

# **Baker Boyer Bancorp and Subsidiary**

**Consolidated Financial Report**

**December 31, 2008**

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## INDEPENDENT AUDITOR'S REPORT

To the Board of Directors  
Baker Boyer Bancorp  
Walla Walla, Washington

We have audited the accompanying consolidated balance sheets of Baker Boyer Bancorp and Subsidiary as of December 31, 2008 and 2007, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on those financial statements based on our audit.

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 our audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Baker Boyer Bancorp and Subsidiary as of December 31, 2008 and 2007, 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.

*Moss Adams LLP*

Spokane, Washington  
February 27, 2009

# Consolidated Financial Statements

Baker Boyer Bancorp and Subsidiary

## Consolidated Balance Sheets

Dollars in Thousands

December 31,	2008	2007
<b>Assets</b>		
Cash and amounts due from banks	\$ 12,132	\$ 20,167
Interest-bearing deposits at other financial institutions	38,164	2,030
Federal funds sold	18,250	4,995
<b>Total Cash and Cash Equivalents</b>	<b>68,546</b>	<b>27,192</b>
Securities available for sale, at fair value	33,191	31,525
Securities held to maturity at cost (market value \$15,285 and \$16,984)	15,007	16,783
Other investments, at cost	1,880	1,880
Loans held for sale	0	315
Loans	293,898	300,009
Total Loans	293,898	300,324
Allowance for credit losses	(4,217)	(3,814)
<b>Net Loans</b>	<b>289,681</b>	<b>296,510</b>
Premises and equipment, net	14,245	14,302
Foreclosed real estate	0	0
Accrued interest receivable	2,527	2,609
Other assets	1,559	1,462
<b>Total Assets</b>	<b>\$426,636</b>	<b>\$392,263</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities</b>		
Deposits:		
Demand, non-interest-bearing	\$ 82,644	\$ 75,070
Savings and interest-bearing demand	183,689	150,858
Time	103,513	118,225
<b>Total Deposits</b>	<b>369,846</b>	<b>344,153</b>
Accrued interest payable	419	613
Federal funds purchased and security repurchase agreements	13,836	8,855
Other borrowed funds	6,200	3,000
Other liabilities	718	841
<b>Total Liabilities</b>	<b>391,019</b>	<b>357,462</b>
<b>Commitments and Contingencies (Note 11)</b>		
<b>Shareholders' Equity</b>		
Common stock (no par value, stated value \$3.125 per share); Authorized 4,000,000 shares; issued and outstanding: 2008 -1,295,161 shares; 2007 -1,296,980 shares	4,047	4,053
Additional paid-in capital	508	609
Retained earnings	30,708	30,010
Accumulated other comprehensive income	354	129
<b>Total Shareholders' Equity</b>	<b>35,617</b>	<b>34,801</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$426,636</b>	<b>\$392,263</b>

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

# Consolidated Financial Statements

Baker Boyer Bancorp and Subsidiary

## Consolidated Statements of Income

Dollars in Thousands, except per share amounts

December 31,	2008	2007
<b>Interest and Dividend Income</b>		
Loans, including fees	\$19,870	\$21,370
Federal funds sold	136	201
Investment securities:		
Taxable	625	950
Tax-exempt	1,109	1,243
Other investment income and dividends	43	36
Interest-bearing deposits at other financial institutions	647	56
<b>Total Interest and Dividend Income</b>	<b>22,430</b>	<b>23,856</b>
<b>Interest Expense</b>		
Deposits	6,010	8,361
Federal funds purchased, security repurchase agreements, & borrowed funds	474	319
<b>Total Interest Expense</b>	<b>6,484</b>	<b>8,680</b>
<b>Net Interest Income</b>	<b>15,946</b>	<b>15,176</b>
<b>Provision for Credit Losses</b>	<b>729</b>	<b>318</b>
<b>Net interest income after provision for credit losses</b>	<b>15,217</b>	<b>14,858</b>
<b>Non-Interest Income</b>		
Trust and investment management fees	4,812	5,052
Service charges on deposit accounts	1,202	1,084
Other service charges and fees	847	840
Non-deposit retail brokerage fees	551	453
Net gain (loss) on sale of securities available for sale	1	(30)
Net gain on sale of foreclosed real estate	0	7
Other operating income	349	219
<b>Total Non-Interest Income</b>	<b>7,762</b>	<b>7,625</b>
<b>Non-Interest Expense</b>		
Salaries and employee benefits	11,125	10,727
Occupancy	1,011	869
Furniture and equipment	699	707
Professional services	528	590
Office supplies and printed forms	209	254
Information systems and data processing	1,215	980
Marketing & charitable contributions	443	497
Business & FDIC insurances	257	261
Other	1,550	1,682
<b>Total Non-Interest Expense</b>	<b>17,037</b>	<b>16,567</b>
<b>Income Before Income Taxes</b>	<b>5,942</b>	<b>5,916</b>
<b>Income Taxes</b>	<b>1,535</b>	<b>1,541</b>
<b>Net Income</b>	<b>\$ 4,407</b>	<b>\$ 4,375</b>
<b>Earnings Per Share</b>	<b>\$3.44</b>	<b>\$3.40</b>
<b>Weighted Average Number of Shares Outstanding</b>	<b>1,282,586</b>	<b>1,285,348</b>

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

## Consolidated Financial Statements

Baker Boyer Bancorp and Subsidiary

### Consolidated Statements of Shareholders' Equity

Dollars in Thousands, except per share amounts

	Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Compre- hensive Income (Loss)	Total
<b>Balance at December 31, 2006</b>	1,297,376	\$4,054	\$677	\$29,112	(\$43)	\$33,800
Comprehensive income:						
Net income	--	--	--	4,375	--	4,375
Other comprehensive income, net of tax:						
Change in fair value of securities available for sale	--	--	--	--	172	172
<b>Comprehensive income</b>						<b>4,547</b>
Cash dividends paid (\$2.60 per share)	--	--	--	(3,477)	--	(3,477)
Stock issued to directors as fees for directors' services	820	3	47	--	--	50
Restricted stock issued to officers under stock incentive plan	2,918	9	(9)	--	--	--
Restricted stock compensation	--	--	126	--	--	126
Restricted stock forfeited	--	--	--	--	--	--
Repurchases of common stock	(4,134)	(13)	(232)	--	--	(245)
<b>Balance at December 31, 2007</b>	1,296,980	\$4,053	\$609	\$30,010	\$129	\$34,801
Comprehensive income:						
Net income	--	--	--	4,407	--	4,407
Other comprehensive income, net of tax:						
Change in fair value of securities available for sale	--	--	--	--	225	225
<b>Comprehensive income</b>						<b>4,632</b>
Cash dividends paid (\$2.86 per share)	--	--	--	(3,709)	--	(3,709)
Stock issued to directors as fees for directors' services	1,041	3	60	--	--	63
Restricted stock issued to officers under stock incentive plan	3,150	10	(10)	--	--	--
Excess tax benefit	--	--	5	--	--	5
Restricted stock compensation	--	--	174	--	--	174
Repurchases of common stock	(6,010)	(19)	(330)	--	--	(349)
<b>Balance at December 31, 2008</b>	1,295,161	\$4,047	\$508	\$30,708	\$354	\$35,617

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

# Consolidated Financial Statements

Baker Boyer Bancorp and Subsidiary

## Statements of Cash Flows

Dollars in Thousands

December 31,	2008	2007
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 4,407	\$ 4,375
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	729	318
Depreciation and amortization	932	835
Loss on disposal of assets	4	25
Restricted stock compensation expense	174	126
Amortization of deferred loan fees	117	357
Stock incentive plan compensation expense	63	50
Excess tax benefits from vesting restricted stock	(5)	0
Net investment amortization	143	231
Deferred income taxes	(292)	(185)
Net (gain) loss on sale of investment securities	(1)	30
Loss (gain) on sale of foreclosed real estate	0	7
Origination of loans held for sale	(12,309)	(2,307)
Proceeds from sale of loans held for sale	12,668	1,996
Gain on sales of loans	(44)	(4)
(Increase) decrease in interest receivable	82	153
Increase (decrease) in interest payable	(194)	22
Other - net	(47)	682
<b>Net cash provided by operating activities</b>	<b>6,427</b>	<b>6,711</b>
<b>Cash Flows from Investing Activities</b>		
Activity in securities available for sale:		
Maturities, prepayments and calls	25,323	10,902
Purchases	(26,818)	0
Sales	100	0
Activity in securities held to maturity:		
Maturities, prepayments and calls	1,815	3,502
Purchases	(111)	0
Increase in loans made to customers, net of principal collections	5,668	(27,749)
Purchases of premises and equipment	(871)	(4,673)
Proceeds from sale of foreclosed real estate	0	170
<b>Net cash provided (used) by investing activities</b>	<b>5,106</b>	<b>(17,848)</b>

(continued)

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

## Consolidated Financial Statements

Baker Boyer Bancorp and Subsidiary

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### Consolidated Statements of Cash Flows *(concluded)*

*Dollars in Thousands*

	2008	2007
<b>Cash Flows from Financing Activities</b>		
Net increase in deposits	\$25,693	\$ 9,577
Net increase in federal funds purchased and security repurchase agreements	4,981	2,195
Proceeds from other borrowed funds	3,200	3,000
Cash dividends paid	(3,709)	(3,477)
Excess tax benefits from vesting of restricted stock	5	0
Repurchases of common stock	(349)	(245)
<b>Net cash provided by financing activities</b>	<b>29,821</b>	<b>11,050</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>41,354</b>	<b>(87)</b>
<b>Cash and Cash Equivalents</b>		
Beginning of year	27,192	27,279
<b>End of year</b>	<b>\$68,546</b>	<b>\$27,192</b>
<b>Supplemental Disclosures of Cash Flow Information</b>		
Interest paid	\$6,678	\$8,658
Income taxes paid	2,111	1,311
<b>Supplemental Disclosures of Non-Cash Investing and Financing Activities</b>		
Fair value adjustment of securities available for sale, net of tax	\$225	\$172
Transfer of loans to foreclosed real estate	0	(179)
Financed sale of foreclosed real estate	0	122
Stock issued to directors	63	50

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

## **Notes to Consolidated Financial Statements**

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

#### **Nature of Operations**

Baker Boyer Bancorp (the Company) and its wholly owned subsidiary, Baker Boyer National Bank (the Bank), provide banking services primarily to the greater Walla Walla Valley area of southeastern Washington and northeastern Oregon. Services are marketed primarily to individuals, small businesses, and the agricultural industry. The Company and its subsidiary are subject to competition from other financial institutions, as well as non-financial intermediaries. Primary sources of revenue are loans, investment securities, and wealth management services. The Company and its subsidiary are also subject to the regulations of certain federal and state agencies, and undergo periodic examinations by those regulatory agencies.

#### **Principles of Consolidation**

The consolidated financial statements include the amounts of the parent company and its wholly owned subsidiary. All significant intercompany transactions and balances have been eliminated.

#### **Use of Estimates**

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

#### **Cash and Cash Equivalents**

Cash and cash equivalents include amounts due from banks, interest-bearing deposits at other financial institutions, and federal funds sold. Interest-bearing deposits at other financial institutions mature within three years, are carried at cost, and generally are 100 percent FDIC insured. Federal funds sold generally mature in one day.

#### **Securities Available for Sale**

Securities available for sale consist of debt securities that the Bank intends to hold for an indefinite period, but not necessarily to maturity, and certain equity securities. Such securities may be sold to implement the Bank's asset/liability management strategies and in response to changes in interest rates and similar factors. Securities available for sale are reported at fair value. Unrealized gains and losses, net of the related deferred tax effect, are reported as a net amount in a separate component of shareholders' equity entitled "accumulated other comprehensive income (loss)." Realized gains and losses on securities available for sale, determined using the specific-identification method, are included in earnings. Amortization of premiums and accretion of discounts are recognized in interest income over the period to maturity.

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## Notes to Consolidated Financial Statements

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### Note 1 - Summary of Significant Accounting Policies *(continued)*

#### Securities Held to Maturity

Debt securities for which the Bank has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized in interest income over the period to maturity.

Declines in the fair value of individual securities held to maturity and available for sale below their cost that are other than temporary result in write-downs of the individual securities to their fair value. Management evaluates individual securities for other than temporary impairment on a quarterly basis based on the securities' current credit quality, interest rates, term to maturity, and management's intent and ability to hold the securities until the net book value is recovered. Any other than temporary declines in fair value are recognized on the consolidated statements of income as loss on sale of investments.

#### Other Investments

The Bank, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in FHLB capital stock in an amount equal to the greater of \$500 or .75 percent of its outstanding home loans and pass-through securities plus 3.5 percent of advances outstanding from FHLB. The recorded amount of FHLB stock equals its fair value because the shares can only be redeemed by the FHLB at the \$100 per share par value. The Bank also holds Pacific Coast Bankers Bank capital stock in order to obtain favorable fed funds sold rates as well as Federal Reserve Bank stock as stipulated in the requirements of the Federal Reserve Act.

#### Loans and Allowance for Credit Losses

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 principal balances adjusted for any charge-offs, the allowance for credit losses, and any deferred fees or costs on originated loans, and unamortized premiums or discounts on purchased loans. Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income.

Because some loans may not be repaid in full, an allowance for credit losses is recorded. An allowance for credit losses is a valuation allowance for probable incurred credit losses. The allowance for credit losses is increased by a provision for credit losses charged to expense and decreased by charge-offs (net of recoveries). The allowance is based on ongoing, quarterly assessments of the probable and estimable losses inherent in the loan portfolio. The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which include the formula allowance and specific allowances.

The formula portion of the general credit loss allowance is established by applying a loss percentage factor to the different loan types. The allowances are provided based on management's continuing evaluation of the pertinent factors underlying the quality of the loan portfolio, including changes in the size and composition of the loan portfolio, actual loan loss experience, current economic conditions, geographic concentrations, seasoning of the loan portfolio, specific industry conditions, and the duration of the current business cycle. The recovery of the carrying value of loans is susceptible to future market conditions beyond the Company's control, which may result in losses or recoveries differing from those provided.

*(continued)*

## Notes to Consolidated Financial Statements

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### Note 1 - Summary of Significant Accounting Policies *(continued)*

#### Loans and Allowance for Credit Losses *(concluded)*

Specific allowances are established in cases where management has identified significant conditions or circumstances related to a loan that management believes indicate the probability that a loss has been incurred. Impaired loans consist of loans receivable that are not expected to be repaid in accordance with their contractual terms and are measured using the fair value of the collateral. Smaller balance loans are excluded from this analysis.

Interest income on loans is accrued over the term of the loans based upon the principal outstanding. The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. Past due status is based on contractual terms of the loan. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent that cash payments are received until, in management's judgment, the borrower has the ability to make contractual interest and principal payments, in which case the loan is returned to accrual status.

The ultimate recovery of all loans is susceptible to future market factors beyond the Bank's control. These factors may result in losses or recoveries differing significantly from those provided in the consolidated financial statements. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses and may require the Bank to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

#### Loans Held for Sale

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated market value in the aggregate. Net unrealized losses, if any, are recognized through a charge to income.

#### Premises and Equipment

Premises and equipment are recorded at cost. Depreciation is computed on the straight-line method over the following estimated useful lives: building and improvements - up to forty years; software, furniture and equipment - three to seven years; and automobiles - five years. Amortization of leasehold improvements is calculated on the straight-line method over the shorter of the estimated useful lives of the assets or corresponding contractual lease term, which does not generally include renewal options. These assets are reviewed for impairment when events indicate their carrying value may not be recoverable. If management determines impairment exists, the asset is reduced with an offsetting charge to expense. The cost of maintenance and repairs is charged to expense as incurred. Gains and losses on dispositions are reflected in earnings.

#### Foreclosed Real Estate

Real estate properties acquired through, or in lieu of, foreclosure are to be sold and are initially recorded at the lower of cost or fair value of the properties less estimated costs of disposal. Any write-down to fair value at the time of transfer to foreclosed real estate is charged to the allowance for credit losses. Properties are evaluated regularly to ensure that the recorded amounts are supported by their current fair values. Any subsequent reductions in carrying values and revenues and expenses from the operations of properties are charged to operations.

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## Notes to Consolidated Financial Statements

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### Note 1 - Summary of Significant Accounting Policies *(continued)*

#### Trust Assets

Assets held by the Company in a fiduciary or agency capacity for trust department customers are not included in the consolidated financial statements because such items are not assets of the Company or its subsidiary. Assets totaling \$525,045,000 and \$658,185,000 were held in trust as of December 31, 2008 and 2007, respectively.

#### 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 their maturity.

#### Advertising Costs

Advertising costs are expensed as incurred. Advertising costs were \$204,000 and \$253,000 for the years ending December 31, 2008 and 2007, respectively.

#### Income Taxes

Deferred income taxes reflect the effect of temporary differences between the tax basis of assets and liabilities and the reported amounts of those assets and liabilities for financial reporting purposes. Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

#### Cash Equivalents and Cash Flows

The Company considers all amounts included in the balance sheet caption "Cash and amounts due from banks, interest-bearing deposits at other financial institutions, and federal funds sold" to be cash equivalents. Cash flows from loans, federal funds purchased and security repurchase agreements, federal funds sold, and deposits are reported net.

The Company maintains balances in depository institution accounts, which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

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## Notes to Consolidated Financial Statements

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### Note 1 - Summary of Significant Accounting Policies *(continued)*

#### Fair Values of Financial Instruments

Statement of Financial Accounting Standards No. 107, *Disclosures About Fair Value of Financial Instruments*, requires disclosure of estimated fair values for financial instruments. Such estimates are subjective in nature, and significant judgment is required regarding the risk characteristics of various financial instruments at a discrete point in time. Therefore, such estimates could vary significantly if assumptions regarding uncertain factors were to change. Major assumptions, methods and fair value estimates for the Company's significant financial instruments are set forth below:

##### **Cash and Cash Equivalents**

The recorded amount is a reasonable estimate of fair value.

##### **Securities Available for Sale and Held to Maturity**

Fair value for securities is based on quoted market prices.

##### **Other Investments**

The carrying value of stock holdings approximates fair value.

##### **Loans**

For variable rate loans that reprice frequently and have no significant change in credit risk, fair value is based on carrying value. Fair value for fixed rate loans is estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair value for impaired loans is estimated using discounted cash flow analyses or underlying collateral values, where applicable.

##### **Deposits**

The fair value of deposits with no stated maturity date is included at the amount payable on demand. The fair value of fixed maturity certificates of deposit is estimated by discounting future cash flows using the rates currently offered by the Bank for deposits of similar remaining maturities.

##### **Federal Funds Purchased, other Borrowed Funds, and Security Repurchase Agreements**

Carrying amounts of federal funds purchased and security repurchase agreements approximate their fair value. Fair value of other borrowings is estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements. The fair value of the companies long term borrowings are estimated using discounted cash flow analysis based on the company's current incremental borrowing rates for similar instruments.

##### **Accrued Interest**

Carrying amounts of accrued interest approximate their fair values.

##### **Off-Balance-Sheet Instruments**

The fair value of commitments to extend credit and standby letters of credit was estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the customers. Since the majority of the Bank's off-balance-sheet instruments consist of non-fee producing, variable-rate commitments, the Bank has determined they do not have a distinguishable fair value.

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## Notes to Consolidated Financial Statements

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### Note 1 - Summary of Significant Accounting Policies *(continued)*

#### Stock-Based Compensation

Effective January 1, 2006 the Company adopted the fair value recognition provision of SFAS No. 123-R (SFAS 123-R), *Share-Based Payment*. Prior to this time the Company accounted for its stock-based compensation awards under the provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*. Therefore there were no significant changes to the accounting treatment from those previously applied. Compensation expense, based on the fair market value of the stock at the date of the award, is recognized in the consolidated statements of income for stock awards under the stock incentive plan.

The Company records compensation expense in the accompanying consolidated statement of income related to restricted stock awards by recognizing the grant date fair value of such awards over the vesting period. Unearned shares are reflected in additional paid in capital on the consolidated statement of shareholders' equity. At December 31, 2008, unrecognized compensation expense related to nonvested restricted stock awards was \$372,000 and is expected to be recognized as follows:

	<b>Stock-Based Compensation Expense</b>
2009	\$ 158
2010	105
2011	71
2012	<u>38</u>
<b>Total</b>	<b><u>\$ 372</u></b>

#### Earnings Per Share

Basic earnings per share are computed by dividing net income by the weighted-average number of common shares outstanding.

#### Recent Accounting Pronouncements

##### **Fair Value Measurements**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. It clarifies that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. This statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. FASB Staff Position No. FAS 157-2 delayed the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis to fiscal years beginning after November 15, 2008. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

*(continued)*

## Notes to Consolidated Financial Statements

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### Note 1 - Summary of Significant Accounting Policies *(continued)*

#### Recent Accounting Pronouncements *(continued)*

##### **Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans**

In December 2007, the FASB issued Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – An Amendment of SFAS Statements no. 87, 88, 106, and 132R*. This statement requires an employer to fully recognize the obligations associated with single-employer defined benefit pension, retiree healthcare, and other postretirement plans in its financial statements. This new standard applies to plan sponsors that are public and private companies and nongovernmental not-for-profit organizations, and requires an employer to:

- Recognize in its statement of financial position an asset for a plan's overfunded status or a liability for a plan's underfunded status;
- Measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year (with limited exceptions); and
- Recognize changes in funded status of a defined benefit postretirement plan in the year in which the changes occur; these changes will be reported in comprehensive income of a business entity and in changes in net assets of a not-for-profit organization.

The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006, for entities with publicly traded equity securities, and at the end of the fiscal year ending after June 15, 2007, for all other entities. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The Company does not expect the adoption of this statement will have a material impact on its financial position, results of operation and cash flows.

##### **Noncontrolling Interest in Consolidated Financial Statements**

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interest in Consolidated Financial Statement*. This new standard requires all entities to report noncontrolling (i.e., minority) interests in subsidiaries as equity in the Consolidated Financial Statements and to account for transactions between an entity and noncontrolling owners as equity transactions if the parent retains its controlling financial interest in the subsidiary. SFAS No. 160 also requires expanded disclosure that distinguishes between the interests in the controlling owners and the interests of the noncontrolling owners of a subsidiary. SFAS No. 160 is effective for fiscal years and interim periods beginning on or after December 15, 2008, and earlier adoption is not permitted. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

##### **Hierarchy of Generally Accepted Accounting Principles**

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, which is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles for nongovernmental entities. SFAS No. 162 is effective 60 days following the SEC's approval of the PCAOB amendments to AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

*(continued)*

## Notes to Consolidated Financial Statements

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### Note 1 - Summary of Significant Accounting Policies *(concluded)*

#### Recent Accounting Pronouncements *(concluded)*

##### **Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities**

In June 2008, the FASB issued FASB Staff Position (FSP) EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. This FSP provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. The FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. Upon adoption, a company is required to retrospectively adjust its earnings per share data (including any amounts related to interim periods, summaries of earnings and selected financial data) to conform with the provisions in this FSP. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

##### **Accounting For Transfers of Financial Assets and Repurchase Financing Transactions**

In February 2008, the FASB issued SFAS No. 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*. This requires that an initial transfer of a financial asset and a repurchase financing that was entered into contemporaneously with, or in contemplation of, the initial transfer be evaluated together as a linked transaction under SFAS No. 140, unless certain criteria are met. The FSP is effective for repurchase financings in which the initial transfer is entered into in fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

##### **Determination of the Useful Life of Intangible Assets**

In April 2008, the FASB issued FSP FAS No. 142-3, *Determination of the Useful Life of Intangible Assets*. It amends the list of factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under SFAS No. 142. The new guidance applies to (1) intangible assets that are acquired individually or with a group of other assets and (2) intangible assets acquired in both business combinations and asset acquisitions. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. While the guidance on determining the useful life of a recognized intangible assets must be applied prospectively only to intangible assets acquired after the FSP's effective date, the disclosure requirements of the FSP must be applied prospectively to all intangible assets recognized as of, and after, the FSP's effective date. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

## Notes to Consolidated Financial Statements

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### Note 2 - Restricted Assets

Federal Reserve Board regulations require that the Bank maintain reserves in the form of cash and deposit balances with the Federal Reserve Bank, based on a percentage of deposits. The amounts of such balances for the years ended December 31, 2008 and 2007 were approximately \$1,843,000 and \$885,000, respectively.

### Note 3 - Debt and Equity Securities

Debt and equity securities have been classified according to management's intent. The amortized cost of securities and their approximate fair values were as follows (dollars in thousands):

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Values</u>
<b>Securities Available for Sale</b>				
<b>December 31, 2008</b>				
U.S. Government and agency securities	\$20,052	\$405	\$ 0	\$20,457
State and political debt securities	12,594	103	20	12,677
Equity securities	9	48	0	57
<b>Total</b>	<b><u>\$32,655</u></b>	<b><u>\$556</u></b>	<b><u>\$ 20</u></b>	<b><u>\$33,191</u></b>
<b>December 31, 2007</b>				
U.S. Government and agency securities	\$19,994	\$ 58	\$ 44	\$20,008
State and political debt securities	11,327	59	52	11,334
Equity securities	9	174	0	183
<b>Total</b>	<b><u>\$31,330</u></b>	<b><u>\$291</u></b>	<b><u>\$ 96</u></b>	<b><u>\$31,525</u></b>
<b>Securities Held to Maturity</b>				
<b>December 31, 2008</b>				
State and political debt securities	<u>\$15,007</u>	<u>\$278</u>	<u>\$ 0</u>	<u>\$15,285</u>
<b>December 31, 2007</b>				
State and political debt securities	<u>\$16,783</u>	<u>\$203</u>	<u>\$ 2</u>	<u>\$16,984</u>

*(continued)*

## Notes to Consolidated Financial Statements

### Note 3 - Debt and Equity Securities *(continued)*

The fair values of temporarily impaired securities, the amount of unrealized losses, and the length of time these unrealized losses existed as of December 31 are as follows (dollars in thousands):

	<u>Less Than 12 Months</u>		<u>More Than 12 Months</u>		<u>Total</u>	
	<u>Fair Values</u>	<u>Unrealized Losses</u>	<u>Fair Values</u>	<u>Unrealized Losses</u>	<u>Fair Values</u>	<u>Unrealized Losses</u>
<b>Securities Available for Sale</b>						
<b>December 31, 2008</b>						
State and political debt securities	\$2,764	\$17	\$247	\$3	\$3,011	\$20
<b>December 31, 2007</b>						
U.S. Government and agency	\$ --	\$ --	\$14,950	\$ 44	\$14,950	\$ 44
State and political debt securities	851	3	5,669	49	6,520	52
<b>Total</b>	<b>\$ 851</b>	<b>\$ 3</b>	<b>\$20,619</b>	<b>\$ 93</b>	<b>\$21,470</b>	<b>\$ 96</b>

### Securities Held to Maturity

#### December 31, 2007

State & political debt securities	\$- -	\$- -	\$1,000	\$2	\$1,000	\$2
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As of December 31, 2008 there were 13 securities available for sale in an unrealized loss position. There were no securities held to maturity at December 31, 2008 with unrealized losses. Management has concluded, as of December 31, 2008, that these investments are not other-than-temporarily impaired. This assessment was based on the following factors: i) the length of time and the extent to which the market value has been less than cost; ii) the financial condition and near-term prospects of the issuer; iii) the intent and ability of the Company to retain its investment in a security for a period of time sufficient to allow for any anticipated recovery in market value; and iv) general market conditions which reflect prospects for the economy as a whole, including interest rates and sector credit spreads.

*(continued)*

## Notes to Consolidated Financial Statements

### Note 3 - Debt and Equity Securities *(concluded)*

The contractual maturities of debt securities held to maturity and available for sale at December 31, 2008, are as follows (dollars in thousands):

	<u>Held to Maturity</u>		<u>Available for Sale</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in one year or less	\$1,363	\$1,379	\$6,283	\$6,347
Due from one year to five years	7,613	7,795	23,219	23,619
Due from five to ten years	5,517	5,590	1,993	2,011
Due after ten years	514	521	1,151	1,157
<b>Total</b>	<b>\$15,007</b>	<b>\$15,285</b>	<b>\$32,646</b>	<b>\$33,134</b>

Gross realized gains on the sale of securities totaled \$1,000 in 2008. There were no gross realized gains on sales of securities in 2007. There were no gross realized losses in 2008. Gross realized losses on called securities totaled \$30,000 in 2007.

Securities, carried at approximately \$35,005,000 at December 31, 2008 and \$35,345,000 at December 31, 2007, were pledged to secure repurchase agreements, public and trust deposits, and for other purposes required or permitted by law.

### Note 4 - Loans

Loans at December 31 consist of the following (dollars in thousands):

	<u>2008</u>	<u>2007</u>
Commercial, agricultural, and industrial	\$ 73,679	\$ 76,626
Real estate - one to four family residential	112,133	112,372
Real estate - all others	95,534	96,839
Installment and student	13,710	15,528
	<u>295,056</u>	<u>301,365</u>
Less net deferred loan origination fees	1,158	1,041
<b>Total loans</b>	<b><u>\$293,898</u></b>	<b><u>\$300,324</u></b>

*(continued)*

## Notes to Consolidated Financial Statements

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### Note 4 - Loans (concluded)

Changes in the allowance for credit losses for the years ended December 31 are as follows (dollars in thousands):

	<u>2008</u>	<u>2007</u>
Balance at beginning of year	\$3,814	\$3,591
Provision for credit losses	729	318
Charge-offs	(588)	(220)
Recoveries	262	125
<b>Net charge-offs</b>	<u>(326)</u>	<u>(95)</u>
<b>Balance at end of year</b>	<u><b>\$4,217</b></u>	<u><b>\$3,814</b></u>

Following is a summary of information pertaining to impaired loans (dollars in thousands):

	<u>2008</u>	<u>2007</u>
<b>December 31</b>		
Impaired loans without a valuation allowance	\$1,217	\$1,050
Impaired loans with a valuation allowance	603	0
<b>Total impaired loans</b>	<u><b>\$1,820</b></u>	<u><b>\$1,050</b></u>
<b>Valuation allowance related to impaired loans</b>	<u><b>\$64</b></u>	<u><b>\$0</b></u>
<b>Years Ended December 31</b>		
Average investment in impaired loans	\$1,520	\$1,478
Interest income recognized on a cash basis on impaired loans	0	0
Total nonaccrual loans	1,217	1,050

At December 31, 2008, there were no commitments to lend additional funds to borrowers whose loans have been modified. Loans 90 days and over past due still accruing interest were \$191,892 and \$209,242 at December 31, 2008 and 2007, respectively.

Certain related parties of the Bank, principally Bank directors and their associates, were loan customers of the Bank in the ordinary course of business during 2008 and 2007. Total loans outstanding at December 31, 2008 and 2007, to key officers and directors were \$6,030,627 and \$7,757,612, respectively. During 2008 loan advances totaled \$6,411,437 and loan repayments totaled \$8,138,421 on these loans. During 2007 loan advances totaled \$6,548,690 and loan repayments totaled \$5,601,306.

## Notes to Consolidated Financial Statements

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### Note 5 - Servicing

Mortgage loans serviced for others are not included on the accompanying consolidated balance sheets. The unpaid principal balances of mortgage and other loans serviced for others were \$21,708,879 and \$12,194,000 at December 31, 2008 and 2007, respectively. The balance of capitalized servicing rights included in other assets at December 31, 2008 and 2007 was \$0 and \$2,000, respectively. The amount of mortgage servicing rights amortized at December 31, 2008 and 2007 was \$0 and \$3,000, respectively.

### Note 6 - Premises and Equipment

The components of premises and equipment at December 31 are as follows (dollars in thousands):

	<u>2008</u>	<u>2007</u>
Land	\$ 1,798	\$ 1,798
Buildings	16,028	11,935
Construction in Progress	0	3,715
Furniture and equipment	6,025	6,013
	<u>23,851</u>	<u>23,461</u>
Less accumulated depreciation and amortization	9,606	9,159
<b>Total premises and equipment</b>	<b><u>14,245</u></b>	<b><u>14,302</u></b>

The total depreciation expense for years ending December 31, 2008 and 2007 was \$787,000 and \$690,000, respectively.

The Bank leases premises and equipment under various operating leases expiring through 2009. Rental expense of leased premises and equipment totaled \$137,144 and \$133,200 in 2008 and 2007, respectively, which are included in occupancy and furniture and equipment expense.

Minimum net rental commitments under noncancellable leases having an original or remaining term of more than one year for future years ending December 31 are as follows (dollars in thousands):

2009	<u>\$ 88</u>
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Certain leases contain renewal options from two to five years and escalation clauses based on increases in property taxes and other costs.

## Notes to Consolidated Financial Statements

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### Note 7 - Deposits

The aggregate amount of certificates of deposit with balances of \$100,000 or more was approximately \$33,552,760 and \$39,137,000 at December 31, 2008 and 2007, respectively. Included in time deposits at December 31, 2008, are \$22,210,220 of time deposits in denominations of more than \$100,000 but less than \$250,000, as these qualify for expanded FDIC insurance coverage.

Scheduled maturities of certificates of deposit for future years ending December 31 are as follows (dollars in thousands):

2009	\$ 82,132
2010	9,383
2011	4,717
2012	3,951
2013	3,317
Thereafter	<u>13</u>
<b>Total</b>	<b><u>\$103,513</u></b>

Certain related parties of the bank, principally Bank directors and their associates, have deposit accounts with the Bank. Total related parties bank deposits outstanding were \$1,813,000 and \$1,496,000 for years ending December 31, 2008 and 2007, respectively.

### Note 8 - Federal Funds Purchased and Security Repurchase Agreements

Federal funds purchased and security repurchase agreements generally mature within one to four days from the transaction date. Information concerning these borrowings is summarized as follows for the years ended December 31 (dollars in thousands):

	<u>2008</u>	<u>2007</u>
Average balance during the year	\$10,922	\$9,115
Average interest rate during the year	2.36%	2.86%
Maximum month-end balance during the year	\$14,627	\$11,039
Balance outstanding at year-end	\$13,836	\$8,855
Average interest rate at year-end	1.73%	2.59%

### Note 9 - Employee Benefits

#### 401(k) Profit Sharing Plan

The Company has a profit-sharing 401(k) plan, with cash or deferred arrangements permitted by Internal Revenue Code subsection 401(k). Eligibility requirements are six months of service and attainment of age 21, with plan entry the following January 1 or July 1. The Company's profit-sharing contribution is 6 percent of eligible compensation. The Company's safe-harbor matching contribution is 100 percent of the first 6 percent of a participant's eligible compensation per payroll period deferred as 401(k) contributions. Under the 401(k) savings aspect of the plan, employees may contribute up to the dollar limitation for deferrals, plus the catch-up dollar limitation. The safe harbor matching contribution does not have an hour of service or employment on the last day of the plan year accrual requirement. The profit sharing contribution has a greater than 500 hours of service accrual requirement if not employed on the last day of the plan year; no hour of service accrual requirement if employed on the last day of the plan year, died, disabled, or attained the plan's normal retirement age. Total employer contribution expenses were \$912,000 and \$856,000 for 2008 and 2007, respectively.

*(continued)*

## Notes to Consolidated Financial Statements

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### Note 9 - Employee Benefits *(concluded)*

#### Outside Directors' Nonqualified Deferred Compensation Plan

The Company has an outside directors' nonqualified deferred compensation plan. Under the terms of the plan, an outside director (a non-employee director) may participate in the plan. The participant may elect to defer a portion of his or her directors' fees as designated at the beginning of each plan year. The Company does not make nonelective contributions to the plan. Payments begin after termination of service for any reason. Payments may begin prior to termination of service for an unforeseeable emergency. There are currently four participants in the plan. Total deferrals plus earnings were \$406,713 and \$364,559 at December 31, 2008 and 2007, respectively. The expense to the Company for this plan is \$1,968 and \$2,704 for the 2008 and 2007 plan years, respectively.

#### Stock Incentive Plan

In February 1979, and as amended in March 1997, the Company adopted a non-qualified stock incentive plan for the benefit of key employees. The objective of the plan is to retain personnel of experience and ability in key positions by providing them with a proprietary interest in the Company. The plan is also expected to enhance the ability of the Company to attract and retain key employees. The Company's plan is administered by its board of directors' Executive Compensation Committee. Members of this committee consist only of non-officer, outside directors.

The plan allows for the issuance to participants of up to 240,800 shares of the Company's common stock.

For the year ended December 31, 2008, the Company awarded 3,150 shares of restricted stock with a fair market value of \$60.00 per share under the plan. The restricted stock is awarded to the employees at the end of a five year vesting period. During the vesting period the employees have voting and dividend rights. Compensation expense in the amount of the fair value of the common stock at the date of the grant to the plan participants will be recognized straight line over the five-year vesting period. Compensation expense related to the plan was \$174,000 and \$126,000 for the years ended December 31, 2008 and 2007, respectively. The tax benefit recognized on this compensation was \$49,000 and \$43,000 for the years ending December 31, 2008 and 2007, respectively.

As of December 31, 2008, shares remaining in reserve for issuance under the plan were 72,281. Subsequent to December 31, 2008, additional shares of restricted stock were awarded on February 9, 2009.

The following summarizes activity under the restricted stock plan for the year December 31, 2008:

	Shares	Aggregate Intrinsic Value	Weighted Average Grant Date Fair Value
Restricted stock grants unearned at December 31, 2006	9,190	\$542,000	\$50.24
Granted	2,918	--	59.00
Restricted stock grants unearned at December 31, 2007	12,108	\$751,000	\$ 52.15
Granted	3,150		60.00
Vested from retirement	578		51.52
Restricted stock grants unearned at December 31, 2008	14,680	\$866,120	\$ 53.86

## Notes to Consolidated Financial Statements

### Note 10 - Income Taxes

Income taxes are comprised of the following for the years ended December 31 (dollars in thousands):

	<u>2008</u>	<u>2007</u>
Current		
Federal	\$1,792	\$1,667
State	35	53
Total Current Tax Expense	<u>1,827</u>	<u>1,720</u>
Deferred		
Federal	(268)	(185)
State	(24)	6
Total Deferred taxes	<u>(292)</u>	<u>(179)</u>
<b>Total Tax Expense</b>	<b><u>\$1,535</u></b>	<b><u>\$1,541</u></b>

The following is reconciliation between the statutory and the effective federal income tax rate for the years ended December 31 (dollars in thousands):

	<u>2008</u>		<u>2007</u>	
	<u>Amount</u>	<u>Percent of Pretax Income</u>	<u>Amount</u>	<u>Percent of Pretax Income</u>
Income tax at statutory rates	\$2,009	34.0%	\$2,011	34.0%
Increase (decrease) resulting from:				
Tax-exempt income	(511)	(8.50)	(445)	(7.69)
Other	37	0.5	15	(0.02)
<b>Total income taxes expense</b>	<b><u>\$1,535</u></b>	<b>26%</b>	<b><u>\$1,541</u></b>	<b>26.29%</b>

Tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities at December 31 are as follows (dollars in thousands):

	<u>2008</u>	<u>2007</u>
<b>Deferred Tax Assets</b>		
Allowance for credit losses	\$ 834	\$ 593
Deferred compensation	86	89
Other	241	56
Unrealized loss on securities available for sale	0	0
Stock-based compensation on restricted stock	137	95
<b>Total deferred tax assets</b>	<b><u>1,298</u></b>	<b><u>833</u></b>
<b>Deferred Tax Liabilities</b>		
Accumulated depreciation and amortization	479	509
Deferred income	705	500
Difference between financial versus tax basis of bonds purchased	13	15
Unrealized gain on securities available for sale	120	67
Prepaid expenses	88	88
<b>Total deferred tax liabilities</b>	<b><u>1,405</u></b>	<b><u>1,179</u></b>
<b>Net deferred tax liabilities</b>	<b><u>\$ 107</u></b>	<b><u>\$ 346</u></b>

Deferred tax liabilities are recorded in other liabilities on the consolidated balance sheet.

(continued)

## Notes to Consolidated Financial Statements

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### Note 10 - Income Taxes *(concluded)*

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. The company had no unrecognized tax benefits which would require an adjustment to the January 1, 2007 beginning balance of retained earnings. The Company had no unrecognized tax benefits at December 31, 2007 and at December 31, 2008.

The Company recognizes interest and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2008 and 2007 the Company recognized no interest and penalties. The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states. With few exceptions, the Company is no longer subject to U.S. federal or state/local income tax examinations by tax authorities for years before 2005.

### Note 11 - Commitments and Contingencies

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the consolidated balance sheets.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. A summary of the Bank's commitments at December 31 is as follows (dollars in thousands):

	<u>2008</u>	<u>2007</u>
Commitments to extend credit	\$59,895	\$72,646
Standby letters of credit	\$446	\$458

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 commitment amounts do not necessarily represent future cash requirements. The Bank's experience has been that approximately 46 percent of loan commitments is drawn upon by customers. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above, and is required in instances where the Bank deems necessary.

The Bank has agreements with commercial banks for lines of credit totaling \$34,000,000, none of which was used at December 31, 2008, and a credit line with the Federal Home Loan Bank of Seattle totaling 20 percent of assets dependent upon additional capital stock purchases, of which \$6,200,000 was used at December 31, 2008. These borrowings included a fixed advance of \$1,000,000 at 4.04% maturing in December 2010, a fixed rate advance of \$1,000,000 at 3.85% maturing January 2013, a fixed rate advance of \$200,000 at 3.29% maturing March 2011, two putable advances totaling \$2,000,000 at 4.74% that mature in July 2012, and two short term advances of \$1,000,000 at .68% and \$1,000,000 at .58% maturing in February and March 2009.

*(continued)*

## Notes to Consolidated Financial Statements

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### Note 11 - Commitments and Contingencies *(concluded)*

Because of the nature of its activities, the Company is subject to various pending and threatened legal actions which arise in the ordinary course of business. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on the financial position of the Company.

The Company has entered into employment contracts with its president and other key officers which provide for deferred compensation at retirement and for contingent payments subject to future events.

### Note 12 - Significant Concentrations of Credit Risk

Most of the Bank's business activity is with customers located in Washington and northeastern Oregon. Investments in state and municipal securities involve governmental entities primarily within the state of Washington. Loans are generally limited, by federal banking regulations, to 15 percent of the Bank's shareholders' equity, excluding accumulated other comprehensive income (loss).

### Note 13 - Regulatory Matters

The Company and the Bank are 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 and Company's financial statements. Under capital adequacy guidelines of the regulatory framework for prompt corrective action, the Bank must meet specific capital adequacy guidelines that involve quantitative measures of the Company's assets, liabilities and certain off-balance-sheet items, as calculated under regulatory accounting practices. The Bank's capital classification is also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

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

As of December 31, 2008, the most recent notification from the Bank's regulator categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

The Company's and the Bank's actual capital amounts and ratios are also presented in the following table. Management believes, as of December 31, 2008, that the Company and the Bank meet all capital requirements to which they are subject (dollars in thousands):

*(continued)*

## Notes to Consolidated Financial Statements

### Note 13 - Regulatory Matters (concluded)

	Actual Amount	Ratio	Capital Adequacy Purposes Amount	Ratio	To be Well Capitalized Under Prompt Corrective Action Provisions Amount	Ratio
<b>December 31, 2008</b>						
<i>Tier 1 capital (to average assets):</i>						
Company	\$35,263	8.6%	\$16,423	4.0%	N/A	N/A
Bank	34,654	8.4	16,421	4.0	\$20,526	5.0%
<i>Tier 1 capital (to risk-weighted assets):</i>						
Company	\$35,263	11.5	\$12,308	4.0	N/A	N/A
Bank	34,654	11.3	12,308	4.0	18,462	6.0
<i>Total capital (to risk-weighted assets):</i>						
Company	\$39,136	12.7	\$24,617	8.0	N/A	N/A
Bank	38,527	12.5	24,617	8.0	30,771	10.0
<b>December 31, 2007</b>						
<i>Tier 1 capital (to average assets):</i>						
Company	\$34,672	9.2%	\$15,373	4.0%	N/A	N/A
Bank	34,185	8.9	15,373	4.0	\$19,216	5.0%
<i>Tier 1 capital (to risk-weighted assets):</i>						
Company	\$34,672	10.6	\$13,073	4.0	N/A	N/A
Bank	34,185	10.5	13,073	4.0	19,610	6.0
<i>Total capital (to risk-weighted assets):</i>						
Company	\$38,566	11.8	\$26,147	8.0	N/A	N/A
Bank	38,079	11.7	26,147	8.0	32,683	10.0

## Notes to Consolidated Financial Statements

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### Note 14 - Condensed Financial Information - Parent Company Only

#### Condensed Balance Sheets

*Dollars in Thousands*

December 31,	<u>2008</u>	<u>2007</u>
<b>Assets</b>		
Cash	\$ 178	\$ 150
Investment in Bank	35,008	34,313
Other assets	<u>431</u>	<u>721</u>
<b>Total Assets</b>	<b><u>\$35,617</u></b>	<b><u>\$35,184</u></b>
<b>Liabilities</b>	\$ 0	\$ 383
<b>Shareholders' Equity</b>	<b><u>35,617</u></b>	<b><u>34,801</u></b>
<b>Total Liabilities and Shareholders' Equity</b>	<b><u>\$35,617</u></b>	<b><u>\$35,184</u></b>

*(continued)*

## Notes to Consolidated Financial Statements

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### Note 14 - Condensed Financial Information - Parent Company Only (concluded)

#### Condensed Statements of Income

*Dollars in Thousands*

December 31,	<u>2008</u>	<u>2007</u>
<b>Dividend Income from the Bank</b>	\$4,000	\$3,709
<b>Expenses</b>	<u>96</u>	<u>97</u>
<b>Income before income taxes and equity in undistributed income of the Bank</b>	3,904	3,612
<b>Income Tax Benefit</b>	<u>33</u>	<u>33</u>
<b>Income before undistributed income of the Bank</b>	3,937	3,645
<b>Equity in Undistributed Income of the Bank</b>	<u>470</u>	<u>730</u>
<b>Net Income</b>	<u><u>\$4,407</u></u>	<u><u>\$4,375</u></u>

#### Condensed Statements of Cash Flows

*Dollars in Thousands*

December 31,	<u>2008</u>	<u>2007</u>
<b>Cash Flows from Operating Activities</b>		
Net income	\$4,407	\$4,375
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed income of the Bank	(470)	(730)
Excess tax benefits from vesting of restricted stock	(5)	0
Restricted stock compensation	174	126
Stock Incentive Plan	63	50
Other - net	<u>(88)</u>	<u>(33)</u>
<b>Net cash provided by operating activities</b>	4,081	3,788
<b>Cash Flows from Financing Activities</b>		
Cash dividends paid	(3,709)	(3,477)
Excess tax benefits from vesting of restricted stock	5	0
Repurchase of common stock	<u>(349)</u>	<u>(245)</u>
<b>Net cash used in financing activities</b>	(4,053)	(3,722)
<b>Increase (decrease) in cash</b>	28	66
<b>Cash</b>		
Beginning of year	<u>150</u>	<u>84</u>
<b>End of year</b>	<u><u>\$ 178</u></u>	<u><u>\$ 150</u></u>

## Notes to Consolidated Financial Statements

### Note 15 - Fair Value of Financial Instruments

The estimated fair value of the Company's financial instruments at December 31 was as follows (dollars in thousands):

	2008		2007	
	Carrying Amounts	Fair Value	Carrying Amounts	Fair Value
<b>Financial Assets</b>				
Cash and cash equivalents	\$ 68,546	\$ 68,546	\$ 27,192	\$ 27,192
Securities available for sale	33,191	33,191	31,525	31,525
Securities held to maturity	15,007	15,285	16,783	16,984
Other Investments	1,880	1,880	1,880	1,880
Loans receivable, net	289,681	289,762	296,510	296,358
Accrued interest receivable	2,527	2,527	2,609	2,609
<b>Financial Liabilities</b>				
Deposits	\$369,846	\$368,981	\$344,153	\$343,344
Federal funds purchased and security repurchase agreements	13,836	13,836	8,855	8,855
Other borrowed funds	6,200	5,045	3,000	2,984
Accrued interest payable	419	419	613	613

The Bank assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Bank's financial instruments will change when interest rate levels change, and that change may either be favorable or unfavorable to the Bank. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities, and attempts to minimize interest rate risk by adjusting terms of new loans and deposits, and by investing in securities with terms that mitigate the Bank's overall interest rate risk.

On January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("Statement 157"). Statement 157 provides enhanced guidance for measuring assets and liabilities using fair value and applies to situations where other standards require or permit assets or liabilities to be measured at fair value. Statement 157 also requires expanded disclosure of items that are measured at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings.

Valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's assumptions about market value. These two types of inputs create the following fair value hierarchy:

Level 1 – Quoted prices for identical instruments in active markets.

Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable.

Level 3 – Instruments whose significant value drivers are unobservable.

(continued)

## Notes to Consolidated Financial Statements

### Note 15 - Fair Value of Financial Instruments *(concluded)*

The following table summarizes the Company's financial instruments that were measured at fair value at December 31, 2008:

Description of Financial Instrument	Fair Value Measurements Using			
	Fair Value (dollars in thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets Measured at Fair Value on a Recurring Basis				
Securities available-for-sale	\$33,191	\$57	\$33,134	\$ 0
Assets Measured at Fair Value on a Nonrecurring Basis				
Impaired loans	\$ 1,820	0	0	\$1,820

The Bank's U.S. equity securities included in securities available-for-sale trade in a very active market of identical instruments and their valuation is therefore included under Level 1. The remainder of the Bank's securities available-for-sale at December 31, 2008 primarily consisted of U.S. Government and Agency obligations and state and political debt securities that trade in active markets. These securities are included under Level 2 because there may or may not be daily trades in each of the individual securities and because the valuation of these securities may be based on instruments that are not exactly identical to those owned by the Bank. Temporary changes in the valuation of securities available-for-sale do not affect current income; instead, unrealized gains or losses on available-for-sale securities are reported as a net amount in accumulated comprehensive income. Declines in the fair value of individual available-for-sale securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value. No such write-downs have occurred during the periods presented.

Impaired loans are individually reviewed to determine the amount of each loan considered to be at risk of non-collection. In determining the amount of each loan at risk, the Bank reviews real property appraisals, equipment valuations, accounts receivable and payable listings and other financial information. The estimated amount of impaired loans at risk of non-collection at December 31, 2008 was \$64 thousand and is included as a part of the allowance for loan losses as a component of the category "Analyzed Impairment."

## Notes to Consolidated Financial Statements

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### Note 16 - Comprehensive Income

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available for sale.

The components of accumulated other comprehensive income and related tax effects are as follows:

December 31,	<u>2008</u>	<u>2007</u>
Unrealized holding gains on available-for-sale Securities	\$ 342	\$ 231
Reclassification adjustment for gains (losses) realized in income	<u>(1)</u>	<u>30</u>
Net unrealized gains	341	261
Tax effect	<u>(116)</u>	<u>(89)</u>
Net-of-tax amount	\$ 225	\$ 172