



Capital Pacific Bank

A N N U A L R E P O R T

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Capital Pacific Bank

Dear Shareholder

When we opened the doors of Capital Pacific Bank in the summer of 2003, we knew there was a market eager to engage with a local business and professional bank committed to helping customers achieve success. We therefore focused our resources on attracting experienced and productive bankers to deliver not merely attention, but an elite level of service. We supplemented our staff with the judicious use of technology to provide innovative convenience for our customers and support for our forward-thinking business model.



These factors have helped differentiate Capital Pacific Bank from its competition in a dramatic way. Our first full year has thus been one of considerable accomplishment, both financially and operationally.

Financially, we achieved strong growth in all areas. Net interest income grew from \$218,000 to \$1,330,000, a six-fold increase from the 2003 year end. Total loans for the year grew from \$9,865,000 to \$41,279,000, more than quadrupling over the year. Total deposits increased nearly six-fold, going from \$5,609,000 to \$29,064,000 by year end. We also ended the year with a very strong 4th quarter net interest margin of 5.28%.

Excellent results come from excellent people, systems and planning. Over the year we have added exceptional people in key roles. In addition to augmenting our sales staff, we added depth to credit administration to maintain service levels commensurate with our growth. Effective systems are important to ensure that we deliver elite service to our customers and have the ability to tightly monitor performance. Both internal and external audits give us confidence that our systems are sound and being appropriately utilized.

Finally, we are executing on our Business and Strategic Plans. Those plans, and their tightly focused core strategy, enable us to concentrate on our target market of local businesses, professionals and high net worth individuals, with a high level of responsiveness and productivity. They also support our longer term objective of broadening the array of financial services offered through our Client Service Officers, leveraging and enhancing their relationships with our customers.

In addition to our internal strength, several external factors give us considerable optimism for the current year going forward. We continue to see improvement in our local economy. Credit line usage is increasing as companies grow their businesses, and we see greater commitment to the future in the form of more construction financing for owner-occupied warehouses and offices. The sheer volume of banking opportunity is impressive.

The underlying trends which have made community banks attractive to their customers continue. Several national banks have recently proposed to act as a "silent partner" to underwrite and process loans initiated and developed by selected community banks, recognizing the strengths of the community banks at the customer interface. This is an extension of the larger banks being a supplier to community banks for credit cards, merchant services and other products and services where scale is an issue. Far from being threatened by their larger counterparts, community banks more and more are entering into strategic alliances with them in a way that speaks to the relative strengths of each.

All of this creates opportunity for Capital Pacific Bank. While there have been new entrants in and around our marketplace this year, we have successfully attracted and retained business and professional customers who recognize and value the elite service, trusted advice and innovative convenience that Capital Pacific Bank offers. Our motto of "getting it done" is producing results, providing peace of mind for our customers, and helping us grow this bank into a trusted, comprehensive financial ally for our customers.

Sincerely,

Lawrence Rosencrantz
Chairman and CEO

Getting it done.

CAPITAL PACIFIC BANK

INDEPENDENT AUDITOR'S REPORT
AND
FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

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Note: These financial statements have not been reviewed, or confirmed for accuracy or relevance by the Federal Deposit Insurance Corporation.

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Stockholders
Capital Pacific Bank

We have audited the accompanying balance sheets of Capital Pacific Bank as of December 31, 2004 and 2003, and the related statements of operations, changes in stockholders' equity and comprehensive loss, and cash flows for the years then ended. These financial statements are the responsibility of Capital Pacific Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Capital Pacific Bank as of December 31, 2004 and 2003, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Moss Adams LLP

Portland, Oregon
January 14, 2005

CAPITAL PACIFIC BANK
BALANCE SHEETS

	December 31,	
	2004	2003
ASSETS		
Cash and due from banks	\$ 425,057	\$ 250,670
Federal funds sold	-	2,380,000
	<hr/>	<hr/>
Cash and cash equivalents	425,057	2,630,670
Time certificates of deposit with other banks	793,000	2,379,000
Available-for-sale investment securities	2,105,412	4,354,625
Interest-only strips	19,319	20,770
Federal Home Loan Bank stock, at cost	500	500
Loans, net of allowance for loan losses and unearned loan fees	40,631,705	9,740,657
Furniture and equipment, net of accumulated Depreciation	290,646	310,910
Accrued interest receivable and other assets	291,200	106,253
	<hr/>	<hr/>
TOTAL ASSETS	\$ 44,556,839	\$ 19,543,385
	<hr/> <hr/>	<hr/> <hr/>
LIABILITIES		
Deposits:		
Noninterest-bearing demand deposits	\$ 8,069,488	\$ 2,685,747
Interest-bearing demand and money market accounts	13,750,470	2,562,640
Time deposits	7,243,759	360,946
	<hr/>	<hr/>
Total deposits	29,063,717	5,609,333
Other borrowings	2,872,130	201,017
Accrued interest payable and other liabilities	343,315	132,156
	<hr/>	<hr/>
Total liabilities	32,279,162	5,942,506
	<hr/> <hr/>	<hr/> <hr/>
COMMITMENTS AND CONTINGENCIES (Notes 11 and 13)		
STOCKHOLDERS' EQUITY		
Common stock, no par value, 10,000,000 shares authorized; 1,509,845 shares issued and outstanding	14,526,842	14,526,842
Accumulated deficit	(2,237,113)	(920,354)
Accumulated other comprehensive loss, net of tax	(12,052)	(5,609)
	<hr/>	<hr/>
Total stockholders' equity	12,277,677	13,600,879
	<hr/> <hr/>	<hr/> <hr/>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 44,556,839	\$ 19,543,385
	<hr/> <hr/>	<hr/> <hr/>

CAPITAL PACIFIC BANK
STATEMENTS OF OPERATIONS

	Years Ended December 31,	
	2004	2003
INTEREST INCOME		
Interest and fees on loans	\$ 1,384,936	\$ 105,778
Interest on investment securities	82,757	54,414
Interest on federal funds sold	29,028	48,917
Other interest income	35,798	15,810
	1,532,519	224,919
INTEREST EXPENSE		
Interest on interest-bearing deposit accounts	135,373	4,843
Interest on time deposits	55,711	693
Interest on borrowed funds	11,792	894
	202,876	6,430
Net interest income before provision for loan losses	1,329,643	218,489
PROVISION FOR LOAN LOSSES	397,000	117,000
Net interest income after provision for loan losses	932,643	101,489
NONINTEREST INCOME		
Gain on sale of loans	155,152	105,443
Service charges and fees	53,993	3,742
Loss on sale of investment securities	(26,484)	-
Other noninterest income	28,602	722
	211,263	109,907
NONINTEREST EXPENSE		
Salaries and employee benefits	1,496,411	624,641
Occupancy expense	463,339	217,318
Data processing	96,500	44,056
Advertising	94,228	81,552
Professional fees	58,927	34,978
Provision for undisbursed commitments	48,000	-
Correspondent bank charges	27,754	-
Other noninterest expense	175,506	117,436
	2,460,665	1,119,981
NET LOSS	\$ (1,316,759)	\$ (908,585)
BASIC AND DILUTED LOSS PER SHARE OF COMMON STOCK	\$ (0.87)	\$ (0.60)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING FOR THE PERIOD	1,509,845	1,504,831

See accompanying notes.

CAPITAL PACIFIC BANK
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
AND COMPREHENSIVE LOSS

	Common Stock		Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders' Equity	Comprehensive Loss
	Shares	Amount				
Preopening expenses from previous year	-	\$ -	\$ (11,769)	\$ -	\$ (11,769)	\$ -
Stock issued from initial stock offering	1,509,845	14,526,842	-	-	14,526,842	-
Net loss	-	-	(908,585)	-	(908,585)	(908,585)
Other comprehensive loss:						
Unrealized losses arising during the period, net of tax	-	-	-	(5,609)	(5,609)	(5,609)
Comprehensive loss						<u>\$ (914,194)</u>
BALANCE,						
December 31, 2003	1,509,845	14,526,842	(920,354)	(5,609)	13,600,879	
Net loss	-	-	(1,316,759)	-	(1,316,759)	(1,316,759)
Other comprehensive loss:						
Unrealized losses arising during the period, net of tax	-	-	-	(6,443)	(6,443)	(6,443)
Comprehensive loss						<u>\$ (1,323,202)</u>
BALANCE,						
December 31, 2004	<u>1,509,845</u>	<u>\$14,526,842</u>	<u>\$(2,237,113)</u>	<u>\$ (12,052)</u>	<u>\$ 12,277,677</u>	

CAPITAL PACIFIC BANK
STATEMENTS OF CASH FLOWS

	Years Ended December 31,	
	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (1,316,759)	\$ (908,585)
Adjustments to reconcile net loss to net cash from operating activities:		
Depreciation and amortization	84,466	32,870
Loss on sale of investment securities	26,484	-
Amortization of premiums and discounts on investment securities and interest-only strips	14,453	3,208
Recognition of interest-only strips	(3,190)	(21,642)
Gain on sale of loans	(155,152)	(105,443)
Provision for loan losses	397,000	117,000
Provision for undisbursed commitments	48,000	-
Changes in cash and cash equivalents in certain assets and liabilities:		
Increase in interest receivable and other assets	(176,275)	(98,703)
Increase in interest payable and other liabilities	163,159	120,387
	<u>(917,814)</u>	<u>(860,908)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of investment securities	(762,596)	(4,668,650)
Proceeds from maturity of investment securities	486,169	298,530
Proceeds from sale of investment securities	2,474,229	-
Purchases of Federal Home Loan Bank stock	-	(500)
Net purchases (maturities) of time certificates of deposit with other banks	1,586,000	(2,379,000)
Net loans made to customers	(31,132,896)	(9,752,214)
Purchase of furniture and equipment	(64,202)	(343,780)
	<u>(27,413,296)</u>	<u>(16,845,614)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Demand deposit and money market accounts received from customers	16,571,571	5,248,387
Time deposits received from customers	6,882,813	360,946
Net proceeds from borrowed funds	21,113	201,017
Net federal funds purchased	2,650,000	-
Proceeds from sale of common stock, net of issuance costs	-	14,526,842
	<u>26,125,497</u>	<u>20,337,192</u>

CAPITAL PACIFIC BANK
STATEMENTS OF CASH FLOWS

	Years Ended December 31,	
	2004	2003
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	\$ (2,205,613)	\$ 2,630,670
CASH AND CASH EQUIVALENTS, beginning of year	2,630,670	-
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 425,057</u>	<u>\$ 2,630,670</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Interest paid in cash	<u>\$ 194,464</u>	<u>\$ 5,950</u>
Taxes paid in cash	<u>\$ -</u>	<u>\$ -</u>
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES		
Change in fair value of available-for-sale investment securities, net of taxes	<u>\$ (6,443)</u>	<u>\$ (5,609)</u>

**NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING
POLICIES**

Organization – During its formation, Capital Pacific Bank (the Bank) completed the sale and issuance of 1,509,845 shares of common stock at \$10 per share, pursuant to an Offering Circular dated March 6, 2003. Proceeds from the sale of stock were \$15,098,450, which, after deducting issuance costs of \$571,608, provided initial capitalization of \$14,526,842. On June 3, 2003, the Bank received regulatory approval to become a state chartered institution authorized to provide banking services in the state of Oregon, and commenced operations on August 4, 2003. Accordingly, the statement of operations for the year ended December 31, 2003, included revenues recognized by the Bank from its commencement of operations on August 4, 2003, and expenses incurred for the entire year. Expenses incurred in 2003 prior to the commencement of the Bank's operations were approximately \$228,000 and are classified as noninterest expenses in the statement of operations.

The Bank, operating from its headquarters in Portland, Oregon, provides banking services to businesses and individuals located primarily in the Portland area. It is subject to the regulations of certain state and federal agencies, and will undergo periodic examinations by those regulatory authorities.

Management's estimates and assumptions – The financial statements have been prepared in accordance with generally accepted accounting principles and reporting practices applicable to the banking industry. The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

The most significant accounting estimate for the Bank involves the determination of the recorded value of the allowance for loan losses. Management believes the assumptions used in arriving at these estimates are appropriate.

Cash and cash equivalents – For purposes of reporting cash flows, cash and cash equivalents include cash, interest-bearing deposits with correspondent banks with original maturities of 90 days or less, and federal funds sold. Federal funds sold represent excess cash funds that are, generally, invested on a daily basis. At December 31, 2004, the Bank had cash deposits at other financial institutions in excess of FDIC insured limits. However, as the Bank places these deposits with large, well capitalized financial institutions, management believes the risk of loss to be minimal.

Investment securities – The Bank is required to specifically identify its investment securities as "available-for-sale," "held-to-maturity," or "trading accounts." Accordingly, management has determined that all investment securities held at December 31, 2004 and 2003, are "available-for-

CAPITAL PACIFIC BANK

NOTES TO FINANCIAL STATEMENTS

NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (continued)

sale.” Securities are classified as available-for-sale if the instrument may be sold in response to such factors as: (1) changes in market interest rates and related changes in prepayment risk, (2) needs for liquidity, (3) changes in the availability of and the yield on alternative instruments, and (4) changes in funding sources and terms. Gains or losses on the sale of available-for-sale securities are determined using the specific-identification method. Unrealized holding gains and losses, net of tax, on available-for-sale securities are carried as accumulated other comprehensive income or loss within stockholders’ equity until realized. Fair values for these investment securities are based on quoted market prices.

Declines in the fair value of individual available-for-sale securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value. The related write-downs would be included in earnings as realized losses. Premiums and discounts are recognized in interest income using the effective interest method over the period to maturity.

Federal Home Loan Bank stock – The Bank’s investment in Federal Home Loan Bank (FHLB) stock is a restricted investment carried at par value, which approximates its fair value. As a member of the FHLB system, the Bank is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding FHLB advances. The Bank may request redemption at par value of any shares in excess of the amount the Bank is required to hold. Stock redemptions are made at the discretion of the FHLB.

Loans, net of allowance for loan losses and unearned loan fees – Loans are stated at the amount of unpaid principal, reduced by an allowance for loan losses and unearned loan fees. Interest on loans is calculated by the simple-interest method on daily balances of the principal amount outstanding. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment to the yield of the related loan.

The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for loan losses when management believes that the collectibility of principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may become uncollectible, based on evaluations of the collectibility of loans. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrower’s ability to pay. Various regulatory agencies, as a regular part of their examination process, will periodically review the Bank’s allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on their judgment of information available to them at the time of examinations.

**NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING
POLICIES – (continued)**

Impaired loans are carried at the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's market price, or the fair value of the collateral if the loan is collateral dependent. Accrual of interest is discontinued on impaired loans when management believes, after considering economic and business conditions, collection efforts and collateral position, that the borrower's financial condition is such that collection of interest is doubtful. When the accrual of interest is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received.

Furniture and equipment – Furniture and equipment are recorded at cost, less accumulated depreciation. Depreciation is computed using the straight-line method over the expected useful lives of the assets, ranging from two to ten years. The costs of maintenance and repairs are expensed as they are incurred, while major expenditures for renewals and betterments are capitalized.

Gain on sale of loans and interest-only strips – From time-to-time, the Bank may sell all or a partial interest in selected loans. The amount of gain or loss recognized on the sale of a loan is determined upon an allocation of the sale price to the carrying amount of the portion of the loan sold and to the retained interest in the loan based on the relative fair value at the date of transfer. The fair values allocated to loan interests sold and retained are based on market prices, if available. Otherwise, fair values are determined based upon management's estimate of the present value of expected cash flows of instruments similar to the various components sold and retained.

When the Bank sells all or a portion of certain loans, it may retain the contractual right to receive a portion of the interest due on the sold loan. The right to these payments represents a retained interest in the sold loan and is commonly referred to as an interest-only strip. Interest-only strips are recorded at fair value similar to debt securities classified as available-for-sale. At December 31, 2004 and 2003, the carrying value of interest-only strips approximated fair market value.

Income taxes – Deferred tax assets and liabilities are determined based on the tax effects of the differences between the book and tax bases of various balance sheet assets and liabilities. Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Valuation allowances are established to reduce deferred tax assets if it is uncertain that all or a portion of the deferred tax assets will be realized.

Advertising – The Bank expenses advertising costs as they are incurred. Advertising costs were \$94,228 and \$81,552 for the years ended December 31, 2004 and 2003, respectively.

CAPITAL PACIFIC BANK
 NOTES TO FINANCIAL STATEMENTS

NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING
 POLICIES – (continued)

Earnings (loss) per share of common stock – Basic earnings (loss) per share of common stock is computed by dividing net income (loss) available to stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share of common stock is computed similar to basic earnings per share of common stock except that the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. Outstanding common stock options and warrants of 262,729 and 255,600 at December 31, 2004 and 2003, respectively, are excluded from diluted earnings per share because their impact on the calculation would have been antidilutive.

Stock-based compensation – The Bank applies Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees,” and related interpretations in accounting for common stock warrants and options issued to employees using the intrinsic value-based method. Accordingly, compensation costs are recognized as the difference between the exercise price of each warrant or option and the market price of the Bank’s stock at the date of each issuance. Had compensation cost for the Bank’s 2003 issuance of stock options and warrants to employees been determined consistent with the fair value-based method defined in Statement of Financial Accounting Standards (SFAS) No. 123, “Accounting for Stock-Based Compensation,” its net loss and loss per common share for December 31 would approximate the pro forma amounts below.

	<u>2004</u>	<u>2003</u>
Net loss, as reported	\$ (1,316,759)	\$ (908,585)
Total stock-based employee compensation expense determined under fair value-based methods for all awards, net of related tax effects	<u>(68,000)</u>	<u>(176,000)</u>
Pro forma net loss	<u><u>\$ (1,384,759)</u></u>	<u><u>\$ (1,084,585)</u></u>
Loss per share:		
Basic and diluted – as reported	\$ (0.87)	\$ (0.60)
Basic and diluted – pro forma	\$ (0.92)	\$ (0.72)

NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING
POLICIES – (continued)

The fair value of each stock option and warrant issued is estimated on the date of issuance using the Black-Scholes option pricing model with the following assumptions for the years ended December 31, 2004 and 2003:

	2004	2003
Dividend yield	0.00%	0.00%
Expected life (years)	7	5 to 7
Expected volatility	0.00%	0.00%
Risk-free rate	4.00%	3.50%

The effects of applying SFAS No. 123 in this pro forma disclosure are not indicative of future amounts arising from the issuance of options or warrants in the future.

Off-balance sheet financial instruments – The Bank holds no derivative financial instruments. However, in the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit, commercial letters of credit, and standby letters of credit. These financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received. The Bank maintains an allowance for off-balance sheet items, established as an accrued liability through charges to noninterest expense. The allowance is an amount that management believes will be adequate to absorb possible losses associated with off-balance sheet credit risk. The evaluations take into consideration such factors as changes in the nature and volume of the commitments to extend credit, undisbursed balance of existing lines of credit, and letters of credit.

Reclassifications – Certain reclassifications have been made to the 2003 financial statements to conform to current year presentations.

CAPITAL PACIFIC BANK
NOTES TO FINANCIAL STATEMENTS

NOTE 2 - INVESTMENT SECURITIES

The amortized cost and estimated fair values of available-for-sale investment securities at December 31 are summarized as follows:

	2004			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	\$ 876,091	\$ 2,810	\$ (13,059)	\$ 865,842
Obligations of U.S. government agencies	1,249,484	-	(9,914)	1,239,570
	<u>\$ 2,125,575</u>	<u>\$ 2,810</u>	<u>\$ (22,973)</u>	<u>\$ 2,105,412</u>
	2003			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	\$ 609,883	\$ 5,007	\$ (36)	\$ 614,854
Obligations of U.S. government agencies	1,753,412	3,567	(1,300)	1,755,679
Mutual funds	2,000,713	-	(16,621)	1,984,092
	<u>\$ 4,364,008</u>	<u>\$ 8,574</u>	<u>\$ (17,957)</u>	<u>\$ 4,354,625</u>

Substantially all of the securities in the December 31, 2004, table above had gross unrealized losses for less than 12 months. The Bank has evaluated the unrealized losses for the mortgage-backed securities and U.S. government obligations and determined that the decline in value at December 31, 2004, is temporary and is related to the change in market interest rates since the date of their purchase.

CAPITAL PACIFIC BANK
NOTES TO FINANCIAL STATEMENTS

NOTE 2 – INVESTMENT SECURITIES – (continued)

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

	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 663,933	\$ 660,371
Due after one year through five years	1,431,648	1,414,585
Due after five years through ten years	29,994	30,456
	\$ 2,125,575	\$ 2,105,412

For the purpose of the maturity table, mortgage-backed securities, which are not due at a single maturity date, have been allocated over maturity groupings based on the weighted average contractual maturities of underlying collateral. Mortgage-backed securities may mature earlier than their weighted average contractual maturities due to unanticipated principal prepayments.

At December 31, 2004 and 2003, available-for-sale investment securities of \$1,400,626 and \$249,431, respectively, were pledged to secure other borrowings, as permitted or required by law.

NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES

As of December 31 the loan portfolio consisted of the following:

	2004	2003
Commercial loans	\$ 26,189,484	\$ 8,434,947
Real estate loans	14,982,739	1,426,719
Consumer loans	82,162	2,500
Overdrafts	24,849	400
Total loans	41,279,234	9,864,566
Less allowance for loan losses	(514,000)	(117,000)
Less unearned loan fees	(133,529)	(6,909)
Loans, net of allowance for loan losses and unearned loan fees	\$ 40,631,705	\$ 9,740,657

No loans were charged off, recovered, considered impaired, or carried on a nonaccrual basis as of or for the years ended December 31, 2004 and 2003.

CAPITAL PACIFIC BANK
NOTES TO FINANCIAL STATEMENTS

NOTE 4 - FURNITURE AND EQUIPMENT

As of December 31 the composition of furniture and equipment is summarized as follows:

	<u>2004</u>	<u>2003</u>
Furniture and equipment	\$ 299,117	\$ 272,708
Software	80,022	71,072
Construction in progress	<u>28,845</u>	<u>-</u>
Total furniture and equipment	407,984	343,780
Less accumulated depreciation	<u>(117,338)</u>	<u>(32,870)</u>
Furniture and equipment, net of accumulated depreciation	<u>\$ 290,646</u>	<u>\$ 310,910</u>

NOTE 5 - TIME DEPOSITS

Time certificates of deposit of \$100,000 and over aggregated to \$4,773,793 and \$310,529 at December 31, 2004 and 2003, respectively.

The scheduled maturities for all time certificates of deposit are as follows:

Years ending December 31,	2005	\$ 3,328,025
	2006	1,143,364
	2007	1,610,131
	2008	<u>1,162,239</u>
		<u>\$ 7,243,759</u>

NOTE 6 - LINES OF CREDIT AND OTHER BORROWINGS

The Bank has a borrowing agreement with the Federal Reserve Bank of San Francisco whereby it participates in the Treasury, Tax, and Loan Note Option program. Borrowings under this program are collateralized by investment securities and carry an interest rate of 0.25% less than the federal funds borrowing rate, or approximately 2.00% at December 31, 2004. The note balance, which was \$222,130 and \$201,017 as of December 31, 2004 and 2003, is payable on demand.

CAPITAL PACIFIC BANK
NOTES TO FINANCIAL STATEMENTS

NOTE 6 – LINES OF CREDIT AND OTHER BORROWINGS – (continued)

The Bank, as a member of the Federal Home Loan Bank (FHLB) of Seattle, has entered into a credit arrangement with the FHLB under which authorized borrowings are collateralized by the Bank's FHLB stock as well as loans or other instruments which may be pledged. As of December 31, 2004, the Bank had no outstanding borrowings with the FHLB. Maximum borrowings available from the FHLB for notes payable, lines of credit, and the Cash Management Advance program totaled \$3.4 million at December 31, 2004. Available borrowings are subject to eligible collateral being pledged and are reduced by outstanding letters of credit.

The Bank also has federal funds line of credit agreements with two financial institutions and the Federal Reserve Bank of San Francisco. Maximum aggregate borrowings available under these lines totaled \$7.3 million as of December 31, 2004. These lines support short-term liquidity and their use may be limited, depending on the lending institution. At December 31, 2004, there was \$2,650,000 in outstanding borrowings under these agreements.

NOTE 7 – INCOME TAXES

At December 31, 2004 and 2003, the Bank had available to offset future taxable income, net operating loss carryforwards of approximately \$2,511,000 and \$934,000 and unamortized preopening expenses, capitalized for tax purposes, of approximately \$180,000 and \$250,000, respectively. The net operating loss carryforwards will begin expiring in 2024, unless utilized in earlier tax years. The preopening expenses are being amortized and deducted for tax purposes over a 60-month period.

Deferred income taxes represent the tax effect of differences in timing between financial income and taxable income. As of December 31, 2004 and 2003, net deferred tax benefits in the accompanying balance sheets include the following components:

	<u>2004</u>	<u>2003</u>
Deferred tax assets:		
Unamortized preopening expenses	\$ 69,000	\$ 95,732
Net operating loss carryforward	964,000	358,654
Charitable contribution carryforward	<u>2,500</u>	<u>614</u>
 Total deferred tax assets	 <u>1,035,500</u>	 <u>455,000</u>

CAPITAL PACIFIC BANK
NOTES TO FINANCIAL STATEMENTS

NOTE 7 – INCOME TAXES – (continued)

	<u>2004</u>	<u>2003</u>
Deferred tax liabilities:		
Deferred loan fee income	\$ 71,500	\$ 16,415
Allowance for loan losses	29,000	6,066
Accumulated depreciation	59,000	52,361
Accrual to cash adjustment	17,000	26,158
Loan participation sale adjustment	<u>7,000</u>	<u>-</u>
Total deferred tax liabilities	<u>183,500</u>	<u>101,000</u>
	852,000	354,000
Valuation allowance	<u>(852,000)</u>	<u>(354,000)</u>
Net deferred tax assets	<u>\$ -</u>	<u>\$ -</u>

A valuation allowance has been established at December 31, 2004, since it is uncertain if the Bank will be able to utilize all of the existing deferred tax assets as a deduction to future tax liabilities.

NOTE 8 – TRANSACTIONS WITH RELATED PARTIES

Certain directors, executive officers, and principal stockholders are customers of and have had banking transactions with the Bank in the ordinary course of business, and the Bank expects to have such transactions in the future. Management believes loans and commitments to loan included in such transactions are made in compliance with applicable laws on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable transactions with other persons and, in the opinion of the management of the Bank, do not involve more than the normal risk of collection or present any other unfavorable features. At December 31, 2004 and 2003, loans outstanding to directors, executive officers, principal stockholders, and companies with which they are associated totaled \$44,878 and \$2,500, respectively.

Deposits of related parties held by the Bank at December 31, 2004 and 2003, amounted to approximately \$1,219,558 and \$859,740, respectively.

NOTE 9 – FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

In the normal course of business to meet the financing needs of its customers, the Bank is a party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and the issuance of letters of credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the balance sheets. The contract amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and letters of credit written is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

A summary of the notional amounts of the Bank's financial instruments with off-balance sheet risk at December 31, 2004, are as follows:

	<u>Contract Amounts</u>
Financial instruments whose contract amounts contain credit risk:	
Undisbursed balance of existing lines of credit	\$ 17,394,178
Commitments to extend credit	750,000
Letters of credit written	<u>961,490</u>
	<u>\$ 19,105,668</u>

Commitments to extend credit are agreements to lend to customers, 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. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing properties.

Letters of credit written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds cash, marketable securities, or real estate as collateral supporting those commitments for which collateral is deemed necessary.

CAPITAL PACIFIC BANK

NOTES TO FINANCIAL STATEMENTS

NOTE 9 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

- (continued)

An allowance for off-balance sheet loan commitments, undisbursed lines of credit, and letters of credit has been established as an accrued liability in the amount of \$48,000 at December 31, 2004.

NOTE 10 - CONCENTRATIONS OF CREDIT RISK

A majority of the Bank's loans and commitments have been granted to customers in the Bank's market area. The distribution of commitments to extend credit approximates the distribution of loans outstanding. The majority of such customers are also depositors of the Bank. Concentrations of credit by type of loan are set forth in Note 3. The Bank's loan policies do not allow the extension of credit to any single borrower in excess of 25% of the Bank's capital (15% for non-real estate secured loans).

NOTE 11 - COMMITMENTS AND CONTINGENCIES

Lease commitments - At December 31, 2004, the Bank leased its office space in Portland, Oregon, under an operating lease agreement which expires on August 31, 2013, and includes a fixed escalation clause. Approximate future minimum payments under this lease agreement are as follows:

Years ending December 31,	2005	\$	193,000
	2006		226,000
	2007		226,000
	2008		239,000
	2009		257,000
	Thereafter		<u>1,010,000</u>
		\$	<u>2,151,000</u>

Rent expense, excluding common area maintenance, was \$239,712 and \$118,776 for the years ended December 31, 2004 and 2003, respectively.

NOTE 11 – COMMITMENTS AND CONTINGENCIES – (continued)

Legal contingencies – The Bank may become a defendant in certain claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, there are no matters presently known that are expected to have a material adverse effect on the financial condition of the Bank.

NOTE 12 – COMMON STOCK WARRANTS AND OPTIONS

Employee warrants – Current employees, who placed capital at risk to fund the Bank's organizational expenses prior to the initial offering of common stock, received one common stock warrant for each \$10 invested. The Bank issued 40,400 warrants to these employees, each of which is exercisable for one share of common stock at a price of \$10 per share. The warrants expire on August 4, 2013. Had issuance of the warrants been accounted for as compensation costs consistent with SFAS No. 123, the effect would have been to increase the net loss from \$908,585 to \$943,585 for the year ended December 31, 2003. As of December 31, 2004, no warrants issued to employees have been exercised.

Warrants issued to nonemployees – As compensation for services rendered in connection with the initial offering of common stock, the Bank issued a warrant to its Placement Agent. The warrant allows the Placement Agent to purchase up to 18,800 shares of common stock at \$10 per share. The warrant expires June 4, 2008, and may be exercised at any time after June 4, 2004, until expiration. The Bank also issued warrants to a professional assisting with the initial offering as compensation for services rendered and to a director who placed capital at risk to fund the Bank's organizational expenses. These warrants allow the holders to purchase an aggregate of 2,900 shares of common stock at \$10 per share through expiration on August 4, 2013. As of December 31, 2004, no warrants issued to nonemployees have been exercised.

Stock option plan – The Bank maintains a stock incentive plan approved by the Board of Directors and ratified by the stockholders in April 2004, authorizing the grant of up to 305,000 common stock shares. The stock incentive plan allows for the granting of both incentive and nonstatutory stock options. For all options, the option price, number of shares granted, and duration for the stock options are determined and approved by the Board of Directors. However, the exercise price for incentive stock options must be at least 100% of the fair market value of the shares on the date of grant, and if the optionee is a significant stockholder, the exercise price for incentive stock options must be at least 110% of the fair market value of the shares on the date of grant. The maximum life for stock option grants is ten years from the date of grant or five years if the optionee is a significant stockholder.

CAPITAL PACIFIC BANK
NOTES TO FINANCIAL STATEMENTS

NOTE 12 – COMMON STOCK WARRANTS AND OPTIONS – (continued)

The following table summarizes stock options outstanding under this plan at December 31, 2004:

	<u>Total Options</u>	<u>Incentive Options</u>	<u>Nonstatutory Options</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Fair Value</u>
Options granted in 2003:					
Incentive stock options	159,500	159,500	-	\$ 10.05	\$ 2.17
Nonstatutory stock options	<u>34,000</u>	<u>-</u>	<u>34,000</u>	\$ 10.06	\$ 2.16
Options under grant – December 31, 2003	193,500	159,500	34,000	\$ 10.05	
Options granted in 2004:					
Incentive stock options	<u>7,129</u>	<u>7,129</u>	<u>-</u>	\$ 11.28	\$ 2.04
Options under grant – December 31, 2004	<u>200,629</u>	<u>166,629</u>	<u>34,000</u>	\$ 10.10	
Options available for grant – December 31, 2004	<u>104,371</u>				

The following table summarizes information regarding stock options outstanding at December 31, 2004, under the Bank's stock option plan:

<u>Incentive Stock Options</u>				<u>Nonstatutory Stock Options</u>			
<u>Exercise Price</u>	<u>Number of Options Outstanding</u>	<u>Number of Options Exercisable</u>	<u>Average Remaining Contractual Life (in years)</u>	<u>Exercise Price</u>	<u>Number of Options Outstanding</u>	<u>Number of Options Exercisable</u>	<u>Average Remaining Contractual Life (in years)</u>
\$ 10.00	144,500	48,167	8.01	\$ 10.00	30,000	10,000	8.52
\$ 10.00	3,000	750	8.37	\$ 10.50	4,000	1,333	8.76
\$ 10.70	12,000	3,000	8.84				
\$ 10.75	5,150	-	9.33				
\$ 10.90	750	-	8.98				
\$ 13.30	375	-	9.72				
\$ 13.92	604	-	9.80				
\$ 14.00	250	-	9.76				
	<u>166,629</u>	<u>51,917</u>			<u>34,000</u>	<u>11,333</u>	

NOTE 13 – EMPLOYMENT AGREEMENTS

The Bank has entered into three-year employment agreements with its executive officers. In addition to providing each officer with compensation and other customary benefits, under certain conditions, if conditions for termination as provided in the employment agreement are met, the officer is entitled to receive salary and other benefits from the effective date of termination through the remaining term of his or her employment agreement. At current compensation levels, if all covered executive officers under contract were terminated and entitled to receive benefits, the Bank would be required to make maximum monthly payments of \$46,000 until the expiration of the contracts in June 2006.

NOTE 14 – EMPLOYEE BENEFIT PLAN

The Bank has adopted a 401(k) savings investment plan which allows employees to defer certain amounts of compensation for income tax purposes under section 401(k) of the Internal Revenue Code. Essentially, all employees over the age of 18 are eligible to participate in the plan. Employees may elect to defer and contribute up to the statutory limits. Their contributions and those of the Bank, which are discretionary, are invested in employee-designated funds. For the years ending December 31, 2004 and 2003, the Bank made no matching or profit sharing contributions to the plan.

NOTE 15 – REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by 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 the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, banks must meet specific capital guidelines that involve quantitative measures of the bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by regulators about components, risk weightings, and other factors.

Quantitative measures, established by regulation to ensure capital adequacy, require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes the Bank is well capitalized under the regulatory framework for prompt corrective action.

CAPITAL PACIFIC BANK
NOTES TO FINANCIAL STATEMENTS

NOTE 15 – REGULATORY MATTERS – (continued)

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

	Actual		Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(in thousands)						
December 31, 2004						
Total capital to risk-weighted assets:	\$12,852	26.46%	\$ 3,886	≥8%	\$ 4,858	≥10%
Tier 1 capital to risk-weighted assets:	\$12,290	25.30%	\$ 1,943	≥4%	\$ 2,915	≥6%
Tier 1 capital to average assets:	\$12,290	31.45%	\$ 1,563	≥4%	\$ 1,954	≥5%
December 31, 2003						
Total capital to risk-weighted assets:	\$ 13,710	98.95%	\$ 1,108	≥8%	\$ 1,386	≥10%
Tier 1 capital to risk-weighted assets:	\$ 13,593	98.10%	\$ 554	≥4%	\$ 831	≥6%
Tier 1 capital to average assets:	\$ 13,593	82.01%	\$ 663	≥4%	\$ 829	≥5%

Capital Pacific Bank



Met Capital Pacific Bank's management team - experienced bankers and business executives who joined together to build a new kind of bank. These seasoned professionals provide an elite level of financial service to Portland-area business customers, professionals and high-wealth individuals. (From left) Felice Belfiore, *Chief Financial Officer*; Harlan Barcus, *Chief Credit Officer*; Mack Lai, *Chief Operating Officer*; Larry Rosencrantz, *Chief Executive Officer*; Tyson Smith, *Chief Information Officer*; Robert Countryman, *Senior Vice President, Client Service*.

Getting it done.



Capital Pacific Bank

Board of Directors

Richard Alexander

Mark A. Coffey

Mack Lai

Frances Matson

Lawrence Rosencrantz, *Chairman*

Ronald A. Shellan

Thomas Tomjack

Karen Whitman

Management

Lawrence Rosencrantz, *Chief Executive Officer*

Felice Belfiore, *Chief Financial Officer*

Mack Lai, *Chief Operating Officer*

Harlan D. Barcus, *Chief Credit Officer*

Tyson Smith, *Chief Information Officer*

Robert L. Countryman, *Senior Vice President,
Client Service*

Getting it done.

805 S.W. Broadway, Suite 780

Portland, Oregon 97205

503-796-0100 Phone

503-796-0101 Fax

www.capitalpacificbank.com