 1,678 | 238,000 |
| Charge-offs | (256,686) | – | – | – | (256,686) |
| Adjustments | (35,000) | – | – | – | (35,000) |
| Recoveries | 61,988 | – | – | – | 61,988 |
| End of Year | $ 2,445,672 | $ 44,696 | $ 371,175 | $ 1,759 | $ 2,863,302 |
| **Reserves:** | | | | | |
| Specific | $ 509,366 | $ – | $ 1,639 | $ – | $ 511,005 |
| General | 1,936,306 | 44,696 | 369,536 | 1,759 | 2,352,297 |
| | $ 2,445,672 | $ 44,696 | $ 371,175 | $ 1,759 | $ 2,863,302 |
| **Loans Evaluated for Impairment:** | | | | | |
| Individually | $ 4,313,492 | $ – | $ 32,783 | $ – | $ 4,346,275 |
| Collectively | 75,105,461 | 2,458,722 | 16,212,943 | 119,329 | 93,896,455 |
| | $ 79,418,953 | $ 2,458,722 | $ 16,245,726 | $ 119,329 | $ 98,242,730 |

| December 31, 2011 | Commercial Real Estate | Residential Real Estate | Commercial | Consumer | Total |
|---|---|---|---|---|---|
| **Allowance for Loan Losses:** | | | | | |
| Beginning of Year | $ 1,541,841 | $ 77,990 | $ 304,490 | $ 679 | $ 1,925,000 |
| Provisions | 804,482 | 5,509 | 120,607 | (598) | 930,000 |
| Charge-offs | – | – | – | – | – |
| Adjustments | – | – | – | – | – |
| Recoveries | – | – | – | – | – |
| End of Year | $ 2,346,323 | $ 83,499 | $ 425,097 | $ 81 | $ 2,855,000 |
| **Reserves:** | | | | | |
| Specific | $ 609,461 | $ – | $ 3,480 | $ – | $ 612,941 |
| General | 1,736,862 | 83,499 | 421,617 | 81 | 2,242,059 |
| | $ 2,346,323 | $ 83,499 | $ 425,097 | $ 81 | $ 2,855,000 |
| **Loans Evaluated for Impairment:** | | | | | |
| Individually | $ 3,953,440 | $ – | $ 69,601 | $ – | $ 4,023,041 |
| Collectively | 61,391,656 | 4,167,493 | 16,839,263 | 5,031 | 82,403,443 |
| | $ 65,345,096 | $ 4,167,493 | $ 16,908,864 | $ 5,031 | $ 86,426,484 |

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

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

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

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

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

**Based on the most recent analysis performed, the approximate amount of loans by risk category and class of loans is as follows as of December 31, 2012 and 2011:**

| December 31, 2012 | Pass | Special Mention | Substandard | Doubtful & Impaired | Total |
|---|---|---|---|---|---|
| **Loans:** | | | | | |
| Construction and land | $ 12,409,341 | $ 895,300 | $ 382,163 | $ – | $13,686,804 |
| Commercial real estate | 62,696,120 | 1,544,340 | 991,689 | 500,000 | 65,732,149 |
| Residential real estate | 2,458,722 | – | – | – | 2,458,722 |
| Commercial and industrial | 14,143,023 | 32,783 | – | – | 14,175,806 |
| Small Business Administration | 2,069,920 | – | – | – | 2,069,920 |
| Other | 119,329 | – | – | – | 119,329 |
| | $93,896,455 | $ 2,472,423 | $ 1,373,852 | $ 500,000 | $98,242,730 |

| December 31, 2011 | Pass | Special Mention | Substandard | Doubtful & Impaired | Total |
|---|---|---|---|---|---|
| **Loans:** | | | | | |
| Construction and land | $ 13,364,069 | $ – | $ 1,425,614 | $ – | $14,789,683 |
| Commercial real estate | 48,027,587 | 1,771,140 | 756,686 | – | 50,555,413 |
| Residential real estate | 4,167,493 | – | – | – | 4,167,493 |
| Commercial and industrial | 14,416,423 | 69,601 | – | – | 14,486,024 |
| Small Business Administration | 2,422,840 | – | – | – | 2,422,840 |
| Other | 5,031 | – | – | – | 5,031 |
| | $82,403,443 | $ 1,840,741 | $ 2,182,300 | $ – | $86,426,484 |

**In general, the Bank would not recognize any interest income on loans that are classified as impaired. The following is a summary of the investment in impaired loans as of December 31, 2012 and 2011, including the related allowance for loan losses and cash-basis income recognized. Also shown are loans on non-accrual and those that are past due and still accruing interest:**

| | As of December 31, 2012 | As of December 31, 2011 |
|---|---|---|
| **Impaired Loans:** | | |
| Recorded investment in impaired loans | $ 500,000 | $ – |
| Related allowance for loan loss | 250,000 | – |
| Average recorded investment in impaired loans | 500,000 | – |
| Interest income recognized for cash payments while impaired | – | – |
| Total loans on non-accrual | 500,000 | – |
| Total loans past due 90 days or more and still accruing interest | – | – |

**Past due and nonaccrual loans presented by loan class were as follows as of December 31, 2012 and 2011:**

| | Still Accruing | | |
|---|---|---|---|
| **December 31, 2012** | 30-89 Days Past Due | Over 90 Days Past Due | Nonaccrual |
| Commercial Real Estate: | | | |
| Construction and Land Development | $ – | $ – | $ 500,000 |
| Multifamily | – | – | – |
| Other | – | – | – |
| Residential Real Estate | – | – | – |
| Commercial | – | – | – |
| | $ – | $ – | $ 500,000 |

| | Still Accruing | | |
|---|---|---|---|
| **December 31, 2011** | 30-89 Days Past Due | Over 90 Days Past Due | Nonaccrual |
| Commercial Real Estate: | | | |
| Construction and Land Development | $ – | $ – | $ – |
| Multifamily | – | – | – |
| Other | – | – | – |
| Residential Real Estate | – | – | – |
| Commercial | – | – | – |
| | $ – | $ – | $ – |

## Note 4. Premises and Equipment

**The following presents the cost of premises and equipment including leasehold improvements and the related accumulated depreciation and amortization at December 31, 2012 and December 31, 2011:**

| | December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Leasehold improvements | $ 294,469 | $ 294,469 |
| Furniture, fixtures and equipment | 222,657 | 212,892 |
| Software and capitalized data & item processing | 145,660 | 145,660 |
| Computer equipment | 156,406 | 152,167 |
| Automobile | 20,282 | 20,282 |
| Construction-in-progress | – | – |
| Total premises and equipment | 839,474 | 825,470 |
| Less accumulated depreciation and amortization | 812,036 | 702,626 |
| Premises and equipment, net | $ 27,438 | $ 122,844 |

Depreciation and amortization expense of premises and equipment aggregated $109,410, $138,632 and $179,820 for the years ended December 31, 2012, December 31, 2011 and December 31, 2010, respectively.

## Note 5. Income Taxes

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

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| **Current:** | | | |
| Federal | $ 841,587 | $ 875,287 | $ 376,584 |
| State | 307,224 | 234,480 | 56,622 |
| Total current | 1,148,811 | 1,109,767 | 433,206 |
| **Deferred:** | | | |
| Federal | (64,000) | (344,000) | (127,731) |
| State | 77,000 | (122,000) | (13,211) |
| Valuation Allowance Reversal | – | (733,000) | (337,000) |
| Total deferred | 13,000 | (1,199,000) | (477,942) |
| Total expense (benefit) | $ 1,161,811 | $ (89,233) | $ (44,736) |

**Deferred income taxes are the result of differences between income tax accounting and accounting principles generally accepted in the United States of America, with respect to income and expense recognition. The following is a summary of the components of the net deferred tax asset accounts as of December 31, 2012 and 2011:**

| | 2012 | 2011 |
|---|---|---|
| Pre-opening expenses | $ 71,000 | $ 82,000 |
| Stock-based compensation | 164,000 | 164,000 |
| OREO expenses | 94,000 | 152,000 |
| Loan loss reserve | 1,158,000 | 1,126,000 |
| Other | 177,000 | 153,000 |
| | 1,664,000 | 1,677,000 |
| Valuation allowance | – | – |
| Net deferred tax asset | $ 1,664,000 | $ 1,677,000 |

Beginning in the year 2010 and continuing through 2011, the Bank demonstrated the ability to maintain a consistent level of profitability such that a 100% reserve against the net deferred tax assets is no longer necessary. Therefore, in 2010 and 2011, the valuation allowance on deferred tax assets was reversed in the amounts of $337,000 and $733,000, respectively. The deferred tax asset balance as of December 31, 2010 has been adjusted to reflect income tax return adjustments to the deferred amounts. Such adjustment has no net impact on tax expense as the adjustment is equally offset by a change in current income taxes payable or receivable.

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

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| Tax at statutory federal rate | 34.00% | 34.00% | 34.00% |
| State tax net of federal benefit | 7.15 | 7.15 | 7.15 |
| Deferred tax valuation allowance | – | (54.76) | (55.97) |
| Other | (2.55) | 6.94 | 7.39 |
| | 38.6% | (6.67)% | (7.43)% |

The Bank's Federal and State income tax returns are subject to review by Federal and State taxing authorities for the three and four year periods ending December 31, 2012, respectively.

### Note 6. Time Deposits

**The aggregate amount of time deposit accounts equal to or greater than $100,000 was $21,072,019 and $19,057,867 at December 31, 2012 and December 31, 2011, respectively. At December 31, 2012 the scheduled maturities for time deposits were as follows (in thousands):**

| | |
|---|---|
| Due in 2013 | $ 23,505 |
| Due in 2014 | 5,167 |
| Due in 2015 | 1,126 |
| Due in 2016 | 885 |
| Due in 2017 | 720 |
| | $ 31,403 |

Interest expense on time deposits of $100,000 or more was $212,875, $191,771 and $233,531 in 2012, 2011 and 2010, respectively.

### Note 7. Borrowed Funds

The Bank has obtained federal funds borrowing guidance lines with its correspondent banks in an aggregate amount of $7.0 million on an unsecured basis. The only usage of these guidance lines was to successfully test their availability. Additionally, the Bank has established a secured borrowing facility with the Federal Home Loan Bank of San Francisco (FHLB). The Bank had no FHLB borrowings during the years-ended December 31, 2012, or December 31, 2011. At December 31, 2012, the Bank had a total available borrowing capacity of $41,306,600 which included $34,306,600 in secured borrowing capacity from the FHLB.

### Note 8. Stock Options

The Bank has adopted a qualified stock option plan (the Plan) for employees, non-employee directors and Bank founders, under which a maximum of 555,908 shares of Bank's common stock may be issued. The Plan calls for the exercise prices of the options to be equal to or greater than the fair market value of the stock at the time of grant. Options granted to Bank founders who are not also Bank directors or Bank officers were fully vested upon the date of grant. All other options shares granted have annual vesting over the first three years of the option contract. All option contracts for founders who are not also Bank directors or Bank officers have expiration dates of ten years from the date of grant. All director and employee option contracts have expiration dates on the earlier of termination of service or 10 years from the date of grant. For all periods presented, amounts in the succeeding tables reflect the 10% stock dividend of December 5, 2011 and the 5% stock dividend of March 8, 2013.

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

| | Options Outstanding | Weighted Average Exercise Price |
|---|---|---|
| Balance at December 31, 2009 | 506,000 | $ 9.11 |
| Granted 2010 | 3,450 | 6.50 |
| Exercised 2010 | – | – |
| Cancelled 2010 | (20,700) | 8.66 |
| Balance at December 31, 2010 | 488,750 | 9.11 |
| Granted 2011 | 3,450 | 6.73 |
| Exercised 2011 | – | – |
| Cancelled 2011 | (23,000) | 9.09 |
| Balance at December 31, 2011 | 469,200 | 9.09 |
| Granted 2012 | 11,865 | 9.23 |
| Exercised 2012 | – | – |
| Cancelled 2012 | (9,240) | 10.11 |
| Balance at December 31, 2012 | $ 471,825 | $ 9.08 |

| | Options Outstanding | | | Options Exercisable | | |
|---|---|---|---|---|---|---|
| | Number | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number | Weighted Average Contractual Life | Weighted Average Exercise Price |
| December 31, 2011: | 469,200 | 5.77 years | $ 9.09 | 443,300 | 5.84 years | $ 9.11 |
| December 31, 2012: | 471,825 | 4.90 years | $ 9.08 | 437,800 | 4.77 years | $ 9.08 |

There was an aggregate intrinsic value of stock option awards outstanding and exercisable of $839,150 and $283,675, respectively, at December 31, 2012 and December 31, 2011.

**The number and weighted average grant date fair value of options granted is as follows for the years ended December 31, 2012, December 31, 2011 and December 31, 2010:**

| | Number | Weighted Average Grant Date Fair Value |
|---|---|---|
| 2010 | 3,300 | $3.63 |
| 2011 | 3,300 | $2.72 |
| 2012 | 11,300 | $4.37 |

**The weighted average assumptions used for 2012, 2011 and 2010 in determining the fair value of options granted are as follows:**

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| Expected life (yrs.) | 6 | 6 | 6 |
| Volatility | 48.31% | 35.28% | 57.04% |
| Risk free rate of return | 1.72% | 3.44% | 2.96% |
| Dividend yield | 0.00% | 0.00% | 0.00% |

As of December 31, 2012, there was $48,646 unrecognized stock compensation expense that will be recognized through July 31, 2014.

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

All employees of the Bank are immediately, upon employment, eligible to participate in the Bank's 401(k) Plan which is a tax-deferred savings plan designed to assist employees in preparing for their retirement years. Employees may contribute to the Plan up to certain limits prescribed by the Internal Revenue Service. The Bank made $18,117 and $17,824 matching employee 401(k) contributions in 2012 and 2011, respectively, and did not match employee contributions in 2010.

## Note 10. Related Party Transactions

In the ordinary course of business, Bank policies allow the making of loans to directors, officers, principal shareholders and their associates on substantially the same terms, including interest rates, origination and commitment fees, and collateral, as comparable transactions with unaffiliated persons, and such loans do not involve more than the normal risk of collectability. The Bank had no loans and/or extensions of credit made to or guaranteed by the Bank's directors and officers and their related companies at December 31, 2012, and December 31, 2011.

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

**Restrictions on Cash and Due from Banks.** As compensation for check clearing and other services, compensating balances of approximately $2,000,000 and $1,000,000 were maintained with correspondent banks at December 31, 2012 and December 31, 2011, respectively.

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

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

| | |
|---|---|
| 2013 | 151,200 |
| 2014 | 151,200 |
| 2015 | 151,200 |
| 2016 | 151,200 |
| 2017 | 151,200 |
| | $756,000 |

Building rent expense was $151,200 for the year ended December 31, 2012 and was $140,400 for both of the years ended December 31, 2011 and December 31, 2010.

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

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

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

**Financial instruments whose contract amounts represent credit risk at December 31, 2012 and December 31, 2011 are as follows:**

| | December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Commitments to extend credit | $23,733,806 | $13,811,511 |
| Total unfunded financial commitments | $23,733,806 | $13,811,511 |

**Legal Matters.** At December 31, 2012, the Bank was not subject to or knows of any claims and/or lawsuits that could have a material financial impact on the operations of the Bank.

## Note 12. Fair Value of Financial Instruments

In accordance with applicable accounting guidance, the Bank groups its financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- **Level 1**: Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Level 1 also includes U.S. Treasury, other U.S. government and agency mortgage-backed securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

- **Level 2**: Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities.
- **Level 3**: Valuations for assets and liabilities that are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

The only assets or liabilities measured at fair value on a recurring basis on the Bank's balance sheet at December 31, 2012 and 2011 are the investment securities classified as available for sale totaling $14,893,712 and $7,106,750, respectively. Fair value for this group is based on the Level 2 assumption. Assets measured at fair value on a non-recurring basis at December 31, 2012, and December 31, 2011, consist solely of other real estate owned of $370,000 and $396,000 having a fair value assertion based on the Level 3 assumption.

As of December 31, 2012, 2011 and 2010, specific allocated reserves on OREO properties as well as write-downs on such properties aggregated $26,000, $80,680 and $87,603.

There were no changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the year ended December 31, 2012.

The following table presents the carrying amounts and estimated fair values of the Bank's financial instruments at December 31, 2012 and December 31, 2011. The fair value of financial instruments does not represent actual amounts that may be realized upon any sale or liquidation of the related assets or liabilities. In addition, these values do not give effect to discounts to fair value which may occur when financial instruments are sold in larger quantities. The fair values presented represent the Bank's best estimate of fair value using the methodologies discussed below.

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

| | December 31, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| | Amount | Fair Value | Amount | Fair Value |
| **Financial Assets:** | | | | |
| Cash and cash equivalents | $ 34,574,059 | $ 34,574,059 | $ 21,304,988 | $ 21,304,988 |
| Interest-bearing deposits in other banks | 17,006,673 | 17,006,673 | 28,280,805 | 28,280,805 |
| Securities available-for-sale | 14,893,712 | 14,893,712 | 7,106,750 | 7,106,750 |
| Bankers' bank and Federal Home Loan Bank stock | 730,452 | 730,452 | 594,597 | 594,597 |
| Bank Owned Life Insurance | 4,123,688 | 4,123,688 | – | – |
| Loans, net | 94,845,494 | 89,972,655 | 83,092,951 | 82,132,657 |
| Accrued interest receivable | 345,290 | 345,290 | 329,595 | 329,595 |
| **Financial Liabilities:** | | | | |
| Noninterest-bearing demand deposits | $ 37,314,565 | $ 37,314,565 | $ 31,366,553 | $ 31,366,553 |
| Interest-bearing demand deposits | 7,900,787 | 7,900,787 | 10,133,478 | 10,133,478 |
| Money market deposits | 65,489,949 | 65,489,949 | 50,166,365 | 50,166,365 |
| Time certificates of deposit | 31,403,040 | 31,401,956 | 28,654,544 | 28,655,326 |
| Savings account deposits | 5,015,643 | 5,015,643 | 3,561,268 | 3,561,268 |
| Borrowings | – | – | – | – |
| Accrued interest payable | 12,320 | 12,320 | 11,940 | 11,940 |

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

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

**Loans:** The fair value of fixed rate loans is determined as the present value of expected future cash flows discounted at the interest rate currently offered by the Bank, which approximates rates currently offered by local lending institutions for loans of similar terms to companies with comparable credit risk. Variable rate loans which re-price frequently with changes in approximate market rates were valued using the outstanding principal balance. The estimated fair value of loan commitments and contingent liabilities at December 31, 2012 and December 31, 2011 approximate current book values.

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

## Note 13. Other Operating Income and Expense

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

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| **Other non-interest income:** | | | |
| Gain (loss) on sale of assets | $ (1,599) | $ 89,644 | $ 51,412 |
| Wire transfer fees | 7,340 | 7,000 | 5,655 |
| Merchant card processing | 5,025 | 4,353 | 5,131 |
| Imprinted check sales | 4,027 | 3,700 | 3,324 |
| Internet banking fees | 5,620 | 5,205 | 3,255 |
| Safe deposit fees | 3,160 | 2,800 | 2,450 |
| BOLI non-interest income | 123,688 | – | – |
| Other non-interest income | 59,469 | 33,447 | 12,325 |
| Total other non-interest income | $ 206,730 | $ 146,149 | $ 83,552 |
| **Other operating expense:** | | | |
| Other real estate owned expense | $ 36,406 | $124,239 | $ 173,138 |
| Regulatory assessments | 180,580 | 181,606 | 201,967 |
| Directors' and organizers' stock-based compensation expense | – | – | 94,250 |
| Correspondent bank charges | 59,443 | 52,111 | 82,256 |
| Stationery, supplies and printing | 25,559 | 23,136 | 26,653 |
| Shareholder related expense | 30,729 | 30,787 | 26,330 |
| Insurance and security | 26,384 | 26,360 | 25,951 |
| Telephone, postage and electronic communications | 22,154 | 23,241 | 21,732 |
| Director fees | 67,650 | 57,234 | 16,666 |
| Loan and collection expense | 21,965 | 16,053 | 10,263 |
| Armored car and messenger | 8,115 | 7,953 | 6,892 |
| ATM surcharge fees | 8,817 | 7,392 | 6,600 |
| Publications and subscriptions | 15,009 | 12,602 | 6,027 |
| Meetings, conferences, education, and training | 8,800 | 5,713 | 3,944 |
| Human resources administration fees | 2,264 | 2,278 | 3,867 |
| Dues and memberships | 6,331 | 4,951 | 1,579 |
| Customer checks and stamps | 5,028 | 5,859 | 1,563 |
| Other operating expenses | 95,813 | 33,179 | 21,510 |
| Total other operating expenses | $ 621,047 | $ 614,694 | $730,828 |

## Note 14. Capital Adequacy

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

Quantitative measures, established by the regulators to ensure capital adequacy, require that the Bank maintain minimum ratios (set forth in the following table) of capital to risk-weighted assets and average assets. Management believes that, as of December 31, 2012, the Bank met all capital adequacy requirements to which they were subject.

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

| (Dollars in thousands) | Actual | | For Capital Adequacy Purposes: | | For Regulatory Adequacy Purposes (first seven years) | | To Be Well Capitalized Under the FDICIA Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **As of December 31, 2012** | | | | | | | | |
| Total capital (to risk-weighted assets) | $22,015 | 18.18% | $ 9,686 | 8.00% | $ 12,108 | 10.00% | $12,108 | 10.00% |
| Tier 1 capital (to risk-weighted assets) | $20,484 | 16.92% | $ 4,843 | 4.00% | $ 7,265 | 6.00% | $ 7,265 | 6.00% |
| Tier 1 capital (to average assets) leverage ratio | $20,484 | 12.07% | $ 6,791 | 4.00% | $ 13,582 | 8.00% | $ 8,489 | 5.00% |
| **As of December 31, 2011** | | | | | | | | |
| Total capital (to risk-weighted assets) | $19,879 | 20.11% | $ 7,907 | 8.00% | $ 9,884 | 10.00% | $ 9,884 | 10.00% |
| Tier 1 capital (to risk-weighted assets) | $18,623 | 18.84% | $ 3,953 | 4.00% | $ 5,930 | 6.00% | $ 5,930 | 6.00% |
| Tier 1 capital (to average assets) leverage ratio | $18,623 | 13.36% | $ 5,574 | 4.00% | $ 11,149 | 8.00% | $ 6,968 | 5.00% |

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

## Note 15. Regulatory Matters

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

## Note 16. Subsequent Events

On March 8, 2013, the Bank issued a 5% stock dividend to owners of record as of February 22, 2013. The financial statements have been adjusted to give effect to this stock dividend. The fair value per share used to compute the dividend amount was $9.43.

# Board of Directors

(In order from left to right)

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Watsonville Community Hospital

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*Executive Vice President and Chief Financial Officer*
Echelon Corporation

**Richard G. Hofstetter**
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Lighthouse Bank

**Stephen D. Pahl**
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Burroughs Financial Services
*Chairman*
Foothill Securities, Inc.

**Bruce A. McPherson**
*Fifth District Supervisor*
Santa Cruz County

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

"With business financing from Lighthouse Bank we've been able to expand our business in ways we never thought possible. They provide us with the tools we need to turn our dreams into reality."

**Jorah Roussopoulos and Andrea Rubalcaba**
Mountain Feed and Farm Supply

# Senior Management

(In order from left to right)

**Lane S. Lawson, Jr.**
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*Chief Credit Officer*

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

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

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

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

"Partnering with Lighthouse Bank has been a great decision for our business. They are a true community bank that has a vested interest in seeing our local businesses thrive. It is a pleasure to speak directly with the decision makers about our specific and unique business needs."

**Josh, Faviola, and Zach Meschi**
Meschi Construction, Inc.

# Staff

(In order from left to right)

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

**Dara Harris**
*Assistant Vice President*
*Loan Support Officer*

**Lauren Glover**
*Client Service*
*Representative*

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

**Joey Garcia**
*Service Officer*

**Ruby Stiga**
*Client Service*
*Representative*

**Robert Dennis**
*Vice President*
*Relationship Manager*

**Claudia Morales**
*Client Service*
*Representative*

**Matthew Sinnott**
*Deposit Services Officer*

**Lisa Ratliff**
*Senior Loan Servicing*
*Specialist*

**Matthew Sclafani**
*Assistant Vice President*
*Controller*

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

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

**Jamie Ganly**
*Vice President*
*Relationship Manager*

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

"In today's commercial real estate lending market, it helps to have a partner like Lighthouse Bank. The communication and quick response provided by a local community bank is truly refreshing."

**Steven Allen**
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Vice President – Bartfield Motel Group, Inc.

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*President and Medical Director*
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Atack & Penrose, LLP

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

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

# Shareholder Relations and Information

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

**Market Makers**

**Summit Wealth and Retirement Partners, Inc.**
Lisa Gallo
(925) 788-7682
lisa@swrpteam.com

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

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

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

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

**Brianna Carabba**
*Vice President*
*Executive Administrator*
Lighthouse Bank
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Phone: (831) 600-4007

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

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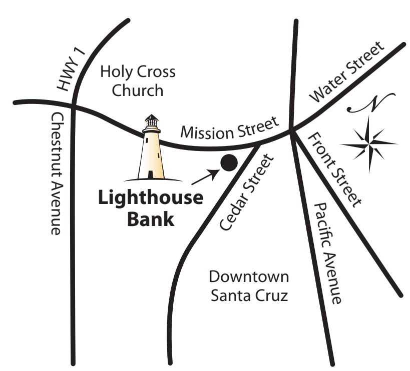


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EQUAL HOUSING LENDER


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