



**SIUSLAW**

**FINANCIAL  
GROUP**

**2009  
ANNUAL REPORT**



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# REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Stockholders  
of Siuslaw Financial Group, Inc.

We have audited the accompanying consolidated balance sheet of Siuslaw Financial Group, Inc. and its subsidiary, Siuslaw Bank (collectively, "the Company"), as of December 31, 2009, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The consolidated financial statements of the Company as of and for the year ended December 31, 2008, were audited by Symonds, Evans & Company, P.C., who merged with Delap LLP as of June 1, 2009, and whose report dated April 10, 2009, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2009 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Siuslaw Financial Group, Inc. and its subsidiary as of December 31, 2009, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States.

DELAP LLP

Lake Oswego, Oregon  
April 6, 2010

# CONSOLIDATED BALANCE SHEETS

<b>Assets</b>	<i>December 31,</i>	
	<u>2009</u>	<u>2008</u>
Cash and cash equivalents:		
Cash and due from banks	\$ 6,552,881	\$ 5,268,753
Interest-bearing demand deposit with Federal Home Loan Bank	2,292	3,889
Federal funds sold	<u>10,610,000</u>	<u>280,000</u>
Total cash and cash equivalents	17,165,173	5,552,642
Interest-bearing time deposits	9,000,000	1,000,000
Investment securities available-for-sale	18,210,762	27,005,798
Federal Home Loan Bank stock	654,800	654,800
Loans, net	218,098,882	220,051,340
Mortgage loans held for sale	1,580,736	995,011
Premises and equipment, net	6,246,320	6,464,164
Bank-owned life insurance	5,893,724	5,609,710
Accrued interest receivable and other assets	<u>7,368,660</u>	<u>5,922,434</u>
Total assets	<u>\$ 284,219,057</u>	<u>\$ 273,255,899</u>
 <b>Liabilities and Stockholders' Equity</b>		
Liabilities:		
Deposits:		
Demand	\$ 37,287,029	\$ 33,028,851
NOW and money market	129,161,787	112,009,455
Savings	25,687,476	23,485,121
Time	<u>44,458,866</u>	<u>52,172,052</u>
Total deposits	236,595,158	220,695,479
Short-term borrowings	6,000,000	12,500,000
Junior subordinated debentures	8,248,000	8,248,000
Accrued interest payable and other liabilities	<u>3,633,871</u>	<u>3,267,179</u>
Total liabilities	254,477,029	244,710,658
Stockholders' equity:		
Series A preferred stock, \$1 par value; 200,000 shares authorized; 107,050 shares issued and outstanding (108,324 in 2008)	107,050	108,324
Common stock, \$1 par value; 10,000,000 shares authorized; 4,017,539 shares issued and outstanding (4,031,639 in 2008)	4,017,539	4,031,639
Surplus	7,749,178	7,779,926
Retained earnings	17,427,742	16,246,275
Accumulated other comprehensive income	<u>440,519</u>	<u>379,077</u>
Total stockholders' equity	<u>29,742,028</u>	<u>28,545,241</u>
Total liabilities and stockholders' equity	<u>\$ 284,219,057</u>	<u>\$ 273,255,899</u>

See accompanying notes.

# CONSOLIDATED STATEMENTS OF INCOME

	<i>Years ended December 31,</i>	
	<u>2009</u>	<u>2008</u>
Interest and dividend income:		
Interest and fees on loans	\$ 15,242,239	\$ 15,471,672
Taxable interest on investment securities available-for-sale	879,678	1,363,361
Nontaxable interest on investment securities available-for-sale	203,620	181,244
Interest on federal funds sold	35,864	67,356
Interest on deposits with Federal Home Loan Bank	21,250	56,162
Dividends on Federal Home Loan Bank stock	-	6,521
	<hr/>	<hr/>
Total interest and dividend income	16,382,651	17,146,316
Interest expense:		
Deposits	2,225,291	3,429,092
Junior subordinated debentures	306,660	497,496
Short-term borrowings	129,372	237,434
	<hr/>	<hr/>
Total interest expense	2,661,323	4,164,022
Net interest income	13,721,328	12,982,294
Loan loss provision	<hr/>	<hr/>
	1,600,000	250,000
Net interest income after loan loss provision	12,121,328	12,732,294
Noninterest income:		
Mortgage loan servicing fees, net	1,376,485	1,253,074
Service charges on deposit accounts	622,130	634,374
Mortgage loan origination and processing fees, net	471,871	257,174
Credit card merchant fees, net	448,460	541,089
Interchange, ATM and associated fees	344,756	297,215
Earnings on bank-owned life insurance policies	282,188	232,989
Other	499,484	187,875
	<hr/>	<hr/>
Total noninterest income, net	4,045,374	3,403,790
Noninterest expenses:		
Salaries and employee benefits	7,270,384	6,519,893
Occupancy, net	824,637	850,265
Regulatory insurance and assessments	467,460	105,747
Communications	388,727	397,401
Other real estate owned	347,059	44,645
Data processing	274,484	279,011
Other	1,564,985	1,680,335
	<hr/>	<hr/>
Total noninterest expenses, net	11,137,736	9,877,297
Income before income taxes	5,028,966	6,258,787
Provision for income taxes	<hr/>	<hr/>
	1,690,000	2,193,000
Net income	<hr/>	<hr/>
	\$ 3,338,966	\$ 4,065,787
Basic earnings per common share	<hr/>	<hr/>
	\$ 0.81	\$ 0.98

See accompanying notes.

# CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	<i>Series A</i>		<i>Common Stock</i>	
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>
Balances at December 31, 2007	109,518	\$ 109,518	4,041,630	\$ 4,041,630
Change in accounting for split-dollar life insurance arrangements (net of income taxes of approximately \$87,000) (Note 1)	-	-	-	-
Comprehensive income:				
Net income	-	-	-	-
Other comprehensive income – unrealized gains on investment securities available-for-sale (net of income taxes of approximately \$65,000)	-	-	-	-
Total comprehensive income	-	-	-	-
Stock reclassification (Note 1)	1,021	1,021	(1,021)	(1,021)
Repurchases of Series A preferred stock	(2,215)	(2,215)	-	-
Repurchases of common stock	-	-	(8,970)	(8,970)
Cash dividends paid:				
Common (\$.80 per share)	-	-	-	-
Preferred (\$.84 per share)	-	-	-	-
Balances at December 31, 2008	108,324	108,324	4,031,639	4,031,639
Comprehensive income:				
Net income	-	-	-	-
Other comprehensive income – unrealized gains on investment securities available-for-sale (net of income taxes of approximately \$38,000)	-	-	-	-
Total comprehensive income	-	-	-	-
Repurchases of Series A preferred stock	(1,274)	(1,274)	-	-
Repurchases of common stock	-	-	(14,100)	(14,100)
Cash dividends paid:				
Common (\$.50 per share)	-	-	-	-
Preferred (\$.53 per share)	-	-	-	-
Balances at December 31, 2009	107,050	\$ 107,050	4,017,539	\$ 4,017,539

See accompanying notes.

	<i>Surplus</i>	<i>Retained earnings</i>	<i>Comprehensive income</i>	<i>Accumulated other comprehensive income</i>	<i>Total stockholders' equity</i>
\$	7,802,296	\$ 15,739,310		\$ 274,149	\$ 27,966,903
	-	(139,418)		-	(139,418)
	-	4,065,787	\$ 4,065,787	-	4,065,787
	-	-	<u>104,928</u>	104,928	104,928
	-	-	<u>\$ 4,170,715</u>	-	-
	-	-		-	-
	(4,430)	(19,621)		-	(26,266)
	(17,940)	(78,210)		-	(105,120)
	-	(3,229,792)		-	(3,229,792)
	-	(91,781)		-	(91,781)
	<u>7,779,926</u>	<u>16,246,275</u>		<u>379,077</u>	<u>28,545,241</u>
	-	3,338,966	\$ 3,338,966	-	3,338,966
	-	-	<u>61,442</u>	61,442	61,442
	-	-	<u>\$ 3,400,408</u>	-	-
	(2,548)	(6,845)		-	(10,667)
	(28,200)	(79,602)		-	(121,902)
	-	(2,014,165)		-	(2,014,165)
	-	(56,887)		-	(56,887)
<u>\$</u>	<u>7,749,178</u>	<u>\$ 17,427,742</u>		<u>\$ 440,519</u>	<u>\$ 29,742,028</u>

# CONSOLIDATED STATEMENTS OF CASH FLOWS

	<i>Years ended December 31,</i>	
	<u>2009</u>	<u>2008</u>
Cash flows from operating activities:		
Net income	\$ 3,338,966	\$ 4,065,787
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,044,278	1,025,741
Gain on sale of land and building	(121,345)	-
Losses (gains) on sales of mortgage loans held for sale, net	(253,693)	45,956
Loan loss provision	1,600,000	250,000
Losses on sales of other real estate	177,585	-
Credit for deferred income taxes	(551,000)	(514,000)
Amortization of net premiums on investment securities available-for-sale	17,484	48,319
Decrease (increase) in accrued interest receivable and other assets	(1,590,933)	36,021
Increase in accrued interest payable and other liabilities	328,713	218,410
Originations of mortgage loans held for sale	(44,256,384)	(40,816,708)
Proceeds from sales of mortgage loans held for sale	43,924,352	47,877,514
Net cash provided by operating activities	3,658,023	12,237,040
Cash flows from investing activities:		
Increase in interest-bearing time deposits	(8,000,000)	-
Purchases of investment securities available-for-sale	(785,000)	(1,250,000)
Proceeds from maturities, calls, and prepayments of investment securities available-for-sale	9,661,973	7,582,010
Purchases of mortgage servicing rights	(40,484)	(196,989)
Net increase in other loans	(141,451)	(19,375,481)
Purchases of premises and equipment, net	(73,676)	(293,127)
Proceeds from sales of other real estate	421,102	-
Purchases of bank-owned life insurance	(284,014)	(214,054)
Net cash provided by (used in) investing activities	758,450	(13,747,641)
Cash flows from financing activities:		
Net increase in deposits	15,899,679	2,040,383
Net increase (decrease) in short-term borrowings	(6,500,000)	500,000
Repurchases of common and preferred stock	(132,569)	(131,386)
Cash dividends paid	(2,071,052)	(3,321,573)
Net cash provided by (used in) financing activities	7,196,058	(912,576)
Net increase (decrease) in cash and cash equivalents	11,612,531	(2,423,177)
Cash and cash equivalents at beginning of year	5,552,642	7,975,819
Cash and cash equivalents at end of year	<u>\$ 17,165,173</u>	<u>\$ 5,552,642</u>

See accompanying notes.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies

### *Basis of Presentation*

The accompanying consolidated financial statements include the accounts of Siuslaw Financial Group, Inc. (SFG), a bank holding company, and its wholly-owned subsidiary, Siuslaw Bank (the Bank) (collectively, "the Company"). All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company has also established a subsidiary grantor trust in connection with the issuance of trust preferred securities (see Note 9). In accordance with accounting principles generally accepted in the United States (GAAP), the accounts and transactions of this trust are not included in the accompanying consolidated financial statements.

Certain amounts in 2008 have been reclassified to conform with the 2009 presentation.

### *Description of Business*

The Bank conducts a general banking business in the Lane County, Oregon area and primarily operates in one business segment. Its activities include the usual lending and deposit functions of a commercial bank: commercial, real estate, installment, credit card, and mortgage loans; checking, money market, savings, and time deposit accounts; Internet banking and bill payment; automated teller machines; collection and escrow services; and safe deposit facilities. The Bank also originates and sells mortgage loans into the secondary market and provided insurance premium financing through December 2009.

### *Method of Accounting*

The Company prepares its consolidated financial statements in conformity with GAAP and prevailing practices within the banking industry. The Company utilizes the accrual method of accounting which recognizes income and gains when earned and expenses and losses when incurred. The preparation of consolidated financial statements in conformity with GAAP requires management of the Company (Management) to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities as of the date of the consolidated balance sheet, and the reported amounts of income, gains, expenses, and losses during the reporting period. Actual results could differ from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the reserve for loan losses (see Note 5).

### *Subsequent events*

Management has evaluated, for potential recognition or disclosure in the financial statements, subsequent events that have occurred through April 6, 2010, which is the date that the financial statements were available to be issued.

### *Cash and Cash Equivalents*

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks (including cash items in the process of collection), an interest-bearing demand deposit with the Federal Home Loan Bank of Seattle (FHLB), and federal funds sold. Generally, interest-bearing deposits in banks are invested for a maximum of 90 days. Federal funds are generally sold for one-day periods.

The Bank maintains balances in correspondent bank accounts which, at times, may exceed federally insured limits. In addition, federal funds sold are essentially uncollateralized loans to other financial institutions. Management believes that its risk of loss associated with such balances is minimal due to the financial strength of the correspondent banks and counterparty financial institutions. The Bank has not experienced any losses in such accounts.

### *Supplemental Disclosures of Cash Flow Information*

Non-cash transactions resulted from unrealized gains and losses on investment securities available-for-sale, net of income taxes and the 2008 reclassification of common stock to Series A preferred stock, as disclosed in the accompanying consolidated statements of changes in stockholders' equity. In addition, non-cash investing activities resulted from the net capitalization of approximately \$37,000 and \$78,000 in originated mortgage servicing rights during 2009 and 2008, respectively, and the transfer of approximately \$494,000 and \$795,000 of loans to other real estate owned (OREO) in 2009 and 2008, respectively.

During 2009 and 2008, the Company paid approximately \$2,738,000 and \$4,235,000, respectively, in interest expense.

During 2009 and 2008, the Company made income tax payments of approximately \$2,229,000 and \$2,537,000, respectively.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

### *Investment Securities*

Investment securities that Management has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and are reported at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized in interest income using the interest method over the period to maturity. The Company had no held-to-maturity securities during 2009 or 2008.

Investment securities that are purchased and held principally for the purpose of selling them in the near term are classified as trading securities and are reported at fair value, with unrealized gains and losses included in noninterest income. The Company had no trading securities during 2009 or 2008.

Investment securities that are not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and are reported at fair value, with unrealized gains and losses excluded from earnings and reported as other comprehensive income or loss, net of income taxes. The fair value of available-for-sale securities is based on prices for similar securities or on model-based techniques in which all significant inputs are observable.

Management determines the appropriate classification of securities at the time of purchase.

Gains and losses on sales of available-for-sale securities – which are determined using the specific-identification method – are included in earnings. Amortization of premiums and accretion of discounts on available-for-sale securities are recognized in interest income using the interest method, generally over the expected period to maturity. Premiums and discounts on mortgage-backed securities are amortized/accreted using the interest method over a period that anticipates prepayment of principal.

Declines in the fair value of individual available-for-sale securities below their cost that are deemed to be other-than-temporary would result in write-downs of the individual securities to their fair value. In estimating other-than-temporary impairment losses, Management considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near term prospects of the issuer, and (iii) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery of fair value. The related write-downs would be included in earnings as realized losses. Management believes that all unrealized losses on individual investment securities at December 31, 2009 and 2008 are temporary (see Note 3).

### *FHLB Stock*

As a member of the Federal Home Loan Bank system (the FHLB system), the Bank is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding mortgages, total assets, or FHLB advances. At December 31, 2009 and 2008, the Bank met its minimum required investment. The Bank may request redemption at par value of any FHLB stock in excess of the minimum required investment; however, stock redemptions are at the discretion of the FHLB.

The Bank's investment in FHLB stock – which has limited marketability – is carried at cost, which approximates fair value. GAAP provides that, for impairment testing purposes, the value of long-term investments such as FHLB stock is based on the "ultimate recoverability" of the par value of the security without regard to temporary declines in value. The determination of whether a decline affects the ultimate recovery is influenced by criteria such as: 1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and length of time a decline has persisted; 2) the impact of legislative and regulatory changes on the FHLB; and 3) the liquidity position of the FHLB. The FHLB of Seattle is one of twelve member banks of the entire FHLB system, which has significant borrowing capacity through the U.S. Department of the Treasury. The twelve member banks are, individually and collectively, liable for the debts of all members. This joint and several liability strengthens the overall position of the individual member banks. As of December 31, 2009, the FHLB reported that it had met all of its regulatory capital requirements, but remained classified as "undercapitalized" by its regulator. The FHLB will not repurchase capital stock or pay a dividend while it is classified as undercapitalized. The FHLB has noted that its primary concern with meeting its risk-based capital requirements relates to the potential impact of other-than-temporary-impairment charges that they may be required to record on their private label mortgage-backed securities. While the FHLB was undercapitalized as of December 31, 2009, the Company does not believe that its investment in FHLB stock is impaired. However, this estimate could change if: 1) significant other-than-temporary losses are incurred on the FHLB's mortgage-backed securities causing a significant decline in its regulatory capital status; 2) the economic losses resulting from credit deterioration on the FHLB's mortgage-backed securities increases significantly; or 3) capital preservation strategies being utilized by the FHLB become ineffective.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

### *Loans*

Loans that Management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are stated at the amount of unpaid principal, reduced by the reserve for loan losses and deferred loan fees.

Interest income on all loans is accrued as earned on the simple interest method. The accrual of interest on loans is discontinued when, in Management's opinion, the borrower may be unable to make payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all principal and interest payments contractually due are brought current and, in Management's opinion, future payments are reasonably assured.

Loan origination and commitment fees, net of certain direct loan origination costs, are deferred and generally recognized as an adjustment of the yield of the related loan.

### *Reserve for Loan Losses*

The reserve for loan losses represents Management's recognition of the assumed risks of extending credit and the quality of the existing loan portfolio. The reserve is established to absorb Management's best estimate of known and inherent losses in the loan portfolio as of the balance sheet date. The reserve requires complex subjective judgments as a result of the need to make estimates about matters that are uncertain. The reserve is maintained at a level considered adequate to provide for potential loan losses based on Management's assessment of various factors affecting the portfolio. Such factors include historical loss experience; review of problem loans; underlying collateral values and guaranties; current economic conditions; and an overall evaluation of the quality, risk characteristics, and concentration of loans in the portfolio. The Bank's methodology for assessing the appropriate level of the reserve for loan losses generally consists of applying loss factors to outstanding loan balances segregated by differing risk categories. Loss factors are derived from Management's understanding of the Bank's current loan portfolio and estimates based on historical and industry experience.

The unallocated portion of the reserve is based upon management's evaluation of various factors that are not directly measured in the determination of the allocated and specific reserves. Such factors include uncertainties in economic conditions, uncertainties in identifying triggering events that directly correlate to subsequent loss rates, internal and external risk factors that have not yet manifested themselves in loss allocation factors and historical loss experience data that may not precisely correspond to the current portfolio. Also, loss data representing a complete economic cycle is not available for all sections of the loan portfolio. Accordingly, the unallocated reserve helps to minimize the risk related to the margin of imprecision inherent in the estimation of allocated loan losses. Due to the subjectivity involved in the determination of the unallocated portion of the reserve for loan losses, the relationship of the unallocated component to the total reserve for loan losses may fluctuate from period to period.

The reserve is based on estimates, and ultimate losses may vary from the current estimates. These estimates are reviewed periodically, and, as adjustments become necessary, they are reported in earnings in the periods in which they become known. The reserve is increased by provisions charged to operations and reduced by loans charged-off, net of recoveries.

The Bank considers loans to be impaired when Management believes that it is probable that all amounts due will not be collected according to the contractual terms. An impaired loan must be valued using the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of the loan's underlying collateral or related guaranty. The Bank primarily measures impairment on all large balance nonaccrual loans (typically commercial and commercial real estate loans) based on the estimated fair value of the underlying collateral. In certain other cases, impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. Amounts deemed impaired are either specifically allocated for in the reserve for loan losses or reflected as a partial charge-off of the loan balance. Smaller balance homogeneous loans (typically installment loans) are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual installment loans for impairment disclosure. Generally, the Bank evaluates a loan for impairment when it is placed on nonaccrual status.

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

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

### *Reserve for Unfunded Loan Commitments*

The Bank maintains a separate reserve for estimated losses related to unfunded loan commitments. Management estimates the amount of probable losses related to unfunded loan commitments by applying loss factors to an estimate of the expected amount of funding of these loan commitments. The reserve for unfunded loan commitments totaled approximately \$44,000 and \$94,000 at December 31, 2009 and 2008, respectively. In accordance with industry practice and regulatory guidance, the reserve for estimated losses related to unfunded loan commitments is included in accrued interest payable and other liabilities in the accompanying consolidated balance sheets. Increases (decreases) in the reserve for estimated losses related to unfunded loan commitments are recorded in other noninterest expenses in the accompanying consolidated statements of income.

### *Mortgage Loans and Mortgage Servicing Rights*

Mortgage loans originated and intended for sale in the secondary market are reported as mortgage loans held for sale and are carried at the lower of cost or estimated market value. Market value is determined on an aggregate loan basis. At December 31, 2009 and 2008, mortgage loans held for sale were carried at cost, which approximated estimated market value.

At December 31, 2009 and 2008, the Bank held servicing rights to approximately \$360,092,000 and \$363,143,000, respectively, in mortgage loans which have been sold into the secondary market. The balances of these sold loans are not included in the accompanying consolidated balance sheets. The carrying value of mortgage servicing rights is the original estimated value of the originated mortgage servicing rights or the cost of purchased mortgage servicing rights, net of subsequent amortization, write-offs due to prepayments, or other write-downs or valuation allowances due to impairment.

During the years ended December 31, 2009 and 2008, the Bank capitalized approximately \$388,000 and \$233,000, respectively, in originated mortgage servicing rights. The originated mortgage servicing rights are measured by allocating the carrying value of loans between the assets sold and interest retained, based upon the relative estimated fair value at the date of sale. In addition, during the years ended December 31, 2009 and 2008, the Bank purchased mortgage servicing rights from third-parties totaling approximately \$41,000 and \$197,000, respectively. The capitalized mortgage servicing rights (CMSRs) are being amortized in proportion to, and over the period of, estimated net servicing income. During the years ended December 31, 2009 and 2008, the amortization of CMSRs totaled approximately \$492,000 and \$432,000, respectively.

The Bank analyzes its CMSRs by underlying loan type and interest rate (primarily fixed and adjustable). The estimated fair value of CMSRs is obtained through an independent third-party valuation, utilizing future cash flows which incorporate numerous assumptions including servicing income, servicing costs, market discount rates, prepayment speeds, default rates, and other market-driven data. Accordingly, changes in such assumptions could significantly affect the estimated fair values of the CMSRs. GAAP requires that, in the event that the estimated fair value of CMSRs falls below the Company's carrying value, the Company would record an impairment loss. To mitigate this risk, Management amortizes CMSRs over their expected life and fully amortizes CMSRs that are specifically associated with any serviced mortgage loans that are paid-off. The Company does not employ specific hedges to mitigate fair value changes that may occur due to market fluctuations. There can be no assurance regarding the possible impairment of CMSRs in future periods. The estimated fair value of CMSRs was approximately \$3,911,000 and \$3,941,000 as of December 31, 2009 and 2008, respectively. The net amount of CMSRs at December 31, 2009 and 2008 (approximately \$986,000 and \$1,049,000, respectively) is included in accrued interest receivable and other assets in the accompanying consolidated balance sheets.

### *Premises and Equipment*

Premises and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization on premises and equipment is computed using straight-line and accelerated methods over the shorter of the estimated useful lives of the assets or terms of the related leases. Amortization of leasehold improvements is included in depreciation and amortization expense in the accompanying consolidated financial statements. Gains or losses on dispositions are reflected in earnings as incurred.

Assets are reviewed for impairment when events indicate that their carrying value may not be recoverable. If Management determines that impairment exists, the assets are reduced with an offsetting charge to expense.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

### *Bank-owned Life Insurance (BOLI)*

The Company has purchased BOLI on certain executives. The BOLI is recorded at fair value, which is based on the cash surrender value (net of surrender charges) of the underlying insurance contracts. Changes in the cash surrender value of the BOLI are included in noninterest income in the accompanying consolidated statements of income.

### *OREO*

OREO, acquired through foreclosure or deeds in lieu of foreclosure, is carried at the lower of cost or estimated net realizable value. When the property is acquired, any excess of the loan balance over the estimated net realizable value is charged to the reserve for loan losses. Holding costs; subsequent write-downs to net realizable value, if any; and any disposition gains or losses are included in noninterest expenses. The valuation of OREO is subjective in nature and may be adjusted in the future because of changes in economic conditions. Management considers third-party appraisals, as well as independent fair market value assessments from realtors or persons involved in selling OREO, in determining the fair value of particular properties. OREO of approximately \$556,000 and \$795,000 at December 31, 2009 and 2008, respectively, is included in accrued interest receivable and other assets in the accompanying consolidated balance sheets.

### *Stockholders' Equity*

In June 2007, the Company's Board of Directors (the Board) filed amended Articles of Incorporation (the Amended Articles) authorizing the issuance of 200,000 shares of Series A preferred stock and a reclassification of common stock into shares of Series A preferred stock. As a result, and subject to certain dissenters' rights, shareholders who held fewer than 2,500 shares of common stock when the Amended Articles were filed received one share of Series A preferred stock for each share of common stock. As a result, 114,288 shares of common stock were reclassified into Series A preferred stock during the year ended December 31, 2007. Reclassification of an additional 1,021 shares was completed during the year ended December 31, 2008.

The Company's Series A preferred stock has a par value of \$1, and holders of Series A preferred stock are entitled to a 5% preference in the distribution of dividends, when and if declared and paid by the Company. Holders of Series A preferred stock do not have any preemptive rights to purchase any additional shares of Series A preferred stock; the Series A preferred stock ranks senior to common stock with respect to dividend rights; and it does not have voting rights except under very limited circumstances.

During the year ended December 31, 2009, the Company repurchased 14,100 shares of common stock for \$121,902 and 1,274 shares of Series A preferred stock for \$10,667. During the year ended December 31, 2008, the Company repurchased 8,970 shares of common stock for \$105,120 and 2,215 shares of Series A preferred stock for \$26,266.

The Company's earnings per common share is computed by dividing net income, less preferred stock dividends declared and undistributed earnings allocable to the participating preferred shares (\$91,463 and \$112,248 for the years ended December 31, 2009 and 2008, respectively), by the weighted average number of common shares outstanding during the period. The weighted average number of common shares outstanding used to compute basic earnings per common share was 4,026,352 and 4,037,421 in 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 (i) the assets have been isolated from the Company, (ii) 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 (iii) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

### *Advertising*

Advertising costs are generally charged to expense during the year in which they are incurred. Advertising costs charged to expense were approximately \$95,000 and \$103,000 during the years ended December 31, 2009 and 2008, respectively.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

### *Income Taxes*

The provision (credit) for income taxes is based on income and expenses as reported for financial statement purposes using the “asset and liability method” for accounting for deferred taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. 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 (credit) for income taxes.

### *New Accounting Pronouncements*

Effective for reporting periods ending after September 15, 2009, the Financial Accounting Standards Board’s (FASB’s) *Accounting Standards Codification* (the ASC) became the FASB’s single source of authoritative GAAP for all public and non-public non-governmental entities. While the ASC does not change GAAP, all existing authoritative accounting literature, with certain exceptions, was superseded by and incorporated into the ASC. Accordingly, all references to specific GAAP literature in the accompanying consolidated financial statements have been modified to reflect this change. Subsequent changes to GAAP will be incorporated into the ASC through the issuance of Accounting Standards Updates (ASUs). The adoption of the ASC did not affect the Company’s consolidated financial condition, results of operations or cash flows.

In July 2006, the FASB clarified the accounting for uncertainty in income taxes, establishing a recognition threshold and measurement for income tax positions recognized in an enterprise’s consolidated financial statements and prescribing a two-step evaluation process for tax positions. The first step is recognition, and the second is measurement. For recognition, an enterprise judgmentally determines whether it is “more-likely-than-not” that a tax position will be sustained upon examination, including resolution of related appeals or litigation processes, based on the technical merits of the position. If the tax position meets the “more-likely-than-not” recognition threshold, it is measured and recognized in the consolidated financial statements. If a tax position does not meet the more-likely-than-not recognition threshold, the benefit of that position is not recognized in the consolidated financial statements. Tax positions that meet the “more-likely-than-not” recognition threshold at the effective date of this guidance may be recognized, or continue to be recognized, upon its adoption. The cumulative effect of applying this guidance shall be reported as an adjustment to the opening balance of retained earnings for that fiscal year. This guidance became effective for nonpublic entities for fiscal years beginning after December 15, 2008, and adoption did not have a significant effect on the Company’s consolidated financial statements.

In September 2006, the FASB ratified earlier guidance related to accounting for deferred compensation and postretirement benefit aspects of endorsement split-dollar life insurance arrangements. This guidance requires that endorsement split-dollar life insurance arrangements which provide a postretirement benefit to an employee be recorded in accordance with either of two alternatives under GAAP, based on the substance of the agreement with the employee. Under the provisions of GAAP, if the employer has effectively agreed to maintain a life insurance policy during the employee’s retirement, the cost of the insurance policy during postretirement periods should be accrued in accordance with either alternative. Similarly, if the employer has effectively agreed to provide the employee with a death benefit, the employer should accrue, over the service period, a liability for the actuarial present value of the future death benefit as of the employee’s expected retirement date, in accordance with either alternative. The Company has endorsement assignment split-dollar life insurance arrangements within the scope of this guidance for certain employees. Accordingly, the Company adopted this guidance effective January 1, 2008, and recorded an increase in other liabilities of approximately \$226,000 and a reduction in retained earnings of approximately \$139,000, net of deferred income taxes.

In December 2007, the FASB issued new accounting guidance related to business combinations, which applies to all transactions and other events in which one entity obtains control over one or more other businesses. This guidance requires that the acquisition method of accounting be used for all business combinations and for the acquirer to be identified for each business combination. The guidance requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of the acquisition date. This guidance also requires an acquirer to recognize assets acquired and liabilities assumed arising from contractual contingencies as of the acquisition date, measured at their acquisition-date fair values. This changes the requirements of previous GAAP which permitted deferred recognition of preacquisition contingencies until certain criteria were met. This guidance also requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed. This guidance became effective for business combination reporting for fiscal years beginning after December 15, 2008. This new standard will change the Company’s accounting treatment for business combinations on a prospective basis for any future business combinations.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

In December 2007, the FASB issued new accounting guidance dealing with noncontrolling interests in consolidated financial statements. This guidance establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This guidance also clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. This guidance requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. Prior to this guidance, net income attributable to the noncontrolling interest generally was reported as an expense in arriving at consolidated net income. Additional disclosures are required as a result of this guidance to clearly identify and distinguish between the interests of the parent's owners and the interests of the noncontrolling owners of a subsidiary. This guidance became effective for fiscal years beginning after December 15, 2008, and adoption did not have a significant effect on the Company's consolidated financial statements.

In April 2009, the FASB issued new authoritative literature to provide additional guidance and enhance disclosures regarding fair value measurements and impairment of securities as follows:

- The first of these standards includes new authoritative accounting guidance which (i) changes existing guidance for determining whether an impairment is other-than-temporary to debt securities and (ii) replaces the existing requirement that the entity's management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not that it will not have to sell the security before recovery of its cost basis. Under this guidance, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses to the extent that the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income or loss. The Company adopted the provisions of the new authoritative accounting guidance during the year ended December 31, 2009, which did not significantly affect the Company's consolidated financial statements.
- The second standard provides additional guidance for estimating fair value when the volume and level of activity for the asset or liability have decreased significantly. The standard also provides guidance on identifying circumstances that indicate a transaction is not orderly. The revised provisions of the standard were effective for the year ended December 31, 2009 and did not have a significant effect on the Company's consolidated financial statements.
- Further new authoritative accounting literature provides guidance for measuring the fair value of a liability in circumstances in which a quoted price in an active market for the identical liability is not available. In such instances, a reporting entity is required to measure fair value utilizing a valuation technique that uses (i) the quoted price of the identical liability when traded as an asset, (ii) quoted prices for similar liabilities or similar liabilities when traded as assets, or (iii) another valuation technique that is consistent with the existing principles, such as an income approach or market approach. The new authoritative accounting guidance also clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. The foregoing new authoritative accounting guidance became effective for the Company's consolidated financial statements for periods ending after October 1, 2009 and did not have a significant effect on the Company's consolidated financial statements.

In May 2009, the FASB issued new authoritative guidance to establish general standards of accounting for – and disclosure of – events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. In particular, this guidance sets forth (i) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements; (ii) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements; and (iii) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. This guidance was effective beginning June 15, 2009 and does not apply to subsequent events or transactions that are within the scope of other applicable GAAP that provide different guidance on the accounting treatment for subsequent events or transactions. The adoption of this guidance as of December 31, 2009 did not have a significant effect on the Company's consolidated financial statements.

In June 2009, the FASB issued new authoritative guidance to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. This guidance eliminates the concept of a "qualifying special-purpose entity" and changes the requirements for derecognizing financial assets. This guidance also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The new authoritative guidance became effective January 1, 2010 and is not expected to have a significant effect on the Company's future consolidated financial statements.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 2. Cash and Due from Banks

By regulation, the Bank must meet reserve requirements as established by the Federal Reserve Bank (FRB). The Bank complies with such requirements by holding cash and maintaining average reserve balances with the FRB in accordance with such regulations. The Bank was not required to maintain an average reserve balance at December 31, 2009 or 2008.

## 3. Investment Securities Available-For-Sale

Investment securities available-for-sale at December 31, 2009 and 2008 consisted of the following:

	<i>Amortized cost</i>	<i>Gross unrealized gains</i>	<i>Gross unrealized losses</i>	<i>Estimated fair value</i>
<u>2009</u>				
Collateralized mortgage obligations	\$ 8,263,309	\$ 221,282	\$ -	\$ 8,484,591
Obligations of state and political subdivisions	6,292,287	303,977	590	6,595,674
U.S. Government and agency securities	2,001,402	78,287	-	2,079,689
Mortgage-backed securities	940,950	109,858	-	1,050,808
	<u>\$ 17,497,948</u>	<u>\$ 713,404</u>	<u>\$ 590</u>	<u>\$ 18,210,762</u>
<u>2008</u>				
Collateralized mortgage obligations	\$ 15,580,981	\$ 206,731	\$ 1,267	\$ 15,786,445
Obligations of state and political subdivisions	5,605,812	189,345	-	5,795,157
U.S. Government and agency securities	4,015,648	150,612	-	4,166,260
Mortgage-backed securities	1,189,964	67,972	-	1,257,936
	<u>\$ 26,392,405</u>	<u>\$ 614,660</u>	<u>\$ 1,267</u>	<u>\$ 27,005,798</u>

In the opinion of Management, the Company has the ability and intent to hold the investment securities available-for-sale for a period of time sufficient for a recovery of cost. Furthermore, as of December 31, 2009, Management does not have the intent to sell any investment securities available-for-sale and believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost. The unrealized losses on the above investment securities are primarily due to increases in market interest rates over the yields available at the time the underlying investment securities were purchased by the Company. Management expects the fair values of these investment securities to recover as the investment securities approach their maturity dates or repricing dates or as market yields for such investment securities decline. Management does not believe that any of the investment securities are impaired due to reasons of credit quality. Accordingly, at December 31, 2009 and 2008, Management believes that all unrealized losses on investment securities available-for-sale are temporary and, accordingly, no impairment losses have been realized in the accompanying consolidated statements of income.

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

	<i>Amortized cost</i>	<i>Estimated fair value</i>
Due in one year or less	\$ 360,323	\$ 364,020
Due after one year through five years	3,907,921	4,100,468
Due after five years through ten years	3,371,307	3,547,754
Due after ten years	654,138	663,121
Collateralized mortgage obligations	8,263,309	8,484,591
Mortgage-backed securities	940,950	1,050,808
	<u>\$ 17,497,948</u>	<u>\$ 18,210,762</u>

Investment securities with a carrying value of approximately \$15,849,000 and \$8,824,000 at December 31, 2009 and 2008, respectively, were pledged to secure public deposits (see Note 10) and for other purposes as required or permitted by law (see Note 8).

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 4. Loans

Loans at December 31, 2009 and 2008 consisted of the following:

	<u>2009</u>	<u>2008</u>
Commercial	\$ 30,443,874	\$ 30,242,903
Real estate:		
Commercial	141,828,742	134,526,528
Residential and commercial construction	24,734,410	33,539,837
Mortgage	12,497,854	14,779,438
Installment	7,925,379	7,515,626
Other	4,691,588	2,447,127
	<u>222,121,847</u>	<u>223,051,459</u>
Less:		
Reserve for loan losses	3,189,094	2,299,735
Deferred loan fees	833,871	700,384
	<u>4,022,965</u>	<u>3,000,119</u>
Loans, net	<u>\$ 218,098,882</u>	<u>\$ 220,051,340</u>

The Bank's branches and customers are located in Lane County, Oregon, and a substantial portion of the Bank's loans are collateralized by real estate in this geographic area. Accordingly, the ultimate collectibility of a substantial portion of the Bank's loan portfolio is susceptible to changes in the economic conditions in this market.

In the normal course of business, the Bank participates portions of loans to third-parties in order to extend the Bank's lending capability or to mitigate risk. At December 31, 2009 and 2008, the portion of these loans participated to third-parties (which are not included in the accompanying consolidated financial statements) totaled approximately \$10,117,000 and \$10,467,000, respectively.

In the normal course of business, the Bank finances qualified construction projects. The majority of residential construction loans are sold into the secondary market subsequent to completion of the projects.

## 5. Reserve for Loan Losses

Transactions in the reserve for loan losses for the years ended December 31, 2009 and 2008 were as follows:

	<u>2009</u>	<u>2008</u>
Balance at beginning of year	\$ 2,299,735	\$ 2,237,419
Loan loss provision	1,600,000	250,000
Loans charged-off	(801,048)	(197,417)
Recoveries of loans previously charged-off	90,407	9,733
Balance at end of year	<u>\$ 3,189,094</u>	<u>\$ 2,299,735</u>

Loans on nonaccrual status at December 31, 2009 and 2008 were approximately \$10,091,000 and \$5,971,000, respectively. Interest income which would have been realized on such nonaccrual loans outstanding at year-end, if they had remained current, was approximately \$671,000 and \$379,000 for the years ended December 31, 2009 and 2008, respectively.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 5. Reserve for Loan Losses (Continued)

Total impaired loans as of December 31, 2009 and 2008 were as follows:

	<u>2009</u>	<u>2008</u>
Impaired loans with an associated allowance	\$ 8,435,645	\$ —
Impaired loans without an associated allowance	18,203,405	5,971,335
Total recorded investment in impaired loans	<u>\$ 26,639,050</u>	<u>\$ 5,971,335</u>
Amount of the reserve for loan losses allocated to impaired loans	<u>\$ 924,192</u>	<u>\$ —</u>

The average recorded investment in impaired loans was approximately \$10,977,000 and \$2,149,000 in 2009 and 2008, respectively. Interest income recognized for cash payments received on impaired loans was insignificant in 2009 and 2008.

Loans past due 90 days or more and still accruing interest were \$384,000 and \$557,000 at December 31, 2009 and 2008, respectively.

## 6. Premises and Equipment

Premises and equipment at December 31, 2009 and 2008 consisted of the following:

	<u>2009</u>	<u>2008</u>
Land	\$ 2,444,425	\$ 2,469,425
Buildings and leasehold improvements	6,942,266	6,888,113
Furniture and equipment	<u>2,513,940</u>	<u>2,527,342</u>
	11,900,631	11,884,880
Less accumulated depreciation and amortization	<u>5,654,311</u>	<u>5,420,716</u>
Premises and equipment, net	<u>\$ 6,246,320</u>	<u>\$ 6,464,164</u>

## 7. Time Deposits

Time deposits in excess of \$100,000 aggregated approximately \$18,157,000 and \$19,838,000 at December 31, 2009 and 2008, respectively.

At December 31, 2009, the scheduled annual maturities of all time deposits were approximately as follows:

2010	\$ 38,428,000
2011	3,470,000
2012	643,000
2013	800,000
2014	1,099,000
Thereafter	<u>19,000</u>
	<u>\$ 44,459,000</u>

The Bank utilizes the Certificate of Deposit Registry Program (CDARS™) to meet the needs of certain customers whose investment policies may necessitate or require Federal Deposit Insurance Corporation (FDIC) insurance. Time deposits in excess of \$100,000 under the CDARS program totaled approximately \$2,858,000 and \$7,866,000 at December 31, 2009 and 2008, respectively.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 8. Short-Term Borrowings

The Bank has a committed line of credit with the FHLB up to 25% of total assets, subject to the Bank pledging sufficient collateral and maintaining the required investment in FHLB stock. Borrowings outstanding under this credit line are collateralized by a blanket pledge agreement on the Bank's FHLB stock, any funds on deposit with the FHLB, investment securities, and loans. As of December 31, 2009 and 2008, the maximum available FHLB borrowings were approximately \$47,466,000 and \$42,294,000, respectively. As of December 31, 2009, the Bank had \$6,000,000 in borrowings from the FHLB with a weighted-average fixed interest rate of 1.50% and maturing in 2010. As of December 31, 2008, the Bank had \$12,500,000 in borrowings from the FHLB with a weighted-average fixed interest rate of 1.90%. To fully utilize the Bank's available borrowings from the FHLB at December 31, 2009, the Bank would be required to purchase additional FHLB stock of approximately \$1,481,000.

As an additional source of liquidity, the Bank has federal fund borrowing agreements with correspondent banks aggregating approximately \$24,000,000 at December 31, 2009.

## 9. Junior Subordinated Debentures

The Company has a subsidiary grantor trust (Siuslaw Statutory Trust I) (the Trust) which issued \$8,000,000 of trust preferred securities (the TPS) and \$248,000 of common securities. The common securities were purchased by the Company and represent a 3% minority interest in the Trust. The Company's investment in the common securities is included in accrued interest receivable and other assets in the accompanying consolidated balance sheets. The TPS are subordinated to any other borrowings of the Company and are due and payable on June 17, 2034. The TPS pay quarterly interest at the 3-month London Inter-Bank Offered Rate (LIBOR) plus 2.7% (3.0% as of December 31, 2009). The Trust used the proceeds received from the issuance of the TPS and the common securities to purchase \$8,248,000 of junior subordinated debentures (the Debentures) of the Company. The Debentures were issued with substantially the same terms as the TPS and are the sole assets of the Trust. The Company's obligations under the Debentures and related agreements, taken together, constitute a full and irrevocable guarantee by the Company of the obligations of the Trust. The TPS are mandatorily redeemable upon the maturity of the Debentures or upon earlier redemption as provided in the indenture related to the Debentures. As of June 2009, the TPS became callable by the Company at par value. Management believes that as of December 31, 2009 and 2008, the TPS met applicable regulatory guidelines to qualify as Tier 1 capital.

## 10. Commitments, Guarantees, and Contingencies

In the ordinary course of business, the Bank is a party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit, commitments under credit card lines of credit, and standby letters of credit. These financial instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of amounts recognized in the accompanying consolidated balance sheets. The contractual amounts of these financial instruments reflect the extent of the Bank's involvement in these particular classes of financial instruments. As of December 31, 2009 and 2008, the Bank had no commitments to extend credit at below-market interest rates and held no significant derivative financial instruments.

The Bank's exposure to credit loss for commitments to extend credit, commitments under credit card lines of credit, and standby letters of credit is represented by the contractual amount of these instruments. The Bank follows the same credit policies in underwriting and offering commitments and conditional obligations as it does for on-balance sheet financial instruments. The distribution of commitments to extend credit approximates the distribution of loans outstanding.

A summary of the Bank's off-balance sheet financial instruments at December 31, 2009 and 2008 was approximately as follows:

	<u>2009</u>	<u>2008</u>
Commitments to extend credit	\$ 28,142,000	\$ 35,518,000
Commitments under credit card lines of credit	4,772,000	3,953,000
Standby letters of credit	870,000	1,577,000
Total off-balance sheet financial instruments	<u>\$ 33,784,000</u>	<u>\$ 41,048,000</u>

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 10. Commitments, Guarantees, and Contingencies (Continued)

A commitment to extend credit is an agreement to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of fees. 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 applies established credit related standards and underwriting practices in evaluating the creditworthiness of such obligors. The amount of collateral obtained, if it is deemed necessary by the Bank upon the extension of credit, is based on Management's credit evaluation of the counterparty.

The Bank typically does not obtain collateral related to credit card commitments. Collateral held for other commitments varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

Standby letters of credit are written conditional commitments issued by the Bank to guarantee the performance of a customer to a third-party. These guarantees are primarily issued to support public and private borrowing arrangements. In the event the customer does not perform in accordance with the terms of the agreement with the third-party, the Bank would be required to fund the commitment. The maximum potential amount of future payments the Bank could be required to make is represented by the contractual amount of the commitment. If the commitment were funded, the Bank would be entitled to seek recovery from the customer. The Bank's policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those involved in extending loans to customers. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loan facilities to customers.

The Bank considers the fees collected in connection with the issuance of standby letters of credit to be representative of the fair value of its obligations undertaken in issuing the guarantees. In accordance with GAAP related to guarantees, the Bank defers fees collected in connection with the issuance of standby letters of credit. The fees are then recognized in income proportionately over the life of the standby letter of credit agreements. At December 31, 2009 and 2008, the Bank's deferred standby letter of credit fees – which represent the estimated fair value of the Bank's potential obligations under the standby letter of credit guarantees – were insignificant to the accompanying consolidated financial statements.

The Bank also has certain lending commitments for conforming residential mortgage loans to be sold into the secondary market which are considered derivative instruments under GAAP. However, in the opinion of Management, such derivative amounts are not significant, and, therefore, no derivative assets or liabilities are recorded in the accompanying consolidated financial statements.

The Bank is a participant in the Oregon Public Funds Collateralization Program (the Program) and, accordingly, accepts deposit funds belonging to, or held for the benefit of, the state of Oregon, political subdivisions thereof, municipal corporations, and other public funds. In accordance with applicable state law, in the event of default of one bank, all participating banks in the state collectively assure that no loss of funds is suffered by any public depositor. Generally, in the event of default by a public depository, the assessment attributable to all public depositories is allocated on a pro rata basis in proportion to the maximum liability of each public depository as it existed on the date of loss. The Bank has pledged securities (see Note 3) which fully collateralize public deposits held by the Bank which are not otherwise insured by the FDIC. At December 31, 2009, there was no liability associated with the Bank's participation in the Program, because all participating banks are presently required to fully collateralize uninsured Oregon public deposits or obtain supporting letters of credit, and there were no occurrences of an actual loss on Oregon public deposits at such participating banks. The maximum future contingent liability is dependent upon the occurrence of an actual loss, the amount of such loss, the failure of collateral to cover such a loss and the resulting share of loss to be assessed to the Bank.

In the ordinary course of business, the Bank becomes involved in various litigation arising from normal banking activities. In the opinion of Management, the ultimate disposition of these actions will not have a material adverse effect on the Company's consolidated financial statements as of and for the year ended December 31, 2009.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 11. Income Taxes

The provision (credit) for income taxes was comprised of the following for the years ended December 31, 2009 and 2008:

	<u>2009</u>	<u>2008</u>
Current:		
Federal	\$ 1,759,000	\$ 2,320,000
State	482,000	387,000
	<u>2,241,000</u>	<u>2,707,000</u>
Deferred	(551,000)	(514,000)
Provision for income taxes	<u>\$ 1,690,000</u>	<u>\$ 2,193,000</u>

The provision (credit) for income taxes results in effective tax rates which are different than the federal income tax statutory rate. The nature of the differences for the years ended December 31, 2009 and 2008 were approximately as follows:

	<u>2009</u>	<u>2008</u>
Expected federal income tax provision at statutory rate	\$ 1,710,000	\$ 2,128,000
State income taxes, net of federal effect	246,000	223,000
Effect of nontaxable interest income, net	(122,000)	(79,000)
Other, net	(144,000)	(79,000)
Provision for income taxes	<u>\$ 1,690,000</u>	<u>\$ 2,193,000</u>

The components of the net deferred tax assets at December 31, 2009 and 2008 were approximately as follows:

	<u>2009</u>	<u>2008</u>
Deferred tax assets:		
Deferred compensation plan expenses, net	\$ 1,232,000	\$ 1,002,000
Reserve for loan losses	962,000	648,000
Deferred loan fees and points	411,000	351,000
Capital losses	104,000	102,000
Other	12,000	9,000
Total deferred tax assets	<u>2,721,000</u>	<u>2,112,000</u>
Deferred tax liabilities:		
CMSRs	300,000	279,000
Net unrealized gains on investment securities available-for-sale	272,000	236,000
FHLB stock dividends	162,000	159,000
Accumulated depreciation and amortization	52,000	18,000
Total deferred tax liabilities	<u>786,000</u>	<u>692,000</u>
Net deferred tax assets	<u>\$ 1,935,000</u>	<u>\$ 1,420,000</u>

Management believes that, based upon the Company's historical performance, the net deferred tax assets will be recognized in the normal course of operations, and, accordingly, Management has not reduced net deferred tax assets by a valuation allowance. Net deferred tax assets are included in accrued interest receivable and other assets in the accompanying consolidated balance sheets.

Management has evaluated the Company's income tax positions as of December 31, 2009 and 2008. Based on this evaluation, Management has determined that the Company has no uncertain tax positions for which an unrecognized tax liability should be recorded.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 12. Transactions with Related Parties

Certain directors, officers, and principal stockholders of the Company (and the companies with which they are associated) are customers of, and have had banking transactions with, the Bank in the ordinary course of the Bank's business. In addition, the Bank expects to continue to have such banking transactions in the future. All loans, and commitments to loan, to such parties are made in compliance with applicable laws and are generally made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons. In the opinion of Management, these transactions do not involve more than the normal risk of collectibility or present any other unfavorable features.

Activity with respect to loans to officers and directors for the years ended December 31, 2009 and 2008 was approximately as follows:

	<u>2009</u>	<u>2008</u>
Balance at beginning of year	\$ 109,000	\$ 787,000
Appointment of new Board member	839,000	-
Advances	-	123,000
Repayments	(116,000)	(227,000)
Resignation of Board member	-	(574,000)
	<u>\$ 832,000</u>	<u>\$ 109,000</u>

In addition, a company associated with a director of the Company purchased a loan participation from the Bank with a balance of approximately \$123,000 and \$133,000 at December 31, 2009 and 2008, respectively.

## 13. Benefit Plans

### *401(k) Profit Sharing Plan*

The Company maintains a 401(k) profit sharing plan (the Plan) which covers substantially all employees with at least 90 days of service. The Company matches 100% of each employee's voluntary contributions up to 4% of each employee's compensation. The Company may also contribute amounts to the Plan at the discretion of the Board. No discretionary contributions to the Plan were made during the years ended December 31, 2009 or 2008. Total expense related to the Plan was approximately \$187,000 and \$192,000 for the years ended December 31, 2009 and 2008, respectively.

### *Other Benefit Plans*

The Bank has deferred compensation, salary continuation, and supplemental executive retirement income (SERI) plans for certain key executives. In accordance with the provisions of the deferred compensation plan, participants can elect to defer portions of their annual compensation or fees. The deferred amounts generally vest as deferred. The deferred compensation plus interest is generally payable upon termination in either a lump-sum or monthly installments for 120 months. The salary continuation and SERI plans provide defined benefits to the participants upon termination of employment with the Bank. The defined benefits for the participants are for periods of fifteen years. The benefits are subject to certain vesting requirements, and vested amounts are generally payable upon termination – and, for certain participants, upon a change of control of the Company – in either a lump-sum or monthly installments. The Bank annually expenses amounts sufficient to accrue for the present value of the benefits payable to the participants under these plans.

The salary continuation and SERI plans also include death benefit provisions for certain participants. To assist in the funding of these plans, the Bank has purchased BOLI policies on all of the participants. The cash surrender value of these policies at December 31, 2009 and 2008 was approximately \$5,894,000 and \$5,610,000, respectively. As of December 31, 2009 and 2008, the liabilities related to the salary continuation and SERI plans included in accrued interest payable and other liabilities in the accompanying consolidated balance sheets totaled approximately \$2,390,000 and \$2,201,000, respectively. The amount of expense charged to operations in 2009 and 2008 for the salary continuation and SERI plans was approximately \$282,000 and \$506,000, respectively. For financial reporting purposes, such expense amounts have not been adjusted for income earned on the BOLI policies.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 14. Estimated Fair Values of Financial Instruments

GAAP defines fair value, establishes a framework for measuring fair value, and requires certain disclosures about fair value measurements. GAAP permits an entity to choose to measure many financial instruments and certain other items at fair value and contains financial statement presentation and disclosure requirements for assets and liabilities for which the fair value option is elected. The Company has not elected to report any assets or liabilities at fair value in the consolidated financial statements under the “fair value option” provided by GAAP.

GAAP provides the following hierarchy of valuation techniques:

- Level 1 – Quoted unadjusted prices in active markets for identical assets or liabilities
- Level 2 – Significant observable inputs other than quoted prices in Level 1, such as quoted prices in active markets for similar assets or liabilities, or quoted prices for identical assets or liabilities in markets that are not active
- Level 3 – Significant unobservable inputs based on a company’s own assumptions about the assumptions that market participants would use in pricing the asset or liability

Certain assets and liabilities are measured at fair value on a recurring or non-recurring basis. Assets and liabilities measured at fair value on a recurring basis are initially measured at fair value and then re-measured at fair value at each financial statement reporting date. Assets and liabilities measured at fair value on a non-recurring basis result from write-downs due to impairment or lower-of-cost-or-market accounting on assets or liabilities not initially measured at fair value.

In accordance with GAAP, the Company applied the fair value measurement and disclosure requirements to nonfinancial assets and liabilities measured at fair value on a non-recurring basis beginning with the year ended December 31, 2009.

The Company’s investment securities have been valued by reference to prices for similar securities or through model-based techniques in which all significant inputs are observable and, therefore, such valuations have been classified as Level 2.

Loans are generally not recorded at fair value on a recurring basis. Periodically, the Company records nonrecurring adjustments to the carrying value of loans based on fair value measurements for partial charge-offs of the uncollectible portions of those loans. Nonrecurring adjustments also include certain impairment amounts for collateral-dependent loans when establishing the reserve for loan losses. Such amounts are generally based on the fair value of the underlying collateral supporting the loan and, as a result, the carrying value of the loan less the calculated valuation amount does not necessarily represent the fair value of the loan. Real estate collateral is typically valued using appraisals or other indications of value based on recent comparable sales of similar properties or assumptions generally observable in the marketplace, and the related nonrecurring fair value measurement adjustments have generally been classified as Level 2. Loans subject to nonrecurring fair value measurement were approximately \$26,639,000 at December 31, 2009.

OREO is measured at estimated fair value less estimated costs to sell. Fair value was generally determined based on third-party appraisals of fair value in an orderly sale. Historically, appraisals have considered comparable sales of similar assets in reaching a conclusion as to fair value. Since many recent real estate sales could be termed “distressed sales” since a preponderance have been short-sale or foreclosure related, this has directly impacted appraisal valuation estimates. Estimated costs to sell OREO were based on standard market factors. The valuation of OREO is subject to significant external and internal judgment. Management periodically reviews OREO to determine whether the property continues to be carried at the lower of its recorded book value or estimated fair value, net of estimated costs to sell. At December 31, 2009 the carrying value of OREO was approximately \$556,000 which approximates fair value.

At December 31, 2009 and 2008, the Company had no financial liabilities measured at fair value on a recurring basis. The Company’s financial assets measured at fair value on a recurring basis at December 31, 2009 and 2008 were as follows:

	<i>Quoted prices in active markets for identical assets (Level 1)</i>	<i>Significant other observable inputs (Level 2)</i>	<i>Significant unobservable inputs (Level 3)</i>
<u>2009</u>			
Investment securities available-for-sale	\$ —	\$ 18,210,762	\$ —
<u>2008</u>			
Investment securities available-for-sale	\$ —	\$ 27,005,798	\$ —

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 14. Estimated Fair Values of Financial Instruments (Continued)

Certain assets are measured at fair value on a nonrecurring basis (i.e., the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments when there is evidence of impairment). The following table represents the assets measured at fair value on a nonrecurring basis at December 31, 2009 and 2008:

	<i>Quoted prices in active markets for identical assets (Level 1)</i>	<i>Significant other observable inputs (Level 2)</i>	<i>Significant unobservable inputs (Level 3)</i>
<u>2009</u>			
Impaired loans	\$ —	\$ —	\$ 26,639,050
OREO	—	—	555,910
	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 27,194,960</u>
<u>2008</u>			
Impaired loans	\$ —	\$ —	\$ 5,971,335
OREO	—	—	794,550
	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 6,765,885</u>

Certain non-financial assets are also measured at fair value on a nonrecurring basis. These assets primarily consist of intangible assets and other non-financial long-lived assets which are measured at fair value for periodic impairment assessments. At December 31, 2009 and 2008, the Company had no financial liabilities measured at fair value on a nonrecurring basis.

The following disclosures are made in accordance with GAAP, which requires the disclosure of fair value information about financial instruments where it is practicable to estimate that value.

In cases where quoted market values are not available, the Company primarily uses present value techniques to estimate the fair values of its financial instruments. Valuation methods require considerable judgment, and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used. Accordingly, the estimates provided herein do not necessarily indicate amounts which could be realized in a current market exchange.

In addition, as the Company normally intends to hold the majority of its financial instruments until maturity, it does not expect to realize many of the estimated amounts disclosed. The disclosures also do not include estimated fair value amounts for items which are not defined as financial instruments but which may have significant value. These include such off-balance sheet items as core deposit intangibles. The Company does not believe that it would be practicable to estimate a representational fair value for these types of items as of December 31, 2009 and 2008.

Because GAAP excludes certain financial and nonfinancial instruments from its disclosure requirements, any aggregation of the fair value amounts presented would not represent the underlying value of the Company.

The Company used the following methods and assumptions to estimate the fair value of its financial instruments:

Cash and cash equivalents: The carrying amount approximates the estimated fair value of these instruments.

Interest-bearing time deposits: The carrying amount approximates the estimated fair value.

Investment securities available-for-sale: The market value of investment securities has been estimated by reference to prices for similar securities or through model-based techniques.

FHLB stock: The carrying amount approximates the estimated fair value.

Loans, net: The estimated fair value of loans is calculated by discounting the contractual cash flows of the loans using December 31, 2009 and 2008 origination rates. The resulting amounts are adjusted to estimate the effect of changes in the credit quality of borrowers since the loans were originated.

Mortgage loans held for sale: The carrying amount approximates the estimated fair value.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 14. Estimated Fair Values of Financial Instruments (Continued)

BOLI: The carrying amount approximates the estimated fair value of these instruments.

OREO: Fair value is estimated as described above.

Deposits: The estimated fair value of demand deposits, consisting of checking, NOW and money market, and savings accounts, is represented by the amounts payable on demand. At the reporting date, the estimated fair value of time deposits is calculated by discounting the scheduled cash flows using the December 31, 2009 and 2008 rates offered on those instruments.

Short-term borrowings: Due to the short-term nature of these liabilities, the carrying value approximates the estimated fair value.

Junior subordinated debentures: The carrying amount of the junior subordinated debentures approximates fair value, as the interest rate is adjusted on a quarterly basis.

Loan commitments and standby letters of credit: The majority of the Bank's commitments to extend credit have variable interest rates and "escape" clauses if the customer's credit quality deteriorates. Therefore, the fair values of these items are not significant and are not included in the following table.

The estimated fair values of the Company's significant on-balance sheet financial instruments at December 31, 2009 and 2008 were as follows:

	2009		2008	
	Carrying value	Estimated fair value	Carrying value	Estimated fair value
Financial assets:				
Cash and cash equivalents	\$ 17,165,173	\$ 17,165,173	\$ 5,552,642	\$ 5,552,642
Interest-bearing time deposits	9,000,000	9,000,000	1,000,000	1,000,000
Investment securities available-for-sale	18,210,762	18,210,762	27,005,798	27,005,798
FHLB stock	654,800	654,800	654,800	654,800
Loans, net (including mortgage loans held for sale)	219,679,618	220,698,000	221,046,351	221,194,000
BOLI	5,893,724	5,893,724	5,609,710	5,609,710
OREO	555,910	555,910	794,550	794,550
Financial liabilities:				
Deposits	236,595,158	236,804,000	220,695,479	221,001,000
Short-term borrowings	6,000,000	6,000,000	12,500,000	12,500,000
Junior subordinated debentures	8,248,000	8,248,000	8,248,000	8,248,000

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

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 tables below) of Tier 1 capital to total average assets and minimum ratios of Tier 1 and total capital to risk-weighted assets (all as defined in the regulations). Management believes that as of December 31, 2009 and 2008, the Company and the Bank met or exceeded all relevant capital adequacy requirements.

As of December 31, 2009, the most recent notification from the FDIC 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 following tables. There are no conditions or events since the notifications from the regulators that Management believes would change the Company's or the Bank's regulatory capital categorization.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 15. Regulatory Matters (Continued)

The Company's actual and required capital amounts and ratios are presented in the following table (dollars in thousands):

	<i>Actual</i>		<i>Regulatory minimum to be "adequately capitalized"</i>		<i>Regulatory minimum to be "well capitalized" under prompt corrective action provisions</i>	
	<i>Amount</i>	<i>Ratio</i>	<i>Amount</i>	<i>Ratio</i>	<i>Amount</i>	<i>Ratio</i>
<i>December 31, 2009:</i>						
Tier 1 capital (to average assets)	\$ 37,557	12.9%	\$ 11,630	4.0%	N/A	N/A
Tier 1 capital (to risk-weighted assets)	37,557	15.3	9,832	4.0	N/A	N/A
Total capital (to risk-weighted assets)	40,605	16.5	19,664	8.0	N/A	N/A
<i>December 31, 2008:</i>						
Tier 1 capital (to average assets)	36,350	13.0	11,151	4.0	N/A	N/A
Tier 1 capital (to risk-weighted assets)	36,350	14.6	9,934	4.0	N/A	N/A
Total capital (to risk-weighted assets)	38,650	15.6	19,868	8.0	N/A	N/A

The Bank's actual and required capital amounts and ratios are presented in the following table (dollars in thousands):

	<i>Actual</i>		<i>Regulatory minimum to be "adequately capitalized"</i>		<i>Regulatory minimum to be "well capitalized" under prompt corrective action provisions</i>	
	<i>Amount</i>	<i>Ratio</i>	<i>Amount</i>	<i>Ratio</i>	<i>Amount</i>	<i>Ratio</i>
<i>December 31, 2009:</i>						
Tier 1 capital (to average assets)	\$ 37,071	12.8%	\$ 11,607	4.0%	\$ 14,509	5.0%
Tier 1 capital (to risk-weighted assets)	37,071	15.1	9,832	4.0	14,747	6.0
Total capital (to risk-weighted assets)	40,119	16.3	19,663	8.0	24,579	10.0
<i>December 31, 2008:</i>						
Tier 1 capital (to average assets)	34,893	12.6	11,119	4.0	13,899	5.0
Tier 1 capital (to risk-weighted assets)	34,893	14.0	9,934	4.0	14,901	6.0
Total capital (to risk-weighted assets)	37,193	15.0	19,868	8.0	24,835	10.0



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