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**U.S. SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

☒ Quarterly report Pursuant to section 13 or 15(d) of the Securities and Exchange act of 1934  
**For the quarter ended March 31, 2004**

☐ Transition report pursuant to section 13 or 15(d) of the Securities and Exchange act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

**Commission file number 0-23881**

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**COWLITZ BANCORPORATION**

**(Exact name of registrant as specified in its charter)**

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

**91-1529841**  
(I.R.S. Employer  
Identification No.)

**927 Commerce Ave., Longview, Washington 98632**  
(Address of principal executive offices) (Zip Code)

**(360) 423-9800**  
(Registrant's telephone number, including area code)

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

Yes ☒ No ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act)

Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, no par value on April 30, 2004: 3,913,152 shares

**COWLITZ BANCORPORATION AND SUBSIDIARY**  
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**Forward-Looking Statements**

*Management's discussion and the information in this document and the accompanying financial statements contain forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies and expectations of the Company, are generally identifiable by words such as "expect", "believe", "intend", "anticipate", "estimate" or similar expressions, and are subject to risks and uncertainties that could cause actual results to differ materially from those stated. Examples of such risks and uncertainties that could have a material adverse effect on the operations and future prospects of the Company, and could render actual results different from those expressed in the forward-looking statements, include, without limitation: changes in general economic conditions, competition for financial services in the market area of the Company, the level of demand for loans, quality of the loan and investment portfolio, deposit flows, legislative and regulatory initiatives, and monetary and fiscal policies of the U.S. Government affecting interest rates. The reader is advised that this list of risks is not exhaustive and should not be construed as any prediction by the Company as to which risks would cause actual results to differ materially from those indicated by the forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements.*

# Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

### COWLITZ BANCORPORATION AND SUBSIDIARY CONSOLIDATED STATEMENTS OF CONDITION (dollars in thousands)

	March 31, 2004	December 31, 2003
<b>ASSETS</b>		
Cash and cash equivalents	\$ 26,663	\$ 24,527
Investment securities:		
Available-for-sale (at fair value, cost of \$49,796 and \$46,658 at March 31, 2004 and December 31, 2003, respectively)	50,716	47,000
Held-to-maturity (at amortized cost, fair value of \$100 and \$8,270 at March 31, 2004 and December 31, 2003, respectively)	100	8,144
Total investment securities	50,816	55,144
Federal Home Loan Bank stock, at cost	1,966	1,974
Loans held-for-sale	-	8,360
Loans, net of deferred loan fees	165,929	163,490
Allowance for loan losses	(4,003)	(3,968)
Total loans, net	161,926	159,522
Cash surrender value of bank-owned life insurance	8,303	8,170
Premises and equipment, net of accumulated depreciation of \$4,455 and \$4,350 at March 31, 2004 and December 31, 2003, respectively	4,079	4,171
Goodwill, net of impairment adjustments and accumulated amortization of \$1,987 at March 31, 2004 and December 31, 2003, respectively	852	852
Intangible assets, net of accumulated amortization of \$1,800 and \$1,734 at March 31, 2004 and December 31, 2003, respectively	170	236
Accrued interest receivable and other assets	4,929	5,843
<b>TOTAL ASSETS</b>	<u>\$ 259,704</u>	<u>\$ 268,799</u>
<b>LIABILITIES</b>		
Deposits:		
Non-interest-bearing demand	\$ 52,956	\$ 60,572
Savings and interest-bearing demand	86,363	86,375
Certificates of deposit	81,141	79,533
Total deposits	220,460	226,480
Federal funds purchased	2,125	225
Federal Home Loan Bank borrowings	608	5,653
Other borrowings	1,950	2,739
Accrued interest payable and other liabilities	1,906	1,900
<b>TOTAL LIABILITIES</b>	227,049	236,997
<b>SHAREHOLDERS' EQUITY</b>		
Preferred stock, no par value; 5,000,000 shares authorized; no shares issued and outstanding at March 31, 2004 and December 31, 2003	-	-
Common stock, no par value; 25,000,000 shares authorized; with 3,913,152 and 3,898,652 shares issued and outstanding at March 31, 2004 and December 31, 2003, respectively	18,031	17,957
Additional paid-in capital	1,609	1,609
Retained earnings	12,408	12,011
Accumulated other comprehensive income, net of taxes	607	225
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<u>32,655</u>	<u>31,802</u>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<u>\$ 259,704</u>	<u>\$ 268,799</u>

See accompanying notes

**COWLITZ BANCORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(dollars in thousands, except per share amounts)

	Three Months Ended March 31,		Year Ended December 31,
	2004	2003	2003
<b>INTEREST INCOME</b>			
Interest and fees on loans	\$ 3,058	\$ 4,233	\$ 14,586
Interest on taxable investment securities	461	250	1,089
Interest on non-taxable investment securities	80	3	102
Other interest and dividend income	21	173	505
Total interest income	<u>3,620</u>	<u>4,659</u>	<u>16,282</u>
<b>INTEREST EXPENSE</b>			
Savings and interest-bearing demand	184	324	1,141
Certificates of deposit	497	1,003	3,117
Federal funds purchased	3	7	16
Federal Home Loan Bank borrowings	19	140	460
Other borrowings	51	57	228
Total interest expense	<u>754</u>	<u>1,531</u>	<u>4,962</u>
Net interest income before (benefit) provision for loan losses	2,866	3,128	11,320
<b>(BENEFIT) PROVISION FOR LOAN LOSSES</b>	<u>(13)</u>	<u>523</u>	<u>237</u>
Net interest income after (benefit) provision for loan losses	<u>2,879</u>	<u>2,605</u>	<u>11,083</u>
<b>NON-INTEREST INCOME</b>			
Service charges on deposit accounts	188	246	858
Gains on loans sold	172	1,749	4,404
Mortgage brokerage fees	105	843	1,992
Escrow fees	-	337	961
Credit card income	138	153	633
Fiduciary income	101	90	320
Increase in cash surrender value of bank-owned life insurance	133	-	170
Net losses on sales of investment securities available-for-sale	-	-	(9)
Net (losses) gains on sale of repossessed assets	(80)	33	(13)
Other income	51	43	90
Total non-interest income	<u>808</u>	<u>3,494</u>	<u>9,406</u>
<b>NON-INTEREST EXPENSE</b>			
Salaries and employee benefits	1,662	2,624	9,478
Net occupancy and equipment expense	435	647	2,564
Professional fees	160	467	1,527
Goodwill impairment	-	-	1,472
Business taxes	55	133	12
FDIC assessment	104	138	505
Credit card expense	130	155	616
Data processing and communications	78	129	454
Loan expense	15	113	746
Postage and freight	62	103	426
Travel and education	36	71	288
Stationery and supplies	37	61	233
Temporary help	4	134	377
Amortization of intangible assets	66	66	265
Expenses relating to other real estate owned	19	27	196
Other expenses	310	237	1,251
Total non-interest expense	<u>3,173</u>	<u>5,105</u>	<u>20,410</u>
Income before provision for income taxes	514	994	79
<b>INCOME TAX PROVISION (BENEFIT)</b>	<u>117</u>	<u>351</u>	<u>(38)</u>
<b>NET INCOME</b>	<u>\$ 397</u>	<u>\$ 643</u>	<u>\$ 117</u>
<b>BASIC EARNINGS PER SHARE OF COMMON STOCK</b>	<u>\$ 0.10</u>	<u>\$ 0.17</u>	<u>\$ 0.03</u>
<b>DILUTED EARNINGS PER SHARE OF COMMON STOCK</b>	<u>\$ 0.10</u>	<u>\$ 0.16</u>	<u>\$ 0.03</u>
<b>WEIGHTED-AVERAGE SHARES OUTSTANDING – BASIC</b>	<u>3,906,379</u>	<u>3,819,424</u>	<u>3,854,253</u>
<b>WEIGHTED-AVERAGE SHARES OUTSTANDING – DILUTED</b>	<u>4,135,912</u>	<u>3,918,460</u>	<u>4,004,502</u>

See accompanying notes

**COWLITZ BANCORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
(dollars in thousands)

	<u>Common stock</u>		<u>Additional</u>	<u>Retained</u>	<u>Accumulated</u>	<u>Total</u>	<u>Comprehensive</u>
	<u>Shares</u>	<u>Amount</u>	<u>Paid-in</u>	<u>Earnings</u>	<u>Other</u>	<u>Shareholders'</u>	<u>Income</u>
			<u>Capital</u>		<u>Comprehensive</u>	<u>Equity</u>	
					<u>Income</u>		
<b>BALANCE, December 31, 2002</b>	3,818,272	\$ 17,491	\$ 1,538	\$ 11,894	\$ 340	\$ 31,263	
Comprehensive income:							
Net income	-	-	-	117	-	117	\$ 117
Net changes in unrealized gains on investments available-for-sale, net of deferred taxes of \$42	-	-	-	-	(115)	(115)	(115)
Comprehensive income							<u>\$ 2</u>
Proceeds from the exercise of stock options	80,380	466	-	-	-	466	
Tax benefit from the exercise of stock options	-	-	71	-	-	71	
<b>BALANCE, December 31, 2003</b>	3,898,652	17,957	1,609	12,011	225	31,802	
Comprehensive income:							
Net income	-	-	-	397	-	397	\$ 397
Net unrealized gains on investments reclassified from held-to-maturity to available-for-sale, net of deferred taxes of \$(134)	-	-	-	-	261	261	261
Net changes in unrealized gains on investments available-for-sale, net of deferred taxes of \$(63)	-	-	-	-	121	121	121
Comprehensive income							<u>\$ 779</u>
Proceeds from the exercise of stock options	14,500	74	-	-	-	74	
<b>BALANCE, March 31, 2004</b>	3,913,152	\$ 18,031	\$ 1,609	\$ 12,408	\$ 607	\$ 32,655	

See accompanying notes

**COWLITZ BANCORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(dollars in thousands)

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income from operations	\$ 397	\$ 643
Adjustments to reconcile net income to net cash from operating activities:		
Deferred tax expense (benefit)	163	(769)
Depreciation and amortization	179	217
(Benefit) provision for loan losses	(13)	523
Increase in cash surrender value of bank-owned life insurance	(133)	-
Federal Home Loan Bank stock dividends	(19)	(38)
Net amortization of investment security premiums and accretion of discounts	91	70
Net losses (gains) on sales of foreclosed assets	80	(33)
Net (gains) losses on the sale and disposal of premises and equipment	(2)	10
Net gains on loans sold	(172)	(1,749)
Origination of loans held-for-sale	(3,019)	(125,069)
Proceeds from loan sales	10,663	153,308
Decrease in accrued interest receivable and other assets	74	365
Increase in accrued interest payable and other liabilities	6	328
Net cash from operating activities	<u>8,295</u>	<u>27,806</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds from maturities and sales of investment securities available-for-sale	4,816	6,097
Purchases of available-for-sale investment securities		
Purchases of available-for-sale investment securities	-	(8,117)
Proceeds from redemption of Federal Home Loan Bank stock	27	42
Net (increase) decrease in loans	(1,568)	14,220
Proceeds from sale of foreclosed assets	465	711
Purchases of premises and equipment	(21)	(11)
Proceeds from the sale of premises and equipment	2	4
Net cash from investment activities	<u>3,721</u>	<u>12,946</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net decrease in savings, noninterest-bearing and interest-bearing demand deposits	(7,628)	(6,277)
Net increase (decrease) in certificates of deposit	1,608	(22,193)
Net increase in federal funds purchased	1,900	1,150
Proceeds from Federal Home Loan Bank borrowings	10,000	-
Repayment of Federal Home Loan Bank borrowings	(15,045)	(8,045)
Repayment of other borrowings	(789)	(34)
Proceeds from the exercise of stock options	74	29
Net cash from financing activities	<u>(9,880)</u>	<u>(35,370)</u>
Net increase in cash and cash equivalents	2,136	5,382
<b>CASH AND CASH EQUIVALENTS, beginning of period</b>	<u>24,527</u>	<u>43,691</u>
<b>CASH AND CASH EQUIVALENTS, end of period</b>	<u><u>\$ 26,663</u></u>	<u><u>\$ 49,073</u></u>

*See accompanying notes*

COWLITZ BANCORPORATION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(amounts in thousands, except number of shares and per share amounts)

## 1. Nature of Operations

Cowlitz Bancorporation (the "Company") was organized in 1991 under Washington law to become the holding company for Cowlitz Bank (the "Bank"), a Washington state chartered bank that commenced operations in 1978. The principal executive offices of the Company are located in Longview, Washington. Cowlitz Bank operates four branches in Cowlitz County in southwest Washington. Outside of Cowlitz County, the Bank does business under the name Bay Bank with branches in Bellevue, Washington, and Portland, Oregon, a loan production office in Vancouver, Washington, and a limited service branch in a retirement center in Wilsonville, Oregon. The Oregon branches of Bay Bank were previously operated under the name Northern Bank of Commerce (NBOC). Cowlitz Bank also provides mortgage banking services through its Bay Mortgage division with offices in Longview and Vancouver, Washington. During much of 2003, the Company also operated Bay Mortgage and Bay Escrow offices in Bellevue and Seattle, Washington. As part of a strategy to consolidate resources into commercial banking, and reduce reliance on mortgage lending activities, those offices were closed during the fourth quarter of 2003 and the first quarter of 2004.

The Company offers or makes available a broad range of financial services to its customers, primarily small and medium-sized businesses, professionals, and retail customers. The Bank's commercial and personal banking services include commercial and real estate lending, consumer lending, and trust services. The Company's goals are to offer exceptional customer service and to invest in the markets it serves through its business practices and community service.

## 2. Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its subsidiary. All significant intercompany transactions and balances have been eliminated.

The interim financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments, including normal recurring accruals necessary for fair presentation of results of operations for the interim periods included herein have been made. The results of operations for the three months ended March 31, 2004 are not necessarily indicative of results to be anticipated for the year ending December 31, 2004.

## 3. Cash and Cash Equivalents

For the purpose of presentation in the statements of cash flows, cash and cash equivalents include cash on hand, amounts due from banks and federal funds sold. Federal funds sold generally mature the day following purchase.

## 4. Use of Estimates in the Preparation of Financial Statements

Preparation of the consolidated financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Significant estimates include the allowance for loan losses and the carrying value of the Company's goodwill. Actual results could differ from those estimates.

## 5. Earnings Per Share

The following table reconciles the denominator of the basic and diluted earnings per share computations:

	Three Months Ended March 31,		Year Ended December 31,
	2004	2003	2003
Weighted-average shares – basic	3,906,379	3,819,424	3,854,253
Effect of assumed conversion of stock options	229,533	99,036	150,249
Weighted-average shares – diluted	<u>4,135,912</u>	<u>3,918,460</u>	<u>4,004,502</u>

Options to purchase 239,966 shares of common stock with exercise prices ranging from \$10.99 to \$12.00, with an average price of \$11.66, were outstanding at March 31, 2004 but were not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common shares for the three month period ended March 31, 2004. These options expire from 2009-2014.

Options to purchase 279,566 shares of common stock with exercise prices ranging from \$7.00 to \$12.00, with an average price of \$11.02, were outstanding at March 31, 2003 but were not included in the computation of diluted earnings per share because the

COWLITZ BANCORPORATION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(amounts in thousands, except number of shares and per share amounts)

options' exercise price was greater than the average market price of the common shares for the three month period ended March 31, 2003. These options expire from 2008-2012.

Options to purchase 536,966 shares of common stock with exercise prices ranging from \$8.75 to \$12.00, with an average price of \$11.12, were outstanding at December 31, 2003 but were not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common shares for the year ended December 31, 2003. These options expire from 2009-2013.

**6. Recently Issued Accounting Standards**

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46, Consolidation of Variable Interest Entities. It defined a variable interest entity ("VIE") as a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. This interpretation will require a VIE to be consolidated or deconsolidated by a company if that company is subject to a majority of the risk of loss from the VIE's activities or entitled to receive a majority of the entity's residual return. In December 2003, FASB made revisions and delayed implementation of certain provisions of FIN 46. The Company is now required to apply FIN 46 to all unconsolidated variable interest entities no later than March 31, 2004. The Company does not have any VIEs and, accordingly, the implementation of this Interpretation did not impact its consolidated financial statements.

In April 2003, FASB issued Statement of Financial Accounting Standards (SFAS) No. 149, "Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities." This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement is effective for contracts entered into or modified after June 30, 2003. Adoption of this statement did not impact the Company's consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of these financial instruments were previously classified as equity. This statement is effective for financial instruments entered into or modified after May 31, 2003, and was otherwise effective at the beginning of the first interim period beginning after June 15, 2003. Adoption of this statement did not impact the Company's consolidated financial statements.



COWLITZ BANCORPORATION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(amounts in thousands, except number of shares and per share amounts)

**7. Stock-Based Compensation**

SFAS No. 123, "Accounting for Stock-Based Compensation," requires disclosure about stock-based compensation arrangements regardless of the method used to account for them. As permitted by SFAS No. 123, the Company has decided to apply the accounting provisions of Accounting Principles Board (APB) Opinion No. 25, and therefore discloses the difference between compensation cost included in net income and the related cost measured by the fair value-based method defined by SFAS No. 123, including tax effects, that would have been recognized in the statement of income if the fair value method had been used. Under APB Opinion No. 25, no compensation cost has been recognized for the Company's stock option plans. Had compensation cost for these plans been determined consistent with SFAS No. 123 and recognized over the vesting period, the Company's net income (loss) and earnings (loss) per share would have been reduced to the following pro forma amounts:

	Three Months Ended March 31, 2004		Three Months Ended March 31, 2003		Year Ended December 31, 2003	
	As Reported	Pro Forma	As Reported	Pro Forma	As Reported	Pro Forma
	(dollars in thousands, except for share amounts)					
Net income (loss)	<u>\$ 397</u>	<u>\$ 355</u>	<u>\$ 643</u>	<u>\$ 505</u>	<u>\$ 117</u>	<u>\$ (506)</u>
Basic earnings (loss) per share	<u>\$ 0.10</u>	<u>\$0.09</u>	<u>\$ 0.17</u>	<u>\$ 0.13</u>	<u>\$ 0.03</u>	<u>\$(0.13)</u>
Diluted earnings (loss) per share	<u>\$ 0.10</u>	<u>\$0.09</u>	<u>\$ 0.16</u>	<u>\$ 0.13</u>	<u>\$ 0.03</u>	<u>\$(0.13)</u>

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used for March 31, 2004 and 2003 and for December 31, 2003.

	Three Months Ended March 31,		Year Ended December 31,
	2004	2003	2003
Dividend yield	0.00%	0.00%	0.00%
Expected life (years)	4.26	4.17	4.17 - 4.26
Expected volatility	38.40%	52.11%	48.31% - 52.11%
Risk-free rate	2.98%	2.98%	2.87% - 2.98%

COWLITZ BANCORPORATION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(amounts in thousands, except number of shares and per share amounts)

**8. Comprehensive Income**

For the Company, comprehensive income includes net income reported on the statements of income and changes in the fair value of its available-for-sale investments reported as a component of shareholders' equity.

The components of comprehensive income (loss) for the three months ended March 31, 2004 and 2003 and the twelve months ended December 31, 2003, are as follows:

	Three Months Ended March 31,		Twelve Months Ended December 31,
(dollars in thousands)	2004	2003	2003
Unrealized gain (loss) arising during the period, net of tax	\$ 382	\$ (75)	\$ (121)
Less reclassification adjustment for net realized losses on securities available-for-sale included in net income during the year, net of tax	-	-	(6)
Net unrealized gain (loss) included in other comprehensive income	<u>\$ 382</u>	<u>\$ (75)</u>	<u>\$ (115)</u>

**9. Segments of an Enterprise and Related Information**

The Company is principally engaged in community banking activities through its branches and corporate offices. Community banking activities include accepting deposits, providing loans and lines of credit to local individuals, businesses and governmental entities, investing in investment securities and money market instruments, and holding or managing assets in a fiduciary agency capacity on behalf of its customers and their beneficiaries. The mortgage banking segment, Bay Mortgage, offers a full line of residential lending products including FHA and VA loans, construction loans, and bridge loans.

The community banking and mortgage banking activities are monitored and reported by Company management as separate operating segments. Despite the closure of Bay Escrow and the Bellevue and Seattle offices of Bay Mortgage during the fourth quarter of 2003, mortgage lending activities in the remaining locations will continue to be reported as a separate operating segment.

The accounting policies for the Company's segment information provided in the following tables are the same as those described for the Company in the summary of significant accounting policies footnote included in the Company's 2003 annual report, except that some operating expenses and the results of discontinued operations are not allocated to segments.

COWLITZ BANCORPORATION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(amounts in thousands, except number of shares and per share amounts)

Summarized financial information for the three months ended March 31, 2004 and 2003, and the year ended December 31, 2003 concerning the Company's reportable segments is shown in the following tables:

	Three Months Ended March 31, 2004				
	Banking	Mortgage Banking	Holding Company	Intersegment	Consolidated
(unaudited)					
Interest income	\$ 4,071	\$ 107	\$ 3	\$ (561)	\$ 3,620
Interest expense	1,173	92	50	(561)	754
Net interest income	2,898	15	(47)	-	2,866
Provision (benefit) for loan losses	150	-	(163)	-	(13)
Noninterest income	531	277	-	-	808
Noninterest expense	2,519	484	170	-	3,173
Income (loss) before provision (benefit) for income taxes	760	(192)	(54)	-	514
Provision (benefit) for income taxes	200	(66)	(17)	-	117
Net income (loss)	<u>\$ 560</u>	<u>\$ (126)</u>	<u>\$ (37)</u>	<u>\$ -</u>	<u>\$ 397</u>
Depreciation and amortization	<u>\$ 162</u>	<u>\$ 17</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 179</u>
Total assets	<u>\$ 257,633</u>	<u>\$ 2,009</u>	<u>\$ 34,609</u>	<u>\$ (34,547)</u>	<u>\$ 259,704</u>

Compared to quarterly segment information reported during 2003, the mortgage banking segment experienced significantly lower activity during the first quarter of 2004. In December 2003 and the first quarter of 2004, the Company began reducing the size of its mortgage banking operations by closing its Bay Mortgage offices in Bellevue and Seattle. Management believes that the net loss reported for the mortgage banking segment during the three months ended March 31, 2004 could have been significantly higher if the segment had continued to operate as it had during 2003. Reduced demand for mortgage refinance loans and a desire to concentrate resources on the core banking segment were the factors leading to the decision to scale back the mortgage banking segment. The credit to the provision for loan losses on the Holding Company segment was generated from the recovery of a previously charged-off loan.

COWLITZ BANCORPORATION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(amounts in thousands, except number of shares and per share amounts)

	Three Months Ended March 31, 2003				
	Banking	Mortgage Banking	Holding Company	Intersegment	Consolidated
(unaudited)					
Interest income	\$ 4,282	\$ 944	\$ 8	\$ (575)	\$ 4,659
Interest expense	<u>1,525</u>	<u>525</u>	<u>56</u>	<u>(575)</u>	<u>1,531</u>
Net interest income	2,757	419	(48)	-	3,128
Provision (benefit) for loan losses	(751)	-	1,274	-	523
Noninterest income	565	2,929	-	-	3,494
Noninterest expense	<u>2,735</u>	<u>2,307</u>	<u>63</u>	<u>-</u>	<u>5,105</u>
Income (loss) before provision (benefit) for income taxes	1,338	1,041	(1,385)	-	994
Provision (benefit) for income taxes	<u>468</u>	<u>359</u>	<u>(476)</u>	<u>-</u>	<u>351</u>
Net income (loss)	<u>\$ 870</u>	<u>\$ 682</u>	<u>\$ (909)</u>	<u>\$ -</u>	<u>\$ 643</u>
Depreciation and amortization	<u>\$ 189</u>	<u>\$ 28</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 217</u>
Total assets	<u>\$ 308,376</u>	<u>\$ 54,156</u>	<u>\$ 34,707</u>	<u>\$ (86,549)</u>	<u>\$ 310,690</u>

The segment information for the three months ended March 31, 2003 includes a reclassification between the Banking and Holding Company segments of \$901,000 for the provision for loan losses. This reclassification does not affect the consolidated results of operation or earnings per share, but has resulted in a benefit to the Banking segment presentation above.

COWLITZ BANCORPORATION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(amounts in thousands, except number of shares and per share amounts)

	Year Ended December 31, 2003				
	<u>Banking</u>	<u>Mortgage Banking</u>	<u>Holding Company</u>	<u>Intersegment</u>	<u>Consolidated</u>
(dollars in thousands)					
Interest income	\$ 16,224	\$ 2,525	\$ 21	\$ (2,488)	\$ 16,282
Interest expense	<u>5,859</u>	<u>1,367</u>	<u>224</u>	<u>(2,488)</u>	<u>4,962</u>
Net interest income	10,365	1,158	(203)	-	11,320
Provision for loan losses	(426)	-	663	-	237
Non-interest income	2,031	7,358	17	-	9,406
Non-interest expense	<u>10,797</u>	<u>9,257</u>	<u>356</u>	<u>-</u>	<u>20,410</u>
Income (loss) before provision (benefit) for income taxes	2,025	(741)	(1,205)	-	79
Provision (benefit) for income taxes	<u>599</u>	<u>(256)</u>	<u>(381)</u>	<u>-</u>	<u>(38)</u>
Net income (loss)	<u>\$ 1,426</u>	<u>\$ (485)</u>	<u>\$ (824)</u>	<u>\$ -</u>	<u>\$ 117</u>
Depreciation and amortization	<u>\$ 679</u>	<u>\$ 111</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 790</u>
Total assets	<u>\$ 266,970</u>	<u>\$ 14,947</u>	<u>\$ 34,547</u>	<u>\$ (47,665)</u>	<u>\$ 268,799</u>

The segment information for the year ended December 31, 2003 includes a reclassification between the Banking and Holding Company segments of \$901,000 for the provision for loan losses. This reclassification does not affect the consolidated results of operation or earnings per share, but has resulted in a benefit to the Banking segment presentation above. The net loss reported for the mortgage banking segment is primarily due to costs associated with the closure of that segment's Bellevue and Seattle offices recorded during the fourth quarter of 2003.

## **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **Results of Operations for the Three Months Ended March 31, 2004 and 2003**

During the first quarter of 2004 the Company's net income was \$397,000, or \$0.10 per diluted share, compared to net income of \$643,000, or \$0.16 per diluted share, during the first quarter of 2003. Net interest income was \$262,000 lower for the three months ended March 31, 2004 when compared to the same period of 2003, but the Company benefited from a reduction in the provision for loan losses of \$536,000. The first quarter of 2004 includes a credit to the provision for loan losses of \$13,000, the result of a \$163,000 recovery by the Holding Company of a previously charged-off loan, while the Banking segment recorded a provision for loan losses of \$150,000 for the first quarter of 2004. Non-interest income and non-interest expenses were \$2.7 million and \$1.9 million lower, respectively comparing the first quarters of 2004 and 2003. These decreases primarily resulted from reductions in the Company's mortgage operations.

### **Financial Condition as of March 31, 2004 and December 31, 2003**

At March 31, 2004, total assets were \$259.7 million and total liabilities were \$227.0 million. Total assets have decreased \$9.1 million or 3.4% from \$268.8 million at December 31, 2003 and liabilities have decreased \$9.9 million or 4.2% from \$237.0 million at December 31, 2003.

The decline in total assets is primarily due to a reduction in loans held-for-sale since December 31, 2003. At December 31, 2003, the loans held-for-sale were \$8.4 million but as of March 31, 2004, the entire balance had been sold into the secondary market. As part of the strategy to curtail the mortgage operations, the Company will no longer originate loans for sale into the secondary market. Although the Company has ceased its secondary market function and closed its Bellevue and Seattle, Washington Bay Mortgage offices, mortgage lending products will continue to be offered to the Company's customers in its remaining Bay Mortgage locations in Longview and Vancouver, Washington.

Reductions in the volumes of non-interest-bearing demand deposits and Federal Home Loan Bank (FHLB) borrowings, account for the majority of the decline in total liabilities from December 31, 2003 to March 31, 2004. The balance in these accounts was uncharacteristically high at December 31, 2003 at \$60.6 million but had declined to \$53.0 at March 31, 2004. The average balance of non-interest-bearing demand deposits for the first quarter of 2004 was \$54.9 million, which compares favorably to an average of \$53.3 million during the fourth quarter of 2003. The Company had \$18.6 million in brokered deposits at March 31, 2004, or 8.4% of the \$220.5 million total deposits compared to \$10.4 million or 4.6% of \$226.5 million of total deposits at December 31, 2003. FHLB borrowings were \$5.0 million lower at March 31, 2004 than at December 31, 2003.

### **Critical Accounting Policies**

The Company's most critical accounting policy is related to the allowance for loan losses. The Company utilizes both quantitative and qualitative considerations in establishing an allowance for loan losses believed to be appropriate as of each reporting date.

Quantitative factors include:

- the volume and severity of non-performing loans and adversely classified credits,
- the level of net charge-offs experienced on previously classified loans,
- the nature and value of collateral securing the loans,
- the trend in loan growth and the percentage of change,
- the level of geographic and/or industry concentration,
- the relationship and trend over the past several years of recoveries in relation to charge-offs, and
- other known factors regarding specific loans.

Qualitative factors include:

- the effectiveness of credit administration,
- the adequacy of loan review,
- the adequacy of loan operations personnel and processes,
- the effect of competitive issues that impact loan underwriting and structure
- the impact of economic conditions, and
- the introduction of new loan products or specific marketing efforts.

Changes in the above factors could significantly effect the determination of the adequacy of the allowance for loan losses. Management performs a full analysis, no less often than quarterly, to ensure that changes in estimated loan loss levels are adjusted on a timely basis. For further discussion of this significant management estimate, see "Allowance for Loan Losses."

Another critical accounting policy for the Company is that related to the carrying value of goodwill. Goodwill was recognized from the excess of cost over the fair value of net assets acquired from the purchase of Bay Mortgage, and Bay Bank, formerly Northern Bank of Commerce. Goodwill was amortized by the straight-line method over a 15-year period until December 31, 2001.

Effective January 1, 2002, pursuant to Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," the Bank ceased amortization of goodwill and completed its first of ongoing assessments of goodwill impairment in March 2002. Goodwill impairment is deemed to exist if the net book value of a reporting unit, considered by the Bank to represent its operating segments, exceeds its estimated fair value. Based on the Company's initial assessment of impairment in 2002, goodwill associated with Bay Mortgage operations was determined to be impaired. Accordingly, an impairment charge resulted in a \$1.2 million write-down of goodwill and the recognition of an expense, recorded as the cumulative effect of a change in accounting principle of \$791,000, net of \$417,000 in related taxes. Continued analysis of this and other goodwill components indicated that no additional impairment existed at December 31, 2002. In 2003, with the Bank's realignment of its mortgage banking operations, management determined all remaining goodwill associated with the acquisition of Bay Mortgage to be fully impaired which resulted in a charge to 2003 pre-tax earnings of \$1.5 million.

### Analysis of Net Interest Income

The primary component of the Company's earnings is net interest income. Net interest income is the difference between interest income, principally from loans and the investment securities portfolio, and interest expense, principally on customer deposits and borrowings. Changes in net interest income result from changes in "volume," "spread," and "margin." Volume refers to the dollar level of interest-earning assets and interest-bearing liabilities. Spread refers to the difference between the yield on interest-earning assets and the cost of interest-bearing liabilities. Net interest margin is the ratio of net interest income to total interest-earning assets and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities.

#### Three months ended March 31, 2004 and 2003

Interest income from certain of the Company's earning assets is non-taxable. The following table presents interest income and expense, including adjustments for non-taxable interest income, and the resulting tax adjusted yields earned, rates paid, interest rate spread, and net interest margin for the periods indicated.

(unaudited) (dollars in thousands)	Three Months Ended		Increase (Decrease)	Change
	March 31,			
	<u>2004</u>	<u>2003</u>		
Interest income	\$ 3,620	\$ 4,659	\$ (1,039)	-22.3%
Tax effect of non-taxable interest income	38	8	30	375.0%
Tax equivalent interest income	3,658	4,667	(1,009)	-21.6%
Interest expense	754	1,531	(777)	-50.8%
Net interest income	<u>\$ 2,904</u>	<u>\$ 3,136</u>	<u>\$ (232)</u>	-7.4%
Average interest earning assets	\$ 234,075	\$ 304,488	\$ (70,413)	-23.1%
Average interest bearing liabilities	\$ 169,536	\$ 242,167	\$ (72,631)	-30.0%
Average yields earned (1)	6.25%	6.13%	0.12%	
Average rates paid (1)	1.78%	2.53%	-0.75%	
Net interest spread (1)	4.47%	3.60%	0.87%	
Net interest margin (1)	4.96%	4.12%	0.84%	

(1) Ratios for the three months ended March 31, 2004 and 2003 have been annualized

Comparing the quarter ended March 31, 2004 to the quarter ended March 31, 2003, interest income declined \$1.0 million, interest expense declined \$777,000, and net interest income decreased \$262,000. The Company's average interest-earning assets and interest-bearing liabilities each declined over \$70.0 million under the same comparison. The overall tax-equivalent average earning asset yield was 6.25% for the quarter ended March 31, 2004 compared to 6.13% for the quarter ended March 31, 2003. An increase in average non-taxable municipal bonds caused the increase in tax equivalent interest income comparing the two periods. Under the same comparison, the average rates paid on interest-bearing liabilities declined substantially. Because of the decline in rates paid, both the interest spread and interest margin were higher during the quarter ended March 31, 2004 compared to the same period of 2003.

Reductions in the average balances of loans and loans held-for-sale account for the majority of the total interest-earning asset decline between the first quarter of 2003 and the first quarter of 2004. Excluding loans held-for-sale, average total loans declined \$21.6

million from \$186.9 million during the first quarter of 2003 to \$165.3 million during the first quarter of 2004. Loans held-for-sale averaged \$35.5 million during the quarter ended March 31, 2003 compared to only \$2.4 million during the same period of 2004.

The decline in average rates paid on interest-bearing liabilities is primarily attributable to higher rate long-term certificates of deposit maturing during 2003 and early 2004, which either did not renew or re-priced at current, lower rates. Certificates of deposit averaged \$127.3 million during the first quarter of 2003, but declined to an average of \$77.9 million during the first quarter of 2004. In addition, the Company paid off \$5.0 million in FHLB borrowings and re-borrowed \$5.0 million at a lower rate.

#### **Provision for Loan Losses**

The amount of the allowance for loan losses is analyzed by management on a regular basis to ensure that it is adequate to absorb losses inherent in the loan portfolio as of the reporting date. When a provision for loan losses is recorded, the amount is based on past charge-off experience, a careful analysis of the current loan portfolio, the level of non-performing and impaired loans, evaluation of future economic trends in the Company's market area, and other factors relevant to the loan portfolio. The quarterly provision recorded as an increase to the allowance for loan losses is based upon estimates of probable losses inherent in the loan portfolio. The loss amount actually realized for these loans can vary significantly from the estimated amounts. See the "Allowance for Loan Losses" discussion for additional detail.

#### *Three months ended March 31, 2004 and 2003*

The Company recognized a benefit for loan losses of \$13,000 for the quarter ended March 31, 2004 compared to an expense, or provision for loan losses, of \$523,000 for the same period of 2003. During the first quarter of 2004, the Banking segment recognized a provision for loan losses of \$150,000, while the Holding Company recovered \$163,000 of a loan previously charged-off. Because the Holding Company does not currently have any loans or an allowance for loan losses, any recovery of previously charged-off amounts flow through the income statement as a credit, or benefit, to the provision expense.



## Non-Interest Income

Three months ended March 31, 2004 and 2003

Non-interest income consists of the following components:

(unaudited) (dollars in thousands)	Three Months Ended March 31,	
	2004	2003
Service charge on deposit accounts	\$ 188	\$ 246
Gains on loans sold	172	1,749
Mortgage brokerage fees	105	843
Fiduciary income	101	90
Increase in cash surrender value of bank-owned life insurance	133	-
Escrow fees	-	337
Credit Card income	138	153
ATM income	12	13
Safe deposit box fees	24	25
(Loss) gain on sale of repossessed assets	(80)	33
Other miscellaneous fees and income	15	5
Total non-interest income	<u>\$ 808</u>	<u>\$ 3,494</u>

Non-interest income was \$808,000 for the quarter ended March 31, 2004, a decline of \$2.7 million from \$3.5 million for the same period of 2003. Non-interest income generated by the mortgage banking segment has declined substantially due to the reorganization of that segment. Gains on loans sold and escrow fees will no longer be generated under the current structure, and mortgage brokerage fees will be significantly lower than in past periods.

During the first quarter 2004, income of \$133,000 was generated by the increase in cash surrender value of bank-owned life insurance. Write-downs of the carrying value of certain repossessed assets generated a loss of \$80,000 during the period. These losses were generated from expenditures to prepare certain assets for resale, but did not increase the carrying value of the asset, so were recognized as a loss when incurred.

## Non-Interest Expense

Three months ended March 31, 2004 and 2003

Non-interest expense consists of the following components:

(unaudited) (dollars in thousands)	Three Months Ended March 31,	
	2004	2003
Salaries and employee benefits	\$ 1,662	\$ 2,624
Net occupancy and equipment	435	647
Amortization of intangible assets	66	66
Net cost of operation of other real estate owned	19	27
Business taxes	55	133
Data processing and communications	78	129
Stationery and supplies	37	61
Credit card expense	130	155
Travel and education	36	71
Loan expense	15	113
Advertising	21	17
Professional fees	160	467
Postage and freight	62	103
Temporary help	4	134
FDIC insurance	104	138
Other miscellaneous expenses	289	220
Total non-interest expense	<u>\$ 3,173</u>	<u>\$ 5,105</u>

Total non-interest expenses declined \$1.9 million to \$3.2 million for the quarter ended March 31, 2004 compared to \$5.1 million for the quarter ended March 31, 2003. The majority of this decline is attributable to the reorganization of the Company's mortgage segment. Salaries and employee benefits, net occupancy and equipment, business taxes, data processing and communications, stationery and supplies, professional fees, postage and freight, and temporary help are all lower due to the closure of the Bellevue and Seattle mortgage offices and the cessation of the mortgage loan secondary marketing function.

At March 31, 2004, the Company had 106 full-time equivalent employees compared to 179 at March 31, 2003. The mortgage segment reorganization accounted for 67 of the reduction of 73 full-time equivalent employees. Also included in salary expenses are ordinary annual wage increases for many existing employees.

Net occupancy and equipment expenses consist of depreciation on premises and equipment, lease costs, parking, maintenance and repair expenses, utilities and related expenses. The Company's net occupancy expense was reduced by \$212,000 when comparing the three months ended March 31, 2004 to the same period of 2003.

Although the FDIC insurance premium rate remains unchanged at \$.17 per \$100 of domestic deposits when comparing the quarters ended March 31, 2004 and 2003, the total expense has declined due to a reduction in deposit volume. The FDIC sets deposit insurance premiums based upon the risks a particular bank or savings association poses to the deposit insurance funds. This system bases an institution's risk category partly upon whether the institution is well capitalized, adequately capitalized or less than adequately capitalized. Each insured depository institution is also assigned to one of three "supervisory" categories based on reviews by regulators, statistical analysis of financial statements and other relevant information. An institution's assessment rate depends upon the capital category and supervisory category to which it is assigned. Annual assessment rates currently range from zero per \$100 of domestic deposits for the highest rated institution to \$0.27 per \$100 of domestic deposits for an institution in the lowest category. Under legislation enacted in 1996 to recapitalize the Savings Association Insurance Fund, the FDIC is authorized to collect assessments against insured deposits to be paid to the Financing Corporation ("FICO") to service FICO debt incurred in the 1980's. The current FICO assessment rate for insured deposits is \$0.0162 per \$100 of deposits per year. Any increase in deposit insurance of FICO assessments could have an adverse effect on Cowlitz Bank's earnings.

Professional fees include exam and audit expenses, accounting, consulting and legal fees, and other professional fees. These expenses declined to \$160,000 for the three months ended March 31, 2004 from \$467,000 for the same period of 2003. Professional fees for the first quarter 2003 included approximately \$79,000 for the State of Washington Department of Financial Institutions examination conducted in 2002. The professional fees recorded during the first quarter 2003 included consultation to establish or improve internal controls and regulatory reporting, and also included expenses for employee placement services.

Temporary help expenses have been reduced dramatically when comparing the first quarter of 2004 to the first quarter of 2003. Contracted temporary employees were utilized during 2003 to assist management on various special projects and to help during the transition of new management. Business taxes are based on adjusted revenues, and the expense has declined when comparing the first quarter of 2004 to the first quarter of 2003 as overall revenues, specifically from the mortgage segment, have declined.

## Income Taxes

*Three months ended March 31, 2004 and 2003*

During the first quarter of 2004 the provision for income taxes was \$117,000 compared to \$351,000 for the first quarter of 2003. These provisions resulted in an effective tax rate of 22.8% and 35.3% for the quarters ended March 31, 2004 and 2003, respectively. Non-taxable income generated from increased investment in non-taxable municipal bonds and from the \$8.0 million of bank-owned life insurance resulted in the reduced effective tax rate for the first quarter of 2004.

## Loans

Total loans outstanding were \$165.9 million and \$163.5 million at March 31, 2004 and December 31, 2003, respectively. Unfunded loan commitments such as home equity and other lines of credit, unused available credit on credit cards, and letters of credit, were \$43.7 million at March 31, 2004 and \$42.4 million at December 31, 2003.

The following table presents the composition of the Company's loan portfolio at the dates indicated:

(unaudited) (dollars in thousands)	March 31, 2004		December 31, 2003	
	Amount	Percent	Amount	Percent
Commercial	\$ 38,105	22.90%	\$ 38,793	23.63%
Real estate construction	18,929	11.37%	18,305	11.15%
Real estate commercial	77,107	46.34%	77,412	47.17%
Real estate mortgage	28,406	17.07%	25,530	15.55%
Consumer and other	3,869	2.32%	4,103	2.50%
	<u>166,416</u>	<u>100.00%</u>	<u>164,143</u>	<u>100.00%</u>
Deferred loan fees	(487)		(653)	
Total loans	<u>165,929</u>		<u>163,490</u>	
Allowance for loan losses	<u>(4,003)</u>		<u>(3,968)</u>	
Total loan, net	<u>\$ 161,926</u>		<u>\$ 159,522</u>	

## Allowance for Loan Losses

The allowance for loan losses represents management's estimate of potential losses as of the date of the financial statements. The loan portfolio is regularly reviewed to evaluate the adequacy of the allowance for loan losses. In determining the level of the allowance, the Company evaluates the amount necessary for specific non-performing loans and estimates losses inherent in other loans. An important element in determining the adequacy of the allowance for loan losses is an analysis of loans by loan risk-rating categories. At a loan's inception, management evaluates the credit risk by using a risk-rating system. This grading system currently includes eleven levels of risk. Risk ratings range from "1" for the strongest credits to "10" for the weakest. A "10" rated loan would normally represent a loss. All loans rated 7-10 are collectively the Company's "Watch List". The specific grades from 7-10 are "watch list" (risk-rating 7), "special mention" (risk-rating 7.5), "substandard" (risk-rating 8), "doubtful" (risk-rating 9), and "loss" (risk-rating 10). When indicators such as operating losses, collateral impairment or delinquency problems show that a credit may have weakened, the credit will be downgraded as appropriate. Similarly, as borrowers bring loans current, show improved cash flows, or improve the collateral position of a loan, the credits may be upgraded. Management reviews all credits periodically for changes in such factors. The result is an allowance with four components, specific allowance, general allowance, special allowance, and an unallocated allowance.

*Specific Allowance.* Loans on the Company's Watch List, as described above, are specifically reviewed and analyzed. Management considers in its analysis expected future cash flows, the value of collateral and other factors that may impact the borrower's ability to pay. When significant conditions or circumstances exist on an individual loan indicating greater risk, specific reserves may be allocated in addition to the general reserve percentage for that particular risk-rating.

*General Allowance.* All loans are risk-rated 1 to 10. Those that do not require a specific allocation are subject to a general allocation based upon historic loss factors. Management determines these factors by analyzing the volume and mix of the existing loan portfolio, in addition to other factors. Management also analyzes the following:

- the volume and severity of non-performing loans and adversely classified credits;
- the level of net charge-offs experienced on previously classified loans;
- the nature and value of collateral securing the loans; and
- the relationship and trend over the past several years of recoveries in relation to charge-offs.

*Special Allowance.* From time to time, special reserves will be established to facilitate a change in the Bank's strategy and other factors. Special allocations are to take into consideration various factors that include, but are not limited to:

- Effectiveness of credit administration;
- Adequacy of loan review;
- Loan operations;
- The trend in loan growth and the percentage of change;
- Concentrations both geographic and industry;
- Competitive issues that impacts loan underwriting/structure;
- Economic conditions; and
- Any special marketing or introduction of various loan products.

*Unallocated Allowance.* Management also attempts to ensure that the overall allowance appropriately reflects a margin for the imprecision necessarily inherent in estimates of expected loan losses.

The quarterly analysis of specific, general, and special allocations of the allowance is the principal method relied upon by management to ensure that changes in estimated loan loss levels are adjusted on a timely basis. The inclusion of historical loss factors in the process of determining the general component of the allowance also acts as a self-correcting mechanism of management's estimation process, as loss experience more remote in time is replaced by more recent experience. In its analysis of the specific, the general, and special allocations of the allowance, management also considers regulatory guidance in addition to the Company's own experience.

Loans and other extensions of credit deemed uncollectable are charged to the allowance. Subsequent recoveries, if any, are credited to the allowance. Actual losses may vary from current estimates and the amount of the provision may be either greater than or less than actual net charge-offs when and if they occur. The related provision for loan losses that is charged to income is the amount necessary to adjust the allowance to the level determined through the above process.

Management's evaluation of the loan portfolio resulted in total allowances for loan losses of \$4.0 million at both March 31, 2004 and December 31, 2003. The allowance, as a percentage of total loans, was also relatively unchanged at 2.41% at March 31, 2004 and 2.43% at December 31, 2003. Management believes the allowance for loan losses at both March 31, 2004 and December 31, 2003 is adequate to absorb current potential or anticipated losses.

The following table shows the components of the allowance for loan loss for the periods indicated:

(unaudited) (dollars in thousands)	March 31, 2004		December 31, 2003	
	Amount	Percent	Amount	Percent
General	\$ 2,222	55.51%	\$ 2,362	59.53%
Specific	93	2.32%	456	11.49%
Special	1,273	31.80%	709	17.87%
Unallocated	415	10.37%	441	11.11%
	<u>\$ 4,003</u>	<u>100.00%</u>	<u>\$ 3,968</u>	<u>100.00%</u>

The specific portion of the allowance has declined during the first quarter of 2004. Based on Management's assessment of the watch list loans, a lower volume of loans require specific reserves in addition to the risk rating reserve levels. The special reserves have increased from December 31, 2003 to March 31, 2004 based upon a more in-depth analysis of potential risk factors including underwriting and servicing loans, competitive pressures, geographic and industry concentrations, and economic conditions.

The allowance for loan losses is based upon estimates of probable losses inherent in the loan portfolio. The amount actually observed for these losses can vary significantly from the estimated amounts. The following table shows the Company's loan loss performance for the periods indicated.

(balances exclude amounts from discontinued operations) (dollars in thousands)	Three Months Ended March 31,		Year Ended December 31,
	2004	2003	2003
Loans outstanding at end of period, net of deferred fees (1)	\$ 165,929	\$ 178,809	\$ 163,490
Average loans outstanding during the period	\$ 165,277	\$ 186,876	\$ 173,966
Allowance for loan losses, beginning of period	\$ 3,968	\$ 6,150	\$ 6,150
Loans charged off:			
Commercial	67	470	1,409
Real Estate	24	180	1,671
Consumer	-	43	83
Credit Cards	53	18	61
Total loans charged-off	<u>144</u>	<u>711</u>	<u>3,224</u>
Recoveries:			
Commercial	164	6	504
Real Estate	22	-	237
Consumer	2	-	56
Credit Cards	4	2	8
Total recoveries	<u>192</u>	<u>8</u>	<u>805</u>
Provision for loan losses	(13)	523	237
Allowance for loan losses, end of period	<u>\$ 4,003</u>	<u>\$ 5,970</u>	<u>\$ 3,968</u>
Net loans charged-off during the period	(48)	703	2,419
Ratio of net loans charged-off to average loans outstanding	-0.03%	0.38%	1.39%
Ratio of allowance for loan losses to loans at end of period	2.41%	3.34%	2.43%

(1) Excludes loans held-for-sale

## Impaired Loans

The Company, during its normal loan review procedures, considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. A loan is not considered to be impaired during a period of minimal delay (less than 90 days) unless available information strongly suggests impairment. The Company measures impaired loans 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 market value of the collateral if the loan is collateral dependent. Impaired loans are charged to the allowance when management believes that, after considering economic and business conditions, collection efforts, and collateral position, the borrower's financial condition indicates that collection of principal is not probable.

Generally, no interest is accrued on loans when factors indicate collection of interest is doubtful or when principal or interest payments become 90 days past due, unless collection of principal and interest are anticipated within a reasonable period of time and the loans are well secured. For such loans, previously accrued but uncollected interest is charged against current earnings, and income is only recognized to the extent payments are subsequently received and collection of the remaining recorded principal balance is considered probable.

## Non-Performing Assets

Non-performing loans include all loans greater than 90 days past due with respect to either principal or interest, and all loans to which the accrual of interest has been suspended. These loans, combined with repossessed real estate and other repossessed assets, are collectively considered to be non-performing assets. The following table presents information on all non-performing assets:

(unaudited) (dollars in thousands)	March 31, 2004	December 31, 2003
Loans on non-accrual status	\$ 2,505	\$ 1,856
Loans past due greater than 90 days but not on non-accrual status	5	17
Other real estate owned	842	1,352
Other repossessed assets	-	-
Total non-performing assets	<u>\$ 3,352</u>	<u>\$ 3,225</u>
Total assets	<u>\$ 259,704</u>	<u>\$ 268,799</u>
Percentage of non-performing assets to total assets	<u>1.29%</u>	<u>1.20%</u>

At March 31, 2004 non-performing assets were \$3.4 million or 1.29% of total assets compared to \$3.2 million or 1.20% of total assets at December 31, 2003. The increase in non-accrual loans from \$1.9 million at December 31, 2003 to \$2.5 million at March 31, 2004 is attributable to a single \$1.4 million real estate loan added to non-accrual during March. The loan is secured by real estate with an appraised value of \$2.8 million, and no loss is expected. Excluding this single loan, total non-performing assets declined by \$1.2 million during the first quarter of 2004.

Other real estate owned was \$842,000 at March 31, 2004, a decrease of \$510,000 compared to \$1.4 million at December 31, 2003. During the first three months of 2004, eight properties were sold or had a reduction in their carrying value resulting in a \$546,000 decline in the balance of other real estate owned. During the same time period of 2004, \$36,000 of properties were repossessed and added to the carrying value of other real estate owned.

## Liquidity

Liquidity represents the ability to meet deposit withdrawals and fund loan demand, while retaining the flexibility to take advantage of business opportunities. The Company's primary sources of funds have been customer and brokered deposits, loan payments, sales or maturities of investments, sales of loans or other assets, borrowings, and the use of the federal funds market.

Historically the Company has utilized borrowings from the FHLB as an important source of funding for its growth. The Company has an established borrowing line with the FHLB that permits it to borrow up to 15% of the Bank's assets, subject to collateral limitations. Advances from the FHLB have original maturity periods ranging from 10 years through 15 years and at March 31, 2004, bear interest at rates ranging from 6.11% to 8.62%. At December 31, 2003, \$5.7 million in advances were outstanding from the FHLB, and at March 31, 2004 had been reduced to \$608,000. These borrowings mature from 2005 to 2009.

Brokered certificates of deposit is another funding source the Company utilizes to provide additional liquidity as necessary. At March 31, 2004, the Company's broker certificate of deposit balance was \$18.6 million compared to \$10.4 million at December 31, 2003.

In order to maintain the ability to access cash through sale of securities, during the first quarter of 2004, \$8.0 million of held-to-maturity investments were reclassified as available-for-sale. Accordingly, the fair value of these investment securities was recognized within Accumulated Other Comprehensive Income upon their reclassification.

## Regulatory Capital

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

The following table presents selected capital information for the Company and the Bank as of March 31, 2004 and December 31, 2003:

	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Action Provision	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>March 31, 2004</b>						
Total risk-based capital:						
Consolidated	\$ 33,207	16.81%	\$ 15,806	≥8.00%	N/A	N/A
Bank	\$ 34,106	17.27%	\$ 15,801	≥8.00%	\$ 19,751	≥10.00%
Tier 1 risk-based capital:						
Consolidated	\$ 30,718	15.55%	\$ 7,903	≥4.00%	N/A	N/A
Bank	\$ 31,618	16.01%	\$ 7,900	≥4.00%	\$ 11,851	≥6.00%
Tier 1 (leverage) capital:						
Consolidated	\$ 30,718	11.95%	\$ 10,285	≥4.00%	N/A	N/A
Bank	\$ 31,618	12.30%	\$ 10,282	≥4.00%	\$ 12,853	≥5.00%
<b>December 31, 2003</b>						
Total risk-based capital:						
Consolidated	\$ 32,679	16.38%	\$ 15,962	≥8.00%	N/A	N/A
Bank	\$ 33,614	16.85%	\$ 15,956	≥8.00%	\$ 19,946	≥10.00%
Tier 1 risk-based capital:						
Consolidated	\$ 30,166	15.12%	\$ 7,981	≥4.00%	N/A	N/A
Bank	\$ 31,102	15.59%	\$ 7,978	≥4.00%	\$ 11,967	≥6.00%
Tier 1 (leverage) capital:						
Consolidated	\$ 30,166	11.39%	\$ 10,597	≥4.00%	N/A	N/A
Bank	\$ 31,102	11.75%	\$ 10,591	≥4.00%	\$ 13,239	≥5.00%

Quantitative measures established by regulation to ensure capital adequacy require Cowlitz Bancorporation and Cowlitz Bank to maintain minimum amounts and ratios (set forth in the tables above) of Tier 1 capital to average assets, and Tier 1 and total risk-based capital to risk-weighted assets (all as defined in the regulations). Management believes that as of March 31, 2004 and December 31, 2003, Cowlitz Bancorporation and Cowlitz Bank met or exceeded all relevant capital adequacy requirements.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

#### Credit Risk

The Company, like other lenders, is subject to credit risk, which is the risk of losing principal and interest due to customers' failure to repay loans in accordance with their terms. Although the Company has established lending criteria and an adequate allowance for loan losses to help mitigate credit risk, a continued downturn in the economy or the real estate market or a rapid increase in interest rates could have a negative effect on collateral values and borrowers' ability to repay. The Company's targeted customers are small to medium-size businesses, professionals and retail customers that may have limited capital resources to repay loans during a prolonged economic downturn.

### *Interest Rate Risk*

The Company's earnings are largely derived from net interest income, which is interest income and fees earned on loans and investment income, less interest expense paid on deposits and other borrowings. Interest rates are highly sensitive to many factors that are beyond the control of the Company's management, including general economic conditions, and the policies of various governmental and regulatory authorities. As interest rates change, net interest income is affected. With fixed rate assets (such as fixed rate loans) and liabilities (such as certificates of deposit), the effect on net interest income depends on the maturities of the assets and liabilities. The Company's primary objective in managing interest rate risk is to minimize the adverse impact of changes in interest rates on the Company's net interest income and capital, while structuring the Company's asset/liability position to obtain the maximum yield-cost spread on that structure. Interest rate risk is managed through the monitoring of the Company's gap position and sensitivity to interest rate risk by subjecting the Company's balance sheet to hypothetical interest rate shocks. In a falling rate environment, the spread between interest yields earned and interest rates paid, may narrow, depending on the relative level of fixed and variable rate assets and liabilities. In a stable or increasing rate environment the Company's variable rate loans will remain steady or increase immediately with changes in interest rates, while fixed rate liabilities, particularly certificates of deposit will only re-price as the liability matures.

### **Item 4. Controls and Procedures**

As of March 31, 2004, the Company evaluated, under the supervision and the participation of Management, including the Chief Executive Officer and Chief Financial Officer, the effectiveness of the design and operation of disclosure controls and procedures. Based on that evaluation, Management, including the Chief Executive Officer and Chief Financial Officer, concluded that disclosure controls and procedures were effective.

There have been no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation.



## **Part II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

The Company from time to time enters into routine litigation resulting from the collection of secured and unsecured indebtedness as part of its business of providing financial services. In some cases, such litigation will involve counterclaims or other claims against the Company. Such proceedings against financial institutions sometimes also involve claims for punitive damages in addition to other specific relief. The Company is not a party to any litigation other than in the ordinary course of business. In the opinion of management, the ultimate outcome of all pending legal proceedings will not individually or in the aggregate have a material adverse effect on the financial condition or the results of operations of the Company.

### **Item 2. Changes in Securities and Use of Proceeds**

Not applicable

### **Item 3. Defaults upon Senior Securities**

Not applicable

### **Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable

### **Item 5. Other Information**

Not applicable

### **Item 6. Exhibits and Reports on Form 8-K**

(a) Exhibits. The following constitutes the exhibit index.

- 3.1\* Restated and Amended Articles of Incorporation of Registrant
- 3.2\* Bylaws of Registrant
- 31.1 Certification of Chief Executive Officer
- 31.2 Certification Chief Financial Officer
- 32 Certification of Chief Executive Officer and Chief Financial Officer

\* Incorporated by reference from Registration Statement on Form S-1, Reg. No. 333-44355

(b) During the quarter ended March 31, 2004, the Company filed a Current Report on Form 8-K on March 8, 2004, under item 5, and the Company furnished information under Item 12 of Form 8-K on February 4, 2004.

## SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: May 15, 2004

**Cowlitz Bancorporation**  
(Registrant)

By:

/s/ Richard J. Fitzpatrick

Richard J. Fitzpatrick, President and Chief Executive Officer

/s/ Donna P. Gardner

Donna P. Gardner, Vice-President, Chief Financial Officer

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER**

I, Richard J. Fitzpatrick, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cowlitz Bancorporation;
2. Based on my knowledge, this quarterly 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 quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures 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 quarterly report is being prepared;
  - b) 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
  - c) disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is likely to materially affect the registrant's internal control over financial reporting;
5. The registrant's other certifying officers 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 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.

Date: May 14, 2004

/s/ Richard J. Fitzpatrick

Richard J. Fitzpatrick, Chief Executive Officer  
Cowlitz Bancorporation

**CERTIFICATION OF CHIEF FINANCIAL OFFICER**

I, Donna P. Gardner, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cowlitz Bancorporation;
2. Based on my knowledge, this quarterly 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 quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures 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 quarterly report is being prepared;
  - b) 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
  - c) disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is likely to materially affect the registrant's internal control over financial reporting;
5. The registrant's other certifying officers 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 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.

Date: May 15, 2004

/s/ Donna P. Gardner

Donna P. Gardner, Chief Financial Officer  
Cowlitz Bancorporation

**CERTIFICATION OF  
CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER**

This certification is given by the undersigned Chief Executive Officer and Chief Financial Officer of Cowlitz Bancorporation (the "Registrant") pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Each of the undersigned hereby certifies, with respect to the Registrant's quarterly report of Form 10-Q for the period ended March 31, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934;  
and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Richard J. Fitzpatrick  
Richard J. Fitzpatrick  
Chief Executive Officer  
Cowlitz Bancorporation

/s/ Donna P. Gardner  
Donna P. Gardner  
Chief Financial Officer  
Cowlitz Bancorporation

May 14, 2004