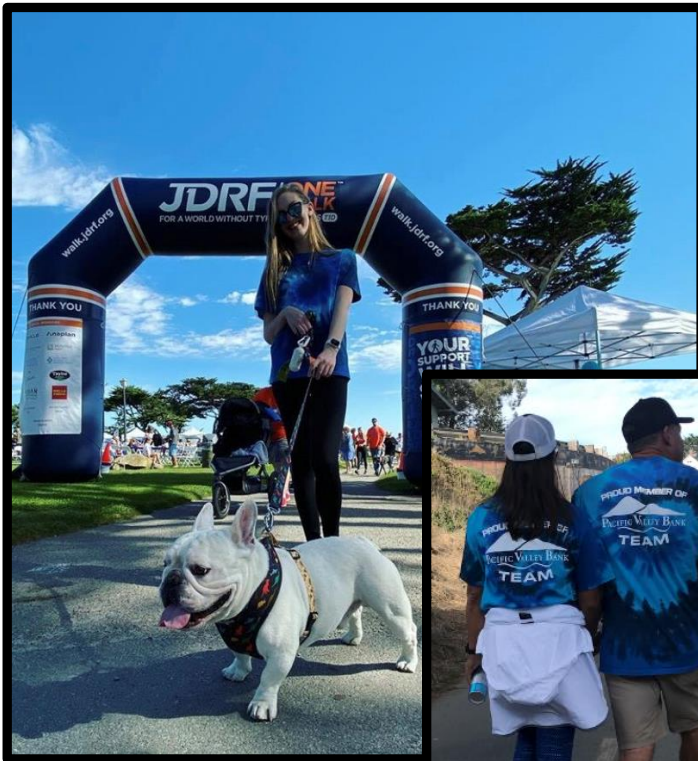


# Annual Report 2019



# A Letter from the President



Dear Shareholders,

It wouldn't make sense to talk about the year behind us or the one ahead without acknowledging the unusual and unprecedented circumstances we are all experiencing due to the Coronavirus. As I write this, first and foremost, our concern and focus continues to be the health—physical, emotional, and financial—of our community. While this is a global event that emphasizes how connected we all are and expands the definition of community, our mission starts here where we have deep roots in the Salinas Valley and throughout Monterey County.

## **Looking Back**

The Board of Directors and Bank management set an aggressive strategic plan that outlined thoughtful growth in assets along with investments in the Bank's technology and processes infrastructure to support growth and facilitate efficiency. We are pleased to be seeing the anticipated improvements as those initiatives take hold. Our commitment to community engagement is an essential part of our core values and we had significant momentum in participation on both an individual level from our staff and as a corporate sponsor. The "new normal" has impacted us all, but we will find ways to continue our community support and involvement.

The Bank's financial health continued to be strong. At December 31, 2019, total assets of the Bank were \$351 million. This represents an increase of \$30 million or 9% since December 31, 2018. Total net loans were \$266 million, an increase of nearly \$22 million for the year. Our loan quality was exceptional with non-performing loans accounting for only 0.35% of total loans. Deposits increased \$27 million for the year, ending 2019 at \$314 million. Non-interest deposits account for the majority of the increase, nearly \$18 million from a year ago, representing a 16% increase.

The Bank reported record earnings in 2019, an additional indicator of a solid financial position. Net income was \$2,685,000, a 9.3% increase over 2018. Interest income on earning assets was \$14 million, an increase of 17% from 2018. Offsetting this was an increase in deposit interest expense of 100%, or \$1 million. Management was faced with increased costs on deposits during 2019; however, cost of funds has declined sharply into 2020. Capital levels reinforced our financial position which exceed regulatory standards for well capitalized institutions.

## **Plans Ahead**

Pacific Valley Bank celebrated its 15<sup>th</sup> anniversary on September 4, 2019, with gratitude for the support of our shareholders and loyal customers. Your value to our past and continued success is immeasurable. The Board, management, and staff are dedicated to earning your continued loyalty and support as we adapt to the ever-evolving landscape. There will be challenges, but we remain committed to seeing our community recover and thrive.

Let's get this done!

A handwritten signature in blue ink, appearing to read "Anker P. Fanoe".

Anker P. Fanoe  
President & Chief Executive Officer

## **FORWARD LOOKING STATEMENTS**

*This release may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are subject to risks and uncertainties that could cause actual results, performance and/or achievements to differ materially from those projected. Accordingly, readers should not place undue reliance on these forward-looking statements. These risks and uncertainties include, but are not limited to, economic conditions in all areas in which the Bank conducts business, including the competitive environment for attracting loans and deposits; supply and demand for real estate and periodic deterioration in real estate prices and/or values in California or other states where we lend; changes in the financial performance and/or condition of our borrowers, depositors, key vendors or counterparties; changes in our levels of delinquent loans, nonperforming assets, allowance for loan losses and charge-offs; the effect of changes in laws and regulations, including accounting practices; changes in estimates of future reserve requirements and minimum capital requirements based upon periodic review thereof under relevant regulatory and accounting requirements; fluctuations in the interest rate and market environment; cyber-security threats, including the loss of system functionality, theft, loss of customer data or money; technological changes and the expanding use of technology in banking; the costs and effects of legal, compliance and regulatory actions; acts of war or terrorism, or natural disasters; and other factors beyond the Bank's control. These forward-looking statements, which reflect management's views, are as of the date of this release. Pacific Valley Bank has no obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances.*

Financial Statements  
December 31, 2019 and 2018  
**Pacific Valley Bank**

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## Independent Auditor's Report

The Board of Directors and Shareholders  
Pacific Valley Bank  
Salinas, California

### Report on the Financial Statements

We have audited the accompanying financial statements of Pacific Valley Bank, which comprise the statement of financial condition as of December 31, 2019, and the related statements of income, comprehensive income, shareholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

### Management's Responsibility for the Financial Statements

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

### Auditor's Responsibility

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

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

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

What inspires you, inspires us. | [eidebailly.com](http://eidebailly.com)

**Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pacific Valley Bank as of December 31, 2019, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

**Other Matter**

The financial statements of Pacific Valley Bank as of and for the year ended December 31, 2018, were audited by Vavrinek, Trine, Day & Co. LLP, who joined Eide Bailly LLP on July 22, 2019, and whose report dated March 29, 2019, expressed an unmodified opinion on those statements.

The image shows a handwritten signature in cursive script that reads "Eide Bailly LLP".

Laguna Hills, California  
March 27, 2020



Pacific Valley Bank  
Statements of Financial Condition  
December 31, 2019 and 2018

	2019	2018
Assets		
Cash and Due from Banks	\$ 6,734,000	\$ 5,956,000
Federal Funds Sold	61,620,000	53,460,000
Total cash and cash equivalents	68,354,000	59,416,000
Time Deposits in Other Banks	6,860,000	7,595,000
Loans, Net of Deferred Fees and Costs	270,672,000	248,718,000
Allowance for Loan Losses	(4,675,000)	(4,576,000)
Net loans	265,997,000	244,142,000
Federal Home Loan and Other Bank Stocks, at Cost	1,478,000	1,336,000
Premises and Equipment	595,000	744,000
Bank Owned Life Insurance	5,642,000	5,523,000
Accrued Interest and Other Assets	2,074,000	1,915,000
Total assets	<u>\$ 351,000,000</u>	<u>\$ 320,671,000</u>
Liabilities and Shareholders' Equity		
Deposits		
Noninterest-bearing	\$ 131,717,000	\$ 113,785,000
Interest-bearing	182,084,000	172,581,000
Total deposits	313,801,000	286,366,000
Accrued Interest and Other Liabilities	1,361,000	1,229,000
Total liabilities	315,162,000	287,595,000
Commitments and Contingencies (Notes 4 and 11)		
Shareholders' Equity		
Preferred stock - 5,000,000 shares authorized, none outstanding	-	-
Common stock - no par value, 10,000,000 shares authorized, shares issued and outstanding - 3,994,747 at December 31, 2019 and 3,956,747 at December 31, 2018	32,557,000	32,480,000
Retained earnings	3,281,000	596,000
Total shareholders' equity	35,838,000	33,076,000
Total liabilities and shareholders' equity	<u>\$ 351,000,000</u>	<u>\$ 320,671,000</u>

Pacific Valley Bank  
Statements of Income  
Years Ended December 31, 2019 and 2018

	2019	2018
Interest Income		
Interest and fees on loans	\$ 12,932,000	\$ 11,491,000
Interest on federal funds sold and other	1,380,000	766,000
Total interest income	14,312,000	12,257,000
Interest Expense		
Interest on savings, NOW, and money market accounts	1,101,000	474,000
Interest on time deposits	985,000	378,000
Interest on borrowings	-	189,000
Total interest expense	2,086,000	1,041,000
Net Interest Income	12,226,000	11,216,000
Provision for Loan Losses	75,000	250,000
Net Interest Income After Provision For Loan Losses	12,151,000	10,966,000
Noninterest Income		
Service charges and fees on deposit accounts	313,000	281,000
Other service charges and fees	51,000	44,000
Gain on sale of other real estate owned	-	493,000
Interchange fees	86,000	95,000
Earnings on bank owned life insurance	119,000	124,000
Total noninterest income	569,000	1,037,000
Noninterest Expense		
Salaries and employee benefits	5,907,000	5,592,000
Occupancy and equipment expense	660,000	703,000
Other expenses	2,336,000	2,258,000
Total noninterest expense	8,903,000	8,553,000
Income Before Income Taxes	3,817,000	3,450,000
Income Taxes	1,132,000	994,000
Net Income	\$ 2,685,000	\$ 2,456,000
Net Income per Share - Basic	\$ 0.67	\$ 0.62
Net Income per Share - Diluted	\$ 0.67	\$ 0.62



Pacific Valley Bank  
Statements of Comprehensive Income  
Years Ended December 31, 2019 and 2018

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	<u>2019</u>	<u>2018</u>
Net Income	\$ 2,685,000	\$ 2,456,000
Other Comprehensive Income		
Unrealized gain and loss on securities available for sale:		
Unrealized gain on investment securities	<u>-</u>	<u>-</u>
	-	-
Income tax expense (benefit)		
Change in net unrealized gain	<u>-</u>	<u>-</u>
	-	-
Total other comprehensive income	<u>-</u>	<u>-</u>
Total comprehensive income	<u><u>\$ 2,685,000</u></u>	<u><u>\$ 2,456,000</u></u>

Pacific Valley Bank  
Statement of Shareholders' Equity  
Years Ended December 31, 2019 and 2018

	Common Stock		Retained Earnings (Deficit)	Total
	Number of Shares	Amount		
Balance January 1, 2018	3,596,996	\$ 32,480,000	\$ (1,978,000)	\$ 30,502,000
Adoption of New Accounting Standard, Net of Taxes of \$49,000			118,000	118,000
10% Stock Dividend	359,751	-	-	-
Net Income			2,456,000	2,456,000
Balance at December 31, 2018	3,956,747	32,480,000	596,000	33,076,000
Issuance of Stock Grants	38,000			
Share Based Compensation		77,000		77,000
Net Income	-	-	2,685,000	2,685,000
Balance at December 31, 2019	3,994,747	\$ 32,557,000	\$ 3,281,000	\$ 35,838,000

See Notes to Financial Statements

Pacific Valley Bank  
Statements of Cash Flows  
Years Ended December 31, 2019 and 2018

	<u>2019</u>	<u>2018</u>
Operating Activities		
Net income	\$ 2,685,000	\$ 2,456,000
Adjustments to reconcile net income to net cash from operating activities		
Depreciation and amortization	144,000	162,000
Provision (benefit) for loan losses	75,000	250,000
Gain on sale of other real estate owned	-	(493,000)
Earnings on bank owned life insurance	(119,000)	(124,000)
Stock based compensation	77,000	-
Deferred income taxes	(20,000)	499,000
Other items	(2,000)	(602,000)
Total adjustments	<u>155,000</u>	<u>(308,000)</u>
Net Cash from Operating Activities	<u>2,840,000</u>	<u>2,148,000</u>
Investing Activities		
Net change in time deposits in other banks	735,000	4,165,000
Principal payments on debt securities available for sale	-	51,000
Net change in loans to customers	(21,930,000)	(38,173,000)
Purchase of federal home loan bank stock	(142,000)	(164,000)
Proceeds from sale of other real estate owned	-	1,128,000
Purchases of premises and equipment	-	(123,000)
Net Cash from Investing Activities	<u>(21,337,000)</u>	<u>(33,116,000)</u>
Financing Activities		
Net change in demand deposits and savings accounts	42,495,000	11,637,000
Net change in time deposits	(15,060,000)	33,140,000
Net Cash from Financing Activities	<u>27,435,000</u>	<u>44,777,000</u>
Net Change in Cash and Cash Equivalents	8,938,000	13,809,000
Cash and Cash Equivalents, Beginning of Year	<u>59,416,000</u>	<u>45,607,000</u>
Cash and Cash Equivalents, End of Year	<u>\$ 68,354,000</u>	<u>\$ 59,416,000</u>
Supplemental Disclosures of Cash Flow Information		
Interest paid	\$ 2,089,000	\$ 1,039,000
Taxes paid	\$ 1,055,000	\$ 645,000
Lease liabilities arising from obtaining right-of-use assets	\$ 459,000	\$ -

## **Note 1 - Summary of Significant Accounting Policies**

### **Nature of Operations**

The Bank opened for business during September 2004. Our products and services are targeted to customers who operate small and middle-market businesses, professionals, high net worth individuals and families residing in Monterey County, California. We serve business and individual customers from three branch locations: Salinas, Monterey, and King City, California. Our mission is to "create prosperity in the community through excellence in banking". It is our goal to compete on responsive service and not solely on the basis of price.

### **Subsequent Events**

The Bank has evaluated subsequent events for recognition and disclosure through March 27, 2020, which is the date the financial statements were available to be issued. Subsequent to year-end, the Bank has loan customers who are expected to be negatively impacted by the effects of the world-wide coronavirus pandemic. The Bank is closely monitoring its loan portfolio, operations, liquidity, and capital resources and is actively working to minimize the current and future impact of this unprecedented situation. As of the date of issuance of these financial statements, the full impact to the Bank's financial position is not known.

### **Use of Estimates in the Preparation of Financial Statements**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant changes in the near term relate to the determination of the allowance for loan losses.

### **Cash and Cash Equivalents**

For purposes of reporting cash flows, cash and cash equivalents include cash, due from banks, deposits with other financial institutions with original maturities ninety days or less and federal funds sold. Generally, federal funds are sold for periods of less than ninety days.

### **Cash and Due from Banks**

Banking regulations require that banks maintain a percentage of their deposits as reserves in cash or on deposit with the Federal Reserve Bank. The Bank was in compliance with its reserve requirements as of December 31, 2019 and 2018.

The Bank maintains amounts due from banks, which may exceed federally insured limits. The Bank has not experienced any losses in such accounts.

### **Time Deposits in Other Banks**

Time deposits in other banks generally mature within one year and are carried at cost.

## **Debt Securities**

Debt securities are classified in three categories and accounted for as follows: debt securities that the Bank has the positive intent and ability to hold to maturity are classified as held-to-maturity and are measured at amortized cost; debt securities bought and held principally for the purpose of selling in the near term are classified as trading securities and are measured at fair value, with unrealized gains and losses included in earnings; debt securities not classified as either held-to-maturity or trading securities are deemed as available-for-sale and are measured at fair value, with unrealized gains and losses, net of applicable taxes, reported in a separate component of shareholders' equity. Gains or losses on sales of debt securities are determined on the specific identification method. Premiums and discounts are amortized or accreted using the interest method over the expected lives of the related securities.

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

## **Loans**

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding unpaid principal balances reduced by any charge-offs or specific valuation accounts and net of deferred fees or costs on originated loans, or unamortized premiums or discounts on purchased loans. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan. Amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. The accrual of interest on loans is discontinued when principal or interest is past due 90 days based on the contractual terms of the loan or when, in the opinion of management, there is reasonable doubt as to collectability. When loans are placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period interest income. Income on nonaccrual loans is subsequently recognized only to the extent that cash is received and the loan's principal balance is deemed collectible. Interest accruals are resumed on such loans only when they are brought current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectible as to all principal and interest.

### **Allowance for Loan Losses**

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

The Bank determines a separate allowance for each portfolio segment. The allowance consists of specific and general reserves. Specific reserves relate to loans that are individually classified as impaired. A loan is impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status, collateral value, and the probability of collecting all amounts when due. Measurement of impairment is based on the expected future cash flows of an impaired loan, which are to be discounted at the loan's effective interest rate, or measured by reference to an observable market value, if one exists, or the fair value of the collateral for a collateral-dependent loan. The Bank selects the measurement method on a loan-by-loan basis except that collateral-dependent loans for which foreclosure is probable are measured at the fair value of the collateral.

The Bank recognizes interest income on impaired loans based on its existing methods of recognizing interest income on nonaccrual loans. Loans, for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired with measurement of impairment as described above.

If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral.

General reserves cover non-impaired loans and are based on historical loss rates for each portfolio segment, adjusted for the effects of qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the portfolio segment's historical loss experience. Qualitative factors include consideration of the following: changes in lending policies and procedures; changes in economic conditions, changes in the nature and volume of the portfolio; changes in the experience, ability and depth of lending management and other relevant staff; changes in the volume and severity of past due, nonaccrual and other adversely graded loans; changes in the loan review system; changes in the value of the underlying collateral for collateral-dependent loans; concentrations of credit and the effect of other external factors such as competition and legal and regulatory requirements.

Portfolio segments identified by the Bank include construction and land development, real estate, commercial and agriculture and consumer loans. Relevant risk characteristics for these portfolio segments generally include debt service coverage, loan-to-value ratios and financial performance on non-consumer loans and debt-to-income, collateral type and loan-to-value ratios for consumer loans.

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 that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Bank's primary regulators, the Federal Deposit Insurance Corporation ("FDIC") and California Department of Business Oversight, 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.

#### **Allowance for Credit Losses on Off-Balance Sheet Credit Exposures**

The Bank also maintains a separate allowance for off-balance sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance sheet commitments totaled \$82,000 at December 31, 2019 and 2018, and is included in other liabilities on the balance sheet.

#### **Federal Home Loan Bank ("FHLB") and Other Bank Stock**

The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors and may invest in additional amounts. The Bank also has restricted securities in the form of capital stock invested in Pacific Coast Banker's Bank and The Independent Banker Bank. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on the ultimate recovery of par value. Both cash and stock dividends are reported as income. The Bank's investment in FHLB stock was approximately \$1,222,000 and \$1,080,000 at December 31, 2018 and 2017, respectively.

Pursuant to the adoption of ASU 2016-01 on January 1, 2018, the Bank elected the measurement alternative for measuring equity securities without readily determinable fair values at cost less impairment, plus or minus observable price changes in orderly transactions. The carrying amount of equity securities without readily determinable fair values is \$256,000 as of December 31, 2019 and 2018, and includes investment in Pacific Coast Bankers' Bank ("PCBB") and The Independent Bankers' Bank stock. No gain or loss was recorded to income in 2019 and 2018. Adjustments to the carrying value of banker's bank stock is based on observable activity in the stock when available.

#### **Other Real Estate Owned ("OREO")**

Real estate acquired through foreclosure or deed in lieu of foreclosure is recorded at fair value at the date legal title is transferred, establishing a new cost basis by a charge to the allowance for loan losses, if necessary. Other real estate owned is carried at the lower of the Bank's carrying value of the property or its fair value, less estimated carrying costs and costs of disposition. Fair value is based on current appraisals less estimated selling costs. Any subsequent write-downs are charged against operating expenses and recognized as a valuation allowance. Operating expenses of such properties, net of related income, and gains and losses on their disposition are included in other operating expenses. As of December 31, 2019 and 2018, the Bank had no other real estate owned.



### **Premises and Equipment**

Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives, which ranges from three to seven years for furniture and equipment and forty years for premises. Leasehold improvements are amortized using the straight-line method over the estimated useful lives of the improvements or the remaining lease term, whichever is shorter. Expenditures for betterments or major repairs are capitalized and those for ordinary repairs and maintenance are charged to operations as incurred.

### **Leases**

The Bank determines if an arrangement contains a lease at contract inception and recognize right-of-use ("ROU") assets and operating lease liabilities based on the present value of lease payments over the lease term. While operating leases may include options to extend the term, the Bank does not take into account the options in calculating the ROU asset and lease liability unless it is reasonably certain such options will be reasonably exercised. The present value of lease payments is determined based on the Bank's incremental borrowing rate and other information available at lease commencement. Leases with an initial term of 12 months or less are not recorded in the statements of financial condition. Lease expense is recognized on a straight-line basis over the lease term. The Bank has elected to account for lease agreements with lease and non-lease components as a single lease component. Refer to - Accounting Standards Adopted in 2019 below and Note 5, *Leases* for further discussion on the Bank's leasing arrangements and related accounting.

### **Bank Owned Life Insurance**

Bank owned life insurance is recorded at the amount that can be realized under insurance contracts at the date of the statement of financial condition, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

### **Loss Contingencies**

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

### **Revenue Recognition – Noninterest Income**

The Bank adopted the provisions of ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), on January 1, 2018 and all subsequent ASUs that modified Topic 606. Results for reporting periods beginning after December 31, 2017 are presented under Topic 606, while prior period amounts have not been adjusted and continue to be reported in accordance with Topic 605. The Bank recognizes revenue as it is earned and noted no significant impact to its revenue recognition policies as a result of the adoption of ASU 2014-09. All of the Bank's revenue from contracts with customers within the scope of ASC 606 is recognized in non-interest income. The impact of the ASU on uncompleted contracts at the date of adoption resulted in the Bank recording a deferred gain from the sale of other real estate owned in a prior period. The deferred gain amounted to \$118,000, net of taxes, and was recorded in retained earnings as of January 1, 2018.

In accordance with Topic 606, revenues are recognized when control of promised goods or services is transferred to customers in an amount that reflects the consideration the Bank expects to be entitled to in exchange for those goods or services. To determine revenue recognition for arrangements that an entity determines are within the scope of Topic 606, the Bank performs the following five steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligation in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligation in the contract; and (v) recognize revenue when (or as) the Bank satisfies a performance obligation. The Bank only applies the five-step model to contracts when it is probable that the entity will collect the consideration it is entitled to in exchange for the goods or services it transfers to the customer. At contract inception, once the contract is determined to be within the scope of Topic 606, the Bank assesses the goods or services that are promised within each contract and identifies those that contain performance obligation and assesses whether each promised good or service is distinct. The Bank then recognizes as revenue the amount of the transaction price that is allocated to the respective performance obligation when (or as) the performance obligation is satisfied.

The following is a discussion of key revenues within the scope of the new revenue guidance.

#### **Service Charges and Fees on Deposit Accounts**

The Bank earns fees from its deposit customers for account maintenance, transaction-based and overdraft services. Account maintenance fees consist primarily of account fees and analyzed account fees charged on deposit accounts on a monthly basis. The performance obligation is satisfied and the fees are recognized on a monthly basis as the service period is completed. Transaction-based fees on deposits accounts are charged to deposit customers for specific services provided to the customer, such as non-sufficient funds fees, overdraft fees, and wire fees. The performance obligation is completed as the transaction occurs and the fees are recognized at the time each specific service is provided to the customer.

#### **Interchange Fees**

Interchange fees represents fees earned when a debit card issued by the Bank is used. The Bank earns interchange fees from debit cardholder transactions through a payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The performance obligation is satisfied and the fees are earned when the cost of the transaction is charged to the card. Certain expenses directly associated with the debit card are recorded on a net basis with the fee income.

#### **Gains/Losses on OREO Sales**

Gains/losses on the sale of OREO are included in non-interest income and are generally recognized when the performance obligation is complete. This is typically at delivery of control over the property to the buyer at the time of each real estate closing.

### **Stock-Based Compensation**

The Bank recognizes the cost of employee services received in exchange for awards of stock options, or other equity instruments, based on the grant-date fair value of those awards. This cost is recognized over the period which an employee is required to provide services in exchange for the award, generally the vesting period, on a straight-line basis.

The Bank has elected to account for forfeitures of stock-based awards as they occur. Excess tax benefits and tax deficiencies relating to stock-based compensation are recorded as income tax expense or benefit in the income statement when incurred.

See Note 13 for additional information on the Bank's stock option plan.

### **Income Taxes**

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

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

### **Earnings Per Share ("EPS")**

Earnings per common share is computed under the two-class method. Basic EPS excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period, excluding outstanding participating securities. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Bank. Unvested share-based awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are included in the computation of earnings per share pursuant to the two-class method. The Bank has determined that its outstanding non-vested restricted share awards are participating securities.

### **Comprehensive Income**

The Bank had no comprehensive income other than net income for the years ended December 31, 2019 and 2018.

## Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit, commercial letters of credit, and standby letters of credit as described in Note 11. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

## Fair Value Measurement

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

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a Bank's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

As of December 31, 2019, and 2018, the Bank did not have any financial instruments measured at fair value on a recurring or non-recurring basis.

## Recently Adopted Accounting Pronouncements

The Bank adopted ASU 2016-02, *Leases (Topic 842)* and ASU 2018-11, *Leases (Topic 842): Targeted Improvements*, referred to herein as Topic 842, effective January 1, 2019. The new guidance establishes the principles to report transparent and economically neutral information about the assets and liabilities that arise from leases. Entities are required to recognize ROU assets and lease liabilities that arise from leases in the statements of financial condition and to disclose qualitative and quantitative information about lease transactions, such as information about variable lease payments and options to renew and terminate leases. Under the amendments in ASU 2018-11, entities may elect not to recast the comparative periods presented when transitioning to the new leasing standard.

Upon adoption, the Bank elected to use the modified retrospective transition approach and recorded ROU assets and lease liabilities of approximately \$459,000 at the date of adoption with no adjustment to opening equity. The Bank elected to apply the package of practical expedients which permits entities to not reassess: (i) whether any expired or existing contracts contain a lease; (ii) lease classification for any expired or existing leases; and (iii) whether initial direct costs for any existing leases qualify for capitalization under the amended guidance. The Bank also elected not to include short-term leases (leases with initial terms of twelve months or less) on the statements of financial condition.

### **Recent Accounting Guidance Not Yet Effective**

In June 2016, the FASB issued ASU No. 2016-13, Measurement of Credit Losses on Financial Instruments (Topic 326). This ASU significantly changes how entities will measure credit losses for most financial assets and certain other instruments that aren't measured at fair value through net income. In issuing the standard, the FASB is responding to criticism that today's guidance delays recognition of credit losses. The standard will replace today's "incurred loss" approach with an "expected loss" model. The new model, referred to as the current expected credit loss ("CECL") model, will apply to: (1) financial assets subject to credit losses and measured at amortized cost, and (2) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments, and financial guarantees. The CECL model does not apply to available-for-sale ("AFS") debt securities. For AFS debt securities with unrealized losses, entities will measure credit losses in a manner similar to what they do today, except that the losses will be recognized as allowances rather than reductions in the amortized cost of the securities. As a result, entities will recognize improvements to estimated credit losses immediately in earnings rather than as interest income over time, as they do today. The ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans. ASU 2016-13 also expands the disclosure requirements regarding an entity's assumptions, models, and methods for estimating the allowance for loan and lease losses. In addition, public business entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination. ASU No. 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2022 for all entities, other than SEC filers that do not qualify as a Smaller Reporting Company as defined by the SEC. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). The Bank is currently evaluating the provisions of ASU No. 2016-13 for potential impact on its financial statements and disclosures.

In August 2018, the FASB issued ASU No. 2018-13, "Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement." This ASU eliminates, adds and modifies certain disclosure requirements for fair value measurements. Among the changes, entities will no longer be required to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, but will be required to disclose the range and weighted average used to develop significant unobservable inputs for Level 3 fair value measurements. ASU No. 2018-13 is effective for all entities for interim and annual reporting periods beginning after December 15, 2019. Early adoption is permitted. As ASU No. 2018-13 only revises disclosure requirements, it will not have a material impact on the Bank's financial statements.

### **Note 2 - Loans**

The Bank's loan portfolio consists primarily of loans to borrowers within Monterey County, California and surrounding communities. Although the Bank seeks to avoid concentrations of loans to a single industry or based upon a single class of collateral, real estate and real estate associated businesses are among the principal industries in the Bank's market area and, as a result, the Bank's loan and collateral portfolios are, to some degree, concentrated in those industries. The Bank's loan portfolio concentration in real estate secured credit at December 31, 2019 and 2018, was approximately 85% and 83%, respectively.

The Bank has pledged loans to secure lines of credit with the Federal Home Loan Bank as discussed in Note 6.

At December 31, the composition of the loan portfolio is as follows:

	2019	2018
Construction and Land Development	\$ 9,260,000	\$ 13,155,000
Real Estate - Other		
1-4 family residential	17,831,000	20,034,000
Multifamily residential	23,096,000	17,916,000
Commercial real estate	158,623,000	137,894,000
Commercial and Agriculture		
Commercial and industrial	32,354,000	31,909,000
Agriculture production	7,131,000	9,332,000
Secured by farmland	20,529,000	17,234,000
Consumer and Other	1,848,000	1,244,000
 Total loans	 270,672,000	 248,718,000
 Allowance for loan losses	 (4,675,000)	 (4,576,000)
 Net loans	 <u>\$ 265,997,000</u>	 <u>\$ 244,142,000</u>

The balance of unamortized loan origination costs and premiums, net of unamortized (fees), included in total loans was \$689,000 and \$870,000 as of December 31, 2019 and 2018, respectively.

A summary of the changes in the allowance for loan losses as of December 31 follows:

	2019	2018
Balance at beginning of year	\$ 4,576,000	\$ 4,300,000
Provision charged to expense	75,000	250,000
Recoveries on loans charged off	26,000	26,000
	4,677,000	4,576,000
Less loans charged off	(2,000)	-
	<u>\$ 4,675,000</u>	<u>\$ 4,576,000</u>

The following table presents the activity in the allowance for loan losses for the year 2019, and the recorded investment in loans and impairment method as of December 31, 2019, by portfolio segment:

	Construction and Land Development	Real Estate - Other	Commercial and Agriculture	Consumer	Total
Allowance for Loan Losses					
Beginning of year	\$ 373,000	\$ 2,953,000	\$ 1,246,000	\$ 4,000	\$ 4,576,000
Provisions (benefit)	(53,000)	253,000	(127,000)	2,000	75,000
Charge-offs	-	(2,000)	-	-	(2,000)
Recoveries	-	26,000	-	-	26,000
End of Year	<u>\$ 320,000</u>	<u>\$ 3,230,000</u>	<u>\$ 1,119,000</u>	<u>\$ 6,000</u>	<u>\$ 4,675,000</u>
Reserves					
Specific	\$ -	\$ -	\$ 1,000	\$ -	\$ 1,000
General	<u>320,000</u>	<u>3,230,000</u>	<u>1,118,000</u>	<u>6,000</u>	<u>4,674,000</u>
	<u>\$ 320,000</u>	<u>\$ 3,230,000</u>	<u>\$ 1,119,000</u>	<u>\$ 6,000</u>	<u>\$ 4,675,000</u>
Loans Evaluated for Impairment					
Individually	\$ -	\$ 954,000	\$ 100,000	\$ -	\$ 1,054,000
Collectively	<u>9,260,000</u>	<u>198,596,000</u>	<u>59,914,000</u>	<u>1,848,000</u>	<u>269,618,000</u>
	<u>\$ 9,260,000</u>	<u>\$ 199,550,000</u>	<u>\$ 60,014,000</u>	<u>\$ 1,848,000</u>	<u>\$ 270,672,000</u>

The following table presents the activity in the allowance for loan losses for the year 2018, and the recorded investment in loans and impairment method as of December 31, 2018, by portfolio segment:

	Construction and Land Development	Real Estate - Other	Commercial and Agriculture	Consumer	Total
Allowance for Loan Losses					
Beginning of year	\$ 203,000	\$ 2,886,000	\$ 1,191,000	\$ 20,000	\$ 4,300,000
Provisions (benefit)	170,000	67,000	29,000	(16,000)	250,000
Charge-offs	-	-	-	-	-
Recoveries	-	-	26,000	-	26,000
End of Year	<u>\$ 373,000</u>	<u>\$ 2,953,000</u>	<u>\$ 1,246,000</u>	<u>\$ 4,000</u>	<u>\$ 4,576,000</u>
Reserves					
Specific	\$ -	\$ -	\$ 61,000	\$ -	\$ 61,000
General	<u>373,000</u>	<u>2,953,000</u>	<u>1,185,000</u>	<u>4,000</u>	<u>4,515,000</u>
	<u>\$ 373,000</u>	<u>\$ 2,953,000</u>	<u>\$ 1,246,000</u>	<u>\$ 4,000</u>	<u>\$ 4,576,000</u>
Loans Evaluated for Impairment					
Individually	\$ -	\$ 1,675,000	\$ 156,000	\$ -	\$ 1,831,000
Collectively	<u>13,155,000</u>	<u>174,169,000</u>	<u>58,319,000</u>	<u>1,244,000</u>	<u>246,887,000</u>
	<u>\$ 13,155,000</u>	<u>\$ 175,844,000</u>	<u>\$ 58,475,000</u>	<u>\$ 1,244,000</u>	<u>\$ 248,718,000</u>



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

Pass - Loans classified as pass include loans not meeting the risk ratings defined below.

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

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

Doubtful - A loan classified 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.

The risk category of loans by class of loans was as follows as of December 31, 2019:

	Pass	Special Mention	Substandard	Doubtful	Total
Construction and Land Development	\$ 9,260,000	\$ -	\$ -	\$ -	\$ 9,260,000
Real Estate - Other					
1-4 family residential	16,877,000	-	954,000	-	17,831,000
Multifamily residential	22,854,000	242,000	-	-	23,096,000
Commercial real estate	153,693,000	4,930,000	-	-	158,623,000
Commercial and Agriculture					
Commercial and industrial	32,354,000	-	-	-	32,354,000
Agriculture production	7,131,000	-	-	-	7,131,000
Secured by farmland	16,951,000	3,578,000	-	-	20,529,000
Consumer and Other	1,848,000	-	-	-	1,848,000
	<u>\$ 260,968,000</u>	<u>\$ 8,750,000</u>	<u>\$ 954,000</u>	<u>\$ -</u>	<u>\$ 270,672,000</u>

The risk category of loans by class of loans was as follows as of December 31, 2018:

	Pass	Special Mention	Substandard	Doubtful	Total
Construction and Land Development	\$ 13,155,000	\$ -	\$ -	\$ -	\$ 13,155,000
Real Estate - Other					
1-4 family residential	18,734,000	-	1,300,000	-	20,034,000
Multifamily residential	17,668,000	248,000	-	-	17,916,000
Commercial real estate	136,448,000	1,071,000	375,000	-	137,894,000
Commercial and Agriculture					
Commercial and industrial	31,520,000	-	389,000	-	31,909,000
Agriculture production	9,332,000	-	-	-	9,332,000
Secured by farmland	13,556,000	3,678,000	-	-	17,234,000
Consumer and Other	1,244,000	-	-	-	1,244,000
	<u>\$ 241,657,000</u>	<u>\$ 4,997,000</u>	<u>\$ 2,064,000</u>	<u>\$ -</u>	<u>\$ 248,718,000</u>

An aging analysis of the loan portfolio by past due, nonaccrual and current loans presented by loan class is as follows as of December 31, 2019:

	30-89 Days Past Due	Over 90 Days Past Due and Still Accruing	Nonaccrual	Current	Total Loans
Construction and Land Development	\$ -	\$ -	\$ -	\$ 9,260,000	\$ 9,260,000
Real Estate - Other					
1-4 family residential	-	-	954,000	16,877,000	17,831,000
Multifamily residential	-	-	-	23,096,000	23,096,000
Commercial real estate	-	-	-	158,623,000	158,623,000
Commercial and Agriculture					
Commercial and industrial	-	-	-	32,354,000	32,354,000
Agriculture production	-	-	-	7,131,000	7,131,000
Secured by farmland	-	-	-	20,529,000	20,529,000
Consumer and Other	-	-	-	1,848,000	1,848,000
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 954,000</u>	<u>\$ 269,718,000</u>	<u>\$ 270,672,000</u>

An aging analysis of the loan portfolio by past due, nonaccrual and current loans presented by loan class is as follows as of December 31, 2018:

	30-89 Days Past Due	Over 90 Days Past Due and Still Accruing	Nonaccrual	Current	Total Loans
Construction and Land Development	\$ -	\$ -	\$ -	\$ 13,155,000	\$ 13,155,000
Real Estate - Other					
1-4 family residential	-	-	1,300,000	18,734,000	20,034,000
Multifamily residential	-	-	-	17,916,000	17,916,000
Commercial real estate	-	-	375,000	137,519,000	137,894,000
Commercial and Agriculture					
Commercial and industrial	-	-	26,000	31,883,000	31,909,000
Agriculture production	-	-	-	9,332,000	9,332,000
Secured by farmland	-	-	-	17,234,000	17,234,000
Consumer and Other	-	-	-	1,244,000	1,244,000
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,701,000</u>	<u>\$ 247,017,000</u>	<u>\$ 248,718,000</u>

Information relating to individually impaired loans presented by class of loans was as follows as of December 31, 2019:

	Unpaid Principal Balance	Recorded Investment	Impaired Loans		Related Allowance	Average Recorded Investment	Interest Income Recognized
			Without Specific Allowance	With Specific Allowance			
Construction and Land Development	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Real Estate - Other							
1-4 family residential	1,013,000	954,000	954,000	-	-	994,000	-
Commercial and Agriculture							
Agriculture production	100,000	100,000	-	100,000	1,000	115,000	8,000
	<u>\$ 1,113,000</u>	<u>\$ 1,054,000</u>	<u>\$ 954,000</u>	<u>\$ 100,000</u>	<u>\$ 1,000</u>	<u>\$ 1,109,000</u>	<u>\$ 8,000</u>

Information relating to individually impaired loans presented by class of loans was as follows as of December 31, 2018:

	Unpaid Principal Balance	Recorded Investment	Impaired Loans		Related Allowance	Average Recorded Investment	Interest Income Recognized
			Without Specific Allowance	With Specific Allowance			
Construction and Land Development	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Real Estate - Other							
1-4 family residential	1,322,000	1,300,000	1,300,000	-	-	718,000	-
Multifamily residential	-	-	-	-	-	-	-
Commercial real estate	424,000	375,000	375,000	-	-	509,000	-
Commercial and Agriculture							
Commercial and industrial	29,000	26,000	26,000	-	-	34,000	-
Agriculture production	130,000	130,000	-	130,000	61,000	159,000	11,000
	<u>\$ 1,905,000</u>	<u>\$ 1,831,000</u>	<u>\$ 1,701,000</u>	<u>\$ 130,000</u>	<u>\$ 61,000</u>	<u>\$ 1,420,000</u>	<u>\$ 11,000</u>

Cash basis income recognized on impaired loans for the years ended December 31, 2019 and 2018 was not material.

At December 31, 2019 and 2018, the Bank had approximately \$100,000 and \$130,000 in recorded investment in loans identified as troubled debt restructurings, respectively, and had allocated approximately \$1,000 and \$61,000 as specific reserves for these loans, respectively. The Bank has committed not to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings as of December 31, 2019. No loans were modified as troubled debt restructurings during 2019 and 2018.

There were no loans modified as troubled debt restructuring for which there was a payment default within twelve months following the modification during the years ended December 31, 2019 and 2018. A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms.

### Note 3 - Premises and Equipment

A summary of premises and equipment as of December 31 follows:

	2019	2018
Land	\$ 111,000	\$ 111,000
Bank premises	284,000	284,000
Leasehold improvements	1,187,000	1,187,000
Furniture, fixtures, and equipment	1,618,000	1,623,000
	<u>3,200,000</u>	<u>3,205,000</u>
Less accumulated depreciation and amortization	<u>(2,605,000)</u>	<u>(2,461,000)</u>
	<u>\$ 595,000</u>	<u>\$ 744,000</u>

Depreciation and amortization included in occupancy and equipment expense totaled \$144,000 and \$162,000 during the years ended December 31, 2019 and 2018, respectively.

#### **Note 4 - Leases**

ASU 2016-02, *Leases (Topic 842)*, and related amendments were adopted on January 1, 2019, using the modified retrospective transition method whereby comparative periods were not restated. No cumulative effect adjustment to the opening balance of retained earnings was required. The Bank elected the package of practical expedients permitted under the new standard, which allowed carry forward historical lease classifications, account for lease and nonlease components as a single lease component, and not to recognize a ROU asset and lease liability for short-term leases.

The Bank has entered into a lease for its main office, which will expire in March 2021. The lease also includes provisions for options to extend the lease. The Bank has leased its Monterey branch location, which will expire in May 2020. The lease also includes a provision to extend the lease for an additional three years. The amount of the lease liability and ROU asset is impacted by the lease term and the discount rate applied to determine the present value of future lease payments. The leases include provisions for periodic rent increases as well as payment by the lessee of certain operating expenses. The exercise of renewal options is at the sole discretion of the Bank. Renewal options periods were not included in the measurement of ROU assets and lease liabilities as they are not considered reasonably certain of exercise. Lease costs relating to these leases and other short term rentals was approximately \$238,000 and \$233,000 for the years ended December 31, 2019 and 2018, respectively.

Upon adoption of this standard, ROU assets and lease liabilities of approximately \$459,000 were recognized. The balance of ROU assets and lease liabilities are included in other assets and other liabilities on the statements of financial condition. The statement of financial condition and supplemental information at December 31, 2019 are shown below.

Operating Lease Right-of-Use Assets Classified as Accrued Interest and Other Assets	\$ 242,000
Operating Lease Liabilities Classified as Accrued Interest and Other Liabilities	\$ 266,000
Weighted Average Remaining Lease Term, in Years	1.16
Weighted Average Discount Rate	5.00%

The Bank elected, for all classes of underlying assets, not to separate lease and non-lease components and instead to account for them as a single lease component. Variable lease cost primarily represents variable payments such as common area maintenance and utilities. The following table represents lease costs and other lease information for the year ended December 31, 2019:

Operating lease cost	\$ 235,000
Variable lease cost	<u>3,000</u>
Total lease costs	<u><u>\$ 238,000</u></u>
Cash Paid for Amounts Included in the Measurement of Lease Liabilities	\$ 261,000
Right-of-Use Assets Obtained in Exchange for Lease Obligations	\$ 459,000

Maturities of lease liabilities for periods indicated:

Year Ending	
2020	\$ 225,000
2021	<u>50,000</u>
Total lease payments	275,000
Less imputed interest	<u>(9,000)</u>
Present value of net future minimum lease payments	<u><u>\$ 266,000</u></u>

## Note 5 - Deposits

Deposits consist of the following at December 31:

	2019	2018
Deposits		
Noninterest-bearing demand	\$ 131,717,000	\$ 113,785,000
Savings and NOW accounts	34,402,000	30,527,000
Money market accounts	104,226,000	83,538,000
Time deposits under \$250,000	26,579,000	37,170,000
Time deposits \$250,000 and over	<u>16,877,000</u>	<u>21,346,000</u>
Total deposits	<u><u>\$ 313,801,000</u></u>	<u><u>\$ 286,366,000</u></u>

At December 31, 2019, the scheduled maturities of time deposits are as follows:

2020	\$ 39,088,000
2021	3,801,000
2022	524,000
2023	26,000
2024	17,000
	<u>\$ 43,456,000</u>

The Bank's ten largest deposit relationships represent approximately \$123,079,000 or 39% of the total outstanding deposits of the Bank. The loss of any one of these large depositors could have a material impact on our operations. However, some of these large depositors have other business relationships with us, such as commercial loans and lines of credit, and or are related parties, which we believe mitigates the risk of a material decline in these deposits.

#### **Note 6 - Other Borrowings**

The Bank may borrow up to \$14,000,000 overnight on an unsecured basis from three correspondent banks. As of December 31, 2019 and 2018, no amounts were outstanding under these arrangements.

As of December 31, 2019, the Bank had an available line of credit with the Federal Home Loan Bank of San Francisco ("FHLB") secured by the assets of the Bank. Under this line, the Bank may borrow up to \$52,262,000 subject to providing adequate collateral and continued compliance with the Advances and Security Agreement and other eligibility requirements established by the FHLB. The Bank has pledged all of its loans as collateral for this line. As of December 31, 2019 and 2018, no advances were outstanding under this arrangement.

#### **Note 7 - Income Taxes**

The provision for income taxes for the years ended December 31, consists of the following:

	2019	2018
Current		
Federal	\$ 821,000	\$ 494,000
State	331,000	1,000
	<u>1,152,000</u>	<u>495,000</u>
Deferred taxes	(20,000)	499,000
	<u>\$ 1,132,000</u>	<u>\$ 994,000</u>

The Bank is subject to federal income tax and franchise tax of the state of California. Income tax returns for years ending on or after December 31, 2016 and 2015 are open to audit by the federal and state authorities, respectively. The Bank does not expect the total amount of unrecognized tax benefits to significantly increase or decrease within the next twelve months.



A comparison of the federal statutory income tax rates to the Bank's effective income tax rates follows:

	2019		2018	
	Amount	Rate	Amount	Rate
Statutory federal tax	\$ 801,000	21.0 %	\$ 725,000	21.0 %
State tax, net of federal benefit	320,000	8.4	288,000	8.3
Tax free income	(25,000)	(0.7)	(26,000)	(0.8)
Other items, net	36,000	1.0	7,000	0.3
	<u>\$ 1,132,000</u>	<u>29.7 %</u>	<u>\$ 994,000</u>	<u>28.8 %</u>

Deferred taxes are a result of differences between income tax accounting and generally accepted accounting principles with respect to income and expense recognition. The following is a summary of the components of the net deferred tax asset accounts recognized in the accompanying statement of financial condition at December 31:

	2019	2018
Deferred Tax Assets		
Depreciation differences	\$ 138,000	\$ 111,000
Allowance for loan losses due to tax limitations	361,000	339,000
Nonaccrual loan interest	77,000	94,000
Stock-based compensation	23,000	-
Tax credits	-	68,000
Other assets and liabilities	271,000	147,000
	<u>870,000</u>	<u>759,000</u>
Deferred Tax Liabilities		
Deferred loan costs	(142,000)	(149,000)
Other assets and liabilities	(199,000)	(101,000)
	<u>(341,000)</u>	<u>(250,000)</u>
Net deferred tax assets	<u>\$ 529,000</u>	<u>\$ 509,000</u>

## Note 8 - Other Expenses

Other expenses as of December 31 are comprised of the following:

	2019	2018
Professional fees	\$ 312,000	\$ 356,000
Data processing	837,000	815,000
Director fees and expenses	297,000	242,000
Office expenses	93,000	91,000
Marketing and business promotion	254,000	227,000
Insurance	91,000	111,000
Other expenses	452,000	416,000
	<u>\$ 2,336,000</u>	<u>\$ 2,258,000</u>

## Note 9 - Related Party Transactions

In the ordinary course of business, the Bank has extended credit to and received deposits from certain members of its Board of Directors and Executive Officers and companies in which they have an interest. These related parties had outstanding deposits at the Bank approximating \$7.5 million and \$11.5 million and outstanding loans of \$3.2 million plus \$1.0 million in available credit and \$2.3 million outstanding plus \$2.0 million in available credit, at December 31, 2019 and 2018, respectively.

## Note 10 - Earnings Per Share ("EPS")

The following is a reconciliation of net income and shares outstanding to the income and number of shares used to compute EPS under the two-class method:

	2019		2018	
	Income	Shares	Income	Shares
Net income as reported	\$ 2,685,000		\$ 2,456,000	
Less earnings allocated to participating securities	(22,000)		-	
Shares outstanding at year-end		3,994,747		3,956,747
Less weighted average shares of participating securities		(32,904)		
Impact of weighting shares issued during the year		(5,096)		
Used in basic and dilutive EPS	<u>\$ 2,663,000</u>	<u>3,956,747</u>	<u>\$ 2,456,000</u>	<u>3,956,747</u>

During 2018, the Bank declared a 10% stock dividend. The per share data in the income statement and footnotes have been adjusted to give effect to this dividend.

## **Note 11 - Commitments**

In the ordinary course of business, the Bank enters into financial commitments to meet the financing needs of its customers. Those instruments involve, to varying degrees, elements of credit and interest rate risk not recognized in the Bank's financial statements.

The Bank's exposure to loan loss in the event of nonperformance on commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments as it does for loans reflected in the financial statements.

As of December 31, 2019 and 2018, the Bank had the following outstanding financial commitments whose contractual amount represents credit risk:

	<u>2019</u>	<u>2018</u>
Commitments to extend credit	\$ 46,817,000	\$ 44,283,000
Standby letters of credit	<u>2,725,000</u>	<u>2,387,000</u>
	<u>\$ 49,542,000</u>	<u>\$ 46,670,000</u>

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total amounts do not necessarily represent future cash requirements. The Bank evaluates each client's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank, is based on management's credit evaluation of the customer. The majority of the Bank's commitments to extend credit and standby letters of credit are secured by real estate, equipment, or personal property.

## **Note 12 - Employee Benefit Plan**

The Bank adopted a 401(k) Plan for its employees. Under the plan, eligible employees may defer a portion of their salaries. The plan also provides for a matching contribution by the Bank. The Bank made contributions of \$120,000 and \$108,000 for 2019 and 2018, respectively.

### Note 13 - Stock-Based Compensation

During 2017 the board of directors of the Bank approved the 2017 Omnibus Stock Incentive Plan ("2017 Plan"). The plan was approved in July 2018 by the shareholders. Under the terms of the 2017 Plan, officers and key employees may be granted both nonqualified and incentive stock options and directors and other consultants, who are not also an officer or employee, may only be granted nonqualified stock options. The 2017 Plan also permits the grant of stock appreciation rights ("SARs"), restricted shares, deferred shares, performance shares and performance unit awards. The 2017 Plan provides for the total number of awards of common stock that may be issued over the term of the plan not to exceed 1,079,098 shares, of which a maximum of 539,549 shares may be granted as incentive stock options. The aggregated number of awards that may be granted to an individual participant may not exceed 100,000 shares per year. Stock options and performance share and unit awards are granted at a price not less than 100% of the fair market value of the stock on the date of grant. The 2017 plan provides for accelerated vesting if there is a change of control as defined in the 2017 Plan. Equity awards generally vest over three to five years. Stock options expire no later than ten years from the date of grant.

A summary of the status of the Bank's outstanding restricted shares as of December 31, 2019 and changes during the year ended are as follows:

	Shares	Weighted-Average Grant Date Fair Value
Nonvested at January 1, 2019	-	\$ -
New stock grants	40,000	\$ 9.64
Shares vested	-	\$ -
Shares forfeited	(2,000)	\$ 9.64
Nonvested at December 31, 2019	<u>38,000</u>	\$ 9.64

As of December 31, 2019, there was \$290,000 of total unrecognized compensation cost related to the restricted shares that will be recognized over a weighted-average period of 2.1 years.

### Note 14 - Fair Value of Financial Instruments

The fair value of a financial instrument is the amount at which the asset or obligation could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument.

These estimates do not reflect any premium or discount that could result from offering for sale at one time the entire holdings of a particular financial instrument. Because no market value exists for a significant portion of the financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature, involve uncertainties and matters of judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on financial instruments both on and off the balance sheet without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Additionally, tax consequences related to the realization of the unrealized gains and losses can have a potential effect on fair value estimates and have not been considered in many of the estimates.

The fair value hierarchy level and estimated fair value of financial instruments at December 31, 2019 and 2018 are summarized as follows:

		2019		2018	
	Fair Value Hierarchy	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial Assets					
Cash and cash equivalents	Level 1	\$ 68,354,000	\$ 68,354,000	\$ 59,416,000	\$ 59,416,000
Time deposits in other banks	Level 1	6,860,000	6,860,000	7,595,000	7,595,000
Loans, net	Level 3	265,997,000	266,754,000	244,142,000	245,577,000
Federal home loan and other bank stock	N/A	1,478,000	N/A	1,336,000	N/A
Accrued interest receivable	Level 2	1,038,000	1,038,000	1,052,000	1,052,000
Financial Liabilities					
Deposits	Level 2	313,801,000	313,728,000	286,366,000	285,846,000
Accrued interest payable	Level 2	2,000	2,000	5,000	5,000

## Note 15 - Regulatory Matters

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

In July 2013, the federal bank regulatory agencies approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks. The new rules became effective on January 1, 2015, with certain of the requirements phased-in over a multi-year schedule, and fully phased in by January 1, 2019. Under Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in at the rate of 0.625% per year from 0.0%

in 2015 to 2.50% by January 1, 2019. The capital conservation buffer for 2019 is 2.50% and for 2018 is 1.875%. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total, Tier 1 and CET1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2019 and 2018, that the Bank meets all capital adequacy requirements.

As of December 31, 2019 and 2018, 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, the Bank must maintain minimum ratios as set forth in the table below.

The following table also sets forth the Bank's actual capital amounts and ratios at December 31, 2019:

	Amount of Capital Required					
	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)	\$ 39,270,000	14.37%	\$ 21,869,000	8.00%	\$ 27,336,000	10.00%
Tier 1 capital (to risk-weighted assets)	\$ 35,837,000	13.11%	\$ 16,402,000	6.00%	\$ 21,869,000	8.00%
CET1 capital (to risk-weighted assets)	\$ 35,837,000	13.11%	\$ 12,301,000	4.50%	\$ 17,768,000	6.50%
Tier 1 capital (to average assets)	\$ 35,837,000	10.67%	\$ 13,431,000	4.00%	\$ 16,789,000	5.00%

The following table also sets forth the Bank's actual capital amounts and ratios at December 31, 2018:

	Amount of Capital Required					
	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)	\$ 35,726,000	14.38%	\$ 19,869,000	8.00%	\$ 24,836,000	10.00%
Tier 1 capital (to risk-weighted assets)	\$ 32,603,000	13.13%	\$ 14,902,000	6.00%	\$ 19,869,000	8.00%
CET1 capital (to risk-weighted assets)	\$ 32,603,000	13.13%	\$ 11,176,000	4.50%	\$ 16,143,000	6.50%
Tier 1 capital (to average assets)	\$ 32,603,000	11.11%	\$ 11,734,000	4.00%	\$ 14,667,000	5.00%

The California Financial Code provides that a bank may not make a cash distribution to its shareholders in excess of the lesser of the bank's undivided profits or the bank's net income for its last three fiscal years less the amount of any distribution made to the bank's shareholders during the same period.

## **Pacific Valley Bank Corporate Information**

### **Annual Meeting of Shareholders**

The annual meeting of shareholders of Pacific Valley Bank will be not be held in 2020 as explained in the letter accompanying this annual report. Our plan at this time is to resume our traditional annual meeting in 2021.

### **Stock Transfer Agent and Registrar**

Pacific Valley Bank's stock transfer agent, Continental Stock Transfer & Trust, maintains all shareholder records and can assist with stock transfer and registration, address changes, and changes or corrections in Social Security or Tax Identification numbers.

Continental Stock Transfer & Trust

Attn: Customer Service

1 State Street 30th Floor

New York NY 10004-1561

Overnight/Courier

1 State Street 30th Floor

New York NY 10004-1561

Phone: 800.509.5586

Email: [cstmail@continentalstock.com](mailto:cstmail@continentalstock.com)

Website: [www.continentalstock.com](http://www.continentalstock.com)

### **Stock Listing**

Pacific Valley Bank is listed on the Over the Counter – Pink Sheets ([www.otcbb.com](http://www.otcbb.com)) under the symbol PVBK.

### **Independent Auditors**

Eide Bailly LLP

25231 Paseo De Alicia Suite 100

Laguna Hills CA 92653

### **Legal Counsel**

Loren P. Hansen, Esquire

Loren P. Hansen, APC

1301 Dove Street Suite 370

Newport Beach CA 92660

### **Corporate Office**

Pacific Valley Bank

422 Main Street

Salinas CA 93901

### **Market Makers**

JWTT Inc.

1231 NW Hoyt Street Suite 206

Portland OR 97209

Contact: Joey Warmenhoven

971.323.0700

Raymond James & Associates

One Embarcadero Center Suite 650

San Francisco CA 94111

Contact: John Thomas Cavendar

415.616.8935

Western Financial Corporation

600 B Street Suite 2204

San Diego CA 92101

Contact: Steven M. Levenson

800.488.5990 or 619.234.3235

## **Pacific Valley Bank Locations**

### **Salinas**

422 Main Street  
Salinas CA 93901  
831.771.4330

### **Monterey**

498 Alvarado Street  
Monterey CA 93940  
831.645.6560

### **King City**

302 Broadway Street  
King City CA 93930  
831.385.2200

## **Board of Directors**

### **Andrew P. Ausonio**

President and CEO, Ausonio, Incorporated

### **Michael D. Cling**

Attorney

### **Anthony M. Cosentino**

Real Estate Broker  
Vice President, Cosentino Realty Company Inc./  
Columbus Property Management

### **Lucio P. Cosentino**

President and CEO  
Cosentino Realty Company, Inc./  
Columbus Property Management

### **Anker Fanoe**

President & CEO, Pacific Valley Bank

### **Robert LaBrier**

Retired Senior Vice President,  
American Ag Credit

### **Guillermo Nieto, Sr.**

General Partner, The Nieto Limited Partnership

### **Joseph L. Robello**

Chairman  
Retired Telecommunications Company Owner

### **Gordon Rubbo**

Certified Public Accountant

## **Executive Management**

### **Anker Fanoe**

President & Chief Executive Officer

### **Lee-Ann Cimino**

Executive Vice President & Chief Financial Officer

### **Carol Corsetti**

Executive Vice President & Chief Credit Officer

### **Jana Hatten**

Executive Vice President & Chief Compliance Officer



**[WWW.PACIFICVALLEYBANK.COM](http://WWW.PACIFICVALLEYBANK.COM)**

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