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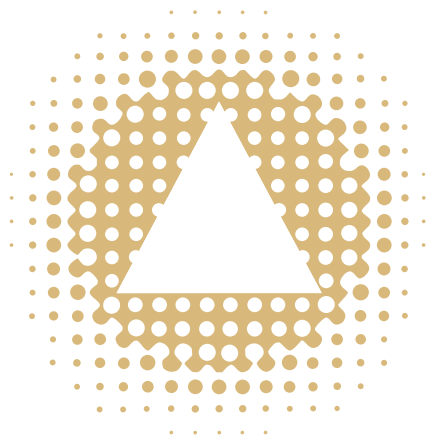
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## LETTER TO SHAREHOLDERS



March 20, 2012

To our Shareholders:

Positive momentum continues at Summit Bank. Our team successfully navigated the difficult economic and regulatory environment of 2011, resulting in a stronger organization heading into 2012.

Many of the same themes that we shared with you last year are at the forefront of the Bank's performance for 2011. Principal among these are earnings growth and improving asset quality.

The Bank's \$1 million in pre-tax earnings was the largest in its history. Higher earnings were the result of improving loan quality, lower operating expenses, and higher net interest income. Losses from sales and write-downs on other real estate owned dropped from \$269 thousand in 2010 to \$37 thousand in 2011, a reduction of 86 percent. Provision expense for potential losses on troubled loans was reduced from \$332 thousand in 2010 to \$189 thousand in 2011. Additionally, the Bank was successful in reducing its noninterest expenses from the previous year by \$77 thousand while increasing net interest income by \$41 thousand.

Summit was successful in growing core deposits (checking, savings, money market accounts, and time deposits less than \$100 thousand) in 2011. This segment of deposits grew nearly 21 percent, from \$78 million to \$94 million during the year. Despite a challenging local economy, loan growth was \$2.4 million. Summit's liquidity position was strengthened in 2011, with cash and securities increasing from \$22.1 million to \$25.8 million, or 19.4% of total assets. These solid earnings increased the Bank's already strong capital position by \$527 thousand to bring the Bank's total equity to \$11.5 million at year end.

Summit's business model of expert bankers providing innovative solutions is working. We remain committed to the financial health of our clients and our community and believe that giving our customers our very best every day will result in sustainable success.

Thank you for your investment in Summit Bank.

R. Paul Weinhold  
Board Chair

Ann Marie Mehлум  
President & CEO



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## Independent Auditors' Report

To the Board of Directors  
Summit Bank:

We have audited the accompanying balance sheets of Summit Bank (the "Bank") as of December 31, 2011 and 2010, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Summit Bank as of December 31, 2011 and 2010, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Isler CPA, LLC*

March 5, 2012

## BALANCE SHEETS

	December 31	
	2011	2010
<b>ASSETS</b>		
Cash and cash equivalents:		
Cash and due from banks	\$ 4,500,467	\$ 5,007,512
Interest-bearing deposits with other banks	2,976,557	1,005,661
Federal funds sold	-	4,105,000
Total cash and cash equivalents	7,477,024	10,118,173
Investment securities available-for-sale	18,057,784	11,699,669
Loans, less allowance for loan losses	90,873,876	88,489,434
Interest receivable	397,261	377,561
Equity investments	264,300	264,300
Property, net of accumulated depreciation	2,933,915	3,028,993
Deferred income taxes	592,092	551,272
Foreclosed real estate	455,806	680,832
Cash surrender value of bank owned life insurance	1,795,084	1,740,581
Other assets	380,489	605,966
	115,750,607	107,438,608
Total assets	\$ 123,227,631	\$ 117,556,781
<b>LIABILITIES and STOCKHOLDERS' EQUITY</b>		
Liabilities:		
Deposits:		
Noninterest-bearing demand	\$ 29,785,482	\$ 25,331,399
Savings and interest-bearing demand	63,136,725	50,495,762
Time, \$100,000 and over, maturing 2012-2015	7,172,021	18,869,233
Other time, maturing 2012-2015	1,629,845	2,107,702
Total deposits	101,724,073	96,804,096
Interest payable	79,600	102,005
Other liabilities	4,497,722	2,756,712
Repurchase agreements	4,096,074	5,085,472
Term borrowings	1,308,629	1,813,841
Total liabilities	111,706,098	106,562,126
Stockholders' equity:		
Common stock, no par value; 10,000,000 shares authorized, 998,612 shares outstanding in 2011 and 2010	10,211,504	10,191,621
Retained earnings	1,303,969	686,711
Accumulated other comprehensive income	6,060	116,323
Total stockholders' equity	11,521,533	10,994,655
Total liabilities and stockholders' equity	\$ 123,227,631	\$ 117,556,781

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

## STATEMENTS OF INCOME

	<b>Year Ended December 31</b>	
	<b>2011</b>	<b>2010</b>
Interest income:		
Interest and fees on loans	\$ 4,461,988	\$ 4,801,239
Interest on investment securities	339,422	304,456
Interest on federal funds sold and time deposits	39,099	26,879
	<u>4,840,509</u>	<u>5,132,574</u>
Interest expense	<u>522,869</u>	<u>855,699</u>
Net interest income	4,317,640	4,276,875
Provision for loan losses	<u>188,648</u>	<u>331,737</u>
Net interest income after provision for loan losses	<u>4,128,992</u>	<u>3,945,138</u>
Noninterest income:		
Rental income	221,610	208,788
Service charges and fees	128,881	76,882
Gain on sale of loans	39,667	128,214
Loss on sale of foreclosed real estate	(17,980)	-
Other	185,375	198,501
	<u>557,553</u>	<u>612,385</u>
Noninterest expense:		
Salaries and employee benefits	2,242,888	2,264,562
Occupancy and equipment expense	329,090	328,428
Data processing	250,068	205,843
Foreclosed real estate expenses	37,045	269,162
Other	827,044	927,193
	<u>3,686,135</u>	<u>3,995,188</u>
Income before income taxes	1,000,410	562,334
Income tax expense	<u>383,152</u>	<u>221,026</u>
Net income	<u>\$ 617,258</u>	<u>\$ 341,308</u>
Earnings per share:		
Basic	\$ .62	\$ .34
Diluted	\$ .62	\$ .34

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

## STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Years Ended December 31, 2011 and 2010

	Common Stock		Retained	Accumulated Other Comprehensive	
	Shares	Amount	Earnings	Income	Total
Balance, January 1, 2010	998,612	\$ 10,123,977	\$ 345,403	\$ 111,653	\$ 10,581,033
Net income			341,308		341,308
Other comprehensive income:					
Increase in unrealized gains on investment securities				26,118	
Deferred income taxes				(21,448)	
				4,670	4,670
Comprehensive income					345,978
Share-based compensation		67,644			67,644
Balance, December 31, 2010	998,612	10,191,621	686,711	116,323	10,994,655
Net income			617,258		617,258
Other comprehensive income:					
Increase in unrealized gains on investment securities				(181,354)	
Deferred income taxes				71,091	
				(110,263)	(110,263)
Comprehensive income					506,995
Share-based compensation		19,883			19,883
Balance, December 31, 2011	<u>998,612</u>	<u>\$ 10,211,504</u>	<u>\$ 1,303,969</u>	<u>\$ 6,060</u>	<u>\$ 11,521,533</u>

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

## STATEMENTS OF CASH FLOWS

	Year Ended December 31	
	2011	2010
Cash flows from operating activities:		
Net income	\$ 617,258	\$ 341,308
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	169,403	176,667
Share based compensation	19,883	67,644
Amortization of investment premiums, net	248,251	45,317
Provision for loan losses	188,648	331,737
Gain on sale of loans	(39,667)	(128,214)
Loss on sale of foreclosed real estate	17,980	-
Write downs of foreclosed real estate	20,024	269,162
Deferred income taxes	30,273	(274,119)
Change in:		
Interest receivable and other assets	151,274	5,922
Deferred loan fees	20,397	(22,511)
Interest payable and other liabilities	1,718,605	751,682
Net cash provided by operating activities	3,162,329	1,564,595
Cash flows from investing activities:		
Purchase of investment securities	(19,457,155)	(8,181,682)
Principal payments and maturities of investment securities	12,669,434	3,845,195
Net proceeds from sale of loans	1,168,048	3,679,668
Purchase of loans	(1,680,764)	-
Proceeds from sale of foreclosed real estate	187,022	213,829
Purchase of bank owned life insurance	-	(400,000)
Loans originated, net of principal collected	(2,041,104)	196,628
Purchase of fixed assets	(74,325)	(53,303)
Net cash used in investing activities	(9,228,844)	(699,665)
Cash flows from financing activities:		
Net increase (decrease) in deposits	4,919,977	(9,708,589)
Increase (decrease) in repurchase agreements	(989,398)	452,071
Payments on term borrowings	(505,213)	(122,617)
Net cash provided (used) by financing activities	3,425,366	(9,379,135)
Net decrease in cash and cash equivalents	(2,641,149)	(8,514,205)
Cash and cash equivalents, beginning of year	10,118,173	18,632,378
Cash and cash equivalents, end of year	\$ 7,477,024	\$ 10,118,173
Supplemental information:		
Cash paid during the year for interest	\$ 545,274	\$ 920,786
Cash paid during the year for income taxes	267,076	237,970
Change in unrealized losses on investment securities available-for-sale, net of deferred income taxes	(110,263)	4,670
Transfer of loans to foreclosed real estate	-	323,849

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



## NOTES TO FINANCIAL STATEMENTS

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

**General** – The Bank provides commercial banking, financing, real estate lending and other services in Western Oregon. The accounting and reporting policies of the Bank conform with accounting principles generally accepted in the United States of America and prevailing practices within the banking industry.

**Financial Statement Presentation** – The preparation of the financial statements in conformity with U.S. generally accepted accounting principles (“GAAP”) requires management to make estimates and assumptions that affect reported amounts and related disclosures, and actual results could differ from those estimates. The most significant estimates are the allowance for loan losses and fair value estimates. The Bank has evaluated subsequent events through March 5, 2012, the date the financial statements were available for distribution. Certain prior year amounts have been reclassified to conform to the current year presentation.

**Cash and Cash Equivalents** – For purposes of presentation in the statements of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheets caption “cash and due from banks”. Such amounts include both interest-bearing and noninterest-bearing deposits with other banks, principally short-term time deposits, and federal funds sold on an overnight basis and may exceed amounts insured by the Federal Deposit Insurance Corporation (“FDIC”).

**Investment Securities** – The Bank classifies all investment securities as available-for-sale. Securities available-for-sale are held for indefinite periods of time and may be sold in response to changes in market interest rates, shifts in the maturity mix or concentration of Bank assets or liabilities or to alleviate liquidity demands. Securities designated as available-for-sale are carried at estimated fair value. Unrealized gains and losses are excluded from earnings and are included in other comprehensive income in stockholders’ equity, net of applicable deferred taxes.

Interest income on debt securities is included in income using the effective interest method. Gains and losses realized on sales of securities are recognized using the specific identification method. Investment income includes accretion and amortization of discounts and premiums resulting from securities purchased at other than par value. Both are calculated using a “constant yield” methodology either to maturity (for non-callable securities) or to “worst call date” for callable securities. Premiums and discounts on mortgage backed securities are amortized/accreted based upon current and expected future rates of prepayments on the securities.

The Bank has not recognized any other-than-temporary impairment of its debt securities.

The Bank evaluates its securities classified as available for sale for other-than-temporary impairments (OTTI) in accordance with Accounting Standards Codification (“ASC”) 320. Accordingly, the Bank assesses whether it intends to sell or it is more likely than not that it will be required to sell a security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other-than-temporarily impaired and that the Bank does not intend to sell and will not be required to sell prior to recovery of the amortized cost basis, the Bank would separate the amount of the impairment into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component would be recognized in earnings and would be the difference between the security’s amortized cost basis and the present value of its expected future cash flows discounted at the security’s effective yield. The remaining difference between the security’s fair value and the present value of future expected cash flows would be due to factors that are not credit related and, therefore, would not be required to be recognized as losses in the income statement, but would be recognized in other comprehensive income.

## NOTES TO FINANCIAL STATEMENTS

**Loans and Income Recognition** – Loans are stated at the amount of unpaid principal, reduced by deferred loan origination fees and an allowance for loan losses. Interest on loans is calculated using the simple-interest method on daily balances of the principal amount outstanding. Accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of the interest is doubtful. In accordance with GAAP, payments received on nonaccrual loans are applied to the principal balance and no interest income is recognized. Interest income is subsequently recognized only to the extent cash payments are received satisfying all delinquent principal and interest amounts, and the prospects for future payments in accordance with the loan agreement appear relatively certain. A nonaccrual loan may be restored to accrual status when none of its principal and interest is due and unpaid and the Bank expects full repayment of the remaining contractual principal and interest, or when it otherwise becomes well secured and in the process of collection. Loan origination fees, net of associated direct costs, if significant, are amortized by the interest or straight-line method over the contractual life of the loan.

**Allowance for Loan Losses** – The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged off against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. The allowance is an amount that management considers adequate to absorb possible losses on existing loans that may become uncollectible based on evaluations of the collectibility of loans and prior loss experience. The evaluations take into consideration such factors as changes in the nature and value of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrower's ability to pay.

A loan is considered impaired when management believes that it is probable that all amounts will not be collected according to the contractual terms. An impaired loan is valued using the estimated fair value of the loan's collateral or related guaranty, the present value of expected cash flows discounted at the loan's effective interest rate, or the observable market price of the loan. These estimates are necessarily subjective and may be adjusted as more current information becomes available. Any adjustment could be significant. Loans deemed impaired are specifically allocated for in the allowance for loan losses.

The Bank classifies loss reserves for unfunded loan commitments in other liabilities.

Federal and state bank regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance in the future based on their judgment of the information available to them at the time of their examinations.

**Equity Investments** – Equity investments consist of the following:

	<u>2011</u>	<u>2010</u>
Federal Home Loan Bank stock	\$ 74,300	\$ 74,300
Pacific Coast Bankers' Bancshares stock	<u>190,000</u>	<u>190,000</u>
	<u>\$ 264,300</u>	<u>\$ 264,300</u>

## NOTES TO FINANCIAL STATEMENTS

The investment in Federal Home Loan Bank (“FHLB”) stock is carried at par, which approximates its fair value. As a member of 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, 2011, the Bank’s minimum required investment was \$66,600. Stock redemptions may be requested at par value and are made at the discretion of the FHLB.

The Bank also holds an investment in its primary correspondent bank, Pacific Coast Bankers’ Bancshares. This investment is carried at cost, which approximates fair value.

**Property** – Property is stated at cost, net of accumulated depreciation. Additions, betterments and replacements of major units are capitalized. Expenditures for normal maintenance, repairs and replacements of minor units are charged to expense as incurred. Gains or losses realized from sales or retirements are reflected in operations. Depreciation is computed by the straight-line method over the estimated useful lives of the assets.

**Foreclosed Assets** – Assets acquired through, or in lieu of, foreclosure are held-for-sale and are initially recorded at fair value at the date of foreclosure based on current appraisals, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of the carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in other noninterest expense.

**Bank-owned Life Insurance (BOLI)** – The Bank is beneficiary of BOLI on certain Bank officers. The BOLI is recorded at fair value, which is based on the cash surrender value (net of surrender charges) of the insurance contracts. Changes in the cash surrender value are included in noninterest income.

**Advertising** – Advertising costs are charged to expense during the period in which they are incurred. Advertising expenses were \$26,105 and \$51,386 for the years ended December 31, 2011 and 2010, respectively.

**Income Taxes** – Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are calculated on differences between financial statement and tax bases of assets and liabilities using tax rates in effect for the year in which the differences are expected to reverse. A valuation allowance is recognized if, based on the available evidence, it is determined it is more likely than not some portion or all of the deferred tax assets will not be realized.

Uncertain tax positions are accounted for in accordance with ASC 740 which prescribes recognition and measurement standards for uncertain income tax positions. The Standard provides guidance on recognition, derecognition, interest, penalties and disclosure. There is no material impact of potential tax uncertainties on Bank’s financial condition or results of operations at December 31, 2011.

## NOTES TO FINANCIAL STATEMENTS

**Derivative Instruments** – The Bank uses derivative financial instruments (interest rate swaps) to limit exposure to changes in interest rates related to specific loan assets. Derivatives entered into by the Bank are designated as fair value hedges with perfect effectiveness between changes in the value of the interest rate swap and the hedged instrument (loan asset). All derivatives and related hedged loans are recognized in the balance sheet at their fair value. Changes in the fair value of a derivative that is highly effective, along with the loss or gain on the hedged asset that is attributable to the hedged risk, are recorded in current-period earnings. The Bank formally documents all relationships between hedging instruments and hedged assets, as well as its risk-management objective and strategy for undertaking various hedged transactions. The Bank also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values of hedged items.

The Bank would discontinue hedge accounting when: (a) it is determined that a derivative is no longer effective in offsetting changes in the fair value of the associated hedged item; (b) the derivative expires or is sold, terminated, or exercised; or (c) management determines that designation of the derivative as a hedge instrument is no longer appropriate. The hedged asset would no longer be adjusted for changes in fair value and the derivative would be carried at its fair value in the balance sheet, with changes in its fair value recognized in current-period earnings.

**Stockholders' Equity and Earnings Per Share** – Basic earnings per share are computed by dividing net income by the weighted average number of shares outstanding during the period. Diluted earnings per share include the effect of common stock equivalents that would arise from the exercise of stock options discussed in Note 11.

**Share-Based Compensation** – Financial accounting standards require companies to measure and recognize compensation expense for all share-based payments at the grant date based on the fair value of the award, as defined in ASC 718, and include such costs as an expense over the requisite service (vesting) period. The Bank adopted ASC 718 using the modified prospective application, whereby the provisions of the statement have been applied prospectively only from the date of adoption for new (issued subsequent to December 31, 2005) and unvested stock option awards for which the requisite service is rendered after the date of adoption. Thus, the Bank recognizes as expense the fair value of stock options issued prior to January 1, 2006, but vesting after January 1, 2006, over the remaining vesting period.

**SBA/USDA Loans Sales and Servicing** – The Bank, on a limited basis, sells or transfers loans, including the government guaranteed portion of the loans (with loan servicing retained) for proceeds equal to the principal amount of loans, as adjusted to yield interest to the investor based upon the current market rates. The Bank records an asset representing the right to service loans for others when it sells a loan and retains the servicing rights included in other assets. The carrying value of loans is allocated between the loan and the servicing rights, based on their relative fair values. The fair value of servicing rights is estimated by discounting estimated future cash flows from servicing using discount rates that approximate current market rates and using estimated prepayment rates. The servicing rights are carried at the lower of cost or market and are amortized in proportion to, and over the period of the estimated net servicing income, assuming prepayments.

## NOTES TO FINANCIAL STATEMENTS

For purposes of evaluating and measuring impairment, servicing rights are based on a discounted cash flow methodology, current prepayment speeds and market discount rates. Impairment is measured as the amount by which the carrying value of servicing rights for a loan asset exceeds its fair value. The carrying value of the servicing rights at December 31, 2011 and 2010, were \$93,328 and \$104,071, respectively. No impairment charges were recorded for the years ended December 31, 2011 or 2010, related to the servicing assets.

A premium over the adjusted carrying value is received upon the sale of the guaranteed portion of a loan. The Bank's investment in the loan is allocated among the sold and retained portions of the loan based on the relative fair value of each portion at the time of loan origination, adjusted for payments and other activities. Because the portion retained does not carry a guarantee, part of the gain recognized on the sold portion of the loan may be deferred and amortized as a yield enhancement on the retained portion in order to obtain a market equivalent yield.

**Fair Value** – The Bank applies the hierarchy and framework for measuring fair value, and expanded disclosure about fair value measurements and the reliability of valuation inputs as provided in ASC 820. When determining the fair value, the Bank considers the transaction to sell an asset or transfer a liability occurs in the principal or at least the most advantageous market for that asset or liability. Within the hierarchy, Level 1 instruments use observable market prices for the identical item in active markets and have the most reliable valuations. Level 2 instruments are valued through broker/dealer quotation or through market-observable inputs for similar items in active markets, including forward and spot prices, interest rates and volatilities. Level 3 instruments are valued using inputs not observable in an active market such as Bank-developed future cash flow estimates, and are considered the least reliable. Valuations for all of the Bank's financial instruments fall within Levels 2 and 3.

**Recently Issued Accounting Pronouncements Adopted in 2011** – In July 2010, FASB issued Accounting Standards Update No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. The objective of this update is to provide greater transparency about an entity's allowance for credit losses and the credit quality of its financing receivables.

In January 2010, FASB issued Accounting Standards Update No. 2010-06, *Fair Value Measurements and Disclosures, Improving Disclosures about Fair Value Measurements*. The objective of this statement was to increase the transparency in financial reporting of *Fair Value Measurement*.

There was no material impact on the Bank's results of operations or financial condition upon adoption of the new standards.

**Recently Issued Accounting Pronouncements Effective in 2012 and 2013** – In April 2011, FASB issued Accounting Standard Update No. ASU 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*. This ASU sets forth the guidance to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment and for disclosure of troubled debt restructurings. This update is effective for the Bank for the year ended December 31, 2012.

## NOTES TO FINANCIAL STATEMENTS

In April 2011, FASB issued Accounting Standard Update No. ASU 2011-03, *Transfer and Services (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. This ASU removes from the assessment of effective control in the accounting for repurchase agreements (a) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (b) the collateral maintenance implementation guidance related to that criterion. This update is effective for the Bank for the year ended December 31, 2012.

In May 2011, FASB issued Accounting Standard Update No. ASU 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*. This ASU supersedes most of the guidance in Topic 820, although many of the changes are clarifications of existing guidance or wording changes to align with IFRS 13. In addition, certain amendments in ASU 2011-04 change a particular principle or requirement for measuring fair value or disclosing information about fair value measurements. This update is effective for the Bank for the year ended December 31, 2012.

In June 2011, FASB issued Accounting Standard Update No. ASU 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. This ASU requires all nonowner changes in stockholders' equity to be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This update is effective for the Bank for the year ended December 31, 2012.

In December 2011, FASB issued Accounting Standard Update No. ASU 2011-115, *Disclosures about Offsetting Assets and Liabilities Balance Sheet (Topic 210)*. Offsetting (netting) assets and liabilities is an important aspect of presentation in financial statements. Entities are required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. This update is effective for the Bank for the year ended December 31, 2013.

The Bank is currently evaluating the impact that the amendments effective in 2012 will have on its future financial statements.

### 2. **INTEREST-BEARING DEPOSITS WITH OTHER BANKS:**

Interest-bearing deposits with other banks at December 31, 2011 consist of demand account balances at the Federal Home Loan Bank of Seattle and time deposits at commercial banks, all FDIC insured.



## NOTES TO FINANCIAL STATEMENTS

### 3. INVESTMENT SECURITIES:

The amortized cost and estimated fair values of available-for-sale investment securities at December 31 are as follows:

December 31, 2011						
	Available-for-Sale				Securities in Continuous Unrealized Loss	Securities in Continuous Unrealized Loss
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Position for Less Than 12 Months	Position for 12 Months or Longer
Obligations of U.S. Government sponsored agencies	\$ 1,402,423	\$ 27,529	\$ -	1,429,952	\$ -	-
Corporate securities	2,393,842	2,119	(102,052)	2,293,909	1,564,197	226,738
Mortgage-backed securities	14,251,509	125,385	(42,971)	14,333,923	9,048,520	-
	<u>\$ 18,047,774</u>	<u>\$ 155,033</u>	<u>\$ (145,023)</u>	<u>\$ 18,057,784</u>	<u>\$ 10,612,717</u>	<u>\$ 226,738</u>
December 31, 2010						
	Available-for-Sale				Securities in Continuous Unrealized Loss	Securities in Continuous Unrealized Loss
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Position for Less Than 12 Months	Position for 12 Months or Longer
Obligations of U.S. Government sponsored agencies	\$ 2,153,932	\$ 45,667	\$ -	2,199,599	\$ -	-
Corporate securities	2,005,952	5,474	(4,711)	2,006,715	996,525	-
Mortgage-backed securities	7,348,421	160,902	(15,968)	7,493,355	1,142,304	-
	<u>\$ 11,508,305</u>	<u>\$ 212,043</u>	<u>\$ (20,679)</u>	<u>\$ 11,699,669</u>	<u>\$ 2,138,829</u>	<u>\$ -</u>

The amortized cost and estimated fair value of investment securities at December 31, 2011, 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.

	Available-for-Sale	
	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 501,216	503,335
Due after one year through five years	2,292,626	2,247,071
Due after more than five years	1,002,423	973,455
Mortgage-backed securities	14,251,509	14,333,923
	<u>\$ 18,047,774</u>	<u>\$ 18,057,784</u>

There were no sales of investment securities in 2011 or 2010.

At December 31, 2011, investment securities with estimated fair value of \$7,309,390 and amortized cost of \$7,452,967 were pledged for Federal Home Loan Bank borrowing, repurchase agreements and other borrowing.

## NOTES TO FINANCIAL STATEMENTS

### 4. LOANS:

Major classifications of loans at December 31 are as follows:

	<u>2011</u>	<u>2010</u>
Real estate loans	\$ 72,199,955	\$ 66,009,800
Commercial loans	17,442,907	21,180,703
Consumer loans	<u>2,938,632</u>	<u>2,990,630</u>
	92,581,494	90,181,133
Deferred loan origination fees	<u>(232,264)</u>	<u>(211,868)</u>
	92,349,230	89,969,265
Allowance for loan losses	<u>(1,475,353)</u>	<u>(1,479,831)</u>
Loans, net	<u>\$ 90,873,876</u>	<u>\$ 88,489,434</u>

Loans serviced for others are not included in the accompanying balance sheets. The unpaid principal balances of such serviced loans were \$27,347,678 and \$35,276,010 at December 31, 2011 and 2010, respectively.

The loan portfolio at December 31, 2011 and 2010, includes \$28,482,084 and \$39,357,597, respectively, of loans which have rates of interest that change more often than annually, exclusive of fixed rate loans that are effectively converted to variable rate loans via interest rate swaps. The December 31, 2011, amount includes \$11,005,107 of loans with interest rates at their contractual floors.

The following is an analysis of impaired loans as of December 31, 2011:

	<b>Impaired Loans with Allowance</b>			<b>Impaired Loans without Allowance</b>		<b>Total Impaired Loans</b>	
	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>
<b>Commercial loans:</b>							
Nonaccrual	\$ 47,365	\$ 202,900	\$ 50,000	\$ 32,840	\$ 51,341	\$ 80,205	\$ 254,241
Other	75,791	76,457	57,512	-	-	75,791	76,457
Subtotals	123,156	279,357	107,512	32,840	51,341	155,996	330,698
<b>Real estate loans:</b>							
Nonaccrual	-	-	-	2,433,483	3,169,048	2,433,483	3,169,048
Other	-	-	-	-	-	-	-
Subtotals	-	-	-	2,433,483	3,169,048	2,433,483	3,169,048
<b>Consumer loans:</b>							
Nonaccrual	-	-	-	69	12,608	69	12,608
Other	-	-	-	-	-	-	-
Subtotals	-	-	-	69	12,608	69	12,608
Totals	\$ 123,156	\$ 279,357	\$ 107,512	\$ 2,466,392	\$ 3,232,997	\$ 2,589,548	\$ 3,512,354

Recorded investment<sup>1</sup> in financing receivables as of December 31, 2011 and 2010, was:

	<u>2011</u>	<u>2010</u>
Individually evaluated for impairment	\$ 2,589,737	\$ 5,659,094
Collectively evaluated for impairment	90,074,090	84,616,966
Totals	<u>\$ 92,663,827</u>	<u>\$ 90,276,060</u>

<sup>1</sup> Recorded investment includes unpaid principal balance, net of charge-offs, unamortized deferred loan fees and costs, and accrued interest.



## NOTES TO FINANCIAL STATEMENTS

The average recorded investment in impaired loans was \$3,995,112 in 2011 and \$8,490,763 in 2010. Interest income which would have been realized on nonaccrual loans had they remained accruing was approximately \$151,229 and \$182,923 in 2011 and 2010, respectively. There were no loans contractually past due 30 days or more as to interest or principal payments that were still accruing interest at December 31, 2011. Loans modified as to their original agreements to terms more favorable than market conditions totalled \$3,649,503 and \$2,180,886 (exclusive of loans in nonaccrual status) at December 31, 2011 and 2010, respectively.

### 5. ALLOWANCE FOR LOAN LOSSES:

The 2011 changes in the allowance for loan losses are as follows:

	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance	Specific Reserve	General Allocation
<b>Real Estate</b>							
Acquisition, Development & Construction	\$ 362,909	\$ -	\$ -	\$ 72,043	\$ 434,952	\$ -	\$ 434,952
Commercial	257,976	-	4,206	(42,214)	219,968	-	219,968
Multifamily	195,998	-	-	(65,462)	130,536	-	130,536
Owner Occupied	241,694	(156,879)	-	125,780	210,595	-	210,595
<b>Commercial and Industrial</b>	317,425	(36,379)	102,822	8,447	392,315	107,512	284,803
<b>Consumer</b>							
Secured	83,408	(112,518)	8,339	89,159	68,389	-	68,389
Unsecured	20,420	-	-	(1,823)	18,597	-	18,597
<b>Total</b>	<u>\$ 1,479,831</u>	<u>\$ (305,775)</u>	<u>\$ 115,367</u>	<u>\$ 185,929</u>	<u>\$ 1,475,352</u>	<u>\$ 107,512</u>	<u>\$ 1,367,840</u>

The 2010 changes in the allowance for loan losses are summarized as follows:

Balance, January 1, 2010	<b>\$ 1,600,404</b>
Loans charged off, net	<b>(453,550)</b>
Provision charged to income	<b>331,737</b>
Reclassify reserve for unfunded loan commitments	<b>1,240</b>
	<hr/>
Balance, December 31, 2010	<b><u>\$ 1,479,831</u></b>

**Risk Elements** – The Bank manages credit risk through lending limit constraints, credit review, approval policies and extensive ongoing internal monitoring. Additionally, credit risk is managed via diversification of the loan portfolio by loan, industry and borrower type as well as limits on the aggregation of debt to a single borrower.

**Risk Rating** – The monitoring process for the Bank's loan portfolio includes periodic reviews of individual loans with risk ratings assigned to each loan. Based upon the analysis, loans are given a risk rating of 1 to 10 based on the following criteria;

- Ratings of 1 to 3 indicate minimal to low credit risk,
- Ratings of 4 to 5 indicate average to acceptable credit risk,
- Ratings of 6 to 7 indicate potential weakness and elevated credit risk requiring greater attention by Bank personnel and Management,
- Rating of 8 indicates a loss is possible if loan deficiencies are not corrected,
- Rating of 9 indicates a loss is possible,
- Rating of 10 indicates that the loan is uncollectable, and when identified is charged off.

## NOTES TO FINANCIAL STATEMENTS

Loans risk rated 8, 9 or 10 are reviewed regularly to assess the ability of the borrowers to service all interest and principal obligations and as a result, the risk ratings may be adjusted accordingly. In the event that full collection of principal and interest is not reasonably assured, the loan is appropriately downgraded and if warranted, placed on non-accrual status even though the loan may be current as to principal and interest payments. Additionally, an assessment is made as to whether an impairment of a loan warrants specific reserves or a write down of the loan.

The following is an analysis of the credit quality of the Bank's loan portfolio as of December 31, 2011:

	<b>Weighted - Average Risk Rating</b>	<b>Recorded Investment in Loans<sup>1</sup></b>	<b>Percentage</b>
<b>Real Estate</b>			
Acquisition, Development & Construction	6.68	7,618,818	8.6%
Commercial	3.85	26,816,662	28.0%
Multifamily	4.18	6,241,701	6.8%
Owner Occupied	3.83	26,749,313	28.2%
<b>Commercial and Industrial</b>	3.93	16,179,804	18.2%
<b>Consumer</b>			
Secured	4.18	6,511,414	7.3%
Unsecured	3.24	2,546,115	2.9%
<b>Total</b>		<b>\$ 92,663,827</b>	<b>100.0%</b>

<sup>1</sup> Recorded investment includes unpaid principal balance, net of charge-offs, unamortized deferred loan fees and costs, and accrued interest.

### 6. PROPERTY:

Property at December 31 consists of the following:

	<b>2011</b>	<b>2010</b>
Land	<b>\$ 1,139,500</b>	\$ 1,139,500
Building and improvements	<b>2,162,648</b>	2,122,361
Computer equipment and software	<b>270,995</b>	257,527
Furniture and equipment	<b>340,963</b>	320,393
	<b>3,914,106</b>	3,839,781
Accumulated depreciation	<b>(980,191)</b>	(810,788)
Property, net	<b>\$ 2,933,915</b>	\$ 3,028,993

The Bank owns its headquarters building and leases to others approximately 60% of the building. Rental income recorded under noncancelable leases as well as other month-to-month agreements totalled \$221,610 in 2011 and \$208,788 in 2010, respectively and is recorded in noninterest income. Future expected revenues from noncancelable leases are:

2012	120,582
2013	93,660
2014	37,800
2015	3,150
	<u>\$ 255,192</u>

## NOTES TO FINANCIAL STATEMENTS

### 7. BORROWINGS:

Short-term borrowings are repurchase agreements of \$4,096,074 (average rate 0.25%) and \$5,085,472 (average rate 0.29%) at December 31, 2011 and 2010, respectively. Investment securities are pledged as collateral in an amount equal to the repurchase agreements.

Term borrowings consist of an FHLB term advance payable monthly with interest at 4.68%, fixed, and a short term FHLB advance with interest at 0.59%, fixed due as follows:

	<b>FHLB</b>
2012	\$ 1,083,677
2013	88,838
2014	94,317
2015	41,797
	<u>\$ 1,308,629</u>

The Bank has a borrowing limit with the FHLB equal to 10% of total assets. This borrowing line is limited to collateral consisting of FHLB stock, funds on deposit with FHLB, and eligible portions of the Bank's loan and securities portfolios. The available borrowing line at December 31, 2011, is approximately \$2,283,000.

The Bank has secured and unsecured federal funds borrowing lines available with correspondent banks totalling \$3,560,000 at December 31, 2011. There were no borrowings against these lines at December 31, 2011. The Bank has a secured borrowing line available with the Federal Reserve Discount Window which is secured by a portion of the Bank's loan portfolio. The Bank had no outstanding advances from the facility at December 31, 2011, and had an availability of approximately \$2,750,000.

### 8. INTEREST AND FEES ON LOANS:

Interest and fees on loans for the years ended December 31 is comprised of the following:

	<b>2011</b>	<b>2010</b>
Real Estate	<b>\$ 3,262,491</b>	\$ 2,812,457
Commercial	<b>1,035,844</b>	1,605,360
Consumer	<b>163,654</b>	383,422
Total interest and fees on loans	<b><u>\$ 4,461,988</u></b>	<b><u>\$ 4,801,239</u></b>

### 9. INTEREST EXPENSE:

Interest expense for the years ended December 31 is comprised of the following:

	<b>2011</b>	<b>2010</b>
Savings and interest-bearing demand	<b>\$ 307,922</b>	\$ 432,944
Time deposits in excess of \$100,000	<b>68,718</b>	258,854
Other time deposits	<b>27,254</b>	25,561
Other borrowings	<b>118,975</b>	138,340
Total interest expense	<b><u>\$ 522,869</u></b>	<b><u>\$ 855,699</u></b>

## NOTES TO FINANCIAL STATEMENTS

### 10. BENEFIT PLANS:

The Bank has a 401(k) profit sharing plan covering substantially all employees. Employer contributions are determined annually by the Board of Directors. Employer contributions were \$64,310 and \$70,024 in 2011 and 2010, respectively.

The Bank has a deferred cash incentive plan for the benefit of certain key employees and a directors' deferred compensation plan for the Bank's directors. Bank contributions totalled \$38,629 and \$0 in 2011 and 2010, respectively.

### 11. STOCK OPTION PLANS:

The Bank has an Employee and Nonemployee Director Stock Option Plan that reserves shares of stock for issuance to employees and directors. Under the plan, the exercise price of each option must equal the market price of the Bank's stock on the date of the grant, and the option's maximum term is ten years. Vesting generally occurs over one to three-year periods. Information with respect to options granted under the stock option plan is as follows:

	2011		2010	
	Options Outstanding	Weighted- average exercise price	Options Outstanding	Weighted- average exercise price
Balance, beginning of year	141,285	\$10.97	119,247	\$11.51
Granted:				
Directors	15,120	7.40	17,820	8.28
Employees	1,000	7.20	6,000	8.22
Exercised	0	n/a	0	n/a
Expired	(8,800)	n/a	(1,782)	n/a
Balance, end of year	<u>148,605</u>	<u>\$10.36</u>	<u>141,285</u>	<u>\$10.97</u>
Exercisable, end of year	<u>119,235</u>		<u>113,797</u>	
Options available for grant	<u>9,706</u>		<u>13,444</u>	

Outstanding options are as follows:

<u>Expiration</u>	<u>Average price per share</u>	<u>December 31, 2011</u>	
		<u>Exercisable</u>	<u>Outstanding</u>
2015	\$ 9.49	58,498	58,498
2016	\$ -	-	-
2017	\$ 19.34	11,849	11,849
2018	\$ 15.28	8,200	9,200
2019	\$ 9.17	24,650	30,900
2020	\$ 8.26	16,038	22,038
2021	\$ -	-	16,120
		<u>119,235</u>	<u>148,605</u>
Aggregate intrinsic value		<u>\$0</u>	<u>\$0</u>

## NOTES TO FINANCIAL STATEMENTS

Weighted average shares outstanding at December 31 are as follows:

	<u>2011</u>	<u>2010</u>
Basic	<b>998,612</b>	998,612
Common stock equivalents attributable to stock options	<b>1,409</b>	2,891
Diluted	<b><u>1,000,021</u></b>	<u>1,001,503</u>

The compensation cost related to stock options that has been charged against income (included in salaries and employee benefits) was \$19,883 and \$67,644 for the years ended December 31, 2011 and 2010, respectively. The total income tax benefit recognized in the income statement related to stock options was \$7,777 and \$26,528 for the years ended December 31, 2011 and 2010, respectively. As of December 31, 2011, there was \$32,055 of total unrecognized compensation cost related to nonvested stock options which is expected to be recognized over a weighted-average period of 0.90 years.

The weighted average fair value of each option granted (\$1.20 and \$1.01 in 2011 and 2010, respectively) is estimated on the date of the grant using the Black-Scholes option pricing model.

### 12. OTHER EXPENSE:

Other expense for the years ended December 31 is comprised of the following:

	<u>2011</u>	<u>2010</u>
Regulatory assessments	\$ 209,003	\$ 241,147
Professional services	124,130	133,062
Loan expenses and collection	111,905	90,894
Advertising, marketing and public relations	72,969	82,594
Printing, supplies and postage	63,209	61,601
Correspondent bank fees	58,471	89,185
Communications	49,263	56,365
Contract funds administration	-	58,073
Other operating expenses	138,094	114,272
Total other expense	<b><u>\$ 827,044</u></b>	<b><u>\$ 927,193</u></b>

### 13. INCOME TAXES:

The provision for income taxes results in effective tax rates different from the federal income tax statutory rate. The reasons for the differences are as follows:

	<u>2011</u>	<u>2010</u>
Tax on income at federal statutory rate	\$ 340,140	\$ 191,170
State income tax, net of federal benefit	52,161	44,930
Deferred tax rate adjustments and other	<b><u>(9,149)</u></b>	<b><u>(15,074)</u></b>
Total tax expense	<b><u>\$ 383,152</u></b>	<b><u>\$ 221,026</u></b>

## NOTES TO FINANCIAL STATEMENTS

The provision for deferred income taxes results from timing differences in the recognition of transactions for financial statement and tax purposes. The nature and tax effects of these differences for the periods ended December 31 are as follows:

	<u>2011</u>	<u>2010</u>
Interest on nonaccrual loans	\$ (45,328)	\$ (57,922)
Write downs of foreclosed real estate	(21,645)	(46,911)
Loan loss deduction for tax purposes more than provision for financial reporting purposes	153,264	36,446
Depreciation	(13,945)	(37,253)
Loan origination costs	2,230	(9,757)
Deferred compensation	(6,027)	(16,978)
Prepaid expense	(3,419)	12,232
Other	967	9,143
	<u>          </u>	<u>          </u>
Deferred tax benefit	\$ 66,097	\$ (111,000)

The components of deferred tax assets and liabilities at December 31 are as follows:

	<u>2011</u>	<u>2010</u>
Assets:		
Allowance for loan losses	\$ 565,049	\$ 506,546
Foreclosed real estate	146,402	136,121
Accrued vacation pay	7,204	8,171
Deferred compensation	23,005	16,978
Secondary accrued interest	7,051	98,319
	<u>          </u>	<u>          </u>
Total deferred tax assets	748,711	766,135
Liabilities:		
Excess tax over book depreciation	87,721	73,749
Loan origination costs	33,194	30,964
Prepaid expenses deducted for tax purposes	31,796	35,150
Unrealized gain on investment securities available-for-sale	3,908	75,000
	<u>          </u>	<u>          </u>
Total deferred tax liabilities	156,619	214,863
	<u>          </u>	<u>          </u>
Net deferred tax assets	\$ 592,092	\$ 551,272

It is anticipated that all deferred tax asset items will be fully utilized in the normal course of operations and, accordingly, management has not reduced deferred tax assets by a valuation allowance.

### 14. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK:

In order to meet the financing needs of its customers, the Bank commits to extensions of credit and issues standby letters of credit. 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 notional 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.

## NOTES TO FINANCIAL STATEMENTS

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

To manage interest rate risk, the Bank enters into interest rate swaps that effectively convert fixed rate loans into variable rate instruments earning a margin over the one month or three month LIBOR rate. These fair value hedges have been structured to be perfectly effective, thus no ineffectiveness is recognized in earnings. Compensating balances and investment securities totalling of \$3,801,695 held at a correspondent bank are pledged as security for these interest rate swaps.

Financial instruments with off-balance-sheet risk at December 31 are as follows:

	<u>2011</u>	<u>2010</u>
Commitments to extend credit	\$ 16,322,236	\$ 13,632,679
Standby letters of credit	30,000	30,000
Interest rate swaps (receive variable - pay fixed, maturing 2015-2021):		
Principal amount of hedged loans	17,811,690	18,263,515
Credit risk amount (included in other liabilities)	<u>3,804,227</u>	<u>2,424,893</u>
Total fair value of hedged loans	<u>21,615,917</u>	<u>20,688,408</u>

### 15. RELATED PARTY TRANSACTIONS:

The Bank has granted loans to officers and directors and to companies with which they are associated. Such loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated parties. Activity with respect to these loans during the periods ended December 31 was as follows:

	<u>2011</u>	<u>2010</u>
Balance, beginning of year	\$ 2,305,582	\$ 2,851,492
Additions or renewals	697,000	218,743
Amounts collected or renewed	<u>(893,222)</u>	<u>(764,653)</u>
Balance, end of year	<u>\$ 2,109,360</u>	<u>\$ 2,305,582</u>

In addition, there were \$834,587 in commitments to extend credit to officers and directors, including related entities, at December 31, 2011, which are included as part of commitments in Note 14.

Deposits from officers, directors and related parties totalled \$6,827,808 and \$3,741,910 at December 31, 2011 and 2010, respectively.

## NOTES TO FINANCIAL STATEMENTS

### 16. FAIR VALUE DISCLOSURES OF FINANCIAL INSTRUMENTS:

The following disclosures are made in accordance with provisions of ASC 825. The use of different assumptions and estimation methods could have a significant effect on fair value amounts. Accordingly, the estimates of fair value herein are not necessarily indicative of the amounts that might be realized in a current market exchange.

The estimated fair values of the financial instruments at December 31 are as follows:

	2011		2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and cash equivalents	\$ 7,477,024	\$ 7,477,024	\$ 10,118,173	\$ 10,118,173
Investment securities available-for-sale	18,057,784	18,057,784	11,699,669	11,699,669
Hedged loans, net of allowance for loan losses	21,430,824	21,430,824	20,507,079	20,507,079
Other loans, net of allowance for loan losses	69,443,052	70,406,662	67,974,582	68,252,443
Interest receivable	397,261	397,261	377,561	377,561
Equity investments	264,300	264,300	264,300	264,300
Cash surrender value of bank owned life insurance	1,795,084	1,795,084	1,740,581	1,740,581
Financial liabilities:				
Deposits	101,724,073	101,732,353	96,804,096	96,824,113
Interest payable	79,600	79,600	102,005	102,005
Repurchase agreements	4,096,074	4,096,074	5,085,472	5,085,472
Term borrowings	1,308,628	1,329,554	1,813,841	1,877,872
Interest rate swap agreements	3,804,227	3,804,227	2,424,893	2,424,893

**Cash and Cash Equivalents** – The fair value approximates carrying amount.

**Securities** – Fair value is estimated using quoted market prices from similar securities.

**Loans** – Fair value of fixed-rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Variable rate loans not at contractual floors have carrying amounts that are a reasonable estimate of fair value.

**Equity investments** – As stated in Note 1, equity investments are carried at cost which approximates fair value.

**Deposits** – Fair value of demand, interest-bearing demand and savings deposits is the amount payable on demand at the reporting date. Fair value of time deposits is estimated using the interest rates currently offered for the deposits of similar remaining maturities. The estimated fair values of deposits do not take into account the benefit that results from low-cost funding such deposits provide.

**Repurchase agreements** – The carrying amount is a reasonable estimate of fair value because of the short-term nature of these borrowings.

**Borrowings** – The fair value of fixed rate issuances is estimated using a discounted cash flow calculation.



## NOTES TO FINANCIAL STATEMENTS

The following table presents the Bank's fair value hierarchy for those assets and liabilities measured at fair value as of December 31, 2011:

Description	Fair Value Measurements Using					Total Period Losses Included in Earnings	
	Total	Quoted Prices in Active Markets for Identical Assets (Level I)		Significant Other Observable Inputs (Level II)	Significant Unobservable Inputs (Level III)		
Recurring items:							
Assets							
Securities	\$	18,057,784	\$	-	\$ 18,057,784	\$	-
Cash surrender value of life insurance		1,795,084		-	1,795,084		-
Hedged loans		21,615,917		-	21,615,917		-
Total assets measured at fair value on a recurring basis	\$	41,468,785	\$	-	\$ 41,468,785	\$	-
Liabilities							
Interest rate swap agreements	\$	3,804,227	\$	-	\$ 3,804,227	\$	-
Non-recurring items:							
Assets							
Loans measured for impairment	\$	2,878,133	\$	-	\$ -	\$ 2,820,621	\$ 57,512
Foreclosed real estate		493,810		-	-	455,806	38,004
Total assets measured at fair value on a non-recurring basis	\$	3,371,943	\$	-	\$ -	\$ 3,276,427	\$ 95,516

There were no transfers to or from Level III during 2011.

The following table presents the Bank's fair value hierarchy for those assets and liabilities measured at fair value on a recurring basis as of December 31, 2010:

Description	Fair Value Measurements Using					Total Period Losses Included in Earnings
	Total	Quoted Prices	Significant	Significant	Total Period Losses Included in Earnings	
		in Active Markets for Identical Assets (Level I)	Other Observable Inputs (Level II)	Unobservable Inputs (Level III)		
Recurring items:						
Assets						
Securities	\$ 11,699,669	\$ -	\$ 11,699,669	\$ -	\$ -	
Cash surrender value of life insurance	1,740,581	-	1,740,581	-	-	
Hedged loans	20,688,408	-	20,688,408	-	-	
Total assets measured at fair value on a recurring basis	<u>\$ 34,128,658</u>	<u>\$ -</u>	<u>\$ 34,128,658</u>	<u>\$ -</u>	<u>\$ -</u>	
Liabilities						
Interest rate swap agreements	<u>\$ 2,424,893</u>	<u>\$ -</u>	<u>\$ 2,424,893</u>	<u>\$ -</u>	<u>\$ -</u>	
Non-recurring items:						
Assets						
Loans measured for impairment	\$ 2,073,988	\$ -	\$ -	\$ 1,804,988	\$ 269,000	
Foreclosed real estate	949,994	-	-	680,832	269,162	
Total assets measured at fair value on a non-recurring basis	<u>\$ 3,023,982</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,485,820</u>	<u>\$ 538,162</u>	

There were no transfers to or from Level III during 2010.

## NOTES TO FINANCIAL STATEMENTS

The fair value represents management's best estimates based on a range of methodologies and assumptions. For loans with doubt as to collectability and foreclosed real estate expected cash flows are discounted using an appropriate rate considering the time of collection, credit risk, and the discount for the uncertainty of the flows. The value of collateral is also considered.

### 17. REGULATORY MATTERS:

The Bank is subject to the regulations of certain federal and state agencies and receives periodic examinations by those regulatory authorities. In addition, the Bank is subject to various regulatory capital requirements administered by 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 financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

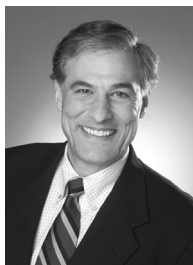
Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum ratios (set forth in the table below) of Total and Tier I capital to risk-weighted assets, and of Tier I capital to leverage assets, all as defined in the regulations. As of December 31, 2011, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized as defined by regulations. To be categorized as well capitalized, the Bank must maintain minimum Total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

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

	Actual		For Capital Adequacy Purposes		To be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2011:						
Total capital (to risk-weighted assets)	\$ 12,755	12.78%	\$ 7,985	8.00%	\$ 9,981	10.00%
Tier I capital (to risk-weighted assets)	\$ 11,507	11.53%	\$ 3,992	4.00%	\$ 5,989	6.00%
Tier I capital (to leverage assets)	\$ 11,507	9.03%	\$ 5,099	4.00%	\$ 6,373	5.00%
As of December 31, 2010:						
Total capital (to risk-weighted assets)	\$ 12,057	12.40%	\$ 7,779	8.00%	\$ 9,724	10.00%
Tier I capital (to risk-weighted assets)	\$ 10,837	11.15%	\$ 3,889	4.00%	\$ 5,834	6.00%
Tier I capital (to leverage assets)	\$ 10,837	8.49%	\$ 5,108	4.00%	\$ 6,385	5.00%

The Federal Deposit Insurance Corporation has not reviewed the financial data and related data in this statement for accuracy or relevance.

## BOARD OF DIRECTORS



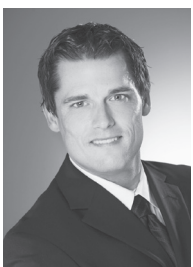
### **RICHARD M. ABRAHAM, MD**

Dr. Abraham is a Founding Director and is active in the Bank's business development efforts. He has been a practicing Emergency and Occupational Medicine physician with Cascade Medical Associates since 1979 and is their current President. He is also managing partner of Eugene Urgent Care walk-in clinics and the Medical Director of Cascade Health Solutions Occupational Medicine Program. He serves on the boards of Cascade Health Solutions, McKenzie Willamette Medical Center, and the Safety and Health Institute. He has previously served on the boards of Pacific Source and the Marist Foundation.



### **ALAN V. EVANS**

Mr. Evans is a Founding Director and currently serves as a member of the Loan Committee. He is founder and President of Evans, Elder & Brown, Inc., a commercial real estate brokerage active in sales, leasing, and development of commercial properties. He also serves as Vice Chair of the Arts and Business Alliance of Eugene. He previously served as Chair of the Arts Foundation of Western Oregon and as a member of the boards for the Eugene Opera and the Oregon Bach Festival.



### **STEVEN J. KORTH**

Mr. Korth has been a Director since 2008 and currently serves as a member of the Loan Committee. He is the Director of Real Estate and Development for his family business McKay Investment Company. He has served on the boards of the Eugene Chamber of Commerce, Lane Metro Partnership, and the Oregon Community Foundation. He is also active in local government, having served on the Mayor of Eugene's Economic Development Committee, the Eugene Enterprise Zone Committee, and as a member of the Eugene School Districts "Shaping 4-J's Future" task force.



### **ANN MARIE MEHLUM**

Ms. Mehlum has been the Chief Executive Officer and a Director since the Bank's inception in 2004. Her banking career spans over thirty five years. She currently serves on the board of the Oregon Bankers Association, where she is the Past Chair, the Eugene Chamber of Commerce, and is a member of the Community Bankers Advisory Council to the Federal Deposit Insurance Corporation. She previously served on the American Bankers Association Community Banking Council and on the boards of United Way of Lane County, Eugene Chamber of Commerce, and Lane Metro Partnership.



### **J. ANDREW MOORE**

Mr. Moore has been a Director since 2010 and currently serves as a member of the Audit Committee. He is Co-President of MLF Group, LLC (Pepsi-Cola Eugene, Coos Bay & Newport and Northwest Vending Company) and President of Pepsi-Cola Bottling Company of Bend. He serves on the boards of the Oregon Soft Drink Association, the American Beverage Association, Cascade Health Solutions, Willamette Valley Council of the Oregon Community Foundation, and the Eugene Country Club. He previously served on the boards of the Pepsi-Cola Bottler's Association and Lane Community College Foundation.

## BOARD OF DIRECTORS



### **DENNIS G. OREM**

Mr. Orem is a Founding Director and currently serves as a member of the Compensation and Nominating Committee. He is the CEO of Jerry's Home Improvement Centers with stores in Eugene and Springfield. He has been an active participant in local, regional, and national industry trade organizations including serving on the boards of the Western Building Materials Association, the Home Center Institute, and the Eugene Chamber of Commerce.



### **GRETCHEN N. PIERCE**

Mrs. Pierce is a Founding Director, past Board Chair and currently serves as the Chair of the Asset Liability Committee and as a member of the Compensation and Nominating Committee. She is President and General Manager of Hult & Associates, LLC, a local commercial and industrial real estate development company. She also serves on the boards of Pacific Source, Peace Health, and the Southern Oregon Leadership Council of the Oregon Community Foundation. She previously served on the boards of the University of Oregon Foundation, the Eugene Chamber of Commerce, the Oregon Community Foundation, Associated Oregon Industries, and Siuslaw Bank.



### **ANDY J. STORMENT**

Mr. Storment is a Founding Director and currently serves as the Board Vice Chair, and as Chair of the Loan Committee. He is a Managing Director of McKenzie Capital, a locally-owned private equity firm that manages investments in commercial real estate and operating companies in Oregon. Formerly, he was Executive Vice President, Treasurer, and Secretary of Percon Incorporated and has prior experience in the accounting and wood products industries.



### **R. PAUL WEINHOLD**

Mr. Weinhold is a Founding Director and currently serves as the Board Chair, Chair of the Compensation and Nominating Committee and as a member of the Audit Committee. He is the President of the University of Oregon Foundation. He has served in leadership roles for a variety of local non-profits and currently serves as the Vice President of the Oregon Urology Foundation. Prior to joining the University of Oregon Foundation, he spent more than twenty years in leadership roles in the commercial insurance industry.



### **JOHN R. YORK, MD**

Dr. York is a Founding Director and currently serves as the Chair of the Audit Committee. He is the retired President of Women's Care Associates. He also serves on the Board of Trillium Holdings. He previously served on the boards of Agate Resources, Pacific Source, Medical and Surgical Specialists, and was the OBGYN Department Chair for Peace Health.