

BANNER CORP  
Form 10-K/A  
April 18, 2002

FORM 10-K/A

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the fiscal year ended ..... **December 31, 2001**

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number **0-26584**

**Banner Corporation**

(Exact name of registrant as specified in its charter)

**Washington**  
(State or other jurisdiction of  
incorporation or organization)

**91-1691604**  
(I.R.S. Employer  
Identification No.)

**10 S. First Avenue Walla Walla, Washington 99362**  
(Address of principal executive offices and zip code)

**(509) 527-3636**  
(Registrant's telephone number, including area code)

**N/A**  
(Former name, former address and former fiscal year, if changed since last report.)

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to section 12(g) of the Act:

**Common Stock \$.01 par value per share**  
(Title of class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

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Yes [**X**]      No [ ]

Indicate by check mark if disclosure of delinquent files pursuant to Item 405 of Regulations S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K. [**X**]

The aggregate market value of the voting stock held by nonaffiliates of the registrant based on the closing sales price of the registrant's common stock quoted on the Nasdaq national Market on February 28, 2002, was:

**Common Stock - \$226,145,615**

The number of shares outstanding of the issuer's classes of common stock as of February 28, 2002:

**Common Stock, \$.01 par value - 11,597,211 shares**

**DOCUMENT INCORPORATED BY REFERENCE**

**Portions of Proxy Statement for Annual Meeting of Shareholders to be held April 19, 2002 are incorporated by reference into Part III.**

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The Registrant hereby amends Part II, Item 8 of its Annual Report for the fiscal year ended December 31, 2001 for the purpose of correcting typographical errors that occurred in the Edgarization process. These corrections include: (i) correcting a line item entitled "Bank owned life insurance" contained in the Consolidated Statements of Financial Condition; (ii) moving "unaudited" from the 2000 column to the 1999 column in Notes 6, 7 and 8 to the Notes to Consolidated Financial Statements. No revisions were made to the Registrant's Consolidated Financial Statements for the year ended December 31, 2001.

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS  
Banner CORPORATION AND SUBSIDIARIES  
(Item 8 and Item 14 (a) (1))**

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March 12, 2002

Report of Management:

To the Stockholders:

The management of Banner Corporation (the Company) is responsible for the preparation, integrity, and fair presentation of its published financial statements and all other information presented in this annual report. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and, as such, include amounts based on informed judgments and estimates made by management. In the opinion of management, the financial statements and other information herein present fairly the financial condition and operations of the Company at the dates indicated in conformity with accounting principles generally accepted in the United States of America.

Management is responsible for establishing and maintaining an effective system of internal control over financial reporting. The internal control system is augmented by written policies and procedures and by audits performed by an internal audit staff which reports to the Audit Committee of the Board of Directors. Internal auditors monitor the operation of the internal control system and report findings to management and the Audit Committee. When appropriate, corrective actions are taken to address identified control deficiencies and other opportunities for improving the system. The Audit Committee provides oversight to the financial reporting process. There are inherent limitations in the effectiveness of any system of internal control, including the possibility of human error and circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of an internal control system may vary over time.

The Audit Committee of the Board of Directors is comprised entirely of outside directors who are independent of the Company's management. The Audit Committee is responsible for recommending to the Board of Directors the selection of independent auditors. It meets periodically with management, the independent auditors and the internal auditors to ensure that they are carrying out their responsibilities. The Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting, and auditing procedures of the Company in addition to reviewing the Company's financial reports. The independent auditors and the internal auditors have full and free access to the Audit Committee, with or without the presence of management, to discuss the adequacy of the internal control structure for financial reporting and any other matters which they believe should be brought to the attention of the Committee.

Gary Sirmon, Chief Executive Officer    Lloyd W. Baker, Chief Financial Officer

March 12, 2002

Report of the Audit Committee of the Board of Directors

The Audit Committee of the Board of Directors is comprised entirely of directors who are not employees of the Company. The Audit Committee has reviewed the audited financial statements of Banner Corporation with management of the Company, including a discussion of the quality of the accounting principles applied and significant judgments and estimates affecting the financial statements. The Audit Committee has also discussed with the outside auditors the auditors' opinion of the quality of those principles and significant judgments as applied by management in preparation of the financial statements. In addition, the members of the Audit Committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the committee by management and the outside auditors and have met regularly with the internal audit staff, without management present, to review compliance with approved policies and procedures. In reliance on these reviews and discussions, the Audit Committee believes that the financial statements of Banner Corporation and subsidiaries are fairly presented.

Robert D. Adams  
Audit Committee Chairman

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**INDEPENDENT AUDITORS REPORT**

Board of Directors  
Banner Corporation and Subsidiaries  
Walla Walla, Washington

We have audited the accompanying consolidated statements of financial condition of Banner Corporation and subsidiaries (the Company) as of December 31, 2001 and 2000, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years ended December 31, 2001 and 2000 and the nine-month period ended December 31, 1999. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial condition of Banner Corporation and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for the years ended December 31, 2001 and 2000 and the nine-month period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States of America.

/s/Deloitte and Touche LLP

DELOITTE & TOUCHE LLP  
Seattle, Washington  
March 12, 2002

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**BANNER CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**  
**(in thousands, except shares)**  
**December 31, 2001 and 2000**

|   | <u>2001</u> | <u>2000</u> |
|---|-------------|-------------|
| <b>ASSETS</b>   |             |             |
| Cash and due from banks                                     | \$ 67,728   | \$ 67,356   |
| Securities available for sale, cost \$298,332 and \$310,538 |             |             |

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|  |             |             |
|--|-------------|-------------|
| Encumbered   | 64,126      | 66,405      |
| Unencumbered   | 237,721     | 242,393     |
|  | <hr/>       | <hr/>       |
|  | 301,847     | 308,798     |
| Securities held to maturity, fair value \$14,902 and \$18,269  | 14,828      | 17,717      |
| Federal Home Loan Bank stock   | 30,840      | 28,807      |
| Loans receivable:  |             |             |
| Held for sale, fair value \$43,647 and \$8,011   | 43,235      | 7,934       |
| Held for portfolio   | 1,549,742   | 1,479,149   |
| Allowance for loan losses  | (17,552)    | (15,314)    |
|  | <hr/>       | <hr/>       |
|  | 1,575,425   | 1,471,769   |
| Accrued interest receivable  | 12,929      | 12,963      |
| Real estate held for sale, net   | 3,011       | 3,287       |
| Property and equipment, net  | 18,151      | 17,746      |
| Costs in excess of net assets acquired (goodwill), net   | 31,437      | 34,617      |
| Deferred income tax asset, net   | 1,443       | 2,337       |
| Bank owned life insurance  | 20,304      | 14,190      |
| Other assets   | 9,151       | 3,244       |
|  | <hr/>       | <hr/>       |
|  | \$2,087,094 | \$1,982,831 |
|  | <hr/>       | <hr/>       |
| <b>LIABILITIES</b>   |             |             |
| Deposits:  |             |             |
| Non-interest-bearing   | \$ 180,813  | \$ 140,779  |
| Interest-bearing   | 1,114,998   | 1,051,936   |
|  | <hr/>       | <hr/>       |
|  | 1,295,811   | 1,192,715   |
| Advances from Federal Home Loan Bank   | 501,982     | 507,098     |
| Other borrowings   | 76,715      | 74,538      |
| Accrued expenses and other liabilities   | 17,591      | 10,857      |
| Deferred compensation  | 2,655       | 2,293       |
| Income taxes payable   | --          | 1,535       |
|  | <hr/>       | <hr/>       |
|  | 1,894,754   | 1,789,036   |
|  | <hr/>       | <hr/>       |
| <b>COMMITMENTS AND CONTINGENCIES</b>   |             |             |
| <b>STOCKHOLDERS' EQUITY</b>  |             |             |
| Preferred stock - \$0.01 par value, 500,000 shares authorized, no shares issued  | --          | --          |
| Common stock - \$0.01 par value, 27,500,000 shares authorized, 13,201,418 shares issued:<br>11,634,159 shares and 12,005,302 shares outstanding<br>at December 31, 2001 and 2000, respectively     | 126,844     | 133,839     |
| Retained earnings  | 68,104      | 66,893      |
| Accumulated other comprehensive income (loss):   |             |             |
| Unrealized gain (loss) on securities available for sale  | 2,264       | (1,125)     |
| Unearned shares of common stock issued to Employee Stock Ownership Plan (ESOP) trust:<br>577,039 and 633,278 restricted shares outstanding<br>at December 31, 2001 and 2000, respectively, at cost | (4,769)     | (5,234)     |
| Carrying value of shares held in trust for stock related compensation plans  | (2,870)     | (3,130)     |
| Liability for common stock issued to deferred, stock related, compensation plan  | 2,767       | 2,552       |
|  | <hr/>       | <hr/>       |

|  |             |              |
|--|-------------|--------------|
|  | (103)       | (578)        |
|  | 192,340     | 193,795      |
|  | \$2,087,094 | \$ 1,982,831 |

See notes to consolidated financial statements

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**BANNER CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(in thousands except for per share data)  
For the Years Ended December 31, 2001, 2000 and 1999 and the Nine Months Ended December 31, 1999

|  | Years Ended<br>December 31 |                |                | Nine<br>Months Ended<br>December 31 |
|--|----------------------------|----------------|----------------|-------------------------------------|
|  | 2001                       | 2000           | 1999           | 1999                                |
| INTEREST INCOME:                                     |                            |                | (Unaudited)    |                                     |
| Loans receivable                                     | \$135,765                  | \$ 131,394     | \$ 106,468     | \$ 82,107                           |
| Mortgage-backed securities                           | 12,196                     | 15,358         | 14,953         | 11,630                              |
| Securities and cash equivalents                      | 9,705                      | 11,546         | 10,081         | 7,295                               |
|  | <u>157,666</u>             | <u>158,298</u> | <u>131,502</u> | <u>101,032</u>                      |
| INTEREST EXPENSE:                                    |                            |                |                |                                     |
| Deposits   | 52,702                     | 53,120         | 40,801         | 31,475                              |
| Federal Home Loan Bank advances                      | 29,990                     | 31,568         | 24,284         | 18,505                              |
| Other borrowings                                     | 3,252                      | 4,906          | 4,275          | 3,221                               |
|  | <u>85,944</u>              | <u>89,594</u>  | <u>69,360</u>  | <u>53,201</u>                       |
| Net interest income before provision for loan losses | 71,722                     | 68,704         | 62,142         | 47,831                              |
| PROVISION FOR LOAN LOSSES                            | 13,959                     | 2,867          | 2,516          | 1,885                               |
| Net interest income                                  | <u>57,763</u>              | <u>65,837</u>  | <u>59,626</u>  | <u>45,946</u>                       |
| OTHER OPERATING INCOME:                              |                            |                |                |                                     |
| Loan servicing fees                                  | 1,158                      | 1,069          | 953            | 741                                 |
| Other fees and service charges                       | 5,704                      | 5,251          | 4,398          | 3,367                               |
| Gain on sale of loans                                | 4,575                      | 2,517          | 1,989          | 1,157                               |
| Gain on sale of securities                           | 687                        | 63             | 6              | 2                                   |
| Miscellaneous  | 1,341                      | 351            | 266            | 248                                 |

|  |          |           |           |           |
|--|----------|-----------|-----------|-----------|
| Total other operating income                   | 13,465   | 9,251     | 7,612     | 5,515     |
| OTHER OPERATING EXPENSES:                      |          |           |           |           |
| Salary and employee benefits                   | 29,865   | 26,392    | 23,121    | 17,503    |
| Less capitalized loan origination costs        | (4,897)  | (3,519)   | (3,262)   | (2,572)   |
| Occupancy and equipment                        | 7,947    | 7,084     | 6,051     | 4,660     |
| Information/computer data services             | 4,191    | 2,526     | 2,224     | 1,751     |
| Advertising                                    | 1,171    | 788       | 688       | 514       |
| Check kiting loss                              | 8,100    | --        | --        | --        |
| Amortization of goodwill                       | 3,180    | 3,170     | 3,047     | 2,364     |
| Miscellaneous                                  | 10,079   | 10,061    | 8,004     | 6,302     |
| Total other operating expenses                 | 59,636   | 46,502    | 39,873    | 30,522    |
| Income before provision for income taxes       | 11,592   | 28,586    | 27,365    | 20,939    |
| PROVISION FOR INCOME TAXES                     | 4,142    | 10,238    | 10,467    | 8,070     |
| NET INCOME                                     | \$ 7,450 | \$ 18,348 | \$ 16,898 | \$ 12,869 |
| Earnings per common share: see Notes 2 and 24  |          |           |           |           |
| Basic  | \$ 0.67  | \$ 1.62   | \$ 1.46   | \$ 1.12   |
| Diluted  | \$ 0.64  | \$ 1.60   | \$ 1.41   | \$ 1.09   |
| Cumulative dividends declared per common share | \$ 0.56  | \$ 0.52   | \$ 0.44   | \$ 0.33   |

See notes to consolidated financial statements

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**BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(in thousands)**

**For the Years Ended December 31, 2001, 2000 and 1999 and the Nine Months Ended December 31, 1999**

|   | Years Ended<br>December 31 |          |                         | Nine<br>Months Ended<br>December 31 |
|---|----------------------------|----------|-------------------------|-------------------------------------|
|   | 2001                       | 2000     | 1999                    | 1999                                |
| NET INCOME  | \$ 7,450                   | \$18,348 | (Unaudited)<br>\$16,898 | \$12,869                            |
| OTHER COMPREHENSIVE INCOME (LOSS), NET OF<br>INCOME TAXES:  |                            |          |                         |                                     |
| Unrealized holding gain (loss) during the period, net<br>of deferred income tax (benefit) of<br>\$2,107, \$2,344, \$(4,201) and \$(4,123) | 3,836                      | 4,248    | (7,767)                 | (7,626)                             |

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|  |                  |                 |                 |                 |
|--|------------------|-----------------|-----------------|-----------------|
| Less adjustment for gains included in net income,<br>net of income tax of \$240, \$21, \$2 and \$1 | (447)            | (42)            | (4)             | (1)             |
| Other comprehensive income (loss)  | 3,389            | 4,206           | (7,771)         | (7,627)         |
| <b>COMPREHENSIVE INCOME</b>  | <b>\$ 10,839</b> | <b>\$22,554</b> | <b>\$ 9,127</b> | <b>\$ 5,242</b> |

See notes to consolidated financial statements

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**BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(in thousands)**

**For the Years Ended December 31, 2001, 2000 and 1999 and the Nine Months Ended December 31, 1999**

|   | Years Ended<br>December 31 |            |             | Nine<br>Months Ended<br>December 31 |
|---|----------------------------|------------|-------------|-------------------------------------|
|   | 2001                       | 2000       | 1999        | 1999                                |
| <b>COMMON STOCK:</b>  |                            |            | (Unaudited) |                                     |
| Balance, beginning of period  | \$ 133,839                 | \$ 123,204 | \$ 122,049  | \$130,770                           |
| Issuance of stock in connection with acquisitions                           | --                         | 53         | 11,516      | --                                  |
| Assumption of options in connection with acquisitions                       | --                         | --         | 527         | --                                  |
| Net proceeds (cost) of common stock reissued for exercised stock options    | 2,277                      | 578        | 100         | 80                                  |
| Issuance of shares--10% stock dividend: see Note 2                          | --                         | 14,731     | --          | --                                  |
| Purchase and retirement of common stock                                     | (10,162)                   | (5,373)    | (12,515)    | (8,572)                             |
| Net issuance of stock through employees' stock plans, including tax benefit | 890                        | 646        | 1,527       | 926                                 |
| Balance, end of period  | 126,844                    | 133,839    | 123,204     | 123,204                             |
| <b>RETAINED EARNINGS:</b>   |                            |            |             |                                     |
| Balance, beginning of period  | 66,893                     | 69,170     | 57,273      | 59,958                              |
| Net income  | 7,450                      | 18,348     | 16,898      | 12,869                              |
| Issuance of shares--10% stock dividend                                      | --                         | (14,731)   | --          | --                                  |



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|  |                   |                   |                   |                   |
|--|-------------------|-------------------|-------------------|-------------------|
| Cash dividends   | (6,239)           | (5,887)           | (5,001)           | (3,657)           |
| Other  | --                | (7)               | --                | --                |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Balance, end of period   | 68,104            | 66,893            | 69,170            | 69,170            |
| ACCUMULATED OTHER COMPREHENSIVE INCOME (loss):                               |                   |                   |                   |                   |
| Balance, beginning of period   | (1,125)           | (5,331)           | 2,440             | 2,296             |
| Other comprehensive income (loss), net of related income taxes               | 3,389             | 4,206             | (7,771)           | (7,627)           |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Balance, end of period   | 2,264             | (1,125)           | (5,331)           | (5,331)           |
| UNEARNED, RESTRICTED ESOP SHARES AT COST:                                    |                   |                   |                   |                   |
| Balance, beginning of period   | (5,234)           | (6,162)           | (6,781)           | (6,781)           |
| Release of earned ESOP shares  | 465               | 928               | 619               | 619               |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Balance, end of period   | (4,769)           | (5,234)           | (6,162)           | (6,162)           |
| CARRYING VALUE OF SHARES HELD IN TRUST FOR STOCK RELATED COMPENSATION PLANS: |                   |                   |                   |                   |
| Balance, beginning of period   | \$ (578)          | \$ (1,708)        | \$ (4,098)        | \$ (2,635)        |
| Cumulative effect of change in accounting for Rabbi Trust: see Note 1        | --                | --                | 673               | --                |
| Stock issued to fund Rabbi Trust plans                                       | --                | --                | (601)             | --                |
| Net change in number and/or valuation of shares held in trust                | 4                 | 140               | 1,095             | 5                 |
| Issuance of stock for MRP grant  | (52)              | (62)              | (52)              | (52)              |
| Amortization of compensation related to MRP                                  | 523               | 1,052             | 1,275             | 974               |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Balance, end of period   | (103)             | (578)             | (1,708)           | (1,708)           |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| TOTAL STOCKHOLDERS' EQUITY   | \$ 192,340        | \$ 193,795        | \$ 179,173        | \$ 179,173        |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

continued on next page

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**BANNER CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
(in thousands)  
**For the Years Ended December 31, 2001, 2000 and 1999 and the Nine Months Ended December 31, 1999**  
(Continued from prior page)

|  | Years Ended<br>December 31 | Years Ended<br>December 31 | Years Ended<br>December 31 | Nine<br>Months Ended<br>December 31 |
|--|----------------------------|----------------------------|----------------------------|-------------------------------------|
|  | 2001                       | 2000                       | 1999                       | 1999                                |
|  | <u>          </u>          | <u>          </u>          | <u>          </u>          | <u>          </u>                   |

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| COMMON STOCK, SHARES ISSUED:*   | (Unaudited)   |               |               |               |
|---|---------------|---------------|---------------|---------------|
| Number of shares, beginning of period   | 13,201        | 13,201        | 13,201        | 13,201        |
| Number of shares, end of period   | 13,201        | 13,201        | 13,201        | 13,201        |
| <b>LESS COMMON STOCK RETIRED/REPURCHASED:*</b>  |               |               |               |               |
| Number of shares, beginning of period   | (1,196)       | (864)         | (769)         | (388)         |
| Purchase and retirement of common stock   | (569)         | (394)         | (693)         | (487)         |
| Reissuance of common stock to deferred compensation plan and/or exercised stock options | 198           | 70            | 44            | 13            |
| Stock issued in acquisitions  | --            | 2             | 558           | --            |
| Repurchase of stock forfeited from MRP  | --            | (10)          | (4)           | (2)           |
| Shares of stock retired/repurchased, end of period                                      | (1,567)       | (1,196)       | (864)         | (864)         |
| <b>SHARES OUTSTANDING, END OF PERIOD *</b>  | <b>11,634</b> | <b>12,005</b> | <b>12,337</b> | <b>12,337</b> |
| <b>UNEARNED, RESTRICTED ESOP SHARES:*</b>   |               |               |               |               |
| Number of shares, beginning of period   | (633)         | (746)         | (821)         | (821)         |
| Release of earned shares  | 56            | 113           | 75            | 75            |
| Number of shares, end of period   | (577)         | (633)         | (746)         | (746)         |

\* Adjusted for stock dividends: see Note 2.

See notes to consolidated financial statements

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**BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)**

**For the Years Ended December 31, 2001, 2000 and 1999 and the Nine Months Ended December 31, 1999**

|                       | Years Ended<br>December 31 |      |      | Nine<br>Months Ended<br>December 31 |
|-----------------------|----------------------------|------|------|-------------------------------------|
|                       | 2001                       | 2000 | 1999 | 1999                                |
| OPERATING ACTIVITIES: |                            |      |      |                                     |
|                       |                            |      |      | (Unaudited)                         |

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|  |                   |                   |                   |                   |
|--|-------------------|-------------------|-------------------|-------------------|
| Net income   | \$ 7,450          | \$ 18,348         | \$ 16,898         | \$ 12,869         |
| Adjustments to reconcile net income to net cash provided by operating activities:          |                   |                   |                   |                   |
| Deferred taxes   | (973)             | 678               | (303)             | (302)             |
| Depreciation   | 3,021             | 2,718             | 2,369             | 1,764             |
| Loss (gain) on sale of securities  | (687)             | (63)              | (6)               | (2)               |
| Increase in cash surrender value of bank owned life insurance                              | (1,114)           | (348)             | (331)             | (242)             |
| Net amortization of premiums and discounts on investments                                  | 89                | 86                | 655               | 325               |
| Amortization of costs in excess of net assets acquired                                     | 3,180             | 3,170             | 3,047             | 2,364             |
| Amortization of MRP compensation liability   | 523               | 1,052             | 1,275             | 974               |
| Loss (gain) on disposal of equipment   | 166               | 41                | (7)               | (7)               |
| Loss (gain) on sale of loans   | (4,468)           | (2,121)           | (1,619)           | (1,029)           |
| Net change in deferred loan fees, premiums and discounts                                   | (980)             | 765               | 1,931             | 1,934             |
| Loss (gain) on disposal of real estate held for sale                                       | 123               | 43                | (50)              | (61)              |
| Amortization of mortgage servicing rights  | 574               | 251               | 296               | 215               |
| Capitalization of mortgage servicing rights from sale of mortgages with servicing retained | (107)             | (395)             | (370)             | (128)             |
| Provision for losses on loans and REO  | 14,050            | 3,058             | 2,516             | 1,885             |
| FHLB stock dividend  | (2,033)           | (1,727)           | (1,722)           | (1,287)           |
| Net change in:   |                   |                   |                   |                   |
| Loans held for sale  | (35,301)          | 1,585             | 5,187             | 1,737             |
| Accrued interest receivable  | 34                | (2,231)           | (1,345)           | (454)             |
| Other assets   | (6,136)           | (136)             | 1,233             | 238               |
| Deferred compensation  | 514               | 463               | 520               | 382               |
| Accrued expenses and other liabilities   | 6,779             | (3)               | 1,599             | 2,512             |
| Income taxes payable   | (1,535)           | (601)             | 1,261             | 1,092             |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Net cash (used) provided by operating activities   | (16,831)          | 24,633            | 33,034            | 24,779            |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| INVESTING ACTIVITIES:  |                   |                   |                   |                   |
| Purchases of securities available for sale   | (125,381)         | (17,969)          | (116,025)         | (45,021)          |
| Principal repayments and maturities of securities available for sale                       | 133,351           | 42,303            | 106,384           | 53,120            |
| Sales of securities available for sale   | 4,828             | 21,703            | 6,260             | 5,829             |
| Purchases of securities held to maturity   | --                | (4,759)           | (12,058)          | (12,058)          |
| Principal repayments and maturities of securities held to maturity                         | 2,896             | 830               | 586               | 449               |
| Origination of loans, net of principal repayments  | (346,316)         | (292,237)         | (340,904)         | (272,692)         |
| Purchases of loans and participating interest in loans                                     | (4,860)           | (11,986)          | (40,236)          | (13,171)          |
| Sales of loans and participating interest in loans   | 270,254           | 135,670           | 143,799           | 99,316            |
| Net sales (purchases) of FHLB stock  | --                | (2,537)           | 269               | (119)             |
| Proceeds from sale of property and equipment   | 23                | 19                | 10                | 10                |
| Purchases of property and equipment  | (3,615)           | (3,887)           | (2,539)           | (1,866)           |
| Additional investment in real estate held for sale, net of insurance proceeds              | (286)             | (88)              | (426)             | (346)             |
| Proceeds from sale of real estate held for sale  | 4,507             | 1,608             | 3,395             | 2,407             |
| Funds transferred to deferred compensation plans   | (131)             | (136)             | (489)             | (99)              |
| (Investment in) proceeds from bank owned life insurance                                    | (5,000)           | (10,000)          | 280               | 280               |
| Acquisitions, net of cash acquired   | --                | (6)               | (874)             | (5,423)           |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Net cash used by investing activities  | (69,730)          | (141,472)         | (252,568)         | (189,384)         |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

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**BANNER CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

**For the Years Ended December 31, 2001, 2000 and 1999 and the Nine Months Ended December 31, 1999**  
(continued from prior page)

|   | Years Ended<br>December 31 |            |            | Nine<br>Months Ended<br>December 31 |
|---|----------------------------|------------|------------|-------------------------------------|
|   | 2001                       | 2000       | 1999       | 1999                                |
| FINANCING ACTIVITIES:   |                            |            |            |                                     |
|   | (Unaudited)                |            |            |                                     |
| Increase (decrease) in deposits   | \$ 103,096                 | \$ 114,563 | \$ 142,885 | \$ 86,302                           |
| Proceeds from FHLB advances   | 213,064                    | 873,179    | 477,153    | 420,90                              |
| Repayment of FHLB advances  | (218,180)                  | (832,605)  | (411,480)  | (362,628)                           |
| Proceeds from repurchase agreement borrowings   | 9,430                      | 993        | 4,500      | 4,500                               |
| Repayment of repurchase agreement borrowings  | (12,994)                   | (4,301)    | (12,246)   | (10,492)                            |
| Increase (decrease) in other borrowings   | 5,638                      | (3,705)    | 5,029      | 9,180                               |
| Compensation expense recognized for<br>shares released for allocation to participants of the ESOP:                |                            |            |            |                                     |
| Original basis of shares  | 465                        | 928        | 619        | 619                                 |
| Excess of fair value of released shares over basis  | 579                        | 582        | 685        | 686                                 |
| Cash dividends paid   | (6,284)                    | (5,553)    | (4,694)    | (3,709)                             |
| Net (cost) proceeds from exercised stock options  | 2,277                      | 578        | 100        | 80                                  |
| Repurchases of stock, net of forfeitures  | (10,158)                   | (5,233)    | (12,481)   | (8,567)                             |
| Net cash provided by financing activities   | 86,933                     | 139,426    | 190,07     | 136,871                             |
| NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS  | 372                        | 22,587     | (29,464)   | (27,734)                            |
| CASH AND DUE FROM BANKS, BEGINNING OF PERIOD  | 67,356                     | 44,769     | 74,233     | 72,503                              |
| CASH AND DUE FROM BANKS, END OF PERIOD  | \$ 67,728                  | \$ 67,356  | \$ 44,769  | \$ 44,769                           |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:  |                            |            |            |                                     |
| Interest paid   | \$ 86,684                  | \$ 88,444  | \$ 70,719  | \$ 54,792                           |
| Taxes paid  | 7,580                      | 10,161     | 9,037      | 7,298                               |
| Non-cash transactions:  |                            |            |            |                                     |
| Loans, net of discounts, specific loss allowances and<br>unearned income transferred to real estate held for sale | 4,159                      | 1,922      | 3,890      | 3,854                               |
| Net change in accrued dividends payable   | 45                         | 336        | 333        | 52                                  |
| Net change in unrealized gain (loss) in deferred compensation<br>trust and related liability                      | 184                        | 113        | 2,17       | 66                                  |
| Stock issued to Rabbi Trust/MRP   | 52                         | 86         | 653        | 52                                  |
| Stock forfeited by MRP  | 4                          | 5          | 34         | 5                                   |
| Recognize tax benefit of vested MRP shares  | 259                        | 2          | 188        | 188                                 |
| Non-cash portion of 10% stock dividend  | --                         | 14,731     | --         | --                                  |

The following summarizes the non-cash activities relating to acquisitions:

|  |       |        |             |            |
|--|-------|--------|-------------|------------|
| Fair value of assets acquired  | \$    | \$(48) | \$(157,278) | \$(51,374) |
| Fair value of liabilities assumed  |       | --     | 134,917     | 41,201     |
| Fair value of stock issued and options assumed to acquisitions' shareholders | --    | 48     | 12,043      | --         |
|  |       |        |             |            |
| Cash paid out in acquisition   | --    | --     | (10,318)    | (10,173)   |
| Less cash acquired   | --    | --     | 9,444       | 4,750      |
|  |       |        |             |            |
| Net cash acquired (used)   | \$ -- | \$ --  | \$ (874)    | \$ (5,423) |

See notes to consolidated financial statements

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## BANNER CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### Note 1: BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Nature of Business:* Banner Corporation (BANR or the Company) is a bank holding company incorporated in the State of Washington. The Company is primarily engaged in the business of planning, directing and coordinating the business activities for its wholly owned subsidiary, Banner Bank (BB or the Bank). BB is a Washington-chartered commercial bank the deposits of which are insured by the Federal Deposit Insurance Corporation (FDIC) under both the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). BB conducts business from its main office in Walla Walla, Washington, and, as of January 1, 2002, its 39 branch offices and six loan production offices located in 18 counties in Washington, Oregon and Idaho.

The Company is subject to regulation by the Federal Reserve Board (FRB). The Bank is subject to regulation by the State of Washington Department of Financial Institutions Division of Banks and the FDIC.

The operating results of the Company depend primarily on its net interest income, which is the difference between interest income on interest-earning assets, consisting of loans and securities, and interest expense on interest-bearing liabilities, composed primarily of savings deposits, Federal Home Loan Bank (FHLB) advances and repurchase agreements. Net interest income is a function of the Company's interest rate spread, which is the difference between the yield earned on interest-earning assets and the rate paid on interest-bearing liabilities, as well as a function of the average balance of interest-earning assets as compared to the average balance of interest-bearing liabilities.

In addition to interest income on loans and securities, the Bank receives other income from deposit service charges, loan origination and servicing fees and from the sale of loans and investments.

*Change in Fiscal Year End:* During May of 1999, the Company announced its decision to change its fiscal year from April 1 through March 31 to January 1 through December 31. Results of operations are shown for the nine-month transition period April 1, 1999 through December 31, 1999.

*Principles of Consolidation:* The consolidated financial statements include the accounts of BANR and its wholly owned subsidiary, BB. All material intercompany transactions, profits and balances have been eliminated.

*Use of Estimates:* The preparation of the financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect amounts reported in the financial statements. Changes in these estimates and

assumptions are considered reasonably possible and may have a material impact on the financial statements. The Company has used significant estimates in determining reported reserves and allowances for loan losses, goodwill, tax liabilities and other contingencies.

*Securities:* Securities are classified as held to maturity when the Company has the ability and positive intent to hold them to maturity. Securities classified as available for sale are available for future liquidity requirements and may be sold prior to maturity.

Securities held to maturity are carried at cost, adjusted for amortization of premiums and accretion of discounts to maturity. Unrealized losses on securities held to maturity due to decreases in fair value are recognized when it is determined that an other than temporary decline in value has occurred. Securities available for sale are carried at fair value. Unrealized gains and losses on securities available for sale are excluded from earnings and are reported net of tax as accumulated other comprehensive income, a component of stockholders' equity, until realized. Realized gains and losses on sale are computed on the specific identification method and are included in operations on the trade date sold.

*Loans Receivable:* The Bank originates mortgage loans for both portfolio investment and sale in the secondary market. At the time of origination, mortgage loans are designated as held for sale or held for investment. Loans held for sale are stated at lower of cost or estimated fair value determined on an aggregate basis. The Bank also originates commercial, financial, agribusiness and installment credit loans for portfolio investment. Loans receivable not designated as held for sale are recorded at the principal amount outstanding, net of allowance for loan losses, deferred fees, discounts, and premiums. Premiums, discounts and deferred loan fees are amortized to maturity using the level-yield methodology.

Interest is accrued as earned unless management doubts the collectibility of the loan or the unpaid interest. Interest accruals are generally discontinued when loans become 90 days past due for interest. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. Future collection of interest is included in interest income based upon an assessment of the likelihood that the loans will be repaid or recovered. A loan may be put on nonaccrual status sooner than this policy would dictate if, in management's judgment, the loan may be uncollectible. Such interest is then recognized as income only if it is ultimately collected.

*Allowance for Loan Losses:* The adequacy of general and specific reserves is based on management's continuing evaluation of the pertinent factors underlying the quality of the loan portfolio, including changes in the size and composition of the loan portfolio, delinquency rates, actual loan loss experience and current economic conditions. Large groups of smaller-balance homogeneous loans are collectively evaluated

for impairment. Loans that are collectively evaluated for impairment include residential real estate and consumer loans. Smaller balance non-homogeneous loans also may be evaluated collectively for impairment. Larger balance non-homogeneous residential construction and land, commercial real estate, commercial business loans and unsecured loans are individually evaluated for impairment. Loans are considered impaired when, based on current information and events, management determines that it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, the financial condition of the borrower, value of the underlying collateral and current status of the economy. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. Subsequent changes in the value of impaired loans are included within the provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the provision that would otherwise be reported.

The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which include specific allowances, an allocated formula allowance, and an unallocated allowance. Losses on specific loans are provided for when the losses are probable and estimable. General loan loss reserves are established to provide for inherent loan portfolio risks not specifically provided for. The level of general reserves is based on analysis of potential exposures existing in the Bank's loan portfolio including evaluation of historical trends, current market conditions and other relevant factors identified by management at the time the financial statements are prepared. The formula allowance is calculated by applying loss factors to outstanding loans, excluding loans with specific allowances. Loss factors are based on the Company's historical loss experience adjusted for significant factors including the experience of other banking organizations that, in management's judgment, affect the collectibility of the portfolio as of the evaluation date. The unallocated allowance is based upon management's evaluation of various factors that are not directly measured in the determination of the formula and specific allowances. This methodology may result in losses or recoveries differing significantly from those provided in the financial statements.

When available information confirms that specific loans or portions thereof are uncollectible, these amounts are charged off against the allowance for loan losses. The existence of some or all of the following criteria will generally confirm that a loss has been incurred: the loan is significantly delinquent and the borrower has not evidenced the ability or intent to bring the loan current; the Company has no recourse to the borrower, or if it does, the borrower has insufficient assets to pay the debt; or the fair value of the loan collateral is significantly below the current loan balance and there is little or no near-term prospect for improvement.

*Loan Origination and Commitment Fees:* Loan origination fees, net of certain specifically defined direct loan origination costs, are deferred and recognized as an adjustment of the loans' interest yield using the level-yield method over the contractual term of each loan adjusted for actual loan prepayment experience. Net deferred fees or costs related to loans held for sale are recognized in income at the time the loans are sold. Loan commitment fees are deferred until the expiration of the commitment period unless management believes there is a remote likelihood that the underlying commitment will be exercised, in which case the fees are amortized to fee income using the straight-line method over the commitment period. If a loan commitment is exercised, the deferred commitment fee is accounted for in the same manner as a loan origination fee. Deferred commitment fees associated with expired commitments are recognized as fee income.

*Real Estate Held for Sale:* Property acquired by foreclosure or deed in lieu of foreclosure is recorded at the lower of estimated fair value, less cost to sell, or the principal balance of the defaulted loan. Development, improvement, and direct holding costs relating to the property are capitalized. The carrying value of such property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are charged or credited to operations in the period in which they are realized. The amounts the Bank will ultimately recover from real estate held for sale may differ substantially from the carrying value of the assets because of future market factors beyond the Bank's control or because of changes in the Bank's strategy for recovering the investment.

*Property and Equipment:* The provision for depreciation is based upon the straight-line method applied to individual assets and groups of assets acquired in the same year at rates adequate to charge off the related costs over their estimated useful lives:

|  |             |
|--|-------------|
| Buildings and leased improvements..... | 10-30 years |
| Furniture and equipment.....           | 3-10 years  |

Routine maintenance, repairs, and replacement costs are expensed as incurred. Expenditures which materially increase values or extend useful lives are capitalized. The Company reviews buildings, leasehold improvements, and equipment for impairment whenever events or changes in circumstances indicate that the undiscounted cash flows for the property are less than its carrying value. If identified, an impairment loss is recognized through a charge to earnings based on the fair value of the property.

*Costs in Excess of Net Assets Acquired:* Costs in excess of net assets acquired (goodwill) is an intangible asset arising from the Company's acquisitions. Through December 31, 2001, goodwill has been amortized on a straight-line basis over the 14-year period of expected benefit. The Company periodically evaluates goodwill for impairment. This policy will be modified due to the adoption of Statement of Financial Accounting Standards (SFAS) No. 142, (see Note 2).

*Mortgage Servicing Rights:* Purchased servicing rights represent the cost of acquiring the right to service mortgage loans. Originated servicing rights are recorded when mortgage loans are originated and subsequently sold or securitized with the servicing rights retained. The total cost of

mortgage loans sold is allocated to the servicing rights and the loans (without the servicing rights) based on relative fair values. The cost relating to purchased and originated servicing is capitalized and amortized in proportion to, and over the period of, estimated future net servicing income.

The Bank assesses the fair value of unamortized servicing rights for impairment on a stratum by stratum basis every quarter by using secondary market quotes for comparable packages of serviced loans and a valuation model that calculates the present value of future cash flows using market discount rates and market based assumptions for prepayment speeds, servicing costs and ancillary income for those pools of serviced mortgages for which secondary market quotes are not readily available. For purposes of measuring impairment, the servicing rights are stratified based on their interest rate, original and remaining terms to maturity and balances outstanding.

*Derivative Instruments:* In June 1998 the Financial Accounting Standards Board (FASB) issued SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended. The Company adopted SFAS No. 133 effective on January 1, 2001. The adoption did not have a material impact on the Company's consolidated results of operations, financial position or cash flows.

*Transfers and Servicing of Financial Assets:* In September 2000, the FASB issued SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but carries over most of the provisions of SFAS No. 125 without reconsideration. SFAS No. 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. The provisions of this statement did not have a material effect on the Company's financial position or results of operations.

*Income Taxes:* The Company files a consolidated income tax return including all of its wholly owned subsidiaries on a calendar year basis. Income taxes are accounted for using the asset and liability method. Under this method, a deferred tax asset or liability is determined based on the enacted tax rates which will be in effect when the differences between the financial statement carrying amounts and tax bases of existing assets and liabilities are expected to be reported in the Company's income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period of change. Where state income tax laws do not permit consolidated income tax returns, applicable state income tax returns are filed.

*Stock Compensation Plans:* The Company loaned the Employees Stock Ownership Plan (ESOP) the funds necessary to fund the purchase of 8% of the Company's initial public offering of common stock. The loan to the ESOP will be repaid principally from the Company's contribution to the ESOP, and the collateral for the loan is the Company's common stock purchased by the ESOP. As the debt is repaid, shares are released from collateral based on the proportion of debt service paid in the year and allocated to participants' accounts. As shares are released from collateral, compensation expense is recorded equal to the average current market price of the shares, and the shares become outstanding for earnings-per-share calculations. Stock and cash dividends on allocated shares are recorded as a reduction of retained earnings and paid or distributed directly to participants' accounts. Stock and cash dividends on unallocated shares are recorded as a reduction of debt and accrued interest (see additional discussion in Note 15). The Company stock purchased for a Rabbi Trust obligation and the related liability for deferred compensation are recorded at acquisition cost.

*Average Balances:* Average balances are obtained from the best available daily, weekly or monthly data, which the Company's management believes approximate the average balances calculated on a daily basis.

*Reclassification:* Certain amounts in the prior periods' financial statements have been reclassified to conform to the current period's presentation.

## **Note 2: RECENT DEVELOPMENTS AND ACQUISITIONS**

*Restatement of Financial Statements:* On September 17, 2001, the Company announced that it had become aware of irregularities associated with a former senior lending officer. The irregularities included a check kiting scheme of a single commercial loan customer, as well as activities designed to conceal credit weaknesses of several loan customers. Upon further review, the Company determined that it would be necessary to file amended quarterly reports on Form 10-Q/A for each of the quarters ended March 31, 2001 and June 30, 2001, to recognize charges in those periods which appropriately reflect the timing of losses incurred as a result of the check kiting and credit manipulation activities. For the restated quarter ended March 31, 2001, the Company recorded an expense of \$3.6 million (\$2.3 million after tax) as a result of the check kiting scheme. During the restated quarter ended June 30, 2001, the Company recorded \$2.6 million (\$1.7 after tax) of expense related to the check kiting scheme and an additional \$2.0 million (\$1.3 million after tax) was added to the provision for loan losses. The Company recorded an additional expense of \$1.9 million in the quarter ended September 30, 2001, with respect to the check kiting scheme and also recognized \$4.2 million and \$4.0 million, respectively of additional provision for loan losses associated with the credit manipulation in the quarters ended September 30, 2001 and December 31, 2001. The changes in the financial statements resulted in restated net income of \$1.6 million for the quarter ended June 30, 2001, compared to \$4.6 million as previously reported. For the six months ended June 30, 2001, restated net income was \$3.9 million compared to \$9.2 million as previously reported.

*Subsequent Event:* On February 25, 2002, the Company announced that it expected to record an additional \$1.9 million of loan loss provision in the quarter ended March 31, 2002, as a recent result of further deterioration in the quality of five of the problem loans



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associated with the former senior lending officer as referenced above. All five of these problem credits were identified in 2001 with associated loss provisions recorded in that year and workout plans were developed for each of these credits at that time. However, they have not performed as planned, prompting the Company to announce the expected additional loan loss provision.

*Name Change/Consolidation of Banking Operations:* On October 30, 2000, First Washington Bancorp, Inc. (FWWB) changed its name to Banner Corporation in conjunction with a consolidation of banking operations affecting its banking subsidiaries. Towne Bank (TB) merged with First Savings Bank of Washington (FSBW), FSBW converted from a Washington state-chartered savings bank to a Washington state-chartered commercial bank and changed its name, along with the names of its divisions, Whatcom State Bank and Seaport Citizens Bank, to Banner Bank. At the same time, Inland Empire Bank (IEB) changed its name to Banner Bank of Oregon (BBO). The combination was designed to strengthen the Company by more effectively sharing the resources of the existing subsidiaries, improving operating efficiency and developing a broader regional brand identity. The Banks adopted one name, Banner Bank, and were united under the leadership of an experienced management team. The same ten individuals became members of the Board of Directors of the Company and each of the Banks. Final integration of all data processing into a common system was completed by December 31, 2001. In light of the Gramm-Leach-Bliley financial modernization legislation, the Company initially chose to retain a separate charter for Banner Bank of Oregon (formerly IEB) and to operate two banking subsidiaries. However, with release of the FHLB's implementing procedures, including rules expanding eligible collateral for members not qualifying as community financial institutions, the Company determined that the potential benefits of additional borrowing capacity were not as substantial as the efficiencies it would derive by operating under a single bank charter. Therefore, the Company merged BB and BBO on September 1, 2001, with BB, the surviving entity, operating as a Washington state-chartered commercial bank.

*Declaration of 10% Stock Dividend:* On October 19, 2000 BANR's Board of Directors declared a 10% stock dividend payable November 10, 2000 to shareholders of record on October 31, 2000. All earnings per share and share data have been adjusted to reflect the 10% stock dividend.

*Recently Issued Accounting Standards:* In July 2001, the FASB issued SFAS No. 141, *Business Combinations*, which applies to all business combinations initiated after June 30, 2001. This statement requires that all business combinations be accounted for using the purchase method of accounting; the use of the pooling-of-interests method is no longer permitted. The purchase method of accounting requires goodwill to be measured as the excess of the cost of an acquired entity over the estimated fair value of net amounts assigned to assets acquired and liabilities assumed. This statement also addresses the disclosures required in the financial statements pertaining to business combinations. The provisions of this statement did not have a material effect on the Company's financial position or results of operations.

In July 2001, the FASB issued SFAS No. 142, *Goodwill and Other Intangible Assets*, which applies to all acquired intangible assets whether acquired singly, as part of a group, or in a business combination. This statement requires that goodwill not be amortized; however, goodwill must be allocated to each reporting unit and must be evaluated for impairment on at least an annual basis using a two-step approach. The first step used to identify potential impairment compares the estimated fair value of a reporting unit to its carrying amount, including goodwill. If the fair value of a reporting unit is less than its carrying amount, the second step of the impairment evaluation which compares the implied fair value of goodwill to its carrying amount must be performed to determine the amount of the impairment loss, if any. This statement also provides standards for financial statement disclosures of goodwill and other intangible assets and related impairment losses. The Company will be required to adopt this statement on January 1, 2002. The adoption of this statement is expected to have a material impact on the Company's results of operations. Goodwill will no longer be amortized, which will reduce other operating expenses by an estimated \$793,000 per quarter, or \$3.2 million a year, with a corresponding increase in net income.

In August 2001, SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, was issued. The statement supercedes SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, but retains the requirements relating to recognition and measurement of an impairment loss and resolves certain implementation issues resulting from Statement 121. The statement became effective January 1, 2002 and is not expected to have a material impact on the results of operations or financial condition of the Bank.

*Mortgage Lending Subsidiary:* On April 1, 2000 BB opened a new mortgage lending subsidiary, Community Financial Corporation (CFC), located in the Lake Oswego area of Portland, Oregon, with John Satterberg as President. Primary lending activities for CFC are in the area of construction and permanent financing for one- to four-family residential dwellings. CFC, an Oregon corporation, functions as a wholly-owned subsidiary of BB. BB has capitalized CFC with \$2 million of equity capital and provides funding support for CFC's lending operations.

*Acquisition of Oregon Business Bank:* On January 1, 2002, the Company completed the acquisition of Oregon Business Bank (OBB). BB paid \$10.0 million in cash for all the outstanding common shares of OBB, which was headquartered in Lake Oswego, Oregon. As a result of the merger of OBB into BB, OBB operates as a division of BB. The acquisition was accounted for as a purchase and resulted in the recording of approximately \$4.7 million of costs in excess of the fair value of OBB's net assets acquired (goodwill). In addition, approximately \$714,000 of core deposit intangibles was recorded which will be amortized on an accelerated basis over an estimated five-year period resulting in a first-year charge to earnings of \$286,000. Opened in 1999, OBB was an Oregon state-chartered commercial community bank which had, before recording of purchase accounting adjustments, approximately \$39 million in total assets, \$33 million

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in deposits, \$33 million in loans, and \$4.7 million in shareholders' equity at December 31, 2001. OBB operates one full service branch in Lake Oswego, Oregon.

*Acquisition of Seaport Citizens Bank:* On April 1, 1999, the Company and FSBW (now operating as BB) completed the acquisition of Seaport Citizens Bank (SCB). FSBW paid \$10.1 million in cash for all the outstanding common shares of SCB, which was headquartered in Lewiston, Idaho. As a result of the merger of SCB into FSBW, SCB became a division of FSBW. The acquisition was accounted for as a purchase and resulted in the recording of \$6.1 million of costs in excess of the fair value of SCB's net assets acquired (goodwill). As noted above, effective January 1, 2002, goodwill will no longer be subject to amortization but will be evaluated for impairment on at least an annual basis. Founded in 1979, SCB was a commercial bank which had, before recording of purchase accounting adjustments, approximately \$45 million in total assets, \$41 million in deposits, \$27 million in loans, and \$4.1 million in shareholders' equity at March 31, 1999. SCB operated two full service branches in Lewiston, Idaho. SCB's results of operations are included in the Company's consolidated results of operations and financial statements for all periods subsequent to April 1, 1999.

*Acquisition of Whatcom State Bancorp, Inc.:* On January 1, 1999 the Company completed the acquisition of Whatcom State Bancorp, Inc. The Company paid \$12.1 million in common stock for all the outstanding common shares and stock options of Whatcom State Bancorp, Inc., which was the holding company for Whatcom State Bank (WSB), headquartered in Bellingham, Washington. As a result of the merger of Whatcom State Bancorp, Inc. into the Company, WSB became a division of FSBW (now operating as BB). The acquisition was accounted for as a purchase and resulted in the recording of approximately \$6.0 million of costs in excess of the fair value of Whatcom State Bancorp, Inc. net assets acquired (goodwill). As noted above, effective January 1, 2002, goodwill will no longer be subject to amortization but will be evaluated for impairment on at least an annual basis. Founded in 1980, WSB was a community commercial bank which had, before recording of purchase accounting adjustments, approximately \$99 million in total assets, \$85 million in deposits, \$79 million in loans, and \$5.4 million in shareholders' equity at December 31, 1998. WSB operated five branches in the Bellingham, Washington, area Bellingham, Ferndale, Lynden, Blaine and Point Roberts. WSB's results of operations are included in the Company's consolidated results of operations and financial statements for all periods subsequent to January 1, 1999.

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### Note 3: CASH AND DUE FROM BANKS

Cash and due from banks consisted of the following (in thousands):

| <b>December 31<br/>2001</b> | December 31<br>2000         |
|-----------------------------|-----------------------------|
| <u>                    </u> | <u>                    </u> |

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|                                 |                 |                 |
|---------------------------------|-----------------|-----------------|
| Cash on hand and due from banks | \$ 55,320       | \$ 52,053       |
| Cash equivalents:               |                 |                 |
| Short-term cash investments     | 10,008          | 4,073           |
| Federal funds sold              | 2,400           | 11,230          |
|                                 | <u>        </u> | <u>        </u> |
|                                 | \$ 67,728       | \$ 67,356       |
|                                 | <u>        </u> | <u>        </u> |

For the purpose of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, overnight investments and short-term deposits with original maturities less than 90 days.

FRB regulations require depository institutions to maintain certain minimum reserve balances. Included in cash and demand deposits were reserves required by the FRB of \$26.0 million and \$12.5 million at December 31, 2001 and 2000, respectively.

**Note 4: SECURITIES AVAILABLE FOR SALE**

The amortized cost and estimated fair value of securities available for sale are summarized as follows (in thousands):

|   | <b>December 31, 2001</b> |                              |                               |                            |                     |
|---|--------------------------|------------------------------|-------------------------------|----------------------------|---------------------|
|   | Amortized<br>cost        | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Estimated<br>fair<br>value | Percent of<br>Total |
| U.S. Government and agency obligations    | \$ 50,535                | \$ 750                       | \$ --                         | \$ 51,285                  | 16.99%              |
| Municipal bonds:                          |                          |                              |                               |                            |                     |
| Taxable                                   | 5,315                    | 97                           | (239)                         | 5,173                      | 1.71%               |
| Tax exempt                                | 21,093                   | 601                          | (125)                         | 21,569                     | 7.15%               |
| Corporate bonds                           | 15,962                   | --                           | (1,135)                       | 14,827                     | 4.91%               |
| Mortgage-backed securities:               |                          |                              |                               |                            |                     |
| FHLMC certificates                        | 1,509                    | 37                           | (2)                           | 1,544                      | 0.51%               |
| FHLMC collateralized mortgage obligations | 35,738                   | 549                          | (69)                          | 36,218                     | 12.00%              |
| Total FHLMC mortgage-backed securities    | 37,247                   | 586                          | (71)                          | 37,762                     | 12.51%              |
| GNMA certificates                         | 37,840                   | 166                          | (103)                         | 37,903                     | 12.56%              |
| GNMA collateralized mortgage obligations  | 566                      | 1                            | --                            | 567                        | 0.19%               |
| Total GNMA mortgage-backed securities     | 38,406                   | 167                          | (103)                         | 38,470                     | 12.75%              |
| FNMA certificates                         | 17,744                   | 162                          | (18)                          | 17,888                     | 5.93%               |
| FNMA collateralized mortgage obligations  | 57,191                   | 396                          | (188)                         | 57,399                     | 19.02%              |
| Total FNMA mortgage-backed securities     | 74,935                   | 558                          | (206)                         | 75,287                     | 24.95%              |
| Other mortgage backed securities          | 8,000                    | --                           | --                            | 8,000                      | 2.65%               |
| Other collateralized mortgage obligations | 45,480                   | 711                          | (275)                         | 45,916                     | 15.21%              |
| Equities:                                 |                          |                              |                               |                            |                     |
| FHLMC stock                               | 1,026                    | 2,029                        | (2)                           | 3,053                      | 1.01%               |
| FNMA stock                                | 303                      | 100                          | --                            | 403                        | 0.13%               |
| FARMERMAC stock                           | 10                       | 65                           | --                            | 75                         | 0.02%               |
| Miscellaneous equities                    | 20                       | 7                            | --                            | 27                         | 0.01%               |

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|           |          |            |           |         |
|-----------|----------|------------|-----------|---------|
| \$298,332 | \$ 5,671 | \$ (2,156) | \$301,847 | 100.00% |
|-----------|----------|------------|-----------|---------|

Proceeds from sales of securities during the year ended December 31, 2001 were \$4,828,000. Gross gains of \$687,000 and gross losses of \$0 were realized on those sales.

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**Note 4: SECURITIES AVAILABLE FOR SALE (continued)**

|   | December 31, 2000 |                        |                         |                      |                  |
|---|-------------------|------------------------|-------------------------|----------------------|------------------|
|   | Amortized cost    | Gross unrealized gains | Gross unrealized losses | Estimated fair value | Percent of Total |
| U.S. Government and agency obligations    | \$ 61,468         | \$ 181                 | \$ (224)                | \$ 61,425            | 19.89%           |
| Municipal bonds:                          |                   |                        |                         |                      |                  |
| Taxable                                   | 5,354             | 20                     | (259)                   | 5,115                | 1.66             |
| Tax exempt                                | 25,383            | 583                    | (193)                   | 25,773               | 8.35             |
| Corporate bonds                           | 21,350            | --                     | (915)                   | 20,435               | 6.62             |
| Mortgage-backed securities:               |                   |                        |                         |                      |                  |
| FHLMC certificates                        | 3,025             | 40                     | (21)                    | 3,044                | 0.99             |
| FHLMC collateralized mortgage obligations | 38,643            | 29                     | (1,284)                 | 37,388               | 12.10            |
| Total FHLMC mortgage-backed securities    | 41,668            | 69                     | (1,305)                 | 40,432               | 13.09            |
| GNMA certificates                         | 16,808            | 76                     | (242)                   | 16,642               | 5.39             |
| GNMA collateralized mortgage obligations  | 7,220             | 19                     | (39)                    | 7,200                | 2.33             |
| Total GNMA mortgage-backed securities     | 24,028            | 95                     | (281)                   | 23,842               | 7.72             |
| FNMA certificates                         | 5,311             | 81                     | (27)                    | 5,365                | 1.74             |
| FNMA collateralized mortgage obligations  | 67,641            | 482                    | (1,700)                 | 66,423               | 21.51            |
| Total FNMA mortgage-backed securities     | 72,952            | 563                    | (1,727)                 | 71,788               | 23.25            |
| Other collateralized mortgage obligations | 56,987            | 129                    | (1,097)                 | 56,019               | 18.14            |
| Equities:                                 |                   |                        |                         |                      |                  |
| FHLMC stock                               | 1,035             | 2,479                  | --                      | 3,514                | 1.14             |
| FNMA stock                                | 303               | 101                    | --                      | 404                  | 0.13             |
| FARMERMAC stock                           | 10                | 34                     | --                      | 44                   | 0.01             |
| Miscellaneous equities                    | --                | 7                      | --                      | 7                    | --               |
|   | \$310,538         | \$ 4,261               | \$(6,001)               | \$308,798            | 100.00%          |

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Proceeds from sales of securities during the year ended December 31, 2000 were \$21,703,000. Gross gains of \$957,000 and gross losses of \$894,000 were realized on those sales.

At December 31, 2001 and 2000, the Company's investment portfolio did not contain any securities of an issuer (other than the U.S. Government, its agencies and U.S. Government sponsored enterprises) which had an aggregate book value in excess of 10% of the Company's stockholders' equity at that date.

The amortized cost and estimated fair value of securities available for sale at December 31, 2001 and 2000, by contractual maturity, are shown below (in thousands). 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.

|  | December 31, 2001 |                      | December 31, 2000 |                      |
|--|-------------------|----------------------|-------------------|----------------------|
|  | Amortized Cost    | Estimated fair value | Amortized Cost    | Estimated fair value |
| Due in one year or less                | \$ 13,943         | \$ 14,097            | \$ 12,034         | \$ 12,016            |
| Due after one year through five years  | 53,042            | 53,938               | 61,413            | 61,449               |
| Due after five years through ten years | 20,250            | 20,427               | 24,991            | 24,785               |
| Due after ten years                    | 209,738           | 209,827              | 210,752           | 206,579              |
|  | 296,973           | 298,289              | 309,190           | 304,829              |
| Equity securities                      | 1,359             | 3,558                | 1,348             | 3,969                |
|  | <u>\$298,332</u>  | <u>\$301,847</u>     | <u>\$310,538</u>  | <u>\$308,798</u>     |

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**Note 5: SECURITIES HELD TO MATURITY**

The amortized cost and estimated fair value of securities held to maturity are summarized as follows (in thousands):

|                             | December 31, 2001 |                |                        |                         |                      |
|-----------------------------|-------------------|----------------|------------------------|-------------------------|----------------------|
|                             | Percent of total  | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| Mortgage-backed securities: |                   |                |                        |                         |                      |
| FHLMC certificates          | 7.16%             | \$ 1,062       | \$ 43                  | \$ --                   | \$ 1,105             |
| FNMA certificates           | 4.64              | 688            | 29                     | --                      | 717                  |
|                             | 11.80             | 1,750          | 72                     | --                      | 1,822                |
| Municipal bonds:            |                   |                |                        |                         |                      |

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|                         |                |                  |               |                |                  |
|-------------------------|----------------|------------------|---------------|----------------|------------------|
| Taxable                 | 7.42           | 1,100            | 34            | --             | 1,134            |
| Tax exempt              | 14.19          | 2,104            | 36            | --             | 2,140            |
| Corporate bonds         | 47.21          | 7,000            | --            | (67)           | 6,933            |
| Asset-backed securities | 19.38          | 2,874            | --            | (1)            | 2,873            |
|                         | <u>100.00%</u> | <u>\$ 14,828</u> | <u>\$ 142</u> | <u>\$ (68)</u> | <u>\$ 14,902</u> |

December 31, 2000

|                             | Percent<br>of total | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Estimated<br>fair<br>value |
|-----------------------------|---------------------|-------------------|------------------------------|-------------------------------|----------------------------|
| Mortgage-backed securities: |                     |                   |                              |                               |                            |
| FHLMC certificates          | 11.24%              | \$ 1,992          | \$ 44                        | \$ --                         | \$ 2,036                   |
| Municipal bonds:            |                     |                   |                              |                               |                            |
| Taxable                     | 5.63                | 997               | 8                            | --                            | 1,005                      |
| Tax exempt                  | 13.76               | 2,438             | 34                           | (27)                          | 2,445                      |
| Corporate bonds             | 39.51               | 7,000             | 493                          | --                            | 7,493                      |
| Asset-backed securities     | 29.86               | 5,290             | --                           | --                            | 5,290                      |
|                             | <u>100.00%</u>      | <u>\$ 17,717</u>  | <u>\$ 579</u>                | <u>\$ (27)</u>                | <u>\$ 18,269</u>           |

The amortized cost and estimated fair value of securities held to maturity at December 31, 2001 and 2000, by contractual maturity, are shown below (in thousands):

|  | December 31, 2001 |                         | December 31, 2000 |                         |
|--|-------------------|-------------------------|-------------------|-------------------------|
|  | Amortized<br>Cost | Estimated<br>fair value | Amortized<br>Cost | Estimated<br>fair value |
| Due in one year or less                | \$ 375            | \$ 382                  | \$ 227            | \$ 226                  |
| Due after one year through five years  | 4,772             | 4,826                   | 7,557             | 7,562                   |
| Due after five years through ten years | 102               | 110                     | 102               | 113                     |
| Due after ten years                    | 9,579             | 9,584                   | 9,831             | 10,368                  |
|  | <u>\$14,828</u>   | <u>\$14,902</u>         | <u>\$17,717</u>   | <u>\$18,269</u>         |

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**Note 6: ADDITIONAL INFORMATION REGARDING INTEREST INCOME FROM SECURITIES AND CASH EQUIVALENTS**

The following table sets forth the composition of income from securities and cash equivalents for the periods indicated (in thousands):

Note 6: ADDITIONAL INFORMATION REGARDING INTEREST INCOME FROM SECURITIES AND CASH EQUIVALENTS

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|   | Years Ended<br>December 31 |           |             | Nine<br>Months Ended<br>December 31 |
|---|----------------------------|-----------|-------------|-------------------------------------|
|   | 2001                       | 2000      | 1999        | 1999                                |
|   |                            |           | (Unaudited) |                                     |
| Taxable interest income                           | \$ 5,952                   | \$ 7,853  | \$ 6,239    | \$ 4,409                            |
| Tax-exempt interest income                        | 1,619                      | 1,859     | 2,036       | 1,517                               |
| Other stock--dividend income                      | 101                        | 106       | 85          | 83                                  |
| Federal Home Loan Bank stock--dividend income     | 2,033                      | 1,728     | 1,721       | 1,286                               |
| Total income from securities and cash equivalents | \$ 9,705                   | \$ 11,546 | \$ 10,081   | \$ 7,295                            |

**Note 7: LOANS RECEIVABLE**

Loans receivable at December 31, 2001 and 2000 are summarized as follows (in thousands) (includes loans held for sale):

|                                  | December 31, 2001 |         | December 31, 2000* |         |
|----------------------------------|-------------------|---------|--------------------|---------|
|                                  | Amount            | Percent | Amount             | Percent |
| Loans:                           |                   |         |                    |         |
| Secured by real estate:          |                   |         |                    |         |
| One- to four-family              | \$ 422,456        | 26.52%  | \$ 418,057         | 28.11%  |
| Commercial                       | 363,560           | 22.82   | 366,071            | 24.62   |
| Multifamily                      | 79,035            | 4.96    | 84,282             | 5.67    |
| Construction and land            | 335,798           | 21.08   | 271,273            | 18.24   |
| Commercial business              | 270,022           | 16.95   | 228,676            | 15.38   |
| Agricultural business            | 76,501            | 4.80    | 67,809             | 4.56    |
| Consumer, credit card and other  | 45,605            | 2.87    | 50,915             | 3.42    |
| Total loans                      | 1,592,977         | 100.00% | 1,487,083          | 100.00% |
| Less allowance for loan losses   | 17,552            |         | 15,314             |         |
| Total net loans at end of period | \$1,575,425       |         | \$1,471,769        |         |

\* Amounts have been reclassified to conform to the current periods presentation.

Loan amounts are net of unearned, unamortized loan fees of \$5,945,000 and \$6,005,000 at December 31, 2001 and 2000, respectively.

A substantial portion of the loans are to borrowers in the states of Washington, Oregon and Idaho. Accordingly, their ultimate collectivity is particularly susceptible to changes in market and economic conditions within these states.

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Loans serviced for others totaled \$224,034,000 and \$284,551,000 at December 31, 2001 and 2000, respectively. Custodial accounts maintained in connection with this servicing totaled \$4,432,000 and \$2,469,000 at December 31, 2001 and 2000, respectively.

The Bank's outstanding loan commitments totaled \$374,458,000 and \$262,418,000 at December 31, 2001 and 2000, respectively. In addition, the Bank had outstanding commitments to sell loans of \$48,303,000 at December 31, 2001.

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The amount of impaired loans and the related allocated reserve for loan losses were as follows (in thousands):

|                 | <b>December 31<br/>2001</b> |                       | December 31<br>2000 |                       |
|-----------------|-----------------------------|-----------------------|---------------------|-----------------------|
|                 | Loan<br>amount              | Allocated<br>reserves | Loan<br>amount      | Allocated<br>reserves |
| Impaired loans: |                             |                       |                     |                       |
| Non-accrual     | \$ 16,659                   | \$ 1,783              | \$ 3,865            | \$ 133                |
| Accrual         | --                          | --                    | --                  | --                    |
|                 | <u>\$ 16,659</u>            | <u>\$ 1,783</u>       | <u>\$ 3,865</u>     | <u>\$ 133</u>         |

The average balance of impaired loans and the related interest income recognized were as follows:

|                                   | Years Ended<br>December 31 |          |          | Nine<br>Months Ended<br>December 31 |
|-----------------------------------|----------------------------|----------|----------|-------------------------------------|
|                                   | <b>2001</b>                | 2000     | 1999     | 1999                                |
| Average balance of impaired loans | \$ 8,923                   | \$ 3,899 | \$ 3,455 | \$ 3,447                            |
| Interest income recognized        | --                         | --       | --       | --                                  |

(Unaudited)

The Bank originates both adjustable- and fixed-rate loans. At December 31, 2001, the maturity and repricing composition of those loans, less undisbursed amounts and deferred fees, were as follows (in thousands):

|  | <b>December 31<br/>2001</b> | December 31<br>2000 |
|--|-----------------------------|---------------------|
| Fixed-rate (term to maturity):           |                             |                     |
| Due in one year or less                  | \$ 98,438                   | \$ 49,844           |
| Due after one year through three years   | 78,152                      | 80,466              |
| Due after three years through five years | 108,710                     | 95,240              |
| Due after five years through ten years   | 152,968                     | 142,888             |
| Due after ten years                      | 349,197                     | 342,179             |
|  | <u>\$ 787,465</u>           | <u>\$ 710,617</u>   |



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Adjustable-rate (term to rate adjustment):

|  |                   |                   |
|--|-------------------|-------------------|
| Due in one year or less                  | \$ 772,367        | \$ 601,110        |
| Due after one year through three years   | 14,501            | 65,676            |
| Due after three years through five years | 15,574            | 70,911            |
| Due after five years through ten years   | 3,070             | 32,173            |
| Due after ten years                      | --                | 6,596             |
|  | <u>          </u> | <u>          </u> |
|  | \$ 805,512        | \$ 776,466        |
|  | <u>          </u> | <u>          </u> |

The adjustable-rate loans have interest rate adjustment limitations and are generally indexed to the Bank's internal cost of funds, the FHLB's National Cost of Funds Index and 11th District Cost of Funds, One Year Constant Maturity Treasury Index, or Prime Rate (The Wall Street Journal). Future market factors may affect the correlation of the interest rate adjustment with the rates the Bank pays on the short-term deposits that primarily have been utilized to fund these loans.

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**Note 8: ALLOWANCE FOR LOAN LOSSES**

An analysis of the changes in the allowance for loan losses is as follows (in thousands):

|   | Years Ended<br>December 31 |                   |                   | Nine<br>Months Ended<br>December 31 |
|---|----------------------------|-------------------|-------------------|-------------------------------------|
|   | 2001                       | 2000              | 1999              | 1999                                |
|   |                            |                   | (Unaudited)       |                                     |
| Balance, beginning of period                  | \$ 15,314                  | \$ 13,541         | \$ 10,718         | \$ 12,261                           |
| Allowance added through business combinations | --                         | --                | 1,554             | 477                                 |
| Sale of credit card portfolio                 | --                         | (174)             | --                | --                                  |
| Provision                                     | 13,959                     | 2,867             | 2,516             | 1,885                               |
| Recoveries of loans previously charged off:   |                            |                   |                   |                                     |
| Secured by real estate:                       |                            |                   |                   |                                     |
| One- to four-family                           | 2                          | 2                 | 2                 | --                                  |
| Commercial                                    | --                         | 2                 | --                | 1                                   |
| Multifamily                                   | --                         | --                | --                | --                                  |
| Commercial business                           | 118                        | 40                | 458               | 450                                 |
| Agricultural business                         | --                         | 1                 | 6                 | 6                                   |
| Consumer, credit card and other               | 22                         | 66                | 21                | 11                                  |
|   | <u>          </u>          | <u>          </u> | <u>          </u> | <u>          </u>                   |
|   | 142                        | 111               | 487               | 468                                 |
| Loans charged off:                            |                            |                   |                   |                                     |
| Secured by real estate:                       |                            |                   |                   |                                     |
| One- to four-family                           | (97)                       | (90)              | (532)             | (532)                               |

Note 7: LOANS RECEIVABLE

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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Commercial   | --        | (31)      | (29)      | --        |
| Multifamily  | --        | --        | --        | --        |
| Construction and land  | (107)     | (12)      | (33)      | (24)      |
| Commercial business  | (10,541)  | (403)     | (856)     | (841)     |
| Agricultural business  | (208)     | (16)      | (19)      | (19)      |
| Consumer, credit card and other  | (910)     | (479)     | (265)     | (134)     |
|  |           |           |           |           |
|  | (11,863)  | (1,031)   | (1,734)   | (1,550)   |
| Net charge-offs  | (11,721)  | (920)     | (1,247)   | (1,082)   |
|  |           |           |           |           |
| Balance, end of period   | \$ 17,552 | \$ 15,314 | \$ 13,541 | \$ 13,541 |
|  |           |           |           |           |
| Ratio of allowance to net loans before allowance for loan losses                                   | 1.10%     | 1.03%     | 1.02%     | 1.02%     |
| Ratio of net loan charge-offs to the average net book value of loans outstanding during the period | 0.75%     | 0.06%     | 0.10%     | 0.09%     |

The following is a schedule of the Company's allocation of the allowance for loan losses (in thousands):

|   | <b>December 31<br/>2001</b> | December 31<br>2000 | December 31<br>1999 |
|---|-----------------------------|---------------------|---------------------|
| Specific or allocated loss allowance:   |                             |                     |                     |
| Secured by real estate:   |                             |                     |                     |
| One- to four-family   | \$ 2,366                    | \$ 2,256            | \$ 2,334            |
| Commercial  | 3,967                       | 4,556               | 3,685               |
| Multifamily   | 593                         | 731                 | 588                 |
| Construction and land   | 3,431                       | 2,738               | 1,638               |
| Commercial business   | 4,660                       | 3,540               | 2,330               |
| Agricultural business   | 990                         | 170                 | 500                 |
| Consumer, credit card and other   | 774                         | 879                 | 1,023               |
|   |                             |                     |                     |
| Total allocated   | 16,781                      | 14,870              | 12,098              |
| Unallocated   | 771                         | 444                 | 1,443               |
|   |                             |                     |                     |
| Total allowance for loan losses   | \$ 17,552                   | \$ 15,314           | \$ 13,541           |
|   |                             |                     |                     |
| Ratio of allowance for loan losses to non-performing loans  | 0.97%                       | 1.83%               | 2.67%               |
| Allowance for loan losses as a percent of net loans (loans receivable excluding allowance for losses) | 1.10%                       | 1.03%               | 1.02%               |

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**Note 9: PROPERTY AND EQUIPMENT**

Land, buildings and equipment owned by the Company and its subsidiaries at December 31, 2001 and 2000 are summarized as follows (in thousands):

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|                                      | <b>December 31<br/>2001</b> | December 31<br>2000 |
|--------------------------------------|-----------------------------|---------------------|
| Buildings and leasehold improvements | \$ 18,751                   | \$ 17,789           |
| Furniture and equipment              | 17,247                      | 15,320              |
|                                      | 35,998                      | 33,109              |
| Less accumulated depreciation        | 20,171                      | 17,694              |
|                                      | 15,827                      | 15,415              |
| Land                                 | 2,324                       | 2,331               |
|                                      | <b>\$ 18,151</b>            | <b>\$ 17,746</b>    |

**Note 10: DEPOSITS**

Deposits consist of the following at December 31, 2001 and 2000 (in thousands):

|   | <b>December 31<br/>2001</b> | Percent of<br>Total | December 31<br>2000 | Percent of<br>Total |
|---|-----------------------------|---------------------|---------------------|---------------------|
| Demand, NOW and money market accounts, including non-interest-bearing deposits at December 31, 2001 and 2000 of \$180,813 and \$140,779, respectively, 0% to 6% | \$443,376                   | 34.22%              | \$349,636           | 29.32%              |
| Regular savings, 2% to 6%   | 42,228                      | 3.26                | 44,427              | 3.72                |
| Certificate accounts:   |                             |                     |                     |                     |
| 0.00% to 2%   | 18,364                      | 1.42                | 257                 | 0.02                |
| 2.01% to 4%   | 338,342                     | 26.11               | 2,015               | 0.17                |
| 4.01% to 6%   | 272,614                     | 21.03               | 217,799             | 18.26               |
| 6.01% to 8%   | 180,857                     | 13.96               | 425,456             | 35.67               |
| 8.01% to 10%  | 22                          | --                  | 153,075             | 12.83               |
| 10.01% to 12%   | 8                           | --                  | 50                  | 0.01                |
|   | 810,207                     | 62.52               | 798,652             | 66.96               |
|   | <b>\$1,295,811</b>          | <b>100.00%</b>      | <b>\$1,192,715</b>  | <b>100.00%</b>      |

Deposits at December 31, 2001 and 2000 include public funds of \$109,127,000 and \$82,205,000, respectively. CDs and securities with a carrying value of \$15,562,000 and \$14,092,000 were pledged as collateral on these deposits at December 31, 2001 and 2000, respectively, which exceeds the minimum collateral requirements established by state regulations.

Scheduled maturities of certificate accounts at December 31, 2001 and 2000 are as follows (in thousands):

|  | <b>December 31<br/>2001</b> | December 31<br>2000 |
|--|-----------------------------|---------------------|
| Due in one year or less                  | \$ 669,133                  | \$ 614,873          |
| Due after one year through two years     | 87,376                      | 121,329             |
| Due after two years through three years  | 18,443                      | 36,202              |
| Due after three years through four years | 11,227                      | 8,050               |
| Due after four years through five years  | 18,355                      | 9,581               |
| Due after five years                     | 5,673                       | 8,617               |

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\$ 810,207      \$ 798,652

Included in deposits are deposit accounts in excess of \$100,000 of \$385,070,000 and \$314,889,000 at December 31, 2001 and 2000, respectively. Interest on deposit accounts in excess of \$100,000 totaled \$19,024,000 for the year ended December 31, 2001, \$13,103,000 for the year ended December 31, 2000 and \$8,786,000 for the nine months ended December 31, 1999.

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The following table sets forth the deposit activities of the Bank for the periods indicated (in thousands).

|   | Years Ended<br>December 31 |             | Nine<br>Months Ended<br>December 31 |
|---|----------------------------|-------------|-------------------------------------|
|   | 2001                       | 2000        | 1999                                |
| Beginning balance                                   | \$1,192,715                | \$1,078,152 | \$ 950,848                          |
| Acquisitions  | --                         | --          | 40,645                              |
| Net increase (decrease)<br>before interest credited | 50,394                     | 61,443      | 55,184                              |
| Interest credited                                   | 52,702                     | 53,120      | 31,475                              |
| Net increase in deposits                            | 103,096                    | 114,563     | 127,304                             |
| Ending balance                                      | \$1,295,811                | \$1,192,715 | \$1,078,152                         |

Deposit interest expense by type for the years ended December 31, 2001, 2000 and 1999, and the nine months ended December 31, 1999 was as follows (in thousands):

|                                       | Years Ended<br>December 31 |           |             | Nine<br>Months Ended<br>December 31 |
|---------------------------------------|----------------------------|-----------|-------------|-------------------------------------|
|                                       | 2001                       | 2000      | 1999        | 1999                                |
|                                       |                            |           | (Unaudited) |                                     |
| Certificates                          | \$ 46,367                  | \$ 44,892 | \$ 32,553   | \$ 25,105                           |
| Demand, NOW and money market accounts | 5,604                      | 6,782     | 6,497       | 5,034                               |
| Regular savings                       | 731                        | 1,446     | 1,751       | 1,336                               |
|                                       | \$ 52,702                  | \$ 53,120 | \$ 40,801   | \$ 31,475                           |

**Note 11: ADVANCES FROM FEDERAL HOME LOAN BANK OF SEATTLE**

The Bank has entered into borrowing arrangements with the FHLB to borrow funds under a short-term cash management advance program and long-term loan agreements. All borrowings are secured by stock of, and cash held by, the FHLB. Additionally, specific securities issued, insured, or guaranteed by the U.S. Government or agencies thereof with a carrying value of \$107,165,000 at December 31, 2001 are pledged as security for the loans along with a blanket pledge of qualifying loans receivable. At December 31, 2001, FHLB advances were scheduled to

mature as follows (in thousands):

|  | Adjustable-rate advances |           | Fixed-rate advances |           | Total advances |           |
|--|--------------------------|-----------|---------------------|-----------|----------------|-----------|
|  | Rate*                    | Amount    | Rate*               | Amount    | Rate*          | Amount    |
| Due in one year or less                  | 6.61%                    | \$ 27,500 | 5.43%               | \$278,970 | 5.54%          | \$306,470 |
| Due after one year through two years     | --                       | --        | 5.87                | 101,890   | 5.87           | 101,890   |
| Due after two years through three years  | --                       | --        | 5.06                | 29,094    | 5.06           | 29,094    |
| Due after three years through four years | --                       | --        | 6.58                | 34,600    | 6.58           | 34,600    |
| Due after four years through five years  | --                       | --        | 5.12                | 5,000     | 5.12           | 5,000     |
| Due after five years                     | --                       | --        | 6.16                | 24,928    | 6.16           | 24,928    |
|  | 6.61%                    | \$ 27,500 | 5.62%               | \$474,482 | 5.68%          | \$501,982 |

\* Weighted average interest rate

The maximum and average outstanding balances and average interest rates on advances from the FHLB were as follows for the years ended December 31, 2001, 2000 and 1999, and the nine months ended December 31, 1999 (in thousands):

|                                      | Years Ended<br>December 31 |            |             | Nine<br>Months Ended<br>December 31 |
|--------------------------------------|----------------------------|------------|-------------|-------------------------------------|
|                                      | 2001                       | 2000       | 1999        | 1999                                |
| Maximum outstanding at any month end | \$ 515,598                 | \$ 545,198 | \$ 466,524  | \$ 466,524                          |
| Average outstanding                  | 505,631                    | 509,665    | 420,647     | 425,293                             |
| Weighted average interest rates:     |                            |            | (Unaudited) |                                     |
| Annual                               | 5.93%                      | 6.19%      | 5.77%       | 5.78%                               |
| End of period                        | 5.68                       | 6.27       | 5.86        | 5.86                                |
| Interest expense during the period   | \$ 29,990                  | \$ 31,568  | \$ 24,284   | \$ 18,505                           |

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**Note 12: OTHER BORROWINGS**

Other borrowings consist of retail repurchase agreements, wholesale repurchase agreements and other short-term borrowings.

*Retail Repurchase Agreements:* At December 31, 2001, retail repurchase agreements carry interest rates ranging from 1.83% to 7.20%, payable at maturity, and are secured by the pledge of certain FNMA, GNMA and FHLMC mortgage-backed securities with a carrying value of \$13,079,000 as of December 31, 2001. As required under the terms of the repurchase agreements the Bank pledged, subsequent to year end, additional collateral for the agreements consisting of a GNMA mortgage-related security with a fair value of \$7,991,000 at December 31, 2001.

A summary of retail repurchase agreements at December 31, 2001 and 2000 by the period remaining to maturity is as follows (in thousands):

December 31, 2001

December 31, 2000

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|  | Weighted<br>average<br>rate | Balance          | Weighted<br>average<br>rate | Balance          |
|--|-----------------------------|------------------|-----------------------------|------------------|
| Retail repurchase agreements:            |                             |                  |                             |                  |
| Due in one year or less                  | 2.04%                       | \$ 14,521        | 6.24%                       | \$ 6,449         |
| Due after one year through two years     | 7.18                        | 941              | 6.82                        | 251              |
| Due after two years through three years  | 7.00                        | 1,427            | 7.19                        | 973              |
| Due after three years through four years | --                          | --               | 6.45                        | 2,046            |
| Due after five years                     | --                          | --               | 5.75                        | 1,429            |
|  | <u>2.75%</u>                | <u>\$ 16,889</u> | <u>6.31%</u>                | <u>\$ 11,148</u> |

The maximum and average outstanding balances and average interest rates on retail repurchase agreements and other short-term borrowings were as follows for the years ended December 31, 2001, 2000 and 1999, and the nine months ended December 31, 1999, respectively, (in thousands):

|                                      | Years Ended<br>December 31 |           |             | Nine<br>Months Ended<br>December 31 |
|--------------------------------------|----------------------------|-----------|-------------|-------------------------------------|
|                                      | 2001                       | 2000      | 1999        | 1999                                |
|                                      |                            |           | (Unaudited) |                                     |
| Maximum outstanding at any month end | \$ 16,889                  | \$ 12,806 | \$ 14,957   | \$ 9,917                            |
| Average outstanding                  | 14,769                     | 10,217    | 7,928       | 8,698                               |
| Weighted average interest rates:     |                            |           |             |                                     |
| Annual                               | 3.38%                      | 6.67%     | 5.60%       | 5.49%                               |
| End of period                        | 2.75                       | 6.31      | 5.53        | 5.53                                |
| Interest expense during the period   | \$ 499                     | \$ 681    | \$ 444      | \$ 360                              |

*Wholesale Repurchase Agreements:* The table below outlines the wholesale repurchase agreements as of December 31, 2001 and 2000. The agreements to repurchase are secured by mortgage-backed securities with a carrying value of \$64,126,000 at December 31, 2001. The broker holds the security while BB continues to receive the principal and interest payments from the security. Upon maturity of the agreement the pledged securities will be returned to BB.

A summary of wholesale repurchase agreements at December 31, 2001 and 2000 by the period remaining to maturity is as follows (in thousands):

|                         | December 31, 2001           |          | December 31, 2000           |          |
|-------------------------|-----------------------------|----------|-----------------------------|----------|
|                         | Weighted<br>average<br>rate | Balance  | Weighted<br>average<br>rate | Balance  |
| Due in one year or less | 2.34%                       | \$59,826 | 6.64%                       | \$63,390 |

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The maximum and average outstanding balances and average interest rates on wholesale repurchase agreements were as follows for the year ended December 31, 2001, 2000 and 1999, and the nine months ended December 31, 1999 (in thousands):

|                                      | Years Ended<br>December 31 |           |           | Nine<br>Months Ended<br>December 31 |
|--------------------------------------|----------------------------|-----------|-----------|-------------------------------------|
|                                      | 2001                       | 2000      | 1999      | 1999                                |
|                                      |                            |           |           | (Unaudited)                         |
| Maximum outstanding at any month end | \$ 63,160                  | \$ 65,810 | \$ 74,444 | \$ 71,099                           |
| Average outstanding                  | 58,926                     | 65,043    | 70,364    | 68,982                              |
| Weighted average interest rates:     |                            |           |           |                                     |
| Annual                               | 4.67%                      | 6.50%     | 5.44%     | 5.50%                               |
| End of period                        | 2.34                       | 6.64      | 6.02      | 6.02                                |
| Interest expense during the period   | \$ 2,753                   | \$ 4,225  | \$ 3,831  | \$ 4,409                            |

### Note 13: INCOME TAXES

Provisions of the Small Business Job Protection Act of 1996 (the Job Protection Act) significantly altered the Company's tax bad debt deduction method and the circumstances that would require a tax bad debt reserve recapture. Prior to enactment of the Job Protection Act, savings institutions were permitted to compute their tax bad debt deduction through use of either the reserve method or the percentage of taxable income method. The Job Protection Act repealed both of these methods for large savings institutions and allows bad debt deductions based only on actual current losses. While repealing the reserve method for computing tax bad debt deductions, the Job Protection Act allows thrifts to retain their existing base year bad debt reserves but requires that reserves in excess of the balance at December 31, 1987, be recaptured into taxable income. The tax liability for this recapture is included in the accompanying Consolidated Financial Statements.

The base year reserve is recaptured into taxable income only in limited situations, such as in the event of certain excess distributions, complete liquidation or disqualification as a bank. None of the limited circumstances requiring recapture are contemplated by the Company. The amount of the Company's tax bad debt reserves subject to recapture in these circumstances approximates \$5,318,000 at December 31, 2001. Due to the remote nature of events that may trigger the recapture provisions, no tax liability has been established in the accompanying Consolidated Financial Statements.

In addition, as a result of certain acquisitions, the Company is required to recapture certain tax bad debt reserves of the acquired institution. The Company has elected to recapture these reserves into income over a four-year period using the deferral method. The recapture does not result in a charge to earnings as the Company provided for this liability on the acquisition date.

The provision for income taxes for the years ended December 31, 2001 and 2000, and the nine-month period ended December 31, 1999 differs from that computed at the statutory corporate tax rate as follows (in thousands):

|   | Years Ended<br>December 31 |           | Nine<br>Months Ended<br>December 31 |
|---|----------------------------|-----------|-------------------------------------|
|   | 2001                       | 2000      | 1999                                |
| Taxes at statutory rate   | \$ 4,057                   | \$ 10,005 | \$ 7,329                            |
| Increase (decrease) in taxes:   |                            |           |                                     |
| Tax-exempt interest   | (465)                      | (571)     | (463)                               |
| Amortization of costs in excess of net assets acquired                  | 1,099                      | 1,096     | 817                                 |
| Investment in life insurance  | (386)                      | (115)     | (48)                                |
| Difference in fair market value versus<br>basis of released ESOP shares | 100                        | (10)      | 32                                  |
| State income taxes net of federal tax benefit                           | 320                        | 281       | 229                                 |

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|       |                   |                   |                   |
|-------|-------------------|-------------------|-------------------|
| Other | (583)             | (448)             | 174               |
|       | <u>          </u> | <u>          </u> | <u>          </u> |
|       | \$ 4,142          | \$ 10,238         | \$ 8,070          |
|       | <u>          </u> | <u>          </u> | <u>          </u> |

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**Note 13: INCOME TAXES (continued)**

The provision for income tax expense for the years ended December 31, 2001 and 2000, and the nine months ended December 31, 1999 is composed of the following (in thousands):

|          | Years Ended<br>December 31 |                   | Nine<br>Months Ended<br>December 31 |
|----------|----------------------------|-------------------|-------------------------------------|
|          | <u>          </u>          | <u>          </u> | <u>          </u>                   |
|          | 2001                       | 2000              | 1999                                |
| Current  | \$ 5,115                   | \$ 9,560          | \$ 8,346                            |
| Deferred | (973)                      | 678               | (276)                               |
|          | <u>          </u>          | <u>          </u> | <u>          </u>                   |
|          | \$ 4,142                   | \$ 10,238         | \$ 8,070                            |
|          | <u>          </u>          | <u>          </u> | <u>          </u>                   |

Income taxes are provided for the temporary differences between the tax basis and financial statement carrying amounts of assets and liabilities. Components of the Company's net deferred tax assets (liabilities) at December 31, 2001 and 2000 consisted of the following (in thousands):

|                                    | December 31<br>2001 | December 31<br>2000 |
|------------------------------------|---------------------|---------------------|
|                                    | <u>          </u>   | <u>          </u>   |
| Deferred tax assets:               |                     |                     |
| Loan loss reserves per books       | \$ 6,191            | \$ 5,461            |
| Deferred compensation and vacation | 1,863               | 1,869               |
| Other                              | 490                 | 121                 |
|                                    | <u>          </u>   | <u>          </u>   |
|                                    | 8,544               | 7,451               |
|                                    | <u>          </u>   | <u>          </u>   |

Deferred tax liabilities:



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|  |                 |                 |
|--|-----------------|-----------------|
| Change in method of accounting for amortization of premium and discount on investments | 84              | 59              |
| Tax basis bad debt reserves to be recovered  | 240             | 439             |
| FHLB stock dividends   | 3,959           | 3,256           |
| Depreciation   | 797             | 984             |
| Deferred loan fees and servicing rights  | 760             | 827             |
| Other  | 10              | 165             |
|  | <u>5,850</u>    | <u>5,730</u>    |
|  | 2,694           | 1,721           |
| Income benefit related to unrealized gain/loss on securities available for sale        | <u>(1,251)</u>  | <u>616</u>      |
| Deferred tax asset (liability), net  | <u>\$ 1,433</u> | <u>\$ 2,337</u> |

**Note 14: EMPLOYEE BENEFIT PLANS**

The Bank has its own profit sharing plan for all eligible employees. The plan is funded annually at the discretion of the Board of Directors. Contributions charged to operations for the year ended December 31, 2001 were \$449,000. There were no contributions for the year ended December 31, 2000 and the nine months ended December 31, 1999.

The Bank has entered into a salary continuation agreement with certain of its senior management. This program was funded by purchasing single premium life insurance contracts. The program provides for aggregate continued annual compensation for all participants totaling \$240,000 for life with a 15-year guarantee. Participants vest ratably each plan year until retirement, termination, death or disability. The Bank is recording the salary obligation over the estimated remaining service lives of the participants. Expenses related to this program for the years ended December 31, 2001 and 2000 and nine months ended December 31, 1999 were \$149,500, \$241,300 and \$162,300, respectively. The plan's projected benefit obligation is \$2,117,000, of which \$1,143,700 was vested at December 31, 2001. The assumed discount rate was 7.00% for the years ended December 31, 2001 and 2000 and the nine months ended December 31, 1999, respectively. At December 31, 2001, an obligation of \$1,143,700 and cash value of life insurance of \$3,031,300 were recorded. At December 31, 2000, an obligation of \$1,039,500 and cash value of life insurance of \$2,441,800 were recorded. Increases in cash surrender value and related net earnings from the life insurance contracts partially offset the expenses of this program resulting in a net cost of \$40,000 and \$131,200 for the years ended December 31, 2001 and 2000, respectively, and \$82,700 for the nine months ended December 31, 1999.

The Bank also has a non-qualified, non-contributory retirement compensation plan for certain employees whose benefits are based upon a percentage of defined participant compensation. Expenses related to the plan included in the years and nine months ended December 31, 2001, 2000 and 1999 results of operations were \$96,000, \$84,000 and \$102,000, respectively.

The Company and the Bank also offer non-qualified deferred compensation plans to members of their Boards of Directors and certain employees. The plans permit each participant to defer a portion of director fees, non-qualified retirement contributions, salary or bonuses until the future. Compensation is charged to expense in the period earned. In order to fund the plans' future obligations the Company has purchased life insurance policies, contributed to money market investments and purchased common stock of the Company which are held in a Rabbi

Trust. As the Company is the owner of the investments and beneficiary of life insurance contracts, and in order to reflect the Company's policy to pay benefits equal to accumulations, the assets and liabilities under the plans are reflected in the consolidated balance sheets of the Company. Common stock of the Company held for such plans is reported as a contra-equity account and was recorded at original cost of \$2,767,000 at December 31, 2001 and \$2,552,000 at December 31, 2000. The money market investments and cash surrender value of the life insurance policies are included in other assets.

During the year ended December 31, 2001 the Company adopted a Supplemental Executive Retirement Program (SERP) for selected senior executives (individually, the Executive). At termination of employment at or after attaining age 62 with at least 15 years of service, the Executive's annual benefit under the SERP would be computed as the product of 3% of the Executive's final average compensation (defined as the three calendar years of Executive's annual cash compensation, including bonuses, which produce the highest average within the Executive's final eight full calendar years of employment) and the Executive's annual years of service, reduced by certain amounts, such as the amount payable to the Executive under the Company's 401(k) profit sharing plan and its ESOP, employer-contributed deferred compensation, and any amount payable to an Executive under the salary continuation agreements described above and in Note 15. The maximum benefit would be 60% of final average compensation, less applicable reductions. A reduced benefit is payable at termination of employment at or after attaining age 59½ with at least 15 years of service. Expenses relating to this SERP totaled \$180,000 for the year ended December 31, 2001 and none in the prior periods.

**Note 15: EMPLOYEE STOCK OWNERSHIP PLAN AND TRUST**

The Company established for eligible employees an ESOP and related trust that became effective upon the former mutual holding company's conversion to a stock-based holding company. Eligible employees of BB as of January 1, 1995 and eligible employees of the Company employed after such date who have been credited with at least 1,000 hours during a twelve-month period are participants.

The ESOP borrowed \$8,728,500 from the Company in order to purchase the common stock. The loan will be repaid principally from the Company's contributions to the ESOP over a period not to exceed 25 years, and the collateral for the loan is the unreleased, restricted common stock purchased by the ESOP. Contributions to the ESOP will be discretionary; however, the Company intends to make annual contributions to the ESOP in an aggregate amount at least equal to the principal and interest requirements of the debt. The interest rate for the loan is 8.75%.

Participants generally become 100% vested in their ESOP account after seven years of credited service or if their service was terminated due to death, early retirement, permanent disability or a change in control of the Company. Prior to the completion of one year of credited service, a participant who terminates employment for reasons other than death, retirement, disability, or change in control of the Company will not receive any benefit. Forfeitures will be reallocated among remaining participating employees in the same proportion as contributions. Benefits are payable upon death, retirement, early retirement, disability or separation from service. The contributions to the ESOP are not fixed, so benefits payable under the ESOP cannot be estimated. ESOP compensation expense for the years ended December 31, 2001 and 2000, and the nine months ended December 31, 1999 was \$1,093,000, \$1,510,000 and \$974,000, respectively.

As of December 31, 2001, the Company has 577,039 unearned, restricted shares remaining to be released to the ESOP. The fair value of unearned, restricted shares held by the ESOP trust was \$9,758,000 at December 31, 2001.

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**Note 16: STOCK BASED COMPENSATION PLANS AND STOCK OPTIONS**

The Company operates the following stock based compensation plans as approved by the shareholders: the 1996 Management Recognition and Development Plan (MRP), the 1996 Stock Option Plan, the 1998 Stock Option Plan and the 2001 Stock Option Plan (together, SOPs).

Under the MRP, the Company is authorized to grant up to 528,075 shares of restricted stock to its directors, officers and employees of BANR. Shares granted under the MRP vest ratably over a five-year period. The consolidated statements of income for the year ended December 31, 2001 and 2000, and nine months ended December 31, 1999 reflect an accrual of \$543,000, \$1,137,000 and \$1,045,000, respectively, in compensation expense for the MRP including \$19,500, \$84,500 and \$71,000, respectively, of expense for dividends on the allocated, restricted stock. A summary of the changes in the granted, but not vested, MRP shares for the years ended December 31, 2001 and 2000, and the nine months ended December 31, 1999 follows:

| <b>Years Ended<br/>December 31<br/>2001</b> | Years Ended<br>December 31<br>2000 | Nine<br>Months Ended<br>December 31<br>1999* |
|---|------------------------------------|--|
|   |                                    |  |

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|   |              |               |                |
|---|--------------|---------------|----------------|
| Shares granted--not vested, beginning of period | 86,324       | 183,527       | 287,753        |
| Shares granted                                  | 3,025        | 4,476         | 3,025          |
| Shares vested                                   | (80,597)     | (90,330)      | (106,779)      |
| Shares forfeited                                | (331)        | (11,349)      | (472)          |
|   | <u>8,421</u> | <u>86,324</u> | <u>183,527</u> |
| Shares granted--not vested, end of period       |              |               |                |

\* Adjusted for stock dividend: see Note 2

Under the 1996, 1998 and 2001 SOPs, the Company has reserved 2,284,186 shares for issuance pursuant to the exercise of stock options which may be granted to directors and employees. The exercise price of the stock options is set at 100% of the fair market value of the stock price at date of grant. Such options will vest ratably over a five-year period and any unexercised options will expire ten years after date of grant or 90 days after employment or service ends.

Details of stock options granted, vested, exercised, forfeited or terminated are as follows:

|   | Weighted<br>average<br>fair value at<br>date of grant | Weighted<br>average<br>exercise<br>price | Number of option shares |                |                  |
|---|---|--|-------------------------|----------------|------------------|
|   |   |  | Total                   | Granted        | Exercisable      |
| For the nine months ended December 31, 1999: *  |   |  |                         |                |                  |
| Options granted                                 | \$ 5.30   | \$ 14.21                                 | 211,463                 | 211,463        | --               |
| Options vested                                  |   |  | --                      | (288,389)      | 288,389          |
| Options forfeited                               |   | 17.24                                    | (18,125)                | (18,125)       | --               |
| Options exercised                               |   | 8.42                                     | (9,631)                 | --             | (9,631)          |
| Options terminated                              |   |  | --                      | --             | --               |
| Number of option shares<br>at December 31, 1999 |   | \$ 13.75                                 | <u>1,753,804</u>        | <u>881,074</u> | <u>872,730</u>   |
| For the year ended December 31, 2000: *         |   |  |                         |                |                  |
| Options granted                                 | \$ 4.37   | \$ 13.47                                 | 224,525                 | 224,525        | --               |
| Options vested                                  |   |  | --                      | (312,039)      | 312,039          |
| Options forfeited                               |   | 14.64                                    | (54,902)                | (31,668)       | (23,234)         |
| Options exercised                               |   | 8.42                                     | (66,391)                | --             | (66,391)         |
| Options terminated                              |   |  | --                      | --             | --               |
| Number of option shares<br>at December 31, 2000 |   | \$ 13.88                                 | <u>1,857,036</u>        | <u>761,892</u> | <u>1,095,144</u> |
| For the year ended December 31, 2001: *         |   |  |                         |                |                  |
| Options granted                                 | \$ 7.03   | \$ 16.62                                 | 152,825                 | 152,825        | --               |
| Options vested                                  |   |  | --                      | (338,365)      | 338,365          |
| Options forfeited                               |   | 18.79                                    | (35,459)                | (21,214)       | (14,245)         |
| Options exercised                               |   | 11.55                                    | (195,288)               | --             | (195,288)        |
| Options terminated                              |   |  | --                      | --             | --               |
| Number of option shares<br>at December 31, 2001 |   | \$ 14.28                                 | <u>1,779,114</u>        | <u>555,138</u> | <u>1,223,976</u> |

\* Adjusted for stock dividends: see Note 2

**Note 16: STOCK BASED COMPENSATION (continued)**

Financial data pertaining to outstanding stock options granted or assumed as a result of certain acquisitions at December 31, 2001 were as follows: \*

| Exercise Price | Weighted average exercise price of option shares granted | Number of option shares granted | Number of option shares vested and exercisable | Weighted average exercise price of option shares exercisable | Weighted average remaining contractual life |
|----------------|--|---------------------------------|--|--|---|
| \$ 1.18        | \$ 1.18  | 3,373                           | 3,373  | \$ 1.18  | 7.0 yrs                                     |
| 3.82 to 3.89   | 3.88   | 4,098                           | 4,098  | 3.88   | 6.3 yrs                                     |
| 4.26 to 5.58   | 4.93   | 54,275                          | 54,275   | 4.93   | 6.3 yrs                                     |
| 7.56           | 7.56   | 253                             | 253  | 7.56   | 7.0 yrs                                     |
| 8.03           | 8.03   | 2,532                           | 2,532  | 8.03   | 7.0 yrs                                     |
| 10.51          | 10.51  | 24,044                          | 24,044   | 10.51  | 7.0 yrs                                     |
| 12.19 to 13.95 | 12.53  | 1,174,050                       | 939,700  | 12.70  | 5.0 yrs                                     |
| 14.09 to 15.29 | 14.94  | 52,250                          | 17,710   | 14.70  | 6.5 yrs                                     |
| 16.31 to 17.84 | 17.04  | 174,575                         | 8,800  | 16.57  | 7.7 yrs                                     |
| 20.09 to 21.44 | 21.28  | 170,368                         | 105,366  | 21.32  | 6.2 yrs                                     |
| 22.05 to 22.57 | 22.05  | 119,296                         | 63,825   | 22.06  | 7.0 yrs                                     |
|                | \$ 13.40   | 1,779,114                       | 1,223,976                                      | \$ 14.28   | 5.4 yrs                                     |

\* Adjusted for stock dividends: see Note 2

SFAS No. 123, *Accounting for Stock-based Compensation*, requires expanded disclosures of stock-based compensation arrangements with employees and encourages (but does not require) application of the fair value recognition provisions in the statement. Companies may continue following those rules to recognize and measure compensation as outlined in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, but they are required to disclose the pro forma amounts of net income and earnings per share that would have been reported had the company elected to follow the fair value recognition provisions of SFAS No. 123. The Company continues to measure its employee stock-based compensation arrangements under the provisions of APB Opinion No. 25. Accordingly, no compensation cost has been recognized for its stock option plans. If the compensation cost for the Company's compensation plans had been determined consistent with SFAS No. 123, the Company's net income available to diluted common stock and diluted earnings per share would have been reduced to the pro forma amounts indicated below:

|  | Years Ended<br>December 31 |           | Nine<br>Months Ended<br>December 31 |
|--|----------------------------|-----------|-------------------------------------|
|  | 2001                       | 2000      | 1999                                |
| (dollars in thousands, except per share amounts) |                            |           |                                     |
| Net income attributable to common stock:         |                            |           |                                     |
| Basic:   |                            |           |                                     |
| As reported                                      | \$ 7,450                   | \$ 18,348 | \$ 12,869                           |
| Pro forma  | 6,561                      | 17,168    | 11,891                              |
| Diluted:   |                            |           |                                     |
| As reported                                      | \$ 7,450                   | \$ 18,348 | \$ 12,869                           |

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|                                |         |         |         |
|--------------------------------|---------|---------|---------|
| Pro forma                      | 6,561   | 17,168  | 11,891  |
| Net income per common share: * |         |         |         |
| Basic:                         |         |         |         |
| As reported                    | \$ 0.67 | \$ 1.62 | \$ 1.12 |
| Pro forma                      | 0.59    | 1.52    | 1.04    |
| Diluted:                       |         |         |         |
| As reported                    | \$ 0.64 | \$ 1.60 | \$ 1.09 |
| Pro forma                      | 0.57    | 1.49    | 1.00    |

The compensation expense included in the pro forma net income attributable to diluted common stock and diluted earnings per share is not likely to be representative of the effect on reported net income for future years because options vest over several years and additional awards generally are made each year.

\* Adjusted for stock dividends: see Note 2

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**Note 16: STOCK BASED COMPENSATION (continued)**

The fair value of options granted under the Company's SOPs is estimated on the date of grant using the Black-Scholes options-pricing model with the following weighted average assumptions used for grants:

|                         | Years Ended<br>December 31 |               | Nine<br>Months Ended<br>December 31 |
|-------------------------|----------------------------|---------------|-------------------------------------|
|                         | 2001                       | 2000          | 1999                                |
| Annual dividend yield   | 3.25%                      | 4.25%         | 2.75%                               |
| Expected volatility     | 28.3 to 57.8%              | 28.2 to 41.1% | 30.8 to 38.5%                       |
| Risk free interest rate | 4.25 to 5.09%              | 6.18 to 6.95% | 5.51 to 6.57%                       |
| Expected lives          | 5 to 9 yrs                 | 5 to 9 yrs    | 8.5 to 12.5 yrs                     |

**Note 17: REGULATORY CAPITAL REQUIREMENTS**

The Company is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended (BHCA), and the regulations of the Federal Reserve. Banner Bank is a state-chartered federally insured institution subject to the capital requirements established by the FDIC.

The capital adequacy requirements are quantitative measures established by regulation that require the Company and the Bank to maintain minimum amounts and ratios of capital. The Federal Reserve requires the Company to maintain capital adequacy that generally parallels the FDIC requirements. The FDIC requires the Bank to maintain minimum ratios of total capital and Tier 1 capital to risk-weighted assets as well as Tier 1 leverage capital to average assets.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) created a statutory framework that increased the importance of meeting applicable capital requirements. For the Bank, FDICIA established five capital categories: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution's category depends upon where its capital levels are in relation to relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure, and certain other factors. The federal banking agencies (including the FDIC) have adopted regulations that implement this statutory framework. Under these regulations, an institution is treated as well-capitalized if its ratio of total capital to risk-weighted assets is 10.00% or more, its ratio of core capital to risk-weighted assets is 6.00% or more, its ratio of core capital to adjusted total assets is 5.00% or more and it is not subject to any federal supervisory order or directive to meet a specific capital level. In order to be adequately capitalized, an institution must have a total risk-based

capital ratio of not less than 8.00%, a Tier 1 risk-based capital ratio of not less than 4.00%, and leverage ratio of not less than 4.00%. Any institution which is neither well-capitalized nor adequately capitalized will be considered undercapitalized.

Undercapitalized institutions are subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by the Bank to comply with applicable capital requirements would, if unremedied, result in restrictions on its activities and lead to enforcement actions against it by the FDIC, including, but not limited to, the issuance of a capital directive to ensure the maintenance of required capital levels. FDICIA requires the federal banking regulators to take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Additionally, FDIC approval of any regulatory application filed for its review may be dependent on compliance with capital requirements.

Federal law requires that the federal banking agencies' risk-based capital guidelines take into account various factors including interest rate risk, concentration of credit risk, risks associated with nontraditional activities, and the actual performance and expected risk of loss of multifamily mortgages. In 1994, the federal banking agencies jointly revised their capital standards to specify that concentration of credit and nontraditional activities are among the factors that the agencies will consider in evaluating capital adequacy. In that year, the FDIC amended its risk-based capital standards with respect to the risk weighting of loans made to finance the purchase or construction of multifamily residences. Management believes that the effect of including such an interest rate risk component in the calculation of risk-adjusted capital will not cause the Company and the Bank to cease to be well-capitalized. In June 1996, the FDIC and certain other federal banking agencies issued a joint policy statement providing guidance on prudent interest rate risk management principles. The agencies stated that they would determine banks' interest rate risk on a case-by-case basis, and would not adopt a standardized measure or establish an explicit minimum capital charge for interest rate risk.

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**Note 17: REGULATORY CAPITAL REQUIREMENTS (continued)**

The Company may not declare or pay cash dividends on, or repurchase, any of its shares of common stock if the effect thereof would cause equity to be reduced below applicable regulatory capital maintenance requirements or if such declaration and payment would otherwise violate regulatory requirements.

|   | Actual     |        | Minimum for capital adequacy purposes |       | Minimum to be categorized as "well-capitalized" under prompt corrective action provisions |        |
|---|------------|--------|---------------------------------------|-------|---|--------|
|   | Amount     | Ratio  | Amount                                | Ratio | Amount  | Ratio  |
| (dollars in thousands)                    |            |        |                                       |       |   |        |
| <b>December 31, 2001:</b>                 |            |        |                                       |       |   |        |
| The Company--consolidated                 |            |        |                                       |       |   |        |
| Total capital to risk-weighted assets     | \$ 177,054 | 11.57% | \$ 122,458                            | 8.00% | N/A   | N/A    |
| Tier 1 capital to risk-weighted assets    | 158,513    | 10.36  | 61,229                                | 4.00  | N/A   | N/A    |
| Tier 1 leverage capital to average assets | 158,513    | 7.71   | 82,222                                | 4.00  | N/A   | N/A    |
| <b>BB</b>                                 |            |        |                                       |       |   |        |
| Total capital to risk-weighted assets     | 173,773    | 11.40  | 121,982                               | 8.00  | \$152,477   | 10.00% |
| Tier 1 capital to risk-weighted assets    | 155,232    | 10.18  | 60,991                                | 4.00  | 91,486  | 6.00   |
| Tier 1 leverage capital to average assets | 155,232    | 7.56   | 82,169                                | 4.00  | 102,712   | 5.00   |
| <b>December 31, 2000:</b>                 |            |        |                                       |       |   |        |
| The Company--consolidated                 |            |        |                                       |       |   |        |

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|   |         |       |         |      |         |       |
|---|---------|-------|---------|------|---------|-------|
| Total capital to risk-weighted assets     | 176,623 | 12.29 | 114,963 | 8.00 | N/A     | N/A   |
| Tier 1 capital to risk-weighted assets    | 160,130 | 11.14 | 57,481  | 4.00 | N/A     | N/A   |
| Tier 1 leverage capital to average assets | 160,130 | 8.25  | 77,599  | 4.00 | N/A     | N/A   |
| <b>BB</b>                                 |         |       |         |      |         |       |
| Total capital to risk-weighted assets     | 150,882 | 12.20 | 98,975  | 8.00 | 123,718 | 10.00 |
| Tier 1 capital to risk-weighted assets    | 136,273 | 11.01 | 49,487  | 4.00 | 74,231  | 6.00  |
| Tier 1 leverage capital to average assets | 136,273 | 7.92  | 68,787  | 4.00 | 85,983  | 5.00  |
| <b>BBO</b>                                |         |       |         |      |         |       |
| Total capital to risk-weighted assets     | 20,702  | 10.79 | 15,354  | 8.00 | 19,193  | 10.00 |
| Tier 1 capital to risk-weighted assets    | 18,833  | 9.81  | 7,677   | 4.00 | 11,516  | 6.00  |
| Tier 1 leverage capital to average assets | 18,833  | 8.54  | 8,818   | 4.00 | 11,023  | 5.00  |

Company management believes that as of December 31, 2001, the Company and BB individually met all capital adequacy requirements to which they were subject. There have been no conditions or events since the end of the period that management believes have changed the Bank's individual category. The most recent exam notifications from the FDIC or state banking regulators as of September 30, 2001, individually categorized BB as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, a bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table above.

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**Note 18: CONTINGENCIES**

In the normal course of business, the Company and/or its subsidiaries have various legal claims and other contingent matters outstanding. The Company believes that any liability ultimately arising from these actions would not have a material adverse effect on the results of operations or consolidated financial position at December 31, 2001.

**Note 19: INTEREST RATE RISK**

The financial condition and operation of the Company are influenced significantly by general economic conditions, including the absolute level of interest rates as well as changes in interest rates and the slope of the yield curve. The Company's profitability is dependent to a large extent on its net interest income, which is the difference between the interest received from its interest-earning assets and the interest expense incurred on its interest-bearing liabilities.

The activities of the Company, like all financial institutions, inherently involve the assumption of interest rate risk. Interest rate risk is the risk that changes in market interest rates will have an adverse impact on the institution's earnings and underlying economic value. Interest rate risk is determined by the maturity and repricing characteristics of an institution's assets, liabilities, and off-balance-sheet contracts. Interest rate risk is measured by the variability of financial performance and economic value resulting from changes in interest rates. Interest rate risk is the primary market risk impacting the Company's financial performance.

The greatest source of interest rate risk to the Company results from the mismatch of maturities or repricing intervals for rate-sensitive assets, liabilities and off-balance-sheet contracts. This mismatch or gap is generally characterized by a substantially shorter maturity structure for interest-bearing liabilities than interest-earning assets. Additional interest rate risk results from mismatched repricing indices and formulae (basis risk and yield curve risk), product caps and floors, and early repayment or withdrawal provisions (option risk), which may be contractual or market driven, that are generally more favorable to customers than to the Company.

The Company's primary monitoring tool for assessing interest rate risk is asset/liability simulation modeling, which is designed to capture the dynamics of balance sheet, interest rate and spread movements, and to quantify variations in net interest income and net market value resulting from those movements under different rate environments. Another monitoring tool used by the Company to assess interest rate risk is gap analysis. The matching of repricing characteristics of assets and liabilities may be analyzed by examining the extent to which such assets and liabilities are interest sensitive and by monitoring the Company's interest sensitivity gap. Management is aware of the sources of interest rate risk and in its opinion actively monitors and manages it to the extent possible, and considers that the Company's current level of interest rate risk is reasonable.

**Note 20: GOODWILL**

Costs in excess of net assets acquired (goodwill) consisted of the following (in thousands):

|  | <b>December 31<br/>2001</b> | December 31<br>2000 |
|--|-----------------------------|---------------------|
| Acquisitions net of accumulated amortization of \$12,594,000 and \$9,414,000, respectively | \$ 31,437                   | \$ 34,617           |

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**Note 21: FAIR VALUE OF FINANCIAL INSTRUMENTS**

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of SFAS No. 107, *Disclosures About Fair Value of Financial Instruments*. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is necessary to interpret market data in the development of the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. The estimated fair value of financial instruments is as follows (in thousands):

|   | <b>December 31, 2001</b> |                         | December 31, 2000 |                         |
|---|--------------------------|-------------------------|-------------------|-------------------------|
|   | Carrying<br>value        | Estimated<br>fair value | Carrying<br>value | Estimated<br>fair value |
| <b>Assets:</b>                                  |                          |                         |                   |                         |
| Cash  | \$ 67,728                | \$ 67,728               | \$ 67,356         | \$ 67,356               |
| Securities available for sale                   | 301,847                  | 301,847                 | 308,798           | 308,798                 |
| Securities held to maturity                     | 14,828                   | 14,902                  | 17,717            | 18,269                  |
| Loans receivable held for sale                  | 43,235                   | 43,647                  | 7,934             | 8,011                   |
| Loans receivable                                | 1,532,190                | 1,547,699               | 1,463,835         | 1,455,901               |
| FHLB stock                                      | 30,840                   | 30,840                  | 28,807            | 28,807                  |
| Mortgage servicing rights                       | 1,261                    | 1,375                   | 1,728             | 1,860                   |
| <b>Liabilities:</b>                             |                          |                         |                   |                         |
| Demand, NOW and money market accounts           | 443,376                  | 443,376                 | 349,636           | 349,636                 |
| Regular savings                                 | 42,228                   | 42,228                  | 44,427            | 44,427                  |
| Certificates of deposit                         | 810,207                  | 820,147                 | 798,652           | 802,231                 |
| FHLB advances                                   | 501,982                  | 509,016                 | 507,098           | 510,708                 |
| Other borrowings                                | 76,715                   | 76,875                  | 74,538            | 74,667                  |
| <b>Off-balance-sheet financial instruments:</b> |                          |                         |                   |                         |
| Commitments to sell loans                       | \$ --                    | \$ 83                   | \$ --             | \$ --                   |
| Commitments to originate loans                  | --                       | (83)                    | --                | --                      |
| Commitments to purchase securities              | --                       | --                      | --                | --                      |



Commitments to sell securities

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Fair value estimates, methods, and assumptions are set forth below for the Company's financial and off-balance-sheet instruments:

*Cash:* The carrying amount of these items is a reasonable estimate of their fair value.

*Securities:* The estimated fair values of investment securities and mortgaged-backed securities available for sale and held to maturity are based on quoted market prices or dealer quotes.

*Loans Receivable:* Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as multifamily real estate, residential mortgage, nonresidential, commercial/agricultural, consumer and other. Each loan category is further segmented into fixed- and adjustable-rate interest terms and by performing and non-performing categories.

The fair value of performing residential mortgages held for sale is estimated based upon secondary market sources by type of loan and terms such as fixed or variable interest rates. For performing loans held in portfolio, the fair value is based on discounted cash flows using as a discount rate the current rate offered on similar products.

Fair value for significant non-performing loans is based on recent appraisals or estimated cash flows discounted using rates commensurate with risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discount rates are judgmentally determined using available market information and specific borrower information.

*FHLB Stock:* The fair value is based upon the redemption value of the stock which equates to its carrying value.

*Deposit Liabilities:* The fair value of deposits with no stated maturity, such as savings, checking and NOW accounts, is equal to the amount payable on demand. The market value of certificates of deposit is based upon the discounted value of contractual cash flows. The discount rate is determined using the rates currently offered on comparable instruments.

*FHLB Advances and Other Borrowings:* The fair value of FHLB advances and other borrowings is estimated based on discounting the estimated future cash flows using rates currently available to the Company for debt with similar remaining maturities.

*Commitments:* Commitments to sell loans with a notional balance of \$48,303,000 and \$7,940,000 at December 31, 2001 and 2000, respectively, have a carrying value of zero, representing the cost of such commitments. Commitments to originate loans, \$337,425,000 and \$262,418,000 at December 31, 2001 and 2000, respectively, also have a carrying value of zero. There were no commitments to purchase or sell securities at December 31, 2001.

*Limitations:* The fair value estimates presented herein are based on pertinent information available to management as of December 31, 2001. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

Fair value estimates are based on existing on- and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business. The fair value has not been estimated for assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not financial instruments include the deferred tax assets/liabilities; land, buildings and equipment; costs in excess of net assets acquired; and real estate held for sale.

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|  |          |           |           |           |
|--|----------|-----------|-----------|-----------|
| PROVISION FOR (BENEFIT FROM)<br>INCOME TAXES | _____    | _____     | _____     | _____     |
| NET INCOME                                   | \$ 7,450 | \$ 18,348 | \$ 16,898 | \$ 12,869 |
|  | _____    | _____     | _____     | _____     |

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**BANR**

**Statements of Cash Flows**

For the years ended December 31, 2001 and 2000, and the nine months ended December 31, 1999

|   | Years Ended<br>December 31 |           | Nine<br>Months Ended<br>December 31 |
|---|----------------------------|-----------|-------------------------------------|
|   | 2001                       | 2000      | 1999                                |
| <b>OPERATING ACTIVITIES:</b>  |                            |           |                                     |
| Net income  | \$ 7,450                   | \$ 18,348 | \$ 12,869                           |
| Adjustments to reconcile net income<br>to net cash provided by operating<br>activities: |                            |           |                                     |
| Equity in undistributed earnings<br>of subsidiaries                                     | --                         | (11,288)  | (7,638)                             |
| Amortization of MRP liability   | 177                        | 302       | 339                                 |
| (Increase) decrease in deferred taxes   | --                         | --        | (67)                                |
| (Increase) decrease in other assets   | 141                        | (447)     | 52                                  |
| Increase (decrease) in other liabilities  | (203)                      | (1,167)   | 147                                 |
|   | _____                      | _____     | _____                               |
| Net cash provided (used) by<br>operating activities                                     | 7,565                      | 5,748     | 5,702                               |
|   | _____                      | _____     | _____                               |
| <b>INVESTING ACTIVITIES:</b>  |                            |           |                                     |
| Funds transferred to deferred compensation trust  | (76)                       | (60)      | (66)                                |
| Acquisitions of subsidiaries  | --                         | (7)       | --                                  |
| Dividends received from subsidiaries  | 2,265                      | 4,000     | 12,000                              |
| Payments received on loan to ESOP<br>for release of shares                              | 1,043                      | 1,510     | 1,305                               |
| Additional funds returned from<br>(invested in) subsidiaries                            | --                         | (1,100)   | (4,494)                             |
|   | _____                      | _____     | _____                               |
| Net cash provided (used) by<br>investing activities                                     | 3,232                      | 4,343     | 8,745                               |
|   | _____                      | _____     | _____                               |
| <b>FINANCING ACTIVITIES:</b>  |                            |           |                                     |
| Repurchases of stock  | (10,158)                   | (5,233)   | (8,568)                             |
| Repurchase of forfeited MRP shares  | (4)                        | (120)     | --                                  |
| Net proceeds from exercise of stock options   | 3,645                      | 913       | 165                                 |
| Cash dividends paid   | (6,284)                    | (5,553)   | (3,709)                             |
|   | _____                      | _____     | _____                               |
| Net cash provided (used) by<br>financing activities                                     | (12,801)                   | (9,993)   | (12,111)                            |
|   | _____                      | _____     | _____                               |

|                                 |                   |                   |                   |
|---------------------------------|-------------------|-------------------|-------------------|
| NET INCREASE (DECREASE) IN CASH | (2,004)           | 98                | 2,336             |
| CASH, BEGINNING OF PERIOD       | 2,544             | 2,446             | 110               |
|                                 | <u>          </u> | <u>          </u> | <u>          </u> |
| CASH, END OF PERIOD             | \$ 540            | \$ 2,544          | \$ 2,446          |
|                                 | <u>          </u> | <u>          </u> | <u>          </u> |

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**BANR**

**Statements of Cash Flows (continued)**

For the year ended December 31, 2001 and 2000, and the nine months ended December 31, 1999

|   | Years Ended<br>December 31 |                   | Nine<br>Months Ended<br>December 31 |
|---|----------------------------|-------------------|-------------------------------------|
|   | 2001                       | 2000              | 1999                                |
|   | <u>          </u>          | <u>          </u> | <u>          </u>                   |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>  |                            |                   |                                     |
| Interest paid   | \$ --                      | \$ --             | \$ --                               |
| Taxes paid  | --                         | --                | --                                  |
| Non-cash transactions:  |                            |                   |                                     |
| Net change in accrued dividends payable   | 45                         | 336               | 52                                  |
| Net change in unrealized gain (loss) in deferred compensation trust and related liability, including subsidiaries | 133                        | 173               | 56                                  |
| Recognize tax benefit of vested MRP shares, including subsidiaries  | 259                        | 2                 | 188                                 |
| Non-cash portion of 10% stock dividend  | --                         | 14,731            | --                                  |
| The following summarizes the non-cash activities relating to acquisitions:  |                            |                   |                                     |
| Fair value of assets acquired--adjustment   | \$ --                      | \$ (48)           | \$ --                               |
| Fair value of liabilities assumed   | --                         | --                | --                                  |
| Fair value of stock issued to acquisitions' shareholders--subsequent adjustments                                  | n/a                        | 48                | --                                  |
|   | <u>          </u>          | <u>          </u> | <u>          </u>                   |
| Cash paid out in acquisition  | --                         | --                | --                                  |
| Less cash acquired  | --                         | --                | --                                  |
|   | <u>          </u>          | <u>          </u> | <u>          </u>                   |
| Net cash acquired (used)  | \$ --                      | \$ --             | \$ --                               |
|   | <u>          </u>          | <u>          </u> | <u>          </u>                   |

**Note 23: STOCK REPURCHASE**

The Company has periodically engaged in stock repurchase activity. Through December 31, 2001, the Company has repurchased a total of 3,857,089 shares at an average price of \$17.14 per share. On October 25, 2001, the Company's Board of Directors approved continuance of a stock repurchase program authorizing the purchase of up to 5% of total shares outstanding over the next twelve months.

**Note 24: CALCULATION OF WEIGHTED AVERAGE SHARES OUTSTANDING USED TO CALCULATE EARNINGS PER SHARE (in thousands)**

|  | Years Ended<br>December 31 |         |             | Nine<br>Months Ended<br>December 31 |
|--|----------------------------|---------|-------------|-------------------------------------|
|  | 2001                       | 2000    | 1999*       | 1999*                               |
|  |                            |         |             |                                     |
|  |                            |         | (Unaudited) |                                     |
| Total shares issued  | 13,201                     | 13,201  | 13,201      | 13,201                              |
| Less stock repurchased/retired<br>including shares allocated to MRP                                    | (1,389)                    | (1,150) | (818)       | (908)                               |
| Less unallocated shares held by the ESOP   | (633)                      | (746)   | (820)       | (820)                               |
| Basic weighted average shares outstanding  | 11,179                     | 11,305  | 11,563      | 11,473                              |
| Plus MRP and stock option incremental<br>shares considered outstanding for diluted<br>EPS calculations | 421                        | 182     | 411         | 378                                 |
| Diluted weighted average shares outstanding  | 11,600                     | 11,487  | 11,974      | 11,851                              |

\* Weighted average shares, restated for stock dividend: see Note 2

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**Note 25: SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)**

Results of operations on a quarterly basis were as follows (in thousands):

|  | Year Ended December 31, 2001 |                   |                  |                   |
|--|------------------------------|-------------------|------------------|-------------------|
|  | First<br>Quarter             | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
| Interest income  | \$ 40,578                    | \$ 39,739         | \$ 39,858        | \$ 37,491         |
| Interest expense                                       | 23,107                       | 22,545            | 21,544           | 18,748            |
| Net interest income                                    | 17,471                       | 17,194            | 18,314           | 18,743            |
| Provision for loan losses                              | 950                          | 2,950             | 5,959            | 4,100             |
| Net interest income after provision<br>for loan losses | 16,521                       | 14,244            | 12,355           | 14,643            |
| Non-interest income                                    | 2,865                        | 3,635             | 3,314            | 3,651             |

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|  |          |          |           |          |
|--|----------|----------|-----------|----------|
| Non-interest expense                     | 15,711   | 15,201   | 15,601    | 13,123   |
| Income before provision for income taxes | 3,675    | 2,678    | 68        | 5,171    |
| Provision for income taxes               | 1,366    | 1,059    | 212       | 1,505    |
| Net operating income                     | \$ 2,309 | \$ 1,619 | \$ (144)  | \$ 3,666 |
| *Basic earnings per share                | \$ 0.21  | \$ 0.14  | \$ (0.01) | \$ 0.33  |
| *Diluted earnings per share              | \$ 0.20  | \$ 0.14  | \$ (0.01) | \$ 0.32  |
| *Cash dividends declared                 | \$ 0.14  | \$ 0.14  | \$ 0.14   | \$ 0.14  |

Year Ended December 31, 2000

|  | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
|--|------------------|-------------------|------------------|-------------------|
| Interest income  | \$ 36,630        | \$ 39,108         | \$ 40,923        | \$ 41,637         |
| Interest expense                                       | 19,985           | 21,777            | 23,690           | 24,142            |
| Net interest income                                    | 16,645           | 17,331            | 17,233           | 17,495            |
| Provision for loan losses                              | 545              | 819               | 651              | 852               |
| Net interest income after provision<br>for loan losses | 16,100           | 16,512            | 16,582           | 16,643            |
| Non-interest income                                    | 1,631            | 1,822             | 2,225            | 3,573             |
| Non-interest expense                                   | 10,810           | 11,285            | 11,686           | 12,721            |
| Income before provision for income taxes               | 6,921            | 7,049             | 7,121            | 7,495             |
| Provision for income taxes                             | 2,496            | 2,506             | 2,515            | 2,721             |
| Net operating income                                   | \$ 4,425         | \$ 4,543          | \$ 4,606         | \$ 4,774          |
| *Basic earnings per share                              | \$ 0.39          | \$ 0.40           | \$ 0.41          | \$ 0.42           |
| *Diluted earnings per share                            | \$ 0.38          | \$ 0.40           | \$ 0.40          | \$ 0.42           |
| *Cash dividends declared                               | \$ 0.13          | \$ 0.13           | \$ 0.13          | \$ 0.14           |

Nine Months Ended December 31, 1999

|  | First<br>Quarter | Second<br>Quarter | Third<br>Quarter |
|--|------------------|-------------------|------------------|
| Interest income  | \$ 32,173        | \$ 33,595         | \$ 35,264        |
| Interest expense                                       | 16,926           | 17,609            | 18,666           |
| Net interest income                                    | 15,247           | 15,986            | 16,598           |
| Provision for loan losses                              | 710              | 510               | 665              |
| Net interest income after provision<br>for loan losses | 14,537           | 15,476            | 15,933           |
| Non-interest income                                    | 1,861            | 1,919             | 1,735            |
| Non-interest expense                                   | 9,783            | 10,594            | 10,145           |
| Income before provision for income taxes               | 6,615            | 6,801             | 7,523            |
| Provision for income taxes                             | 2,558            | 2,594             | 2,918            |

|                             |          |          |          |
|-----------------------------|----------|----------|----------|
| Net operating income        | \$ 4,057 | \$ 4,207 | \$ 4,605 |
| *Basic earnings per share   | \$ 0.35  | \$ 0.37  | \$ 0.34  |
| *Diluted earnings per share | \$ 0.34  | \$ 0.36  | \$ 0.33  |
| *Cash dividends declared    | \$ 0.11  | \$ 0.11  | \$ 0.11  |

\* Adjusted for stock dividends, see Note 2

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## Note 26: BUSINESS SEGMENTS

The Company has been managed by legal entity or bank, not by lines of business. Each Bank has been managed by its management team that was responsible for its own lending, deposit operations, information systems and administration. Marketing support, sales training assistance, and human resource services were provided from a central source at BB, and costs were allocated to the individual Banks using appropriate methods based on usage. In addition, corporate overhead and centralized administrative costs were allocated to each Bank. In prior periods, business segment reporting included results for each subsidiary Bank; however, over the past year all of the subsidiary Banks have been merged into a single legal entity, BB, with a consolidated management team. For comparative purposes prior period segment information has been regrouped to match current business segments/grouping after merger of the Bank subsidiaries. All of the executive officers of BANR are members of the BB management team.

BB is a community oriented commercial bank chartered in the State of Washington. As explained above under *Consolidation of Banking Operations* in Note 2, BB includes the operations of the former First Savings Bank of Washington and its divisions, Whatcom State Bank and Seaport Citizens Bank, the former Towne Bank and BBO (formerly IEB). BB offers a wide variety of deposit products to its consumer and commercial customers. Lending activities include the origination of real estate, commercial/agricultural business and consumer loans. BB's primary business is that of a traditional banking institution, gathering deposits and originating loans for portfolio in its primary market area. BB is also an active participant in the secondary market, originating residential loans for sale on both a servicing released and servicing retained basis. In addition to interest income on loans and investment securities, BB receives other income from deposit servicing charges, loan servicing fees and from the sale of loans and investments. BB also has a mortgage lending subsidiary, CFC, located in the Lake Oswego area of Portland, Oregon, that was established in fiscal 2000. CFC's primary lending activities are in the area of construction and permanent financing for one- to four-family residential dwellings.

BBO (formerly IEB) was a community oriented commercial bank chartered in the State of Oregon which historically offered a wide variety of deposit and loan products to its consumer and commercial customers. Lending activities included origination of consumer, commercial, agricultural and real estate loans. BBO also engaged in mortgage banking activity with respect to residential lending within its local markets and originating loans for sale generally on a servicing released basis. BBO operated a division, Inland Financial Services, which offered insurance and brokerage services to its customers. BBO was merged into BB on September 1, 2001.

The performance of the Bank is reviewed by the Company's executive management team and the Board of Directors on a monthly basis.

Generally accepted accounting principles establish standards to report information about operating segments in annual financial statements and requires reporting of selected information about operating segments in interim reports to stockholders. It also establishes standards for related disclosures about products and services, geographic areas and major customers. The Company has concluded that as a result of the mergers completed during the 2001 year it has one segment.

Financial highlights by legal entity were as follows:

### Year Ended December 31, 2001

(dollars in thousands)

#### Condensed Income Statement

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|                                   | BB          | BBO<br>(now merged into BB) | TB<br>(now merged into BB) | Other *    | Total       |
|-----------------------------------|-------------|-----------------------------|----------------------------|------------|-------------|
| Net interest income (loss)        | \$71,660    | \$ --                       | \$ --                      | \$ 62      | \$71,722    |
| Provision for loan losses         | 13,959      | --                          | --                         | --         | 13,959      |
| Other income                      | 13,465      | --                          | --                         | --         | 13,465      |
| Other expenses                    | 57,738      | --                          | --                         | 1,898      | 59,636      |
| Income (loss) before income taxes | 13,428      | --                          | --                         | (1,836)    | 11,592      |
| Income taxes (benefit)            | 4,785       | --                          | --                         | (643)      | 4,142       |
| Net income (loss)                 | \$ 8,643    | \$ --                       | \$ --                      | \$ (1,193) | \$ 7,450    |
| <b>December 31, 2001</b>          |             |                             |                            |            |             |
| Total Assets                      | \$2,081,147 | \$ --                       | \$ --                      | \$ (5,947) | \$2,087,094 |

\* Includes intercompany eliminations and holding company amounts.

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Year Ended December 31, 2000

(dollars in thousands)

**Condensed Income Statement**

|                                     | BB          | BBO<br>(now merged into BB) | TB<br>(now merged into BB) | Other *     | Total       |
|-------------------------------------|-------------|-----------------------------|----------------------------|-------------|-------------|
| Net interest income (loss)          | \$68,654    | \$ --                       | \$ --                      | \$50        | \$68,704    |
| Provision for loan losses           | 2,867       | --                          | --                         | --          | 2,867       |
| Other income                        | 9,324       | --                          | --                         | (73)        | 9,251       |
| Other expenses                      | 44,547      | --                          | --                         | 1,955       | 46,502      |
| Income (loss) before income taxes   | 30,564      | --                          | --                         | (1,978)     | 28,586      |
| Income taxes (benefit)              | 10,926      | --                          | --                         | (688)       | 10,238      |
| Net income (loss)                   | \$ 19,638   | \$ --                       | \$ --                      | \$ (1,290)  | \$ 18,348   |
| <b>December 31, 2000</b>            |             |                             |                            |             |             |
| Total Assets                        | \$1,997,766 | \$ --                       | \$ --                      | \$ (14,935) | \$1,982,831 |
| <b>Year Ended December 31, 1999</b> |             |                             |                            |             |             |



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(dollars in thousands) (Unaudited)

**Condensed Income Statement**

|                                   | BB       | BBO<br>(now merged into BB) | TB<br>(now merged into BB) | Other *   | Total    |
|-----------------------------------|----------|-----------------------------|----------------------------|-----------|----------|
| Net interest income (loss)        | \$62,009 | \$ --                       | \$ --                      | \$133     | \$62,142 |
| Provision for loan losses         | 2,516    | --                          | --                         | --        | 2,516    |
| Other income                      | 7,680    | --                          | --                         | (68)      | 7,612    |
| Other expenses                    | 38,190   | --                          | --                         | 1,683     | 39,873   |
| Income (loss) before income taxes | 28,983   | --                          | --                         | (1,618)   | 27,365   |
| Income taxes (benefit)            | 11,036   | --                          | --                         | (569)     | 10,467   |
| Net income (loss)                 | \$17,947 | \$ --                       | \$ --                      | \$(1,049) | \$16,898 |

December 31, 1999 (Unaudited)

|                     |             |       |       |       |             |
|---------------------|-------------|-------|-------|-------|-------------|
| <b>Total Assets</b> | \$1,819,665 | \$ -- | \$ -- | \$445 | \$1,820,110 |
|---------------------|-------------|-------|-------|-------|-------------|

\*Includes intercompany eliminations and holding company amounts.

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**Signatures of Registrant**

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Company has duly caused this amended report to be signed on its behalf by the undersigned, thereunto duly authorized on April 18, 2002.

Banner Corporation

/s/ Gary Sirmon

Gary Sirmon  
President and Chief Executive Officer