

	2006	2005	2004	2003	2002
<b>Performance Results</b>					
Net income to average equity	15.41%	16.55%	17.60%	15.61%	18.30%
Equity to assets	8.72%	8.75%	8.63%	8.27%	8.93%
Earnings per share*	\$2.44	\$2.35	\$2.30	\$1.83	\$1.86
Dividends per share*	\$0.68	\$0.66	\$0.66	\$0.66	\$0.63
Book value per share*	\$17.06	\$15.23	\$13.75	\$12.45	\$10.91
Net overhead to average assets	1.38%	1.58%	1.33%	1.38%	1.60%
Average earning assets to average total assets	95.76%	95.00%	94.62%	95.44%	95.81%
Allowance for possible credit losses to total loans at December 31	1.64%	1.80%	1.80%	1.80%	1.83%
<b>Yield and Cost of Funds</b>					
Yield on investments	5.4%	4.4%	3.7%	3.0%	4.4%
Yield on loans	7.6%	7.7%	7.8%	8.4%	8.7%
Cost of funds	3.2%	2.4%	1.8%	2.1%	2.4%
Net interest margin	3.8%	4.1%	4.1%	3.6%	4.7%
<b>Selected Items (in thousands)</b>					
Total cash and deposit balances	\$16,363	\$17,714	\$26,717	\$41,488	\$26,612
Total investments	\$264,352	\$257,910	\$261,427	\$258,591	\$196,715
Total loans	\$500,933	\$417,035	\$340,364	\$286,993	\$258,218
Total assets	\$805,088	\$714,659	\$649,913	\$608,843	\$495,235
Total deposits	\$717,336	\$629,147	\$579,896	\$546,588	\$440,138
Total equity	\$70,247	\$62,518	\$56,058	\$50,525	\$44,237

\* Adjusted for stock splits

Cashmere Valley Financial Corporation and its wholly owned subsidiary, Cashmere Valley Bank, enjoyed another successful year in 2006. We ended the year with \$805 million in assets and over \$10 million in net income. This was achieved in an extremely challenging interest rate environment that was not the most conducive to maximizing our performance.

During the year two major real estate projects were completed. A 640 square foot addition to our Chelan Street Branch has made that facility much more customer friendly. I believe our employees would add that it is also much more employee friendly. The Chelan Street Branch is very conveniently located and not only serves the customers of the Branch but also many customers from our other Branches. We agree with Jenny Pulver, Branch Supervisor, when she says it is the best 640 square feet ever added to a Cashmere Valley Bank branch.

We also completed the construction of the Lake Chelan Branch during the year. Manager Russ Jones and his staff moved in to the facility and opened the doors to customers in January. The Branch is being very well received by the community and we expect to experience good growth in that market during the year.

Like most every other region in the country, Chelan, Douglas and Kittitas Counties have experienced a real estate boom. Wenatchee was even identified as the second hottest real estate market in the country by Money Magazine. We have been discovered! We expect the real estate segment to continue to have a positive impact on the Bank's performance during 2007. However, those of us that have been in the business understand the cyclical nature of the real estate market and are managing the associated risk so that we are well positioned when the inevitable slowdown occurs.

Finally, September 24<sup>th</sup> will be the 75<sup>th</sup> anniversary of the founding of Cashmere Valley Bank. In a time of daily mergers in our business it is unusual for any bank to celebrate many anniversaries. We are very proud that the formula that we refer to as *the little Bank with the big circle of friends* continues to meet our customers' and shareholders' needs.

Sincerely,

A handwritten signature in black ink that reads "Ken Martin". The signature is written in a cursive, slightly slanted style.

Kenneth J. Martin  
President and CEO

To the Board of Directors of **Cashmere Valley Financial Corporation**  
Cashmere, Washington

We have audited the accompanying consolidated balance sheets of **Cashmere Valley Financial Corporation and Subsidiary** (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of income, shareholders' equity and cash flows for the years then ended. These 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, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of **Cashmere Valley Financial Corporation and Subsidiary** as of December 31, 2006 and 2005, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company adopted the provisions of the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, in fiscal year 2006.

Seattle, Washington  
March 21, 2007

## Consolidated Balance Sheets

December 31, 2006 and 2005 (Dollars in Thousands)

	2006	2005
<b>Assets</b>		
Cash and due from banks	\$ 16,358	\$ 17,702
Interest-bearing deposits at other financial institutions	5	12
Federal funds sold	41,820	20,052
Securities available for sale	219,219	234,362
Securities held to maturity (fair value \$3,117 and \$3,574)	3,075	3,496
Federal Home Loan Bank stock, at cost	3,140	3,140
Pacific Coast Banker's Bank stock, at cost	238	-
Loans held for sale	562	477
<b>Loans and leases, net of unearned discount</b>	<b>500,933</b>	<b>417,035</b>
Allowance for credit losses	(8,239)	(7,495)
Net loans and leases	492,694	409,540
Premises and equipment, net	13,083	11,856
Accrued interest receivable	3,676	3,263
Foreclosed real estate	-	7
Goodwill	6,590	6,590
Intangibles	591	741
Mortgage Servicing Rights	535	-
Other assets	3,502	3,421
<b>Total assets</b>	<b>\$805,088</b>	<b>\$714,659</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities</b>		
Deposits:		
Demand	\$ 78,002	\$ 73,628
Savings and interest-bearing demand	441,942	359,871
Time	197,392	195,648
<b>Total deposits</b>	<b>717,336</b>	<b>629,147</b>
Accrued interest payable	1,505	1,308
Short-term borrowings	5,450	4,869
Long-term borrowings	5,389	5,629
Other liabilities	5,161	11,188
<b>Total liabilities</b>	<b>734,841</b>	<b>652,141</b>
Commitments and Contingencies	--	--
<b>Shareholders' Equity</b>		
Common stock (no par value); authorized 10,000,000 shares; issued and outstanding: 2006 - 4,117,768; 2005 - 4,104,628	--	--
Retained earnings	67,570	60,147
Accumulated other comprehensive income	2,677	2,371
<b>Total shareholders' equity</b>	<b>70,247</b>	<b>62,518</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$805,088</b>	<b>\$714,659</b>

See notes to consolidated financial statements.

Years Ended December 31, 2006 and 2005 (Dollars in Thousands,)

	2006	2005
<b>Interest Income</b>		
Loans and leases	\$34,402	\$29,151
Deposits at other financial institutions	19	40
Federal funds sold	401	234
Securities available for sale:		
Taxable	6,828	6,137
Tax-exempt	3,785	2,988
Securities held to maturity - tax-exempt	160	185
<b>Total interest income</b>	<b>45,595</b>	<b>38,735</b>
<b>Interest Expense</b>		
Deposits	20,677	14,057
Short-term borrowings	299	165
Long-term borrowings	320	333
<b>Total interest expense</b>	<b>21,296</b>	<b>14,555</b>
<b>Net interest income</b>	<b>24,299</b>	<b>24,180</b>
Provision for Credit Losses	1,220	695
<b>Net interest income after provision for credit losses</b>	<b>23,079</b>	<b>23,485</b>
<b>Non-Interest Income</b>		
Service charges on deposit accounts	1,642	1,745
Net gain on mortgage loans sold	520	70
Servicing fees on loans sold	404	383
Net (loss) on sales of securities available for sale	(30)	(48)
Net gain (loss) on sales of foreclosed real estate	5	(42)
Brokerage commissions	395	476
Insurance commissions and fees	1,078	1,019
Interchange income	1,087	878
Other	977	859
<b>Total non-interest income</b>	<b>6,078</b>	<b>5,340</b>
<b>Non-Interest Expense</b>		
Salaries and employee benefits	8,909	9,233
Occupancy	947	884
Furniture and equipment	1,363	1,373
Audits and examinations	366	262
State and local business and occupation taxes	352	275
Interchange expenses	447	458
Collection and legal costs	102	240
Check losses and charge-offs	212	168
Other	3,615	3,072
<b>Total non-interest expense</b>	<b>16,313</b>	<b>15,965</b>
<b>Income before income taxes</b>	<b>12,844</b>	<b>12,860</b>
Income Taxes	2,811	3,238
<b>Net income</b>	<b>\$10,033</b>	<b>\$ 9,622</b>

See notes to consolidated financial statements.

*Consolidated Statements of Shareholders' Equity*

Years Ended December 31, 2006 and 2005 *(Dollars in Thousands, Except Per Share Information)*

	Shares of Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2004	2,038,957	\$52,874	\$3,184	\$56,058
<b>Comprehensive income:</b>				
Net income	--	9,622	--	9,622
Other comprehensive loss, net of tax:				
Change in fair value of securities available for sale	--	--	(813)	(813)
<b>Comprehensive income</b>				<b>8,809</b>
Two for one stock split	2,038,957			
Cash dividends paid (\$.66 per share)	--	(2,698)	--	(2,698)
Tax benefit from stock option activity	--	13	--	13
Options exercised	26,714	336	--	336
<b>Balance, December 31, 2005</b>	<b>4,104,628</b>	<b>60,147</b>	<b>2,371</b>	<b>62,518</b>
<b>Comprehensive income:</b>				
Net income	--	10,033	--	10,033
Other comprehensive income, net of tax:				
Change in fair value of securities available for sale	--	--	306	306
<b>Comprehensive income</b>				<b>10,339</b>
Cash dividends paid (\$.68 per share)	--	(2,798)	--	(2,798)
Stock based compensation expense	--	46	--	46
Options exercised	13,140	142	--	142
<b>Balance, December 31, 2006</b>	<b>4,117,768</b>	<b>\$67,570</b>	<b>\$2,677</b>	<b>\$70,247</b>

*See notes to consolidated financial statements.*

Years Ended December 31, 2006 and 2005 (Dollars in Thousands)

	2006	2005
<b>Cash Flows from Operating Activities</b>		
Net income	\$10,033	\$ 9,622
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	921	1,010
Provision for credit losses	1,220	695
Investment amortization - net	2,172	4,151
Deferred income tax	811	250
Stock based compensation expense	46	--
Stock dividends received	--	(15)
Net loss on sales of securities	30	48
Originations of loans held for sale	(28,913)	(39,467)
Proceeds from sales of loans held for sale	28,715	39,316
Gain on sales of loans	(520)	(70)
Loss on sale of premises and equipment	2	--
Increase in accrued interest receivable	(413)	(284)
Increase in accrued interest payable	197	264
Other - net	336	(164)
<b>Net cash provided by operating activities</b>	<b>14,637</b>	<b>15,356</b>
<b>Cash Flows from Investing Activities</b>		
Net decrease in interest-bearing deposits in banks	7	12,848
Net increase in federal funds sold	(21,768)	(20,052)
Activity in securities available for sale:		
Sales	21,535	53,770
Maturities, prepayments and calls	47,524	61,071
Purchases	(62,682)	(90,478)
Activity in securities held to maturity:		
Maturities, prepayments and calls	405	826
Purchase of Pacific Coast Banker's Bank stock	(238)	--
Net increase in loans and leases	(84,374)	(76,024)
Additions to premises and equipment	(2,283)	(2,109)
Cash paid for foreclosed real estate	--	(43)
Other asset additions	--	(84)
Proceeds from sale of premises and equipment	12	--
Proceeds from sales of foreclosed real estate	7	225
<b>Net cash used in investing activities</b>	<b>(101,855)</b>	<b>(60,050)</b>

(continued)

See notes to consolidated financial statements.

## Consolidated Statements of Cash Flows

(concluded)

Years Ended December 31, 2006 and 2005 (Dollars in Thousands)

	2006	2005
<b>Cash Flows from Financing Activities</b>		
Net increase in deposits	\$88,189	\$49,251
Net increase in short-term borrowings	581	1,880
Repayments of long-term borrowings	(240)	(230)
Cash dividends paid	(2,798)	(2,698)
Exercise of stock options	142	336
<b>Net cash provided by financing activities</b>	<b>85,874</b>	<b>48,539</b>
<b>Net increase (decrease) in cash and due from banks</b>	<b>(1,344)</b>	<b>3,845</b>
<b>Cash and Due from Banks</b>		
Beginning of year	17,702	13,857
End of year	\$16,358	\$17,702
<b>Supplemental Disclosures of Cash Flow Information</b>		
Interest paid	\$21,099	\$14,291
Income taxes paid	1,730	3,576
<b>Supplemental Disclosures of Non-Cash Investing and Financing Activities</b>		
Foreclosed real estate acquired in settlement of loans	\$ - -	\$ 29
Fair value adjustment of securities available for sale, net of tax	306	(813)
Reclassification of municipal loans to securities available for sale	- -	11,002

See notes to consolidated financial statements.

## Note 1 - Summary of Significant Accounting Policies

### Principles of Consolidation

At the annual shareholder meeting on March 29, 2005, the shareholders approved the incorporation of **Cashmere Valley Financial Corporation** (the Company), a Washington state corporation, to hold **Cashmere Valley Bank** (the Bank) as its wholly owned subsidiary.

The consolidated financial statements include the accounts of the Company, the Bank, and the Bank's wholly owned subsidiary, **Mitchell, Reed and Associates, Inc.** (MRA), an insurance agency. All significant intercompany transactions and balances have been eliminated.

### Nature of Operations

The Company is a holding company which operates primarily through its subsidiary, the Bank. The Bank was established in 1932 and operates nine branches and a loan production office in North Central Washington. The Bank's lending and other banking activities are carried out in and around Chelan, Douglas and Kittitas Counties. The Bank provides loan and deposit services to customers, who are predominately small and middle-market businesses and middle income individuals. MRA is based in Wenatchee and brokers personal and commercial lines of insurance, including property and casualty insurance, to a customer base similar to the Bank's.

### Consolidated Financial Statement Presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and practices within the banking industry. The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities, as of the date of the consolidated balance sheet, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate primarily to the determination of the allowance for credit losses and valuations of core deposit intangible and goodwill.

Certain prior year amounts have been reclassified to conform to the 2006 presentation, with no change to shareholders' equity or net income previously reported.

### Cash Equivalents and Cash Flows

The Company considers all amounts included in the balance sheet caption "Cash and due from banks" to be cash equivalents. Cash flows from interest-bearing deposits at other financial institutions, federal funds sold, loans, deposits and short-term borrowings are reported net.

### Stock-Based Compensation

At December 31, 2006, the Company has a stock-based employee compensation plan, which is described more fully in Note 13. Prior to 2006 the Company accounted for the plan under the recognition and measurement principles of APB No. 25, "Accounting for Stock Issued to Employees", and related interpretations. Accordingly, no stock-based compensation cost was reflected in net income as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following illustrates the effect on net income and earnings per share, for the year ended December 31, 2005, if the Company had applied the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation", to stock-based compensation for all options granted on or after January 1, 1995 (dollars in thousands, except per share amounts):

	2005
Net income, as reported	\$9,622
Less total stock-based compensation expense determined under the fair-value method for all qualifying awards	54
Pro forma net income	\$9,568

Effective January 1, 2006, the Company adopted SFAS No. 123 revised, "Share-Based Payment" (SFAS 123(R)). Prior to adoption of SFAS 123(R) the Company accounted for stock option grants in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees" (the intrinsic value method). The Company recognized compensation expense totaling \$46,000 during the year ended December 31, 2006.

The Company has adopted SFAS 123(R) using the modified prospective method, which provides for no restatement of prior periods and no cumulative adjustment to equity accounts. Under the modified prospective approach, SFAS 123(R) applies to new awards and to awards that were outstanding on January 1, 2006 that are subsequently modified, repurchased or cancelled. Under the modified prospective approach, compensation costs are recognized based on graded vesting for unvested options outstanding on January 1, 2006 and for new options granted on January 1, 2006 and thereafter.

SFAS 123(R) requires the Company to, among other things, measure future employee stock-based compensation awards using a fair value method and record such expense in the Company's consolidated financial statements. The Company's expected future compensation expense is outlined in Note 13 and will increase only if additional options are granted.

### Securities Available for Sale

Securities available for sale consist of debt securities that the Company intends to hold for an indefinite period, but not necessarily to maturity. Such securities may be sold to implement the Company's asset/liability management strategies and in response to changes in interest rates and similar factors. Securities available for sale are reported at fair value. Unrealized gains and losses, net of the related deferred tax effect, are reported as a net amount in a separate component of shareholders' equity entitled "accumulated other comprehensive income." Realized gains and losses on securities available for sale, determined using the specific identification method, are included in earnings. Amortization of premiums and accretion of discounts are recognized in interest income over the period to maturity.

The Company evaluates the portfolio for impairment each quarter. In estimating other-than-temporary losses, the Company considers the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. If a security has been impaired for more than twelve months, and the impairment is deemed material, a write down will occur in that quarter. If a loss is deemed to be other-than-temporary, it is recognized as a realized loss in the consolidated income statement with the security assigned a new cost basis.

### Securities Held to Maturity

Debt securities which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized in interest income over the period to maturity.

### Federal Home Loan Bank Stock

The Company, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in capital stock of the FHLB in an amount equal to the greater of 1% of its outstanding home loans or 5% of advances from the FHLB. The recorded amount of FHLB stock equals its fair value because the shares can only be redeemed by the FHLB at the \$100 per share par value.

### Loans and Leases

Loans and leases receivable that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal balances adjusted for any charge-offs, the allowance for credit losses, and any deferred fees or costs on originated loans, and unamortized premiums or discounts on purchased loans. Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income using the interest method. Interest on loans is accrued daily based on the principal amount outstanding.

Direct financing leases are carried at the aggregate of lease payments plus estimated residual value of the leased property, less unearned income. Interest income from direct financing leases is recognized over the term of the lease to achieve a constant periodic rate of return on the outstanding investment.

Generally the accrual of interest on loans and leases is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due or when they are past due 90 days as to either principal or interest, unless they are well secured and in the process of collection. Past due status is based on contractual terms of the loan. When interest accrual is discontinued, all unpaid accrued interest is reversed against current income. If management determines that the ultimate collectibility of principal is in doubt, cash receipts on nonaccrual loans are applied to reduce the principal balance on a cash-basis method, until the loans qualify for return to accrual status. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

### Allowance for Credit Losses

The allowance for credit losses is maintained at a level sufficient to provide for probable credit losses based on evaluating known and inherent risks in the loan and lease portfolio. The allowance is provided based upon management's continuing analysis of the pertinent factors underlying the quality of the loan and lease portfolio. These factors include changes in the size and composition of the loan and lease portfolio, delinquency levels, actual loan loss experience, current economic conditions, and detailed analysis of individual loans for which full collectibility may not be assured. The detailed analysis includes techniques to estimate the fair value of loan collateral and the existence of potential alternative sources of repayment. The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies

for estimating specific and general losses in the portfolio. The appropriateness of the allowance for credit losses is estimated based upon these factors and trends identified by management at the time consolidated financial statements are prepared.

When available information confirms that specific loans or portions thereof are uncollectible, identified amounts are charged against the allowance for credit 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 demonstrated 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; the estimated fair value of the loan collateral is significantly below the current loan balance, and there is little or no near-term prospect for improvement.

In accordance with SFAS No. 114, "*Accounting by Creditors for Impairment of a Loan*", and SFAS No. 118, an amendment of SFAS No. 114, a loan or lease is considered impaired when it is probable that a creditor will be unable to collect all amounts (principal and interest) due according to the contractual terms of the loan agreement. Smaller balance homogenous loans, such as residential mortgage loans and consumer loans, are collectively evaluated for potential loss. When a loan or lease has been identified as being impaired, the amount of the impairment is measured by using discounted cash flows, except when, as a practical expedient, the current fair value of the collateral, reduced by costs to sell, is used. When the measurement of the impaired loan or lease is less than the recorded investment in the loan or lease (including accrued interest), impairment is recognized by creating or adjusting an allocation of the allowance for credit losses.

A provision for credit losses is charged against income and added to the allowance for credit losses based on regular assessments of the loan and lease portfolio. The allowance for credit losses is allocated to certain loan and lease categories based on the relative risk characteristics, asset classifications and actual loss experience of the loan and lease portfolio. While management has allocated the allowance for credit losses to various loan and lease portfolio segments, the allowance is general in nature and is available for the loan and lease portfolio in its entirety.

The ultimate recovery of all loans and leases is susceptible to future market factors beyond the Company's control. These factors may result in losses or recoveries differing significantly from those provided in the consolidated financial statements. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for credit losses and may require the Company to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

### Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation, which is computed on the straight-line method over the estimated useful lives of the assets, which range from 35 to 40 years for buildings and 3 to 15 years for furniture, fixtures and equipment. These assets are reviewed for impairment under Statement of Financial Accounting Standards (SFAS) No. 144 when events indicate that the carrying amount may not be recoverable. Gains or losses on dispositions are reflected in earnings.

### Foreclosed Real Estate

Real estate properties acquired through or in lieu of, foreclosure are to be sold and are initially recorded at the lower of cost or fair value of the properties less estimated costs of disposal. Any write-down to fair value at the time of transfer to foreclosed real estate is charged to the allowance for credit losses. Properties are evaluated regularly to ensure that the recorded amounts are supported by their current fair values. Any subsequent reductions in carrying values and revenue and expense from the operations of properties are charged to operations.

### Mortgage Servicing Rights

Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of loans. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage servicing contracts. Capitalized servicing rights are reported in other assets and are amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant risk characteristics, such as interest rate, balance outstanding, loan type, age and remaining term, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranche. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as an increase to income.

Servicing fee income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. The amortization of mortgage servicing rights is netted against loan servicing fee income.

## Mortgage Banking Activities

Mortgage loans originated and intended for sale in the secondary market are reported as loans held for sale and are carried at the lower of cost or estimated market value in the aggregate. Net unrealized losses are recognized in a valuation allowance by charges to income.

## Interest Rate Lock Commitments

The Company regularly enters into commitments to originate and sell loans held for sale. Commitments to originate loans (interest rate lock commitments), which primarily consist of commitments to originate fixed-rate residential mortgage loans, are recorded at fair value. Changes in the fair value of interest rate lock commitments are recognized in non-interest income on a quarterly basis. Such commitments are considered derivative instruments under Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138. These statements require the Company to recognize all derivative instruments as either assets or liabilities on the consolidated balance sheet and to measure those instruments at fair value. As of December 31, 2006 and 2005, the fair value of loan related commitments was estimated to be zero.

## Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

## Income Taxes

Deferred tax assets and liabilities result from differences between the consolidated financial statement carrying amounts and the tax basis of assets and liabilities, and are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. The deferred tax provision represents the difference between the net deferred tax asset/liability at the beginning and end of the year. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

## Goodwill

Goodwill represents costs in excess of net assets acquired and is evaluated periodically for impairment, in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets".

## Intangible Assets

Intangible assets include core deposit premium, a non-competition agreement and customer contracts and lists. The core deposit premium and non-competition agreement are being amortized by the straight-line method over seven and five years, respectively, while the customer contracts and lists are being amortized by the straight-line method over three years. Amortization recognized in 2006 and 2005 on these intangibles was \$160,000 and \$159,000, respectively. Unamortized intangible assets totaled \$591,000 and \$741,000 at December 31, 2006 and 2005, respectively.

Estimated amortization for future years ending December 31 is as follows (dollars in thousands):

2007	\$150
2008	146
2009	146
2010	146
2011	3
	\$591

## Fair Values of Financial Instruments

The following methods and assumptions were used by the Company in estimating fair values of financial instruments as disclosed herein:

### Cash and Due from Banks and Interest Bearing Deposits at Other Financial Institutions

The carrying amounts of cash and due from banks and interest-bearing deposits at other financial institutions approximate their fair values.

### Fed Funds Sold

The carrying value of fed funds sold approximates its fair value.

### Securities Available for Sale and Held to Maturity

The fair value of securities available for sale and held to maturity is based on estimated market prices.

### Federal Home Loan Bank Stock

The carrying value of Federal Home Loan Bank stock approximates its fair value.

### Loans Held for Sale

The carrying values of loans held for sale approximate their fair value.

### Loans and Leases

For variable rate loans and leases that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. Fair value of fixed rate loans and leases is estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values of loans held for sale are based on their estimated market prices. Fair value of impaired loans and leases is estimated using discounted cash flow analyses or underlying collateral values, where applicable.

### Deposit Liabilities

The fair value of deposits with no stated maturity date is included at the amount payable on demand. The fair value of fixed rate certificates of deposit is estimated using a discounted cash flow calculation based on interest rates currently being offered on similar certificates.

### Short-Term Borrowings

The carrying amounts of demand notes issued to U.S. Treasury and repurchase agreements approximate their fair value.

### Long-Term Borrowings

The fair value of the Company's long-term borrowings is estimated using discounted cash flow analyses based on the Company's current incremental borrowing rate for similar types of borrowing arrangements.

### Accrued Interest

The carrying amounts of accrued interest approximate their fair value.

### Off-Balance Sheet Instruments

The fair value of commitments to extend credit and standby letters of credit was estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the customers. Since the majority of the Company's off-balance sheet instruments consist of non-fee producing, variable-rate commitments, the Company has determined they do not have a distinguishable fair value.

### Recent Accounting Pronouncements

In February 2006, FASB issued SFAS 155, "Accounting for Certain Hybrid Financial Instruments", which permits, but does not require, fair value accounting for any hybrid financial instrument that contains an embedded derivative that would otherwise require bifurcation in accordance with SFAS 133, "Accounting for Derivative Instruments and Hedging Activities". The statement also subjects beneficial interests in securitized financial assets to the requirements of SFAS 133. For the Company, this statement is effective for all financial instruments acquired, issued, or subject to remeasurement after the beginning of its fiscal year that begins after September 15, 2006, with earlier adoption permitted. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operations and cash flows.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140." The statement amends SFAS No. 140 by (1) requiring the separate accounting for servicing assets and servicing liabilities, which arise from the sale of financial assets; (2) requiring all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable; and (3) permitting an entity to choose between an amortization method or a fair value method for subsequent measurement for each class of separately recognized servicing assets and servicing liabilities. This statement is effective for fiscal years beginning after September 15, 2006, with earlier adoption permitted. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operations and cash flows.

In June 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes." This interpretation applies to all tax positions accounted for in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN 48 clarifies the application of SFAS No. 109 by defining the criteria that an individual tax position must meet in order for the position to be recognized within the financial statements and provides guidance on measurement, de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition for tax positions. This interpretation is effective for fiscal years beginning after December 15, 2006, with earlier adoption permitted. The Company does not expect that the adoption of this interpretation will have a material impact on its financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements". This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. It clarifies that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. This Statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operations and cash flows.

In February 2007, the FASB issued SFAS No. 159, "Fair Value Option for Financial Assets and Financial Liabilities— Including an amendment of FASB Statement No. 115" ("SFAS No. 159"). SFAS No. 159 provides all entities, including not-for-profit organizations, with an option to report selected financial assets and liabilities at fair value. The standard is designed to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings. The option to report items at fair value generally may be applied on an instrument by instrument basis and is irrevocable. The options may not be applied to portions of instruments. SFAS No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The statement also requires additional disclosures. Management is currently evaluating the impact of the adoption of SFAS No. 159; however, it is not expected to have a material impact on the Company's financial position, results of operations and cash flows.

## Note 2 - Restricted Assets

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Federal Reserve Board regulations require that the Company maintain certain minimum reserve balances on hand or on deposit with the Federal Reserve Bank, based on a percentage of deposits. The required minimum reserve balances at December 31, 2006 and 2005 were \$1,052,000 and \$862,000, respectively. Due to sufficient balances maintained on premises, no balances were required to be on deposit with the Federal Reserve Bank for the years ended December 31, 2006 and 2005.

## Note 3 - Securities

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Securities have been classified according to management's intent. The amortized cost of securities and their approximate fair value are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Securities Available for Sale</b>				
<b>December 31, 2006</b>				
State and municipal securities	\$95,008	\$2,738	\$(310)	\$97,436
U.S. Government agencies	2,073	94	--	2,167
Collateralized mortgage obligations	97,337	1,407	(361)	98,383
Mortgaged-backed securities	20,736	516	(19)	21,233
<b>Total</b>	<b>\$215,154</b>	<b>\$4,755</b>	<b>\$(690)</b>	<b>\$219,219</b>

	Gross Amortized Cost	Gross Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2005				
State and municipal securities	\$ 86,381	\$2,693	(\$ 376)	\$ 88,698
U.S. Government agencies	2,882	133	- -	3,015
Collateralized mortgage obligations	124,703	1,220	(650)	125,273
Mortgaged-backed securities	16,805	627	(56)	17,376
Total	\$230,771	\$4,673	(\$1,082)	\$234,362

### Securities Held to Maturity

#### December 31, 2006

State and municipal securities	\$3,075	\$42	\$--	\$3,117
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#### December 31, 2005

State and municipal securities	\$3,496	\$ 78	\$ - -	\$3,574
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For all of the above investment securities, the unrealized losses are due to changes in interest rates and, as such, are considered to be temporary by the Company.

The following shows the unrealized gross losses and fair value of securities in the available for sale portfolio at December 31, 2006 and 2005, by length of time that individual securities in each category have been in a continuous loss position (dollars in thousands):

	Less Than 12 Months		More Than 12 Months		Total	
	Unrealized Gross Loss	Fair Value	Unrealized Gross Loss	Fair Value	Unrealized Gross Loss	Fair Value
<b>December 31, 2006</b>						
U.S. Government agency securities Including mortgage backed securities	(\$ 10)	\$ 4,242	(\$ 9)	\$ 1,659	(\$ 19)	\$ 5,901
State and municipal securities	(41)	9,023	(269)	19,111	(310)	28,134
Collateralized mortgage obligations	(93)	18,959	(268)	12,639	(361)	31,598
	<b>(\$144)</b>	<b>\$32,224</b>	<b>(\$546)</b>	<b>\$33,409</b>	<b>(\$690)</b>	<b>\$65,633</b>
<b>December 31, 2005</b>						
U.S. Government agency securities Including mortgage backed securities	(\$ 3)	\$ 704	(\$ 53)	\$ 5,363	(\$ 56)	\$ 6,067
State and municipal securities	(100)	7,791	(276)	20,377	(376)	28,168
Collateralized mortgage obligations	(538)	26,222	(112)	4,888	(650)	31,110
	<b>(\$641)</b>	<b>\$34,717</b>	<b>(\$441)</b>	<b>\$30,628</b>	<b>(\$1,082)</b>	<b>\$65,345</b>

The contractual maturities of securities held to maturity and available for sale at December 31, 2006, are shown below (dollars in thousands).

Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations, with or without call or prepayment penalties.

	Held to Maturity		Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 537	\$ 541	\$ 416	\$ 420
Due from one year to five years	305	309	17,519	17,666
Due from five years to ten years	1,590	1,606	57,515	58,240
Due after ten years	643	661	118,968	121,660
Mortgage backed securities	--	--	20,736	21,233
<b>Total</b>	<b>\$3,075</b>	<b>\$3,117</b>	<b>\$215,154</b>	<b>\$219,219</b>

Gross gains realized on sales of securities were \$75,000 and \$134,000 in 2006 and 2005, respectively, and gross losses realized were \$105,000 and \$182,000, respectively. Securities carried at approximately \$102,952,000 and \$60,517,000 at December 31, 2006 and 2005, respectively, were pledged to secure public deposits, repurchase agreements, demand notes issued to U.S. Treasury and other purposes required or permitted by law.

#### Note 4 - Loans and Leases

Loans and leases at December 31 consist of the following (dollars in thousands):

	2006	2005
Commercial and agricultural	\$ 61,361	\$ 53,024
Real estate:		
Residential 1-4 family	73,567	60,321
Commercial	121,970	124,163
Construction	125,519	75,482
Farmland	4,746	3,166
Consumer	20,052	15,372
Dealer contracts	74,910	66,017
Leases	13,993	14,897
Credit card	5,220	4,593
Less deferred loan fees	(405)	--
<b>Total loans and leases</b>	<b>\$500,933</b>	<b>\$417,035</b>

Changes in the allowance for credit losses for the years ended December 31 are as follows (dollars in thousands):

	2006	2005
Balance at beginning of year	\$7,495	\$6,124
Provision for credit losses	1,220	695
Charge-offs	(630)	(352)
Recoveries	154	1,028
Net recoveries (charge-offs)	(476)	676
<b>Balance at end of year</b>	<b>\$8,239</b>	<b>\$7,495</b>

Following is a summary of information pertaining to impaired loans and leases (dollars in thousands):

	2006	2005
December 31		
Impaired loans and leases without a valuation allowance	\$216	\$458
Impaired loans and leases with a valuation allowance	523	492
<b>Total impaired loans</b>	<b>\$739</b>	<b>\$950</b>
Valuation allowance related to impaired loans	\$76	\$143

	2006	2005
Years Ended December 31		
Average investment in impaired loans	\$934	\$1,335
Interest income recognized on a cash basis on impaired loans	--	--

At December 31, 2006, there were no commitments to lend additional funds to borrowers whose loans have been modified. Loans over 90 days past due still accruing interest totaled \$15,000 and \$179,000 at December 31, 2006 and 2005, respectively.

Certain related parties of the Company, principally directors and their associates, were loan customers of the Company in the ordinary course of business during 2006 and 2005. Total loans outstanding at December 31, 2006 and 2005 to key officers and directors were \$15,355,000 and \$15,047,000, respectively. During 2006 loan advances totaled \$4,536,000, principal payments totaled \$4,228,000.

## Note 5 - Premises and Equipment

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Components of premises and equipment at December 31 are as follows (dollars in thousands):

	2006	2005
Land	\$ 2,265	\$ 2,265
Buildings and improvements	11,046	10,245
Furniture	3,987	3,686
Equipment	2,500	2,094
Construction in process	1,887	1,364
<b>Total cost</b>	<b>21,685</b>	<b>19,654</b>
Less accumulated depreciation	8,602	7,798
<b>Total premises and equipment</b>	<b>\$13,083</b>	<b>\$11,856</b>

Construction in progress at December 31, 2006, consisted of amounts related to land acquisition and construction of a new branch in Chelan and various other capital projects. Construction on all projects is expected to be completed in 2007 and substantially all costs related to the projects have been recorded.

Depreciation expense was \$848,000 and \$783,000 in 2006 and 2005.

## Note 6 – Mortgage Servicing Rights

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Mortgage servicing rights are evaluated periodically for possible impairment based on the difference between the carrying amount and current fair value of the MSR's by risk stratification. If a temporary impairment exists, a valuation allowance is established for any excess of amortized cost over the current fair value through a charge to income. A direct write-down is performed when the recoverability of a recorded valuation allowance is determined to be remote. Unlike a valuation allowance, a direct write-down permanently reduces the carrying value of the MSR's and the valuation allowance, precluding subsequent reversals.

Mortgage loans serviced for others are not included on the accompanying consolidated balance sheets. The unpaid principal balances of mortgage loans serviced for others were \$188,501,000 and \$155,554,000 at December 31, 2006 and 2005, respectively. Custodial escrow balances maintained in connection with the foregoing loan servicing were approximately \$909,000 and \$673,000 at December 31, 2006 and 2005, respectively. The weighted average amortization period of the Company's servicing rights is 6.69 years.

The following summarizes the activity in mortgage servicing rights for the year ended December 31, 2006:

Balance, beginning of year	\$ --
Purchases	242
Originations	352
Amortization	(59)
<b>Balance, end of year</b>	<b>\$535</b>

At December 31, 2006 no valuation allowance for impairment of the Company's mortgage servicing rights was necessary.

## Note 7 - Deposits

The composition of deposits is as follows (dollars in thousands):

	Deposits 2006	2005	Interest Expense 2006	2005
Demand deposits, non-interest-bearing NOW accounts	\$ 78,002	\$ 73,628	\$ --	\$ --
Money market and savings accounts	229,156	172,931	5,779	3,103
Time certificates \$100,000 and over	212,786	186,940	6,446	3,953
Other time certificates	75,760	78,090	3,019	2,887
	121,632	117,558	5,433	4,114
	\$ 717,336	\$ 629,147	\$ 20,677	\$14,057

Certificates of deposit at December 31, 2006, are scheduled to mature as follows (dollars in thousands):

	Under \$100	Over \$100
0 to 90 days	\$ 18,272	\$19,018
91 to 365 days	49,918	27,057
1 year to 3 years	39,190	22,803
Over 3 years	14,252	6,882
	\$121,632	\$75,760

Total demand deposit overdrafts that have been reclassified to loans were \$ 585,000 and \$ 237,000 at December 31, 2006 and 2005, respectively.

## Note 8 - Short-Term Borrowings

Securities sold under agreements to repurchase, line of credit advances from the Federal Home Loan Bank (FHLB) of Seattle and demand notes issued to U.S. Treasury represent short-term borrowings. All funds borrowed from FHLB are secured by a blanket pledge of 15% of the Company's assets. Securities sold under agreements to repurchase are secured by specific investments. The following is a summary of such short-term borrowings for the years ended December 31 (dollars in thousands):

	2006	2005
Average balance during the year	\$8,060	\$7,342
Average interest rate during the year	3.71%	2.24%
Maximum month-end balance during the year	\$14,270	\$11,562
Balance at December 31:		
Securities under agreements to repurchase	\$3,521	\$2,826
Demand notes issued to U.S. Treasury	\$1,929	\$2,043
Weighted-average interest rate at year-end	4.66%	2.35%

## Note 9 - Long-Term Borrowings

Long-term borrowings at December 31, 2006 and 2005 represent amounts due to the FHLB totaling \$5,389,000 and \$5,629,000, respectively, and bear interest rates ranging from 3.96% to 6.23%. All funds borrowed from the FHLB are secured by a blanket pledge of 15% of the Company's assets. The schedule of maturities for the long-term FHLB borrowings for future years ending December 31 is as follows (dollars in thousands):

2007	\$ 249
2008	259
2009	270
2010	281
2011	293
Thereafter	4,037
<b>Total</b>	<b>\$5,389</b>

## Note 10 - Income Taxes

Income taxes are comprised of the following for the years ended December 31 (dollars in thousands):

	2006	2005
Current	\$2,000	\$2,988
Deferred expense	811	250
<b>Total income taxes</b>	<b>\$2,811</b>	<b>\$3,238</b>

The following is a reconciliation between the statutory and the effective federal income tax rate for the years ended December 31 (dollars in thousands):

	2006		2005	
	Amount	Percent of Pretax Income	Amount	Percent of Pretax Income
Income tax at statutory rates	\$4,495	35.0%	\$4,501	35.0%
Decrease resulting from:				
Tax-exempt income	(1,222)	(9.5)	(1,094)	(8.5)
Other	(462)	(3.6)	(169)	(1.3)
<b>Total income tax expense</b>	<b>\$2,811</b>	<b>21.9%</b>	<b>\$3,238</b>	<b>25.2%</b>

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities at December 31 are as follows (dollars in thousands):

	2006	2005
<b>Deferred Tax Assets</b>		
Allowance for credit losses	\$2,801	\$2,463
Other	308	965
<b>Total deferred tax assets</b>	<b>3,109</b>	<b>3,428</b>
<b>Deferred Tax Liabilities</b>		
Accumulated depreciation	955	1,897
Deferred income	947	935
Unrealized gain on securities available for sale	1,388	1,220
Other	1,422	--
<b>Total deferred tax liabilities</b>	<b>4,712</b>	<b>4,052</b>
<b>Net deferred tax liabilities</b>	<b>\$1,603</b>	<b>\$ 624</b>

## Note 11 - Commitments and Contingencies

### Credit

The Company is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the consolidated balance sheets.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. A summary of the Company's commitments at December 31 is as follows (dollars in thousands):

	2006	2005
Commitments to extend credit:		
Credit card lines	\$27,651	\$31,614
Other	64,650	49,997
<b>Total commitments to extend credit</b>	<b>\$92,301</b>	<b>\$81,611</b>
Standby letters of credit	\$565	\$707

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company's experience has been that approximately 50% of loan commitments are drawn upon by customers. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above, and is required in instances, which the Company deems necessary.

## Legal

Because of the nature of its activities, the Company is subject to various pending and threatened legal actions which arise in the ordinary course of business. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on the financial position of the Company.

## Borrowing Facilities

The Company has agreements with commercial banks for lines of credit totaling \$30,000,000, none of which was used at December 31, 2006, and a credit line with the Federal Home Loan Bank of Seattle totaling 15% of assets, \$5,389,000 of which was used at December 31, 2006. The Company entered into a Blanket Pledge Agreement with the Federal Home Loan Bank to secure this credit line (*see Note 8*).

## Investments

The Company has entered into a subscription agreement to purchase four units at \$500,000 per unit for an interest in Homestead Equity Fund A-Washington Limited Partnership, an Oregon limited partnership (HEFA-WA). HEF A-WA has been formed to invest in partnerships or limited liability companies, which will acquire, construct, rehabilitate, operate and dispose of low-income housing developments which are located in Washington state. The housing developments will be eligible for the federal low-income housing tax credit and, in some cases, the historic rehabilitation tax credit available under the Internal Revenue Code of 1986, as amended. The Company accounts for the investment under the equity method in accordance with EITF Issue No. 94-1 "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects" and a pass-through loss of \$211,000 and \$110,000 was recorded during 2006 and 2005, respectively. At December 31, 2006 and 2005, the Company's partnership (deficit) equity was \$(264,000) and \$298,000, respectively, and is included in other liabilities. The Company's remaining contractual partner contributions of \$1,712,000 are expected to be paid as follows: \$267,000 in 2007; \$1,357,000 in 2008; and \$88,000 in 2009.

The Company has entered into a subscription agreement to purchase one unit at \$1,000,000 for an interest in Homestead Western Communities Fund (HWC). HWC has been formed to invest in partnerships or limited liability companies, which will acquire, construct, rehabilitate, operate and dispose of low-income housing developments which are located in the state of Oregon, Washington, Idaho, and California. The housing developments will be eligible for the federal low-income housing tax credit and, in some cases, the historic rehabilitation tax credit available under the Internal Revenue Code of 1986, as amended. The Company accounts for the investment under the equity method in accordance with EITF Issue No. 94-1 and a pass-through loss of \$133,000 was recorded during 2006. At December 31, 2006 and 2005, the Company's partnership (deficit) equity was \$(133,000) and \$(65,000), respectively, and is included in other liabilities. The Company's remaining contractual contributions of \$990,000 are expected to be paid as follows: \$115,000 in 2007; \$189,000 in 2008; \$201,000 in 2009; \$225,000 in 2010; \$240,000 in 2011; and \$20,000 in 2012.

## Employment Agreements

The Company has entered into employment contracts with certain key employees, which provide for contingent payments subject to future events.

## Note 12 - Significant Concentrations of Credit Risk

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Most of the Company's business activity is with customers located in the state of Washington. Investments in state and municipal securities involve government entities primarily within the state. At December 31, 2006, 11.96% of total loans outstanding were for residential developed lot loans to consumers. Loans are generally limited, by state banking regulations, to 20% of the Company's shareholders' equity, excluding accumulated other comprehensive income. Standby letters of credit were granted primarily to commercial borrowers. The Company, as a matter of practice, generally does not extend credit to any single borrower or group of related borrowers in excess of \$6,300,000.

Stock Option Plan

The Company has a stock option plan under which certain key employees have been granted options to purchase shares of common stock. Under the plan, the Company may grant options for up to 200,000 shares of its common stock to certain key employees, of which 164,220 were available for grant at December 31, 2006. Options are exercisable at the fair market value of the stock as of the date of grant. All options granted since 1994 are 40% vested on the date of grant, with 20% vesting on each of the three subsequent anniversaries of the grant date and have a maximum contractual term of ten years. The Black-Scholes model requires the use of employee exercise behavior data and the use of a number of assumptions including volatility of the Company's stock price, dividend yield, weighted average risk-free interest rate, and weighted average expected life of the options. The fair value of each option grant is estimated on the date of grant, based on the Black-Scholes option pricing model and using the following weighted-average assumptions:

	2006	2005
Dividend yield	2.38%	2.63%
Expected life	6 years	6 years
Risk-free interest rate	4.8%	3.9%
Expected volatility	13%	17%

The weighted average fair value at grant date of options granted during 2006 and 2005 was \$4.76 and \$3.96, respectively.

The Black-Scholes model used by the Company to calculate option values, as well as other currently accepted option valuation models, were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. These models require highly subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. A summary of the status of the Company's stock option plan as of December 31, and changes during the years ending on those dates, is presented below:

	2006	Weighted Average Exercise Price	2005	Weighted Average Exercise Price
	Shares		Shares	
Outstanding at beginning of year	126,814	\$15.88	135,302	\$14.19
Granted	28,210	28.24	18,826	23.52
Exercised	(13,140)	10.80	(26,714)	12.56
Forfeited	--	--	(600)	21.88
Outstanding at end of year	141,884	18.81	126,814	15.88
Vested and expected to vest	141,884	18.81	126,814	15.88
<b>Options exercisable at year-end</b>	<b>117,313</b>	<b>\$17.15</b>	<b>112,946</b>	<b>\$15.08</b>

The following information summarizes information about stock options outstanding and exercisable at December 31, 2006:

Options Outstanding			Options Exercisable			
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
\$10.88 - \$15.00	39,660	1.88	\$12.66	39,660	\$12.66	1.88
15.50 - 17.50	40,216	4.55	16.13	40,216	16.13	4.55
18.00 - 26.00	33,798	6.65	21.33	26,153	20.71	6.16
26.50 - 31.50	28,210	9.41	28.24	11,284	28.24	9.41
	<b>141,884</b>	<b>5.27</b>	<b>\$18.81</b>	<b>117,313</b>	<b>\$17.15</b>	<b>4.48</b>

The total intrinsic value of the options exercised during 2006 was \$240,000. The total intrinsic value of the stock options exercisable and outstanding at December 31, 2006 is \$1,684,000 and \$1,801,000, respectively.

At December 31, 2006, unrecognized compensation expense related to unvested options totaled \$116,000 and is expected to be recognized over a weighted average period of 1.2 years. During 2006, 17,507 options vested, which had a weighted average fair value at grant date of \$2.61 and during 2005, 16,028 options vested which had a weighted average fair value at grant date of \$3.39.

## Profit-Sharing Plan

The Company has a 401(k) employee benefit plan for those employees who meet eligibility requirements set forth in the plan. Eligible employees may contribute up to 16% of their compensation. The Company matches two-thirds of the first 6% contributed by participants. Additionally, matching contributions may be made by the Company pursuant to a prescribed formula based on the Company's achievement of at least a 1.5% return on assets or 15% return on equity. The Company contributed \$253,000 and \$214,000 in 2006 and 2005, respectively.

Incentive compensation is awarded to all employees based on the financial performance of the Company. Cash bonuses are awarded pursuant to a prescribed formula targeted on the Company achieving a 1.5% return on assets or 15% return on equity. Amounts awarded under the plan for 2006 and 2005 were \$848,000 and \$685,000, respectively.

## Deferred Compensation Plan

The Company entered into deferred compensation arrangements with key employees. The agreements provide for employee and Company matching contributions equal to the amount that would have been contributed under the Company's 401(k) plan, had the employees not been otherwise excluded from the plan. At December 31, 2006 and 2005, the Company had a recorded liability in the amount of \$189,000 and \$148,000, respectively. The Company contributed \$16,000 and \$14,000 in 2006 and 2005, respectively.

The Company entered into employment contracts with certain key employees, which provide for deferred compensation subject to future events. At December 31, 2006 and 2005, \$160,000 and \$260,000 had been accrued for these agreements, respectively. Compensation expense of \$270,000 and \$80,000 was recorded in salary expense related to these contracts in 2006 and 2005, respectively.

## Insurance

The Company provides certain health care, disability and life insurance benefits for current employees. The cost of health care benefits for employees is recognized as expense when paid. Life insurance benefits for employees are provided through an insurance company whose premiums are based on the benefits paid during the year. The Company recognizes the cost of providing such benefits by expensing the monthly insurance premiums. For 2006 and 2005, the cost of providing health care, disability and life insurance benefits was \$799,000 and \$718,000, respectively.

## Note 14 - Regulatory Matters

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The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines of the regulatory framework for prompt corrective action, the Company must meet specific capital adequacy guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance-sheet items, as calculated under regulatory accounting practices. The Company's capital classification is also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 and total capital (as defined) to risk-weighted assets (as defined).

As of December 31, 2006, the most recent notification from the Company's regulator categorized the Company and the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Company must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Company's and the Bank's actual capital amounts and ratios are also presented in the following table (dollars in thousands). Management believes as of December 31, 2006, that the Company meets all capital requirements to which it is subject.

	Actual Amount	Ratio	Capital Adequacy Purposes		To be Well Capitalized Under Prompt Corrective Action Provisions	
			Amount	Ratio	Amount	Ratio
<b>December 31, 2006</b>						
Tier 1 capital (to average assets)						
Company	\$59,854	7.81	\$30,642	4.00%	N/A	N/A
Bank	59,348	7.75	30,637	4.00	\$38,296	5.00%
Tier 1 capital (to risk-weighted assets)						
Company	59,854	10.55	22,694	4.00	N/A	N/A
Bank	59,348	10.46	22,685	4.00	34,027	6.00
Total capital (to risk-weighted assets)						
Company	66,966	11.81	45,388	8.00	N/A	N/A
Bank	66,460	11.72	45,369	8.00	56,712	10.00

	Actual Amount	Ratio	Capital Adequacy Purposes		To be Well Capitalized Under Prompt Corrective Action Provisions	
			Amount	Ratio	Amount	Ratio
<b>December 31, 2005</b>						
Tier 1 capital (to average assets)						
Company	\$52,826	7.62%	\$27,740	4.00%	N/A	N/A
Bank	52,439	7.56	27,739	4.00	\$34,674	5.00%
Tier 1 capital (to risk-weighted assets)						
Company	52,826	11.00	19,203	4.00	N/A	N/A
Bank	52,439	10.92	19,203	4.00	28,804	6.00
Total capital (to risk-weighted assets)						
Company	58,855	12.26	38,407	8.00	N/A	N/A
Bank	58,468	12.18	38,406	8.00	48,007	10.00

### Restrictions on Retained Earnings

The Company is restricted from paying dividends in an amount that would decrease regulatory capital below the minimum amounts shown above.

### Note 15 - Fair Value of Financial Instruments

Estimated fair value of the Company's financial instruments at December 31 were as follows (dollars in thousands):

	2006 Carrying Amount	Fair Value	2005 Carrying Amount	Fair Value
<b>Financial Assets</b>				
Cash and due from banks, federal funds sold and interest-bearing deposits at other financial institutions	\$ 58,183	\$ 58,183	\$ 37,766	\$ 37,766
Securities available for sale	219,219	219,219	234,362	234,362
Securities held to maturity	3,075	3,117	3,496	3,574
Equity securities	3,378	3,378	3,140	3,140
Loans and leases, net	493,256	485,536	410,017	405,693
Accrued interest receivable	3,676	3,676	3,263	3,263

## Financial Liabilities

Deposits	\$717,336	\$714,978	\$629,147	\$627,200
Short-term borrowings	5,450	5,450	4,869	4,869
Long-term borrowings	5,389	5,624	5,629	5,925
Accrued interest payable	1,505	1,505	1,308	1,308

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Company's financial instruments will change when interest rate levels change and that change may either be favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities, and attempts to minimize interest rate risk by adjusting terms of new loans, and deposits and by investing in securities with terms that mitigate the Company's overall interest rate risk.

## Note 16 - Comprehensive Income

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Net unrealized gains and losses include, net of tax, \$306,000 and \$813,000 of unrealized gains arising during 2006 and 2005, respectively less reclassification adjustments of \$40,000 for gains/losses and \$64,000 for gains/losses included in net income in 2006 and 2005, respectively, as follows (dollars in thousands):

	Before-Tax Amount	Tax Benefit (Expense)	Net-of-Tax Amount
<b>Year Ended December 31, 2006</b>			
Unrealized holding gains arising during the year	\$434	(\$168)	\$266
Reclassification adjustment for losses realized in net income	30	10	40
<b>Net unrealized losses</b>	<b>\$464</b>	<b>(\$158)</b>	<b>\$306</b>
<b>Year Ended December 31, 2005</b>			
Unrealized holding losses arising during the year	(\$1,284)	\$407	(\$877)
Reclassification adjustment for losses realized in net income	49	15	64
<b>Net unrealized losses</b>	<b>(\$1,235)</b>	<b>\$422</b>	<b>(\$813)</b>

## Note 17 - Condensed Financial Information - Parent Company Only

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### Condensed Balance Sheet – December 31, 2006 and 2005 (Dollars in Thousands)

Assets	2006	2005
Interest bearing deposits in banks	\$ 205	\$ 328
Investment in Bank	69,741	62,131
Other assets	301	59
<b>Total Assets</b>	<b>\$70,247</b>	<b>\$62,518</b>
<b>Shareholders' Equity</b>	<b>\$70,247</b>	<b>\$62,518</b>

### Condensed Statement of Income - For the year ended December 31, 2006 and 2005 (Dollars in Thousands)

Operating Income	2006	2005
Interest bearing deposits in banks	\$ 11	\$ 2
Dividends from Bank	2,798	1,600
Total operating income	2,809	1,602
Operating Expenses	47	107
Income before income taxes and equity in undistributed income of subsidiaries	2,762	1,495
Income Tax Benefit	(12)	(35)
Income before equity in undistributed income of subsidiaries	2,774	1,530
Equity in Undistributed Income of subsidiaries	7,259	6,011
Net income	\$10,033	\$7,541

### Condensed Statement of Cash Flows – For the year ended December 31, 2006 and 2005 (Dollars in Thousands)

Cash Flows from Operating Activities	2006	2005
Net income	\$10,033	\$7,541
Adjustments to reconcile net income to net cash provided:		
Dividends in excess of income of Bank	(7,259)	(6,011)
Other, net	(3)	(46)
Net cash provided by operating activities	2,771	1,484
Cash Flows from Investing Activities		
Purchases of available for sale securities	(238)	--
Cash Flows from Financing Activities		
Exercise of stock options	142	194
Dividends paid	(2,798)	(1,350)
Net cash used in financing activities	(2,656)	(1,156)
Net increase (decrease) in cash	(123)	328
Interest bearing deposits in bank, beginning of year	328	--
End of year	\$ 205	\$ 328

### Note 18 - Subsequent Event

On January 23 2007, the Company's Board of Directors approved a dividend of \$0.35 per share, payable on January 26, 2007, to shareholders of record as of January 23, 2007.