NORTHWEST BANCORPORATION INC
Form 10-Q
November 09, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

(Mark One)

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended September 30, 2011.**

¨ **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: 000-24151

NORTHWEST BANCORPORATION, INC.

(Exact name of registrant as specified in its charter)

Washington	**91-1574174**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

421 West Riverside, Spokane, WA 99201-0403

(Address of principal executive offices) (Zip Code)

(509) 456-8888

(Registrant s telephone number, including area code)

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. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The Registrant has a single class of common stock, of which there were 3,081,748 shares issued and outstanding as of October 31, 2011.

Table of Contents

NORTHWEST BANCORPORATION, INC.

FORM 10-Q

For the three-month and nine-month periods ended September 30, 2011

TABLE OF CONTENTS

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

Consolidated Statements of Financial Condition

($ in thousands)

	September 30, 2011	December 31, 2010
ASSETS		
Cash and due from banks	$ 16,349	$ 10,813
Federal funds sold and other interest bearing deposits	11,971	5,028
Total cash and cash equivalents	28,320	15,841
Securities available for sale, at fair value	69,587	69,730
Federal Home Loan Bank stock, at cost	1,261	1,261
Loans receivable, net of allowance for loan losses $6,552 and $6,918	262,504	274,416
Loans held for sale	2,816	2,371
Premises and equipment, net	16,668	17,316
Accrued interest receivable	1,633	1,507
Foreclosed real estate	2,869	3,963
Bank owned life insurance	3,882	3,792
Other assets	3,825	4,378
TOTAL ASSETS	$ 393,365	$ 394,575
LIABILITIES		
Deposits	$ 338,223	$ 346,237
Securities sold under agreements to repurchase		135
Accrued interest payable	482	464
Borrowed funds	13,651	9,518
Other liabilities	3,842	2,534
Total liabilities	356,198	358,888
SHAREHOLDERS EQUITY		
Preferred stock Series A Cumulative Perpetual; $1,000 par value; $1,000 liquidation value; 10,500 shares authorized and issued	10,219	10,131
Preferred stock Series B Cumulative Perpetual; $0.01 par value; $1,000 liquidation value; 525 shares authorized and issued	557	566
Common stock, no par value, 5,000,000 shares authorized; 3,081,748 shares issued and outstanding	25,956	25,896
Accumulated deficit	(822)	(175)
Accumulated other comprehensive income (loss), net of tax effect of $-648 and $376	1,257	(731)
Total shareholders equity	37,167	35,687
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 393,365	$ 394,575

See accompanying notes.

Table of Contents

NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

Consolidated Statements of Operations

($ in thousands, except per share data)

	Three months ended September 30, 2011	Three months ended September 30, 2010	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Interest income:				
Loans, including fees	$ 4,129	$ 4,868	$ 13,012	$ 14,730
Investment securities	537	356	1,717	1,063
Federal funds sold and interest bearing deposits	6	5	12	18
Total interest income	4,672	5,229	14,741	15,811
Interest expense:				
Deposits	924	1,345	3,021	4,377
Borrowed funds	99	108	247	474
Total interest expense	1,023	1,453	3,268	4,851
Net interest income	3,649	3,776	11,473	10,960
Provision for loan losses	2,531	600	4,893	2,050
Net interest income after provision for loan losses	1,118	3,176	6,580	8,910
Noninterest income:				
Service charges on deposits	392	399	1,115	1,032
Gain from sale of loans, net	238	237	548	553
Gain on investment securities, net	232	64	265	382
Other noninterest income	320	263	968	956
Total noninterest income	1,182	963	2,896	2,923
Noninterest expense:				
Salaries and employee benefits	1,510	1,619	4,841	4,719
Occupancy and equipment	330	305	978	918
Depreciation and amortization	298	289	901	859
Advertising and promotion	97	65	271	227
(Gain) loss on foreclosed real estate, net	(54)	86	29	289
FDIC assessments	129	203	451	619
Other noninterest expenses	863	806	2,558	2,249
Total noninterest expense	3,173	3,373	10,029	9,880
Income (loss) before income taxes	(873)	766	(553)	1,953
Income tax expense (benefit)	(383)	238	(414)	570
Net income (loss)	$ (490)	$ 528	$ (139)	$ 1,383
Preferred stock dividends and discount accretion, net	169	170	508	508
Net income (loss) applicable to common shares	$ (659)	$ 358	$ (647)	$ 875
Earnings (loss) per common share basic	$ (0.21)	$ 0.12	$ (0.21)	$ 0.34

Earnings (loss) per common share diluted	$ (0.21)	$ 0.12	$ (0.21)	$ 0.34
Weighted average shares outstanding basic	3,081,748	2,967,984	3,079,594	2,579,769
Weighted average shares outstanding diluted	3,081,748	2,970,334	3,079,594	2,581,447

See accompanying notes.

Table of Contents

NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

Consolidated Statements of Comprehensive Income (Loss)

($ in thousands)

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Net income (loss)	($ 490)	$ 528	($ 139)	$ 1,383
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on securities	475	192	1,813	(52)
Less: reclassification adjustment for gains included in net income	153	42	175	252
Other comprehensive income	628	234	1,988	200
Comprehensive income	$ 138	$ 762	$ 1,849	$ 1,583

See accompanying notes.

Table of Contents

NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

Consolidated Statements of Changes in Shareholders Equity

($ in thousands)

	Preferred Stock	Common Stock	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2009	$ 10,592	$ 23,269	($ 443)	$ 388	$ 33,806
Net income	0	0	945	0	945
Stock issued to directors	0	22	0	0	22
Issuance of common stock, net of issuance costs of $162	0	2,585	0	0	2,585
Dividends on preferred stock	0	0	(572)	0	(572)
Accretion of preferred stock discount, net	105	0	(105)	0	0
Equity-based compensation expense	0	34	0	0	34
Tax effect of vested stock awards	0	(14)	0	0	(14)
Change in unrealized gain on securities available for sale, net of taxes	0	0	0	(1,119)	(1,119)
Comprehensive loss					
Balance, December 31, 2010	10,697	25,896	(175)	(731)	35,687
Net loss	0	0	(139)	0	(139)
Stock issued to directors	0	21	0	0	21
Dividends on preferred stock	0	0	(429)	0	(429)
Accretion of preferred stock discount, net	79	0	(79)	0	
Equity-based compensation expense	0	39	0	0	39
Change in unrealized loss on securities available for sale, net of taxes	0	0	0	1,988	1,988
Comprehensive income					
Balance, September 30, 2011	$ 10,776	$ 25,956	($ 822)	$ 1,257	$ 37,167

See accompanying notes.

Table of Contents

NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

Consolidated Statements of Cash Flows

($ in thousands)

	Nine months ended September 30, 2011	Nine months ended September 30, 2010
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	($ 139)	$ 1,383
Adjustments to reconcile net income to cash provided by operating activities:		
Amortization of securities discounts and premiums, net	337	(25)
Gain on sale of securities, net	(265)	(382)
Accretion of net deferred loan fees	(179)	(165)
Provision for loan losses	4,893	2,050
Origination of loans held for sale	(27,238)	(31,368)
Proceeds from sales of loans held for sale	27,341	28,888
Gain on sale of loans held for sale, net	(548)	(553)
Depreciation and amortization	901	859
Loss on disposal of premises and equipment	5	
Provision for losses on foreclosed real estate	429	439
Gain on sale of foreclosed real estate, net	(400)	(150)
Increase in cash surrender value of bank owned life insurance	(90)	(92)
Decrease in deferred income taxes, net	288	(94)
Equity-based compensation expense	39	26
Issuance of common stock under directors compensation arrangements	21	22
Change in assets and liabilities:		
Accrued interest receivable	(126)	(119)
Other assets	(759)	1,670
Accrued interest payable	18	(193)
Other liabilities	879	116
Net cash provided by operating activities	5,407	2,312
CASH FLOWS FROM INVESTING ACTIVITIES		
Securities available for sale:		
Purchases	(23,534)	(45,120)
Proceeds from maturities, calls and principal repayments	20,150	22,409
Proceeds from sales	6,467	6,529
Proceeds from sale of equity investment		189
Net decrease in loans	6,439	20,769
Purchase of premises and equipment	(258)	(460)
Proceeds from sale of foreclosed real estate, net of capital improvements	1,824	1,986
Net cash provided by investing activities	11,088	6,302
CASH FLOWS FROM FINANCING ACTIVITIES		
Net decrease in deposits	(8,014)	(1,900)
Decrease in securities sold under agreement to repurchase	(135)	(97)
Proceeds from borrowed funds	7,000	
Repayment of borrowed funds	(2,867)	(6,058)
Proceeds from issuance of common stock		2,585
Dividends paid on preferred stock		(72)
Net cash used by financing activities	(4,016)	(5,542)

NET CHANGE IN CASH AND CASH EQUIVALENTS	12,479	3,072
Cash and cash equivalents, beginning of period	15,841	18,119
Cash and cash equivalents, end of period	$ 28,320	$ 21,191
SUPPLEMENTAL DISCLOSURES:		
Cash paid during the year for:		
Interest	$ 3,250	$ 5,044
Income taxes	329	574
Noncash investing and financing activities:		
Increase in fair value of securities available for sale, net	1,988	200
Acquisition of real estate in settlement of loans	993	2,539
Foreclosed real estate financed in-house	234	99
Preferred stock dividend accrued but not paid	429	358

See accompanying notes.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. Summary of Significant Accounting Policies

***Basis of presentation and consolidation*:** The consolidated financial statements include the accounts of Northwest Bancorporation, Inc. (the Company) and its wholly-owned subsidiary, Inland Northwest Bank (the Bank). All material intercompany balances and transactions have been eliminated.

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (the SEC). Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America (GAAP) for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the accompanying notes as disclosed in the annual report on Form 10-K for the year ended December 31, 2010.

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities known to exist as of the date the financial statements are published, and the reported amounts of revenues and expenses during the reporting period. Uncertainties with respect to such estimates and assumptions are inherent in the preparation of the Company s consolidated financial statements; accordingly, it is possible that the actual results could differ from these estimates and assumptions, which could have a material effect on the reported amounts of the Company s consolidated financial position and results of operations.

In preparing these financial statements, the Company has evaluated events and transactions subsequent to September 30, 2011 for potential recognition or disclosure. In management s opinion, all accounting adjustments necessary to accurately reflect the financial position and results of operations on the accompanying financial statements have been made. The adjustments include normal and recurring accruals considered necessary for a fair and accurate presentation. The results for interim periods are not necessarily indicative of results for the full year or any other interim period. Certain reclassifications of prior period amounts have been made to conform to current classifications. These reclassifications had no effect on retained earnings or net income as previously presented.

Segment reporting: The Company has not established any independent business activity apart from acting as the parent company of the Bank. The Company and the Bank are managed as a single entity and not by departments or lines of business. Based on management s analysis, no department or line of business meets the criteria established in Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) 280, Segment Reporting, for reporting of selected information about operating segments.

New accounting pronouncements: In addition to other established accounting policies, the following is a discussion of recent accounting pronouncements:

ASU No. 2011-02 Receivables (Topic 310) A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that the restructuring constitutes a concession, and the debtor is experiencing financial difficulties. The amendments to Topic 310 clarify the guidance on a creditor s evaluation of whether it has granted a concession as follows: 1) if a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession; 2) a temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a concession because the new contractual interest rate on the restructured debt could still be below the market interest rate for new debt with similar risk characteristics. In both of these situations, a creditor should consider all aspects of the restructuring in determining whether it has granted a concession. If a creditor determines that it has granted a concession, the creditor must make a separate assessment about whether the debtor is experiencing financial difficulties to determine whether the restructuring constitutes a troubled debt restructuring. Additionally, ASU 2011-02 clarifies that a restructuring that results in a delay in payment that is insignificant is not a concession. However, an entity should consider various factors in assessing whether a restructuring resulting in a delay in payment is insignificant.

Table of Contents

The amendments to Topic 310 also clarify the guidance on a creditor s evaluation of whether a debtor is experiencing financial difficulties. A creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default. A creditor should evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification. In addition, the amendments to Topic 310 clarify that a creditor is precluded from using the effective interest rate test in the debtor s guidance on restructuring of payables when evaluating whether a restructuring constitutes a troubled debt restructuring.

ASU No. 2011-02 is effective beginning in the third quarter of 2011 and will be applied retrospectively to the entire year. As a result of applying these amendments, an entity may identify receivables that are newly considered impaired. For purposes of measuring impairment of those receivables, an entity is expected to apply the amendments prospectively. An entity is also expected to disclose the total amount of receivables and the allowance for credit losses as of the end of the period of adoption related to those receivables that are newly considered impaired because of the provisions of this amendment. This amendment had no impact on the Company s consolidated financial statements.

ASU No. 2011-03, Transfers and Servicing (Topic 860) Reconsideration of Effective Control for Repurchase Agreements. In a typical repurchase transaction, an entity transfers financial assets to a counterparty in exchange for cash with an agreement for the counterparty to return the same or equivalent financial assets for a fixed price in the future. This ASU prescribes when an entity may or may not recognize a sale upon the transfer of financial assets subject to repurchase agreements. That determination is based, in part, on whether the entity has maintained effective control over the transferred financial assets. One of the relevant considerations for assessing effective control is the transferor s ability to repurchase or redeem financial assets before maturity. Under this criterion, an entity must consider whether there is an exchange of collateral in sufficient amount so as to reasonably assure the arrangement s completion on substantially the agreed terms, even in the event of the transferee s default. That is, in order for the transferor to assert that it maintained effective control over the transferred assets, the transferor must have the ability to repurchase the same or substantially the same assets. The FASB determined that the criterion pertaining to an exchange of collateral should not be a determining factor in assessing effective control; the assessment of effective control should focus on a transferor s contractual rights and obligations with respect to transferred financial assets, not on whether the transferor has the practical ability to perform in accordance with those rights or obligations. The FASB also concluded that the remaining criteria are sufficient to determine effective control. Consequently, the amendments remove the transferor s ability criterion from the consideration of effective control for repurchase agreements and other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity. The provisions of this ASU are effective beginning in the first quarter of 2012 and will be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. This ASU is not expected to have a significant impact on the Company s consolidated financial statements.

ASU No. 2011-04, Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The amendments in this ASU result in common fair value measurement and disclosure requirements between GAAP and International Financial Reporting Standards (IFRS). Consequently, the amendments change the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. For many of the requirements, the FASB does not intend for the amendments in this ASU to result in a change in the application of the requirements in Topic 820. Some of the amendments clarify the FASB s intent about the application of existing fair value measurement requirements. Other amendments change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The amendments in this ASU explain how to measure fair value. They do not require additional fair value measurements and are not intended to establish valuation standards or affect valuation practices outside of financial reporting. The provisions of this ASU are effective beginning in the first quarter of 2012 and will be applied prospectively. This ASU is not expected to have a significant impact on the Company s consolidated financial statements.

Table of Contents

ASU No. 2011-05, Comprehensive Income (Topic 220) Presentation of Comprehensive Income. Current GAAP provides three alternatives for presenting other comprehensive income and its components in financial statements. One of those presentation options is to present the components of other comprehensive income as part of the statement of changes in stockholders equity. This ASU eliminates that option and also requires consecutive presentation of the statement of net income and other comprehensive income. Finally, this ASU also requires an entity to present reclassification adjustments on the face of the financial statements from other comprehensive income to net income, rather than presenting other comprehensive income in a footnote. The provisions of this ASU are effective beginning in the first quarter of 2012 and will be applied retrospectively. The Company s presentation of consolidated comprehensive income changed in order to comply with the provisions of this ASU.

NOTE 2. Investment Securities

Securities held by the Bank have been classified in the consolidated statements of financial condition according to management s intent, and all securities were classified as available for sale at September 30, 2011 and December 31, 2010.

The amortized cost of securities and their approximate fair values at September 30, 2011 and December 31, 2010 were as follows:

	September 30, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	($ in thousands)			
State and municipal securities	$ 24,132	$ 1,526	$ (5)	$ 25,653
Corporate debt obligations	14,378	192	(176)	14,394
U.S. government agency securities	10,461	120		10,581
Collateralized mortgage obligations	8,459	74	(42)	8,491
SBA participation certificates	7,904	91	(5)	7,990
Mortgage backed securities	2,348	130		2,478
	$ 67,682	$ 2,133	$ (228)	$ 69,587

	December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	($ in thousands)			
State and municipal securities	$ 23,332	$ 343	$ (676)	$ 22,999
Corporate debt obligations	11,060	40	(302)	10,798
U.S. government agency securities	30,787	16	(679)	30,124
Collateralized mortgage obligations	269		(3)	266
SBA participation certificates	3,243	135		3,378
Mortgage backed securities	2,146	47	(28)	2,165
	$ 70,837	$ 581	$ (1,688)	$ 69,730

Table of Contents

The following tables show the investments gross unrealized losses and fair values, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position:

	September 30, 2011					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	($ in thousands)					
State and municipal securities	$ 1,284	$ 3	$ 259	$ 2	$ 1,543	$ 5
Corporate debt obligations	3,137	88	1,697	88	4,834	176
Collateralized mortgage obligations	5,292	42			5,292	42
SBA participation certificates	2,458	5			2,458	5
	$ 12,171	$ 138	$ 1,956	$ 90	$ 14,127	$ 228

	December 31, 2010					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	($ in thousands)					
State and municipal securities	$ 13,313	$ 625	$ 878	$ 51	$ 14,191	$ 676
Corporate debt obligations	9,223	302			9,223	302
U.S. government agency securities	22,098	679			22,098	679
Collateralized mortgage obligations	266	3			266	3
Mortgage backed securities	1,728	28			1,728	28
	$ 46,628	$ 1,637	$ 878	$ 51	$ 47,506	$ 1,688

Management has evaluated the above securities and does not believe that any individual unrealized loss as of September 30, 2011, represents an other-than-temporary impairment (OTTI). The decline in fair market value of these securities was generally due to changes in market interest rates or the widening of market spreads since purchase and was not related to any known decline in the creditworthiness of the issuer. Management does not intend to sell any impaired securities nor does available evidence suggest it is more likely than not that management will be required to sell any impaired securities. Management believes there is a high probability of collecting all contractual amounts due, because the majority of the securities in the Bank s investment portfolio are backed by government agencies or government-sponsored enterprises. However, a recovery in value may not occur for some time, if at all, and may be delayed for greater than the one-year time horizon or perhaps even until maturity. At September 30, 2011, 27 of the Bank s securities had unrealized losses. At December 31, 2010, 112 of the Bank s securities had unrealized losses.

Table of Contents

Scheduled maturities of securities available for sale at September 30, 2011, are listed below according to contractual maturity date. Expected or actual maturities may differ from contractual maturities, because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value
	($ in thousands)	
Due within one year	$ 325	$ 327
Due after one year through five years	8,426	8,562
Due after five years through ten years	3,570	3,691
Due after ten years	36,650	38,048
Mortgage backed, collateralized mortgage obligation, and SBA participation certificates	18,711	18,959
	$ 67,682	$ 69,587

At September 30, 2011 and December 31, 2010, securities with an amortized cost of $6.3 million and $11.2 million, respectively, were pledged to secure public deposits, repurchase agreements, and for other purposes as required or permitted by law. The market value for these securities was $6.4 million and $11.0 million at September 30, 2011 and December 31, 2010, respectively.

Seven securities were sold in the nine-month period ended September 30, 2011, resulting in gross gains of $267 thousand. Eleven securities were sold in the nine-month period ended September 30, 2010, resulting in gross gains of $443 thousand and gross losses of $61 thousand.

When a security is called by the issuer prior to maturity, any remaining premium or discount is reported in noninterest income as a gain or loss. During the nine-month period ended September 30, 2011, one security was called and the unamortized premium of $2 thousand was included in the total gain on sale of securities. During the nine-month period ended September 30, 2010, all securities with early calls had no remaining unamortized premiums or discounts and therefore, the early calls had no impact on income.

Management reviews investment securities on an ongoing basis for the presence of OTTI, taking into consideration current market conditions, fair value in relationship to cost, extent and nature of the change in fair value, issuer rating changes and trends, whether we intend to sell a security or if it is likely that we will be required to sell the security before recovery of the amortized cost basis of the investment, which may be maturity, and other factors. The evaluation includes a consideration of the risk profile specific to each class of security; for example, the contractual terms of U.S. government agency securities do not permit the issuer to settle the securities at a price less than par. The Bank s securities portfolio does not include any private label mortgage backed securities or investments in trust preferred securities.

For debt securities, if we intend to sell the security or it is likely that we will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If we do not intend to sell the security and it is not likely that we will be required to sell the security but we do not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income (OCI). Impairment losses related to all other factors are presented as separate categories within OCI. If there is an indication of additional credit losses, the security is re-evaluated accordingly to the procedures described above.

At September 30, 2011, the Bank owned $1.3 million of stock of the Federal Home Loan Bank of Seattle (FHLB). As a condition of membership in the FHLB, the Bank is required to purchase and hold a certain amount of FHLB stock, which is based, in part, upon the outstanding principal balance of advances from the FHLB and is calculated in accordance with the Capital Plan of the FHLB. FHLB stock has a par value of $100 per share, is carried at cost, and is subject to impairment testing per Accounting Standards Codification (ASC) 320-10-35. The FHLB has a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency (FHFA), its primary regulator, and therefore has suspended future dividends and the repurchase and redemption of outstanding capital stock. The FHLB has communicated that it believes the calculation of risk-based capital under the current rules of the FHFA significantly overstates the market risk of the FHLB s private-label mortgage-backed securities in the current market environment and that it has enough capital to cover the risks reflected in the FHLB s balance sheet. As a result, an OTTI has not been recorded for the Bank s investment in FHLB stock. However, continued deterioration in the FHLB s financial position may result in impairment in the value of those securities. Management will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of the Bank s investment.

NOTE 3. Loans Receivable and Allowance for Loan Losses

The Bank originates residential mortgage loans intended for sale in the secondary market. Loans held for sale are stated at the lower of cost or estimated fair value determined on an aggregate basis. Any net unrealized losses on loans held for sale are recognized through a valuation allowance by charges to income. The Bank also originates construction and land, commercial and multifamily real estate, commercial business, agricultural and consumer loans for portfolio investment. Loans receivable that have not been designated as held for sale are recorded at the principal amount outstanding. Deferred loan fees, net of costs, are amortized to maturity using the level-yield method.

Interest is accrued as earned unless management determines that the collectability of the loan or the unpaid interest is doubtful. Interest accruals are generally discontinued when loans become 90 days past due on scheduled interest payments. 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.

The following table presents the Bank s loan balances for the periods indicated:

	September 30, 2011	December 31, 2010
	($ in thousands)	
Real estate:		
Commercial	$ 148,737	$ 150,373
Construction and land development	28,643	40,145
Residential	31,865	35,061
Commercial and industrial	53,146	47,345
Consumer	7,097	9,026
	269,488	281,950
Allowance for loan losses	(6,552)	(6,918)
Net deferred loan fees	(432)	(616)
	$ 262,504	$ 274,416

Loan origination/risk management: The Bank has lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, nonperforming loans and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions. In general, loans are underwritten after evaluating and understanding the borrower s ability to operate profitably and prudently and to repay their obligations as agreed. Cash flows of borrowers, however, may not be as expected, and the collateral securing these loans may fluctuate in value. Most loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and typically incorporate a personal guarantee. However, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. In the case of loans secured by real estate, the properties are diverse in terms of type, but are concentrated to a large extent in the Bank s primary market area, which is Spokane County, Washington and Kootenai County, Idaho. This concentration may increase the Bank s exposure to adverse economic events that affect a single market or industry. Construction loans are generally based upon estimates of costs and value associated with the complete project with repayment substantially dependent on the success of the ultimate project such as sales of developed property or an interim loan commitment from the Bank until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

The Bank originates consumer loans utilizing an individualized underwriting process. To monitor and manage consumer loan risk, policies and procedures are developed and modified as needed. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk.

The Bank s internal audit department performs an independent review to validate the credit risk program on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by the Bank s loan officers and credit personnel, as well as the Bank s policies and procedures.

Table of Contents

Past due and nonaccrual loans: The following table presents an age analysis of past due loans, segregated by class of loans:

	September 30, 2011					
	Loans 30-59 Days Past Due	Loans 60-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans
	($ in thousands)					
Real estate:						
Commercial	$ 1,106	$	$ 5,624	$ 6,730	$ 142,007	$ 148,737
Construction and land development	4,203		275	4,478	24,165	28,643
Residential	794	20		814	31,051	31,865
Commercial and industrial	1,176			1,176	51,970	53,146
Consumer	156	21	28	205	6,892	7,097
	$ 7,435	$ 41	$ 5,927	$ 13,403	$ 256,085	$ 269,488

	December 31, 2010					
	Loans 30-59 Days Past Due	Loans 60-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans
	($ in thousands)					
Real estate:						
Commercial	$ 1,202	$ 132	$ 3,394	$ 4,728	$ 145,645	$ 150,373
Construction and land development	272	262	1,691	2,225	37,920	40,145
Residential	662	31	269	962	34,099	35,061
Commercial and industrial			21	21	47,324	47,345
Consumer	49	96	3	148	8,878	9,026
	$ 2,185	$ 521	$ 5,378	$ 8,084	$ 273,866	$ 281,950

No loans over 90 days past due were still on accrual status as of September 30, 2011 and December 31, 2010.

Nonaccrual loans, segregated by class of loans, were as follows:

	September 30, 2011	December 31, 2010
	($ in thousands)	
Real estate:		
Commercial	$ 6,521	$ 8,661
Construction and land development	3,481	2,613
Residential	1,004	1,362
Commercial and industrial	659	21
Consumer	74	56
	$ 11,739	$ 12,713

14

Table of Contents

If the Bank s nonaccrual loans had performed in accordance with their original contractual terms, additional interest income of $533 thousand and $374 thousand would have been recognized for the nine-month periods ended September 30, 2011 and 2010, respectively.

Impaired loans: Loans are considered impaired when, based on current information and events, it is improbable the Bank will be able to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan s existing interest rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are applied to principal if the loan is on nonaccrual. Impaired loans, or portions thereof, are charged off if management determines them to be uncollectible. As of September 30, 2011, the Bank s impaired loan balances were as follows:

	September 30, 2011				
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
			($ in thousands)		
Real estate:					
Commercial	$ 19,061	$ 4,362	$ 12,708	$ 17,070	$ 2,080
Construction and land development	15,388	9,403	3,962	13,365	725
Residential	1,794	115	1,510	1,625	349
Commercial and industrial [1]	1,868	60	1,222	1,282	467
Consumer	161	1	154	155	70
	$ 38,272	$ 13,941	$ 19,556	$ 33,497	$ 3,691

	December 31, 2010				
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
			($ in thousands)		
Real estate:					
Commercial	$ 22,586	$ 2,478	$ 19,664	$ 22,142	$ 2,393
Construction and land development	12,697	8,582	2,432	11,014	678
Residential	2,777	95	2,379	2,474	641
Commercial and industrial	1,585	717	707	1,424	416
Consumer	170	4	137	141	89
	$ 39,815	$ 11,876	$ 25,319	$ 37,195	$ 4,217

[1] One loan with a USDA guarantee was included in this category net of the guarantee.

15

Table of Contents

The average recorded investment in impaired loans and the related interest income recognized for cash payments received were as follows:

	Three months ended September 30, 2011 Average Recorded Investment	Three months ended September 30, 2011 Interest Income Recorded for Cash Payments Received	Three months ended September 30, 2010 Average Recorded Investment	Three months ended September 30, 2010 Interest Income Recorded for Cash Payments Received
	($ in thousands)			
Real estate:				
Commercial	$ 17,427	$ 246	$ 17,456	$ 241
Construction and land development	11,289	172	12,523	106
Residential	2,138	12	2,410	21
Commercial and industrial	2,233	82	1,591	24
Consumer	226	5	58	1
	$ 33,313	$ 517	$ 34,038	$ 393

	Nine months ended September 30, 2011 Average Recorded Investment	Nine months ended September 30, 2011 Interest Income Recorded for Cash Payments Received	Nine months ended September 30, 2010 Average Recorded Investment	Nine months ended September 30, 2010 Interest Income Recorded for Cash Payments Received
	($ in thousands)			
Real estate:				
Commercial	$ 20,286	$ 797	$ 13,972	$ 561
Construction and land development	11,308	395	13,537	303
Residential	2,770	76	2,272	76
Commercial and industrial	2,032	127	1,768	73
Consumer	173	12	78	3
	$ 36,569	$ 1,407	$ 31,627	$ 1,016

Table of Contents

Troubled debt restructuring (TDR): A troubled debt restructuring occurs when, due to a borrower s financial difficulties, the Bank grants a concession that it would not otherwise consider. The concession can take the form of an interest rate or principal reduction or an extention of payments of principal or interest, or both. Restructured loans are included in impaired loans until such time as the restructured loan performs according to the new terms for an acceptable duration, typically one year or longer depending on the circumstances specific to each credit, and is at a market rate for a transaction of similar risk. Restructured loans performing in accordance with their new terms are not included in nonaccrual loans unless there is uncertainty as to the ultimate collection of principal or interest. The recorded investment in restructured loans was as follows:

	September 30, 2011		December 31, 2010	
	Accruing Restructured Loans	Restructured Loans Included in Nonaccrual Loans	Accruing Restructured Loans	Restructured Loans Included in Nonaccrual Loans
	($ in thousands)			
Real estate:				
Commercial	$ 8,813	$ 802	$	$ 3,972
Construction and land development				
Residential		920		705
Commercial and industrial	541		397	
Consumer	13			
	$ 9,367	$ 1,722	$ 397	$ 4,677

For the nine-month periods ended September 30, 2011 and 2010, the Bank recognized interest income of approximately $404 thousand and $40 thousand, respectively, in connection with restructured accruing loans.

Troubled debt restructurings which occurred during the nine-month periods ending September 30, 2011 and 2010, were as follows:

	September 30, 2011			September 30, 2010		
	Number of Contracts	Pre- modification Recorded Investment	Post- modification Recorded Investment	Number of Contracts	Pre-modification Recorded Investment	Post- modification Recorded Investment
	($ in thousands)					
Real estate:						
Commercial	5	$ 6,301	$ 6,301		$	$
Construction and land development						
Residential	1	920	920	1	705	705
Commercial and industrial	1	288	288	3	404	404
Consumer	1	13	13			
	8	$ 7,522	$ 7,522	4	$ 1,109	$ 1,109

In each case, the loans listed above were modified to allow the borrower an additional period of interest-only payments, and in some cases, the interest rate was decreased. The Bank is not committed to lend additional funds to debtors whose loans have been restructured. As a result of the amendments adopted with ASU No. 2011-02, the Bank reassessed all restructurings that occurred on or after the beginning of the the current fiscal year for identification as troubled debt restructurings. No newly impaired loans resulted from this assessment.

Table of Contents

Troubled debt restructurings for which there was a payment default during the nine-month periods ending September 30, 2011 and 2010, were as follows:

	September 30, 2011		September 30, 2010	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
	($ in thousands)			
Real estate:				
Commercial	2	$ 1,553		$
Construction and land development				
Residential				
Commercial and industrial			1	123
Consumer	1	13		
	3	$ 1,566	1	$ 123

Restructured loans for which there was a payment default during the period are included in the calculation of the allowance for loan losses as is deemed appropriate for each defaulted credit.

Credit Quality Indicators: The Bank utilizes a risk grading matrix to assign a risk grade to each loan. Loans are graded on a scale of 1 to 10. The ten risk rating categories can be generally described by the following groupings for non-homogeneous loans:

Pass/Watch These loans range from minimal credit risk to lower than average, but still acceptable, credit risk.

Special Mention A Special Mention loan has potential weaknesses that deserve management s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or the Bank s credit position at some future date. They contain unfavorable characteristics and are generally undesirable. Loans in this category are currently protected but are potentially weak and constitute an undue and unwarranted credit risk, but not to the point of a Substandard classification. A Special Mention loan has potential weaknesses such as inadequate working capital or underperformance compared to plan, which if not checked or corrected, weaken the asset or inadequately protect the Bank s position at some future date. Unlike a Substandard credit, there should be a reasonable expectation that these temporary issues will be corrected in a reasonable period of time, without liquidation of assets and within the normal course of business.

Substandard A Substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of Substandard loans, does not have to exist in individual assets classified as Substandard. Loans are classified as Substandard when they have unsatisfactory characteristics causing unacceptable levels of risk, such as cash flow trends that are of a magnitude as to jeopardize current and future payments, or prolonged unsuccessful business operations or economic trends to which the borrower has not been able to adjust. The likely need to liquidate assets to correct the problem, rather than repayment from successful operations is a key distinction between Special Mention and Substandard.

Doubtful/Loss Loans classified as Doubtful have all the same weaknesses inherent in loans classified as Substandard with the added characteristic that the weaknesses make collection or liquidation in full highly questionable and improbable, on the basis of currently existing facts, conditions and values. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work towards strengthening of the loan, classification as a Loss (and immediate charge-off) is deferred until a more exact status may be determined. Pending factors include proposed merger, acquisition, liquidation procedures, capital injection, and perfection of liens on additional collateral and refinancing plans. A Loss rating is assigned to loans considered uncollectible and of such little value that the continuance as an active Bank asset is not warranted. This rating does not mean that the loan has no recovery or salvage value, but rather that the loan should be charged off now, even though partial or full recovery may be possible in the future.

Table of Contents

The following table summarizes the Bank s internal risk rating by loan class:

	September 30, 2011				
	Pass/Watch	Special Mention	Substandard	Doubtful/Loss	Total Loans
			($ in thousands)		
Real estate:					
Commercial	$ 118,108	$ 10,315	$ 20,314	$	$ 148,737
Construction and land development	11,627	4,220	12,796		28,643
Residential	28,211	1,865	1,789		31,865
Commercial and industrial	48,518	1,558	3,070		53,146
Consumer	6,863	78	156		7,097
	$ 213,327	$ 18,036	$ 38,125	$	$ 269,488

	December 31, 2010				
	Pass/Watch	Special Mention	Substandard	Doubtful/Loss	Total Loans
			($ in thousands)		
Real estate:					
Commercial	$ 113,338	$ 9,075	$ 27,960	$	$ 150,373
Construction and land development	22,650	1,257	16,238		40,145
Residential	30,372	2,143	2,546		35,061
Commercial and industrial	38,717	7,221	1,407		47,345
Consumer	8,829	47	149	1	9,026
	$ 213,906	$ 19,743	$ 48,300	$ 1	$ 281,950

***Allowance for Loan Losses**:* The allowance for loan losses is a reserve established through a provision for loan losses charged to expense. The allowance for loan losses represents management s best estimate of probable losses within the existing loan portfolio. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Bank s allowance for loan loss methodology is based on guidance from ASC Topic 310, *Receivables*, and ASC Topic 450, *Contingencies*. The Bank s process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The amount of the provision reflects not only the necessary increases in the allowance for loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The level of the allowance reflects management s continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management s judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Bank s control, including, among other things, the performance of the Bank s loan portfolio, the economy, changes in interest rates and the view of regulatory authorities toward loan classifications.

Table of Contents

The Bank s allowance for loan losses consists of two elements: (i) general valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted as necessary to reflect the impact of current economic conditions and other qualitative risk factors both internal and external to the Bank; and (ii) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans.

The allowances established for expected losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the borrower s ability to repay; (ii) the financial condition of the borrower; (iii) the quality of the borrower s management; (iv) the underlying collateral, if any; (v) the strength of the guarantors; (vi) the structure of the loan; (vii) the quality, availability and timeliness of financial information; and (viii) the industry and economic environment in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. When a loan has been classified as Substandard or worse, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for loan losses to the loan. Impairment is determined in accordance with ASC Topic 310, which specifies that a loan is impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement, including principal and interest, as scheduled in the loan agreement. Indicators of impairment include evidence the borrower is experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions; loans that are secured with collateral that is no longer readily marketable or that is subject to deterioration in realizable value; loans to borrowers in industries that are currently experiencing economic instability; and other factors. If a loan is determined to be impaired, the balance is segregated from the pool of loans and a specific valuation allowance is established by measuring the impairment. Most loans are collateral dependent and as such, impairment is measured by comparing the loan balance with the current market value of the collateral, less selling and holding costs. A deficiency is recorded as a specific valuation allowance, and is included as a component of the allowance for loan losses.

General valuation allowances are calculated based on the historical loss experience of specific types of loans, plus general economic conditions and other qualitative internal and external risk factors. The Bank calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced compared to the total population of loans in the pool. The historical loss ratios are periodically updated based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool.

Added to the Bank s historical loss experience are metrics of general economic conditions and other qualitative risk factors both internal and external to the Bank. The risk factors believed by management to be most relevant to the loan portfolio are: (i) current unemployment levels in our operating areas, as compared to normal levels of unemployment; (ii) the current level of past due and nonaccrual loans as compared to levels during years of low charge-offs; (iii) a consideration of the trend of median home prices and foreclosure rates as they relate to construction and land loans; (iv) a consideration of the trend of new housing starts and absorption rates as they relate to construction loans; (v) commercial and apartment vacancy rates and their relationship to multi-family and other commercial real estate loans; and (vi) the change in the average risk rating of our portfolio, by loan type, as it relates to charge-off experience. Each component is used to calculate a risk factor, which is input into a general reserve matrix along with the historical loss rates discussed above. The total combined risk factor for each loan type is then applied to the loan balances that remain after impaired loans are segregated from the pool to determine an appropriate general valuation allowance. Management evaluates the change each one of these components has on the quality of the loan portfolio on a quarterly basis. In addition, management evaluates and documents intangible factors such as: (i) the experience, ability and effectiveness of the Bank s lending management and staff; (ii) the effectiveness of the Bank s loan policies, procedures and internal controls; (iii) the composition and concentrations of credit; and, (iv) the effectiveness of the internal loan review function.

Table of Contents

Activity in the allowance for loan losses was as follows for the quarters ended September 30, 2011 and 2010:

	Quarter ended September 30, 2011				
	Balance, Beginning of Period	Provision for Loan Losses	Charge-offs	Recoveries	Balance, End of Period
			($ in thousands)		
Real estate:					
Commercial	$ 3,340	$ (102)	$ (500)	$	$ 2,738
Construction and land development	924	2,679	(2,200)	2	1,405
Residential	1,363	288	(502)	3	1,152
Commercial and industrial	888	6	(45)	9	858
Consumer	227	(41)	(5)	2	183
Unallocated	515	(299)			216
	$ 7,257	$ 2,531	$ (3,252)	$ 16	$ 6,552

	Quarter ended September 30, 2010				
	Balance, Beginning of Period	Provision for Loan Losses	Charge-offs	Recoveries	Balance, End of Period
			($ in thousands)		
Real estate:					
Commercial	$ 2,368	$ 243	$ (31)	$	$ 2,580
Construction and land development	1,099	337	(152)		1,284
Residential	1,218	(161)	(58)	3	1,002
Commercial and industrial	2,102	(348)	(157)		1,597
Consumer	152	69	(44)	15	194
Unallocated	312	460			772
	$ 7,251	$ 600	$ (440)	$ 18	$ 7,429

Activity in the allowance for loan losses was as follows for the nine-month periods ended September 30, 2011 and 2010:

	Nine months ended September 30, 2011				
	Balance, Beginning of Period	Provision for Loan Losses	Charge-offs	Recoveries	Balance, End of Period
			($ in thousands)		
Real estate:					
Commercial	$ 2,779	$ 1,787	$ (1,828)	$	$ 2,738
Construction and land development	1,341	2,589	(2,527)	2	1,405
Residential	1,081	714	(662)	19	1,152
Commercial and industrial	1,162	(80)	(233)	9	858
Consumer	347	(125)	(42)	3	183
Unallocated	208	8			216
	$ 6,918	$ 4,893	$ (5,292)	$ 33	$ 6,552

Table of Contents

	Nine months ended September 30, 2010				
	Balance, Beginning of Period	Provision for Loan Losses	Charge-offs	Recoveries	Balance, End of Period
			($ in thousands)		
Real estate:					
Commercial	$ 1,269	$ 1,461	$ (150)	$	$ 2,580
Construction and land development	1,801	313	(857)	27	1,284
Residential	604	679	(289)	8	1,002
Commercial and industrial	2,660	(758)	(317)	12	1,597
Consumer	134	197	(152)	15	194
Unallocated	614	158			772
	$ 7,082	$ 2,050	$ (1,765)	$ 62	$ 7,429

The Bank s recorded investment in loans and the related allowance for loan losses by portfolio segment, disaggregated on the basis of the Bank s impairment methodology, was as follows:

	September 30, 2011			
	Collectively Evaluated for Impairment		Individually Evaluated for Impairment	
	Loans	Related Allowance	Loans	Related Allowance
		($ in thousands)		
Real estate:				
Commercial	$ 131,667	$ 658	$ 17,070	$ 2,080
Construction and land development	15,278	680	13,365	725
Residential	30,240	803	1,625	349
Commercial and industrial	51,864	391	1,282	467
Consumer	6,942	113	155	70
Unallocated		215		
	$ 235,991	$ 2,860	$ 33,497	$ 3,691

22

Table of Contents

	December 31, 2010			
	Collectively Evaluated for Impairment		Individually Evaluated for Impairment	
	Loans	Related Allowance	Loans	Related Allowance
	($ in thousands)			
Real estate:				
Commercial	$ 128,231	$ 386	$ 22,142	$ 2,393
Construction and land development	29,131	663	11,014	678
Residential	32,587	440	2,474	641
Commercial and industrial	45,920	747	1,424	416
Consumer	8,886	258	141	89
Unallocated		207		
	$ 244,755	$ 2,701	$ 37,195	$ 4,217

Management also evaluates the risk of loss associated with commitments to lend funds, such as with a letter or line of credit. A reserve has been established to absorb inherent losses with unfunded commitments using a blended rate of historical charge-off experience, and is monitored on a regular basis.

NOTE 4. Foreclosed Real Estate

The following table presents the changes in foreclosed real estate, net of any related valuation allowance:

	Quarter ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
	($ in thousands)		($ in thousands)	
Balance, beginning of period	$ 3,329	$ 4,011	$ 3,963	$ 3,672
Transfers from loans	722	644	993	2,539
Capital improvements to property			50	
Dispositions of property	(949)	(479)	(1,708)	(1,935)
Provision charged to income	(233)	(139)	(429)	(239)
Balance, end of period	$ 2,869	$ 4,037	$ 2,869	$ 4,037

Foreclosed real estate is carried at the lower of the recorded investment in the loan (prior to foreclosure) or the fair market value of the property less expected selling costs. Valuation allowances on foreclosed real estate are based on updated appraisals of the underlying collateral as received during the period or management s authorization to reduce the selling price of a property during the period.

NOTE 5. Deposits

Classifications of deposits were as follows:

	September 30, 2011	December 31, 2010
	($ in thousands)	
Noninterest bearing demand deposits	$ 72,263	$ 69,145
Money market accounts	36,782	39,148
NOW accounts	62,216	57,878
Savings accounts	56,224	47,142
Time certificates of deposit, $100,000 and over	61,797	72,170
Time certificates of deposit, under $100,000	48,941	60,754

	$ 338,223	$ 346,237

Table of Contents

NOTE 6. Borrowed Funds

Borrowed funds consist of the following:

	September 30, 2011	December 31, 2010
	($ in thousands)	
Federal Home Loan Bank advances	$ 7,914	$ 3,771
Junior subordinated debentures	5,155	5,155
Capital lease obligation	582	592
	$ 13,651	$ 9,518

FHLB advances are secured by a blanket pledge on Bank assets as well as certain specific loans.

Junior subordinated debentures: In June 2005, the Company issued junior subordinated debentures with an aggregate value of $5.16 million to Northwest Bancorporation Capital Trust I (the Trust), with interest fixed at 5.95% through June 30, 2010, thereafter re-pricing quarterly at three-month LIBOR plus 1.70%, which was 2.05% at September 30, 2011. The Trust issued $155 thousand of common securities to the Company and capital securities with an aggregate liquidation amount of $5 million to third-party investors. The common securities are included in Other assets on the consolidated statements of financial condition; the subordinated debentures are included in Borrowed funds on the consolidated statements of financial condition. The subordinated debentures are includable as Tier I capital for regulatory purposes. The subordinated debentures and the capital securities pay interest and dividends, respectively, on a quarterly basis, which are included in interest expense. The subordinated debentures will mature on June 30, 2035, at which time the capital securities must be redeemed. The subordinated debentures and capital securities can be redeemed prior to maturity, at the Company s discretion, in whole or in part, beginning September 30, 2010, at par value. The Company has provided a full and unconditional guarantee of the obligations of the Trust under the capital securities in the event of default. Pursuant to ASC 810, *Consolidation*, the Trust is not consolidated in these financial statements.

On June 4, 2010, the Company gave written notice to the holders of its outstanding junior subordinated debentures that regularly scheduled interest payments would be deferred. Under the terms of the related trust documents, the Company is allowed to defer payments of interest for up to 20 consecutive quarterly periods without default. During the deferral period, the respective trust will likewise suspend the declaration and payment of dividends on the trust preferred securities. Also during the deferral period, the Company generally may not pay cash dividends on or repurchase its common stock or preferred stock, including the Fixed Rate Cumulative Perpetual Preferred Stock, Series A and Series B, issued by the Company under the U.S. Department of the Treasury s Capital Purchase Program. In addition, the Company will be restricted from making any payment on outstanding debt obligations that rank equally with, or junior to, the junior subordinated notes. As of September 30, 2011 and December 31, 2010, the accumulated deferred interest that was accrued on these securities was $216 thousand and $135 thousand, respectively.

Table of Contents

Capital lease obligation: The capital lease obligation is related to a ground lease, with a purchase option, that the Bank entered into in early 2005 (a copy of the ground lease was filed as an Exhibit to the Company s annual report on Form 10-KSB filed with the SEC on March 24, 2005). As a capitalized lease, the value of the property is included as an asset on the consolidated statements of financial condition in Premises and equipment, net, and the net present value of future payments is included in Borrowed funds.

Lines of credit: The Bank has operating lines of credit with various correspondent banks, which are detailed as follows:

	September 30, 2011		December 31, 2010	
	Line Amount	Outstanding Balance	Line Amount	Outstanding Balance
	($ in thousands)			
Federal Home Loan Bank	$ 54,610	$	$ 65,968	$
Pacific Coast Bankers Bank	10,000		10,000	
Zions Bank	5,000		5,000	

The FHLB line is secured by a blanket pledge on Bank assets as well as certain specific loans; advances on the FHLB line may require additional purchases of FHLB stock. The Pacific Coast Bankers Bank line is unsecured. The Zions Bank line includes $1 million that is unsecured, and the rest of the line is secured by certain investment securities.

NOTE 7. Commitments

The Bank has an agreement with the Spokane Public Facilities District (PFD) for the purchase of naming rights to the INB Performing Arts Center in Spokane. Under the agreement, the Bank will pay the PFD $150 thousand per year for a period of ten years. The contract expires in July 2016, however the Bank has the right to extend the contract for an additional ten years at an annual rate that will not exceed the current annual rate by more than twenty percent. Expenses related to the agreement are recognized as Other noninterest expenses in the consolidated statements of operations.

The Bank leases its principal office and main branch, which is located in the Paulsen Center Building in downtown Spokane. The lease is for a 10-year term with additional renewal options. The initial lease rate is $30,839 per month and escalates approximately 3% per year. A copy of the lease agreement has been filed as Exhibit 99.1 to the current report on Form 8-K filed by the Company with the SEC on May 11, 2009.

Table of Contents

NOTE 8. Income Taxes

The Company s normal, expected statutory income tax rate is 36.0%, representing a blend of the statutory federal income tax rate of 34.0% and apportioned effects of the Idaho income tax rate of 7.6%. The ratio of tax expense (benefit) to the net income (loss) before tax on the Statement of Operations (referred to as the effective tax rate) differs substantially from statutory tax rates due to permanent differences arising primarily from nontaxable interest income on state and municipal securities and nontaxable increases in the value of bank owned life insurance. The differences between tax expense (benefit) at the statutory rates and actual tax expense (benefit) on the Statement of Operations were as follows:

	September 30, 2011	September 30, 2010
	($ in thousands)	
Federal income tax expense (benefit) at statutory rate	$ (189)	$ 664
Effect of tax-exempt interest income	(183)	(158)
Effect of nondeductible interest expense	10	12
Effect of other nondeductible expenses	9	10
Effect of state income tax expense (benefit)	(28)	32
Other	(33)	10
Income tax expense (benefit)	$ (414)	$ 570

During 2009, the Company recorded a valuation allowance of $742 thousand against a portion of its deferred tax assets due to uncertainty about the Company s ability to generate future taxable income sufficient to realize the benefits of temporary deductible differences that could not have been realized through carry-backs to prior years or through the reversal of future temporary taxable differences. Due to the ongoing weakness in the economy and its affect on credit quality, uncertainty remains about the extent to which a pattern of future taxable income will be established. Accordingly, the Company continued to maintain a valuation allowance of $742 thousand as of September 30, 2011.

The Company follows the provisions of ASC 740, *Income Taxes,* relating to the accounting for uncertainty in income taxes. The Company periodically reviews its income tax positions based on tax laws and regulations and financial reporting considerations, and records adjustments as appropriate. This review takes into consideration the status of current taxing authorities examinations of the Company s tax returns, recent positions taken by the taxing authorities on similar transactions, if any, and the overall tax environment.

The Company had no unrecognized tax benefits at September 30, 2011 or December 31, 2010. The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the periods ended September 30, 2011 and December 31, 2010, the Company recognized no interest and penalties. The Company is no longer subject to U.S. federal or Idaho State tax authority examinations for tax years before 2008.

NOTE 9. Common and Preferred Stock

Common Stock:

No cash dividends on common stock were declared during the nine-month periods ended September 30, 2011 and 2010.

On July 15, 2010, the Company concluded a rights offering to the holders of its common stock, raising $2.7 million in exchange for 686,805 shares of the Company s common stock. Net proceeds to the Company, after expenses, were $2.6 million.

Preferred Stock:

On February 14, 2009, as part of the Capital Purchase Program of the U.S. Department of the Treasury (Treasury), the Company entered into a Letter Agreement incorporating an attached Securities Purchase Agreement Standard Terms (collectively, the Purchase Agreement) with the Treasury. Under the Purchase Agreement, the Company agreed to issue and sell to the Treasury (i) 10,500 shares of the Company s Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Series A Preferred Stock), having no par value per share, and (ii) a warrant (the Warrant) to purchase 525.00525 shares of the Company s Fixed Rate Cumulative Perpetual Preferred Stock, Series B (the Series B Preferred Stock), having no par value per share, for an aggregate purchase price of $10.5 million. The Treasury immediately exercised the warrant.

The Series A Preferred Stock pays cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Series B Preferred Stock pays a cumulative dividend of 9% per year. The Series A Preferred Stock and the Series B Preferred Stock (together, the Preferred Stock) may not be redeemed by the Company during the first three years following the investment by the Treasury, except with the proceeds from a Qualified Equity Offering (as defined in the Company s Articles of Amendment). After three years, the Company may, at its option, redeem the Preferred Stock at the issue price, plus accrued and unpaid dividends. The Preferred Stock is generally non-voting and qualifies as Tier 1 capital.

Table of Contents

As a result of the Company s participation in the Capital Purchase Program, the Company is restricted from paying any dividend on its common stock unless all accrued and unpaid dividends are paid in full on the Preferred Stock. During the three year period from February 13, 2009, payment of dividends on common stock by the Company may not exceed the last annual cash dividend of $0.20 per share. Prior consent of the Treasury will be required after February 13, 2012 until February 13, 2019, for any annual increase of 3% or more in aggregate common dividends per share. After February 13, 2019, the Company will be prohibited from paying any common dividends or repurchasing any equity securities or trust preferred securities until all of the Preferred Stock has been redeemed in whole or the Treasury has transferred all of the Preferred Stock to third parties.

During the nine-month periods ended September 30, 2011 and 2010, the Company declared preferred stock dividends totaling $429 thousand each period. Subsequent to the payment made on February 16, 2010, the Company began deferring payment of dividends on its preferred stock but continues to accrue the liability for the dividends. As of September 30, 2011 and December 31, 2010, accrued and unpaid dividends totaled $930 thousand and $500 thousand, respectively.

NOTE 10. Fair Values

The Company determines the fair value of its financial instruments based on the fair value hierarchy established in ASC 820 *Fair Value Measurements and Disclosures*. The Standard provides enhanced guidance for measuring assets and liabilities using fair value and applies to situations where other standards require or permit assets or liabilities to be measured at fair value. ASC 820 also requires expanded disclosure of items that are measured at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings.

The following table presents estimated fair values of the Company s financial instruments:

	September 30, 2011		December 31, 2010	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
		($ in thousands)		
Financial Assets:				
Cash and due from banks	$ 16,349	$ 16,349	$ 10,813	$ 10,813
Federal funds sold and other interest bearing deposits	11,971	11,971	5,028	5,028
Securities available for sale	69,587	69,587	69,730	69,730
Federal Home Loan Bank stock	1,261	1,261	1,261	1,261
Loans receivable, net	262,504	266,877	274,416	280,075
Loans held for sale	2,816	2,816	2,371	2,371
Bank owned life insurance	3,882	3,882	3,792	3,792
Financial Liabilities:				
Deposits	338,223	339,579	346,237	347,504
Securities sold under agreements to repurchase			135	135
Borrowed funds	13,651	11,582	9,518	7,010

Table of Contents

The following table summarizes the Company s financial instruments that were measured at fair value on a recurring basis:

	September 30, 2011			
	Total	Level 1	Level 2	Level 3
	($ in thousands)			
Securities available for sale:				
U.S. government agency securities	$ 10,581	$	$ 10,581	$
State and municipal securities	25,653		25,653	
Corporate debt obligations	14,394		14,394	
SBA participation certificates	7,990		7,990	
Mortgage backed securities	2,478		2,478	
Collateralized mortgage obligations	8,491		8,491	

	December 31, 2010			
	Total	Level 1	Level 2	Level 3
	($ in thousands)			
Securities available for sale:				
U.S. government agency securities	$ 30,124	$	$ 30,124	$
State and municipal securities	22,999		22,999	
Corporate debt obligations	10,798		10,798	
SBA participation certificates	3,378		3,378	
Mortgage backed securities	2,165		2,165	
Collateralized mortgage obligations	266		266	