

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2010 AND 2009**

**AND FOR THE YEARS ENDED**

**DECEMBER 31, 2010, 2009 AND 2008**

**AND**

**INDEPENDENT AUDITOR'S REPORT**

## INDEPENDENT AUDITOR'S REPORT

The Shareholders and  
Board of Directors  
Peninsula Bank Holding Co. and Subsidiary

We have audited the accompanying consolidated balance sheet of Peninsula Bank Holding Co. and subsidiary as of December 31, 2010 and 2009 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2010. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

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

*Perry-Smith LLP*

March 28, 2011

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**CONSOLIDATED BALANCE SHEET**  
December 31, 2010 and 2009

	<b>2010</b>	<b>2009</b>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 7,825,291	\$ 9,712,575
Federal funds sold	37,145,000	46,735,000
	44,970,291	56,447,575
Interest bearing deposits in other banks	-	6,000,000
Available-for-sale investment securities (Note 2)	59,202,000	34,823,000
Loans, less allowance for loan losses of \$4,420,964 in 2010 and \$4,313,218 in 2009 (Notes 3,4 and 10)	204,121,193	199,290,437
Federal Home Loan Bank stock	996,300	816,800
Property and equipment, net (Note 5)	813,931	616,538
Other real estate owned	-	2,596,703
Cash surrender value of life insurance policies (Note 6)	3,204,316	3,098,069
Accrued interest receivable and other assets	3,694,749	4,247,112
	\$ 317,002,780	\$ 307,936,234
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits:		
Non-interest bearing	66,685,668	\$ 71,207,990
Interest bearing (Note 7)	218,002,221	207,110,104
	284,687,889	278,318,094
Total deposits	284,687,889	278,318,094
Accrued interest payable and other liabilities	1,960,633	1,599,914
	286,648,522	279,918,008
Total liabilities	286,648,522	279,918,008
Commitments (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, 2010 and 2009	5,861,094	5,815,852
Common stock - no par value; 5,000,000 shares authorized; 2,602,276 shares issued and outstanding at December 31, 2010 and 2009	27,618,879	27,618,879
Additional paid-in capital	1,401,032	1,132,683
Accumulated deficit	(4,509,800)	(6,554,253)
Accumulated other comprehensive (loss) income, net of taxes (Note 2)	(16,947)	5,065
	30,354,258	28,018,226
Total shareholders' equity	30,354,258	28,018,226
Total liabilities and shareholders' equity	\$ 317,002,780	\$ 307,936,234

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

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENT OF OPERATIONS**  
**For the Years Ended December 31, 2010, 2009 and 2008**

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Interest income:			
Interest and fees on loans	\$ 13,914,915	\$ 14,490,822	\$ 11,647,890
Interest on Federal funds sold	115,571	65,936	656,655
Interest on investment securities	1,687,911	917,012	507,710
	<u>15,718,397</u>	<u>15,473,770</u>	<u>12,812,255</u>
Total interest income			
Interest expense:			
Interest on deposits (Note 7)	3,421,824	3,634,611	4,686,883
	<u>12,296,573</u>	<u>11,839,159</u>	<u>8,125,372</u>
Net interest income			
Provision for loan losses (Note 4)	824,211	3,607,627	3,212,425
	<u>11,472,362</u>	<u>8,231,532</u>	<u>4,912,947</u>
Net interest income after provision for loan losses			
Non-interest income:			
Service charges, fees and other income	204,783	185,670	133,920
Appreciation in cash surrender value of insurance contracts (Note 6)	106,247	106,850	110,644
Gain on sale of investment securities (Note 2)	171,028	-	-
	<u>482,058</u>	<u>292,520</u>	<u>244,564</u>
Total non-interest income			
Non-interest expenses:			
Salaries and employee benefits (Note 13)	4,729,700	4,219,165	3,877,278
Occupancy and equipment (Notes 5 and 10)	1,756,853	1,918,963	1,416,750
Write down of other real estate owned	515,429	558,164	-
Other (Note 15)	2,545,893	2,329,399	1,560,579
	<u>9,547,875</u>	<u>9,025,691</u>	<u>6,854,607</u>
Total other expenses			
Income (loss) before provision for income taxes	2,406,545	(501,639)	(1,697,096)
Provision for income taxes (Note 8)	183,000	57,000	105,000
	<u>\$ 2,223,545</u>	<u>\$ (558,639)</u>	<u>\$ (1,802,096)</u>
Net income (loss)			
Basic income (loss) per common share (Note 11)	<u>\$ 0.79</u>	<u>\$ (0.33)</u>	<u>\$ (0.81)</u>
Diluted income (loss) per common share (Note 11)	<u>\$ 0.79</u>	<u>\$ (0.33)</u>	<u>\$ (0.81)</u>

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

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY**  
For the Years Ended December 31, 2010, 2009 and 2008

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss), Net of Tax	Total Shareholders' Equity	Total Comprehensive Income (Loss)
	Shares	Amount	Shares	Amount					
Balance, January 1, 2008	-	-	1,889,375	\$18,857,568	\$ 548,677	\$ (3,892,894)	\$ 67,393	\$ 15,580,744	
Comprehensive loss:									
Net loss						(1,802,096)		(1,802,096)	\$ (1,802,096)
Other comprehensive gain, net of taxes:									
Net change in unrealized gain on available-for-sale investment securities							15,171	15,171	15,171
Total comprehensive loss									<u>\$ (1,786,925)</u>
Proceeds from stock offering			690,501	8,346,484				8,346,484	
Stock options exercised			22,400	224,000				224,000	
Stock based compensation (Notes 1 and 12)					269,227			269,227	
Balance, December 31, 2008	-	-	2,602,276	\$27,428,052	\$ 817,904	\$ (5,694,990)	\$ 82,564	\$ 22,633,530	
Comprehensive loss:									
Net loss						(558,639)		(558,639)	\$ (558,639)
Other comprehensive loss, net of taxes:									
Net change in unrealized gain on available-for-sale investment securities							(77,499)	(77,499)	(77,499)
Total comprehensive loss									<u>\$ (636,138)</u>
Issuance of preferred stock (net of costs)	6,000	5,780,867						5,780,867	
Issuance of common stock warrants				190,827				190,827	
Preferred stock dividends and accretion		34,985				(300,624)		(265,639)	
Stock based compensation (Notes 1 and 12)					314,779			314,779	
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	
Comprehensive income:									
Net income						2,223,545		2,223,545	\$ 2,223,545
Other comprehensive loss, net of taxes:									
Net change in unrealized gain (loss) on available-for-sale investment securities							(22,012)	(22,012)	(22,012)
Total comprehensive income									<u>\$ 2,201,533</u>
Preferred stock dividends and accretion		45,242				(179,092)		(133,850)	
Stock based compensation (Notes 1 and 12)					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	

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

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**  
For the Years Ended December 31, 2010, 2009 and 2008

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Cash flows from operating activities:			
Net income (loss)	\$ 2,223,545	\$ (558,639)	\$ (1,802,096)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Loss (Gain) on disposal of equipment	1,081	6,295	(6,305)
Gain on sale of investment securities	(171,028)	-	-
Provision for loan losses	824,211	3,607,627	3,212,425
Depreciation, amortization and accretion	544,497	365,425	299,541
Increase in deferred loan origination fees, net	141,340	96,227	327,054
Write down of other real estate owned	515,429	558,164	-
Net increase in cash value of life insurance policies	(106,247)	(106,850)	(110,644)
Stock option compensation expense	268,349	314,779	269,227
Benefit from deferred income taxes	(214,000)		
Decrease (increase) in accrued interest receivable and other assets	781,036	(2,644,847)	(374,089)
Increase in accrued interest payable and other liabilities	526,867	458,845	222,374
Net cash provided by operating activities	<u>5,335,080</u>	<u>2,097,026</u>	<u>2,037,487</u>
Cash flows used in investing activities:			
Purchase of available-for-sale investment securities	(51,007,267)	(46,331,625)	(5,000,000)
Proceeds from sales or calls of available-for-sale investment securities	25,485,547	19,500,000	4,000,000
Proceeds from principle payments on available-for-sale investment securities	1,071,203	6,092	-
Proceeds from maturities of available-for-sale investment securities	-	-	15,000,000
Net decrease (increase) in interest bearing deposits in other banks	6,000,000	9,764,700	(10,919,700)
Purchase of Federal Home Loan Bank stock	(179,500)	(86,600)	(730,200)
Proceeds from sale of other real estate owned	2,081,275		
Net increase in loans	(5,796,306)	(8,011,832)	(57,422,341)
Purchase of premises and equipment	(537,111)	(112,854)	(534,528)
Proceeds from sale of equipment	-	-	27,300
Net cash used in investing activities	<u>(22,882,159)</u>	<u>(25,272,119)</u>	<u>(55,579,469)</u>
Cash flows from financing activities:			
Net increase in demand, interest bearing and savings deposits	3,998,867	18,948,734	70,985,027
Net increase (decrease) in time deposits	2,370,928	11,370,910	(7,203,616)
Net proceeds from stock offering	-	-	8,346,484
Net proceeds from preferred stock issuance and issuance of warrants	-	5,971,694	-
Proceeds from exercise of stock options	-	-	224,000
Cash dividends paid	(300,000)		
Net cash provided by financing activities	<u>6,069,795</u>	<u>36,291,338</u>	<u>72,351,895</u>
(Decrease) increase in cash and cash equivalents	(11,477,284)	13,116,245	18,809,913
Cash and cash equivalents at beginning of period	56,447,575	43,331,330	24,521,417
Cash and cash equivalents at end of year	<u>\$ 44,970,291</u>	<u>\$ 56,447,575</u>	<u>\$ 43,331,330</u>
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest expense	\$ 3,402,478	\$ 3,653,095	\$ 4,877,336
Income taxes	\$ 279,500	\$ 78,280	\$ 45,100
Non-cash investing activities:			
Net change in unrealized gain on available-for-sale investment securities	\$ (36,685)	\$ (129,165)	\$ 70,213
Non-cash financing activities:			
Transfer of loans to other real estate owned	\$ -	\$ 3,984,343	\$ -

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

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

General

Peninsula Bank Holding Co. (the "Company") 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, The Private Bank of the Peninsula (the "Bank") 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.

The Bank, a California state-chartered institution, opened for business on October 1, 2003, 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.

The Bank participated in the FDIC's Transaction Account Guarantee Program. Under this program, through December 31, 2010, all noninterest-bearing transaction accounts were fully guaranteed by the FDIC for the entire amount in the account and the Bank was assessed an annual fee of 20 basis points for all deposit amounts exceeding the existing deposit insurance limit of \$250,000. 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. The Dodd-Frank Wall Street Reform and Consumer Protection Act has extended temporary unlimited FDIC insurance to all non-interest bearing transaction accounts through December 31, 2012.

We have considered all events occurring from December 31, 2010 through March 31, 2011, the date the consolidated financial statements were available for issuance, and no subsequent events occurred requiring additional accrual 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.

Reclassifications

Certain items have been reclassified in prior years' balances to conform with the 2010 presentation.

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.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**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.

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, 2010 and 2009, securities are classified as available-for-sale and there were no transfers between categories.

Gains and losses on the sale of securities are computed using the specific identification method. Interest earned on investment securities is reported in interest income, net of applicable adjustments for accretion of discounts and amortization of premiums. In addition, unrealized losses that are other than temporary are recognized in earnings for all investments.

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 evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other than temporary, 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.

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, 2010 and 2009, FHLB stock totaled \$996,300 and \$816,800, respectively.



**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Loans

Loans are stated at principal balances outstanding. Interest is accrued daily based upon outstanding loan balances. However, when, in the opinion of management, loans are considered to be impaired and the future collectability of interest and principal is in serious doubt, loans are placed on nonaccrual status and the accrual of interest income is suspended. Any interest accrued but unpaid is charged against income. Payments received are applied to reduce principal to the extent necessary to ensure collection. Subsequent payments on these loans, or payments received on nonaccrual loans for which the ultimate collectability of principal is not in doubt, are applied first to earned but unpaid interest and then to principal.

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. An impaired loan is usually 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 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.

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 historical losses 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.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Allowance for Loan Losses (Continued)

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 other 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 over a certain threshold 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.

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 a project's 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 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:

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Allowance for Loan Losses (Continued)

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

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.

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 sales cash flow of the company and advances are made on a portion of eligible 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.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Allowance for Loan Losses (Continued)

Although management believes the allowance to be adequate, 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, 2010 and 2009 reflects management's estimate of possible 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 \$173,736 and \$188,642 at December 31, 2010 and 2009, respectively, and is included in accrued interest payable and other liabilities on the balance sheet.

Property and Equipment

Property and equipment are carried at cost. 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 loan production, branch and administrative offices. Rental income is recorded when earned as a component of "Occupancy and Equipment" expense. All leases are operating leases, as disclosed in Note 10, and do not contain up front considerations.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Other Real Estate Owned

Other real estate owned includes real estate acquired in full or partial settlement of loan obligations. When property is acquired, any excess of the Company's recorded investment in the loan balance and accrued interest income over the estimated fair market value of the property less costs to sell is charged against the allowance for loan losses. Subsequent gains or losses on sales or write downs resulting from permanent impairments are recorded in other income or expenses as incurred. The Company held no other real estate owned at December 31, 2010 and \$2,596,703 at December 31, 2009.

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 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 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, 2010 and 2009.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Income Taxes (Continued)

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.

Coincidental with the acquisition of the Bank by the Company, outstanding options under The Private Bank of the Peninsula 2003 Stock Option Plan were assumed by the Company's 2008 Stock Option Plan. There were 14,000 new options and 54,504 replacement options granted in 2010, and 24,000 new options granted in 2009. The 2010 replacement options were granted in a value for value option exchange, whereby certain existing option grants were replaced with grants with a smaller number of options, a lower strike price, and an equivalent current value. The Company incurred no additional option expense as a result of the exchange.

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, 2010, 2009 and 2008.

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.

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

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Dividend Yield	N/A	N/A	N/A
Expected volatility	36.17%	32.86%	25.24%
Risk-free interest rate	1.23%	1.26%	2.62%
Expected option life	3.8 years	3.2 years	2.9 years

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Earnings (Loss) Per Common Share

Basic earnings (loss) per share (EPS), which excludes dilution, is computed by dividing income (loss) 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 (Loss)

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

Adoption of New Financial Accounting Standards

*Transfers of Financial Assets*

In June 2009, the Financial Accounting Standards Board (FASB) issued FASB Accounting Standards Update ("ASU") 2009-16, Accounting for Transfers of Financial Assets (Statement 166), which amends previously issued accounting guidance to enhance accounting and reporting for transfers of financial assets, including securitizations or continuing exposure to the risks related to transferred financial assets. Prior to the issuance of Statement 166, transfers under participation agreements and other partial loan sales fell under the general guidance for transfers of financial assets. Statement 166 introduces a new definition for a participating interest along with the requirement for partial loan sales to meet the definition of a participating interest for sale treatment to occur. If a participation or other partial loan sale does not meet the definition, the portion sold should remain on the books and the proceeds recorded as a secured borrowing until the definition is met. Additionally, existing provisions that required the transferred assets to be isolated from the originating institution (transferor), that the transferor does not maintain effective control through certain agreements to repurchase or redeem the transferred assets and that the purchasing institution (transferee) has the right to pledge or exchange the assets acquired were retained. The new provisions became effective on January 1, 2010 and early adoption was not permitted. The impact of adoption was not material to the Company's consolidated financial condition, results of operations or cash flows.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Adoption of New Financial Accounting Standards (Continued)

*Fair Value Measurements*

In January 2010, the FASB issued FASB ASU 2010-06, Improving Disclosures about Fair Value Measurements, which amends and clarifies existing standards to require additional disclosures regarding fair value measurements. Specifically, the standard requires disclosure of the amounts of significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for these transfers, the reason for any transfers in or out of Level 3, and information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements on a gross basis. This standard clarifies that reporting entities are required to provide fair value measurement disclosures for each class of assets and liabilities. Previously, separate fair value disclosures were required for each major category of assets and liabilities. This standard also clarifies the requirements to disclose information about both the valuation techniques and inputs used in estimating Level 2 and Level 3 fair value measurements. Except for the requirement to disclose information about purchases, sales, issuances, and settlements in the reconciliation of recurring Level 3 measurements on a gross basis, these disclosures are effective for the year ended December 31, 2010. The requirement to separately disclose purchases, sales, issuances, and settlements of recurring Level 3 measurements becomes effective for the Company for the year beginning on January 1, 2011. The Company adopted this new accounting standard as of January 1, 2010 and the impact of adoption was not material to the Company's consolidated financial position, results of operations or cash flows.

*Disclosures about Credit Quality*

In July 2010, the FASB issued FASB ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. ASU 2010-20 requires more robust and disaggregated disclosures about the credit quality of financing receivables (loans) and allowances for loan losses, including disclosure about credit quality indicators, past due information and modifications of financing receivables. The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on and after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The adoption of this guidance has significantly expanded disclosure requirements related to accounting policies and disclosures related to the allowance for loan losses but did not have an impact on the Company's consolidated financial condition, results of operations or cash flows.





**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

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

Investment securities with unrealized losses at December 31, 2010 and 2009 are summarized and classified according to the duration of the loss period as follows:

	2010					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<u>Available-for-Sale Debt securities</u>						
U.S. Govt. Sponsored Agencies	\$25,556,000	\$(574,812)	\$ -	\$ -	\$ 25,556,000	\$(574,812)
Corporate Debt Securities	9,630,000	(134,436)	-	-	9,630,000	(134,436)
	<u>\$35,186,000</u>	<u>\$(709,248)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 35,186,000</u>	<u>\$(709,248)</u>

	2009					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<u>Available-for-Sale Debt securities</u>						
U.S. Govt. Sponsored Agencies	\$ 5,783,692	\$(216,308)	\$ -	\$ -	\$ 5,783,692	\$(216,308)
Mortgage-backed Securities	8,723,365	(103,704)	-	-	8,723,365	(103,704)
Corporate Debt Securities	2,056,806	(8,473)	-	-	2,056,806	(8,473)
	<u>\$16,563,863</u>	<u>\$(328,485)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 16,563,863</u>	<u>\$(328,485)</u>

U.S. Government Sponsored Agencies

At December 31, 2010, the Bank held eight U.S. Government sponsored agency securities which were in a loss position for less than 12 months. The unrealized losses on the Bank's investments in direct obligations of U.S. government sponsored agencies were caused by interest rate changes. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Bank has the ability and intent to hold those investments until a recovery of fair value, which may be maturity, the Bank does not consider the investments to be other-than-temporarily impaired at December 31, 2010.

Corporate Debt Securities

At December 31, 2010, the Bank's corporate debt securities included three which were in a loss position for less than 12 months. The unrealized losses on these securities were caused by interest rate changes. Based on the Bank's evaluation and its ability and intent to hold the investments for a reasonable period of time sufficient for a recovery of fair value, the Bank does not consider these investments to be other-than-temporarily impaired at December 31, 2010.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

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

The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2010 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.

	2010	
	Amortized Cost	Estimated Fair Value
After one year through five years:	\$ 34,997,180	\$ 35,198,000
After five years through ten years:	16,130,654	15,769,000
After ten years:	8,102,410	8,235,000
	<u>\$ 59,230,244</u>	<u>\$ 59,202,000</u>

Investment securities with amortized costs totaling \$7,000,000 and fair values of \$6,982,402 were pledged to secure public deposits at December 31, 2010. Investment securities with amortized costs totaling \$3,000,000 and fair values of \$2,891,846 were pledged to secure public deposits at December 31, 2009.

**3. LOANS**

Outstanding loans are summarized below:

	December 31,	
	2010	2009
Commercial	\$ 36,145,567	\$ 32,955,867
Construction	48,921,300	62,092,545
Residential Real Estate	22,794,985	28,839,077
Commercial Real Estate	82,584,496	65,654,362
Asset based	16,794,052	10,895,069
Consumer	1,797,503	3,521,141
	<u>209,037,903</u>	<u>203,958,061</u>
Total outstanding loans	209,037,903	203,958,061
Deferred loan origination fees, net	(495,746)	(354,406)
Allowance for loan losses	<u>(4,420,964)</u>	<u>(4,313,218)</u>
Total loans net of reserve	<u>\$ 204,121,193</u>	<u>\$ 199,290,437</u>

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**3. LOANS (Continued)**

Salaries and employee benefits totaling \$363,699, \$384,150, and \$528,528 have been deferred as loan origination costs for the years ended December 31, 2010, 2009 and 2008.

The Bank pledges loans as collateral under a short-term borrowing arrangement through the Discount Window of the Federal Reserve Bank. At December 31, 2010, \$36,610,293 of loans were pledged. (Note 9)

**4. ALLOWANCE FOR LOAN LOSSES**

Changes in the allowance for loan losses during the years ended December 31, 2010, 2009 and 2008 were as follows:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Balance, beginning of year	\$ 4,313,218	\$ 3,748,541	\$ 1,536,534
Provision charged to operations	824,211	3,607,627	3,212,425
Losses charged to allowance	(1,101,849)	(3,044,059)	(1,001,633)
Recoveries	<u>385,384</u>	<u>1,109</u>	<u>1,215</u>
Balance, end of year	<u><u>\$ 4,420,964</u></u>	<u><u>\$ 4,313,218</u></u>	<u><u>\$ 3,748,541</u></u>

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**4. ALLOWANCE FOR LOAN LOSSES (Continued)**

**Allocation of the Allowance for Loan Losses by Portfolio Segment and Impairment Methodology as of December 31, 2010**

	Commercial	Construction	Residential Real Estate	Commercial Real Estate	Asset Based	Other	Unallocated	Total
<b>Allowance for loan losses:</b>								
Ending balance	\$ 409,423	\$ 1,437,073	\$ 157,595	\$ 1,270,894	\$ 664,904	\$ 39,075	\$ 442,000	\$ 4,420,964
Ending balance: individually evaluated for impairment	\$ -	\$ 803,715	\$ -	\$ 173,926	\$ -	\$ -	\$ -	\$ 977,641
Ending balance: collectively evaluated for impairment	\$ 409,423	\$ 633,358	\$ 157,595	\$ 1,096,968	\$ 664,904	\$ 39,075	\$ 442,000	\$ 3,443,323
<b>Loans:</b>								
Ending balance	\$ 36,145,567	\$48,921,300	\$ 22,794,985	\$ 82,584,496	\$ 16,794,052	\$ 1,797,503		\$ 209,037,903
Ending balance: individually evaluated for impairment	\$ -	\$ 4,102,921	\$ -	\$ 896,122	\$ -	\$ -		\$ 4,999,043
Ending balance: collectively evaluated for impairment	\$ 36,145,567	\$44,818,379	\$ 22,794,985	\$ 81,688,374	\$ 16,794,052	\$ 1,797,503		\$ 204,038,860

**Commercial Credit Exposure**

**Credit Risk Profile by Internally Assigned Grade as of December 31, 2010**

	Commercial	Construction	Residential Real Estate	Commercial Real Estate	Asset Based	Other	Total
<b>Grade:</b>							
Pass	\$ 34,595,037	\$42,973,379	\$ 21,384,985	\$ 77,925,412	\$ 13,153,730	\$ 1,797,503	\$ 191,830,046
Special Mention	998,549	990,000	1,410,000		722,273		4,120,822
Substandard-Non-Impaired	551,981	855,000		3,762,962	2,918,049		8,087,992
Substandard-Impaired		4,102,921		896,122			4,999,043
<b>Total</b>	<b>\$ 36,145,567</b>	<b>\$48,921,300</b>	<b>\$ 22,794,985</b>	<b>\$ 82,584,496</b>	<b>\$ 16,794,052</b>	<b>\$ 1,797,503</b>	<b>\$ 209,037,903</b>

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**4. ALLOWANCE FOR LOAN LOSSES** (Continued)

**Past Due and Nonaccrual Loan Detail as of December 31, 2010**

	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total
Commercial Construction	\$ 228,448	\$ -	\$ -	\$ 228,448	\$ 35,917,119	\$ 36,145,567
Commercial Construction			3,232,750	3,232,750	8,755,584	11,988,334
Residential Construction	855,000		870,171	1,725,171	35,207,795	36,932,966
Residential Real Estate					22,794,985	22,794,985
Commercial Real Estate	193,753		896,122	1,089,875	81,494,621	82,584,496
Asset Based					16,794,052	16,794,052
Consumer	10,653			10,653	1,786,850	1,797,503
<b>Total</b>	<b>\$ 1,287,854</b>	<b>\$ -</b>	<b>\$ 4,999,043</b>	<b>\$ 6,286,897</b>	<b>\$ 202,751,006</b>	<b>\$ 209,037,903</b>

**Impaired Loan Detail with a Related Allowance as of December 31, 2010**

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Construction	\$ 4,102,921	\$ 4,102,921	\$ 803,715	\$ 3,864,662	\$ 158,423
Commercial Real Estate	896,122	896,122	173,926	919,680	71,819
<b>Total</b>	<b>\$ 4,999,043</b>	<b>\$ 4,999,043</b>	<b>\$ 977,641</b>	<b>\$ 4,784,342</b>	<b>\$ 230,242</b>

As of December 31, 2010, there were no impaired loans without a related allowance.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**5. PROPERTY AND EQUIPMENT**

Property and equipment consisted of the following:

	December 31,	
	2010	2009
Furniture and equipment	\$ 600,380	\$ 608,481
Leasehold improvements	454,010	451,245
Computer equipment	1,316,856	782,510
	<u>2,371,246</u>	<u>1,842,236</u>
Gross property and equipment		
Less accumulated depreciation and amortization	<u>1,557,315</u>	<u>1,225,698</u>
Property and equipment, net	<u>\$ 813,931</u>	<u>\$ 616,538</u>

Depreciation included in occupancy and equipment expense totaled \$338,637, \$358,857, and \$301,237 for the years ended December 31, 2010, 2009 and 2008.

**6. CASH SURRENDER VALUE OF LIFE INSURANCE POLICIES**

During 2004, the Bank purchased single-premium life insurance policies on the lives of two key executives. Income earned on these policies, net of expenses, totaled \$106,247, \$106,850, and \$110,644 for the years ended December 31, 2010, 2009 and 2008, respectively.

**7. INTEREST-BEARING DEPOSITS**

Interest-bearing deposits consisted of the following:

	December 31,	
	2010	2009
NOW accounts	\$ 16,649,134	\$ 13,767,185
Savings	4,297,555	1,501,477
Money market	132,384,818	129,541,656
Time, \$100,000 or more	58,620,026	55,980,879
Other time	6,050,688	6,318,907
	<u>\$ 218,002,221</u>	<u>\$ 207,110,104</u>
Total interest-bearing deposits		

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**7. INTEREST-BEARING DEPOSITS** (Continued)

Aggregate annual maturities of time deposits are as follows:

Year Ending <u>December 31,</u>	
2011	\$ 62,543,810
2012	1,337,374
2013	27,350
2014	282,651
2015	479,529
Total time deposits	<u><u>\$ 64,670,714</u></u>

Interest expense recognized on interest-bearing deposits for the years ended December 31, 2010, 2009 and 2008 consisted of the following:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
NOW accounts	\$ 53,055	\$ 59,363	\$ 128,191
Savings	22,659	12,715	19,438
Money market	1,984,749	2,169,232	2,400,280
Time, \$100,000 or more	1,246,624	1,251,917	1,580,937
Other time	114,737	141,354	205,378
Brokered deposits and other	-	30	352,659
Total interest expense	<u><u>\$ 3,421,824</u></u>	<u><u>\$ 3,634,611</u></u>	<u><u>\$ 4,686,883</u></u>

At December 31, 2010, the Company had no deposit relationships that exceeded 5% of total deposits, and had two such relationships at December 31, 2009. The aggregate total of these deposit relationships was \$39,206,816 at December 31, 2009.



**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**8. INCOME TAXES**

The provision for income taxes for the years ended December 31, 2010, 2009 and 2008 consisted of the following:

<u>2010</u>	<u>Federal</u>	<u>State</u>	<u>Total</u>
Current	\$ 136,000	\$ 247,000	\$ 383,000
Deferred	580,000	19,000	599,000
Valuation allowance	<u>(703,000)</u>	<u>(96,000)</u>	<u>(799,000)</u>
Provision for income taxes	<u>\$ 13,000</u>	<u>\$ 170,000</u>	<u>\$ 183,000</u>
<u>2009</u>	<u>Federal</u>	<u>State</u>	<u>Total</u>
Current	\$ -	\$ 57,000	\$ 57,000
Deferred	(412,000)	(248,000)	(660,000)
Valuation allowance	<u>412,000</u>	<u>248,000</u>	<u>660,000</u>
Provision for income taxes	<u>\$ -</u>	<u>\$ 57,000</u>	<u>\$ 57,000</u>
<u>2008</u>	<u>Federal</u>	<u>State</u>	<u>Total</u>
Current	\$ -	\$ 105,000	\$ 105,000
Deferred	(249,000)	(160,000)	(409,000)
Valuation allowance	<u>249,000</u>	<u>160,000</u>	<u>409,000</u>
Provision for income taxes	<u>\$ -</u>	<u>\$ 105,000</u>	<u>\$ 105,000</u>

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**8. INCOME TAXES** (Continued)

Deferred tax assets (liabilities) at December 31, 2010 and 2009 consisted of the following:

	2010	2009
Deferred tax assets:		
Net operating losses	\$ 218,000	\$ 707,000
Allowance for credit losses	1,505,000	1,497,000
State tax	84,000	28,000
Property and equipment	33,000	33,000
Accrued expenses	175,000	232,000
Other	72,000	329,000
Unrealized loss on available for sale investment securities	11,000	-
Share-base compensation	329,000	257,000
	2,427,000	3,083,000
Deferred tax assets before valuation allowance		
Valuation allowance	(1,975,000)	(2,774,000)
Total deferred tax assets	452,000	309,000
Deferred tax liabilities:		
Accrual to cash conversion	(54,000)	(108,000)
Other	(44,000)	(30,000)
Loan origination costs	(140,000)	(168,000)
Unrealized gain on available for sale investment securities	-	(3,000)
	(238,000)	(309,000)
Total deferred tax liabilities		
Net deferred tax asset	\$ 214,000	\$ -

A valuation allowance is provided to reduce deferred tax assets to a level which, more likely than not, will be realized. Due to the losses recognized since inception, a valuation allowance has been recorded for the Company's deferred tax assets net of deferred tax liabilities. The need for this valuation allowance will be periodically reviewed and benefits will be recognized when they are determined to be realizable.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**8. INCOME TAXES** (Continued)

The provision for 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,					
	2010		2009		2008	
	Amount	Rate %	Amount	Rate %	Amount	Rate %
Federal income tax (benefit) expense, at statutory rate	\$ 818,000	34.0	\$(170,000)	(34.0)	\$(577,000)	(34.0)
State franchise tax (benefit) expense, net of Federal tax (benefit) expense	163,000	6.8	57,000	11.4	(36,000)	(2.1)
Share-based compensation	32,000	1.3	44,000	8.8	27,000	1.6
Deferred tax valuation allowance	(799,000)	(33.2)	134,000	26.8	381,000	22.5
Tax-exempt income from life insurance policies	(36,000)	(1.5)	(36,000)	(7.2)	(38,000)	(2.2)
Other	5,000	0.2	28,000	5.6	348,000	20.4
	<b>\$ 183,000</b>	<b>7.6</b>	<b>\$ 57,000</b>	<b>11.4</b>	<b>\$ 105,000</b>	<b>6.2</b>

At December 31, 2010, the Company had State net operating loss carryforwards (NOLs) of \$3.0 million, and no Federal NOLs for tax purposes. The State NOLs expire beginning in 2014.

The total amount of unrecognized tax benefits, related to potentially uncertain tax positions, including interest and penalties, at December 31, 2010, 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 2007 through 2009 and California income tax returns for 2006 through 2009 are currently open for Federal or state income tax examinations.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**9. SHORT-TERM BORROWING ARRANGEMENTS**

The Company had unsecured Federal Funds lines of credit totaling \$7 million with its correspondent banks at December 31, 2010 and \$9 million at December 31, 2009. There were no borrowings outstanding under these agreements at December 31, 2010 and 2009.

The Company has a short-term borrowing arrangement with the Federal Reserve Bank through the Discount Window. The Company has pledged certain loans to secure borrowings. The borrowing capacity under the agreement varies depending on the amount and type of loans pledged. There were no borrowings outstanding under the agreement and the Company had \$19.8 million of readily available borrowing capacity at December 31, 2010 based on currently pledged loans.

The Company's banking subsidiary was granted membership in the Federal Home Loan Bank (FHLB) of San Francisco in 2009, and 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 must be secured by pledged assets. The borrowing capacity at December 31, 2010 was \$21.2 million.

**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 a loan production office in San Carlos, California. The loan production office lease expires in 2013 and has one three-year renewal option. The Company also leases space for its former branch and administrative office locations which 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, 2010:

<u>Year Ending</u> <u>December 31,</u>	<u>Leases</u>	<u>Subleases</u>
2011	\$ 1,285,571	\$ (368,045)
2012	1,327,019	(480,382)
2013	1,175,891	(234,697)
2014	847,410	
2015	877,065	
Thereafter	<u>2,570,274</u>	
	<u>\$ 8,083,230</u>	<u>\$ (1,083,124)</u>

Rent expense included in occupancy and equipment expense totaled \$842,436, \$1,023,838, and \$805,642, for the years ended December 31, 2010, 2009, and 2008, net of sublease income of \$461,426, \$301,218 and \$52,011 for the years ended December 31, 2010, 2009 and 2008, respectively.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**10. COMMITMENTS** (Continued)

Operating Leases (continued)

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 \$167,456 as of December 31, 2010. 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, 2010 was \$3.3 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,	
	2010	2009
Commitments to extend credit	\$ 73,727,614	\$ 74,368,399
Standby letters of credit	\$ 2,795,717	\$ 313,540

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.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**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, 2010 and 2009. The Company recognizes these fees as revenue over the term of the commitment or when the commitment is used.

At December 31, 2010, 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, 2010, in management's judgment, a concentration of loans existed in construction and real estate related loans. At that date, approximately 73.8% of the Company's loans were construction and real estate related, representing 23.4% and 50.4% of total outstanding loans, respectively.

At December 31, 2009, in management's judgment, a concentration of loans existed in construction and real estate related loans. At that date, approximately 76.8% of the Company's loans were construction and real estate related, representing 30.5% and 46.3% of total 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. Deposits over \$250,000 that were covered by insurance totaled \$3.4 million and \$3.1 million at December 31, 2010 and 2009, respectively, while \$2.7 and \$3.2 million of interest-bearing deposits were uninsured at December 31, 2010 and 2009, respectively.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**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.

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, 2010, the Warrant had no intrinsic value.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**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 12/31/10, the Company has paid quarterly dividends to the Treasury, for three 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 will be accreted using a straight-line method over 5 years.



**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**11. SHAREHOLDERS' EQUITY (Continued)**

Earnings (Loss) Per Share

A reconciliation of the numerators and denominators of the basic and diluted earnings (loss) per share computations for the years ended December 31, 2010, 2009 and 2008 is shown below.

	Net Income (Loss)	Less Preferred Stock Dividends and Accretion	Net Income (Loss) Available to Common Shareholders	Weighted Average Number of Shares Outstanding	Per Share Amount
<u>December 31, 2010</u>					
Basic income per common share	\$ 2,223,545	\$ (179,092)	\$ 2,044,453	2,602,276	<u>\$ 0.79</u>
Effect of dilutive options				-	-
Diluted income per common share	<u>\$ 2,223,545</u>	<u>\$ (179,092)</u>	<u>\$ 2,044,453</u>	<u>2,602,276</u>	<u>\$ 0.79</u>
<u>December 31, 2009</u>					
Basic loss per common share	\$ (558,639)	(300,624)	\$ (859,263)	2,602,276	<u>\$ (0.33)</u>
Effect of dilutive options					-
Diluted loss per common share	<u>\$ (558,639)</u>	<u>(300,624)</u>	<u>\$ (859,263)</u>	<u>2,602,276</u>	<u>\$ (0.33)</u>
<u>December 31, 2008</u>					
Basic loss per common share	\$ (1,802,096)	-	\$ (1,802,096)	2,237,994	<u>\$ (0.81)</u>
Effect of dilutive options					-
Diluted loss per common share	<u>\$ (1,802,096)</u>	<u>-</u>	<u>\$ (1,802,096)</u>	<u>2,237,994</u>	<u>\$ (0.81)</u>

All options outstanding at 12/31/10 were excluded from the calculation of diluted earnings per share because they are anti-dilutive.

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.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**11. SHAREHOLDERS' EQUITY (Continued)**

Regulatory Capital (Continued)

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, 2010 and 2009.

As of December 31, 2010, 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. The minimum leverage ratio and total risk-based capital ratio for the Bank was temporarily raised at the end of 2009 to 9.00% and 11.00%, respectively, through an agreement with the Bank's regulators.

	2010		2009	
	Amount	Ratio	Amount	Ratio
<u>Leverage Ratio</u>				
Peninsula Bank Holding Co.	\$ 30,371,205	9.18%	\$ 28,061,460	9.28%
Minimum regulatory requirement	\$ 13,237,700	4.00%	\$ 12,101,437	4.00%
The Private Bank of the Peninsula	\$ 30,371,205	9.18%	\$ 28,128,594	9.28%
Minimum requirement for				
"Well-Capitalized" institution	\$ 16,547,125	5.00%	\$ 15,123,440	5.00%
Minimum regulatory requirement	\$ 29,784,825	9.00%	\$ 27,222,192	9.00%
<u>Tier 1 Risk-Based Capital Ratio</u>				
Peninsula Bank Holding Co.	\$ 30,371,205	11.62%	\$ 28,061,460	11.15%
Minimum regulatory requirement	\$ 10,454,116	4.00%	\$ 10,064,398	4.00%
The Private Bank of the Peninsula	\$ 30,371,205	11.62%	\$ 28,128,594	11.19%
Minimum requirement for				
"Well-Capitalized" institution	\$ 15,681,174	6.00%	\$ 15,092,569	6.00%
Minimum regulatory requirement	\$ 10,454,116	4.00%	\$ 10,061,713	4.00%
<u>Total Risk-Based Capital Ratio</u>				
Peninsula Bank Holding Co.	\$ 33,655,205	12.88%	\$ 31,394,387	12.48%
Minimum regulatory requirement	\$ 28,748,818	8.00%	\$ 27,677,095	8.00%
The Private Bank of the Peninsula	\$ 33,655,205	12.88%	\$ 31,461,521	12.45%
Minimum requirement for				
"Well-Capitalized" institution	\$ 26,135,290	10.00%	\$ 25,154,282	10.00%
Minimum regulatory requirement	\$ 28,748,818	11.00%	\$ 27,669,711	11.00%

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**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 83,775 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.

A summary of option activity under the Plan for the years ended December 31, 2010 and 2009 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, 2008	585,899	\$ 13.97		
Options granted	24,000	\$ 8.77		
Options forfeited	(49,000)	\$ 13.75		
Options outstanding at December 31, 2009	<u>560,899</u>	<u>\$ 13.76</u>	<u>2.78 years</u>	<u>\$ -</u>
Options granted	14,000	\$ 6.32		
Options forfeited	(47,600)	\$ 13.98		
Options granted under repricing	50,504	\$ 6.11		
Options cancelled under repricing	<u>(401,549)</u>	<u>\$ 13.79</u>		
Options outstanding at December 31, 2010	<u>176,254</u>	<u>\$ 10.85</u>	<u>2.73 years</u>	<u>\$ 5,400</u>
Options vested or expected to vest at December 31, 2010	<u>149,827</u>	<u>\$ 11.24</u>	<u>2.56 years</u>	<u>\$ -</u>
Options exercisable at December 31, 2010	<u>105,916</u>	<u>\$ 12.30</u>	<u>2.22 years</u>	<u>\$ -</u>

The weighted-average grant-date fair value of options granted during 2010, 2009 and 2008 was \$1.60, \$2.17 and \$2.74, respectively.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**12. SHARE-BASED PAYMENT (Continued)**

Stock Options (Continued)

The total intrinsic value of options exercised in the year ended December 31, 2008 was \$38,040. No options were exercised in 2010 or 2009.

Cash received from options exercised for the year ended December 31, 2008 was \$224,400. There were no options exercised in 2010 or 2009.

A summary of the status of the Company's non-vested shares as of January 1, 2010 and changes during the year ended December 31, 2010, is presented below:

Non-vested Shares	Shares	Weighted Average Exercise Price
Non-vested at January 1, 2010	328,799	\$ 13.39
New options granted	14,000	6.32
Repriced options granted	24,688	6.11
Vested	(27,625)	13.64
Cancelled in repricing	(238,661)	13.56
Forfeited	<u>(25,762)</u>	<u>13.64</u>
Non-vested at December 31, 2010	<u>75,439</u>	<u>\$ 8.98</u>

As of December 31, 2010, the unrecognized compensation cost related to non-vested stock option awards totaled \$258,629. That cost is expected to be amortized on a straight-line basis over a weighted average period of ten months and will be adjusted for subsequent changes in estimated forfeitures. The total fair value of vested options was \$75,458 at December 31, 2010. The expensed cost of vested options was \$268,348, \$314,779, and \$269,228 in 2010, 2009 and 2008, 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 30 days of 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 20% annually for all employees. Bank contributions for the years ended December 31, 2010, 2009 and 2008 totaled \$25,958, \$26,578, and \$25,145, respectively.

**14. RELATED PARTY TRANSACTIONS**

During the normal course of business, the Company enters into transactions with related parties, including Directors and officers. These transactions include borrowings from the Company with substantially the same terms, including rates and collateral, as loans to unrelated parties. The following is a summary of the aggregate activity involving related party borrowers during 2010:

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**14. RELATED PARTY TRANSACTIONS (Continued)**

Balance, January 1, 2010	\$ 12,095,485
Additions	191,500
Amounts repaid	<u>(355,800)</u>
Balance, December 31, 2010	<u>\$ 11,931,185</u>
Undisbursed commitments to related parties, December 31, 2010	<u>\$ 1,620,621</u>

The Company's Chairman provides consulting services related to marketing, real estate and employee related matters. These services are provided under an annually renewable, fixed fee arrangement, approved by the Board of Directors. Payments under the arrangement totaled \$84,000 for each of the years ended December 31, 2010 and 2009. The arrangement was not in place prior to January 1, 2009.

**15. OTHER EXPENSES**

Other expenses for the years ended December 31, 2010, 2009 and 2008 consisted of the following:

	2010	2009	2008
Data processing	\$ 311,425	\$ 229,291	\$ 195,263
Advertising and marketing	282,670	177,737	170,537
Supplies and printing	77,778	72,041	49,544
Professional fees	264,556	281,365	214,346
Legal fees	287,948	300,766	125,975
Director's fees	157,850	166,800	137,375
Insurance and bonding	80,100	62,987	46,598
FDIC and DFI assessments	569,322	523,718	170,928
Credit reports and appraisals	12,006	89,328	27,062
Correspondent bank charges	159,573	129,985	54,147
Other real estate owned expenses	55,206	53,819	-
Other	<u>287,459</u>	<u>241,562</u>	<u>368,804</u>
Total other expenses	<u>\$ 2,545,893</u>	<u>\$ 2,329,399</u>	<u>\$ 1,560,579</u>

**16. COMPREHENSIVE INCOME (LOSS)**

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

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**16. COMPREHENSIVE INCOME (LOSS)** (Continued)

Total comprehensive income and the components of accumulated other comprehensive income (loss) are presented in the statement of changes in shareholders' equity.

At December 31, 2010, 2009 and 2008, the Company recognized other comprehensive income (loss) as follows:

	Before Tax	Tax Benefit (Liability)	After Tax
For the Year Ended December 31, 2010			
Gross unrealized holding gains	\$ 134,343	\$ (53,735)	\$ 80,608
Less: reclassification adjustment for realized gains included in net income	171,028	(68,408)	102,620
Net unrealized holding losses	\$ (36,685)	\$ 14,673	\$ (22,012)
For the Year Ended December 31, 2009			
Net unrealized holding losses	\$ (129,165)	\$ 51,666	\$ (77,499)
For the Year Ended December 31, 2008			
Net unrealized holding gains	\$ 70,213	\$ (55,042)	\$ 15,171

**17. FAIR VALUE OF FINANCIAL INSTRUMENTS**

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.

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

Cash and cash equivalents, Federal Home Loan Bank stock and accrued interest receivable and payable: The current carrying amount approximates estimated fair value.

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. 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.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**17. FAIR VALUE OF FINANCIAL INSTRUMENTS** (Continued)

Loans: The carrying amount of loans is net of deferred loan fees or costs and the allowance for loan losses. To estimate the fair value of the Company's loans, which are primarily adjustable rate and intermediate fixed rate commercial real estate and construction loans, the Company segments loans into categories based on maturity date. The fair value for fixed rate loans are estimated using discounted cash flow analysis, using interest rates currently being offered at each reporting date for loans with similar terms to borrowers of comparable creditworthiness.

Investments in life insurance: Both the carrying amount and the fair value of investments in life insurance reflect the total cash surrender value of each policy. The fair value is equal to the carrying amount in the financial statements.

Customer deposits: The fair value of deposits with no stated term such as demand deposit accounts, NOW accounts, MMDA accounts and savings accounts is the carrying amount reported on the consolidated balance sheet. 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, 2010 or 2009.

	December 31, 2010		December 31, 2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and due from banks	\$ 7,825,291	\$ 7,825,291	\$ 9,712,575	\$ 9,712,575
Federal funds sold	37,145,000	37,145,000	46,735,000	46,735,000
Interest-bearing deposits in other banks	-	-	6,000,000	6,000,000
Available-for-sale investment securities	59,202,000	59,202,000	34,823,000	34,823,000
Loans	204,121,193	217,877,750	199,290,437	211,665,983
Federal Home Loan Bank stock	996,300	996,300	816,800	816,800
Bank owned life insurance	3,204,316	3,204,316	3,098,069	3,098,069
Accrued interest receivable	1,231,435	1,231,435	1,282,041	1,282,041
Financial liabilities:				
Deposits	\$ 284,687,889	\$ 284,504,892	\$ 278,318,094	\$ 277,999,111
Accrued interest payable	44,709	44,709	25,363	25,363

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**18. FAIR VALUE MEASUREMENTS**

*Fair Value Hierarchy*

We group our 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.



**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**18. FAIR VALUE MEASUREMENTS** (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, 2010 and December 31, 2009:

*Recurring Basis*

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

Description	2010			
	Fair Value	Level 1	Level 2	Level 3
U.S. Sponsored Agencies	\$ 30,563,000	\$ -	\$ 30,563,000	\$ -
Mortgage-backed Securities	8,235,000		8,235,000	
Corporate Debt Securities	20,404,000		20,404,000	
Available-for-sale securities	<u>\$ 59,202,000</u>	<u>\$ -</u>	<u>\$ 59,202,000</u>	<u>\$ -</u>

  

Description	2009			
	Fair Value	Level 1	Level 2	Level 3
U.S. Sponsored Agencies	\$ 5,784,000	\$ -	\$ 5,784,000	\$ -
Mortgage-backed Securities	18,431,000		18,431,000	
Corporate Debt Securities	10,608,000		10,608,000	
Available-for-sale securities	<u>\$ 34,823,000</u>	<u>\$ -</u>	<u>\$ 34,823,000</u>	<u>\$ -</u>

Fair values for Level 2 available-for-sale investment securities are based on quoted market prices for similar securities. During the year ended December 31, 2010, there were no significant transfers in or out of Levels 1 and 2.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**18. FAIR VALUE MEASUREMENTS** (Continued)

Assets Recorded at Fair Value (Continued)

*Non-recurring Basis*

The Company may be required, from time to time, to measure certain assets at fair value on a non-recurring basis as follows:

Description	2010			
	Fair Value	Level 1	Level 2	Level 3
Impaired loans				
Construction	\$ 3,299,206	\$ -	\$ -	\$ 3,299,206
Commercial real estate	722,196			722,196
	<u>\$ 4,021,402</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 4,021,402</u>
Description	2009			
	Fair Value	Level 1	Level 2	Level 3
Impaired loans	\$ 2,929,000	\$ -	\$ -	\$ 2,929,000
Other real estate owned	2,596,703			2,596,703
Total impaired loans and other real estate owned	<u>\$ 5,525,703</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,525,703</u>

The fair value of impaired loans and other real estate owned is based on the fair value of the collateral for all collateral dependent loans and for other impaired loans is estimated using a discounted cash flow model. Impaired loans and other real estate owned were determined to be collateral dependent and categorized as Level 3 due to ongoing real estate market conditions resulting in inactive market data, which in turn required the use of unobservable inputs and assumptions in fair value measurements.

Liabilities - The Company did not identify any liabilities that are required to be presented at fair value.

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**19. PARENT ONLY CONDENSED FINANCIAL STATEMENTS**

**PARENT ONLY BALANCE SHEET**  
**December 31, 2010 and 2009**

**ASSETS**

	<b>2010</b>	<b>2009</b>
Cash	\$ 100	\$ 100
Investment in Bank subsidiary	30,354,158	28,085,771
Total assets	\$ 30,354,258	\$ 28,085,871

**LIABILITIES AND SHAREHOLDERS' EQUITY**

Due to Bank subsidiary	\$ -	\$ 67,645
Preferred stock	5,861,094	5,815,852
Common stock	27,618,879	27,618,879
Additional paid-in capital	1,401,032	1,132,683
Accumulated deficit	(4,509,800)	(6,554,253)
Accumulated other comprehensive (loss) income, net of taxes	(16,947)	5,065
Total shareholders' equity	30,354,258	28,018,226
Total liabilities and shareholders' equity	\$ 30,354,258	\$ 28,085,871

**PARENT ONLY STATEMENT OF OPERATIONS**  
**For the years ending December 31, 2010 and 2009**

	<b>2010</b>	<b>2009</b>
<b>INCOME</b>		
Dividends declared by subsidiary - eliminated in consolidation	\$ 300,000	\$ -
Other income	67,645	-
Total income	367,645	-
<b>EXPENSES</b>		
Management expenses	-	6,000
Accounting, reporting expenses	-	49,900
Other expenses	-	11,745
Total operating expense	-	67,645
Income (Loss) before undistributed net income of subsidiary	367,645	(67,645)
Equity in undistributed net income (loss) of subsidiary	1,855,900	(490,994)
Net income (loss)	\$ 2,223,545	\$ (558,639)

**PENINSULA BANK HOLDING CO. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**19. PARENT ONLY CONDENSED FINANCIAL STATEMENTS (Continued)**

**PARENT ONLY STATEMENT OF CASH FLOWS**  
**For the Years Ended December 31, 2010 and 2009**

	<b>2010</b>	<b>2009</b>
Cash flows from operating activities:		
Net income (loss)	\$ 2,223,545	\$ (558,639)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
(Decrease) Increase in other liabilities	(67,645)	67,645
Undistributed net (income) loss of subsidiary	(1,855,900)	490,994
Net cash provided by operating activities	300,000	-
Cash flows from financing activities:		
Proceeds from issuance of preferred stock and warrants	-	5,971,694
Cash dividends paid	(300,000)	-
Net cash (used in) provided by financing activities	(300,000)	5,971,694
Increase in cash and cash equivalents	-	-
Cash and cash equivalents at beginning of period	100	100
Cash and cash equivalents at end of year	\$ 100	\$ 100