

BANNER CORP  
Form 10-K/A  
April 19, 2005

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-K/A

AMENDMENT NO. 1

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(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES  
EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31,  
2004

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD  
FROM \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-26584

BANNER CORPORATION

(Exact name of registrant as specified in its charter)

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Washington  
(State or other jurisdiction of incorporation  
or organization)

91-1691604  
(I.R.S. Employer  
Identification Number)

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

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

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes  No

The aggregate market value of the voting and nonvoting common equity held by nonaffiliates of the registrant based on the closing sales price of the registrant's common stock quoted on the Nasdaq Stock Market on June 30, 2004, was:

Common Stock - \$339,608,673

The number of shares outstanding of the registrant's classes of common stock as of February 28, 2005:

Common Stock, \$.01 par value - 11,879,853 shares

Documents Incorporated by Reference

Portions of Proxy Statement for Annual Meeting of Shareholders to be held April 26, 2005 are incorporated by reference into Part III.

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Amendment No. 1 to the Annual Report on Form 10-K  
For the Fiscal Year Ended December 31, 2004

EXPLANATORY NOTE

We are filing this Amendment No. 1 to our Annual Report Form 10-K for the fiscal year ended December 31, 2004 as filed on March 15, 2005 (the "Annual Report") to correct a typographical error in the date of the report of Deloitte & Touche LLP, the independent registered public accounting firm that audited our consolidated financial statements for the two years in the period ended December 31, 2003 and typographical errors contained in the Consent of Independent Registered Public Accounting Firm that was issued by Deloitte & Touche LLP and contained in Exhibit 23.2.

The complete text of the report amended as well as the consolidated financial statements and financial statement schedules filed under Part IV, Item 15(a) (1) and 15(a) (2), is included in the Amendment pursuant to Rule 12b-15 promulgated under the Securities Exchange Act of 1934. This Amendment amends and restates in their entirety only Part IV, Items 15(a) (1) and 15(a) (2), as well as Part IV, Item 15(b), which contains the exhibit list. This revised consent is contained in Exhibit 23.2. This Amendment does not affect any other Items and Exhibits in the Annual Report, and those unaffected Items or Exhibits are not included in this Amendment.

This Amendment continues to speak as of the date of the original Annual Report, and we have not updated the disclosure contained herein to reflect events that have occurred since the filing of the original Annual Report. Accordingly, this Form 10-K/A should be read in conjunction with our other filings made with the Securities and Exchange Commission subsequent to the filing to the original Annual Report, including any amendments to those filings.

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## Part IV

### ITEM 15 - Exhibits and Financial Statement Schedules

(a) (1) Financial Statements

See Index to Consolidated Financial Statements on page 5.

(2) Financial Statement Schedules

All financial statement schedules are omitted because they are not applicable or not required, or because the required information is included in the Consolidated Financial Statements or the Notes thereto or in Part 1, Item 1.

(b) Exhibits

See Index of Exhibits on page 51.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on April 18, 2005.

BANNER CORPORATION

April 18, 2005

/s/ D. Michael Jones

D. Michael Jones

President and Chief Executive Officer

April 18, 2005

/s/ Lloyd W. Baker

Lloyd W. Baker

Chief Financial Officer

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BANNER CORPORATION AND SUBSIDIARIES  
(Item 8 and Item 15(a)(1))

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March 11, 2005

Report of Management

To the Stockholders:

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

Management is responsible for establishing and maintaining an effective system of internal control over financial reporting. The internal control system is augmented by written policies and procedures and by audits performed by an internal audit staff (assisted in certain instances by contracted external audit resources other than the independent registered public accounting firm), which reports to the Audit Committee of the Board of Directors. Internal auditors monitor the operation of the internal and external control system and report findings to management and the Audit

Committee. When appropriate, corrective actions are taken to address identified control deficiencies and other opportunities for improving the system. The Audit Committee provides oversight to the financial reporting process. There are inherent limitations in the effectiveness of any system of internal control, including the possibility of human error and circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of an internal control system may vary over time.

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

D. Michael Jones, Chief Executive Officer  
Lloyd W. Baker, Chief Financial Officer

March 11, 2005

#### Report of the Audit Committee of the Board of Directors

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

Gordon E. Budke  
Audit Committee Chairman

March 11, 2005

The management of Banner Corporation is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f).

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management with the participation of the Chief Executive Officer and Chief Financial Officer assessed the effectiveness of Banner Corporation's internal control over financial reporting as of December 31, 2004. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*.

Based on its assessment, Management concluded that Banner Corporation maintained effective internal control over financial reporting as of December 31, 2004.

Management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2004 has been audited by Moss Adams LLP, an independent registered public accounting firm, as stated in their attestation report that is included herein.

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REPORT OF INDEPENDENT REGISTERED  
PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
Banner Corporation and Subsidiaries  
Walla Walla, Washington

We have audited the accompanying consolidated statement of financial condition of Banner Corporation and subsidiaries as of December 31, 2004, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the year then ended. We also have audited management's

assessment included in the accompanying Management Report on Internal Control over Financial Reporting, that Banner Corporation maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Banner Corporation and subsidiaries' management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the Banner Corporation and subsidiaries' internal control over financial reporting based on our audit.

We conducted our audit in accordance with auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A Company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and Directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Banner Corporation and subsidiaries as of December 31, 2004, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that Banner Corporation and subsidiaries maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Furthermore, in our opinion, Banner Corporation and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/Moss Adams LLP

Moss Adams LLP



Spokane, Washington  
February 4, 2005

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REPORT OF INDEPENDENT REGISTERED  
PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
Banner Corporation and Subsidiaries  
Walla Walla, Washington

We have audited the accompanying consolidated statement of financial condition of Banner Corporation and subsidiaries (the Company) as of December 31, 2003, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial condition of the Company as of December 31, 2003, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

/s/Deloitte & Touche LLP

Deloitte & Touche LLP  
Seattle, Washington  
March 11, 2004

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BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION  
(in thousands, except shares)  
December 31, 2004 and 2003

	2004	2003
<b>ASSETS</b>		
Cash and due from banks	\$ 51,767	\$ 77,298
Securities available for sale, cost \$548,722 and \$670,033		
Encumbered	31,096	55,228
Unencumbered	516,739	619,714
	547,835	674,942
Securities held to maturity, fair value \$51,437 and \$28,402		
Encumbered	--	216
Unencumbered	49,914	27,016
	49,914	27,232
Federal Home Loan Bank stock	35,698	34,693
Loans receivable:		
Held for sale, fair value \$2,176 and \$16,199	2,145	15,912
Held for portfolio	2,090,703	1,711,013
Allowance for loan losses	(29,610 )	(26,060 )
	2,063,238	1,700,865
Accrued interest receivable	15,097	13,410
Real estate owned held for sale, net	1,485	2,967
Property and equipment, net	39,315	22,818
Goodwill and other intangibles, net	36,369	36,513

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Deferred income tax asset, net	5,888	1,941
Bank-owned life insurance	35,371	33,669
Other assets	15,090	8,965
	<u>          </u>	<u>          </u>
	\$ 2,897,067	\$ 2,635,313
<b>LIABILITIES</b>		
Deposits:		
Non-interest-bearing	\$ 234,761	\$ 205,656
Interest-bearing	1,691,148	1,465,284
	<u>          </u>	<u>          </u>
	1,925,909	1,670,940
Advances from Federal Home Loan Bank	583,558	612,552
Junior subordinated debentures	72,168	56,703
Other borrowings	68,116	69,444
Accrued expenses and other liabilities	25,027	18,444
Deferred compensation	5,208	4,252
Income taxes payable	1,861	178
	<u>          </u>	<u>          </u>
	2,681,847	2,432,513
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS' EQUITY</b>		
Common stock - \$0.01 par value, 27,500,000 shares authorized, 13,201,419 shares issued:		
11,856,889 shares and 11,473,331 shares outstanding at December 31, 2004 and 2003, respectively	127,460	123,375
Retained earnings	92,327	80,286
Accumulated other comprehensive income (loss):		
Unrealized gain (loss) on securities available for sale	(888 )	3,191
Unearned shares of common stock issued to Employee Stock Ownership Plan (ESOP) trust:		
374,595 and 434,299 restricted shares outstanding at December 31, 2004 and 2003, respectively, at cost	(3,096 )	(3,589 )
Carrying value of shares held in trust for stock related compensation plans	(6,135 )	(3,554 )
Liability for common stock issued to deferred, stock related, compensation plan	5,552	3,091
	<u>          </u>	<u>          </u>
	(583 )	(463 )
	<u>          </u>	<u>          </u>
	215,220	202,800
	<u>          </u>	<u>          </u>

\$ 2,897,067      \$ 2,635,313

See notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(in thousands except for per share data)  
For the Years Ended December 31, 2004, 2003 and 2002

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>INTEREST INCOME:</b>			
Loans receivable	\$ 126,992	\$ 116,211	\$ 123,352
Mortgage-backed securities	16,882	12,319	10,738
Securities and cash equivalents	12,356	11,911	10,186
	<u>156,230</u>	<u>140,441</u>	<u>144,276</u>
<b>INTEREST EXPENSE:</b>			
Deposits	35,067	34,984	39,206
Federal Home Loan Bank advances	20,336	21,842	24,094
Junior subordinated debentures	3,461	2,233	1,151
Other borrowings	1,051	789	1,518
	<u>59,915</u>	<u>59,848</u>	<u>65,969</u>
Net interest income before provision for loan losses	<u>96,315</u>	<u>80,593</u>	<u>78,307</u>
<b>PROVISION FOR LOAN LOSSES</b>	<u>5,644</u>	<u>7,300</u>	<u>21,000</u>
Net interest income	90,671	73,293	57,307
<b>OTHER OPERATING INCOME:</b>			

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Deposit fees and other service charges	8,132	7,224	5,804
Mortgage banking operations	5,522	9,447	6,695
Loan servicing fees	1,741	1,056	1,471
Gain on sale of securities	141	63	27
Miscellaneous	1,432	1,791	1,880
	<u>16,968</u>	<u>19,581</u>	<u>15,877</u>
Total other operating income			
OTHER OPERATING EXPENSES:			
Salary and employee benefits	52,331	47,032	38,262
Less capitalized loan origination costs	(7,008 )	(7,196 )	(5,780 )
Occupancy and equipment	11,100	9,575	8,522
Information/computer data services	4,212	3,532	3,331
Professional services	3,258	2,684	2,081
Advertising	4,905	3,373	2,220
Miscellaneous	10,916	10,876	11,809
	<u>79,714</u>	<u>69,876</u>	<u>60,445</u>
Total other operating expenses			
Income before provision for income taxes	27,925	22,998	12,739
PROVISION FOR INCOME TAXES	<u>8,585</u>	<u>6,891</u>	<u>3,479</u>
NET INCOME	\$ 19,340	\$ 16,107	\$ 9,260
Earnings per common share: see Note 25			
Basic	\$ 1.74	\$ 1.49	\$ 0.85
Diluted	\$ 1.65	\$ 1.44	\$ 0.82
Cumulative dividends declared per common share	\$ 0.65	\$ 0.61	\$ 0.60

See notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (in thousands)  
 For the Years Ended December 31, 2004, 2003 and 2002

	<u>2004</u>	<u>2003</u>	<u>2002</u>
NET INCOME	\$ 19,340	\$ 16,107	\$ 9,260
OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAXES:			
Unrealized holding gain (loss) during the period, net of deferred income tax (benefit) of \$(1,980), \$(138) and \$637	(3,987)	(256)	1,241
Less adjustment for gains included in net income, net of income tax of \$49, \$22 and \$10	<u>(92)</u>	<u>(41)</u>	<u>(17)</u>
Other comprehensive income (loss)	<u>(4,079)</u>	<u>(297)</u>	<u>1,224</u>
COMPREHENSIVE INCOME	\$ 15,261	\$ 15,810	\$ 10,484

See notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(in thousands)  
For the Years Ended December 31, 2004, 2003 and 2002

	Common Stock and Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned Restricted ESOP Shares	Carrying Value, Net of Liability, Of Shares Held in Trust for Stock-Related Compensation Plans	Stockholders' Equity
BALANCE, January 1, 2004	\$ 123,375	\$ 80,286	\$ 3,191	\$ (3,589 )	\$ (463 )	\$ 202,800
Net income		19,340				19,340
Change in valuation of securities available for sale, net of income taxes			(4,079 )			(4,079 )
Cash dividend on common stock (\$.65/share cumulative)		(7,299 )				(7,299 )
Purchase and retirement of common stock	(4,162 )					(4,162 )
Proceeds from issuance of common stock for exercise of stock options	6,728					6,728
Net issuance of stock through employees'	1,519			493	(270 )	1,742

stock plans, including  
tax benefit

Amortization of  
compensation related to  
MRP

	_____	_____	_____	_____	_____	_____
					150	150
BALANCE, December 31, 2004	\$ 127,460	\$ 92,327	\$ (888)	\$ (3,096)	\$ (583)	\$ 215,220

Continued

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BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(in thousands)  
For the Years Ended December 31, 2004, 2003 and 2002

	Common Stock and Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned Restricted ESOP Shares	Carrying Value, Net of Liability, Of Shares Held in Trust for Stock-Related Compensation Plans	Stockholders' Equity
	_____	_____	_____	_____	_____	_____
BALANCE, January 1, 2003	\$ 120,554	\$ 70,813	\$ 3,488	\$ (4,262)	\$ (216)	\$ 190,377
Net income		16,107				16,107



Change in valuation of securities available for sale, net of income taxes				(297 )			(297 )
Cash dividend on common stock (\$.61/share cumulative)			(6,634 )				(6,634 )
Purchase and retirement of common stock	(475 )						(475 )
Proceeds from issuance of common stock for exercise of stock options	1,955						1,955
Net issuance of stock through employees' stock plans, including tax benefit	1,341			673	(379 )		1,635
Amortization of compensation related to MRP						132	132
BALANCE, December 31, 2003	\$ 123,375	\$ 80,286	\$ 3,191	\$ (3,589 )	\$ (463 )	\$	202,800

Continued

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(in thousands)

For the Years Ended December 31, 2004, 2003 and 2002

	Common Stock and Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned Restricted ESOP Shares	Value, Net of Liability, Of Shares Held in Trust for Stock-Related Compensation Plans	Stockholders' Equity
BALANCE, January 1, 2002	\$ 126,844	\$ 68,104	\$ 2,264	\$ (4,769 )	\$ (103 )	\$ 192,340
Net income		9,260				9,260
Change in valuation of securities available for sale, net of income taxes			1,224			1,224
Cash dividend on common stock (\$.60/share cumulative)		(6,551 )				(6,551 )
Purchase and retirement of common stock	(8,391 )					(8,391 )
Proceeds from issuance of common stock for exercise of stock options	1,205					1,205
Net issuance of stock through employees' stock plans, including tax benefit	896			507	(155 )	1,248
Amortization of compensation related to MRP					42	42
	\$ 120,554	\$ 70,813	\$ 3,488	\$ (4,262 )	\$ (216 )	\$ 190,377

BALANCE, December 31,  
2002

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BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(continued) (in thousands)  
For the Years Ended December 31, 2004, 2003 and 2002

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>COMMON STOCK, SHARES ISSUED:</b>			
Number of shares, beginning of period	<u>13,201</u>	<u>13,201</u>	<u>13,201</u>
Number of shares, end of period	<u>13,201</u>	<u>13,201</u>	<u>13,201</u>
<b>LESS COMMON STOCK RETIRED:</b>			
Number of shares, beginning of period	(1,728 )	(1,894 )	(1,567 )
Purchase and retirement of common stock	(134 )	(24 )	(423 )
Issuance of common stock to deferred compensation plans and/or exercised stock options	<u>518</u>	<u>190</u>	<u>96</u>
Number of shares retired, end of period	<u>(1,344 )</u>	<u>(1,728 )</u>	<u>(1,894 )</u>
<b>SHARES OUTSTANDING, END OF PERIOD</b>	<b>11,857</b>	<b>11,473</b>	<b>11,307</b>
<b>UNEARNED, RESTRICTED ESOP SHARES:</b>			
Number of shares, beginning of period	(434 )	(516 )	(577 )

Release of earned shares	59	82	61
	<u>          </u>	<u>          </u>	<u>          </u>
Number of shares, end of period	(375 )	(434 )	(516 )

See notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)  
For the Years Ended December 31, 2004, 2003 and 2002

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>OPERATING ACTIVITIES:</b>			
Net income	\$ 19,340	\$ 16,107	\$ 9,260
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	4,515	6,308	3,798
Loss (gain) on sale of securities	(141 )	(63 )	(27 )
Increase in cash surrender value of bank owned life insurance	(1,702 )	(1,860 )	(1,505 )
Loss (gain) on sale of loans, excluding capitalized servicing rights	(5,444 )	(7,870 )	(5,649 )
Loss (gain) on disposal of real estate held for sale and property and equipment	(734 )	(50 )	920
Provision for losses on loans and real estate held for sale	5,835	7,698	21,000
FHLB stock dividend	(1,005 )	(1,862 )	(1,957 )

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Net change in:			
Loans held for sale	13,767	23,454	3,869
Other assets	(10,417 )	(3,104 )	4,000
Other liabilities	11,458	(5,177 )	7,698
	<hr/>	<hr/>	<hr/>
Net cash provided by operating activities	35,472	33,581	41,407
	<hr/>	<hr/>	<hr/>

INVESTING ACTIVITIES:

Purchases of available for sale securities	(177,129 )	(724,136 )	(354,218 )
Principal repayments and maturities of available for sale securities	231,982	416,247	230,675
Proceeds from sales of available for sale securities	49,421	49,287	4,670
Purchases of held to maturity securities	(10,237 )	(15,650 )	(1,006 )
Principal repayments and maturities of held to maturity securities	748	3,391	4,112
Origination of loans, net of principal repayments	(696,310 )	(721,473 )	(368,621 )
Purchases of loans and participating interest in loans	(18,207 )	(34,458 )	(51,999 )
Proceeds from sales of loans and participating interest in loans	338,412	572,231	457,671
Purchases of property and equipment-net	(20,446 )	(5,285 )	(5,452 )
Proceeds from sale of real estate held for sale-net	4,101	10,859	2,481
Investment in bank owned life insurance	--	--	(10,000 )
Cash (used for) provided by acquisitions	--	--	(6,519 )
Other	(180 )	(47 )	(336 )
	<hr/>	<hr/>	<hr/>
Net cash used by investing activities	(297,845 )	(449,034 )	(98,542 )
	<hr/>	<hr/>	<hr/>

FINANCING ACTIVITIES

Increase in deposits	254,969	173,162	168,468
Proceeds from FHLB advances	1,601,100	463,000	310,931
Repayment of FHLB advances	(1,630,094 )	(316,191 )	(347,170 )
Proceeds from issuance of junior subordinated debentures	15,000	15,000	38,723
Proceeds from issuance of repurchase agreement borrowings	--	51,917	2,082
Repayment of repurchase agreement borrowings	(22,289 )	(30,331 )	(31,447 )
Increase (decrease) in other borrowings, net	20,961	6,656	(6,849 )
Cash dividends paid	(7,113 )	(6,486 )	(6,479 )
Repurchases of stock, net of forfeitures	(4,162 )	(475 )	(8,391 )
ESOP shares earned	1,742	1,635	1,244
Exercise of stock options	6,728	1,954	1,205

Net cash provided by financing activities	236,842	359,841	122,317
NET INCREASE (DECREASE) IN CASH AND DUE FROM BANK	(25,531 )	(55,612 )	65,182
CASH AND DUE FROM BANKS, BEGINNING OF PERIOD	77,298	132,910	67,728
CASH AND DUE FROM BANKS, END OF PERIOD	\$ 51,767	\$ 77,298	\$ 132,910

(Continued on next page)

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BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
For the Years Ended December 31, 2004, 2003 and 2002  
(in thousands)  
(continued from prior page)

	2004	2003	2002
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Interest paid	\$ 60,154	\$ 60,200	\$ 67,372
Taxes paid	8,807	5,000	4,900
Non-cash transactions:			
Loans, net of discounts, specific loss allowances and unearned income transferred to real estate owned	1,985	7,733	6,442
Net change in accrued dividends payable	186	148	72
Stock issued to Rabbi Trust/MRP	148	380	155
Recognize tax benefit of vested MRP shares	148	--	4
Recognition of investment in trusts due to deconsolidation	--	1,703	--
Securities classified as available for sale reclassified held to maturity	15,334	--	--
Change in other assets/liabilities	1,664	52	1,488

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

Fair value of assets and intangibles acquired, including goodwill	\$	--	\$	--	\$	(44,544 )
Fair value of liabilities assumed		--		--		34,453
		<u>          </u>		<u>          </u>		<u>          </u>
Cash paid out in acquisition		--		--		(10,091 )
Less cash acquired		--		--		3,572
		<u>          </u>		<u>          </u>		<u>          </u>
Net cash (used for) provided by acquisitions	\$	--	\$	--	\$	(6,519 )

See notes to consolidated financial statements

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## BANNER CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

#### Nature of Business:

Banner Corporation (BANR or the Company) is a bank holding company incorporated in the State of Washington. The Company is primarily engaged in the business of planning, directing and coordinating the business activities for its wholly owned subsidiary, Banner Bank (BB or the Bank). The Bank is a Washington-chartered commercial bank the deposits of which are insured by the Federal Deposit Insurance Corporation (FDIC) under both the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). The Bank conducts business from its main office in Walla Walla, Washington, and, as of December 31, 2004, its 49 branch offices and 12 loan production offices located in 23 counties in Washington, Oregon and Idaho. The Company is subject to regulation by the Federal Reserve Board (FRB). The Bank is subject to regulation by the State of Washington Department of Financial Institutions, Division of Banks and the FDIC.

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

loan losses and the level of its other income, including deposit service charges, loan origination and servicing fees, and gains and losses on the sale of loans and securities, as well as its non-interest operating expenses and income tax provisions.

#### Principles of Consolidation:

The consolidated financial statements include the accounts of BANR and its wholly owned subsidiaries. All material intercompany transactions, profits and balances have been eliminated.

#### Use of Estimates:

The preparation of the financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect amounts reported in the financial statements. Various elements of the Company's accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, management has identified several accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of the Company's financial statements. These policies relate to the methodology for the determination of the allowance for loan and lease losses, the valuation of goodwill and other intangible assets, the valuation of mortgage servicing rights, and the valuation for real estate held for sale. Management believes that the judgments, estimates and assumptions used in the preparation of the Company's financial statements are appropriate given the factual circumstances at the time. However, given the sensitivity of the Company's financial statements to the critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in the Company's results of operation of financial condition.

*Securities:* Securities are classified as held to maturity when the Company has the ability and positive intent to hold them to maturity. Securities classified as available for sale are available for future liquidity requirements and may be sold prior to maturity. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Securities held to maturity are carried at cost, adjusted for amortization of premiums and accretion of discounts to maturity and, if appropriate, any other-than-temporary impairment losses. Securities available for sale are carried at fair value. Normally, unrealized gains and losses on securities available for sale are excluded from earnings and are reported net of tax as accumulated other comprehensive income, a component of stockholders' equity, until realized. Declines in the fair value of securities below their cost that are deemed to be other-than-temporary are recognized in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Realized gains and losses on sale are computed on the specific identification method and are included in operations on the trade date sold.

#### Investment in FHLB Stock:

The Company's investment in the stock of the Federal Home Loan Bank (FHLB) is carried at cost and is classified as restricted, as the Company can only sell stock back to the FHLB at par value or to other member banks. Dividends are included within interest income on securities and cash equivalents.

#### Loans Receivable:

The Bank originates mortgage loans for both portfolio investment and sale in the secondary market. At the time of origination, mortgage loans are designated as held for sale or held for investment. Loans held for sale are stated at lower of cost or estimated fair value determined on an aggregate basis. Net unrealized losses on loans held for sale are recognized through a valuation allowance by charges to income. The Bank also originates commercial, agricultural and consumer loans for portfolio investment. Loans receivable not designated as held for sale are recorded at the principal amount outstanding, net of allowance for loan losses, deferred fees, discounts and premiums. Premiums, discounts and deferred loan fees are amortized to maturity using the level-yield methodology.

Interest is accrued as earned unless management doubts the collectibility of the loan or the unpaid interest. Interest accruals are generally discontinued when loans become 90 days past due for interest. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. Future collection of interest is



included in interest income based upon an assessment of the likelihood that the loans will be repaid or recovered. A loan may be put on nonaccrual status sooner than this policy would dictate if, in management's judgment, the loan may be uncollectible. Such interest is then recognized as income only if it is ultimately collected.

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#### Allowance for Loan Losses:

The adequacy of general and specific reserves is based on management's continuing evaluation of the pertinent factors underlying the quality of the loan portfolio, including changes in the size and composition of the loan portfolio, delinquency rates, actual loan loss experience and current economic conditions, as well as individual review of certain large balance loans. Large groups of smaller-balance homogeneous loans are collectively evaluated for impairment. Loans that are collectively evaluated for impairment include residential real estate and consumer loans. Smaller balance non-homogeneous loans also may be evaluated collectively for impairment. Larger balance non-homogeneous residential construction and land, commercial real estate, commercial business loans and unsecured loans are individually evaluated for impairment. Loans are considered impaired when, based on current information and events, management determines that it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, the financial condition of the borrower, value of the underlying collateral and current status of the economy. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. Subsequent changes in the value of impaired loans are included within the provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the provision that would otherwise be reported.

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

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

#### Loan Origination and Commitment Fees:

Loan origination fees, net of certain specifically defined direct loan origination costs, are deferred and recognized as an adjustment of the loans' interest yield using the level-yield method over the contractual term of each loan adjusted for actual loan prepayment experience. Net deferred fees or costs related to loans held for sale are recognized in income at the time the loans are sold. Loan commitment fees are deferred until the expiration of the commitment period unless management believes there is a remote likelihood that the underlying commitment will be exercised,

in which case the fees are amortized to fee income using the straight-line method over the commitment period. If a loan commitment is exercised, the deferred commitment fee is accounted for in the same manner as a loan origination fee. Deferred commitment fees associated with expired commitments are recognized as fee income.

#### Real Estate Held for Sale:

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

#### Property and Equipment:

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

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

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

#### Goodwill and Other Intangible Assets:

Goodwill and other intangible assets represent the excess of purchase price over the fair value of net assets acquired by the Company. The excess cost over fair value of net assets acquired consists of goodwill and core deposit premiums. Prior to January 1, 2002, the Company's goodwill was being amortized using the straight-line method over 14 years. Other intangible assets are amortized over their estimated useful lives. As of January 1, 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, which eliminated the amortization of goodwill relating to past and future acquisitions. See further discussion in Note 21.

#### 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.

#### Derivative Instruments:

In June 1998 the Financial Accounting Standards Board (FASB) issued SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. The Company adopted SFAS No. 133 effective January 1, 2001. Derivatives include "off-balance-sheet" financial products, the value of which is dependent on the value of underlying financial assets, such as stock, bonds, foreign currency, or a reference rate or index. Such derivatives include "forwards," "futures," "options" or "swaps." The Company and the Bank generally have not invested in "off-balance-sheet" derivative instruments, although investment policies authorize such investments. However, as a part of mortgage banking activities, the Bank issues "rate lock" commitments to borrowers and obtains offsetting "best efforts" delivery commitments from purchasers of loans. While not providing any trading or net settlement mechanisms, these off-balance-sheet commitments do have many of the prescribed characteristics of derivatives and as a result are accounted for as such in accordance with SFAS No. 133, as amended. Accordingly, on December 31, 2004, the Company recorded in other assets an asset for \$50,000 related to rate locks issued and recorded in other liabilities a liability of \$50,000 related to rate locks received. These amounts represent the estimated market value of those commitments. On December 31, 2003, the Company and the Bank had no other investment related off-balance-sheet derivatives. The adoption of SFAS No. 133 did not have a material impact on the Company's consolidated results of operations, financial position or cash flows.

#### 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 Bank, (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 Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

#### Advertising Expenses:

Advertising costs are expensed as incurred. Costs related to production of advertising are considered incurred when the advertising is first used.

#### Income Taxes:

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

#### Stock Compensation Plans:

The Company loaned the Employees Stock Ownership Plan (ESOP) the funds necessary to fund the purchase of 8% of the Company's initial public offering of common stock. The loan to the ESOP will be repaid principally from the Company's contribution to the ESOP, and the collateral for the loan is the Company's common stock purchased by the ESOP. As the debt is repaid, shares are released from collateral based on the proportion of debt service paid in the year and allocated to participants' accounts. As shares are released from collateral, compensation expense is recorded equal to the average current market price of the shares, and the shares become outstanding for earnings-per-share calculations. Stock and cash dividends on allocated shares are recorded as a reduction of retained earnings and paid or distributed directly to participants' accounts. Stock and cash dividends on unallocated shares are recorded as a reduction of debt and accrued interest (see additional discussion in Note 16). The Company stock purchased for a Rabbi Trust obligation and the related liability for deferred compensation are recorded at acquisition cost.

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The Company measures its employee stock-based compensation arrangements under the provisions outlined in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Accordingly, no compensation cost has been recognized for its stock option plans. If the compensation cost for the Company's compensation plans had been determined consistent with SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended, the Company's net income available to diluted common stockholders and diluted earnings per common share would have been reduced to the pro forma amounts indicated below (in thousands except per share amounts):

	Years Ended December 31		
	2004	2003	2002
Net income attributable to common stock:			
Basic:			
As reported	\$ 19,340	\$ 16,107	\$ 9,260
Pro forma	18,499	14,995	8,357
Diluted:			
As reported	\$ 19,340	\$ 16,107	\$ 9,260
Pro forma	18,499	14,995	8,357
Net income per common share:			
Basic:			
As reported	\$ 1.74	\$ 1.49	\$ 0.85
Pro forma	1.66	1.38	0.76
Diluted:			
As reported	\$ 1.65	\$ 1.44	\$ 0.82
Pro forma	1.58	1.34	0.74

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

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

	Years Ended December 31		
	2004	2003	2002
Annual dividend yield	2.05 to 2.44 %	2.53 to 3.76 %	2.58 to 3.56 %

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Expected volatility	31.2 to 34.2 %	29.5 to 49.6 %	40.2 to 64.8 %
	2.72 to 4.78 %	2.94 to 4.44 %	2.63 to 5.21 %
Risk free interest rate			
Expected lives	5 to 9 yrs	5 to 9 yrs	5 to 9 yrs

Wholesale Repurchase Agreements:

The Company enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Company transfers legal control over the assets but still retains effective control through an agreement that both entitles and obligates the Company to repurchase the assets. As a result, repurchase agreements are accounted for as financing arrangements and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the Consolidated Statements of Financial Condition while the dollar amount of securities underlying the agreements remains in the respective asset accounts. Those securities are classified as encumbered. (See Note 13.)

Comprehensive Income:

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. In addition, certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the statement of financial condition, and such items, along with net income, are components of comprehensive income which is reported in the Consolidated Statements of Comprehensive Income.

Average Balances:

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

Reclassification:

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

**Note 2: RECENT DEVELOPMENTS AND SIGNIFICANT EVENTS**

In January 2003, the FASB issued Financial Interpretation No. (FIN) 46, *Consolidation of Certain Variable Interest Entities - An Interpretation of ARB No. 51*, to clarify when an entity should consolidate another entity known as a variable interest entity (VIE), more commonly referred to as a special purpose entity or SPE. A VIE is an entity in which equity investors do not have characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties, and may include many types of SPEs. FIN 46 requires an entity to consolidate a VIE if that enterprise has a variable interest that will absorb a majority of the VIE's expected losses if they occur, receive a majority of the VIE's expected residual returns if they occur, or both. FIN 46 was effective for newly created VIEs beginning February 1, 2003 and for existing VIEs as of the third quarter of 2003. Effective October 10, 2003, FASB deferred the effective date of FIN 46 from July 1, 2003 to the first interim period ending after December 15, 2003 for VIEs originated prior to February 1,

2003. The Company elected to adopt FIN 46 early, which resulted in the deconsolidation of the special purpose business trusts effective December 31, 2003. This increased the Bank's held-to-maturity investments and related borrowings by \$1.7 million as detailed below. Effective July 1, 2004 the \$1.7 million investment in VIE common stock was reclassified to other assets.

#### Junior Subordinated Debentures and Mandatorily Redeemable Trust Preferred Securities:

At December 31, 2003, three wholly-owned subsidiary grantor trusts, Banner Capital Trust I, II, and III (collectively, Trusts), established by the Company had issued \$55 million of pooled trust preferred securities. In addition, as noted below, in March 2004 the Company established a fourth wholly-owned subsidiary grantor trust called Banner Capital Trust IV to facilitate the issuance of an additional \$15 million of trust preferred securities. Trust preferred securities accrue and pay distributions periodically at specified annual rates as provided in the related indentures. The Trusts used the net proceeds from the offerings to purchase a like amount of junior subordinated debentures (Debentures) of the Company. The Debentures are the sole assets of the Trusts. The Company's obligations under the Debentures and related documents, taken together, constitute a full and unconditional guarantee by the Company of the obligations of the Trusts. The trust preferred securities are mandatorily redeemable upon the maturity of the Debentures, or may be redeemed earlier as provided in the indentures. The Company has the right to redeem the Debentures in whole (but not in part) on or after specific dates, at a redemption price specified in the indentures plus any accrued but unpaid interest to the redemption date.

Prior to adoption of FIN 46, the Trusts were considered consolidated subsidiaries of the Company. At December 31, 2002, \$40 million of trust preferred securities were included in the Company's Consolidated Statement of Financial Position in the liabilities section, under the caption, "Trust preferred securities," and the \$1.2 million common capital securities of the issuer retained by the Company were eliminated against the Company's investment in the Trusts. Distributions on these trust preferred securities were recorded as interest expense on the consolidated statements of income.

As a result of the adoption of FIN 46, the Company deconsolidated all three Trusts as of December 31, 2003. As a result, the Debentures issued by the Company to the Trusts, totaling \$56.7 million, were reflected in the Company's consolidated Statement of Financial Position in the liabilities section at December 31, 2003 under the caption, "Junior subordinated debentures." At September 30, 2004, Debentures totaling \$72.2 million were reflected in the Company's consolidated Statement of Financial Position, as discussed in more detail below. Beginning January 1, 2004, the Company has recorded interest expense for the corresponding junior subordinated debentures in its consolidated statements of income. The Company recorded \$1.7 million of the common capital securities issued by the Trusts in the securities held-to-maturity in its consolidated balance sheet at December 31, 2003. Effective July 1, 2004, the \$1.7 million investment in the Trusts' common capital securities was reclassified from securities held-to-maturity to other assets.

#### Sale of \$15 Million of Trust Preferred Securities:

In March 2004, the Company completed the issuance of an additional \$15.5 million of Debentures in connection with a private placement of pooled trust preferred securities called Banner Capital Trust IV. The trust preferred securities were issued by a special purpose business trust owned by the Company and sold to pooled investment vehicles sponsored and marketed by investment banking firms. The Debentures have been recorded as a liability on the statement of financial condition but, subject to limitations under current Federal Reserve guidelines, qualify as Tier 1 capital for regulatory capital purposes. The proceeds from this offering are being used primarily to support growth, including acquisitions, by augmenting the Bank's regulatory capital. Under the terms of the transaction, the trust preferred securities and Debentures have a maturity of 30 years and are redeemable after five years with certain exceptions. The holders of the trust preferred securities and Debentures are entitled to receive cumulative cash distributions at a variable annual rate. The interest rate is reset quarterly to equal three-month LIBOR plus 2.85%.

#### Note 3: ACCOUNTING STANDARDS RECENTLY ADOPTED OR ISSUED

In December 2004, the FASB issued Statement No. 123(Revised 2004), *Share-Based Payment*. This Statement replaces FASB Statement No. 123, *Accounting for Stock Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Statement No. 123(R) requires that the compensation cost relating to share-based payment transactions (for example, stock options granted to employees of the Company) be recognized in the Company's financial statements. That cost will be measured based on the fair value of the equity or liability

instruments used. Statement No. 123 (R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Public entities (other than those filing as small business issuers) will be required to apply Statement No. 123(R) as of the first interim or annual reporting period beginning after June 15, 2005. The Company plans to adopt the provisions of FASB Statement No. 123(R) effective July 1, 2005, and is in the process of evaluating the impact on its consolidated financial position or consolidated results of operations.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29*. Guidance under APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, is based on the principal that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. SFAS No. 153 amends Opinion No. 29 to eliminate the exception for nonmonetary

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exchanges of similar productive assets and replaces it with a general exemption for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange is considered to have commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The adoption of SFAS No. 153 is not expected to have any impact on the Company's current financial condition or results of operations.

In December 2003, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. The SOP addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities acquired in a transfer if those differences are attributable, at least in part to credit quality. The SOP does not apply to loans originated by the Company. Provisions of the SOP limit the yield that may be accreted to the excess of the investor's estimate at acquisition of expected cash flows to be collected over the investor's initial investment in the loan. Additionally, the SOP prohibits the recognition of this excess as an adjustment of yield, loss accrual or valuation allowance. Subsequent increases in cash flows expected to be collected are generally to be recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as impairment. The SOP prohibits "carrying over" or creation of valuation allowance in the initial accounting of all loans acquired in a transfer.

The SOP is effective for loans acquired in fiscal years beginning after December 15, 2004.

Note 4: CASH, DUE FROM BANKS AND CASH EQUIVALENTS

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

	December 31	
	2004	2003
Cash on hand and due from banks	\$ 51,720	\$ 74,654
Cash equivalents:		

Short-term cash investments	47	144
Federal funds sold	--	2,500
	<u>51,767</u>	<u>77,298</u>
	\$	\$

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

FRB regulations require depository institutions to maintain certain minimum reserve balances. Included in cash and demand deposits were reserves required by the FRB of \$6 million and \$35 million at December 31, 2004 and 2003, respectively.

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#### Note 5: SECURITIES AVAILABLE FOR SALE

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

	December 31, 2004				
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	Percent of Total
U.S. Government and agency obligations	\$ 142,192	\$ 30	\$ (2,350 )	\$ 139,872	25.53 %
Municipal bonds:					
Taxable	5,437	162	(34 )	5,565	1.02 %
Tax exempt	4,396	138	(8 )	4,526	0.83 %



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Total municipal bonds	9,833	300	(42 )	10,091	1.85 %
Corporate bonds	61,801	509	(317 )	61,993	11.32 %
Mortgage-backed or related securities:					
FHLMC certificates	63,993	77	(538 )	63,532	11.60 %
FHLMC collateralized mortgage obligations	42,087	115	(185 )	42,017	7.67 %
Total FHLMC mortgage-backed securities	106,080	192	(723 )	105,549	19.27 %
GNMA certificates	7,779	299	--	8,078	1.47 %
GNMA collateralized mortgage obligations	20,765	11	(2 )	20,774	3.79 %
Total GNMA mortgage-backed securities	28,544	310	(2 )	28,852	5.26 %
FNMA certificates	88,618	728	(379 )	88,967	16.24 %
FNMA collateralized mortgage obligations	49,429	15	(634 )	48,810	8.91 %
Total FNMA mortgage-backed securities	138,047	743	(1,013 )	137,777	25.15 %
Other mortgage-backed securities	8,000	--	(89 )	7,911	1.44 %
Other collateralized mortgage obligations	52,189	120	(456 )	51,853	9.46 %
Equity securities:					
FHLMC stock	1,023	1,764	--	2,787	0.51 %
FNMA stock	1,003	91	--	1,094	0.20 %
FARMERMAC stock	10	33	--	43	0.01 %
Miscellaneous equities	--	13	--	13	0.00 %
	\$ 548,722	\$ 4,105	\$ (4,992 )	\$ 547,835	100.00 %

Proceeds from sales of securities during the year ended December 31, 2004 were \$49,421,000. Gross gains of \$633,000 and gross losses of \$492,000 were realized on those sales.

## Note 5: SECURITIES AVAILABLE FOR SALE (continued)

December 31, 2003

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	Percent of Total
U.S. Government and agency obligations	\$ 163,365	\$ 203	\$ (2,227 )	\$ 161,341	23.90 %
Municipal bonds:					
Taxable	4,797	336	(1 )	5,132	0.76 %
Tax exempt	20,257	428	(97 )	20,588	3.05 %
Total municipal bonds	25,054	764	(98 )	25,720	3.81 %
Corporate bonds	68,926	1,187	(602 )	69,511	10.30 %
Mortgage-backed or related securities:					
FHLMC certificates	63,803	241	(261 )	63,783	9.45 %
FHLMC collateralized mortgage obligations	66,395	1,253	(87 )	67,561	10.01 %
Total FHLMC mortgage-backed securities	130,198	1,494	(348 )	131,344	19.46 %
GNMA certificates	13,678	408	--	14,086	2.09 %
GNMA collateralized mortgage obligations	32,885	532	--	33,417	4.95 %
Total GNMA mortgage-backed securities	46,563	940	--	47,503	7.04 %
FNMA certificates	81,826	1,076	(118 )	82,784	12.27 %
FNMA collateralized mortgage obligations	46,122	369	(28 )	46,463	6.88 %
Total FNMA mortgage-backed securities	127,948	1,445	(146 )	129,247	19.15 %
Other mortgage-backed securities	8,000	--	(32 )	7,968	1.18 %
Other collateralized mortgage obligations	97,941	783	(160 )	98,564	14.60 %
Equity securities:					

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FHLMC stock	1,025	1,555	--	2,580	0.38 %
FNMA stock	1,003	92	--	1,095	0.16 %
FARMERMAC stock	10	49	--	59	0.01 %
Miscellaneous equities	--	10	--	10	0.01 %
	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>
	\$ 670,033	\$ 8,522	\$ (3,613 )	\$ 674,942	100.00 %

Proceeds from sales of securities during the year ended December 31, 2003 were \$49,287,000. Gross gains of \$384,000 and gross losses of \$321,000 were realized on those sales.

Proceeds from sales of securities during the year ended December 31, 2002 were \$4,670,000. Gross gains of \$27,000 and no gross losses were realized on those sales.

At December 31, 2004 and 2003, the Company's investment portfolio did not contain any securities of an issuer (other than the U.S. Government, its agencies and U.S. Government sponsored entities) which had an aggregate book value in excess of 10% of the Company's stockholders' equity at that date.

At December 31, 2004, an aging of unrealized losses and fair value of related available-for-sale securities were as follows (in thousands):

	December 31, 2004					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U. S. Government and agency obligations	\$ 82,426	\$ (1,045 )	\$ 52,643	\$ (1,305 )	\$ 135,069	\$ (2,350 )
Municipal bonds	4,404	(42 )	--	--	4,404	(42 )
Corporate bonds	25,692	(317 )	--	--	25,692	(317 )
Mortgage-backed or related securities	204,633	(1,813 )	18,014	(470 )	222,647	(2,281 )
Equity securities	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>
	\$ 317,155	\$ (3,217 )	\$ 70,657	\$ (1,775 )	\$ 387,812	\$ (4,992 )

Management does not believe that any individual unrealized loss as of December 31, 2004 represents an other-than-temporary impairment. The decline in fair market value of these securities is generally due to changes in interest rates and changes in market-desired spreads subsequent to their purchase. There were 62 and 66 available for sale securities with unrealized losses at December 31, 2004 and 2003, respectively.

The amortized cost and estimated fair value of securities available for sale at December 31, 2004 and 2003, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2004		December 31, 2003	
	Amortized Cost	Estimated fair value	Amortized Cost	Estimated fair value
Due in one year or less	\$ 54,444	\$ 54,346	\$ 105,413	\$ 105,540
Due after one year through five years	158,851	156,853	166,187	164,996
Due after five years through ten years	88,165	87,775	111,825	112,377
Due after ten years	245,226	244,922	284,570	288,285
	<u>546,686</u>	<u>543,898</u>	<u>667,995</u>	<u>671,198</u>
Equity securities	<u>2,036</u>	<u>3,937</u>	<u>2,038</u>	<u>3,744</u>
	\$ 548,722	\$ 547,835	\$ 670,033	\$ 674,942

#### Note 6: SECURITIES HELD TO MATURITY

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

	December 31, 2004				Estimated fair value
	Percent of total	Amortized cost	Gross unrealized gains	Gross unrealized losses	
Mortgage-backed securities:					

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F H L M C	0.00 %	\$	--	\$	--	\$	--	\$	--
certificates:									
FNMA certificates	0.48 %		241		18		--		259
	<u>0.48 %</u>		<u>241</u>		<u>18</u>		<u>--</u>		<u>259</u>
	0.48 %		241		18		--		259
Municipal bonds:									
Taxable	3.30 %		1,647		23		--		1,670
Tax Exempt	80.69 %		40,276		566		(86 )		40,756
	<u>83.99 %</u>		<u>41,923</u>		<u>589</u>		<u>(86 )</u>		<u>42,426</u>
Corporate bonds	15.53 %		7,750		1,002		--		8,752
	<u>100.00 %</u>	\$	<u>49,914</u>	\$	<u>1,609</u>	\$	<u>(86 )</u>	\$	<u>51,437</u>

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Note 6: SECURITIES HELD TO MATURITY(continued)

December 31, 2003

	Percent of total	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value				
	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>				
Mortgage-backed securities:									
F H L M C	0.79 %	\$	216	\$	12	\$	--	\$	228
certificates:									
FNMA certificates	1.17 %		319		23		--		342

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	1.96 %	535	35	--	570
Municipal bonds:					
Taxable	0.38 %	104	8	--	112
Tax Exempt	65.70 %	17,890	136	(13 )	18,013
	66.08 %	17,994	144	(13 )	18,125
Corporate bonds	25.71 %	7,000	1,004	--	8,004
Common capital securities issued by unconsolidated financing subsidiary of the Company (1)	6.25 %	1,703	--	--	1,703
	100.00 %	\$ 27,232	\$ 1,183	\$ (13 )	\$ 28,402

(1) Effective July 1, 2004, these securities were reclassified to other assets for financial statement presentation purposes.

At December 31, 2004, an aging of unrealized losses and fair value of related held-to-maturity securities were as follows (in thousands):

	December 31, 2004					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Municipal bonds	\$ 6,961	\$ (63 )	\$ 6,978	\$ (23 )	\$ 13,939	\$ (86 )

Management does not believe that any individual unrealized loss as of December 31, 2004 represents an other-than-temporary impairment. The decline in fair market value of these securities is generally due to changes in interest rates and changes in market-desired spreads subsequent to their purchase. There were 22 and 8 held-to-maturity securities with unrealized losses at December 31, 2004 and 2003, respectively.

The amortized cost and estimated fair value of securities held to maturity at December 31, 2004 and 2003, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties.

December 31, 2004		December 31, 2003	
Amortized cost	Estimated fair value	Amortized cost	Estimated fair value

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Due in one year or less	\$ 154	\$ 156	\$ 1,703	\$ 1,703
Due after one year through five years	725	732	463	487
Due after five years through ten years	11,166	11,283	1,521	1,547
Due after ten years	37,869	39,266	23,545	24,665
	<u>\$ 49,914</u>	<u>\$ 51,437</u>	<u>\$ 27,232</u>	<u>\$ 28,402</u>

Note 7: ADDITIONAL INFORMATION REGARDING INTEREST INCOME FROM SECURITIES AND CASH EQUIVALENTS

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

	Years Ended December 31		
	2004	2003	2002
Taxable interest income	\$ 9,197	\$ 8,715	\$ 6,869
Tax-exempt interest income	1,861	1,222	1,274
Other stock - dividend income	118	111	83
FHLB stock - dividend income	1,180	1,863	1,960
Total income from securities and \$ cash equivalents	<u>12,356</u>	<u>\$ 11,911</u>	<u>\$ 10,186</u>

Note 8: LOANS RECEIVABLE

Loans receivable at December 31, 2004 and 2003 are summarized as follows (dollars in thousands) (includes loans held for sale):

December 31, 2004

December 31, 2003

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	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
<b>Loans:</b>				
Commercial real estate	\$ 547,574	26.16 %	\$ 455,964	26.40 %
Multifamily real estate	107,745	5.15	89,072	5.16
Construction and land	506,137	24.18	398,954	23.10
Commercial business	395,249	18.89	321,671	18.63
Agricultural business, including secured by farmland	148,343	7.09	118,903	6.89
One- to four-family real estate	307,986	14.71	275,197	15.94
Consumer	36,556	1.74	35,887	2.07
Consumer secured by one- to four family real estate	43,258	2.07	31,277	1.81
Total consumer	<u>79,814</u>	<u>3.81</u>	<u>67,164</u>	<u>3.88</u>
Total loans outstanding	2,092,848	100.00 %	1,726,925	100.00 %
Less allowance for loan losses	<u>(29,610 )</u>		<u>(26,060 )</u>	
Total net loans at end of \$ period	2,063,238		\$ 1,700,865	

Loan amounts are net of unearned, unamortized loan fees of \$8,882,000 and \$6,754,000 at December 31, 2004 and 2003, respectively.

Loans receivable includes \$472,000 and \$421,000 of loans at December 31, 2004 and 2003, respectively, that were more than 90 days delinquent and still on accrual of interest.

Loans serviced for others totaled \$250,707,000 and \$278,185,000 at December 31, 2004 and 2003, respectively. Custodial accounts maintained in connection with this servicing totaled \$2,569,000 and \$3,840,000 at December 31, 2004 and 2003, respectively.

The Company's outstanding loan commitments totaled \$633,430,000 and \$546,319,000 at December 31, 2004 and 2003, respectively. In addition, the Company had outstanding commitments to sell loans of \$33,226,000 and \$33,565,000 at December 31, 2004 and 2003, respectively.

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



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The Company's loans by geographic concentration at December 31, 2004 were as follows (in thousands):

	<u>Washington</u>	<u>Oregon</u>	<u>Idaho</u>	<u>Other</u>	<u>Total</u>
Loans:					
Commercial real estate	\$ 377,685	\$ 118,941	\$ 23,571	\$ 27,377	\$ 547,574
Multifamily real estate	86,499	10,774	1,574	8,898	107,745
Construction and land	228,721	249,665	10,823	16,928	506,137
Commercial business	288,163	44,075	56,070	6,941	395,249
Agricultural business, including secured by farmland	50,810	67,411	29,667	455	148,343
One-to four-family real estate	266,982	29,491	4,104	7,409	307,986
Consumer	21,528	12,750	1,254	1,024	36,556
Consumer secured by one- to four-family real estate	34,917	6,356	1,840	145	43,258
	<u>56,445</u>	<u>19,106</u>	<u>3,094</u>	<u>1,169</u>	<u>79,814</u>
Total consumer	<u>\$ 1,355,329</u>	<u>\$ 539,463</u>	<u>\$ 128,903</u>	<u>\$ 69,177</u>	<u>\$ 2,092,848</u>

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The Company's loans to directors and officers are on substantially the same terms and underwriting as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than normal risk of collectability. Such loans had the following balances and activity during 2004 and 2003 (dollars in thousands):

	<u>Years Ended December 31</u>	
	<u>2004</u>	<u>2003</u>
Balance at beginning of year	\$ 8,626	\$ 7,387
New loans or advances	14,165	15,384
Repayments and adjustments	(10,756 )	(10,419 )
Charge-offs	--	--
Net change due to addition/retirement of Directors/Officers	<u>38</u>	<u>(3,726 )</u>

Balance, end of period \$ 12,073 \$ 8,626

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

	December 31, 2004		December 31, 2003	
	Loan amount	Allocated reserves	Loan amount	Allocated reserves
Impaired loans:				
Non-accrual	\$ 15,416	\$ 3,603	\$ 28,010	\$ 4,328
Accrual	--	--	--	--
	<u>\$ 15,416</u>	<u>\$ 3,603</u>	<u>\$ 28,010</u>	<u>\$ 4,328</u>

As of December 31, 2004, the Company was committed to advance \$438,000 in funds on its impaired loans.

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

	Years Ended December 31		
	2004	2003	2002
Average balance of impaired loans	\$ 21,578	\$ 28,812	\$ 23,334
Interest income recognized	--	--	--

For the years ended December 31, 2004, 2003 and 2002, additional interest income of \$772,000, \$2,852,000 and \$1,842,000, respectively, would have been recorded had non-accrual loans been current.

The Company originates both adjustable- and fixed-rate loans. At December 31, 2004 and 2003, the maturity and repricing composition of those loans, less undisbursed amounts and deferred fees, were as follows (in thousands):

December 31

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	2004	2003
	<u>                    </u>	<u>                    </u>
Fixed-rate (term to maturity):		
Due in one year or less	\$ 83,475	\$ 98,799
Due after one year through three years	77,530	71,593
Due after three years through five years	141,554	115,633
Due after five years through ten years	102,333	2,583
Due after ten years	251,621	378,248
	<u>                    </u>	<u>                    </u>
	\$ 656,513	\$ 666,856
	<u>                    </u>	<u>                    </u>
Adjustable-rate (term to rate adjustment):		
Due in one year or less	\$ 1,003,943	\$ 799,027
Due after one year through three years	128,068	85,330
Due after three years through five years	290,860	164,124
Due after five years through ten years	13,135	323
Due after ten years	329	11,265
	<u>                    </u>	<u>                    </u>
	1,436,335	1,060,069
	<u>                    </u>	<u>                    </u>
	\$ 2,092,848	\$ 1,726,925

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

The Bank has invested, as of December 31, 2004, \$446,000 in three limited partnerships, Homestead Equity Fund II, III and IV (HEF), that develop low income housing projects. The Bank's partnership interests commit it to invest up to \$9,000,000 in the partnership. In connection with HEF II's initial development of a project, the Bank has made a commercial loan to the partnership that has an outstanding balance of \$5,029,000 at December 31, 2004. The Bank is committed on this loan to advance up to \$6,930,000. The loan is secured by notes from the limited partners, which includes the Bank, to make capital contributions to the partnership.

Note 9: ALLOWANCE FOR LOAN LOSSES

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

	Years Ended December 31		
	2004	2003	2002
Balance, beginning of period	\$ 26,060	\$ 26,539	\$ 17,552
Allowance added through business combinations	--		460
Sale of credit card portfolio	--		--
Provision	5,644	7,300	21,000
Recoveries of loans previously charged off:			
Secured by real estate:			
One- to four-family	3	14	--
Commercial	519	--	--
Multifamily	--	--	--
Construction and Land	14	80	39
Commercial business	986	924	209
Agricultural business	15	13	3
Consumer	50	44	74
	<u>1,587</u>	<u>1,075</u>	<u>325</u>
Loans charged off:			
Secured by real estate:			
One- to four-family	(100 )	(357 )	(102 )
Commercial	(1,313 )	(2,289 )	(103 )
Multifamily	--	--	--
Construction and land	(347 )	(986 )	(1,129 )
Commercial business	(1,518 )	(4,496 )	(10,643 )
Agricultural business	(41 )	(214 )	(157 )
Consumer	(362 )	(512 )	(664 )
	<u>(3,681 )</u>	<u>(8,854 )</u>	<u>(12,798 )</u>
Net charge-offs	<u>(2,094 )</u>	<u>(7,779 )</u>	<u>(12,473 )</u>
Balance, end of period	\$ 29,610	\$ 26,060	\$ 26,539

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Ratio of allowance to net loans before allowance for loan losses	1.41 %	1.51 %	1.69 %
Ratio of net loan charge-offs to the average net book value of loans outstanding during the period	0.11 %	0.47 %	0.78 %

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

	December 31		
	2004	2003	2002
Specific or allocated loss allowance:			
Secured by real estate:			
One- to four-family	\$ 782	\$ 749	\$ 670
Commercial	5,046	5,058	5,284
Multifamily	539	445	361
Construction and land	5,556	5,207	5,892
Commercial business	9,226	8,161	8,788
Agricultural business	3,628	3,194	2,164
Consumer	464	482	698
Total allocated	25,241	23,296	23,857
Unallocated	4,369	2,764	2,682
Total allowance for loan losses	\$ 29,610	\$ 26,060	\$ 26,539
Ratio of allowance for loan losses to non-performing loans	186 %	92 %	74 %

Note 10: PROPERTY AND EQUIPMENT

Land, buildings and equipment owned by the Company and its subsidiaries at December 31, 2004 and 2003 are summarized as follows (in thousands):

	December 31	
	2004	2003

Buildings and leasehold improvements	\$	33,796	\$	23,795
Furniture and equipment		28,187		21,782
		<u>61,983</u>		<u>45,577</u>
Less accumulated depreciation		<u>(28,424 )</u>		<u>(25,746 )</u>
		33,559		19,831
Land		<u>5,756</u>		<u>2,987</u>
	\$	39,315	\$	22,818

The Bank's depreciation expense related to property and equipment was \$3,948,000, \$3,220,000 and \$3,085,000 for the years ended December 31, 2004, 2003 and 2002, respectively.

The Bank's rental expense was as follows: 2004, \$3,315,000; 2003, \$2,793,000 and 2002, \$2,068,000.

The Bank's obligation under long-term property leases over the next five years is as follows: 2005, \$3,150,000; 2006, \$2,755,000; 2007, \$2,218,000; 2008, \$1,471,000; 2009, \$1,139,000; and thereafter, \$2,759,000.

At December 31, 2004, the Company had entered into various contractual obligations, generally related to the construction or remodel of various premises. Total commitments related to those contractual obligations were \$1.6 million, with \$695,000 remaining unpaid against those commitments at year end.

#### Note 11: DEPOSITS

Deposits consist of the following at December 31, 2004 and 2003 (dollars in thousands):

December 31 2004	Percent of	December 31 2003	Percent of
---------------------	---------------	---------------------	---------------

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		Total		Total
Demand, NOW and money market accounts, including non-interest-bearing deposits at December 31, 2004 and 2003 of \$234,761 and \$205,656, respectively, 0% to 4%	\$ 714,802	37.12 %	\$ 642,125	38.43 %
Regular savings, 0% to 1%	155,931	8.10	47,792	2.86
Certificate accounts:				
0.00% to 2.00%	293,516	15.24	485,971	29.08
2.01% to 4.00%	587,069	30.48	338,373	20.25
4.01% to 6.00%	151,007	7.84	128,464	7.69
6.01% to 8.25%	23,584	1.22	28,215	1.69
	1,055,176	54.78	981,023	58.71
	\$ 1,925,909	100.00 %	\$ 1,670,940	100.00 %

Deposits at December 31, 2004 and 2003 included public funds of \$144,682,000 and \$152,035,000, respectively. Securities with a carrying value of \$22,947,000 and \$33,222,000 were pledged as collateral on these deposits at December 31, 2004 and 2003, respectively, which exceeded the minimum collateral requirements established by state regulations.

Deposits at December 31, 2004 and 2003 included deposits from directors and executive officers of the Company and entities related to the directors and executive officers totaling \$4,376,000 and \$3,360,000, respectively.

Scheduled maturities of certificate accounts at December 31, 2004 and 2003 are as follows (in thousands):

	December 31	
	2004	2003
Due in one year or less	\$ 664,375	\$ 671,894
Due after one year through two years	194,160	124,796
Due after two years through three years	128,214	93,758
Due after three years through four years	31,802	58,307
Due after four years through five years	21,296	16,761
Due after five years	15,329	15,507
	\$ 1,055,176	\$ 981,023

Included in deposits are deposit accounts in excess of \$100,000 of \$611,524,000 and \$546,656,000 at December 31, 2004 and 2003, respectively. Interest on deposit accounts in excess of \$100,000 totaled \$15,543,000 for the year ended December 31, 2004 and \$15,090,000 for the year ended December 31, 2003.

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

	Years Ended December 31		
	2004	2003	2002
Beginning balance	\$ 1,670,940	\$ 1,497,778	\$ 1,295,811
Acquisitions, at book value	--	--	33,151
Net increase (decrease) before interest credited	219,902	138,178	129,610
Interest credited	35,067	34,984	39,206
Net increase in deposits	254,969	173,682	201,967
Ending balance	\$ 1,925,909	\$ 1,670,940	\$ 1,497,778

Deposit interest expense by type for the years ended December 31, 2004, 2003 and 2002 was as follows (in thousands):

	Years Ended December 31		
	2004	2003	2002



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Certificates	\$	27,339	\$	29,384	\$	34,263
Demand, NOW and money market accounts		6,755		5,099		4,470
Regular savings		973		501		473
	\$	35,067	\$	34,984	\$	39,206

Note 12: ADVANCES FROM FEDERAL HOME LOAN BANK OF SEATTLE

The Bank has entered into borrowing arrangements with the FHLB to borrow funds under a short-term floating rate cash management advance program and fixed-term loan agreements. All borrowings are secured by stock of, and cash held by, the FHLB. Additionally, specific securities with a carrying value of \$292,151,000 at December 31, 2004 are pledged as security for the loans along with a blanket pledge of qualifying loans receivable. At December 31, 2004, FHLB advances were scheduled to mature as follows; however, certain advances totaling \$137,000,000 and due after one year have provisions for early termination exercisable at the discretion of the FHLB (dollars in thousands):

	Adjustable-rate advances		Fixed-rate advances		Total advances	
	Rate*	Amount	Rate*	Amount	Rate*	Amount
Due in one year or less	2.35 %	\$ 62,100	3.15 %	\$ 305,600	3.01 %	\$ 367,700
Due after one year through two years	--	--	4.35	55,000	4.35	55,000
Due after two years through three years	--	--	3.48	21,930	3.48	21,930
Due after three years through four years	--	--	4.62	44,000	4.62	44,000
Due after four years through five years	--	--	6.23	18,100	6.23	18,100
Due after five years	--	--	6.05	76,828	6.05	76,828
	2.35 %	\$ 62,100	3.94 %	\$ 521,458	3.77 %	\$ 583,558

\* Weighted average interest rate

The maximum and average outstanding balances and average interest rates on advances from the FHLB were as follows for the years ended December 31, 2004, 2003 and 2002 (dollars in thousands):

Years Ended December 31		
2004	2003	2002

Maximum outstanding at any month end	\$	612,358	\$	612,552	\$	465,743
Average outstanding		568,908		513,819		451,816
Weighted average interest rates:						
Annual		3.57 %		4.25 %		5.33 %
End of period		3.77 %		3.39 %		4.80 %
Interest expense during the period	\$	20,336	\$	21,842	\$	24,094

As of December 31, 2004, the Bank has established a borrowing line with the FHLB to borrow up to the lesser of 35% of its total assets or the total blanket pool of unpledged eligible collateral which would give it a maximum total credit line of \$870,227,000 at December 31, 2004.

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### Note 13: OTHER BORROWINGS

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

#### Retail Repurchase Agreements:

At December 31, 2004, retail repurchase agreements carry interest rates ranging from 0.75% to 5.00%, payable at maturity, and are secured by the pledge of certain mortgage-backed and agency securities with a carrying value of \$41,467,000. The Bank has the right to pledge or sell these securities, but they must replace them with substantially the same security.

A summary of retail repurchase agreements at December 31, 2004 and 2003 by the period remaining to maturity is as follows (dollars in thousands):

	December 31			
	2004		2003	
	Weighted average rate	Balance	Weighted average rate	Balance
Retail repurchase agreements:				
Due in one year or less	1.45 %	\$ 37,682	1.82 %	\$ 16,740
Due after one year through two years	1.71	248	4.04	173
Due after two years through three years	--	--	--	--
Due after five years	5.00	428	4.61	483

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1.49 %    \$            38,358                      1.92 %            \$            17,396

The maximum and average outstanding balances and average interest rates on retail repurchase agreements and other short-term borrowings, such as Fed Funds, were as follows for the years ended December 31, 2004, 2003 and 2002, respectively (dollars in thousands):

	Years Ended December 31		
	2004	2003	2002
Maximum outstanding at any month end	\$ 47,124	\$ 26,357	\$ 19,146
Average outstanding	32,789	16,313	14,741
Weighted average interest rates:			
Annual	1.46 %	2.11 %	3.74 %
End of period	1.49 %	1.92 %	3.17 %
Interest expense during the period	\$ 478	\$ 344	\$ 552

Wholesale Repurchase Agreements:

The table below outlines the wholesale repurchase agreements as of December 31, 2004 and 2003. The agreements to repurchase are secured by mortgage-backed securities with a carrying value of \$31,096,000 at December 31, 2004. The broker holds the security while the Bank continues to receive the principal and interest payments from the security. Upon maturity of the agreement, the pledged securities will be returned to the Bank.

A summary of wholesale repurchase agreements at December 31, 2004 and 2003 by the period remaining to maturity is as follows (dollars in thousands):

	December 31			
	2004		2003	
	Weighted average rate	Balance	Weighted average rate	Balance
Wholesale repurchase agreements:				
Due in one year or less	2.38 %	\$ 29,758	1.16 %	\$ 52,047

The maximum and average outstanding balances and average interest rates on wholesale repurchase agreements were as follows for the years ended December 31, 2004, 2003 and 2002 (dollars in thousands):

	Years Ended December 31		
	2004	2003	2002

Maximum outstanding at any month end	\$	50,967	\$	52,047	\$	60,604
Average outstanding		40,127		35,402		51,837
Weighted average interest rates:						
Annual		1.43 %		1.26 %		1.86 %
End of period		2.38 %		1.16 %		1.43 %
Interest expense during the period	\$	573	\$	445	\$	966

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### Junior Subordinated Debentures and Mandatorily Redeemable Trust Preferred Securities:

At December 31, 2004, four wholly-owned subsidiary grantor trusts, Banner Capital Trust I, II, III and IV (BCT I, II, III and IV), established by the Company had issued \$70 million of pooled trust preferred securities as well as \$2.168 million of common capital securities which were issued to the Company. Trust preferred securities and common capital securities accrue and pay distributions periodically at specified annual rates as provided in the indentures. The trusts used the net proceeds from the offerings to purchase a like amount of junior subordinated debentures (the "Debentures") of the Company. The Debentures are the sole assets of the trusts. The Company's obligations under the debentures and related documents, taken together, constitute a full and unconditional guarantee by the Company of the obligations of the trusts. The trust preferred securities are mandatorily redeemable upon the maturity of the Debentures, or upon earlier redemption as provided in the indentures. The Company has the right to redeem the Debentures in whole on or after specific dates, at a redemption price specified in the indentures plus any accrued but unpaid interest to the redemption date.

BCT I, the initial issue of \$25 million, has a current interest rate of 6.00%, which is reset semi-annually to equal six-month LIBOR plus 3.70%. BCT II, the second issue, for \$15 million, has a current interest rate of 5.42%, which is reset quarterly to equal three-month LIBOR plus 3.35%. BCT III, the third issue, also for \$15 million, has a current interest rate 4.97, which is reset quarterly to equal three-month LIBOR plus 2.90%. BCT IV, the fourth issue, also for \$15 million has a current interest rate of 4.92% which is reset quarterly to equal three-month LIBOR plus 2.85%.

The following tables are a summary of current trust preferred securities at December 31, 2004 and 2003 (dollars in thousands):

December 31, 2004

Name of Trust	Aggregate Liquidation Amount of Trust Preferred Securities	Aggregate Liquidation Amount of Common Capital Securities	Aggregate Principal Amount of Junior Subordinated Debentures	Stated Maturity	Per Annum Interest Rate	Extension Period	Redemption Option
Banner Capital Trust I	\$ 25,000	\$ 774	\$ 25,774	2032	6.000 %	Ten Consecutive Annual Periods	On or after April 22, 2007
Banner Capital Trust	15,000	464	15,464	2033	5.420	20 Consecutive	On or after

II						Quarters	January 7, 2008
Banner Capital Trust III	15,000	465	15,465	2033	4.970	20 Consecutive Quarters	On or after October 8, 2008
Banner Capital Trust IV	<u>15,000</u>	<u>465</u>	<u>15,465</u>	2034	4.920	20 Consecutive Quarters	On or after October 8, 2008
Total TPS Liability	\$ 70,000	\$ 2,168	\$ 72,168		5.424 %		

The following table is a summary of current trust preferred securities at December 31, 2003 (dollars in thousands):

December 31, 2003

Name of Trust	Aggregate Liquidation Amount of Trust Preferred Securities	Aggregate Liquidation Amount of Common Capital Securities	Aggregate Principal Amount of Junior Subordinated Debentures	Stated Maturity	Per Annum Interest Rate	Extension Period	Redemption Option
Banner Capital Trust I	\$ 25,000	\$ 774	\$ 25,774	2032	4.920 %	Ten Consecutive Annual Periods	On or after April 22, 2007
Banner Capital Trust II	15,000	464	15,464	2033	4.500	20 Consecutive Quarters	On or after January 7, 2008
Banner Capital Trust III	<u>15,000</u>	<u>465</u>	<u>15,465</u>	2033	4.040	20 Consecutive Quarters	On or after October 8, 2008
Total TPS Liability	\$ 55,000	\$ 1,703	\$ 56,703		4.565 %		

#### Additional Credit Line:

The Bank also has established a \$26,000,000 Fed Funds credit line with a correspondent bank that will expire in July 2005. There were no balances outstanding under this credit line at December 31, 2004 and 2003.

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## Note 14: INCOME TAXES

Provisions of the Small Business Job Protection Act of 1996 (the Job Protection Act) significantly altered the Company's tax bad debt deduction method and the circumstances that would require a tax bad debt reserve recapture. Prior to enactment of the Job Protection Act, savings institutions were permitted to compute their tax bad debt deduction through use of either the reserve method or the percentage of taxable income method. The Job Protection Act repealed both of these methods for large savings institutions and allows bad debt deductions based only on actual current losses. While repealing the reserve method for computing tax bad debt deductions, the Job Protection Act allows savings institutions to retain their existing base year bad debt reserves but requires that reserves in excess of the balance at December 31, 1987, be recaptured into taxable income over six years. As of December 31, 2003, the reserve in excess of the base year (December 31, 1987) had been fully recaptured into taxable income.

The base year reserve is recaptured into taxable income only in limited situations, such as in the event of certain excess distributions, complete liquidation or disqualification as a bank. None of the limited circumstances requiring recapture are contemplated by the Company. The amount of the Company's tax bad debt reserves subject to recapture in these circumstances approximates \$5,318,000 at December 31, 2004. Due to the remote nature of events that may trigger the recapture provisions, no tax liability has been established in the accompanying Consolidated Financial Statements.

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

The provision for income taxes for the years ended December 31, 2004, 2003, and 2002 differs from that computed at the statutory corporate tax rate as follows (in thousands):

	Years Ended December 31		
	2004	2003	2002
Taxes at statutory rate	\$ 9,774	\$ 8,049	\$ 4,459
Increase (decrease) in taxes:			
Tax-exempt interest	(622 )	(429 )	(485 )
Investment in life insurance	(585 )	(626 )	(521 )
Fair market value vs. basis of ESOP shares released	368	233	147
	254	223	108

State income taxes net of federal tax benefit				
Tax credits		(388 )	(243 )	--
Other		(216 )	(316 )	(229 )
		<u>          </u>	<u>          </u>	<u>          </u>
Provision for income taxes	\$	8,585	\$ 6,891	\$ 3,479

The provision for income tax expense for the years ended December 31, 2004, 2003 and 2002 is composed of the following (in thousands):

		Years Ended December 31		
		<u>2004</u>	<u>2003</u>	<u>2002</u>
Current	\$	10,503	\$ 5,886	\$ 5,326
Deferred		(1,918 )	1,005	(1,847 )
	\$	<u>8,585</u>	\$ <u>6,891</u>	\$ <u>3,479</u>

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Income taxes are provided for the temporary differences between the tax basis and financial statement carrying amounts of assets and liabilities. Components of the Company's net deferred tax assets (liabilities) at December 31, 2004 and 2003 consisted of the following (in thousands):

		December 31	
		<u>2004</u>	<u>2003</u>
Deferred tax assets:			
Loan loss reserves per books	\$	10,441	\$ 9,188
Deferred compensation and vacation		2,887	2,421

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Book vs. tax amortization of intangibles	215	173
Book vs. tax amortization of loan acquisition premiums	236	185
Deferred servicing rights	12	16
Other	507	26
	<u>14,298</u>	<u>12,009</u>
Deferred tax liabilities:		
Change in method of accounting for amortization of premium and discount on investments	15	24
FHLB stock dividends	5,798	5,446
Depreciation	2,186	1,277
Deferred loan fees and servicing rights	548	692
Book vs. tax amortization of deposit acquisition premium	163	153
Other	11	758
	<u>8,721</u>	<u>8,350</u>
	5,577	3,659
Income tax benefit related to unrealized gain/loss on securities available for sale	311	(1,718 )
	<u>5,888</u>	<u>1,941</u>
Deferred tax asset (liability), net	\$ 5,888	\$ 1,941

Management has evaluated the weight of available evidence and concluded that it is more likely than not that the Company will realize the net deferred tax asset in future years.

Note 15: EMPLOYEE BENEFIT PLANS

The Bank has its own profit sharing plan for all eligible employees. The plan is funded annually at the discretion of the Board of Directors. Contributions charged to operations for the years ended December 31, 2004, 2003 and 2002 were \$796,000, \$716,000 and \$571,000, respectively.

The Bank has entered into a salary continuation agreement with certain members of its senior management. This program was funded by purchasing single premium life insurance contracts. The program provides for aggregate continued annual compensation for all participants totaling \$221,000 for life with a 15-year guarantee. Participants vest ratably each plan year until retirement, termination, death or disability. The Bank is recording the salary continuation obligation over the estimated remaining service lives of the participants. Expenses related to this program for the years ended December 31, 2004, 2003 and 2002 were \$191,000, \$181,000 and \$175,500, respectively. The plan's projected benefit obligation is \$2,145,000, of which \$1,555,100 was vested at December 31, 2004. At December 31, 2004, an accumulated benefit obligation of \$1,555,100 and cash value of life insurance of \$2,998,100 were recorded. At December 31, 2003, an obligation of \$1,409,600 and cash value of life insurance of \$2,900,200 were recorded. Increases in cash surrender value and related net earnings from the life insurance contracts partially



offset the expenses of this program.

The Bank also has a non-qualified, non-contributory retirement compensation plan for certain employees whose benefits are based upon a percentage of defined participant compensation. Expenses related to the plan included in the years ended December 31, 2004, 2003 and 2002 results of operations were \$48,000, \$65,000 and \$45,000, respectively. The recorded liability under this plan was \$846,100 and \$869,800 on December 31, 2004 and 2003, respectively. The Bank is carrying life insurance on these employees to partially offset the cost of the plan. The policies had recorded cash surrender values of \$568,000 and \$471,000 at December 31, 2004 and 2003, respectively.

The Company and the Bank also offer non-qualified deferred compensation plans to members of their Boards of Directors and certain employees. The plans permit each participant to defer a portion of director fees, non-qualified retirement contributions, salary or bonuses until the future. Compensation is charged to expense in the period earned. In order to fund the plans' future obligations the Company has purchased life insurance policies, contributed to money market investments and purchased common stock of the Company which are held in a "Rabbi Trust." As the Company is the owner of the investments and beneficiary of life insurance contracts, and in order to reflect the Company's policy to pay benefits equal to accumulations, the assets and liabilities under the plans are reflected in the consolidated balance sheets of the Company. Common stock of the Company held for such plans is reported as a contra-equity account and was recorded at original cost of \$5,552,000 at December 31, 2004 and \$3,091,000 at December 31, 2003. The money market investments and cash surrender value of the life insurance policies are included in other assets.

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During the year ended December 31, 2001, the Company adopted a Supplemental Executive Retirement Program (SERP) for selected senior executives. At termination of employment at or after attaining age 62 with at least 15 years of service or age 65, an executive's annual benefit under the SERP would be computed as the product of 3% of the executive's final average compensation (defined as the three calendar years of executive's annual cash compensation, including bonuses, which produce the highest average within the executive's final eight full calendar years of employment) and the executive's annual years of service, reduced by certain amounts, such as the amount payable to the executive under the Company's 401(k) profit sharing plan and its ESOP, employer-contributed deferred compensation, and any amount payable to the executive under the salary continuation agreements described above. The maximum benefit would be 60% of final average compensation, less applicable reductions. A reduced benefit is payable at termination of employment at or after attaining age 59 1/2 with at least 15 years of service. Expenses relating to this SERP totaled \$660,000, \$600,000 and \$510,000 for the years ended December 31, 2004, 2003 and 2002, respectively. The recorded liability relating to this SERP was \$1,950,000 and \$1,290,000 at December 31, 2004 and December 31, 2003, respectively.

#### Note 16: EMPLOYEE STOCK OWNERSHIP PLAN AND TRUST

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

The ESOP borrowed \$8,728,500 from the Company in order to purchase the common stock. The loan will be repaid principally from the Company's contributions to the ESOP over a period not to exceed 25 years, and the collateral for

the loan is the unreleased, restricted common stock purchased by the ESOP. Contributions to the ESOP are discretionary; however, the Company intends to make annual contributions to the ESOP in an aggregate amount at least equal to the principal and interest requirements of the debt. The interest rate for the loan is 8.75%. Shares are released to participants for allocation based on the cumulative debt service paid to the Company by the ESOP divided by cumulative debt service paid to date plus the scheduled debt service remaining. Dividends on allocated shares are distributed to the participants as additional earnings. Dividends on unallocated shares are used to reduce the Company's contribution to the ESOP.

Participants generally become 100% vested in their ESOP account after seven years of credited service or if their service was terminated due to death, early retirement, permanent disability or a change in control of the Company. Prior to the completion of one year of credited service, a participant who terminates employment for reasons other than death, retirement, disability or change in control of the Company will not receive any benefit. Forfeitures will be reallocated among remaining participating employees in the same proportion as contributions. Benefits are payable upon death, retirement, early retirement, disability or separation from service. The contributions to the ESOP are not fixed, so benefits payable under the ESOP cannot be estimated. ESOP compensation expense for the years ended December 31, 2004, 2003 and 2002 was \$1,745,000, \$1,676,000 and \$1,259,000, respectively.

A summary of key transactions for the ESOP follows:

	Year Ended December 31		
	2004	2003	2002
ESOP contribution expense	\$ 1,745,000	\$ 1,676,000	\$ 1,259,000
Total contribution to ESOP/Debt service	838,600	1,013,700	835,300
Interest portion of debt service	358,000	410,800	444,900
Dividends on unallocated ESOP shares used to reduce ESOP contribution	281,000	309,600	340,500

As of December 31, 2004, the Company has 374,595 unearned, restricted shares remaining to be released to the ESOP. The fair value of unearned, restricted shares held by the ESOP trust was \$11,684,000 at December 31, 2004. The ESOP held 583,647 allocated, earned shares at December 31, 2004.

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**Note 17: STOCK-BASED COMPENSATION PLANS AND STOCK OPTIONS**

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

Under the MRP, the Company is authorized to grant up to 528,075 shares of restricted stock to its directors, officers and employees of BANR. Shares granted under the MRP vest ratably over a five-year period. The consolidated statements of income for the year ended December 31, 2004, 2003 and 2002, reflect an accrual of \$149,000, \$132,000 and \$51,000, respectively, in compensation expense for the MRP including \$22,000, \$7,100 and \$8,300, respectively, of expense for dividends on the allocated, restricted stock. A summary of the changes in the granted, but not vested, MRP shares for the years ended December 31, 2004, 2003 and 2002 follows:

	Years Ended December 31		
	2004	2003	2002
Shares granted - not vested, beginning of period	31,011	13,317	8,421
Shares granted	9,550	25,025	7,000
Shares vested	(7,100 )	(3,505 )	(2,104 )
Shares forfeited	--	(3,826 )	--
Shares granted - not vested, end of period	33,461	31,011	13,317

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

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

	Weighted average fair value at date of grant	Weighted average exercise price	Number of option shares		
			Total	Not Exercisable	Exercisable
Balances January 1, 2002	\$ 14.28		1,779,114	555,138	1,223,976

For the year ended  
December 31, 2002:

Options granted	\$	8.73	\$	20.16	158,750	158,750	--
Options vested					--	(163,526)	163,526
Options forfeited				18.20	(83,977)	(48,174)	(35,803)
Options exercised				13.38	(88,662)	--	(88,662)
Options terminated				16.43	(4,250)	(4,250)	--
<hr/>							
Number of option shares							
At December 31, 2002	\$			14.66	1,760,975	497,938	1,263,037
<hr/>							

For the year ended  
December 31, 2003:

Options granted	\$	6.00	\$	18.61	210,400	210,400	--
Options vested					--	(172,714)	172,714
Options forfeited				18.51	(105,500)	(48,838)	(56,662)
Options exercised				11.85	(164,985)	--	(164,985)
Options terminated				--	--	--	--
<hr/>							
Number of option shares							
At December 31, 2003	\$			15.18	1,700,890	486,786	1,214,104
<hr/>							

For the year ended  
December 31, 2004:

Options granted	\$	9.35	\$	30.03	174,800	174,800	--
Options vested					--	(175,170)	175,170
Options forfeited				17.88	(15,232)	(12,399)	(2,833)
Options exercised				13.30	(508,271)	--	(508,271)
Options terminated				--	--	--	--
<hr/>							
Number of option shares							
At December 31, 2004	\$			17.78	1,352,187	474,017	878,170
<hr/>							

Financial data pertaining to outstanding stock options granted or assumed as a result of certain acquisitions at December 31, 2004 were as follows:

Exercise Price	Weighted average exercise price of option shares granted	Number of option shares granted	Weighted average option shares vested and exercisable	Weighted average exercise price of option shares exercisable	Remaining contractual life
\$1.18 to 8.03	\$ 4.80	9,396	9,396	\$ 4.80	3.4 yrs
10.51	10.51	5,061	5,061	10.51	4.0 yrs
12.19 to 13.95	12.79	557,037	539,600	12.78	2.9 yrs
14.09 to 15.96	15.47	51,250	28,330	15.23	4.4 yrs
16.31 to 17.84	16.56	128,725	83,665	16.59	6.4 yrs
18.09 to 19.82	18.91	221,992	50,892	18.99	7.9 yrs
20.02 to 21.48	21.06	77,920	67,120	21.08	3.5 yrs
22.05 to 23.28	22.24	124,006	93,406	22.15	4.7 yrs
25.28	25.28	3,500	700	25.28	9.0 yrs
26.23 to 27.80	26.35	52,300	--	--	0.0 yrs
28.48 to 29.66	29.55	3,500	--	--	0.0 yrs
31.71	31.71	117,500	--	--	0.0 yrs
	\$ 17.78	1,352,187	878,170	\$ 15.12	

#### Note 18: REGULATORY CAPITAL REQUIREMENTS

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

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

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) created a statutory framework that increased the importance of meeting applicable capital requirements. For the Bank, FDICIA established five capital categories: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution's category depends upon where its capital levels are in relation to relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure, and certain other factors. The federal banking agencies (including the FDIC) have adopted regulations that implement this statutory framework. Under these regulations, an institution is treated as well-capitalized if its ratio of total capital to risk-weighted assets is 10.00% or more, its ratio of core capital to risk-weighted assets is 6.00% or more, its ratio of core capital to adjusted total assets is 5.00% or more and it is not subject to any federal supervisory order or directive to meet a specific capital level. In order to be adequately capitalized, an institution must have a total risk-based capital ratio of not less than 8.00%, a Tier 1 risk-based capital ratio of not less than 4.00%, and leverage ratio of not less than 4.00%. Any institution which is neither well-capitalized nor adequately capitalized will be considered undercapitalized.

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

FDIC regulations recognize two types or tiers of capital: core (Tier 1) capital and supplementary (Tier 2) capital. Tier 1 capital generally includes common stockholders' equity and noncumulative perpetual preferred stock, less most intangible assets. Tier 2 capital, which is limited to 100% of Tier 1 capital, includes such items as qualifying general loan loss reserves, cumulative perpetual preferred stock, mandatory convertible debt, term subordinated debt and limited life preferred stock; however, the amount of term subordinated debt and intermediate term preferred stock (original maturity of at least five years but less than 20 years) that may be included in Tier 2 capital is limited to 50% of Tier 1 capital.

The FDIC currently measures an institution's capital using a leverage limit together with certain risk-based ratios. The FDIC's minimum leverage capital requirement specifies a minimum ratio of Tier 1 capital to average total assets. Most banks are required to maintain a minimum leverage ratio of at least 4% to 5% of total assets. The FDIC retains the right to require a particular institution to maintain a higher capital level based on an institution's particular risk profile.

FDIC regulations also establish a measure of capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in

one of four categories and given a percentage weight - 0%, 20%, 50% or 100% - based on the relative risk of the category. In addition, certain off-balance-sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the four categories. Under the guidelines, the ratio of total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets must be at least 8%, and the ratio of Tier 1 capital to risk-weighted assets must be at least 4%. In evaluating the adequacy of a bank's capital, the FDIC may also consider other factors that may affect the bank's financial condition. Such factors may include interest rate risk exposure, liquidity, funding and market risks, the quality and level of earnings, concentration of credit risk, risks arising from nontraditional

activities, loan and investment quality, the effectiveness of loan and investment policies, and management's ability to monitor and control financial operating risks.

FDIC capital requirements are designated as the minimum acceptable standards for banks whose overall financial condition is fundamentally sound, which are well-managed and have no material or significant financial weaknesses. The FDIC capital regulations state that, where the FDIC determines that the financial history or condition, including off-balance-sheet risk, managerial resources and/or the future earnings prospects of a bank are not adequate and/or a bank has a significant volume of assets classified substandard, doubtful or loss or otherwise criticized, the FDIC may determine that the minimum adequate amount of capital for the bank is greater than the minimum standards established in the regulation.

The Company believes that, under the current regulations, the Bank exceeds its minimum capital requirements. However, events beyond the control of the Bank, such as weak or depressed economic conditions in areas where the Bank has most of its loans, could adversely affect future earnings and, consequently, the ability of the Bank to meet its capital requirements.

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

The following table shows the regulatory capital ratios of the Company and the Bank and the minimum regulatory requirements:

	Actual		Minimum for capital adequacy purposes		Minimum to be categorized as "well-capitalized" under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(dollars in thousands)						
December 31, 2004:						
The Company - consolidated						
Total capital to risk-weighted assets	\$ 281,358	12.24 %	\$ 183,943	8.00 %	N/A	N/A
Tier 1 capital to risk-weighted assets	251,618	10.94	91,972	4.00	N/A	N/A
Tier 1 leverage capital to average assets	251,618	8.93	112,765	4.00	N/A	N/A
The Bank						
Total capital to risk-weighted assets	258,445	11.26	183,543	8.00	\$ 229,429	10.00 %
Tier 1 capital to risk-weighted assets	228,899	9.98	91,771	4.00	137,657	6.00
	228,899	8.13	112,572	4.00	140,715	5.00

Tier 1 leverage capital  
to average assets

December 31, 2003:

## The Company - consolidated

Total capital to risk-weighted assets	\$	244,301	12.77 %	\$	152,996	8.00 %	N/A	N/A
Tier 1 capital to risk-weighted assets		219,601	11.48		76,498	4.00	N/A	N/A
Tier 1 leverage capital to average assets		219,601	8.73		100,573	4.00	N/A	N/A

## The Bank

Total capital to risk-weighted assets		222,192	11.64		152,764	8.00	\$	190,955	10.00 %
Tier 1 capital to risk-weighted assets		197,528	10.34		76,382	4.00		114,573	6.00
Tier 1 leverage capital to average assets		197,528	7.87		100,446	4.00		125,557	5.00

Company management believes that under the current regulations as of December 31, 2004, the Company and the Bank individually met all capital adequacy requirements to which they were subject. Further, there have been no conditions or events since that date that have materially adversely changed the Tier 1 or Tier 2 capital of the Company or the Bank.

## Note 19: CONTINGENCIES

In the normal course of business, the Company and/or its subsidiaries have various legal proceedings and other contingent matters outstanding. These proceedings and the associated legal claims are often contested and the outcome of individual matters is not always predictable. These claims and counter-claims typically arise during the course of collection efforts on problem loans or with respect to action to enforce liens on properties in

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which the Bank holds a security interest. Based upon the information known to management at this time, the Company and the Bank are not a party to any legal proceedings that management believes would have a material adverse effect on the results of operations or consolidated financial position at December 31, 2004.

In connection with certain asset sales, the Bank typically makes representations and warranties about the underlying assets conforming to specified guidelines. If the underlying assets do not conform to the specifications, the Bank may have an obligation to repurchase the assets or indemnify the purchaser against any loss. The Bank believes that the potential for loss under these arrangements is remote. Accordingly, the fair value of such obligations is not material.



## Note 20: INTEREST RATE RISK

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

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

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

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

## Note 21: GOODWILL AND INTANGIBLES

The Company accounts for intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. Goodwill is no longer amortized but is reviewed annually for impairment. Other intangible assets are amortized over their useful lives. The following table provides the gross carrying value and accumulated amortization for intangible assets as of December 31, 2004 and 2003 (in thousands):

Goodwill and intangibles consisted of the following (in thousands):

	December 31	
	2004	2003
Costs in excess of net assets acquired (goodwill)		
net of accumulated amortization of \$12,594,000	\$ 36,229	\$ 36,229

Core deposit intangible, net of accumulated amortization of \$596,000 and \$454,000, respectively	118	260
Internet domain name, net of accumulated amortization of \$3 and \$1, respectively	22	24
	\$ 36,369	\$ 36,513

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Intangible Assets:

The gross carrying amount and accumulated amortization of the Company's intangible assets other than goodwill is as follows (in thousands):

	December 31, 2004		
	Gross Carrying Amount	Accumulated Amortization	Carrying Amount
Core Deposit Intangible (CDI)	\$ 714	\$ (596 )	\$ 118
Mortgage Servicing Rights (MSR)*	2,058	(493 )	1,565
Internet Domain Name	25	(3 )	22
	\$ 2,797	\$ (1,092 )	\$ 1,705

  

	December 31, 2003		
	Gross Carrying Amount	Accumulated Amortization	Carrying Amount
Core Deposit Intangible (CDI)	\$ 714	\$ (454 )	\$ 260
Mortgage Servicing Rights (MSR)*	2,352	(376 )	1,976
Internet Domain Name	25	(1 )	24

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\$ 3,091 \$ (831 ) \$ 2,260

\*Amortization of mortgage servicing rights is recorded as a reduction of loan servicing income. Mortgage servicing rights are recorded on an individual basis with the gross carrying amount and accumulated amortization fully written off if the loan repays in full.

Amortization expense for the years ended December 31, 2004, 2003 and 2002 includes \$142,000, \$199,000 and \$255,000, respectively, of expense related to the CDI amortization and \$489,000, \$1,021,000 and \$686,000, respectively, of expense related to the MSR amortization. MSRs capitalized/recognized for the years ended December 31, 2004, 2003 and 2002 were \$78,000, \$1,576,00 and \$1,046,000, respectively.

Estimated amortization expense in future years with respect to existing intangibles (in thousands):

<u>Year Ended</u>	<u>CDI</u>	<u>MSR</u>	<u>Internet Domain Name</u>	<u>TOTAL</u>
December 31, 2005	\$ 86	\$ 346	\$ 2	\$ 434
December 31, 2006	30	286	2	318
December 31, 2007	--	237	2	239
December 31, 2008	--	195	2	197
December 31, 2009	--	161	2	163

Note 22: FAIR VALUE OF FINANCIAL INSTRUMENTS

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

Years Ending December 31

	2004		2003	
	Carrying value	Estimated fair value	Carrying value	Estimated fair value
<b>Assets:</b>				
Cash and due from banks	\$ 51,767	\$ 51,767	\$ 77,298	\$ 77,298
Securities available for sale	547,835	547,835	674,942	674,942
Securities held to maturity	49,914	51,437	27,232	28,402
Loans receivable held for sale	2,145	2,176	15,912	16,199
Loans receivable	2,061,093	2,074,752	1,684,953	1,701,127
FHLB stock	35,698	35,698	34,693	34,693
Mortgage servicing rights	1,565	1,796	1,976	2,198
<b>Liabilities:</b>				
Demand, NOW and money market accounts	714,802	698,725	641,567	641,567
Regular savings	155,931	153,143	48,350	48,350
Certificates of deposit	1,055,176	1,051,787	981,023	988,451
FHLB advances	585,558	594,417	612,552	630,889
Junior subordinated debentures and other borrowings	140,284	140,584	126,147	125,731
<b>Off-balance-sheet financial instruments:</b>				
Commitments to originate loans	50	50	26	26
Commitments to sell loans	(50 )	(50 )	(19 )	(19 )
Commitments to purchase securities	--	--	--	--

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

**Cash and due from banks:**

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

**Securities:**

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

### Loans Receivable:

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

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

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

### FHLB Stock:

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

### Deposit Liabilities:

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

### FHLB Advances and Other Borrowings:

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

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### Commitments:

Commitments to sell loans with notional balances of \$23,685,000 and \$17,653,000 at December 31, 2004 and 2003, respectively, have a carrying value of (\$50,000) and (\$19,000), representing the fair value of such commitments. Interest rate lock commitments to originate loans held for sale with notional balances of \$23,685,000 and \$18,866,000 at December 31, 2004 and 2003, respectively, have a carrying value of \$50,000 and \$26,000. Other commitments to fund loans totaled \$609,744,000 and \$527,454,000 at December 31, 2004 and 2003, respectively, and have a carrying value of \$0 at both dates, representing the cost of such commitments. There are no commitments to purchase securities at December 31, 2004. Commitments to purchase securities at December 31, 2003, with a notional balance of 1.2 million, have a carrying value of zero, representing the cost of such commitments. There were no commitments to sell securities at December 31, 2004 or 2003

### Limitation

s: The fair value estimates presented herein are based on pertinent information available to management as of December 31, 2004. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

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

Note 23: Banner Corporation (BANR)

(PARENT COMPANY ONLY)

Summary financial information is as follows (in thousands):

BANR

Statements of Financial Condition

December 31, 2004 and 2003

	December 31	
	2004	2003
<b>ASSETS</b>		
Cash	\$ 13,713	\$ 9,109
Investment in trust equities	2,168	1,703
Investment in subsidiaries	264,536	237,430
Deferred tax asset	375	340
Other assets	10,333	14,009
	\$ 291,125	\$ 262,591
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Liabilities	\$ 3,737	\$ 3,088
Junior subordinated debentures	72,168	56,703
Stockholders' equity	215,220	202,800
	\$ 291,125	\$ 262,591

BANR

Statements of Income

For the years ended December 31, 2004, 2003 and 2002

Years Ended

	December 31		
	2004	2003	2002
<b>INTEREST INCOME:</b>			
Certificates, time deposits and dividends	\$ 384	\$ 291	\$ 442
<b>OTHER INCOME (EXPENSE):</b>			
Dividend income from subsidiaries	11,242	9,259	6,715
Equity in undistributed income of subsidiaries	11,185	9,258	4,232
Other Income	83	63	--
Interest on other borrowings	(3,461 )	(2,296 )	(1,185 )
Other expense	(1,830 )	(1,827 )	(1,838 )
	17,603	14,748	8,366
<b>PROVISION FOR (BENEFIT FROM) INCOME TAXES</b>	<b>(1,737 )</b>	<b>(1,359 )</b>	<b>(894 )</b>
<b>NET INCOME</b>	<b>\$ 19,340</b>	<b>\$ 16,107</b>	<b>\$ 9,260</b>

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## BANR

## Statements of Cash Flows

For the years ended December 31, 2004, 2003 and 2002

	Years Ended December 31		
	2004	2003	2002
<b>OPERATING ACTIVITIES:</b>			
Net income	\$ 19,340	\$ 16,107	\$ 9,260
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed earnings of subsidiaries	(11,185 )	(9,258 )	(4,232 )
Amortization	150	114	65

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(Increase) decrease in deferred taxes	(35 )	--	65
(Increase) decrease in other assets	3,589	(11,457 )	1,916
Increase (decrease) in other liabilities	548	2,658	(262 )
	<u>          </u>	<u>          </u>	<u>          </u>
Net cash provided (used) by operating activities	<u>12,407</u>	<u>(1,836 )</u>	<u>6,812</u>
<b>INVESTING ACTIVITIES:</b>			
Funds transferred to deferred compensation trust	(110 )	(47 )	(71 )
Investment in financing subsidiaries	(465 )	(483 )	(1,220 )
Payments received on loan to ESOP for release of shares	1,742	1,635	1,244
Additional funds invested in subsidiaries	(20,000 )	(35,000 )	--
	<u>          </u>	<u>          </u>	<u>          </u>
Net cash provided (used) by investing activities	<u>(18,833 )</u>	<u>(33,895 )</u>	<u>(47 )</u>
<b>FINANCING ACTIVITIES:</b>			
Proceeds from issuance of junior subordinated debentures	15,465	15,087	39,943
Repurchases of stock	--	(475 )	(8,391 )
Issuance (repurchase) of forfeited MRP shares	--	379	--
Net proceeds from exercise of stock options	2,678	1,954	2,002
Cash dividends paid	(7,113 )	(6,486 )	(6,478 )
	<u>          </u>	<u>          </u>	<u>          </u>
Net cash provided (used) by financing activities	<u>11,030</u>	<u>10,459</u>	<u>27,076</u>
NET INCREASE (DECREASE) IN CASH	4,604	(25,272 )	33,841
CASH, BEGINNING OF PERIOD	9,109	34,381	540
	<u>          </u>	<u>          </u>	<u>          </u>
CASH, END OF PERIOD	\$ 13,713	\$ 9,109	\$ 34,381

Years Ended  
December 31

2004

2003

2002

SUPPLEMENTAL DISCLOSURE OF CASH



## FLOW INFORMATION:

Interest paid	\$	3,084	\$	2,328	\$	2,126
Taxes paid		8,807		--		--
Non-cash transactions:						
Net change in accrued dividends payable		186		148		72
Net change in unrealized gain (loss) in deferred compensation trust and related liability, including subsidiaries		2,375		175		117
Recognize tax benefit of vested MRP shares, including subsidiaries		--		--		3

## Note 24: STOCK REPURCHASE

The Company has periodically engaged in stock repurchase activity. During the years ended December 31, 2004 and 2003, the Company repurchased 134,263 and 19,831 shares of its stock at average prices of \$31.00 and \$23.96 per share, respectively. In both years, these repurchases occurred in connection with the exercise of stock options. On July 22, 2004, the Company's Board of Directors authorized the repurchase of up to 100,000 shares of the Company's outstanding common stock over the next twelve months.

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## Note 25: CALCULATION OF WEIGHTED AVERAGE SHARES OUTSTANDING USED TO CALCULATE EARNINGS PER SHARE

(in thousands)

	Years Ended December 31		
	2004	2003	2002
Total shares issued	13,201	13,201	13,201
	(1,620 )	(1,855 )	(1,692 )

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Less stock repurchased/retired including shares allocated to MRP

Less unallocated shares held by the ESOP	(439 )	(516 )	(577 )
	<u>          </u>	<u>          </u>	<u>          </u>
Basic weighted average shares outstanding	11,142	10,830	10,932
Plus MRP and stock option incremental shares considered outstanding for diluted			
EPS calculations	593	387	420
	<u>          </u>	<u>          </u>	<u>          </u>
Diluted weighted average shares outstanding	11,735	11,217	11,352

Note 26: SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

Results of operations on a quarterly basis were as follows (in thousands except for per share data):

Year Ended December 31, 2004

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Interest income	\$ 36,627	\$ 37,832	\$ 40,400	\$ 41,371
Interest expense	13,918	14,432	15,300	16,265
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net interest income	22,709	23,400	25,100	25,106
Provision for loan losses	1,450	1,450	1,444	1,300
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net interest income after provision for loan losses	21,259	21,950	23,656	23,806
Non-interest income	3,816	4,125	4,750	4,277
Non-interest expense	18,828	19,536	20,922	20,428
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Income before provision for income taxes	6,247	6,539	7,484	7,655
Provision for income taxes	1,884	1,991	2,322	2,388
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net operating income	\$ 4,363	\$ 4,548	\$ 5,162	\$ 5,267
Basic earnings per share	\$ 0.39	\$ 0.41	\$ 0.46	\$ 0.47
Diluted earnings per share	\$ 0.38	\$ 0.39	\$ 0.44	\$ 0.45

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Cash dividends declared	\$	0.16	\$	0.16	\$	0.16	\$	0.17
Year Ended December 31, 2003								
		First Quarter		Second Quarter		Third Quarter		Fourth Quarter
Interest income	\$	34,718	\$	35,412	\$	34,522	\$	35,789
Interest expense		15,310		15,347		14,862		14,329
Net interest income		19,408		20,065		19,660		21,460
Provision for loan losses		2,250		2,250		1,400		1,400
Net interest income after provision for loan losses		17,158		17,815		18,260		20,060
Non-interest income		4,818		5,383		5,539		3,841
Non-interest expense		17,057		17,275		17,868		17,676
Income before provision for income taxes		4,919		5,923		5,931		6,225
Provision for income taxes		1,490		1,802		1,778		1,821
Net operating income	\$	3,429	\$	4,121	\$	4,153	\$	4,404
Basic earnings per share	\$	0.32	\$	0.38	\$	0.38	\$	0.40
Diluted earnings per share	\$	0.31	\$	0.37	\$	0.37	\$	0.39
Cash dividends declared	\$	0.15	\$	0.15	\$	0.15	\$	0.16

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Note 26: SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED) (continued)

Year Ended December 31, 2002								
		First Quarter		Second Quarter		Third Quarter		Fourth Quarter

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Interest income	\$	36,018	\$	36,276	\$	36,349	\$	35,633
Interest expense		<u>17,104</u>		<u>16,843</u>		<u>16,270</u>		<u>15,752</u>
Net interest income		18,914		19,433		20,079		19,881
Provision for loan losses		<u>3,000</u>		<u>4,000</u>		<u>4,000</u>		<u>10,000</u>
Net interest income after provision for loan losses		15,914		15,433		16,079		9,881
Non-interest income		3,218		3,549		3,931		5,179
Non-interest expense		<u>13,326</u>		<u>13,840</u>		<u>15,300</u>		<u>17,979</u>
Income before provision for income taxes		5,806		5,142		4,710		(2,919 )
Provision for income taxes		<u>1,897</u>		<u>1,615</u>		<u>1,329</u>		<u>(1,362 )</u>
Net operating income	\$	3,909	\$	3,527	\$	3,381	\$	(1,557 )
Basic earnings per share	\$	0.35	\$	0.32	\$	0.31	\$	(0.14 )
Diluted earnings per share	\$	0.34	\$	0.30	\$	0.30	\$	(0.14 )
Cash dividends declared	\$	0.15	\$	0.15	\$	0.15	\$	0.15

Note 27: BUSINESS SEGMENTS

The Company is managed by legal entity and not by lines of business. The Bank is a community oriented commercial bank chartered in the State of Washington. The Bank's primary business is that of a traditional banking institution, gathering deposits and originating loans for portfolio in its primary market area. The Bank offers a wide variety of deposit products to its consumer and commercial customers. Lending activities include the origination of real estate, commercial/agriculture business and consumer loans. The Bank is also an active participant in the secondary market, originating residential loans for sale on both a servicing released and servicing retained basis. In addition to interest income on loans and investment securities, the Bank receives other income from deposit service charges, loan servicing fees and from the sale of loans and investments. The performance of the Bank is reviewed by the Company's executive management and Board of Directors on a monthly basis. All of the executive officers of the Company are members of the Bank's management team.

Generally accepted accounting principles establish standards to report information about operating segments in annual financial statements and require reporting of selected information about operating segments in interim reports to stockholders. The Company has determined that its current business and operations consist of a single business segment.

Note 28: FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

The Bank has 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.

Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Balance Sheets.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument from commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as for on-balance sheet instruments. As of December 31, 2004, outstanding commitments for which no liability has been recorded consist of the following:

	<u>Contract or Notional Amount (in thousands)</u>
Financial instruments whose contract amounts represent credit risk:	
Commitments to extend credit	
Real estate secured for commercial, construction or land development	\$ 279,407
Revolving open-end lines secured by 1-4 family residential properties	25,944
Other, primarily business and agricultural loans	317,614
Standby letters of credit and financial guarantees	<u>10,465</u>
Total	\$ 633,430

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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. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Many of the commitments may expire without being drawn upon, therefore the total commitment amounts do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income producing commercial properties.

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

Interest rates on residential one- to four-family mortgage loan applications are typically rate locked (committed) to customers during the application stage for periods ranging from 15 to 45 days, the most typical period being 30 days. Typically, pricing for the sale of these loans is locked with various qualified investors under a best-efforts delivery program at or near the time the interest rate is locked with the customer. The Bank makes every effort to deliver these loans before their rate locks expire. This arrangement generally requires the Bank to deliver the loans prior to the expiration of the rate lock. Delays in funding the loans can require a lock extension. The cost of a lock extension at

times is borne by the customer and at times by the Bank. These lock extension costs paid by the Bank are not expected to have a material impact to operations. This activity is managed daily. Changes in the value of rate lock commitments are recorded as assets and liabilities as explained in the Note 1: "Derivatives."

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Banner Corporation

Index of Exhibits

Exhibit

- 3{a} Articles of Incorporation of Registrant [incorporated by reference to Exhibit B to the Proxy Statement for the Annual Meeting of Stockholders dated June 10, 1998].
- 3{b} Bylaws of Registrant [incorporated by reference to Exhibit 3.2 filed with the Current Report on Form 8-K dated July 24, 1998 (file No. 0-26584)].
- 10{a} Employment Agreement with Gary L. Sirmon, dated as of January 1, 2004 [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-26584)].
- 10{b} Executive Salary Continuation Agreement with Gary L. Sirmon [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 0-26584)].
- 10{c} Employment Agreement with Michael K. Larsen [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 0-26584)].
- 10{d} Executive Salary Continuation Agreement with Michael K. Larsen [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 0-26584)].
- 10{e}

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- 1996 Stock Option Plan [incorporated by reference to Exhibit A to the Proxy Statement for the Annual Meeting of Stockholders dated June 10, 1996].
- 10{f} 1996 Management Recognition and Development Plan [incorporated by reference to Exhibit B to the Proxy Statement for the Annual Meeting of Stockholders dated June 10, 1996].
- 10{g} Consultant Agreement with Jesse G. Foster, dated as of December 19, 2003. [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-23584)].
- 10{h} Supplemental Retirement Plan as Amended with Jesse G. Foster [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1997 (file No. 0-26584)].
- 10{i} Towne Bank of Woodinville 1992 Stock Option Plan [incorporated by reference to exhibits filed with the Registration Statement on Form S-8 dated April 2, 1998 (file No. 333-49193)].
- 10{j} Whatcom State Bank 1991 Stock Option Plan [incorporated by reference to exhibits filed with the Registration Statement on Form S-8 dated February 2, 1999 (file No. 333-71625)].
- 10{k} Employment Agreement with Lloyd W. Baker [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 (file No. 0-26584)].
- 10{l} Employment Agreement with D. Michael Jones [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 (file No. 0-26584)].
- 10{m} Supplemental Executive Retirement Program Agreement with D. Michael Jones [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (file No. 0-26584)].
- 10{n} Form of Supplemental Executive Retirement Program Agreement with Gary Sirmon, Michael K. Larsen, Lloyd W. Baker and Cynthia D. Purcell [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 (file No. 0-26584)].
- 10{o} 1998 Stock Option Plan [incorporated by reference to Exhibit A to the Proxy Statement for the Annual Meeting of Stockholders dated June 10, 1998].
- 10{p} 2001 Stock Option Plan [incorporated by reference to Exhibit B to the Proxy Statement of the Annual Meeting of Stockholders dated March 16, 2001].
- 10{q} Form of Employment Contract entered into with Cynthia D. Purcell, Richard B. Barton, Paul E. Folz, John R. Neill and Douglas M. Bennett [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-26584)].
- 14 Code of Ethics [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-26584)].
- 21 Subsidiaries of the Registrant.
- 23.1 Consent of Registered Independent Public Accounting Firm - Moss Adams LLP.
- 23.2 Consent of Registered Independent Public Accounting Firm - Deloitte & Touche LLP.
- 31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

EXHIBIT 21

SUBSIDIARIES OF THE REGISTRANT

Parent

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Banner Corporation

Subsidiaries	Percentage of Ownership	Jurisdiction of State of Incorporation
Banner Bank (1)	100 %	Washington
Community Financial Corporation (2)	100 %	Oregon
Northwest Financial Corporation (2)	100 %	Washington

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(1) Wholly owned by Banner Corporation

(2) Wholly owned by Banner Bank



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EXHIBIT 23.2

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statement Nos. 333-10819, 333-49193, 333-71625, and 333-67168 on Forms S-8 of our report dated March 11, 2004, relating to the financial statements of Banner Corporation and subsidiaries for the two years ended December 31, 2003, appearing in this Annual Report on Form 10-K of Banner Corporation and subsidiaries for the year ended December 31, 2004.

/s/Deloitte & Touche LLP  
Seattle, Washington  
March 11, 2005

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EXHIBIT 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER OF BANNER CORPORATION  
PURSUANT TO RULES 13a-14(a) AND 15d-14(a) UNDER THE SECURITIES ACT OF 1934

I, D. Michael Jones, certify that:

1. I have reviewed this Amendment No. 1 to the Annual Report on Form 10-K of Banner Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

- a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

April 18, 2005

/s/D. Michael Jones

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D. Michael Jones  
Chief Executive Officer

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EXHIBIT 31.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER OF BANNER CORPORATION  
PURSUANT TO RULES 13a-14(a) AND 15d -14(a) UNDER THE SECURITIES ACT OF 1934

I, Lloyd W. Baker, certify that:

1. I have reviewed this Amendment No. 1 to the Annual Report on Form 10-K of Banner Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

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Lloyd W. Baker  
Chief Financial Officer

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EXHIBIT 32

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER  
OF BANNER CORPORATION  
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

The undersigned hereby certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and in connection with this Amendment No. 1 to the Annual Report on Form 10-K, that:

- \* the report fully complies with the requirements of Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, and
- \* the information contained in the report fairly presents, in all material respects, the Company's financial condition and results of operations.

April 18, 2005

/s/D. Michael Jones

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D. Michael Jones  
Chief Executive Officer

April 18, 2005

/s/Lloyd W. Baker

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Lloyd W. Baker  
Chief Financial Officer