



SIUSLAW

**FINANCIAL
GROUP**

**2010
Annual Report**

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INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying consolidated balance sheets of Siuslaw Financial Group, Inc. and its subsidiary, Siuslaw Bank (collectively, "the Company"), as of December 31, 2010 and 2009, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 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 audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Siuslaw Financial Group, Inc. and its subsidiary as of December 31, 2010 and 2009, 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.

DELAP LLP

Lake Oswego, Oregon
March 15, 2011

CONSOLIDATED BALANCE SHEETS

| | <u>December 31,</u> | |
|--|-----------------------|-----------------------|
| | <u>2010</u> | <u>2009</u> |
| Assets | | |
| Cash and cash equivalents: | | |
| Cash and due from banks | \$ 3,289,883 | \$ 6,552,881 |
| Interest-bearing deposits in banks | 37,893,155 | 10,612,292 |
| Total cash and cash equivalents | 41,183,038 | 17,165,173 |
| Interest-bearing time deposits | 13,495,000 | 9,000,000 |
| Investment securities available-for-sale | 15,668,490 | 18,210,762 |
| Federal Home Loan Bank stock | 654,800 | 654,800 |
| Loans, net | 205,605,882 | 218,098,882 |
| Mortgage loans held for sale | 2,036,752 | 1,580,736 |
| Premises and equipment, net | 6,209,172 | 6,246,320 |
| Bank-owned life insurance | 6,145,321 | 5,893,724 |
| Accrued interest receivable and other assets | 8,628,614 | 7,368,660 |
| Total assets | <u>\$ 299,627,069</u> | <u>\$ 284,219,057</u> |
| Liabilities and Stockholders' Equity | | |
| Liabilities: | | |
| Deposits: | | |
| Demand | \$ 48,719,208 | \$ 37,287,029 |
| NOW and money market | 130,455,905 | 129,161,787 |
| Savings | 29,951,703 | 25,687,476 |
| Time | 46,369,704 | 44,458,866 |
| Total deposits | 255,496,520 | 236,595,158 |
| Short-term borrowings | - | 6,000,000 |
| Junior subordinated debentures | 8,248,000 | 8,248,000 |
| Accrued interest payable and other liabilities | 3,946,130 | 3,633,871 |
| Total liabilities | 267,690,650 | 254,477,029 |
| Stockholders' equity: | | |
| Series A preferred stock, \$1 par value; 200,000 shares authorized; 106,050 shares issued and outstanding (107,050 in 2009) | 106,050 | 107,050 |
| Common stock, \$1 par value; 10,000,000 shares authorized; 4,010,177 shares issued and outstanding (4,017,539 in 2009) | 4,010,177 | 4,017,539 |
| Surplus | 7,732,454 | 7,749,178 |
| Retained earnings | 19,721,101 | 17,427,742 |
| Accumulated other comprehensive income | 366,637 | 440,519 |
| Total stockholders' equity | <u>31,936,419</u> | <u>29,742,028</u> |
| Total liabilities and stockholders' equity | <u>\$ 299,627,069</u> | <u>\$ 284,219,057</u> |

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

CONSOLIDATED STATEMENTS OF INCOME

| | <u>Years ended December 31,</u> | |
|---|---------------------------------|---------------|
| | <u>2010</u> | <u>2009</u> |
| Interest and dividend income: | | |
| Interest and fees on loans | \$ 14,381,391 | \$ 15,242,239 |
| Taxable interest on investment securities available-for-sale | 561,271 | 879,678 |
| Nontaxable interest on investment securities available-for-sale | 209,735 | 203,620 |
| Interest on interest-bearing deposits | 96,962 | 21,250 |
| Interest on federal funds sold | — | 35,864 |
| | <hr/> | <hr/> |
| Total interest and dividend income | 15,249,359 | 16,382,651 |
| Interest expense: | | |
| Deposits | 1,610,176 | 2,225,291 |
| Junior subordinated debentures | 254,060 | 306,660 |
| Short-term borrowings | 21,798 | 129,372 |
| | <hr/> | <hr/> |
| Total interest expense | 1,886,034 | 2,661,323 |
| Net interest income | 13,363,325 | 13,721,328 |
| Loan loss provision | <hr/> | <hr/> |
| | 1,000,000 | 1,600,000 |
| Net interest income after loan loss provision | 12,363,325 | 12,121,328 |
| Noninterest income: | | |
| Mortgage loan servicing fees, net | 1,283,806 | 1,376,485 |
| Service charges on deposit accounts | 581,435 | 622,130 |
| Mortgage loan origination and processing fees, net | 512,687 | 471,871 |
| Interchange, ATM and associated fees | 495,549 | 433,826 |
| Credit card merchant fees, net | 380,010 | 448,460 |
| Earnings on bank-owned life insurance policies | 300,009 | 282,188 |
| Other | 430,486 | 410,414 |
| | <hr/> | <hr/> |
| Total noninterest income, net | 3,983,982 | 4,045,374 |
| Noninterest expenses: | | |
| Salaries and employee benefits | 7,640,888 | 7,270,384 |
| Occupancy, net | 787,885 | 824,637 |
| Regulatory insurance and assessments | 422,037 | 467,460 |
| Communications | 381,043 | 388,727 |
| Data processing | 307,483 | 274,484 |
| Other real estate owned | 100,645 | 347,059 |
| Other | 1,574,319 | 1,564,985 |
| | <hr/> | <hr/> |
| Total noninterest expenses, net | 11,214,300 | 11,137,736 |
| Income before income taxes | 5,133,007 | 5,028,966 |
| Provision for income taxes | <hr/> | <hr/> |
| | 1,150,000 | 1,690,000 |
| Net income | <hr/> | <hr/> |
| | \$ 3,983,007 | \$ 3,338,966 |
| Basic earnings per common share | <hr/> | <hr/> |
| | \$ 0.96 | \$ 0.81 |

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

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

| | <i>Series A preferred stock</i> | | <i>Common stock</i> | |
|---|-------------------------------------|---------------|---------------------|---------------|
| | <i>Shares</i> | <i>Amount</i> | <i>Shares</i> | <i>Amount</i> |
| 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 |
| Comprehensive income: | | | | |
| Net income | - | - | - | - |
| Other comprehensive loss – unrealized losses on investment securities available-for-sale (net of income taxes of approximately \$46,000) | - | - | - | - |
| Total comprehensive income, net | - | - | - | - |
| Repurchases of Series A preferred stock | (1,000) | (1,000) | - | - |
| Repurchases of common stock | - | - | (7,362) | (7,362) |
| Cash dividends paid: | | | | |
| Common (\$.40 per share) | - | - | - | - |
| Preferred (\$.42 per share) | - | - | - | - |
| Balances at December 31, 2010 | 106,050 | \$ 106,050 | 4,010,177 | \$ 4,010,177 |

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

| | <u>Surplus</u> | <u>Retained earnings</u> | <u>Comprehensive income (loss)</u> | <u>Accumulated other comprehensive income (loss)</u> | <u>Total stockholders' equity</u> |
|-----------|------------------|--------------------------|------------------------------------|--|-----------------------------------|
| \$ | 7,779,926 | \$ 16,246,275 | | \$ 379,077 | \$ 28,545,241 |
| | - | 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) |
| | - | <u>(56,887)</u> | | - | <u>(56,887)</u> |
| | 7,749,178 | 17,427,742 | | 440,519 | 29,742,028 |
| | - | 3,983,007 | \$ 3,983,007 | - | 3,983,007 |
| | - | - | <u>(73,882)</u> | (73,882) | (73,882) |
| | - | - | <u>\$ 3,909,125</u> | - | - |
| | (2,000) | (4,512) | | - | (7,512) |
| | (14,724) | (33,664) | | - | (55,750) |
| | - | (1,606,527) | | - | (1,606,527) |
| | - | <u>(44,945)</u> | | - | <u>(44,945)</u> |
| <u>\$</u> | <u>7,732,454</u> | <u>\$ 19,721,101</u> | | <u>\$ 366,637</u> | <u>\$ 31,936,419</u> |

CONSOLIDATED STATEMENTS OF CASH FLOWS

| | <u>Years ended December 31,</u> | |
|--|---------------------------------|----------------------|
| | <u>2010</u> | <u>2009</u> |
| Cash flows from operating activities: | | |
| Net income | \$ 3,983,007 | \$ 3,338,966 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 941,448 | 1,044,278 |
| Gain on sale of land and building | - | (121,345) |
| Gains on sales of mortgage loans held for sale, net | (442,291) | (253,693) |
| Loan loss provision | 1,000,000 | 1,600,000 |
| Write-down of other real estate | 78,200 | 110,000 |
| Losses (gains) on sales of other real estate, net | (1,725) | 177,585 |
| Credit for deferred income taxes | (557,000) | (551,000) |
| Amortization of net premiums on investment securities available-for-sale | 49,165 | 17,484 |
| Increase in cash surrender value of bank-owned life insurance | (251,597) | (284,014) |
| Increase in accrued interest receivable and other assets | (417,943) | (1,700,933) |
| Increase in accrued interest payable and other liabilities | 357,928 | 328,713 |
| Originations of mortgage loans held for sale | (49,167,788) | (44,256,384) |
| Proceeds from sales of mortgage loans held for sale | <u>49,154,063</u> | <u>43,924,352</u> |
| Net cash provided by operating activities | 4,725,467 | 3,374,009 |
| Cash flows from investing activities: | | |
| Increase in interest-bearing time deposits | (4,495,000) | (8,000,000) |
| Purchases of investment securities available-for-sale | (7,441,981) | (785,000) |
| Proceeds from maturities, calls, and prepayments of investment securities available-for-sale | 9,815,537 | 9,661,973 |
| Purchases of mortgage servicing rights | (3,862) | (40,484) |
| Net decrease (increase) in other loans | 10,049,052 | (141,451) |
| Purchases of premises and equipment, net | (317,411) | (73,676) |
| Proceeds from sales of other real estate | <u>499,435</u> | <u>421,102</u> |
| Net cash provided by investing activities | 8,105,770 | 1,042,464 |
| Cash flows from financing activities: | | |
| Net increase in deposits | 18,901,362 | 15,899,679 |
| Net decrease in short-term borrowings | (6,000,000) | (6,500,000) |
| Repurchases of common and preferred stock | (63,262) | (132,569) |
| Cash dividends paid | <u>(1,651,472)</u> | <u>(2,071,052)</u> |
| Net cash provided by financing activities | <u>11,186,628</u> | <u>7,196,058</u> |
| Net increase in cash and cash equivalents | 24,017,865 | 11,612,531 |
| Cash and cash equivalents at beginning of year | <u>17,165,173</u> | <u>5,552,642</u> |
| Cash and cash equivalents at end of year | <u>\$ 41,183,038</u> | <u>\$ 17,165,173</u> |

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

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 8). In accordance with accounting principles generally accepted in the United States of America (GAAP), the accounts and transactions of this trust are not included in the accompanying consolidated financial statements.

Certain amounts in 2009 have been reclassified to conform with the 2010 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 4).

Subsequent Events

Management has evaluated, for potential recognition or disclosure in the consolidated financial statements, subsequent events that have occurred through March 15, 2011, which is the date the consolidated 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), and interest-bearing deposits in banks. Generally, interest-bearing deposits in banks are invested for a maximum of 90 days.

The Bank maintains balances in correspondent bank accounts which, at times, may exceed federally insured limits. 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

During 2010 and 2009, non-cash transactions resulted from unrealized gains and losses on investment securities available-for-sale, 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 \$110,000 and \$37,000 in originated mortgage servicing rights during 2010 and 2009, respectively, and the transfer of approximately \$1,444,000 and \$494,000 of loans to other real estate owned (OREO) in 2010 and 2009, respectively.

During 2010 and 2009, the Company paid approximately \$1,897,000 and \$2,738,000, respectively, in interest expense.

During 2010 and 2009, the Company made income tax payments of approximately \$2,021,000 and \$2,229,000, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Interest-bearing Time Deposits

Interest-bearing time deposits mature within one year and are carried at cost. Such deposits totaling \$1,500,000 as of December 31, 2010, were pledged to secure public deposits (see Note 9). No interest-bearing time deposits were pledged to secure public deposits as of December 31, 2009.

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 2010 or 2009.

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 2010 or 2009.

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 noninterest income. 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, (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) 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 as of December 31, 2010 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 Federal Home Loan Bank of Seattle (FHLB) stock based on specific percentages of its outstanding mortgages, total assets, or FHLB advances. As of December 31, 2010 and 2009, 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 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, 2010, the FHLB reported that it had met all of its regulatory capital requirements, but remained classified as "undercapitalized" by its primary regulator, the Federal Housing Finance Agency (FHFA), due to several factors including the possibility that further declines in the value of its private-label mortgage-backed securities could cause it to fall below its risk-based capital requirements. On October 25, 2010, the FHLB announced that it had entered into a Consent Agreement with the FHFA, which requires the FHLB to take certain specified actions related to its business and operations. The FHFA continues to deem the FHLB

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

FHLB Stock (continued)

"undercapitalized" under the FHFA's Prompt Corrective Action rule. 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, 2010, 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.

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. Past due status is based on the contractual terms of the loan.

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. If the loan is repaid prior to maturity, the remaining unamortized deferred loan origination fee is recognized in interest income at the time of repayment.

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 consolidated 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 reserve consists of general and specific components. The general component covers non-impaired loans. The Bank's methodology for determining the appropriate level of the general component of the reserve 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 loss experience of the Bank and the industry. This loss experience data is adjusted, as appropriate, based on Management's continuing evaluation of various factors underlying the quality of the loan portfolio, including lending policies and procedures, economic conditions, experience of lending management, the quality of the Bank's loan review system, the volume of troubled loans, the estimated collateral value of collateral-dependent loans, concentration of credit risk, and regulatory requirements. In calculating the general component of the reserve, the Bank aggregates its loans into eight portfolio segments: construction and development, commercial real estate, multi-family, home equity and second mortgage, one-four family residential, commercial and industrial, consumer, and municipal. Risk factors impacting loans in each loan segment include reduced consumer and business spending as a result of continued high unemployment and reduced credit availability, and lack of consumer confidence in a sustainable economic recovery. Deterioration of property values is a risk factor that particularly impacts the construction and development, home equity and second mortgage, one-four family residential, multi-family, and commercial real estate segments.

The specific component of the reserve relates to loans that are individually classified as impaired. 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. Impaired loans are 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 or reflected as a partial charge-off of the loan balance. Smaller balance

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Reserve for Loan Losses (continued)

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 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. Loan losses are charged against the reserve when Management deems a loan balance to be uncollectible.

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. 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.

Management made certain enhancements to the methodology for calculating the general component of the reserve for 2010. However, Management does not believe that these changes had any material impact on the total reserve.

Troubled Debt Restructurings (TDRs)

A loan is classified as a TDR when a borrower is experiencing financial difficulties and the Bank grants a concession to the borrower in the restructuring that the Bank would not otherwise consider. These concessions may include – but are not limited to – interest rate reductions, principal forgiveness, deferral of interest payments, extension of the maturity date, and other actions intended to minimize potential losses to the Bank. A TDR loan is generally considered to be impaired.

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 as of December 31, 2010 and 2009. 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 in the accompanying consolidated balance sheets and are carried at the lower of cost or estimated market value. Market value is determined on an aggregate loan basis. As of December 31, 2010 and 2009, mortgage loans held for sale were carried at cost, which approximated estimated market value.

As of December 31, 2010 and 2009, the Bank held servicing rights to approximately \$348,658,000 and \$360,092,000, 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 sales and servicing of these mortgage loans are subject to technical underwriting and servicing requirements, related repurchase risks, and regulatory compliance risk. As of December 31, 2010, Management is not aware of any mortgage loans that will have to be repurchased and believes that any potential costs related to regulatory compliance risk would not be significant to the Company's December 31, 2010 consolidated financial statements.

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, 2010 and 2009, the Bank capitalized approximately \$451,000 and \$388,000, 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 values at the date of sale. In addition, during the years ended December 31, 2010 and 2009, the Bank purchased mortgage servicing rights from third-parties totaling approximately \$4,000 and \$41,000,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Mortgage Loans and Mortgage Servicing Rights (continued)

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, 2010 and 2009, the amortization of CMSRs totaled approximately \$454,000 and \$492,000, 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 lives 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 \$3,633,000 and \$3,911,000 as of December 31, 2010 and 2009, respectively. The net book value of CMSRs as of December 31, 2010 and 2009 (approximately \$987,000 and \$986,000, 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. Expenditures for repairs and maintenance are charged to expense as incurred. Additions and betterments are capitalized. Depreciation and amortization are 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.

As part of an on-going review of the valuation and amortization of premises and equipment, Management assesses the carrying value of such assets if facts and circumstances suggest that they may be impaired. If this review indicates that the assets will not be fully recoverable, as determined by a fair-value-based impairment test, the carrying value of the Company's premises and equipment would be reduced to its estimated fair value.

Bank-Owned Life Insurance (BOLI)

The Company has purchased BOLI on certain executives. The BOLI is recorded at 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. The valuation of OREO is also subject to review by Federal and State bank regulatory authorities who may require increases or decreases to carrying amounts based on their evaluation of the information available to them at the time of their examinations of the Bank, in addition to State banking regulations which require periodic mandatory write-downs of OREO. 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. In addition, as certain of these third-party appraisals and independent fair market value assessments are only updated periodically, changes in the values of specific properties may have occurred subsequent to the most recent appraisals. Accordingly, the amounts of any such potential changes and any related adjustments are generally recorded at the time such information is received. OREO of approximately \$1,424,000 and \$556,000 as of December 31, 2010 and 2009, respectively, is included in accrued interest receivable and other assets in the accompanying consolidated balance sheets.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Stockholders' Equity

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.

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 (\$108,325 and \$91,463 for the years ended December 31, 2010 and 2009, respectively), by the weighted average number of common shares outstanding (4,016,110 and 4,026,352 for the years ended December 31, 2010 and 2009, respectively).

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the 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 \$97,000 and \$95,000 during the years ended December 31, 2010 and 2009, respectively.

Income Taxes

The Company utilizes the asset and liability method for accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the consolidated financial statement carrying values and their respective income tax bases (temporary differences). The resulting changes in the net deferred tax assets or liabilities are included in income. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the periods that the temporary differences are expected to be recovered or settled. The effect on deferred income tax assets and liabilities of a change in tax rates is included in income in the period that includes the substantial enactment date. Deferred income tax assets are evaluated periodically, and, if realization is not considered "more likely than not," a valuation allowance is provided.

Income tax positions that meet the "more likely than not" recognition threshold are measured as the largest amount of income tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with income tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized income tax benefits in the accompanying consolidated balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest and penalties associated with unrecognized income tax benefits are classified as additional income taxes in the consolidated statements of income. There were no unrecognized income tax benefits, nor any interest and penalties associated with unrecognized income tax benefits, accrued or expensed as of and for the years ended December 31, 2010 and 2009.

The Company files income tax returns for federal and state of Oregon tax jurisdictions. The Company's federal and state income tax returns for years before 2007 are no longer subject to examination by federal and state tax authorities.

New Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (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. This guidance became effective January 1, 2010 and did not have a significant effect on the Company's consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

New Accounting Pronouncements (continued)

In January 2010, the FASB issued updated guidance concerning fair value measurements and disclosures. The new guidance requires expanded disclosures related to fair value measurements including: (1) the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers; (2) the reasons for transfers of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately; (3) the policy for determining when transfers between levels of the fair value hierarchy are recognized; and (4) for recurring fair value measurements of assets and liabilities in Level 3 of the fair value hierarchy, a gross presentation of information about purchases, sales, issuances, and settlements. The guidance also further clarifies that (1) fair value measurement disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities with a line item in the statement of financial position, and (2) companies should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The disclosures related to the gross presentation of purchases, sales, issuances, and settlements of assets and liabilities included in Level 3 of the fair value hierarchy will be required for the Company for the year ending December 31, 2011, and Management does not expect that the adoption of this disclosure requirement will have a significant impact on the Company's future consolidated financial statements. The remaining disclosure requirements and clarifications under this guidance became effective for the Company for the year ended December 31, 2010 and did not have a significant impact on the Company's consolidated financial statements.

In July 2010, the FASB issued updated guidance on disclosure requirements related to the credit quality of financing receivables and the allowance for credit losses. The new guidance requires entities to provide disclosures designed to facilitate financial statement users' evaluation of (1) the nature of credit risk inherent in the entity's portfolio of financing receivables, (2) how that risk is analyzed and assessed in arriving at the allowance for credit losses, and (3) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segments. The required disclosures include, among other things, a rollforward of the allowance for credit losses as well as information about modified, impaired, nonaccrual and past due loans, and credit quality indicators. This guidance became effective for the Company's consolidated financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period will be required for the Company's consolidated financial statements for the year ending December 31, 2011. Adoption of this guidance did not have a significant impact on the Company's 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 a reserve balance with the FRB at December 31, 2010 and 2009.

3. Investment Securities Available-For-Sale

Investment securities available-for-sale as of December 31, 2010 and 2009 consisted of the following:

| | <i>Amortized cost</i> | <i>Gross unrealized gains</i> | <i>Gross unrealized losses</i> | <i>Estimated fair value</i> |
|---|---------------------------|---------------------------------------|--|-------------------------------------|
| 2010 | | | | |
| Collateralized mortgage obligations | \$ 5,254,965 | \$ 132,881 | \$ 18 | \$ 5,387,828 |
| Obligations of state and political subdivisions | 6,154,014 | 300,272 | 1,556 | 6,452,730 |
| U.S. Government and agency securities | 2,952,013 | 61,736 | - | 3,013,749 |
| Mortgage-backed securities | 714,235 | 99,948 | - | 814,183 |
| | <u>\$ 15,075,227</u> | <u>\$ 594,837</u> | <u>\$ 1,574</u> | <u>\$ 15,668,490</u> |
| 2009 | | | | |
| 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> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Investment Securities Available-For-Sale (Continued)

As of December 31, 2010, 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, 2010 and 2009, 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 as of December 31, 2010, 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 | \$ 1,026,382 | \$ 1,059,434 |
| Due after one year through five years | 2,853,498 | 2,954,573 |
| Due after five years through ten years | 4,322,736 | 4,514,369 |
| Due after ten years | 903,411 | 938,103 |
| Collateralized mortgage obligations | 5,254,965 | 5,387,828 |
| Mortgage-backed securities | 714,235 | 814,183 |
| | <u>\$ 15,075,227</u> | <u>\$ 15,668,490</u> |

Investment securities with a carrying value of approximately \$10,407,000 and \$15,849,000 as of December 31, 2010 and 2009, respectively, were pledged to secure public deposits (see Note 9) and for other purposes as required or permitted by law (see Note 7).

4. Loans and Reserve for Loan Losses

Loans as of December 31, 2010 and 2009 consisted of the following:

| | <i>2010</i> | <i>2009</i> |
|---|-----------------------|-----------------------|
| Commercial | \$ 22,038,338 | \$ 30,443,874 |
| Real estate: | | |
| Commercial | 133,457,890 | 141,828,742 |
| Residential and commercial construction | 25,293,579 | 24,734,410 |
| Mortgage | 10,322,593 | 12,497,854 |
| Municipal | 10,778,714 | 3,518,978 |
| Installment | 7,132,685 | 7,925,379 |
| Other | 1,028,487 | 1,172,610 |
| | <u>210,052,286</u> | <u>222,121,847</u> |
| Less: | | |
| Reserve for loan losses | 3,614,166 | 3,189,094 |
| Deferred loan fees | 832,238 | 833,871 |
| | <u>4,446,404</u> | <u>4,022,965</u> |
| Loans, net | <u>\$ 205,605,882</u> | <u>\$ 218,098,882</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Reserve for Loan Losses (Continued)

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. As of December 31, 2010 and 2009, the portion of these loans participated to third parties (which are not included in the accompanying consolidated financial statements) totaled approximately \$9,624,000 and \$10,117,000, 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.

Transactions in the reserve for loan losses for the years ended December 31, 2010 and 2009 were as follows:

| | <u>2010</u> | <u>2009</u> |
|--|---------------------|---------------------|
| Balance at beginning of year | \$ 3,189,094 | \$ 2,299,735 |
| Loan loss provision | 1,000,000 | 1,600,000 |
| Loans charged-off | (777,697) | (801,048) |
| Recoveries of loans previously charged-off | <u>202,769</u> | <u>90,407</u> |
| Balance at end of year | <u>\$ 3,614,166</u> | <u>\$ 3,189,094</u> |

The following table presents the approximate balance in the reserve for loan losses and recorded investment in loans by portfolio segment and impairment method as of December 31, 2010:

| | <i>Reserve for loan losses</i> | | | <i>Recorded investment in loans</i> | | |
|---------------------------------|--|--|---------------------|--|--|-----------------------|
| | <i>Individually evaluated for impairment</i> | <i>Collectively evaluated for impairment</i> | <i>Total</i> | <i>Individually evaluated for impairment</i> | <i>Collectively evaluated for impairment</i> | <i>Total</i> |
| Real estate: | | | | | | |
| Construction and development | \$ 120,000 | \$ 1,100,000 | \$ 1,220,000 | \$ 10,007,000 | \$ 13,187,000 | \$ 23,194,000 |
| Commercial real estate | 313,000 | 607,000 | 920,000 | 9,479,000 | 100,773,000 | 110,252,000 |
| Multi-family | - | 73,000 | 73,000 | - | 11,353,000 | 11,353,000 |
| Home equity and second mortgage | - | 173,000 | 173,000 | - | 7,486,000 | 7,486,000 |
| One-four family residential | 8,000 | 363,000 | 371,000 | 945,000 | 15,844,000 | 16,789,000 |
| Commercial and industrial | 99,000 | 365,000 | 464,000 | 432,000 | 21,606,000 | 22,038,000 |
| Consumer and other | 101,000 | 208,000 | 309,000 | 101,000 | 8,060,000 | 8,161,000 |
| Municipal | - | 84,000 | 84,000 | - | 10,779,000 | 10,779,000 |
| | <u>\$ 641,000</u> | <u>\$ 2,973,000</u> | <u>\$ 3,614,000</u> | <u>\$ 20,964,000</u> | <u>\$ 189,088,000</u> | <u>\$ 210,052,000</u> |

Total impaired loans as of December 31, 2010 and 2009 were approximately as follows:

| | <u>2010</u> | <u>2009</u> |
|---|----------------------|----------------------|
| Impaired loans with a valuation allowance | \$ 1,942,000 | \$ 8,436,000 |
| Impaired loans without a valuation allowance | <u>19,022,000</u> | <u>18,203,000</u> |
| Total recorded investment in impaired loans | <u>\$ 20,964,000</u> | <u>\$ 26,639,000</u> |
| Amount of the reserve for loan losses allocated to impaired loans | <u>\$ 641,000</u> | <u>\$ 924,000</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Reserve for Loan Losses (Continued)

The following table presents, by class of loans, the approximate recorded investment in – and unpaid principal balances of – impaired loans individually evaluated for impairment and the related allowance as of December 31, 2010:

| | <i>Recorded investment</i> | <i>Unpaid principal balance</i> | <i>Related allowance</i> |
|--|--------------------------------|---|------------------------------|
| With no related allowance recorded: | | | |
| Construction and development | \$ 9,175,000 | \$ 9,175,000 | \$ – |
| Commercial real estate | 8,648,000 | 8,648,000 | – |
| One-four family residential | 866,000 | 866,000 | – |
| Commercial and industrial | 333,000 | 364,000 | – |
| Total with no related allowance recorded | 19,022,000 | 19,053,000 | – |
| With an allowance recorded: | | | |
| Construction and development | 832,000 | 832,000 | 120,000 |
| Commercial real estate | 831,000 | 831,000 | 313,000 |
| One-four family residential | 79,000 | 79,000 | 8,000 |
| Commercial and industrial | 99,000 | 99,000 | 99,000 |
| Consumer and other | 101,000 | 101,000 | 101,000 |
| Total with allowance recorded | 1,942,000 | 1,942,000 | 641,000 |
| | <u>\$ 20,964,000</u> | <u>\$ 20,995,000</u> | <u>\$ 641,000</u> |

The average recorded investment in impaired loans was approximately \$23,800,000 and \$11,000,000 in 2010 and 2009, respectively. Interest income recognized on impaired loans was approximately \$1,212,000 and \$574,000 in 2010 and 2009, respectively. Interest income recognized for cash payments received on impaired loans was approximately \$333,000 and \$395,000 in 2010 and 2009, respectively.

The following table presents the approximate recorded investment in loans on nonaccrual status as of December 31, 2010:

| | |
|------------------------------|---------------------|
| Construction and development | \$ 7,197,000 |
| Commercial real estate | 1,011,000 |
| One-four family residential | 866,000 |
| Commercial and industrial | 148,000 |
| | <u>\$ 9,222,000</u> |

Loans on nonaccrual status as of December 31, 2010 and 2009 were approximately \$9,222,000 and \$10,091,000, respectively.

TDR loans were approximately \$8,757,000 and \$7,799,000 as of December 31, 2010 and 2009, respectively. TDR loans on nonaccrual status were approximately \$832,000 and \$368,000 as of December 31, 2010 and 2009, respectively. The Bank had no remaining commitments to lend on loans accounted for as TDRs as of December 31, 2010 and 2009.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Reserve for Loan Losses (Continued)

The following table presents, by class of loans, the approximate recorded investment in loans by aging category and in total as of December 31, 2010:

| | <i>Days past due</i> | | | <i>Total past due</i> | <i>Current</i> | <i>Total loans</i> |
|---------------------------------|----------------------|----------------|---------------------|-----------------------|----------------------|----------------------|
| | <i>30 - 59</i> | <i>60 - 89</i> | <i>90 or more</i> | | | |
| Real estate: | | | | | | |
| Construction and development | \$ 220,000 | \$ - | \$ 7,197,000 | \$ 7,417,000 | \$ 15,777,000 | \$ 23,194,000 |
| Commercial real estate | 864,000 | - | 1,011,000 | 1,875,000 | 108,377,000 | 110,252,000 |
| Multi-family | - | - | - | - | 11,353,000 | 11,353,000 |
| Home equity and second mortgage | 61,000 | - | - | 61,000 | 7,425,000 | 7,486,000 |
| One-four family residential | 77,000 | - | 866,000 | 943,000 | 15,846,000 | 16,789,000 |
| Commercial and industrial | - | - | 148,000 | 148,000 | 21,890,000 | 22,038,000 |
| Consumer and other | 25,000 | - | - | 25,000 | 8,136,000 | 8,161,000 |
| Municipal | - | - | - | - | 10,779,000 | 10,779,000 |
| | <u>\$ 1,247,000</u> | <u>\$ -</u> | <u>\$ 9,222,000</u> | <u>\$10,469,000</u> | <u>\$199,583,000</u> | <u>\$210,052,000</u> |

No loans were past due 90 days or more and still accruing interest as of December 31, 2010. Loans past due 90 days or more and still accruing interest were \$384,000 as of December 31, 2009.

The Bank categorizes all loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: quality of management, current financial information, historical payment experience, credit documentation, and geographic and industry risk, among other factors. Risk ratings for all loans are reviewed at least quarterly or more often if warranted by events or circumstances. The Bank uses the following definitions for risk ratings:

Special mention - This classification is assigned to loans with emerging problems and those loans that contain potentially unsatisfactory characteristics. These loans are characterized by borrowers who have marginal cash flow, marginal profitability, or have experienced an unprofitable year and/or a declining financial condition. The borrower has in the past handled debts satisfactorily, but in recent months has either been late, delinquent in making payments, or made sporadic payments. While the Bank continues to be adequately secured, the borrower's operating margins have decreased or are decreasing. Other characteristics of such borrowers include inadequate credit information, or weakness of financial condition or repayment capacity, but with collateral that appears to limit exposure.

Substandard - Substandard loans are inadequately protected by current sound net worth, paying capacity of the borrower, or pledged collateral. Borrowers in this category have characteristics that provide unsatisfactory levels of risk and could jeopardize repayment. These characteristics include: inadequate cash flow, debt service coverage, or working capital; declining sales; rising costs; operating losses; few or no financing alternatives; or possible bankruptcy. Collateral may provide marginal protection.

Doubtful - Loans classified as doubtful have all the weaknesses inherent in a loan graded substandard. In addition, these weaknesses make collection in full - including repayment through full liquidation of collateral - on the basis of currently existing facts, conditions and value, highly questionable and improbable.

Loss - Loans classified as loss are considered uncollectible and of such minimal value that continuance as a bankable asset is not warranted.

Loans not meeting the criteria above are considered to be pass-rated loans. The Bank has no loans classified as doubtful or loss as of December 31, 2010.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Reserve for Loan Losses (Continued)

The following table presents, by class of loans, the approximate recorded investment in loans by risk rating as of December 31, 2010, based on the most recent rating assigned to each loan:

| | <i>Pass</i> | <i>Special mention</i> | <i>Substandard</i> | <i>Total</i> |
|---------------------------------|-----------------------|----------------------------|----------------------|-----------------------|
| Real estate: | | | | |
| Construction and development | \$ 12,886,000 | \$ 1,792,000 | \$ 8,516,000 | \$ 23,194,000 |
| Commercial real estate | 99,440,000 | 5,802,000 | 5,010,000 | 110,252,000 |
| Multi-family | 11,353,000 | — | — | 11,353,000 |
| Home equity and second mortgage | 6,456,000 | 881,000 | 149,000 | 7,486,000 |
| One-four family residential | 15,161,000 | 629,000 | 999,000 | 16,789,000 |
| Commercial and industrial | 21,578,000 | 303,000 | 157,000 | 22,038,000 |
| Consumer and other | 8,052,000 | 9,000 | 100,000 | 8,161,000 |
| Municipal | 10,779,000 | — | — | 10,779,000 |
| | <u>\$ 185,705,000</u> | <u>\$ 9,416,000</u> | <u>\$ 14,931,000</u> | <u>\$ 210,052,000</u> |

The Bank's operations, like those of other financial institutions operating in the Bank's market, are significantly influenced by various economic conditions including local economies, the strength of the local real estate market, and the fiscal and regulatory policies of the federal and state government and the regulatory authorities that govern financial institutions. There has been a significant slow-down in the local real estate markets due to negative economic trends and credit market disruption, the impacts of which are not yet completely known or quantified. Recently, there have been tighter credit underwriting and higher premiums on liquidity, both of which may continue to place downward pressure on real estate values. Any further downturn in the local real estate markets could materially and adversely affect the Bank's business because a significant portion of the Bank's loans are secured by real estate. The Bank's ability to recover on defaulted loans by selling the real estate collateral would then be diminished, and the Bank would be more likely to suffer losses on defaulted loans. Consequently, the Bank's results of operations and financial condition are dependent upon the general trends in the economy, and, in particular, the local residential and commercial real estate markets. If there is a further decline in real estate values, the collateral for the Bank's loans would provide less security. Real estate values could be affected by, among other things, a worsening of economic conditions, an increase in foreclosures, a decline in home sale volumes, and an increase in interest rates. Furthermore, the Bank may experience an increase in the number of borrowers who become delinquent, file for protection under bankruptcy laws, or default on their loans or other obligations to the Bank given a sustained weakness or a weakening in business and economic conditions generally or specifically in the principal market in which the Bank does business. An increase in the number of delinquencies, bankruptcies, or defaults could result in a higher level of nonperforming assets, net charge-offs, and provision for loan losses.

5. Premises and Equipment

Premises and equipment as of December 31, 2010 and 2009 consisted of the following:

| | <u>2010</u> | <u>2009</u> |
|--|---------------------|---------------------|
| Land | \$ 2,444,425 | \$ 2,444,425 |
| Buildings and leasehold improvements | 7,177,712 | 6,942,266 |
| Furniture and equipment | <u>2,546,949</u> | <u>2,513,940</u> |
| | 12,169,086 | 11,900,631 |
| Less accumulated depreciation and amortization | <u>5,959,914</u> | <u>5,654,311</u> |
| Premises and equipment, net | <u>\$ 6,209,172</u> | <u>\$ 6,246,320</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

6. Time Deposits

Time deposits in excess of \$100,000 aggregated approximately \$23,812,000 and \$21,015,000 as of December 31, 2010 and 2009, respectively.

As of December 31, 2010, the scheduled annual maturities of all time deposits were approximately as follows:

| | |
|------------|----------------------|
| 2011 | \$ 35,190,000 |
| 2012 | 6,586,000 |
| 2013 | 2,068,000 |
| 2014 | 1,089,000 |
| 2015 | 1,417,000 |
| Thereafter | <u>20,000</u> |
| | <u>\$ 46,370,000</u> |

7. 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, 2010 and 2009, the maximum available FHLB borrowings were approximately \$66,212,000 and \$47,466,000, respectively. As of December 31, 2010, the Bank had no borrowings from the FHLB. 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%. To fully utilize the Bank's available borrowings from the FHLB at December 31, 2010, the Bank would be required to purchase additional FHLB stock of approximately \$2,325,000.

As an additional source of liquidity, the Bank has federal fund borrowing agreements with correspondent banks aggregating approximately \$20,000,000 as of December 31, 2010.

8. 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, 2010). 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. The TPS are callable by the Company at par value. Management believes that as of December 31, 2010 and 2009, the TPS met applicable regulatory guidelines to qualify as Tier 1 capital.

9. 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, 2010 and 2009, 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

9. Commitments, Guarantees, and Contingencies (Continued)

A summary of the Bank's off-balance sheet financial instruments as of December 31, 2010 and 2009 is approximately as follows:

| | <u>2010</u> | <u>2009</u> |
|---|----------------------|----------------------|
| Commitments to extend credit | \$ 32,730,000 | \$ 28,142,000 |
| Commitments under credit card lines of credit | 4,455,000 | 4,772,000 |
| Standby letters of credit | <u>858,000</u> | <u>870,000</u> |
| Total off-balance sheet financial instruments | <u>\$ 38,043,000</u> | <u>\$ 33,784,000</u> |

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, residential real estate, 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 related standby letter of credit agreement. As of December 31, 2010 and 2009, 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 and interest-bearing time deposits which fully collateralize public deposits held by the Bank which are not otherwise insured by the Federal Deposit Insurance Corporation (FDIC). At December 31, 2010, there was no liability associated with the Bank's participation in the Program, because all participating banks were 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, 2010.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

10. Income Taxes

The provision (credit) for income taxes was comprised of the following for the years ended December 31, 2010 and 2009:

| | <u>2010</u> | <u>2009</u> |
|----------------------------|---------------------|---------------------|
| Current: | | |
| Federal | \$ 1,294,000 | \$ 1,759,000 |
| State | 413,000 | 482,000 |
| | <u>1,707,000</u> | <u>2,241,000</u> |
| Deferred | (557,000) | (551,000) |
| Provision for income taxes | <u>\$ 1,150,000</u> | <u>\$ 1,690,000</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, 2010 and 2009 were approximately as follows:

| | <u>2010</u> | <u>2009</u> |
|---|---------------------|---------------------|
| Expected federal income tax provision at statutory rate | \$ 1,745,000 | \$ 1,710,000 |
| State income taxes, net of federal effect | 252,000 | 246,000 |
| Effect of nontaxable interest income, net | (129,000) | (122,000) |
| Low income housing credit | (146,000) | - |
| State tax credits | (127,000) | - |
| Change in tax treatment of cash surrender value of BOLI | (334,000) | - |
| Other, net | (111,000) | (144,000) |
| Provision for income taxes | <u>\$ 1,150,000</u> | <u>\$ 1,690,000</u> |

The components of the net deferred tax assets as of December 31, 2010 and 2009 were approximately as follows:

| | <u>2010</u> | <u>2009</u> |
|--|---------------------|---------------------|
| Deferred tax assets: | | |
| Deferred compensation plan expenses, net | \$ 1,357,000 | \$ 1,232,000 |
| Reserve for loan losses | 1,122,000 | 962,000 |
| Deferred loan fees and points | 410,000 | 411,000 |
| Nonaccrual interest | 292,000 | - |
| Capital losses | 75,000 | 104,000 |
| Other | 71,000 | 12,000 |
| Total deferred tax assets | <u>3,327,000</u> | <u>2,721,000</u> |
| Deferred tax liabilities: | | |
| CMSRs | 343,000 | 300,000 |
| Net unrealized gains on investment securities available-for-sale | 226,000 | 272,000 |
| FHLB stock dividends | 162,000 | 162,000 |
| Accumulated depreciation and amortization | 58,000 | 52,000 |
| Total deferred tax liabilities | <u>789,000</u> | <u>786,000</u> |
| Net deferred tax assets | <u>\$ 2,538,000</u> | <u>\$ 1,935,000</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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. 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, 2010 and 2009 was approximately as follows:

| | <u>2010</u> | <u>2009</u> |
|---------------------------------|-------------------|-------------------|
| Balance at beginning of year | \$ 832,000 | \$ 109,000 |
| Appointment of new Board member | - | 839,000 |
| Repayments | <u>(62,000)</u> | <u>(116,000)</u> |
| Balance at end of year | <u>\$ 770,000</u> | <u>\$ 832,000</u> |

In addition, a company associated with a director of the Company purchased a loan participation from the Bank with a balance of approximately \$112,000 and \$123,000 as of December 31, 2010 and 2009, respectively.

12. 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, 2010 and 2009. Total expense related to the Plan was approximately \$197,000 and \$187,000 for the years ended December 31, 2010 and 2009, respectively.

Other Benefit Plans

The Bank has deferred compensation and salary continuation plans, and supplemental executive retirement plans (SERPs), for certain key executives and Board members. In accordance with the provisions of the deferred compensation plans, 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 or retirement in either a lump-sum or monthly installments for 120 months. The salary continuation plans and SERPs provide defined benefits to the participants upon termination of employment with the Bank. The defined benefits for the participants are for periods of 120 months. 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 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 plans and SERPs 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 as of December 31, 2010 and 2009 was approximately \$6,145,000 and \$5,894,000, respectively. As of December 31, 2010 and 2009, the liabilities related to the salary continuation plans and SERPs included in accrued interest payable and other liabilities in the accompanying consolidated balance sheets totaled approximately \$2,533,000 and \$2,390,000, respectively. The amount of expense charged to operations in 2010 and 2009 for the salary continuation plans and SERPs was approximately \$250,000 and \$282,000, respectively. For financial reporting purposes, such expense amounts have not been adjusted for income earned on the BOLI policies.

13. Fair Value Measurements

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

13. Fair Value Measurements (Continued)

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.

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 impaired 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 estimated fair value of the underlying collateral supporting the loan less estimated costs to sell, which may be less than the carrying value of the loan less any previously calculated valuation adjustment. 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 3. As of December 31, 2010, loans subject to nonrecurring fair value measurements of approximately \$1,942,000 were reduced by specific valuation allowances totaling approximately \$641,000 to a total reported value of approximately \$1,301,000 based on collateral valuations utilizing Level 3 valuation inputs. As of December 31, 2009, loans subject to nonrecurring fair value measurements of approximately \$8,436,000 were reduced by specific valuation allowances totaling approximately \$924,000 to a total reported value of approximately \$7,512,000 based on collateral valuations utilizing Level 3 valuation inputs.

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. During 2010 certain OREO with a carrying value of approximately \$457,000 was reduced by specific valuation allowances totaling approximately \$78,000 to a reported value of approximately \$379,000 based on collateral valuations utilizing Level 3 valuation inputs. During 2009 certain OREO with a carrying value of approximately \$209,000 was reduced by specific valuation allowances totaling approximately \$110,000 to a reported value of approximately \$99,000 based on collateral valuations utilizing Level 3 valuation inputs.

As of December 31, 2010 and 2009, the Company had no financial or non-financial liabilities measured at fair value on a recurring basis. The Company’s financial assets measured at fair value on a recurring basis as of December 31, 2010 and 2009 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>2010</u> | | | |
| Investment securities available-for-sale | \$ — | \$ 15,668,490 | \$ — |
| <u>2009</u> | | | |
| Investment securities available-for-sale | \$ — | \$ 18,210,762 | \$ — |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

13. Fair Value Measurements (Continued)

Certain financial assets, such as impaired loans, 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). 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, and OREO. As of December 31, 2010 and 2009, the Company had no non-financial liabilities measured at fair value on a nonrecurring basis. The following table represents the assets measured at fair value on a nonrecurring basis as of December 31, 2010 and 2009:

| | <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>2010</u> | | | |
| Impaired loans | \$ — | \$ — | \$ 20,964,277 |
| OREO | — | — | 1,423,948 |
| | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 22,388,225</u> |
| <u>2009</u> | | | |
| Impaired loans | \$ — | \$ — | \$ 26,639,050 |
| OREO | — | — | 555,910 |
| | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 27,194,960</u> |

The Company did not change the methodology used to determine fair value for any financial instruments during the years ended December 31, 2010 and 2009. Accordingly, for any given class of financial instruments, the Company did not have any transfers between Level 1, Level 2, or Level 3 during these periods.

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, 2010 and 2009.

Because GAAP excludes certain financial and all 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 of these instruments.

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

13. Fair Value Measurements (Continued)

Loans, net: The estimated fair value of non-impaired loans is calculated by discounting the contractual cash flows of the loans using December 31, 2010 and 2009 origination rates. The resulting amounts are adjusted to estimate the effect of changes in the credit quality of borrowers since the loans were originated. Fair values for impaired loans are estimated using the underlying collateral values.

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

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

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, 2010 and 2009 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 as of December 31, 2010 and 2009 were as follows:

| | 2010 | | 2009 | |
|---|----------------|----------------------|----------------|----------------------|
| | Carrying value | Estimated fair value | Carrying value | Estimated fair value |
| Financial assets: | | | | |
| Cash and cash equivalents | \$ 41,183,038 | \$ 41,183,038 | \$ 17,165,173 | \$ 17,165,173 |
| Interest-bearing time deposits | 13,495,000 | 13,495,000 | 9,000,000 | 9,000,000 |
| Investment securities available-for-sale | 15,668,490 | 15,668,490 | 18,210,762 | 18,210,762 |
| FHLB stock | 654,800 | 654,800 | 654,800 | 654,800 |
| Loans, net (including mortgage loans held for sale) | 207,642,634 | 207,730,000 | 219,679,618 | 220,698,000 |
| BOLI | 6,145,321 | 6,145,321 | 5,893,724 | 5,893,724 |
| Financial liabilities: | | | | |
| Deposits | 255,496,520 | 255,733,000 | 236,595,158 | 236,804,000 |
| Short-term borrowings | — | — | 6,000,000 | 6,000,000 |
| Junior subordinated debentures | 8,248,000 | 8,248,000 | 8,248,000 | 8,248,000 |

14. 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, 2010 and 2009, the Company and the Bank met or exceeded all relevant capital adequacy requirements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

14. Regulatory Matters (Continued)

As of December 31, 2010, 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.

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, 2010:</i> | | | | | | |
| Tier 1 capital (to average assets) | \$ 39,838 | 13.3% | \$ 11,938 | 4.0% | N/A | N/A |
| Tier 1 capital (to risk-weighted assets) | 39,838 | 16.6 | 9,621 | 4.0 | N/A | N/A |
| Total capital (to risk-weighted assets) | 42,853 | 17.8 | 19,242 | 8.0 | N/A | N/A |
| <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 |

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, 2010:</i> | | | | | | |
| Tier 1 capital (to average assets) | \$ 39,749 | 13.3% | \$ 11,920 | 4.0% | \$ 14,900 | 5.0% |
| Tier 1 capital (to risk-weighted assets) | 39,749 | 16.5 | 9,621 | 4.0 | 14,431 | 6.0 |
| Total capital (to risk-weighted assets) | 42,764 | 17.8 | 19,242 | 8.0 | 24,052 | 10.0 |
| <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 |