



2009 ANNUAL REPORT

FIRST BUSINESS BANK N.A.

ANNUAL REPORT 2009



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To Our Shareholders

Fiscal 2009 was another difficult year for the banking industry. National and local economic recession, high unemployment, and compressed margins hurt the performance of most community banks in 2009 including First Business Bank. An additional disappointment was had when our definitive agreement to merge with another San Diego institution was terminated due to certain economic and regulatory factors after several months of intensive efforts. The merger would have produced efficiencies to the benefit of First Business Bank, the local community banking industry, and the local economy in general.

Never the less, 2009 was still a year of accomplishment for your bank. Last year we reported certain operational problems with our SBA 7(a) portfolio that caused a loss provision of \$1.2 million in fiscal 2008. We are pleased to report that in 2009 we were able to work these problems through the liquidation cycle. Expected losses were less than anticipated. We recovered \$540 thousand of the loss provision recorded in 2008 and we believe the problems with our SBA 7(a) business line are behind us.

First Business Bank received \$4.2 million in new capital during 2009 under the federal Troubled Asset Recovery Program, and we remain one of the best capitalized banks in our market. At December 31, 2009, our Total Capital to Risk-Weighted Assets ratio was 25.2% compared to a 10.0% level required to be designated "well-capitalized" under banking regulations; our Tier 1 Capital ratio was 24.0% compared to a 6.0% ratio required to be "well-capitalized."

Fiscal 2009 was also another year of significant balance sheet growth for your bank. Total assets reached \$111.5 million, an increase of 12% year over year. Loans outstanding increased 14%, from \$77.1 million to \$87.4 million. Total deposits grew 18% to \$86 million, and core deposits grew 50% to \$59.2 million from \$39.4 million as we reduced jumbo CD's and other wholesale deposits.

We expect the economy to be weak again in 2010, but we remain committed to improving the performance of First Business Bank, and we remain committed to three principle objectives:

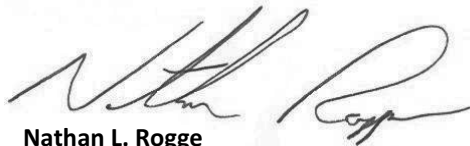
- Continue to grow our core business
- Contain our credit losses
- Solidify our team

We believe our management team is one of the strongest in San Diego. In December 2009 we added Pamela Davis to our staff as EVP, Chief Credit Officer. In January 2010, we promoted Pamela Isaacson to EVP, Chief Administrative Officer; and added two experienced business development officers, David Walters and Katherine Willey, with extensive knowledge of the San Diego market. These additions posture the bank to expand our footprint to downtown San Diego, where we anticipate a new office by mid-year 2010.

We are poised for a break-out year in 2010, despite these difficult times, because we have a solid management team, a solid capital base, and a solid business model. We thank you for your continued confidence and support.



John Farkash
Chairman of the Board of Directors



Nathan L. Rogge
President and Chief Executive Officer

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

VALUE THE DIFFERENCE

INDEPENDENT AUDITORS' REPORT

Board of Directors
First Business Bank N.A.
Del Mar, California

We have audited the accompanying statements of financial condition of First Business Bank N.A. as of December 31, 2009 and 2008, and the related statements of operations, shareholder's equity, and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the 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 financial statements referred to above present fairly, in all material respects, the financial position of First Business Bank, N.A. as of December 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Vavrinek, Trine, Day & Co., LLP

Laguna Hills, California
March 12, 2010

FIRST BUSINESS BANK, N.A.

**STATEMENTS OF FINANCIAL CONDITION
December 31, 2009 and 2008**

ASSETS

	2009	2008
Cash and Due from Banks	\$ 7,388,320	\$ 2,688,359
Excess Reserves at Federal Reserve Bank	11,190,000	-
Federal Funds Sold	-	5,021,302
TOTAL CASH AND CASH EQUIVALENTS	18,578,320	7,709,661
Interest-Bearing Time Deposits in Financial Institutions	-	771,805
Investment Securities Available for Sale	4,669,950	12,703,713
Loans:		
Construction and Land Development	2,640,271	8,772,931
Real Estate - Other	61,854,068	51,653,386
Commercial	20,721,659	15,606,660
Consumer	2,213,421	1,012,331
TOTAL LOANS	87,429,419	77,045,308
Deferred Loan Fees and Discounts, Net of Costs and Premiums	(14,835)	(92,690)
Discount on SBA Loans	(31,690)	(55,783)
Allowance for Loan Losses	(2,204,530)	(2,336,887)
NET LOANS	85,178,364	74,559,948
Stock Investments, at Cost	1,083,550	1,048,600
Premises and Equipment	826,008	1,050,845
Accrued Interest and Other Assets	1,163,651	1,481,873
TOTAL ASSETS	\$ 111,499,843	\$ 99,326,445

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

FIRST BUSINESS BANK, N.A.

**STATEMENTS OF FINANCIAL CONDITION
December 31, 2009 and 2008**

LIABILITIES AND SHAREHOLDERS' EQUITY

	2009	2008
Deposits:		
Noninterest-Bearing Demand	\$ 15,582,277	\$ 11,695,417
Interest-Bearing Demand, Money Market and Savings Accounts	38,397,220	32,181,548
Time Deposits Under \$100,000	24,517,360	13,364,292
Time Deposits \$100,000 and Over	7,491,608	15,567,046
TOTAL DEPOSITS	85,988,465	72,808,303
Federal Home Loan Bank Advances	4,000,000	7,000,000
Reserve for Off-Balance Sheet Credit Exposure	142,399	1,250,643
Accrued Interest and Other Liabilities	1,186,621	1,223,223
TOTAL LIABILITIES	91,317,485	82,282,169
Commitments and Contingencies - Note D and K	-	-
Shareholders' Equity:		
Preferred Stock - Authorized 10,000,000 shares, No Par Value; 4,354 Shares Issued and Outstanding	4,214,715	
Common Stock - 10,000,000 Shares Authorized, \$5.00 Par Value; Issued and Outstanding 2,643,534 in 2009 and 2008	13,217,670	13,217,670
Additional Paid-in Capital	13,410,193	13,375,905
Accumulated Deficit	(10,685,612)	(9,696,784)
Accumulated Other Comprehensive Income - Unrealized Gain on Available-for-Sale Securities, Net of Taxes of \$17,758 in 2009 and \$103,146 in 2008	25,392	147,485
TOTAL SHAREHOLDERS' EQUITY	20,182,358	17,044,276
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 111,499,843	\$ 99,326,445

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

FIRST BUSINESS BANK, N.A.

STATEMENTS OF OPERATIONS
For the Years Ended December 31, 2009 and 2008

	2009	2008
INTEREST INCOME		
Interest and Fees on Loans	\$ 5,085,270	\$ 4,021,292
Investment Securities:		
Interest Income	250,014	607,329
Dividends	38,673	60,670
Interest on Federal Funds Sold	11,304	154,191
Interest on Deposits & Reserves in Financial Institutions	29,844	71,698
TOTAL INTEREST INCOME	5,415,105	4,915,180
INTEREST EXPENSE		
Interest on Savings, NOW and Money Market Accounts	448,102	631,356
Interest on Time Deposits	1,075,503	660,038
Interest on Other Borrowings	50,308	9,701
TOTAL INTEREST EXPENSE	1,573,913	1,301,095
NET INTEREST INCOME	3,841,192	3,614,085
Provision for Loan Losses	700,000	2,840,817
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	3,141,192	773,268
NONINTEREST INCOME		
Gain (Loss) on Sale of Loans	(202,523)	47,090
Loan Referral Fees	20,640	10,000
Service Charges, Fees and Other	340,457	254,161
Gain on Sale of Securities	238,050	-
Gain (Loss) on Sale of Other Real Estate Owned	93,586	(105,336)
Loss on Sale of Premises	(6,379)	(71,285)
	483,831	134,630
NONINTEREST EXPENSE		
Salaries and Employee Benefits	2,461,885	2,982,776
Occupancy and Equipment Expenses	843,735	1,041,037
Provision (Recovery) for Off-Balance Sheet Credit Exposure	(540,000)	1,220,643
Other Expenses	1,826,261	1,454,651
	4,591,881	6,699,107
LOSS BEFORE INCOME TAXES	(966,858)	(5,791,209)
Income Taxes	800	800
NET LOSS	\$(967,658)	\$(5,792,009)
NET LOSS PER SHARE - BASIC	\$(0.37)	\$(2.19)

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

FIRST BUSINESS BANK, N.A.

**STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY
For the Years Ended December 31, 2009 and 2008**

	<u>Preferred Stock</u>		<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Comprehensive Income</u>	<u>Accumulated Deficit</u>	<u>Accumulated Other Comprehensive (Loss) Income</u>	<u>Total Shareholder's Equity</u>
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>					
Balance at January 1, 2008			2,642,534	\$ 13,212,670	\$ 13,256,476		\$ (3,904,775)	\$ 72,453	\$ 22,636,824
Exercise of Stock Options			1,000	5,000	5,000				10,000
Stock Based Compensation					114,429				114,429
Comprehensive Income (Loss):									
Net Income (Loss)						\$ (5,792,009)	(5,792,009)		(5,792,009)
Change in unrealized gain on investment securities available for sale, net of tax effects						75,032	75,032		75,032
Total Comprehensive Loss						<u>\$ (5,716,977)</u>			
Balance at December 31, 2008			2,643,534	13,217,670	13,375,905		(9,696,784)	147,485	17,044,276
Issuance of Stock, net of expense	4,354	4,193,545							4,193,545
Accretion of Redemption Value		21,170					(21,170)		-
Dividends Paid					(71,989)				(71,989)
Stock Based Compensation					106,277				106,277
Comprehensive Income (Loss):									
Net Income (Loss)						\$ (967,658)	(967,658)		(967,658)
Change in unrealized gain on investment securities available for sale, net of tax effects						17,999	17,999		17,999
Reclass for gain recognized in earnings, net of tax effects						(140,092)	(140,092)		(140,092)
Total Comprehensive Loss						<u>\$ (1,089,751)</u>			
Balance at December 31, 2009	<u>4,354</u>	<u>\$ 4,214,715</u>	<u>2,643,534</u>	<u>\$ 13,217,670</u>	<u>\$ 13,410,193</u>		<u>\$ (10,685,612)</u>	<u>\$ 25,392</u>	<u>\$ 20,182,358</u>

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

FIRST BUSINESS BANK, N.A.

STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2009 and 2008

	2009	2008
OPERATING ACTIVITIES		
Net Loss	\$(967,658)	\$(5,792,009)
Adjustments to Reconcile Net Loss to Net Cash Provided (Used) by Operating Activities:		
Depreciation and Amortization	254,890	302,309
(Gain) Loss on sale of Loans and Participations	202,523	(47,090)
Provision for Loan Losses	700,000	2,840,817
Provision (Recovery) of Loss for Off-Balance Sheet Credit Exposure	(540,000)	1,220,643
(Gain) on Sale, Provision for Loss on Other Real Estate Owned	(93,586)	105,336
Stock-Based Compensation	106,277	114,429
Amortization of Net Premiums (Discounts) on Investments	(88)	2,208
Amortization of Servicing Assets	17,745	38,466
Increase in Valuation Allowance on Servicing Assets	-	4,513
Accretion of loan discounts and deferred interest, net of loan origination costs and fees deferred	(19,676)	(76,073)
Gain on Sale of Available for Sale Securities	(238,050)	-
FHLB Stock Dividends paid in FHLB Stock	-	(14,000)
Loss on Disposal of Premises and Equipment	6,379	71,285
Proceeds from Sale of Loans	-	788,920
Increase in Prepaid FDIC Assessments	(488,210)	-
(Increase) Decrease in Other Assets	788,687	(213,853)
Increase (Decrease) in Other Liabilities	(719,606)	183,825
	NET CASH USED BY OPERATING ACTIVITIES	(470,274)
	(990,373)	(470,274)
INVESTING ACTIVITIES		
Purchase of Available-for-Sale Securities	(3,643,603)	(4,681,794)
Purchase of Loans Held for Investment, net of Participations Sold	(5,890,287)	(12,777,524)
Net Maturity of Time Deposits in Financial Institutions	771,805	1,731,412
Proceeds from Sale of Available-for-Sale Securities	8,170,088	-
Proceeds from Maturities of Available-for-Sale Securities	3,537,935	3,913,070
Net Funding of Loans	(6,627,913)	(19,191,964)
Net Purchase of Federal Home Loan and Federal Reserve Bank Stock	(34,950)	(75,350)
Proceeds from Sale of Other Real Estate Owned	1,310,671	-
Purchases of Premises and Equipment, net of Sales proceeds	(36,432)	(264,694)
	NET CASH USED BY INVESTING ACTIVITIES	(31,346,844)
	(2,442,686)	(31,346,844)

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

FIRST BUSINESS BANK, N.A.

STATEMENTS OF CASH FLOWS - CONTINUED
For the Years Ended December 31, 2009 and 2008

	2009	2008
FINANCING ACTIVITIES		
Net Increase in Demand, MMDA and Savings accounts	10,102,532	3,854,983
Net Increase in Time Deposits	3,077,630	19,579,915
Net Increase (Repayment) in Federal Home Loan Bank Advances	(3,000,000)	7,000,000
Proceeds from Preferred Stock offering, net of expenses	4,193,545	-
Dividends on Preferred Stock	(71,989)	-
Proceeds from Exercise of Stock Options	-	10,000
NET CASH PROVIDED BY FINANCING ACTIVITIES	14,301,718	30,444,898
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	10,868,659	(1,372,220)
Cash and Cash Equivalents at Beginning of Year	7,709,661	9,081,881
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 18,578,320	\$ 7,709,661
Supplemental Disclosures of Cash Flow Information:		
Interest Paid	\$ 1,477,601	\$ 1,381,136
Taxes Paid	\$ 800	\$ 800
Loans Transferred from Held for Investment to Held for Sale	\$ -	\$ 618,501
Loans Transferred from Held for Sale to Held for Investment	\$ -	\$ 884,734
Loans Transferred from Held for Investment to Other Real Estate Owned	\$ 1,217,085	\$ 595,759
Change in unrealized Gain on AFS Investments, net of change in Income Tax of \$17,758 and \$103,146, recorded in AOCI	\$ 115,957	\$ 75,032

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

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

First Business Bank, N.A. began business operations in December 2001 under the name Ramona National Bank. The name was changed in late 2006. The Bank operates under a federal charter and its primary regulator is the Office of the Comptroller of the Currency (“OCC”). First Business Bank is organized as a single operating segment that operates three full-service offices in Del Mar Heights, Carlsbad, and Ramona, California. The Bank's primary source of revenue is providing loans to clients, who are predominately small and middle-market businesses and individuals. Client deposits are insured by the Federal Deposit Insurance Corporation (“FDIC”) up to the maximum legal limit and the Bank is a member of the Federal Reserve Bank (“FRB”).

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.

Subsequent Events

The Bank has evaluated subsequent events for recognition and disclosure through March 12, 2010, which is the date the financial statements were available to be issued.

Reclassifications

Certain amounts in the 2008 financial statements have been reclassified to conform to the 2009 presentation. The reclassifications have no material effect on shareholders' equity, or net loss, as previously reported.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks, excess reserves at the Federal Reserve Bank, and federal funds sold. Excess reserves at the Federal Reserve Bank earn interest, vary in amount every day, and are considered an alternative to federal funds sold. Generally, federal funds are sold for one-day periods.

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's net transaction accounts were below the reserve exemption level at December 31, 2009, and the Bank had no reserve requirement at that date. The

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Cash and Due from Banks (continued)

Bank's reserve requirement at December 31, 2008 was \$59,000, which was met through the Bank's vault cash.

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

Interest-Bearing Time Deposits in Financial Institutions

The Bank invests in time certificates of deposit at other financial institutions but has no such investments at December 31, 2009.

Investment Securities

Investment securities are classified as held-to-maturity when the Bank has the positive intent and ability to hold the securities to maturity. Securities held-to-maturity is carried at amortized cost. The amortization of premiums and accretion of discounts are recognized in interest income using methods approximating the interest method over the period to maturity.

Investments not classified as trading securities nor as held-to-maturity securities are classified as available-for-sale securities and recorded at fair value. Unrealized gains or losses on available-for-sale securities are excluded from net income and reported as an amount net of taxes as a separate component of other comprehensive income included in shareholders' equity. Premiums or discounts on held-to-maturity and available-for-sale securities are amortized or accreted into income using the interest method. Realized gains or losses on sales of held-to-maturity or available-for-sale securities are recorded using the specific identification method.

Declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost that are other-than-temporary result in write-downs of the individual securities to their fair value. The related write-downs are included in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers; the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis and more frequently when economic or market conditions warrant.

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Stock Investments

Federal Reserve Bank stock, Federal Home Loan Bank stock and Pacific Coast Bankers' Bank stock are carried at cost. These stocks can only be sold back to the issuing institution at par value or book value. All stock investments are evaluated for impairment based on an estimate of the ultimate recoverability of cost.

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 and net of any 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 originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Fair value is based on commitments on hand from investors or prevailing market prices. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income. The Bank is a Small Business Administration (SBA) lender and will sell the guaranteed portion of the loan in the secondary market. SBA guaranteed loans are classified as Held for Sale when the loan is fully funded and other conditions required for salability have been met.

Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. The accrual of interest on loans is generally discontinued when principal or interest is past due 90 days based on the contractual terms of the loan or earlier when, in the opinion of management, there is reasonable doubt as to collectability. On a case by case basis, loans past due 90 days may remain on accrual, if the loan is well collateralized, actively in process of collection and, in the opinion of management, likely to be paid current within the next payment cycle. 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 collectable as to all principal and interest.

The Bank considers a loan to be impaired when it is probable that the Bank will be unable to collect all amounts due, principal and interest, according to the contractual terms of the loan agreement. 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

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Loans – Continued

foreclosure is probable are measured at the net realizable value of the collateral. The Bank recognizes interest income on impaired loans based on its existing methods of recognizing interest income on nonaccrual loans.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the loan is uncollectible. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

Other Real Estate Owned

Real estate acquired through foreclosure is reclassified from the loan portfolio when legal title is transferred. The real estate owned is reclassified at the lower of the recorded investment in the loan or the net realizable value of the property. Net realizable value is measured as the expected sales price, less the expected expense associated with the sale. Write downs to net realizable value when title is acquired are charged against the allowance for loan loss. Subsequent declines in the net realizable value after title is acquired are recorded as a valuation allowance against the property and charged to expense. Major improvements to the property may be capitalized to the basis in the property, provided the increase to the recorded investment does not exceed the net realizable value.

In 2008, the Bank acquired title to a single commercial property through foreclosure. The property was subject to a 100% valuation allowance at December 31, 2008 and sold in 2009 for a gain on sale of \$55,529. In 2009, the Bank acquired through foreclosure, and liquidated, two properties for a combined gain on sale of \$38,056. At December 31, 2009 the Bank has no other real estate owned.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when; (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before maturity.

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Servicing Assets

Servicing assets are recognized as separate assets when rights are acquired through the sale of financial assets. Capitalized servicing rights are reported in other assets and are amortized into other income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates and terms. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum

Gain on Sale of Loans

The Bank sells the SBA guaranteed portion of loans in the secondary market. When a sale is made, the recorded investment in the guaranteed and unguaranteed portion of the loan, and separately identifiable servicing assets, is reallocated based on the relative fair values of each component. Accounting gain on sale is recognized to the extent the fair value of the assets sold and the servicing asset created exceed the reallocated recorded investment. Servicing assets are initially recorded at fair value. This reallocation of basis results in an accounting gain that is less than the cash premium received with the sale. The difference is recorded as a discount on the unguaranteed portion of the loan retained. The discount is accreted to income over the remaining life of the loan following the interest method.

Loan Referrals

The Bank may elect to refer loan clients to other lending institutions rather than close the transaction itself. These institutions will fund the loan directly and pay the Bank a referral fee for the transaction. The Bank has no credit recourse on these transactions. Limited recourse exists on the fee received, generally contingent on the loan's performance for ninety days after the transaction. Referral fees are recognized as earned in the period received. In 2009, the Bank referred loan transactions for \$1,236,000 in total principal balance to third party lenders for \$20,640 in referral fees. In 2008 the Bank referred loan transactions for \$800,000 in total principle balance for \$10,000 in referral fees.

Premises and Equipment

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, equipment and computer equipment. 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.

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Advertising Costs

The Bank expenses the costs of advertising in the period incurred.

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 consolidated 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. Management believes that all tax positions taken to date are highly certain and, accordingly, no accounting adjustment has been made to the financial statements. Interest and penalties related to uncertain tax positions are recorded as part of income tax expense.

Preferred Stock

On April 10, 2009 in connection with the Troubled Assets Relief Program (“TARP”), the Bank received \$2,211,000 from the U.S. Treasury in exchange for the issuance 2,211 shares of the Bank’s Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series A and a related warrant for 111 shares of the Bank’s Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B, which represents 5% of the Series A Preferred Stock. The aggregate redemption price of the Series A and Series B Preferred Stock together will be \$2,321,000. The difference between the aggregate redemption price and the issuance proceeds, net of issuance costs, of \$141,135 is accreted against retained earnings over the estimated five-year life of the Preferred Stock reducing the reported income available for common shareholders.

The Preferred Stock, Series A pays non-cumulative dividends at a rate of 5% per year for the first five years and 9% per year thereafter. The Preferred Stock, Series B pays non-cumulative dividends at a rate of 9% per year. The Series A Preferred Stock may be redeemed by the Bank subject to application and approval to do so by the U. S. Treasury. The Series B Preferred Stock may be redeemed after all of the Series A Preferred Stock has been redeemed.

On December 11, 2009, the Bank received \$2,032,000 from the U.S. Treasury in exchange for the issuance of 2,032 shares of the Bank’s Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series C. The Series C redemption price is \$2,032,000. The issuance cost of \$18,832 is accreted against retained

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Preferred Stock (continued)

earnings over the estimated five-year life of the Preferred Stock reducing the reported income available for common shareholders. The Series C Preferred Stock pays non-cumulative dividends at a rate of 5% per year and may be redeemed by the Bank subject to application and approval to do so by the U. S. Treasury, independent of the redemption of the Series A and B. Additional disclosures about the dividends on Preferred Stock are made in Note M.

Comprehensive Income

Changes in unrealized gain and loss on available-for-sale securities are the only components of accumulated other comprehensive income for the Bank.

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 K. The Bank is a contingent obligor under a letter of credit issued on its behalf by another financial institution. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

Disclosure about Fair Value of Financial Instruments

The Bank's estimated fair value amounts have been determined using available market information and appropriate valuation methods. However, considerable judgment is required to develop the estimates of fair value. Accordingly, the estimates are not necessarily indicative of the amounts the Bank could have realized in a current market exchange. The use of different market assumptions and/or estimation methods may have a material effect on the estimated fair value amounts. The estimated fair value of the Bank's financial instruments is presented in Note N.

Earnings Per Share (EPS)

Earnings per share presents the net income or loss per common share, after consideration of the preferred shareholders interest in the net income or loss. Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. The Bank had no dilutive securities as of December 31, 2009 and 2008 as well as an operating loss and therefore only reports basic EPS. Weighted average shares outstanding used in the computation of basic earnings per share were 2,643,534 and 2,642,783 in 2009 and 2008, respectively.

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Stock-Based Compensation

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

Fair Value Measurement

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

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

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

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

See Note O for more information and disclosures relating to the Bank's fair value measurements

Adoption of New Accounting Standards

Subsequent Events

In May 2009, the FASB issued guidance which requires the effects of events that occur subsequent to the balance-sheet date be evaluated through the date the financial statements are either issued or available to be issued. Entities are to disclose the date through which subsequent events have been evaluated and whether that date is the date the financial statements were issued or the date the financial statements were available to be issued. Entities are required to reflect in their financial statements the effects of subsequent events that provide additional evidence about conditions at the balance-sheet date (recognized subsequent events). Entities are also prohibited from reflecting in their financial statements the effects of subsequent events that provide evidence about conditions that arose after the balance-sheet date (nonrecognized

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Adoption of New Accounting Standards - *Subsequent Events* (continued)

subsequent events), but requires information about those events to be disclosed if the financial statements would otherwise be misleading. This guidance was effective for annual financial periods ended after June 15, 2009 with prospective application. The Bank adopted the guidance for the year ended December 31, 2009 by including the required disclosures in Note A to the financial statements.

Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles

In June 2009, accounting standards were revised to establish the Accounting Standards Codification (the “Codification”) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with Generally Accepted Accounting Principles (“GAAP”). The Codification does not change current GAAP, but is intended to simplify user access to all authoritative GAAP by providing all the authoritative literature related to a particular topic in one place. The Codification is effective for annual periods ended after September 15, 2009, and as of the effective date, all existing accounting standard documents were superseded. Adoption of the Codification in 2009 did not have a material impact on the Bank’s financial statements.

Fair Value Measurements

In April 2009, accounting standards were amended to provide additional guidance for determining the fair value of a financial asset or financial liability when the volume and level of activity for such asset or liability decreased significantly and also to provide guidance for determining whether a transaction is orderly. The amendments were effective for annual reporting periods ended after June 15, 2009. Adoption of the amendments in 2009 did not have a material impact on the Bank’s financial statements.

In February 2008, the FASB issued instructions that delayed the effective date of fair value measurement for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) for fiscal years beginning after November 15, 2008. Adoption of the fair value measurement rules in 2009 for non-financial assets and non-financial liabilities subject to the delay did not have a material impact on Bank’s financial statements.

Other-Than-Temporary Impairment

In April 2009, accounting standards were amended to provide expanded guidance concerning the recognition and measurement of other-than-temporary impairments of debt securities classified as available for sale or held to maturity. The amendments require an entity to recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the noncredit component in other comprehensive income when the entity does not intend to sell the security and it is more likely than not that the entity will not be required to sell the security prior to recovery. Expanded disclosures are also required concerning such impairments. The amendments were effective for annual reporting periods ended after June 15, 2009. Adoption of the amendments in 2009 did not have a material impact on the Bank’s financial statements.

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Newly Issued Not Yet Effective Accounting Standards

In June 2009, accounting standards were amended to clarify when a transferor has surrendered control over transferred financial assets and thus is entitled to account for the transfer as a sale. The amendments establish specific conditions for accounting for the transfer of a financial asset, or a portion of a financial asset, as a sale. The amendments could impact when a loan participation or SBA loan sale may be accounted for as a sale and the related transferred asset derecognized by the Bank. This guidance is effective for transfers occurring on or after January 1, 2010. The Bank has not yet completed its evaluation of these amendments, but does not expect that they will have a material impact on its balance sheet or statement of operations.

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE B - INVESTMENT SECURITIES

Debt and equity securities have been classified in the statements of condition according to management's intent. The carrying amount of securities and their approximate fair values at December 31 were as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
Available-for-Sale:				
December 31, 2009				
SBA Participation Certificates	\$ 1,108,747	\$ 65,116	\$ -	\$ 1,173,863
U.S. Government and Agency Mortgage-Backed Securities	<u>3,518,053</u>	<u>4,300</u>	<u>(26,266)</u>	<u>3,496,087</u>
	<u>\$ 4,626,799</u>	<u>\$ 69,416</u>	<u>\$(26,266)</u>	<u>\$ 4,669,950</u>
Available-for-Sale:				
December 31, 2008				
U.S. Government and Agency Securities	\$ 4,493,636	\$ 95,041	\$ -	\$ 4,588,677
SBA Participation Certificates	1,226,333	21,957	-	1,248,290
U.S. Government and Agency Mortgage-Backed Securities	<u>6,733,113</u>	<u>137,428</u>	<u>(3,795)</u>	<u>6,866,746</u>
	<u>\$12,453,082</u>	<u>\$ 254,426</u>	<u>\$(3,795)</u>	<u>\$12,703,713</u>

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE B - INVESTMENT SECURITIES - CONTINUED

The amortized cost and estimated fair value of all investment securities as of December 31, 2009 by contractual maturities are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available-for-Sale	
	Amortized Cost	Fair Value
Due in One Year or Less	\$ 23,091	\$ 23,070
Due from One Year to Five Years	50,778	50,963
Due from Five to Ten Years	1,432,346	1,423,102
Due after Ten Years	3,120,585	3,172,814
	\$ 4,626,799	\$ 4,669,950

The Bank will pledge investment securities to collateralize credit lines, secure public deposits, and for other purposes as permitted or required by law. Investment securities carried at \$2,425,850 and \$4,782,000 at December 31, 2009 and 2008, respectively, were in safekeeping at the Federal Home Loan Bank (FHLB) of San Francisco to collateralize credit lines there. Investment securities carried at \$932,798 at December 31, 2009 were pledged at the Federal Reserve discount window. The Bank had no securities pledged at the discount window at December 31, 2008.

The gross unrealized loss and related estimated fair value of investment securities that have been in a continuous loss position for less than twelve months and over twelve months at December 31, 2009 and 2008 are as follows:

	Less than Twelve Months		Over Twelve Months		Total	
	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
December 31, 2009:						
Mortgage-Backed Securities	\$(26,266)	\$ 2,448,921	\$ -	\$ -	\$(26,266)	\$ 2,448,921
	\$(26,266)	\$ 2,448,921	\$ -	\$ -	\$(26,266)	\$ 2,448,921
December 31, 2008:						
Mortgage-Backed Securities	\$(2,350)	\$ 909,358	\$(1,445)	\$ 172,444	\$(3,795)	\$ 1,081,802
	\$(2,350)	\$ 909,358	\$(1,445)	\$ 172,444	\$(3,795)	\$ 1,081,802

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE B - INVESTMENT SECURITIES - CONTINUED

As of December 31, 2009, the Bank had three Mortgage-Backed Securities with a combined estimated fair value that had declined 1.06% from amortized cost. Management does not intend to sell and it is not more likely than not that management would be required to sell the securities prior to their anticipated recovery, and the decline in fair value is due to changes in interest rates. The fair value is expected to recover as the Mortgage-Backed Securities approach maturity.

NOTE C - STOCK INVESTMENTS, at COST

As a member of the FRB System, the Bank must hold FRB stock in an amount equal to 6% of the Bank's common stock and additional paid-in capital, less accumulated deficit. Stock in the FHLB of San Francisco is required for membership. The Bank is required to maintain an investment in FHLB stock in an amount equal to the greater of 1% of its outstanding mortgage loans and investments or 4.7% of advances from the FHLB. The Bank had \$4,000,000 in FHLB advances outstanding at December 31, 2009 and \$7,000,000 at December 31, 2008. No ready market exists for FHLB stock, and it has no quoted market value.

The table below summarizes the Bank's stock investments at December 31:

	<u>2009</u>	<u>2008</u>
Federal Reserve Bank	\$ 553,750	\$ 639,500
Federal Home Loan Bank	469,800	349,100
Pacific Coast Bankers Bank	60,000	60,000
	<u>\$ 1,083,550</u>	<u>\$ 1,048,600</u>

NOTE D - LOANS

The Bank's loan portfolio consists primarily of loans to borrowers within San Diego County, California. 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. The Bank's loan portfolio concentration in real estate secured credit at December 31, 2009 was 74%.

The Bank's total servicing portfolio of sold SBA guaranteed loans was \$3,373,375 at December 31, 2009 and \$5,748,779 at December 31, 2008.

The Bank has pledged loans with a carrying value of \$23,584,987 to collateralize credit lines at the FHLB of San Francisco as of December 31, 2009.

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE D – LOANS - CONTINUED

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

	<u>2009</u>	<u>2008</u>
Beginning Balance	\$ 2,336,887	\$ 676,017
Additions to the Allowance Charged to Expense	700,000	2,840,817
Recoveries on Loans Charged Off	38,991	33,805
	<u>3,075,878</u>	<u>3,550,639</u>
Less Loans Charged Off	<u>(871,348)</u>	<u>(1,213,752)</u>
Ending Balance	<u>\$ 2,204,530</u>	<u>\$ 2,336,887</u>

Below is a summary the Bank's recorded investment in impaired loans outstanding at December 31, 2009 and 2008.

	<u>2009</u>	<u>2008</u>
Impaired Loans with a Valuation Allowance	\$ 834,129	\$ 684,649
Impaired Loans without a Valuation Allowance	<u>1,865,436</u>	<u>547,856</u>
Total Impaired and Nonaccrual Loans	<u>\$ 2,699,565</u>	<u>\$ 1,232,505</u>
Corresponding valuation allowance	<u>\$ 443,008</u>	<u>\$ 267,402</u>
Nonaccrual Loans	<u>\$ 2,699,565</u>	<u>\$ 1,232,505</u>

No additional funds are committed to be advanced on impaired loans. The average recorded investment in impaired loans was \$2,546,056 and \$733,592 in 2009 and 2008, respectively. The Bank recognized no interest income on impaired loans in 2009 or 2008. Interest foregone on impaired loans was \$162,489 in 2009 and \$87,260 in 2008. At December 31, 2009, \$300,079 of the principal balance of impaired loans was guaranteed by the SBA, and \$391,407 in principal balance of impaired loans was guaranteed by the SBA at December 31, 2008.

The Bank had no loans over 90 days past due and still on accrual at December 31, 2009. At December 31, 2008 the Bank had two loans for a total recorded investment of \$618,627 that were over 90 days past due and still on accrual.

In addition to servicing sold SBA guaranteed loans, the Bank also services commercial real estate loans

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE D – LOANS – CONTINUED

for investors and participating financial institutions. The portfolio of these loans serviced for other parties was \$5,375,912 at December 31, 2009 and \$1,544,837 at December 31, 2008.

NOTE E - PREMISES AND EQUIPMENT

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

	<u>2009</u>	<u>2008</u>
Leasehold Improvements	\$ 822,612	\$ 816,432
Furniture, Fixtures, and Equipment	660,245	670,995
Computer Equipment	304,751	298,570
	<u>1,787,608</u>	<u>1,785,997</u>
Less Accumulated Depreciation and Amortization	<u>(961,600)</u>	<u>(735,152)</u>
	<u>\$ 826,008</u>	<u>\$ 1,050,845</u>

Depreciation expense recorded in 2009 and 2008 was \$254,890 and \$302,309, respectively.

The Bank leases its Ramona banking premises from its principal shareholder, under a lease expiring on August 31, 2010. The Bank obtained three independent appraisals regarding the fair market rent, which supports its determination that the terms of the lease are no less favorable to the Bank than could have been obtained from unaffiliated third parties. The Ramona branch lease has two five year renewal options. Monthly lease payments are adjusted annually based on changes in the Consumer Price Index (CPI).

The Bank leased its La Mesa location from an affiliate of its principal shareholder. In December 2008, the Bank terminated this lease 14 months early and made a termination payment called for in the lease of \$80,363. The tenant improvements and certain equipment were transferred to the landlord at a loss of \$71,285. The Bank made a short-term lease with the same landlord for forty-five days ending February 15, 2009 and closed the La Mesa location effective February 6, 2009.

The Bank has a ten-year lease for its main banking office and corporate headquarters in Del Mar Heights, California, with an independent landlord. The Bank took occupancy in January 2008. Total expenditures for tenant improvements, equipment and furnishings at the Del Mar Heights location were \$949,000, including \$2,390 in interest capitalized at the Bank's cost of funds. The Bank is responsible for common area maintenance, taxes and insurance to the extent they exceed the 2008 base year amounts. The lease expires on December 31, 2017. Monthly lease payments are subject to a fixed 3.5% increase on an annual basis. The lease has one renewal option for a period of five years. A third party correspondent bank issued a performance letter of credit for \$775,000 to the landlord on behalf of the Bank to support

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE E - PREMISES AND EQUIPMENT – CONTINUED

the Bank's obligations under the lease. The lease allows for annual reductions in the amount of the letter of credit after three years and eliminates the letter of credit entirely after nine years.

The Bank opened a deposit production office in Carlsbad, California in September 2008 which was upgraded to a full service branch in February 2009. The Bank is responsible for common area operating expenses. The lease term for this branch is six months and has been renewed twice with the current expiration in March 2010.

At December 31, 2009, the future lease rentals payable under noncancellable operating lease commitments to related parties and others are as follows:

	<u>Related</u>	<u>Others</u>
2010	\$ 41,242	\$ 340,886
2011	-	343,679
2012	-	356,092
2013	-	368,505
2014	-	381,694
Thereafter	-	1,226,540
Total	<u>\$ 41,242</u>	<u>\$ 3,017,396</u>

The minimum rental payments shown above are given for the existing lease obligation and are not a forecast of future rental expense. Total rental expense was \$439,114 and \$565,090 for the years ended December 31, 2009 and 2008, respectively.

NOTE F - DEPOSITS

At December 31, 2009, the scheduled maturities of time deposits are as follows:

2010	\$ 21,575,643
2011	3,389,000
2012	1,947,125
2013	<u>5,097,200</u>
	<u>\$ 32,008,968</u>

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE G - BORROWING ARRANGEMENTS

First Business Bank has a \$2,000,000 overnight credit line on an unsecured basis from Pacific Coast Bankers Bank. The line is subject to annual review and renewal. The Bank had no overnight borrowings at December 31, 2009 or 2008.

The Bank has credit availability at the Federal Reserve discount window to the extent of collateral pledged. The Bank had acceptable investments pledged at December 31, 2009 with a value of \$932,798. There was no collateral pledged at December 31, 2008 and the Bank had no discount window borrowings at either December 31, 2009 or 2008.

The Bank may also borrow up to approximately \$18,234,000 from the Federal Home Loan Bank of San Francisco, collateralized by investment securities and liens on specific Bank loans delivered to the FHLB, and subject to fulfilling other conditions of the credit facility. A Letter of Credit issued by the FHLB on the Bank's behalf for \$775,000 was outstanding under the credit facility at both December 31, 2009 and 2008.

At December 31, 2009 the Bank had three advances for a total of \$4,000,000 outstanding with the FHLB. One advance is fixed rate for \$1,000,000 at an interest rate of 1.89% maturing December 29, 2011. The other two advances are variable rate. One variable rate advance is tied to one month LIBOR, adjusts monthly and bears interest at LIBOR plus 42 basis points, which was .65094% at December 31, 2009. This advance is for \$2,000,000 and matures December 30, 2011. The other variable rate advance changes with the prime rate and bears interest at the prime rate minus 1.70%, which was 1.55% at December 31, 2009. This advance is for \$1,000,000 and matures December 31, 2013.

NOTE H - INCOME TAXES

The tax expense for the years ended December 31, 2009 and 2008 was the minimum franchise tax for the State of California. The tax benefits related to the operating losses incurred during the years ended December 31, 2009 and 2008 were not recognized, as realization of the benefits is dependent upon future income.

The Bank is subject to federal and California franchise tax. Income tax returns for the years ended December 31, 2008, 2007 and 2006 are open to audit by the federal authorities and income tax returns for the years ended December 31, 2008, 2007, 2006, and 2005 are open to audit by California authorities. Unrecognized tax benefits are not expected to significantly increase or decrease within the next twelve months.

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE H - INCOME TAXES – CONTINUED

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 statements of financial condition at December 31:

	2009	2008
Deferred Tax Assets:		
Depreciation Differences	\$ 33,000	\$ 4,000
Allowance for Loan Losses Due to Tax Limitations	649,000	750,000
Reserve for Off-Balance Sheet Credit Exposure	59,000	515,000
Stock-Based Compensation	59,000	39,000
Operating Loss Carryforwards	3,420,000	2,445,000
Deferred Rent Expense	40,000	22,000
Accrual to Cash	-	91,000
Other	93,000	60,000
	4,353,000	3,926,000
Valuation Allowance	(4,278,000)	(3,911,000)
Deferred Tax Liabilities:		
Deferred Loan Costs	(75,000)	(15,000)
Unrealized Gain on		
Available for Sale Securities	(17,758)	(103,146)
	(92,758)	(118,146)
Net Deferred Tax Liabilities	\$(17,758)	\$(103,146)

The valuation allowance was established because the Bank has not reported earnings sufficient enough to support the recognition of the deferred tax assets. The Bank has net operating loss carryforwards of approximately \$8,328,000 for federal income and \$8,231,000 for California franchise tax purposes. Federal net operating loss carryforwards, to the extent not used will expire in 2029. California net operating loss carryforwards, to the extent not used will expire in 2029.

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE I - OTHER EXPENSES

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

	<u>2009</u>	<u>2008</u>
Data Processing	\$ 341,143	\$ 329,802
Marketing and Public Relations	90,992	137,889
Professional Fees	621,199	229,524
Litigation Provision	-	50,000
Office Expenses	125,901	149,036
Insurance	29,463	30,555
Deposit Administration and Online Banking	152,058	114,745
Loan Administration	70,262	93,455
OREO Expense	38,614	21,399
Regulatory Assessments	222,482	101,119
Other Expenses	134,147	197,127
	<u>\$ 1,826,261</u>	<u>\$ 1,454,651</u>

NOTE J - RELATED PARTY TRANSACTIONS

In the ordinary course of business, the Bank has granted loans to certain directors and their related interests with which they are associated. In the Bank's opinion, all loans and loan commitments to such parties are made on substantially the same terms including interest rates, and collateral, as those prevailing at the time for comparable transactions with unrelated clients. The balance of these loans outstanding was \$416,867 and \$483,611 at December 31, 2009 and 2008, respectively. Activity in related party loans for the periods ending December 31, 2009 and 2008 is below:

	<u>2009</u>	<u>2008</u>
Balance at Beginning of Year	\$ 483,611	\$ 498,585
Credit Granted, Including Renewals	30,861	60,000
Repayments	<u>(97,605)</u>	<u>(74,974)</u>
	<u>\$ 416,867</u>	<u>\$ 483,611</u>

In addition to active loans and lines to related parties, a standby letter of credit in the amount of \$19,122 was outstanding to a related party at December 31, 2009 and 2008. Deposits held by the Bank from certain shareholders, directors, officers and their related interests at December 31, 2009 and 2008

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE J - RELATED PARTY TRANSACTIONS - CONTINUED

amounted to \$4,697,570 and \$2,285,737, respectively.

In December 2009 the Bank sold a participating interest in five substandard commercial real estate loans to an entity controlled by its principal shareholder. Total aggregate principal sold was \$4,896,253. Management believes the terms and conditions of the sale were comparable with terms and conditions required by unrelated third party buyers. The Bank recorded a loss on sale of \$202,523.

NOTE K – COMMITMENTS & CONTINGENCIES

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

Commitments to extend credit are agreements to lend to a client as long as there is no violation of any condition established in the contract. 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. Collateral may or may not be required 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.

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, 2009 and 2008, the Bank had the following outstanding financial commitments whose contractual amount represents potential credit risk to the Bank, and potential financial obligations of the Bank:

	<u>2009</u>	<u>2008</u>
Commitments to Extend Credit	\$ 11,815,000	\$ 8,741,000
Letters of Credit issued to Clients	<u>98,000</u>	<u>115,000</u>
	<u>\$ 11,913,000</u>	<u>\$ 8,856,000</u>
Letters of Credit Issued on Behalf of the Bank	<u>\$ 775,000</u>	<u>\$ 775,000</u>

The Bank carries a reserve for off-balance sheet credit risk in other liabilities for potential losses on commitments to extend credit and potential recourse on sold loans. The balance of the reserve at

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE K – COMMITMENTS & CONTINGENCIES - CONTINUED

December 31, 2009 was \$142,399 and at December 31, 2008 the balance was \$1,250,643. In 2008 the Bank determined through third party review that the SBA guarantee on certain loans that were sold in the secondary market was impaired because of deficiencies in the loan origination process. The Bank estimated the probable losses at approximately \$1,200,000 and recorded a provision for off-balance sheet credit exposures in this amount. In 2009 the SBA review and liquidation cycle for the loans in question was completed. The Bank sustained \$568,244 in losses which were charged against the reserve for off-balance sheet credit exposure. Management believes the prospect for further recourse losses to the SBA on sold guaranteed loans is remote. The Bank reversed \$540,000 of the reserve for off-balance sheet credit risk in 2009 as a recovery of the prior year's provision. A summary of the changes in the reserve for off-balance sheet credit exposure as of December 31 follows:

	2009	2008
Balance at Beginning of Period	\$ 1,250,643	\$ 30,000
Less Charge-offs	(568,244)	-
Add Recoveries	-	-
Net Charge-off/Recovery	(568,244)	-
Provision (Recovery) Charged to Expense	(540,000)	1,220,643
Balance at End of Period	\$ 142,399	\$ 1,250,643

The Bank evaluates the loss exposure for unfunded commitments to extend credit following the same principles used for the allowance for loan losses, with consideration for experienced utilization rates on client credit lines and the inherently lower risk of unfunded commitments relative to disbursed commitments. The Bank recorded no provision for potential losses on unfunded commitments in 2009, and a provision of \$20,643 in 2008.

Letters of Credit issued on behalf of the Bank represent a potential obligation of the Bank. The Bank caused a letter of credit to be issued by a third party correspondent to its landlord at the Del Mar Heights office. Should the letter of credit be drawn upon, the Bank would be obligated to reimburse the correspondent bank. The letter of credit supports the Bank's performance under the lease.

In the ordinary course of business the Bank may be subject to legal claims by clients and other business constituents. In 2007 the Bank was served with a legal complaint by a former information technology vendor alleging breach of contract and seeking damages of approximately \$610,000. The Bank recorded a provision of \$50,000 in 2008 for the resolution of this case and reached a full and final settlement in exchange for a payment to the vendor in that amount in 2009.

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE L - STOCK OPTION PLAN

The Bank's 2001 Stock Option Plan (the "Plan"), as amended, permits option grants to eligible employees and directors to a maximum of 460,000 common shares. Under the terms of the Plan, officers and key employees may be granted either nonqualified or incentive stock options. Directors, who are not also an officer or employee, may be granted nonqualified stock options. Stock options are generally granted at a price not less than 100% of the fair market value of the stock on the date of grant. Stock options expire no later than ten years from the date of the grant and generally vest over five years. The Plan provides for accelerated vesting if there is a change of control, as defined in the Plan. Shares issued for the exercise of stock options are made from available authorized but unissued shares. The Bank recognized stock-based compensation cost of \$106,277 and \$114,429 in 2009 and 2008, respectively.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. The following table provides the weighted average assumptions used in the pricing model, and the weighted average grant date fair value, for option grants made in 2009 and 2008:

	<u>2009</u>	<u>2008</u>
Expected Volatility	33.25%	26.33%
Expected Term (Years)	6.5	6.3
Expected Dividends	None	None
Risk Free Rate	2.47%	3.21%
Weighted-Average Grant Date Fair Value	\$ 3.70	\$ 3.35

Since the Bank has very limited historical stock trade volume, the expected volatility is based on an index of the historical volatility of similar banks that have a longer trading history at higher volumes. The expected term represents the estimated average period of time that the options remain outstanding. Since the Bank does not have sufficient historical data on the exercise of stock options, the expected term is based on the "simplified" method that measures the expected term as the average of the vesting period and the contractual term. The risk free rate of return reflects the grant date yield on U.S. Treasury bonds with maturities comparable to the expected term of the options.

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NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE L - STOCK OPTION PLAN - CONTINUED

A summary of the status of stock options that have been granted by the Bank as of December 31, 2009 and changes during 2009 is presented below:

	<u>Shares</u>	<u>Weighted- Average Exercise Price</u>	<u>Weighted- Average Remaining Contractual Term</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at Beginning of Year	270,227	\$ 10.00		
Granted	12,900	\$ 10.00		
Exercised	-	\$ -		
Forfeited or Expired	<u>(38,200)</u>	\$ 10.00		
Outstanding at End of Year	<u>244,927</u>	<u>\$ 10.00</u>	<u>6.8 Years</u>	<u>None</u>
Options Exercisable	<u>135,101</u>	<u>\$ 10.00</u>	<u>5.9 Years</u>	<u>None</u>

There were no exercises of stock options in 2009. The intrinsic value of options exercised during the year ended December 31, 2008 was immaterial. Cash received in 2008 was \$10,000 and no tax benefits were realized.

As of December 31, 2009, there was \$335,101 of total unrecognized compensation cost related to the outstanding stock options that will be recognized over a weighted average period of approximately 2.0 years as scheduled below:

Expected pre-tax compensation cost:

2010	\$ 129,066
2011	102,030
2012	76,054
2013	25,575
2014	<u>2,376</u>
	<u>\$ 335,101</u>

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE L - STOCK OPTION PLAN - CONTINUED

Future levels of compensation cost recognized related to stock-based compensation awards may be impacted by new awards and/or modifications, repurchases and cancellations of existing awards. Under the terms of the Plan, vested options expire ninety days after the director or employee terminates the service affiliation with the Bank.

NOTE M - 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 the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined).

As of December 31, 2009, the most recent notification from the Office of the Comptroller of the Currency categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. As of December 31, 2009, the Bank's capital level and ratios indicate that it is "well capitalized" under the regulatory framework for prompt corrective action.

To be categorized as well capitalized, the Bank must maintain minimum ratios as set forth in the table below. Management believes, as of December 31, 2009, that the Bank meets all capital adequacy requirements to which it is subject. The following table also sets forth the Bank's actual capital amounts and ratios (dollar amounts in thousands):

	Amount of Capital Required					
	Actual		For Capital Adequacy Purposes		Well Capitalized Under Prompt Corrective Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2009:						
Total Capital (to Risk-Weighted Assets)	\$21,224	25.2%	\$ 6,730	8.0%	\$8,413	10.0%
Tier 1 Capital (to Risk-Weighted Assets)	\$20,156	24.0%	\$ 3,365	4.0%	\$5,048	6.0%
Tier 1 Capital (to Average Assets)	\$20,156	17.1%	\$ 4,727	4.0%	\$5,909	5.0%
As of December 31, 2008:						
Total Capital (to Risk-Weighted Assets)	\$17,902	22.9%	\$ 7,604	8.0%	\$7,810	10.0%
Tier 1 Capital (to Risk-Weighted Assets)	\$16,894	21.6%	\$ 3,124	4.0%	\$4,686	6.0%
Tier 1 Capital (to Average Assets)	\$16,894	17.8%	\$ 3,802	4.0%	\$4,752	5.0%

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE M - REGULATORY MATTERS - CONTINUED

Under federal law, a national bank generally may not pay cash dividends in excess of the bank's net profits, if it would impair the bank's capital, if the bank is in default on the payment of any assessment due to the FDIC, or if the bank has not paid all cumulative dividends on outstanding preferred stock. In addition, unless and until a bank's additional paid in capital account is equal to its common stock account, no dividend can be declared until the bank has carried to its additional paid-in capital account not less than one-tenth of its net profits for the preceding two consecutive half-years (in the case of annual dividends). The Bank cannot legally pay dividends on common stock at this time and the Bank intends to follow a policy of retaining earnings, if any, for the purpose of increasing its net worth and reserves. Accordingly, the Bank does not anticipate that cash dividends will be declared on common shares for several years and no assurance can be given that its earnings will permit the payment of these dividends.

In 2009 the Bank issued three series of preferred stock to the U. S. Treasury for a combined par value of \$4,354,000. All three series pay non-cumulative dividends. The Bank has no legal capacity to pay dividends and therefore made specific application to the Office of the Comptroller of the Currency for permission to pay dividends on the preferred stock. Permission was received from the OCC to pay dividends as a reduction of capital surplus. Dividends declared and paid in 2009 are charged against additional paid in capital. The dividends are considered a distribution of permanent capital and do not reduce earnings available to the common shares.

NOTE N – 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 following methods and assumptions were used to estimate the fair value of significant financial instruments:

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE N – FAIR VALUE OF FINANCIAL INSTRUMENTS - CONTINUED

Financial Assets

The carrying amounts of cash, deposits due from banks, and interest bearing deposits with banks, including excess reserves at the Federal Reserve Bank, are considered to approximate fair value. The fair values of investment securities are based on quoted market prices for similar securities. The fair value of loans are estimated by discounting estimated future cash flows at an appropriate market rate given the term of the related loans.

Financial Liabilities

The carrying amounts of deposit liabilities payable on demand are considered to approximate fair value. For fixed maturity deposits, fair value is estimated by discounting estimated future cash flows using currently offered rates for deposits of similar remaining maturities. The fair value of long-term debt is based on rates currently available to the Bank for debt with similar terms and remaining maturities.

Off-Balance Sheet Financial Instruments

The fair value of commitments to extend credit and standby letters of credit is estimated using the fees currently charged to enter into similar agreements. The fair value of these financial instruments is not material.

The estimated fair value of financial instruments at December 31 is summarized as follows:

	2009	
	Carrying Value	Fair Value
Financial Assets:		
Cash and Due From Banks	\$ 7,388,320	\$ 7,388,320
Excess Reserves at the Federal Reserve Bank	11,190,000	11,190,000
Investment Securities Available for Sale	4,669,950	4,669,950
Loans, net	85,178,364	85,281,471
FHLB, FRB and Banker's Bank Stock	1,083,550	1,083,550
Accrued Interest Receivable	319,444	319,444
Financial Liabilities:		
Deposits	85,988,465	86,115,000
FHLB Advances	4,000,000	4,069,911
Accrued Interest and Other Liabilities	1,186,621	1,186,621

FIRST BUSINESS BANK, N.A.

**NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008**

NOTE O – FAIR VALUE MEASUREMENT

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value:

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

Collateral-Dependent Impaired Loans: The Bank does not record loans at fair value on a recurring basis. However, from time to time, fair value adjustments are recorded on these loans to reflect (1) partial write-downs, through charge-offs or specific reserve allowances, that are based on the current appraised or market-quoted value of the underlying collateral or (2) the full charge-off of the loan carrying value. In some cases, the properties for which market quotes or appraised values have been obtained are located in areas where comparable sales data is limited, outdated, or unavailable. In these cases, fair value estimates for collateral-dependent impaired loans are obtained from real estate brokers or other third party consultants (Level 3).

The Bank has no liabilities measured and recorded at fair value as of December 31, 2009. The Bank had no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during 2009.

The following table provides the hierarchy and fair value for each major category of asset measured at fair value at December 31, 2009:

	Fair Value Measurements Using			Total
	Level 1	Level 2	Level 3	
Assets measured at fair value on a recurring basis				
Assets:				
Securities Available for Sale	\$ -	\$ 4,669,950	\$ -	\$ 4,669,950
Assets measured at fair value on a non-recurring basis				
Collateral-Dependent Impaired Loans, Net of Specific Reserves	\$ -	\$ -	\$ 866,292	\$ 866,292

Collateral-dependent impaired loans, which are measured for impairment using the fair value of the collateral, had a carrying value of \$1,299,300 and a specific reserve of \$433,008 at December 31, 2009.

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS
December 31, 2009 and 2008

NOTE O – FAIR VALUE MEASUREMENT - CONTINUED

The following table provides the hierarchy and fair value for each major category of asset measured at fair value at December 31, 2008:

	Fair Value Measurements Using			Total
	Level 1	Level 2	Level 3	
Assets measured at fair value on a recurring basis				
Assets:				
Securities Available for Sale	\$ -	\$ 12,703,713	\$ -	\$ 12,703,713
Assets measured at fair value on a non-recurring basis				
Collateral-Dependent Impaired				
Loans, Net of Specific Reserves	\$ -	\$ -	\$ 965,103	\$ 965,103

Collateral-dependent impaired loans, which are measured for impairment using the fair value of the collateral, had a carrying value of \$1,232,505 and a specific reserve of \$267,402 at December 31, 2008.

MISSION STATEMENT

The mission of First Business Bank is to provide personal and business financial services to select San Diego businesses that can benefit from a comprehensive, consultative relationship. As their Trusted Advisor, we want them to experience a unique Private Business Banking relationship.

BOARD OF DIRECTORS

John Farkash | Chairman of the Board

Thomas H. Blair, Jr. | Editor of San Diego Magazine

William V. Ehlen | President of Iron Horse Investments

Lester Machado, MD, DDS, FRCS (Ed) | Oral and Maxillofacial Surgeon

Joseph E. Matranga, C.P.A. | President and Founder of Matranga and Riley CPA’s

Nathan L. Rogge | President and CEO of First Business Bank

EXECUTIVE MANAGEMENT

Nathan L. Rogge | President and Chief Executive Officer

Pamela T. Davis | Executive Vice President and Chief Credit Officer

Pamela C. Isaacson | Executive Vice President and Chief Administrative Officer

William T. Roche, III | Executive Vice President and Chief Financial Officer

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Ramona, CA 92065
Phone (760) 788-8788
Fax (760) 789-5576
Manager: Aracely Scott

ADDITIONAL INFORMATION

Stock Exchange Listing | The common stock is listed on Over the Counter (“OTC”) trading as FBBN.OB.

Market Maker | Western Financial Services, Richard Levinson

PROFESSIONAL CONSULTANTS

Vavrinek Trine Day & Co., LLP | Independent Accountants
Horgan, Rosen, Beckham & Coren, L.L.P. | Legal Counsel
Lambert & Rogers | Legal Counsel

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