

Baker Boyer Bancorp and Subsidiary

**Consolidated Financial Report
December 31, 2009**

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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, 2009 and 2008, and the related consolidated statements of income, shareholders' equity and comprehensive income, 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 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 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, 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.

Moss Adams LLP

Spokane, Washington
February 23, 2010

Consolidated Financial Statements

Baker Boyer Bancorp and Subsidiary

Consolidated Balance Sheets

Dollars in Thousands

December 31,	2009	2008
Assets		
Cash and amounts due from banks	\$ 2,645	\$ 12,132
Interest-bearing deposits at other financial institutions	68,548	38,164
Federal funds sold	0	18,250
Total Cash and Cash Equivalents	71,193	68,546
Securities available for sale, at fair value	49,521	33,191
Securities held to maturity at cost (market value \$13,191 and \$15,285)	12,739	15,007
Other investments, at cost	1,894	1,880
Loans	298,077	293,898
Allowance for credit losses	(5,183)	(4,217)
Net Loans	292,894	289,681
Premises and equipment, net	15,449	14,245
Accrued interest receivable	2,247	2,527
Other assets	3,347	1,559
Total Assets	\$449,284	\$426,636
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Demand, non-interest-bearing	\$ 78,071	\$ 82,644
Savings and interest-bearing demand	206,898	183,689
Time	105,057	103,513
Total Deposits	390,026	369,846
Accrued interest payable	317	419
Federal funds purchased and security repurchase agreements	16,473	13,836
Other borrowed funds	4,200	6,200
Other liabilities	779	718
Total Liabilities	411,795	391,019
Commitments and Contingencies (Note 11)		
Shareholders' Equity		
Common stock (no par value, stated value \$3.125 per share); Authorized 4,000,000 shares; issued and outstanding: 2009 -1,299,724 shares; 2008 -1,295,161 shares	4,061	4,047
Additional paid-in capital	760	508
Retained earnings	31,941	30,708
Accumulated other comprehensive income	727	354
Total Shareholders' Equity	37,489	35,617
Total Liabilities and Shareholders' Equity	\$449,284	\$426,636

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,	2009	2008
Interest and Dividend Income		
Loans, including fees	\$18,883	\$19,870
Federal funds sold	14	136
Investment securities:		
Taxable	581	625
Tax-exempt	1,470	1,109
Other investment income and dividends	28	43
Interest-bearing deposits at other financial institutions	1,279	647
Total Interest and Dividend Income	22,255	22,430
Interest Expense		
Deposits	3,756	6,010
Federal funds purchased, security repurchase agreements, & borrowed funds	489	474
Total Interest Expense	4,245	6,484
Net Interest Income	18,010	15,946
Provision for Credit Losses	1,149	729
Net interest income after provision for credit losses	16,861	15,217
Non-Interest Income		
Trust and investment management fees	4,780	4,812
Service charges on deposit accounts	1,192	1,202
Other service charges and fees	1,163	847
Non-deposit retail brokerage fees	474	551
Net gain (loss) on sale of securities available for sale	0	1
Other operating income	469	349
Total Non-Interest Income	8,078	7,762
Non-Interest Expense		
Salaries and employee benefits	11,769	11,125
Occupancy	1,042	1,011
Furniture and equipment	616	699
Professional services	626	528
Office supplies and printed forms	188	209
Information systems and data processing	1,432	1,215
Marketing & charitable contributions	209	443
Business & FDIC insurances	935	257
Other	1,574	1,550
Total Non-Interest Expense	18,391	17,037
Income Before Income Taxes	6,548	5,942
Income Taxes	1,729	1,535
Net Income	\$ 4,819	\$ 4,407
Earnings Per Share	\$3.76	\$3.44
Weighted Average Number of Shares Outstanding	1,281,220	1,282,586

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 and Comprehensive Income

Dollars in Thousands, except per share amounts

	Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Compre- hensive Income	Total
Balance at December 31, 2007	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	<u>225</u>
Comprehensive income						4,632
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	<u>(6,010)</u>	<u>(19)</u>	<u>(330)</u>	<u>--</u>	<u>--</u>	<u>(349)</u>
Balance at December 31, 2008	1,295,161	\$4,047	\$508	\$30,708	\$354	\$35,617
Comprehensive income:						
Net income	--	--	--	4,819	--	4,819
Other comprehensive income, net of tax:						
Change in fair value of securities available for sale	--	--	--	--	373	<u>373</u>
Comprehensive income						5,192
Cash dividends paid (\$2.76 per share)	--	--	--	(3,586)	--	(3,586)
Stock issued to directors as fees for directors' services	1,075	3	59	--	--	62
Restricted stock issued to officers under stock incentive plan	3,488	11	(11)	--	--	--
Restricted stock compensation	<u>--</u>	<u>--</u>	<u>204</u>	<u>--</u>	<u>--</u>	<u>204</u>
Balance at December 31, 2009	1,299,724	\$4,061	\$760	\$31,941	\$727	\$37,489

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,	2009	2008
Cash Flows from Operating Activities		
Net income	\$4,819	\$ 4,407
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	1,149	729
Depreciation and amortization	883	932
Loss on disposal of assets	13	4
Restricted stock compensation expense	204	174
Stock incentive plan compensation expense	62	63
Amortization of deferred loan fees	(55)	117
Excess tax benefits from vesting restricted stock	0	(5)
Net investment amortization	347	143
Deferred income taxes	(436)	(292)
Net (gain) loss on sale of investment securities	0	(1)
Loss (gain) on sale of foreclosed real estate	0	0
Origination of loans held for sale	(38,607)	(12,309)
Proceeds from sale of loans held for sale	38,866	12,668
Gain on sales of loans	(259)	(44)
(Increase) decrease in interest receivable	280	82
Increase (decrease) in interest payable	(102)	(194)
Other - net	(1,602)	(47)
Net cash provided by operating activities	5,562	6,427
Cash Flows from Investing Activities		
Activity in securities available for sale:		
Maturities, prepayments and calls	29,524	25,323
Purchases	(45,577)	(26,818)
Sales	0	100
Activity in securities held to maturity:		
Maturities, prepayments and calls	2,207	1,815
Purchases	0	(111)
Purchase of Federal Reserve Bank Stock	(14)	(0)
Increase in loans made to customers, net of principal collections	(4,307)	5,668
Purchases of premises and equipment	(1,979)	(871)
Proceeds from sale of foreclosed real estate	0	0
Net cash provided (used) by investing activities	(20,146)	5,106

(continued)

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

Consolidated Financial Statements

Baker Boyer Bancorp and Subsidiary

Consolidated Statements of Cash Flows *(concluded)*

Dollars in Thousands

	<u>2009</u>	<u>2008</u>
Cash Flows from Financing Activities		
Net increase in deposits	\$20,180	\$ 25,693
Net increase in federal funds purchased and security repurchase agreements	2,637	4,981
Proceeds from other borrowed funds	0	3,200
Repayment of other borrowed funds	(2,000)	0
Cash dividends paid	(3,586)	(3,709)
Excess tax benefits from vesting of restricted stock	0	5
Repurchases of common stock	0	(349)
Net cash provided by financing activities	17,231	29,821
Net increase (decrease) in cash and cash equivalents	2,647	41,354
Cash and Cash Equivalents		
Beginning of year	<u>68,546</u>	<u>27,192</u>
End of year	<u>\$71,193</u>	<u>\$68,546</u>
Supplemental Disclosures of Cash Flow Information		
Interest paid	\$4,347	\$6,678
Income taxes paid	2,201	2,111
Supplemental Disclosures of Non-Cash Investing and Financing Activities		
Fair value adjustment of securities available for sale, net of tax	\$373	\$225
Stock issued to directors	62	63

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

Notes to Consolidated Financial Statements

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." 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.

(continued)

Notes to Consolidated Financial Statements

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 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

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.

(continued)

Notes to Consolidated Financial Statements

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 \$614,277,000 and \$525,045,000 were held in trust as of December 31, 2009 and 2008, 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 \$89,000 and \$204,000 for the years ending December 31, 2009 and 2008, 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.

FASB ASC 740-10, *Income Taxes*, requires recognition and measurement of uncertain tax positions using a “more-likely-than-not” approach. The Company’s approach to FASB ASC 740-10 consisted of an examination of its financial statements, its income tax provision, and its federal and state income tax returns. The Company analyzed its tax positions including the permanent and temporary differences as well as the major components of income and expense. As of December 31, 2009, the Company did not believe that it had any uncertain tax positions that would rise to the level of having a material effect on its financial statements. In addition, the Bank had no accrued interest or penalties as of December 31, 2009. It is the Bank’s policy to record interest and penalties as a component of income tax expense.

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.

(continued)

Notes to Consolidated Financial Statements

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

Fair Values of Financial Instruments

ASC 825-10, *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.

(continued)

Notes to Consolidated Financial Statements

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

Stock-Based Compensation

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, 2009, unrecognized compensation expense related to nonvested restricted stock awards was \$370,000 and is expected to be recognized as follows:

	Stock-Based Compensation Expense
2010	\$ 142
2011	110
2012	77
2013	<u>41</u>
Total	<u>\$370</u>

Earnings Per Share

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

Subsequent Events

In preparing these financial statements, management has evaluated subsequent events, if any, through February 23, 2010, which is the date the audited financial statements were available to be issued.

Recent Accounting Pronouncements

Codification and the Hierarchy of Generally Accepted Accounting Principles

On July 1, 2009, FASB issued ACS 105, *FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (SFAS 168). SFAS 168 approved the FASB Accounting Standards Codification as the single source of authoritative nongovernmental GAAP. The FASB accounting Standards Codification is effective for interim or annual periods ending after September 15, 2009. All existing accounting standards have been superseded and all other accounting literature not included in the FASB Accounting Standards Codification will be considered non-authoritative. 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.

Amendments to FASB Interpretation No. 46(R)

On June 12, 2009, the FASB issued ASC 810, *Amendments to FASB Interpretation No. 46 (R)* (SFAS 167). This amendment will be effective January 1, 2010. SFAS 167 amends FIN 46R, *Consolidation of Variable Interest Entities* (FIN 46R), by significantly changing the criteria by which an enterprise determines whether it must consolidate a variable interest entity (VIE). A VIE is an entity, typically an SPE, which has insufficient equity at risk or which is not controlled through voting rights held by equity investors. FIN 46R currently requires

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Notes to Consolidated Financial Statements

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

Recent Accounting Pronouncements *(continued)*

that a VIE be consolidated by the enterprise that will absorb a majority of the expected losses or expected residual returns created by the assets of the VIE. SFAS 167 amends FIN 46R to require that a VIE be consolidated by the enterprise that has both the power to direct the activities that most significantly impact the VIE's economic performance and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. SFAS 167 also requires that an enterprise continually reassess, based on current facts and circumstances, whether it should consolidate the VIEs with which it is involved. SFAS 167 is effective for fiscal years beginning after November 15, 2009. 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

On June 12, 2009, the FASB issued ASC 860, *Accounting for Transfers of Financial Assets-an amendment of FASB Statement No. 140* (SFAS 166). SFAS 166 revises SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS 140)*, which establishes sale accounting criteria for transfers of financial assets. This Statement removes the concept of a qualifying special-purpose entity (QSPE) from Statement 140 and removes the exception from applying FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, to qualifying special -purpose entities. As a result, existing QSPEs will be subject to consolidation in accordance with the guidance provided in SFAS 167. SFAS 140 will be effective January 1, 2010. 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.

Subsequent Events

On May 28, 2009, the FASB issued ASC 958, *Subsequent Events* (SFAS 165). SFAS 165 provides general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In addition, SFAS 165 requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. SFAS 165 is effective for interim and annual periods ending after June 15, 2009. 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.

Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly.

On April 9, 2009 the FASB issued ASC 820, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (FSP FAS 157-4)*. FSP FAS 157-4 provides guidance for determining whether a market is inactive and a transaction is distressed in order to apply the existing fair value measurement guidance in SFAS No. 157, *Fair Value Measurements* (SFAS 157). In addition, FSP FAS 157-4 requires enhanced disclosures regarding financial assets and liabilities that are recorded at fair value. Effective for interim and annual periods ending after June 15, 2009, with early adoption permitted under certain circumstances. 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

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

Recent Accounting Pronouncements *(concluded)*

Recognition and Presentation of Other-Than-Temporary Impairments

On April 9, 2009, the FASB issued ASC 320, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP FAS 115-2 and FAS 124-2). This FSP requires 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 (OCI) 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. FSP FAS 115-2 also requires expanded disclosures. FSP FAS 115-2 does not change the recognition of other-than-temporary impairment for equity securities. Effective for interim and annual periods ending after June 15, 2009, with early adoption permitted under certain circumstances. 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 Assets Acquired and Liabilities Assumed in a Business Combination That Arise From Contingencies

On April 1, 2009, the FASB issued ASC 805-20-25-18A, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies* (FSP FAS 141R-1), whereby assets acquired and liabilities assumed in a business combination that arise from contingencies should be recognized at fair value on the acquisition date if fair value can be determined during the measurement period. If fair value cannot be determined, companies should typically account for the acquired contingencies using existing accounting guidance. FSP FAS 141R-1 is effective for new acquisitions consummated on or after January 1, 2009. 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.

Noncontrolling Interests in Consolidated Financial Statements

In December 2007, the FASB issued ASC 810, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of AFB No. 51* (SFAS No. 160). SFAS 160 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 160 also requires expanded disclosure that distinguishes between the interests of the controlling owners and the interests of the noncontrolling owners of a subsidiary. Effective for fiscal years, interim periods within those fiscal years, beginning on or after December 15, 2008. The standard should be applied prospectively. Presentation and disclosure requirements should be applied retrospectively for all periods presented. Early adoption is prohibited. 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.

Disclosures about Derivative Instruments and Hedging Activities

The FASB issued ASC 815-10-50, *Disclosures about Derivative Instruments and Hedging Activities* – an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 requires expanded qualitative, quantitative and credit-risk disclosures about derivatives and hedging activities and their effects on the Company's financial position, financial performance and cash flows. Effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. 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

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, 2009 and 2008, were approximately \$2,230,000 and \$1,843,000, 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>
Securities Available for Sale				
December 31, 2009				
U.S. Government and agency securities	\$10,818	\$186	\$3	\$11,001
State and political debt securities	37,595	885	53	38,427
Equity securities	9	90	6	93
Total	<u>\$48,422</u>	<u>\$1,161</u>	<u>\$62</u>	<u>\$49,521</u>
December 31, 2008				
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
Total	<u>\$32,655</u>	<u>\$556</u>	<u>\$ 20</u>	<u>\$33,191</u>
Securities Held to Maturity				
December 31, 2009				
State and political debt securities	<u>\$12,741</u>	<u>\$450</u>	<u>\$0</u>	<u>\$13,191</u>
December 31, 2008				
State and political debt securities	<u>\$15,007</u>	<u>\$278</u>	<u>\$ 0</u>	<u>\$15,285</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>
Securities Available for Sale						
December 31, 2009						
U.S. Government and agency	\$ 997	\$ 3	\$ --	\$ --	\$1,000	\$ 3
State and political debt securities	3,152	37	319	16	3,471	53
Total	\$4,149	\$40	\$319	\$16	\$4,471	\$56
December 31, 2008						
State and political debt securities	\$2,764	\$17	\$247	\$3	\$3,011	\$20

As of December 31, 2009, and 2008, there were 18 and 13 securities available for sale, respectively, in an unrealized loss position. There were no securities held to maturity at December 31, 2009 with unrealized losses. Management has concluded, as of December 31, 2009, and 2008 that these investments are not other-than-temporarily impaired, respectively. 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, 2009, 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	\$2,522	\$2,579	\$13,341	\$13,423
Due from one year to five years	5,588	5,843	26,682	27,333
Due from five to ten years	4,372	4,504	3,508	3,610
Due after ten years	259	265	4,882	5,062
Total	\$12,741	\$13,191	\$48,413	\$49,428

There were no gross realized gains on sales of securities in 2009. Gross realized gains on the sale of securities totaled \$1,000 in 2008. There were no gross realized losses in 2009 or 2008.

Securities, carried at approximately \$48,193,000 at December 31, 2009 and \$35,005,000 at December 31, 2008, 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>2009</u>	<u>2008</u>
Commercial, agricultural, and industrial	\$ 76,748	\$ 73,679
Real estate - one to four family residential	102,556	112,133
Real estate - all others	104,599	95,534
Installment and student	<u>15,277</u>	<u>13,710</u>
	299,180	295,056
Less net deferred loan origination fees	<u>1,103</u>	<u>1,158</u>
Total loans	<u>298,077</u>	<u>293,898</u>

(continued)

Notes to Consolidated Financial Statements

Note 4 - Loans *(concluded)*

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

	<u>2009</u>	<u>2008</u>
Balance at beginning of year	\$4,217	\$3,814
Provision for credit losses	1,149	729
Charge-offs	(477)	(588)
Recoveries	<u>294</u>	<u>262</u>
Net charge-offs	<u>(183)</u>	<u>(326)</u>
Balance at end of year	<u>\$5,183</u>	<u>\$4,217</u>

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

	<u>2009</u>	<u>2008</u>
December 31		
Impaired loans without a valuation allowance	\$1,978	\$1,217
Impaired loans with a valuation allowance	<u>0</u>	<u>603</u>
Total impaired loans	<u>\$1,978</u>	<u>\$1,820</u>
Valuation allowance related to impaired loans	<u>\$0</u>	<u>\$64</u>
Years Ended December 31		
Average investment in impaired loans	\$2,448	\$1,520
Interest income recognized on a cash basis on impaired loans	0	0
Total nonaccrual loans	1,978	1,217

At December 31, 2009, 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 \$775,055 and \$191,892 at December 31, 2009 and 2008, 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 2009 and 2008. Total loans outstanding at December 31, 2009 and 2008, to key officers and directors were \$6,246,098 and \$6,030,627, respectively. During 2009 loan advances totaled \$15,003,198 and loan repayments totaled \$14,787,727 on these loans. During 2008 loan advances totaled \$6,411,437 and loan repayments totaled \$8,138,421.

Notes to Consolidated Financial Statements

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 \$50,660,936 and \$21,708,879 at December 31, 2009 and 2008, respectively.

Note 6 - Premises and Equipment

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

	<u>2009</u>	<u>2008</u>
Land	\$ 2,023	\$ 1,798
Buildings	17,413	16,028
Furniture and equipment	<u>5,132</u>	<u>6,025</u>
	24,568	23,851
Less accumulated depreciation and amortization	<u>9,119</u>	<u>9,606</u>
Total premises and equipment	<u>15,449</u>	<u>14,245</u>

The total depreciation expense for years ending December 31, 2009 and 2008 was \$691,000 and \$787,000, respectively.

The Bank leases premises and equipment under various operating leases expiring through 2010. Rental expense of leased premises and equipment totaled \$129,000 and \$137,000 in 2009 and 2008, respectively, which are included in occupancy and furniture and equipment expense.

There were no minimum net rental commitments under noncancellable leases having a remaining term of more than one year.

Notes to Consolidated Financial Statements

Note 7 – Deposits

The aggregate amount of certificates of deposit with balances of \$100,000 or more was approximately \$36,664,000 and \$33,553,000 at December 31, 2009 and 2008, respectively. Included in time deposits at December 31, 2009, are approximately \$26,530,000 of time deposits in denominations of more than \$100,000 but less than or equal to \$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):

2010	\$ 79,031
2011	14,570
2012	4,945
2013	3,020
2014	<u>3,491</u>
Total	<u>\$105,057</u>

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 \$1,401,000 and \$1,813,000 for years ending December 31, 2009 and 2008, 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>2009</u>	<u>2008</u>
Average balance during the year	\$18,755	\$10,922
Average interest rate during the year	1.44%	2.36%
Maximum month-end balance during the year	\$21,959	\$14,627
Balance outstanding at year-end	\$16,473	\$13,836
Average interest rate at year-end	1.37%	1.73%

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. There is no hour of service accrual requirement if employed on the last day of the plan year, the employee dies, becomes disabled, or attains the plan's normal retirement age. Total employer contribution expenses were \$953,000 and \$912,000 for 2009 and 2008, respectively.

(continued)

Notes to Consolidated Financial Statements

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 \$499,460 and \$406,713 at December 31, 2009 and 2008, respectively. The expense to the Company for this plan is \$ 0 and \$1,968 for the 2009 and 2008 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, 2009, the Company awarded 3,488 shares of restricted stock with a fair market value of \$58.00 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 \$204,000 and \$174,000 for the years ended December 31, 2009 and 2008, respectively. The tax benefit recognized on this compensation was \$63,000 and \$49,000 for the years ending December 31, 2009 and 2008, respectively.

As of December 31, 2009, shares remaining in reserve for issuance under the plan were 68,793. Subsequent to December 31, 2009, additional shares of restricted stock have not been awarded.

The following summarizes activity under the restricted stock plan for the year December 31, 2009:

	<u>Shares</u>	<u>Aggregate Intrinsic Value</u>	<u>Weighted Average Grant Date Fair Value</u>
Restricted stock grants unvested at December 31, 2007	12,108	\$751,000	\$52.15
Granted	3,150		60.00
Vested from retirement	<u>578</u>		<u>51.52</u>
Restricted stock grants unvested at December 31, 2008	14,680	\$866,120	\$53.86
Granted	3,488		\$58.00
Vested from retirement	<u>325</u>		<u>54.62</u>
Restricted stock grants unvested at December 31, 2009	17,843	\$1,124,109	\$54.66

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>2009</u>	<u>2008</u>
Current tax expense (benefit)		
Federal	\$2,122	\$1,792
State	43	35
Total Current Tax Expense (benefit)	2,165	1,827
Deferred tax expense (benefit)		
Federal	(428)	(268)
State	(8)	(24)
Total Deferred Tax Expense (benefit)	(436)	(292)
Total Tax Expense	<u>\$1,729</u>	<u>\$1,535</u>

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

	<u>2009</u>		<u>2008</u>	
	<u>Amount</u>	<u>Percent of Pretax Income</u>	<u>Amount</u>	<u>Percent of Pretax Income</u>
Income tax at statutory rates	\$2,226	34.0%	\$2,009	34.0%
Increase (decrease) resulting from:				
Tax-exempt income	(647)	(9.5)	(511)	(8.5)
Other	150	2.5	37	(0.5)
Total Tax Expense	<u>\$1,729</u>	<u>27%</u>	<u>\$1,535</u>	<u>26%</u>

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

	<u>2009</u>	<u>2008</u>
Deferred Tax Assets		
Allowance for credit losses	\$ 1,234	\$ 834
Deferred compensation	120	86
Other	275	264
Non-accrual interest	71	39
Stock-based compensation on restricted stock	190	137
Total deferred tax assets	<u>1,890</u>	<u>1,360</u>
Deferred Tax Liabilities		
Accumulated depreciation and amortization	(495)	(479)
Deferred income	(731)	(705)
Difference between financial versus tax basis of bonds purchased	(15)	(13)
Unrealized gain on securities available for sale	(372)	(182)
Prepaid expenses	(101)	(88)
Other	(37)	0
Total deferred tax liabilities	<u>(1,751)</u>	<u>(1,467)</u>
Net deferred tax assets (liabilities)	<u>\$ 139</u>	<u>(\$ 107)</u>

(continued)

Notes to Consolidated Financial Statements

Note 10 - Income Taxes *(concluded)*

The Bank files income tax returns in the U.S. federal jurisdiction and Oregon. The Company is no longer subject to U.S. federal, state, and local tax authorities for years before 2006. The Company does not have any uncertain tax positions. As of December 31, 2009, there is no accrued interest or penalties recorded in the financial statements.

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>2009</u>	<u>2008</u>
Commitments to extend credit	\$85,485	\$75,996
Standby letters of credit	\$857	\$451

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 are 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 were used at December 31, 2009, and 2008. In addition the Bank has a credit line with the Federal Home Loan Bank (FHLB) of Seattle totaling 20 percent of assets dependent upon additional capital stock purchases; currently the Bank has \$69,700,000 market value of loans pledged with FHLB with a borrowing capacity of \$58,000,000, of which \$4,200,000 was drawn on at December 31, 2009. 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, and two putable advances totaling \$2,000,000 at 4.74% that mature in July 2012.

(continued)

Notes to Consolidated Financial Statements

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 political debt 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.

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, 2009, 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, 2009, 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		Capital Adequacy		To be Well	
	Amount	Ratio	Purposes	Ratio	Capitalized	Under Prompt
			Amount		Corrective Action	Provisions
					Amount	Ratio
December 31, 2009						
<i>Tier 1 capital (to average assets):</i>						
Company	\$36,762	8.3%	\$17,730	4.0%	N/A	N/A
Bank	36,185	8.2	17,730	4.0	\$22,163	5.0%
<i>Tier 1 capital (to risk-weighted assets):</i>						
Company	36,762	10.4	14,094	4.0	N/A	N/A
Bank	36,185	10.3	14,094	4.0	21,140	6.0
<i>Total capital (to risk-weighted assets):</i>						
Company	41,035	11.7	28,187	8.0	N/A	N/A
Bank	40,459	11.5	28,187	8.0	35,234	10.0
December 31, 2008						
<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

Notes to Consolidated Financial Statements

Note 14 - Condensed Financial Information - Parent Company Only

Condensed Balance Sheets

Dollars in Thousands

December 31,	<u>2009</u>	<u>2008</u>
Assets		
Cash	\$ 174	\$ 178
Investment in Bank	36,912	35,008
Other assets	<u>402</u>	<u>431</u>
Total Assets	<u>\$37,488</u>	<u>\$35,617</u>
Liabilities	\$ 0	\$ 0
Shareholders' Equity	<u>37,488</u>	<u>35,617</u>
Total Liabilities and Shareholders' Equity	<u>\$37,488</u>	<u>\$35,617</u>

(continued)

Notes to Consolidated Financial Statements

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

Condensed Statements of Income

Dollars in Thousands

December 31,	<u>2009</u>	<u>2008</u>
Dividend Income from the Bank	\$3,350	\$4,000
Expenses	<u>94</u>	<u>96</u>
Income before income taxes and equity in undistributed income of the Bank	3,256	3,904
Income Tax Benefit	<u>32</u>	<u>33</u>
Income before undistributed income of the Bank	3,288	3,937
Equity in Undistributed Income of the Bank	<u>1,531</u>	<u>470</u>
Net Income	<u>\$4,819</u>	<u>\$4,407</u>

Condensed Statements of Cash Flows

Dollars in Thousands

December 31,	<u>2009</u>	<u>2008</u>
Cash Flows from Operating Activities		
Net income	\$4,819	\$4,407
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed income of the Bank	(1,531)	(470)
Excess tax benefits from vesting of restricted stock	0	(5)
Restricted stock compensation	204	174
Stock Incentive Plan	62	63
Other - net	<u>28</u>	<u>(88)</u>
Net cash provided by operating activities	3,582	4,081
Cash Flows from Financing Activities		
Cash dividends paid	(3,586)	(3,709)
Excess tax benefits from vesting of restricted stock	0	5
Repurchase of common stock	<u>0</u>	<u>(349)</u>
Net cash used in financing activities	(3,586)	(4,053)
Increase (decrease) in cash	(4)	28
Cash		
Beginning of year	<u>178</u>	<u>150</u>
End of year	<u>\$ 174</u>	<u>\$ 178</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):

	2009		2008	
	Carrying Amounts	Fair Value	Carrying Amounts	Fair Value
Financial Assets				
Cash and cash equivalents	\$71,193	\$71,193	\$ 68,546	\$ 68,546
Securities available for sale	49,521	49,521	33,191	33,191
Securities held to maturity	12,739	13,191	15,007	15,285
Other Investments	1,894	1,894	1,880	1,880
Loans receivable, net	292,894	293,095	289,681	289,762
Accrued interest receivable	2,247	2,247	2,527	2,527
Financial Liabilities				
Deposits	390,026	389,262	\$369,846	\$368,981
Federal funds purchased and security repurchase agreements	16,473	16,473	13,836	13,836
Other borrowed funds	4,200	2,985	6,200	5,045
Accrued interest payable	317	317	419	419

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.

ASC 820-10, *Fair Value Measurements and Disclosures*, 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. It 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:

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)
December 31, 2009				
Assets Measured at Fair Value on a Recurring Basis				
Securities available-for-sale				
U.S. Government and agency securities	\$11,001	\$0	\$11,001	\$0
State and political debt securities	38,427	0	38,427	0
Equity securities	93	93	0	0
Total	\$49,521	\$93	\$49,428	\$0
Assets Measured at Fair Value on a Nonrecurring Basis				
Impaired loans	\$272	0	0	\$272
December 31, 2008				
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, 2009 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. There were no impaired loans at risk of non-collection at December 31, 2009. This would be included as a part of the allowance for loan losses as a component of the category "Analyzed Impairment."

Notes to Consolidated Financial Statements

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>2009</u>	<u>2008</u>
Unrealized holding gains on available-for-sale		
Securities	\$563	\$342
Reclassification adjustment for gains (losses)		
realized in income	<u>0</u>	<u>(1)</u>
Net unrealized gains	563	341
Tax effect	<u>(190)</u>	<u>(116)</u>
Net-of-tax amount	<u>\$373</u>	<u>\$225</u>