

valley community bancshares, inc.

2003 ANNUAL REPORT

Valley Community Bancshares, Inc.
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FORWARD-LOOKING STATEMENTS

Except for historical financial information contained herein, certain matters discussed in the Annual Report of Valley Community Bancshares, Inc. constitute “forward-looking statements” within the meaning of the Securities Exchange Act of 1934, as amended. Forward-looking statements are subject to risks and uncertainties that may cause actual future results to differ materially. Such risks and uncertainties with respect to Valley Community Bancshares, Inc. and Valley Bank include, but are not limited to, those related to the economic environment, particularly in the areas in which the Company and the Bank operate, competitive products and pricing, loan delinquency rates, fiscal and monetary policies of the U.S. government, changes in governmental regulations affecting financial institutions, including regulatory fees and capital requirements, changes in prevailing interest rates, acquisitions and the integration of acquired businesses, credit risk management and asset/liability management, the financial and securities markets, and the availability of and costs associated with sources of liquidity.

Valley Community Bancshares, Inc.

Valley Community Bancshares, Inc. (the “Company”) is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company was organized and incorporated under the laws of the State of Washington as a holding company for its principal banking subsidiary, Valley Bank, a state chartered Federal Deposit Insurance Corporation (the “FDIC”) insured commercial bank, through a reorganization completed on July 1, 1998. The Company conducts its business primarily through Valley Bank. Valley Bank is referred to as the “Bank” in this Annual Report.

The Company’s main office is located in Puyallup, Washington, which also serves as the main office of Valley Bank. The Bank provides a full range of commercial banking services to small and medium-sized businesses, professionals, and other individuals through banking offices located in Puyallup, Auburn, and Kent, Washington, and their environs.

The principal sources of the Company’s revenue are (i) interest and fees on loans; (ii) deposit service charges; (iii) merchant credit card processing fees; (iv) interest-bearing deposits with banks; (v) interest on investments (principally government securities), and (vi) origination fees on mortgage loans brokered. The lending activity consists of short- to medium-term commercial and consumer loans, including operating loans and lines of credit, equipment loans, automobile loans, recreational vehicle and truck loans, personal loans or lines of credit, home improvement loans, and rehabilitation loans. The Bank also offers cash management services, merchant credit card processing, safe deposit boxes, wire transfers, direct deposit of payroll and Social Security checks, automated teller machine access, and automatic drafts for various accounts.

Valley Bank

Valley Bank is a Washington State–chartered commercial bank that commenced operations as Puyallup Valley Bank in October 1973. In January 1999 the Company opened Valley Bank, a state-chartered, FDIC insured commercial bank subsidiary located in Auburn, Washington. On January 17, 2003, in an effort to consolidate operations, Puyallup Valley Bank and Valley Bank merged and renamed the resulting institution Valley Bank.

The organizers of the Bank commenced formation efforts in 1972 as Puyallup Valley Bank. Puyallup Valley Bank was formally incorporated on January 9, 1973, under the laws of the State of Washington after having received approval to organize from the Division of Banks of the Washington Department of Financial Institutions (the “Division”) and the FDIC, and commenced operations during October 1973. Puyallup Valley Bank was organized with capital of \$400,000 through the sale of 20,000 shares of Common Stock at a sales price of \$20 per share.

The Bank provides full-service banking to businesses and residents within the Puyallup, Auburn, and Kent communities and the surrounding areas. The Bank places particular emphasis on serving the small to medium-sized business segment of the market by making available a line of banking products tailored to their needs, with those services delivered by experienced professionals concerned with building long-term relationships. The Bank conducts business out of eight full-service offices and one drive-up facility.

On May 16, 2002, the Bank purchased various tangible and intangible assets of Puget Sound Mortgage Brokers, Inc., a Washington Corporation located in Puyallup Washington. The purchase price was not material to the consolidated financial condition and results of operations of the Company or the Bank. The purchase was made to further enhance the Bank’s mortgage banking operations. The mortgage operation is operated as a division of the Bank using the name Puget Sound Mortgage Brokers and operates in a leased facility.

Valley Bank is a wholly owned subsidiary of the Company.

Market Area

The Company’s principal market area is located in south King County and eastern Pierce County regions of Washington State. King County and Pierce County are the two most populous counties in Washington State, with nearly 2,500,000 residents. The economy of the region is dependent upon aerospace, high technology, foreign trade, and natural resources, including agriculture and timber. The region has become more diversified over the past decade as a result of the success of software companies such as Microsoft and the establishment of numerous research and biotechnology firms. The regional economy generally has experienced strong growth and stability in recent years. However, during the fourth quarter of 2001 and throughout 2003 the regional economy has slowed significantly, especially in the aerospace and high technology sectors.

Eastern Pierce County, where the Bank has seven locations, is located approximately 30 miles southeast of Seattle and 5 miles northeast of Tacoma, the region’s two largest cities. The area encompasses several residential and agricultural communities, including Puyallup, South Hill, Sumner, Edgewood, Graham, Orting, and Summit/Fredrickson, and has a population in excess of 150,000 residents. This area is characterized as the Company’s principal market area.

the company

South King County, where the Bank has locations in Auburn and Kent, is centrally located between Seattle and Tacoma and has a population of nearly 300,000 residents. The community is supported by light industry, aerospace, and forest products industries. The Company considers the Auburn and Kent Valley a natural area of expansion because of its close proximity to Eastern Pierce County.

Business Strategy

As a locally owned financial institution, the Company emphasizes local banking needs. The Company seeks to achieve growth in order to establish and then maintain a strong return on equity. The strategy to accomplish these goals is to focus on small businesses that traditionally develop an exclusive relationship with a single bank. The Bank also has the size to give the personal attention required by businesspeople, and significant credit expertise to help these businesses meet their goals.

The Bank offers to its customers a full range of deposit services that are typically available in most banks and savings and loan associations, including checking accounts, savings accounts, and other time deposits of various types, ranging from money market accounts to longer-term certificates of deposit. One major goal in developing the Bank's product mix is to keep the product offerings as simple as possible, both in terms of the number of products and the features and benefits of the individual services. The transaction accounts and time certificates are tailored to the principal market areas at rates competitive in the area. In addition, retirement accounts such as IRAs (Individual Retirement Accounts) are available. The FDIC, up to the maximum amount, insures all deposit accounts. The Bank solicits these accounts from small to medium-sized businesses in their respective primary trade areas, and from individuals who live and/or work within these areas.

The Bank offers loans to their diverse markets and communities. The market consists of South King County and East Pierce County in general and the areas in and around Puyallup, Auburn, and Kent in particular. Loans are provided to creditworthy borrowers regardless of their race, color, national origin, religion, sex, age, marital status, sexual orientation, disability, receipt of public assistance, or any basis prohibited by law. The Bank intends to fulfill this commitment while maintaining prudent credit practices. In the course of fulfilling their obligation to meet the credit needs of the communities that they serve, the Bank gives consideration to each credit application regardless of the fact that the applicant may reside in a low to moderate income neighborhood, and without regard to the geographic location of the residence, property, or business within their market areas.

The Bank provides innovative, quality financial products that meet the banking needs of its customers and communities. The loan programs and acceptance of certain loans may vary from time to time, depending upon funds available and regulations governing the banking industry. The Bank offers all basic types of credit to its local communities, including commercial and consumer loans.

Valley Community Bancshares, Inc.
selected financial data

SELECTED FINANCIAL DATA

The following financial data of the Company are derived from the Company's historical audited financial statements and related footnotes.

valley community bancshares, inc.
selected financial data¹

	at and for the year ended december 31, (dollars in thousands, except per-share amounts)				
	2003	2002	2001	2000	1999
Statement of Income Data					
Interest income	\$ 9,058	\$ 9,886	\$ 10,516	\$ 10,533	\$ 8,958
Interest expense	1,268	1,883	3,435	3,715	2,973
Net interest income	<u>7,790</u>	<u>8,003</u>	<u>7,081</u>	<u>6,818</u>	<u>5,985</u>
Provision for loan losses		213	62	145	84
Net interest income after provision for loan losses	<u>7,790</u>	<u>7,790</u>	<u>7,019</u>	<u>6,673</u>	<u>5,901</u>
Noninterest income	1,469	1,004	870	661	589
Noninterest expense	6,247	5,722	5,359	4,998	4,516
Income before provision for income tax	<u>3,012</u>	<u>3,072</u>	<u>2,530</u>	<u>2,336</u>	<u>1,974</u>
Provision for income tax	963	954	744	728	580
Net income	<u>\$ 2,049</u>	<u>\$ 2,118</u>	<u>\$ 1,786</u>	<u>\$ 1,608</u>	<u>\$ 1,394</u>
Per-Share Data ²					
Cash dividends	\$ 675	\$ 675	\$ 623	\$ 564	\$ 135
Cash dividends per weighted average shares outstanding	\$ 0.58	\$ 0.57	\$ 0.52	\$ 0.47	\$ 0.11
Basic earnings per share	\$ 1.75	\$ 1.79	\$ 1.50	\$ 1.35	\$ 1.19
Diluted earnings per share	\$ 1.74	\$ 1.77	\$ 1.48	\$ 1.33	\$ 1.15
Weighted average shares outstanding	1,172,561	1,182,840	1,187,256	1,188,058	1,175,769
Weighted average diluted shares outstanding	1,178,261	1,197,096	1,206,709	1,211,577	1,210,205
Balance Sheet Data					
Total assets	\$ 182,220	\$ 171,711	\$ 157,174	\$ 146,769	\$ 133,837
Net loans	112,873	103,966	99,599	93,518	77,675
Deposits	157,231	147,436	134,700	125,047	113,809
Shareholders' equity	23,653	22,455	21,161	20,125	18,724
Equity to assets ratio	12.98%	13.08%	13.46%	13.71%	13.99%
Five-Year Financial Performance					
Net income	\$ 2,049	\$ 2,118	\$ 1,786	\$ 1,608	\$ 1,394
Average assets	178,305	164,850	155,828	142,864	132,945
Average stockholders' equity	22,885	21,818	20,597	19,084	17,862
Return on average assets (net income divided by average assets)	1.15%	1.28%	1.15%	1.13%	1.05%
Return on average equity (net income divided by average equity)	8.95%	9.71%	8.67%	8.43%	7.80%
Efficiency ratio (noninterest expense divided by noninterest income plus net interest income)	67.47%	63.53%	67.40%	66.83%	68.69%
Ratio of noninterest expense to average assets	3.50%	3.47%	3.44%	3.50%	3.40%

¹ The computation of the ratios is based on the recorded assets and liabilities after the effect of the changes in market values of securities available for sale.

² The presentation of per-share data prior to 2003 has been restated to reflect the 5 percent stock dividend distributed in February 2003.

management's discussion and analysis of financial condition and results of operations

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is provided for the consolidated operations of the Company, which include its wholly owned subsidiary. The purpose of this discussion is to focus on significant factors affecting the Company's financial condition and results of operations.

Critical Accounting Policies and Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect amounts reported in the consolidated financial statements. Changes in these estimates and assumptions are considered reasonably possible and may have a material impact on the consolidated financial statements, and thus actual results could differ from the amounts reported and disclosed herein. The Company considers the allowance for loan loss a critical accounting policy subject to estimate.

For additional information, regarding the allowance for loan losses, see *Analysis of the Allowance for Loan Losses* in this Management's Discussion and *Allowance for Loan Loss* in Note 1 in Notes to the Consolidated Financial Statements.

Results of Operations

The Company earned net income of \$2,049,000 in 2003, compared to net income of \$2,118,000 in 2002 and net income of \$1,786,000 in 2001. The \$69,000 decrease in net income during 2003 over 2002 is the result of a decrease in net interest income, an increase in noninterest expense, partially offset by a lower provision for loan losses and an increase in noninterest income. The \$332,000 increase in net income during 2002 over 2001 is the result of a significant increase in net interest income and an increase in noninterest income, partially offset by increases in the provision for loan losses, noninterest expense, and income tax.

Noninterest income, during 2003, included a nonrecurring gain in the amount of \$211,000. The gain was realized on the sale of real estate, which the Company held for investment. Without the gain the Company's 2003 net income would have been approximately \$1,910,000, or \$1.62 diluted earnings per share, a decrease of \$208,000 from the \$2,118,000, or \$1.77 diluted earnings per share reported in 2002.

The Company opened a new Kent office during the fourth quarter of 2002. As a result, management experienced higher operating costs during 2003 and anticipates higher costs in 2004 and beyond as the Kent office eventually locates to a more costly permanent facility. Therefore, profitability of the Company may be negatively impacted until the facility generates sufficient revenue to offset the added costs.

The Bank approved an internet banking product for customers during the fourth quarter of 2003. The Bank anticipates implementation of this product during the second quarter of 2004. The Company expects its annual cost to be in excess of \$100,000 per year and anticipates a negative impact to profitability until revenues, if any, offset the added expense.

As a result of Congress passing the Sarbanes Oxley Act of 2002, the Company will be subject to many of the Act's onerous provisions. The Company estimates that during the next two years the Company may incur annual compliance costs in excess of \$100,000. The added expense may have a negative impact on the Company's future profitability.

Performance Ratios

The following table shows the various performance ratios for the Company for the past five years:

valley community bancshares, inc. performance ratios¹

	for the year ended december 31,				
	2003	2002	2001	2000	1999
Return on average assets (net income divided by average assets)	1.15%	1.28%	1.15%	1.13%	1.05%
Return on average equity (net income divided by average equity)	8.95%	9.71%	8.67%	8.43%	7.80%
Dividend payout ratio (dividends per share divided by net income per share)	34.34%	31.91%	34.82%	35.18%	9.64%
Equity to assets ratio (average equity divided by average assets)	12.83%	13.24%	13.22%	13.36%	13.44%

Net Interest Income

Net interest income is the most significant component contributing to net income. It is the difference between interest earned on earning assets (primarily loans and investments) and interest paid on interest-bearing liabilities (deposits and borrowings). The volume of and yields earned on earning assets and the volume of and the rates paid on interest-bearing liabilities determine net interest income. Interest earned and interest paid is also affected by general economic conditions, particularly changes in market interest rates, and by government policies and the action of regulatory authorities.

The earnings on certain assets are exempt from federal income tax. It is customary in the financial services industry to analyze changes in net interest income on a "tax equivalent" (TE) basis. TE is a non-GAAP performance measure used by management in operating the business, which management believes provides investors with a more accurate picture of the interest margin for comparative purposes. Under this method, nontaxable income from loans and investments is adjusted to an amount that would have been earned if such income were subject to federal income tax.

¹ The computation of the ratios is based on the recorded assets and liabilities after the effect of the changes in market values of securities available for sale.

management's discussion and analysis of financial condition and results of operations

The discussion below presents an analysis based on tax equivalent amounts at a 34 percent tax rate.

valley community bancshares, inc.
net interest income, adjusted to a tax equivalent basis
(dollars in thousands),

	for the year ended december 31,		
	2003	2002	2001
Interest income, as reported	\$ 9,058	\$ 9,886	\$ 10,516
Effect of tax-exempt income	139	152	134
TE interest income	9,197	10,038	10,650
Interest expense	1,268	1,883	3,435
TE net interest income	\$ 7,929	\$ 8,155	\$ 7,215

TE net interest income, divided by average earning assets, is referred to as net interest margin. For the years ended December 31, 2003, 2002, and 2001, the Company's net interest margin was 4.78 percent, 5.35 percent, and 5.02 percent, respectively.

TE net interest income during 2003, 2002, and 2001 totaled \$7,929,000, \$8,155,000, and \$7,215,000, respectively, representing a 2.8 percent decrease in 2003 over 2002, and a 13.0 percent increase in 2002 over 2001. The 2003 over 2002 decrease resulted from a significant decrease in the Company's net interest margin partially offset by the earnings generated on the 8.7 percent increase in earning assets. The 2002 over 2001 increase resulted from a 6.0 percent increase in earning assets, primarily loans, and a significant improvement in the Company's net interest margin. The net interest margin decreased during 2003 because of lower rates earned on earning assets partially offset by lower interest rates paid on deposit accounts and higher loan origination fee amortization, net of cost. The net interest margin increased during 2002 because of higher loan origination fee amortization, net of cost, and lower interest rates paid on deposit accounts partially offset by lower interest rates earned on earning assets.

During 2002 and 2001, market interest rates decreased significantly as a result of a slow national and regional economy and because of an aggressively accommodating Federal Reserve monetary policy. During this period the Company's net interest margin increased significantly from 5.02 percent in 2001 to 5.35 percent in 2002. During this period the interest rate paid to depositors decreased faster than the decrease in the interest rate earned on investment securities and loans.

During 2003, market interest rates continued to be at historical lows. As a result, the Company experienced a compression in net interest margin from 5.35 percent in 2002 to 4.75 percent in 2003. The margin compression occurred as the interest rate earned on investment securities and loans decreased faster than the interest rate paid to depositors. During this low interest rate environment borrowers refinanced their higher rate loans to a lower interest rate. At the same time, the Company was limited in its ability to decrease the interest rate paid to depositors with administered interest rates, such as NOW, savings, and money market accounts. The interest rate paid on such deposits is currently below 0.75 percent.

In the event of an increase in market interest rates, the Company's TE net interest income and margin may decrease because the Company has a significant amount of interest-bearing liabilities subject to repricing when compared to interest-earning assets. This may be somewhat offset because the rates paid on deposits with administered interest rates generally do not increase as rapidly as for accounts whose rates change with market interest rates. In the event of continued low market interest rates, the Company anticipates a further decrease in net interest margin as interest-earning assets continue repricing to the lower interest rate levels.

TE interest income during 2003, 2002, and 2001 totaled \$9,197,000, \$10,038,000, and \$10,650,000, respectively, representing an 8.4 percent decrease in 2003 over 2002 and a 5.8 percent decrease in 2002 over 2001. The 2003 and 2002 decreases were the result of the lower interest rates earned, as discussed above, partially offset by higher loan origination fee amortization, net of costs.

Interest expense during 2003, 2002, and 2001 totaled \$1,268,000, \$1,883,000, and \$3,435,000, respectively, representing a 32.7 percent decrease in 2003 over 2002 and a 45.2 percent decrease in 2002 over 2001. The 2003 and 2002 decreases were the result of the lower interest rates paid, as discussed above.

management's discussion and analysis of financial condition and results of operations

Average Balances and an Analysis of Average Rates Earned and Paid

The following tables show average balances and interest income or interest expense, with the resulting average yield or rate by category or average earning asset or interest-bearing liability.

valley community bancshares, inc. average balances and an analysis of average rates earned and paid

	(dollars in thousands)								
	2003			2002			2001		
	average balance	revenue/ expense	yield/ rate	average balance	revenue/ expense	yield/ rate	average balance	revenue/ expense	yield/ rate
ASSETS									
Interest-earning assets									
Loans ^{1,4}	\$ 110,859	\$ 7,605	6.86%	\$ 106,666	\$ 8,074	7.57%	\$ 96,855	\$ 8,109	8.37%
Investment securities - taxable ³	28,780	843	2.93%	25,437	1,167	4.59%	23,694	1,347	5.68%
Investment securities - tax-exempt ^{2,3}	6,497	409	6.30%	6,684	447	6.69%	5,979	395	6.61%
Other earning assets	19,674	340	1.73%	13,765	350	2.54%	17,347	799	4.61%
Total interest-earning assets	\$ 165,810	\$ 9,197	5.55%	\$ 152,552	\$ 10,038	6.58%	\$ 143,875	\$ 10,650	7.40%
Non-interest-earning assets	12,495			12,298			11,953		
TOTAL ASSETS	\$ 178,305			\$ 164,850			\$ 155,828		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Interest-bearing liabilities									
Deposits									
Savings, NOW accounts, and									
money markets	\$ 77,332	\$ 445	0.58%	\$ 69,419	\$ 664	0.96%	\$ 63,244	\$ 1,207	1.91%
Time deposits < \$100,000	23,461	456	1.94%	24,936	735	2.95%	24,562	1,241	5.05%
Time deposits > \$100,000	21,366	362	1.69%	18,951	477	2.52%	20,647	973	4.71%
Total deposits	122,159	1,263	1.03%	113,306	1,876	1.66%	108,453	3,421	3.15%
Other borrowed funds	479	5	1.04%	512	7	1.37%	405	14	3.46%
Total interest-bearing liabilities	\$ 122,638	\$ 1,268	1.03%	\$ 113,818	\$ 1,883	1.65%	\$ 108,858	\$ 3,435	3.16%
Non-interest-bearing liabilities	32,782			29,214			26,373		
Stockholders' equity	22,885			21,818			20,597		
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 178,305			\$ 164,850			\$ 155,828		
Net interest income		\$ 7,929			\$ 8,155			\$ 7,215	
Margin analysis									
Interest income/earning assets		\$ 9,197	5.55%		\$ 10,038	6.58%		\$ 10,650	7.40%
Interest expense/earning assets		1,268	0.76%		1,883	1.23%		3,435	2.39%
TE net interest income/earning assets		7,929	4.78%		8,155	5.35%		7,215	5.02%

¹ Average loan balance includes nonaccrual loans, if any. Interest income on nonaccrual loans has been included.

² Tax-exempt income has been adjusted to a tax-equivalent basis using an incremental rate of 34 percent.

³ The yield on investment securities is calculated using the historical cost basis.

⁴ Loan fees included in loan revenue totaled \$149,000, \$122,000, and \$23,000 in 2003, 2002, and 2001, respectively.

management's discussion and analysis of financial condition and results of operations

Analysis of Changes in Interest Income and Expense

The following table sets forth, on a tax-equivalent basis, a summary of the changes in net interest income and expense resulting from changes in volume and rates.

valley community bancshares, inc. analysis of changes in interest income and expense ¹

	(dollars in thousands and in tax equivalent basis)					
	2003 compared to 2002			2002 compared to 2001		
	volume	rate	net	volume	rate	net
Interest income						
Loans (including fees) ²	\$ 304	\$ (773)	\$ (469)	\$ 776	\$ (811)	\$ (35)
Investment securities – taxable	139	(463)	(324)	94	(274)	(180)
Investment securities – tax-exempt ³	(12)	(26)	(38)	48	4	52
Other interest-earning assets	123	(133)	(10)	(142)	(307)	(449)
Interest income	<u>554</u>	<u>(1,395)</u>	<u>(841)</u>	<u>776</u>	<u>(1,388)</u>	<u>(612)</u>
Interest expense						
Deposits						
Savings, NOW accounts, and money markets	69	(288)	(219)	108	(651)	(543)
Time deposits < \$100,000	(41)	(238)	(279)	19	(525)	(506)
Time deposits > \$100,000	55	(170)	(115)	(74)	(422)	(496)
Total deposits	<u>83</u>	<u>(696)</u>	<u>(613)</u>	<u>53</u>	<u>(1,598)</u>	<u>(1,545)</u>
Other borrowed funds		(2)	(2)	3	(10)	(7)
Interest expense	<u>83</u>	<u>(698)</u>	<u>(615)</u>	<u>56</u>	<u>(1,608)</u>	<u>(1,552)</u>
TE net interest income	<u>\$ 471</u>	<u>\$ (697)</u>	<u>\$ (226)</u>	<u>\$ 720</u>	<u>\$ 220</u>	<u>\$ 940</u>

Provision for Loan Losses

Provisions for loan losses reduce net interest income. The provision for loan losses reflects management's judgment of the expense to be recognized in order to maintain an adequate allowance for loan losses. For further discussion regarding the allowance for loan losses see the discussion on allowance for loan losses under Summary of Loan Loss Experience. The Company provided \$0 for loan losses during 2003 compared to \$213,000 in 2002 and \$62,000 in 2001. The 2002 and 2001 provisions were primarily related to a significant increase in the Company's loan portfolio. Management anticipates that growth in the Company's loan portfolio would require increases in loan loss provisions during the year 2004.

Noninterest Income and Expense

Noninterest income (primarily service charges, and other operating income) and noninterest expenses (primarily salaries and employee benefits, occupancy, equipment, and other operating expenses) also impact net income.

Noninterest Income

Noninterest income during 2003, 2002, and 2001 totaled \$1,469,000, \$1,004,000, and \$870,000, respectively, representing a 46.3 percent increase in 2003 over 2002 and a 15.4 percent increase in 2002 over 2001.

The increase in 2003 was primarily related to higher service charges on deposit accounts, a significant increase in loan origination fees on mortgage loans brokered, the amortization of the deferred gain on real estate held for investment, and other operating income partially offset by lower security gains. The increase in 2002 was primarily related to increased origination fees on mortgaged loans brokered and increased service charges on deposit accounts, partially offset by lower other operating income. The increase in origination fees on mortgage loans brokered in 2003 and 2002 was the result of borrowers refinancing their higher-rate one- to four-family home loans at the current low market interest rates and from the increased volume realized from the operations of Puget Sound Mortgage Brokers, purchased in 2002. In the event market interest rates rise, the Company may experience a decrease in origination fees. Other operating income, during 2002, included a \$34,000 write-off of various fixed assets, which were discarded as a result of the Company's main office remodel.

Noninterest Expense

Noninterest expense during 2003, 2002, and 2001 totaled \$6,247,000, \$5,722,000, and \$5,359,000, respectively, representing a 9.2 percent increase in 2003 over 2002 and a 6.8 percent increase in 2002 over 2001. The percentage of noninterest expense to average assets was 3.50 percent in 2003, compared to 3.47 percent and 3.44 percent during 2002 and 2001, respectively.

¹ The change in interest due to both volume and yield/rate has been allocated to change due to volume and change due to yield/rate in proportion to the absolute value of the change in each.

² Balances of nonaccrual loans, if any, and related income recognized have been included for computational purposes.

³ Tax-exempt income has been converted to a tax-equivalent basis using an incremental rate of 34 percent.

management's discussion and analysis of financial condition and results of operations

The increase in 2003 was related to increased salaries and employee benefits, occupancy, operating, and other expenses associated with the opening of the new Kent and Gig Harbor facilities and the operation of Puget Sound Mortgage Brokers. Occupancy expense also increased as a result of higher depreciation expense resulting from the remodel of the Main Office facility during the fourth quarter of 2002. The increase in professional fees resulted from the merger of Puyallup Valley Bank and Valley Bank. The increase in 2002 was related to higher salaries and benefits and other expenses partially offset by lower occupancy and equipment expenses. Salary and employee benefits increased as a result of the opening of the Kent facility during September of 2002 and the operation of Puget Sound Mortgage Brokers beginning mid-May 2002. Occupancy and equipment expense decreased as a result of lower depreciation expense.

The Bank closed the Gig Harbor facility beginning 2004.

The following table sets forth information concerning the various components of the Company's noninterest expense for the past three years ended December 31, 2003, 2002, and 2001, respectively:

valley community bancshares. inc. noninterest expense

	(dollars in thousands)		
	2003	2002	2001
Noninterest Expense			
Salaries	\$ 2,631	\$ 2,419	\$ 2,112
Employee benefits	649	606	586
Occupancy	556	497	551
Equipment	444	462	527
Operating	531	475	443
Software	204	190	191
Advertising and marketing	177	138	115
Professional	218	205	163
Business and occupation tax	137	146	123
ATM and debit card	141	98	92
Director	112	85	69
Other	447	401	387
Total noninterest expense	\$ 6,247	\$ 5,722	\$ 5,359
Ratio of noninterest expense to average assets	3.50%	3.47%	3.44%

The Company's efficiency ratio, which is the ratio of noninterest expense to net interest income plus noninterest income, was 67.5 percent in 2003, compared to 63.5 percent and 67.4 percent during 2002 and 2001, respectively.

Provision for Income Taxes

The Company's provision for income taxes is a significant reduction of operating income. The provisions for 2003, 2002, and 2001 were \$963,000, \$954,000, and \$744,000, respectively. These amounts represent an effective taxing rate of 32 percent during 2003, 31 percent during 2002, and 29 percent during 2001. The Company's marginal tax rate is currently 34 percent. The difference between the Company's effective and marginal tax rate is primarily related to investments made in tax-exempt securities. The 2003 increase in the effective rate is primarily the result of a reduction in the percentage of interest earned on tax-exempt securities to taxable income.

Credit Management

The Company strives to achieve sound credit-risk management. In order to achieve this goal the Company has established stringent, centralized credit policies and uniform underwriting criteria for all loans. The Company emphasizes diversification in the types of loans offered, regular credit examinations, and quarterly reviews of large loans and of loans experiencing deterioration in credit quality. The Company attempts to identify potential problem loans early, charges off loans promptly, and maintains an adequate allowance for loan loss. In order to achieve sound credit-risk management, the Company has established certain credit guidelines for its lending portfolio.

Loan Portfolio

Managing risk is an essential part of successfully operating a financial institution. The most prominent risk exposures regarding the loan portfolio are credit quality and interest rate risk. Credit quality risk is the risk of not collecting interest and/or principal balance of a loan when it is due. Interest rate risk is the potential reduction of net interest income and changes in the value of financial instruments as the result of rate movements. The Company's loan portfolio is originated and managed with these risks in mind.

The Company follows loan and interest-rate risk policies that have been approved by the Banks' Board of Directors and are overseen by the Executive Loan Committee, the Asset Liability Committee, and management. These policies establish lending limits, review and grading criteria, and other guidelines such as loan administration, the allowance for loan losses, and maturity and interest-rate repricing criteria. Loan applications are approved by the Bank's Board of Directors and/or designated officers in accordance with respective guidelines and underwriting policies of the Company. Loans to one borrower are limited by applicable state and federal banking laws and are further limited by internal limits. Credit limits generally vary according to the type of loan and the individual loan officer's experience.

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Types of Loans

The following table sets forth the composition of the Company's loan portfolio for the past five years ending at December 31 (dollars in thousands):

valley community bancshares, inc. loan portfolio

	outstanding balance at december 31,				
	2003	2002	2001	2000	1999
Real estate					
Construction	\$ 9,913	\$ 9,276	\$ 11,550	\$ 5,959	\$ 7,384
Residential	12,095	15,080	14,690	16,701	15,867
Commercial	65,114	55,266	54,187	52,620	40,254
Commercial	24,872	23,502	16,477	16,258	12,892
Consumer and other	2,409	2,339	3,196	2,523	1,864
Lease	63	83	745	560	377
Total loans	<u>114,466</u>	<u>105,546</u>	<u>100,845</u>	<u>94,621</u>	<u>78,638</u>
Unearned income	(205)	(192)	(90)	(7)	(4)
Net loans	<u>\$ 114,261</u>	<u>\$ 105,354</u>	<u>\$ 100,755</u>	<u>\$ 94,614</u>	<u>\$ 78,634</u>

The Company's loan portfolio primarily consists of commercial loans, residential real estate loans, and commercial real estate loans. At December 31, 2003, loans totaled approximately \$114.3 million, which equals approximately 72.7 percent of total deposits and 62.7 percent of total assets. At December 31, 2003, the majority of loans were originated directly by the Company to borrowers within the Company's principal market area. As a result, the Company has significant risk because of a lack of geographical diversification. The Company mitigates this risk primarily by diversifying the loan portfolio by industry and customer and by strong credit underwriting criteria. At December 31, 2003, approximately 41 percent of the Company's loan portfolio had adjustable rate features and approximately 59 percent were fixed. Approximately 64 percent of adjustable rate loans adjust within a 12-month period and 90 percent of the Company's fixed-rate loan portfolio is scheduled to mature within a five-year period.

Commercial loans consist primarily of loans to businesses for various purposes, including revolving lines of credit, equipment loans, and letters of credit. These loans generally have short maturities, have either adjustable or fixed rates, and are unsecured or secured by inventory, accounts receivable, equipment, and/or real estate. The Company monitors portfolio diversification by industry and by customer. At December 31, 2003, approximately 78 percent had adjustable rates and 22 percent had fixed rates.

Real estate loans include various types of loans for which the Company holds real property as collateral, and consist of loans primarily on single-family residences and commercial properties. These loans generally are secured by a first priority lien but may also be secured by a second priority lien. Real estate loans typically have maturities extending to five years and have fixed or adjustable rate features. Construction loans are typically made to contractors to construct single-family residences and commercial buildings and generally have maturities to 18 months. Currently, the Company does not originate real estate for sale to the secondary market; however, the Company brokers real estate loans to other financial institutions for a fee. At December 31, 2003, approximately 70 percent of the Company's real estate loans were fixed rate and approximately 30 percent had adjustable rate features. However, 92 percent of the Company's real estate loans are scheduled to mature and have adjustable rates within a five-year period.

Consumer loans include various types of loans such as automobiles, boats and recreational vehicles, personal and home equity lines of credit, and other consumer orientated loans. At December 31, 2003, approximately 86 percent of the consumer loan portfolio had fixed rate and approximately 14 percent had adjustable rate features.

There are no foreign loans outstanding during the years presented.

The interest rates charged on loans vary with the degree of risk, the amount of the loan, and the maturity of the loan. Competitive pressures, market interest rates, the availability of funds, and government regulation further influence them.

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Maturities and Sensitivities of Loans to Changes in Interest Rates

The contractual maturities of the Company's loan portfolio are as shown below. Actual maturities may differ from contractual maturities because individual borrowers may have the right to prepay loans with or without prepayment penalties.

valley community bancshares, inc. loans as of december 31, 2003 (dollars in thousands)

	within one year	after one year but within five years	after five years	total
Real estate				
Construction	\$ 5,199	\$ 4,559	\$ 155	\$ 9,913
Residential	1,858	5,386	4,851	12,095
Commercial	7,388	43,257	14,469	65,114
Commercial	12,852	10,705	1,315	24,872
Consumer and other	987	1,330	92	2,409
Lease	22	41		63
Total loans	<u>\$ 28,306</u>	<u>\$ 65,278</u>	<u>\$ 20,882</u>	<u>\$ 114,466</u>

Loan maturities after one year with:

Fixed rates	\$ 51,331	\$ 6,810
Variable rates	13,947	14,072
	<u>\$ 65,278</u>	<u>\$ 20,882</u>

Non-Performing Assets

Non-performing assets consist of: (1) nonaccrual loans; (2) loans 90 days or more past due; (3) restructured loans for which concessions, including the reduction of interest rates below a rate otherwise available to that borrower or the deferral of interest or principal, have been granted due to the borrower's weakened financial condition; and (4) other real estate owned.

The following table sets forth information concerning the Company's non-performing assets for the year ended December 31, 2003 (dollars in thousands).

valley community bancshares, inc. non-performing assets

	year ended december 31,				
	2003	2002	2001	2000	1999
Non-performing assets:					
Nonaccrual loans	\$ 10	\$ *	\$ 129	\$ *	\$ *
Accruing loans 90 days or more past due					
Restructured loans	10	*	909	*	*
	<u>10</u>	<u>*</u>	<u>1,038</u>	<u>*</u>	<u>*</u>
Other real estate owned					
Total nonperforming assets	<u>\$ 10</u>	<u>\$ *</u>	<u>\$ 1,038</u>	<u>\$ *</u>	<u>\$ *</u>

* For the years ended December 31, 2002, 2000, and 1999 there were no non-performing assets.

The accrual of interest on nonaccrual and other impaired loans is discontinued at 90 days or when, in the opinion of management, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. Interest income on restructured loans is recognized pursuant to the terms of the new loan agreement. Interest income on other impaired loans is monitored and based upon the terms of the underlying loan agreement. However, the recorded net investment in impaired loans, including accrued interest, is limited to the present value of the expected cash flows of the impaired loan or the observable fair market value of the loan's collateral.

The gross income that would have been recorded on nonaccrual loans if the loans had been current and in accordance with their original terms during 2003 was insignificant. In 2002 and 2001 the gross income that would have been recorded was approximately \$3,000 and \$16,000, respectively. Interest recognized on the loan for 2002 was \$3,000 and for 2003 and 2001 was insignificant.

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Potential Problem Loans

At December 31, 2003, the Company had two potential problem commercial real estate loans totaling approximately \$2,349,000. These loans are in addition to those categorized as non-performing listed above. Although these loans are currently classified as performing, management has information regarding credit weakness inherent in the loans, which may result in the borrowers' inability to comply with present loan repayment terms. As of December 31, 2003, the Company does not anticipate any losses associated with these credits, although there can be no assurances given in this regard.

Loan Concentrations

In addition to the loan categories discussed under loan types, the Company has additional loan concentrations exceeding 10 percent of total loans at December 31, 2003. They include loans to medical doctors and dentists in the amount of approximately \$23.2 million and loans to nonresidential building contractors of approximately \$14.8 million.

Summary of Loan Loss Experience

Changes in the Allowance for Loan Losses

The following table sets forth information regarding changes in the Company's allowance for loan losses for the most recent five years (dollars in thousands):

valley community bancshares, inc. loan loss experience

	analysis of the allowance for loan losses				
	year ended december 31,				
	2003	2002	2001	2000	1999
Balance at beginning of period	\$ 1,388	\$ 1,156	\$ 1,096	\$ 959	\$ 883
Charge-offs:					
Consumer and other		5	6	20	8
		5	6	20	8
Recoveries:					
Commercial		17			
Consumer and other		7	4	12	
		24	4	12	
Net charge-offs (recoveries)		(19)	2	8	8
Provision for loan losses		213	62	145	84
Balance at end of period	<u>\$ 1,388</u>	<u>\$ 1,388</u>	<u>\$ 1,156</u>	<u>\$ 1,096</u>	<u>\$ 959</u>
Average loans outstanding	\$ 110,859	\$ 106,666	\$ 96,855	\$ 87,934	\$ 72,135
Ratio of net charge-offs during the period to average loans outstanding	0.00%	-0.02%	0.00%	0.01%	0.01%
Ratio of allowance for loan losses to average loans outstanding	1.25%	1.30%	1.19%	1.25%	1.33%

The allowance for loan losses is increased by charges to income and decreased by charge-offs (net of recoveries), and established through a provision for credit losses charged to expense. Loans are charged against the allowance for credit losses when management believes that the collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing loans, commitments to extend credit, and standby letters of credit, based on evaluations of collectibility and prior loss experience of loans. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, loan concentrations, specific problem loans, commitments, standby letters of credit, and current economic conditions that may affect the borrowers' ability to pay.

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for losses on loans and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the estimated losses on loans and foreclosed assets held for sale, management obtains independent appraisals for significant properties.

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The majority of the Company's loan portfolio consists of commercial and single-family residential loans secured by real estate in the Puyallup and Pierce County area and also in the Auburn, Kent, and King County area. Real estate prices in this market are stable at this time. However, the ultimate collectibility of a substantial portion of the Company's loan portfolio may be susceptible to change in local market conditions in the future.

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Company to recognize additional losses based on their judgment about information available to them at the time of their examination.

Breakdown of Allowance for Loan Losses by Category

The following table sets forth information concerning the Company's allocation of the allowance for loan losses (dollars in thousands):

valley community bancshares, inc.

loan loss experience

allocation of the allowance for loan losses

year ended december 31,

	2003		2002		2001		2000		1999	
	amount	% *	amount	% *	amount	% *	amount	% *	amount	% *
Balance at end of period applicable to:										
Real estate										
Construction	\$ 119	9%	\$ 111	9%	\$ 116	11%	\$ 60	6%	\$ 55	10%
Residential	73	11%	90	14%	15	15%	17	18%	16	20%
Commercial	781	56%	663	53%	428	54%	184	55%	141	51%
Commercial	249	22%	235	22%	165	16%	163	17%	129	16%
Consumer and other	48	2%	47	2%	64	3%	50	3%	37	2%
Lease financing	1		2		15	1%	11	1%	4	1%
Unallocated	117	NA	240	NA	353	NA	611	NA	577	NA
	<u>\$ 1,388</u>	<u>100%</u>	<u>\$ 1,388</u>	<u>100%</u>	<u>\$ 1,156</u>	<u>100%</u>	<u>\$ 1,096</u>	<u>100%</u>	<u>\$ 959</u>	<u>100%</u>

* Percent of loans in each category to total loans

Analysis of the Allowance for Loan Losses

The allowance for loan losses reflects management's best estimate of probable losses that have been incurred as of the balance sheet date. The allowance for loan losses is maintained at a level considered adequate by management to provide for loan losses inherent in the loan portfolio based on management's assessment of various factors affecting the loan portfolio, including local economic conditions and growth of the loan portfolio and its composition. Non-performing loans and net charge-offs during these periods have been minimal, demonstrating strong credit quality. Increases in the allowance for loan losses made through provisions were primarily a result of loan growth.

Management determines the amount of the allowance for loan losses by utilizing a loan grading system to determine risk in the loan portfolio and by considering the results of credit reviews. The loan portfolio is separated by quality and then by loan type. Loans of acceptable quality are evaluated as a group, by loan type, with a specific loss rate assigned to the total loans in each type, but unallocated to any individual loan. Conversely, each adversely classified loan is individually analyzed, to determine an estimated loss amount. A valuation allowance is also assigned to these adversely classified loans, but at a higher loss rate due to the greater risk of loss. For those loans where the estimated loss is greater than the background percentage, the estimated loss amount is considered specifically allocated to the allowance.

Although management has allocated a portion of the allowance to the loan categories using the method described above, the adequacy of the allowance must be considered as a whole. To mitigate the imprecision in most estimates of expected loan losses, the allocated component of the allowance is supplemented by an unallocated component. The unallocated portion includes management's judgmental determination of the amounts necessary for qualitative factors such as the consideration of new products and policies, economic conditions, concentrations of credit risk, and the experience and abilities of lending personnel. Loan concentrations, quality, terms, and basic underlying assumptions remained substantially unchanged during the period.

The Company uses the historical loss experience method in conjunction with the specific identification method for calculation of the adequacy of allowance for loan losses. A six-year average historical loan loss rate is calculated. This experienced loss rate is applied to graded loans that are not adversely classified for a subtotal of needed allowance. Loans adversely classified are analyzed for potential loss on an individual basis. This subtotal is added to the experience subtotal and the total is compared to the allowance for loan losses.

The Company also evaluates current conditions and may adjust the historical loss estimate by qualitative factors that affect loan repayment. These factors may include levels of, and trends in, delinquencies and non-accruals; trends in volume and terms of loans; effects of any changes in lending policies; experience, ability, and depth of management and lending staff; national and local economic trends; concentrations of credit; and any legal and regulatory requirements.

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Investment Portfolio

The following table sets forth the carrying values, by type, of the securities in the Company's portfolio (in thousands):

valley community bancshares, inc. investment portfolio

	outstanding balance at december 31,		
	2003	2002	2001
U.S. Treasury and U.S. Government corporations and agencies	\$ 13,721	\$ 10,888	\$ 9,579
States of the United States and political subdivisions	7,778	5,727	6,851
Mortgage-backed securities	17,061	14,454	14,920
Total	<u>\$ 38,560</u>	<u>\$ 31,069</u>	<u>\$ 31,350</u>

Investments in States of the United States and political subdivisions represent purchases of municipal bonds located in Washington State.

The investments below are reported by contractual maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without prepayment penalties.

valley community bancshares, inc. investments as of december 31, 2003 (dollars in thousands)

	within one year	after one year but within five years	after five years but within ten years	after ten years	total
U.S. Treasury and U.S. Government corporations and agencies	\$ 1,001	\$ 11,225	\$ 1,075	\$ 420	\$ 13,721
States of the United States and political subdivisions	361	2,484	4,933		7,778
Mortgage-backed securities	197	3,094	5,767	8,003	17,061
Total	<u>\$ 1,559</u>	<u>\$ 16,803</u>	<u>\$ 11,775</u>	<u>\$ 8,423</u>	<u>\$ 38,560</u>
Weighted average yield *					
U.S. Treasury and U.S. Government corporations and agencies	3.41%	2.51%	1.92%	1.74%	2.51%
States of the United States and political subdivisions	4.87%	3.65%	4.00%		3.93%
Mortgage-backed securities	6.60%	3.23%	4.06%	3.41%	3.63%
Total	<u>4.15%</u>	<u>2.81%</u>	<u>3.84%</u>	<u>3.33%</u>	<u>3.29%</u>

* Yield on tax-exempt obligations has not been computed on a tax-equivalent basis.

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Deposits

Types of Deposits

The Company's primary source of funds is customer deposits. The Company attempts to maintain a high percentage of non-interest-bearing deposits, which are a low-cost funding source. In addition, the Company offers a variety of interest-bearing accounts designed to attract both short-term and longer-term deposits from customers. Interest-bearing accounts earn interest at rates established by Bank management based on competitive market factors and the Company's need for funds. The Company traditionally has not purchased brokered deposits and does not intend to do so in the future.

The following table sets forth the average balances for each major category of deposit and the weighted average interest rate paid for deposits during the year ended December 31 (dollars in thousands):

valley community bancshares, inc. deposits

	average deposits by type									
	2003		2002		2001		2000		1999	
	amount	rate	amount	rate	amount	rate	amount	rate	amount	rate
Non-interest-bearing demand	\$ 31,609		\$ 28,001		\$ 25,092		\$ 23,484		\$ 22,737	
Interest-bearing demand	23,389	0.24%	20,070	0.29%	17,982	0.75%	16,345	1.03%	16,279	1.19%
Money market	38,322	0.82%	35,880	1.33%	34,434	2.58%	30,672	3.60%	28,963	3.26%
Savings	15,621	0.47%	13,469	0.96%	10,828	1.68%	11,119	1.96%	12,392	2.08%
Time certificates < \$100,000	23,461	1.94%	24,936	2.95%	24,562	5.05%	22,699	5.31%	21,019	4.67%
Time certificates > \$100,000	21,366	1.69%	18,951	2.52%	20,647	4.71%	17,797	5.48%	12,582	4.59%
	<u>\$ 153,768</u>		<u>\$ 141,307</u>		<u>\$ 133,545</u>		<u>\$ 122,116</u>		<u>\$ 113,972</u>	

Certificates of Deposit

The following table shows the amounts and remaining maturities of certificates of deposit that had balances of more than \$100,000 at December 31 (dollars in thousands):

valley community bancshares, inc. deposit maturity

	outstanding balance at december 31,									
	2003		2002		2001		2000		1999	
3 months or less	\$ 12,157		\$ 10,486		\$ 10,409		\$ 10,599		\$ 7,235	
Over 3 through 12 months	7,986		9,321		7,761		8,696		6,820	
Over 12 through 36 months	888		1,182		255		459		500	
Over 36 months	626		407							
Total	<u>\$ 21,657</u>		<u>\$ 21,396</u>		<u>\$ 18,425</u>		<u>\$ 19,754</u>		<u>\$ 14,555</u>	

Liquidity and Capital Resources

Management actively analyzes and manages the Company's liquidity position. The objective of liquidity management is to ensure the availability of sufficient cash flows to meet all financial commitments and to capitalize on opportunities for profitable business expansion. Management believes that the Company's cash flow will be sufficient to support its existing operations for the foreseeable future.

Cash flows from operations contribute significantly to liquidity, as do proceeds from maturities of securities and increasing customer deposits. As indicated on the Company's Consolidated Statement of Cash Flows, net cash from operating activities contributed \$2.7 million to liquidity in 2003, \$2.7 million in 2002, and \$2.6 million in 2001. The majority of the Company's funding comes from customer deposits within its operating region. Customer deposits provided \$9.8 million in 2003, \$12.7 million in 2002 and \$9.7 million in 2001. In 2003, demand, money market and savings accounts provided the majority of the deposit growth. In 2002, certificates of deposit, demand deposits, and savings deposits provided the majority of deposit growth. These funds were from local businesses and consumers and are considered by management as a stable source of funds.

Other important sources of liquidity are investments in federal funds and interest-bearing deposits with banks, and the Company's Investment Portfolio. The Company maintains a ladder of securities that provides prepayments and payments at maturity and a portfolio of available-for-sale securities that could be converted to cash quickly. Proceeds from maturities of securities provided \$19.2 million in 2003, \$9.9 million in 2002, and \$15.1 million in 2001.

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Borrowing represents an important long-term and manageable source of liquidity based on the Company's ability to raise new funds and renew maturing liabilities in a variety of markets. The Bank is a member of the Federal Home Loan Bank of Seattle and has committed lines of credit up to 10 percent of assets. In addition, the Bank has committed line-of-credit agreements totaling approximately \$9.5 million from unaffiliated banks with various maturities.

The Company's total stockholders' equity increased to \$23.7 million at December 31, 2003, from \$22.5 million at December 31, 2002. At December 31, 2003, stockholders' equity was 12.98 percent of total assets, compared to 13.08 percent at December 31, 2002. The increase in stockholders' equity was the result of net income earned in 2003 exceeding dividends paid. The Company may continue decreasing the equity to total asset ratio through the growth of assets and through future stock repurchase in order to improve the return on average equity. At December 31, 2003, the Company held approximately \$23.5 million cash on hand and due from banks, interest-bearing deposits with banks, and federal funds sold. In addition, at such date \$38.6 million of the Company's investments were classified as available-for-sale.

The capital levels of the Company exceed applicable regulatory guidelines at December 31, 2003. Management believes the Company's capital will be adequate to fund any future start-up and related costs associated with any new branches until they can achieve the deposit and loan levels necessary to be profitable.

The market value of available-for-sale securities was greater than book value at both December 31, 2003, and December 31, 2002, primarily as a result of low market interest rates, which resulted in net unrealized gains in the investment portfolio. In the event market interest rates increase, the market value of the Company's investment portfolio may decrease. Because changes in the market value of available-for-sale securities are a component of other comprehensive income, within stockholders' equity, a decrease in market value of securities would negatively impact stockholders' equity. At December 31, 2003, the Company performed a simulation analysis of changes in the market value of the investment portfolio given a 300 basis point increase in interest rates. The analysis indicated a decrease in market value of approximately \$1.3 million net of federal income tax. Although stockholders' equity would be reduced by approximately 5.5 percent, the Company would still be well in excess of capital adequacy requirements in the event the Company would be required to liquidate these securities for unforeseen liquidity needs.

The primary impact of inflation on the Company's operations is increased asset yields, deposit costs, and operating overhead. Unlike most industries, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates generally have a more significant impact on a financial institution's performance than they would on non-financial companies. Although interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services, increases in inflation generally have resulted in increased interest rates. The effects of inflation can magnify the growth of assets and, if significant, require that equity capital increase at a faster rate than would be otherwise necessary.

Contractual Obligations and Commitments

The following table sets forth the Company's long-term contractual obligations (dollars in thousands):

valley community bancshares, inc. contractual obligations and commitments

	payments due per period				
	total	less than 1 year	1-3 years	3-5 years	thereafter
Other borrowed funds	\$ 580	\$ 580	\$	\$	\$
Operating lease commitments	355	82	160	113	
Total	<u>\$ 935</u>	<u>\$ 662</u>	<u>\$ 160</u>	<u>\$ 113</u>	<u>\$</u>

Off-Balance-Sheet Commitments

The Bank has commitments to extend credit that may have an impact on the Company's liquidity position. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the commitment. Commitments generally have fixed expiration dates. Since some commitments are expected to expire without being drawn upon, the total commitment amounts do not represent future cash requirements. The Company's experience suggests customers draw on approximately 75 percent of loan commitments. Commitments to extend credit at December 31, 2003 and 2002 were \$21.5 and \$19.8 million, respectively.

valley community bancshares, inc. off-balance-sheet commitments

	amount of commitment expiration per period				
	total	less than 1 year	1-3 years	3-5 years	thereafter
Commitments to extend credit	\$ 21,403	\$ 16,268	\$ 578	\$ 366	\$ 4,191
Standby letters of credit	120	20	100		
Total	<u>\$ 21,523</u>	<u>\$ 16,288</u>	<u>\$ 678</u>	<u>\$ 366</u>	<u>\$ 4,191</u>

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Interest Rate Risk

Interest rate risk refers to the exposure of earnings and capital arising from changes in interest rates. Management's objectives are to control interest rate risk and to ensure predictable and consistent growth of earnings and capital. Interest rate risk management focuses on fluctuations in net interest income identified through computer simulations to evaluate volatility by varying interest rate, spread, and volume assumptions. The risk is quantified and compared against tolerance levels.

The simulation model used by the Company combines the significant factors that affect interest rate sensitivity into a comprehensive earnings simulation. Earning assets and interest-bearing liabilities with longer lives may be subject to more volatility than those with shorter lives. The model accounts for these differences in its simulations. At December 31, 2003, the simulation modeled the impact of assumptions that interest rates would increase or decrease 200 basis points. Results indicated the Company was positioned so equity would not drop below that point where the Company, for regulatory purposes, would no longer continue to be classified "well capitalized." It should be emphasized that the model is static in nature and does not take into consideration possible management actions to minimize the impact on equity. Management also matches assets and liabilities on a maturity gap analysis and repricing gap analysis to assist in interest rate sensitivity measurement.

Interest rate sensitivity is closely related to liquidity because each is directly affected by the maturity of assets and liabilities. Management considers any asset or liability that matures, or is subject to repricing over one year, to be interest sensitive, although continual monitoring is also performed for other time intervals. The difference between interest-sensitive assets and liabilities for a defined period of time is known as the interest-sensitive "gap" and may be either positive or negative. If positive, more assets reprice before liabilities; if negative, the reverse is true. In theory, if the gap is positive, a decrease in general interest rates might have an adverse impact on earnings as interest income decreases faster than interest expense. This assumes that management adjusts rates equally as general interest rates fall. Conversely, an increase in interest rates would increase net interest income as interest income increases faster than interest expense. However, the exact impact of the gap on future income is uncertain both in timing and amount because interest rates for the Company's assets and liabilities can change rapidly as a result of market conditions and customer patterns.

The simulation model process provides a dynamic assessment of interest rate sensitivity, whereas a static interest rate gap table is compiled as of a point in time. The model simulations differ from a traditional gap analysis because a traditional gap analysis does not reflect the multiple effects of interest-rate movement on the entire range of assets and liabilities, and ignores the future impact of new business strategies.

Quantitative and Qualitative Disclosures about Market Risk

The Company's results of operations are largely dependent upon its ability to manage market risks. Changes in interest rates can have a significant effect on the Company's financial condition and results of operation. Other types of market risk such as foreign currency exchange rate risk and commodity price risk do not arise in the normal course of the Bank's business activities. The Company does not use interest rate risk-management products such as interest rate swaps, hedges, or derivatives, nor does management intend to use such products in the future. All of the Company's transactions are denominated in U.S. Dollars. Approximately 41 percent of the Company's loan portfolio has interest rates that are variable. Fixed-rate loans are generally made with a term of five years or less.

The following tables (dollars in thousands) set forth the expected maturity of the Company's interest-earning assets and interest-bearing liabilities. The expected maturities are presented on a contractual basis, adjusted for expected prepayments. Actual maturities may differ from expected maturities because of prepayment, early withdrawal of deposits, and competition.

valley community bancshares, inc. expected maturity

	outstanding balance at december 31, 2003							cumulative total	estimated fair value
	2004	2005	2006	2007	2008	thereafter			
Interest-earning assets:									
Interest-bearing deposits with banks	\$ 6,508	\$ 1,995	\$	\$	\$	\$	\$ 8,503	\$ 8,516	
Weighted average interest rate	2.18%	2.13%					2.17%		
Federal funds sold	9,765						9,765	9,765	
Weighted average interest rate	0.81%						0.81%		
Investment securities ¹									
Fixed rate	4,905	10,127	3,513	2,009	2,559	6,722	29,835	29,835	
Weighted average interest rate	3.56%	2.72%	3.19%	3.70%	3.82%	3.92%	3.23%		
Variable rate	1,725	1,448	1,006	778	602	3,166	8,725	8,725	
Weighted average interest rate	3.38%	3.32%	3.38%	3.37%	3.37%	2.83%	3.21%		
Loans									
Fixed rate	10,045	7,271	9,321	12,522	22,015	6,375	67,549	67,434	
Weighted average interest rate	7.04%	7.20%	7.13%	6.84%	6.32%	6.35%	6.74%		
Variable rate	25,577	5,126	2,489	1,865	2,294	9,361	46,712	46,803	
Weighted average interest rate	5.68%	5.61%	5.87%	5.93%	5.35%	6.37%	5.81%		
Other earning assets							372	372	
Weighted average interest rate							5.00%	5.00%	
Total interest-earning assets	\$ 58,525	\$ 25,967	\$ 16,329	\$ 17,174	\$ 27,470	\$ 25,996	\$ 171,461	\$ 171,450	

¹ Yield on tax-exempt obligations has not been computed on a tax-equivalent basis.

management's discussion and analysis of financial condition and results of operations

valley community bancshares, inc. expected maturity

outstanding balance at december 31, 2003

	outstanding balance at december 31, 2003						cumulative total	estimated fair value
	2004	2005	2006	2007	2008	thereafter		
Interest-bearing liabilities:								
Interest-bearing demand	\$ 24,110	\$	\$	\$	\$	\$	\$ 24,110	\$ 24,110
Weighted average interest rate	0.19%						0.19%	
Savings and money market	55,518						55,518	55,518
Weighted average interest rate	0.60%						0.60%	
Time deposits < \$100,000	18,764	1,437	153	738	164	15	21,271	21,286
Weighted average interest rate	1.26%	1.89%	2.92%	4.68%	2.97%	1.48%	1.45%	
Time deposits > \$100,000	20,159	690	203	414	191		21,657	21,737
Weighted average interest rate	1.05%	2.65%	3.34%	4.81%	3.37%		1.22%	
Other borrowed funds	580						580	580
Weighted average interest rate	0.91%						0.91%	
Total interest-bearing liabilities	\$ <u>119,131</u>	\$ <u>2,127</u>	\$ <u>356</u>	\$ <u>1,152</u>	\$ <u>355</u>	\$ <u>15</u>	\$ <u>123,136</u>	\$ <u>123,231</u>

There are certain shortcomings inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities, they may react differently to changes in market interest rates. Also, interest rates on assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other assets and liabilities may follow changes in market interest rates. Additionally, certain assets have features that restrict changes in the interest rates of such assets, both on a short-term basis and over the lives of such assets.

To more accurately predict the Company's interest rate exposure, a financial analysis to analyze the change in the net interest margin from a changing rate environment is provided below. This estimate of interest rate sensitivity takes into account the differing time intervals and rate-change increments of each type of interest-sensitive asset and liability. It then measures the projected impact of changes in market interest rates on the Company's net interest income, net interest margin, and return on equity.

Based on a financial analysis performed as of December 31, 2003, which takes into account how the specific interest rate scenario would be expected to affect each interest-earning asset and each interest-bearing liability, the Company estimates that changes in the prime interest rate would affect the Company's performance as follows.

valley community bancshares, inc. financial analysis

	increase (decrease) in		
	net interest income	net interest margin ¹ (dollars in thousands)	return on equity
(Current prime rate is 4.00%)			
Prime rate increase of:			
100 basis points to 5.00%	\$ (229)	-0.17%	-0.61%
200 basis points to 6.00%	\$ (237)	-0.20%	-0.63%
Prime rate decrease of:			
100 basis points to 3.00%	\$ (75)	-0.10%	-0.20%
200 basis points to 2.00%	\$ (106)	-0.14%	-0.29%

No assurances can be given that the actual net interest margin (percentage) or net interest income would increase or decrease by such amounts in a 100 or 200 basis point increase or decrease in the prime rate. In addition, the above analysis assumes an instantaneous interest rate change in the prime rate. Generally, the prime interest rate changes occur over longer periods of time, which may have a significant impact on the above analysis.

Valley Community Bancshares, Inc.
independent auditor's report

**To the Board of Directors and Stockholders
Valley Community Bancshares, Inc.**

We have audited the accompanying consolidated balance sheet of Valley Community Bancshares, Inc. and subsidiaries (the Company) as of December 31, 2003 and 2002, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Valley Community Bancshares, Inc. and subsidiary as of December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.



Moss Adams LLP

Everett, Washington
February 6, 2004

Valley Community Bancshares, Inc.
consolidated financial statements
consolidated balance sheet
(dollars in thousands)

	december 31,	
	2003	2002
ASSETS		
Cash and due from banks	\$ 5,199	\$ 4,847
Interest-bearing deposits with banks	8,503	22,191
Federal funds sold	9,765	1,734
Securities available-for-sale	38,560	31,069
Federal Home Loan Bank stock	372	398
	62,399	60,239
Loans	114,261	105,354
Less allowance for loan losses	1,388	1,388
	112,873	103,966
Accrued interest receivable	681	727
Premises and equipment, net	5,850	6,096
Real estate held for investment		224
Other assets	417	459
	182,220	171,711
Total assets	\$ 182,220	\$ 171,711
 LIABILITIES		
Deposits		
Non-interest-bearing	\$ 34,675	\$ 29,119
Interest-bearing	122,556	118,317
	157,231	147,436
Other borrowed funds	580	750
Accrued interest payable	145	295
Other liabilities	611	775
	158,567	149,256
Total liabilities	158,567	149,256
 STOCKHOLDERS' EQUITY		
Common stock, par value \$1 per share; 5,000,000 shares authorized; 1,175,267 and 1,115,994 shares issued and outstanding in 2003 and 2002, respectively	1,175	1,116
Additional paid-in capital	16,903	15,527
Retained earnings	5,204	5,219
Accumulated other comprehensive income, net of tax	371	593
	23,653	22,455
Total stockholders' equity	23,653	22,455
Total liabilities and stockholders' equity	\$ 182,220	\$ 171,711

The accompanying notes are an integral part of these consolidated financial statements.

Valley Community Bancshares, Inc.
consolidated financial statements
consolidated statement of income
(dollars in thousands except for per-share amounts)

	year ended december 31,		
	2003	2002	2001
INTEREST INCOME			
Interest and fees on loans	\$ 7,605	\$ 8,074	\$ 8,109
Interest on federal funds sold and deposits in banks	319	322	767
Securities available-for-sale	1,113	1,462	1,608
Dividends on Federal Home Loan Bank stock	21	28	32
Total interest income	9,058	9,886	10,516
INTEREST EXPENSE			
Interest on deposits	1,263	1,876	3,421
Interest on federal funds and other short-term borrowings	5	7	14
Total interest expense	1,268	1,883	3,435
Net interest income	7,790	8,003	7,081
PROVISION FOR LOAN LOSSES			
Net interest income after provision for loan losses	7,790	7,790	7,019
NONINTEREST INCOME			
Service charges	473	465	387
Gain on sale of investment securities, net	36	54	54
Gain on sale of real estate held for investment	211		
Origination fees on mortgage loans brokered	375	189	114
Other operating income	374	296	315
Total noninterest income	1,469	1,004	870
NONINTEREST EXPENSE			
Salaries	2,631	2,419	2,112
Employee benefits	649	606	586
Occupancy	556	497	551
Equipment	444	462	527
Other operating expenses	1,967	1,738	1,583
Total noninterest expense	6,247	5,722	5,359
INCOME BEFORE INCOME TAX	3,012	3,072	2,530
PROVISION FOR INCOME TAX	963	954	744
NET INCOME	\$ 2,049	\$ 2,118	\$ 1,786
EARNINGS PER SHARE			
Basic	\$ 1.75	\$ 1.79	\$ 1.50
Diluted	\$ 1.74	\$ 1.77	\$ 1.48
Weighted average shares outstanding	1,172,561	1,182,840	1,187,256
Weighted average diluted shares outstanding	1,178,261	1,197,096	1,206,709

The accompanying notes are an integral part of these consolidated financial statements.

Valley Community Bancshares, Inc.
consolidated financial statements
consolidated statement of changes in stockholders' equity
(dollars in thousands)

	<u>common stock</u>		<u>additional</u>	<u>comprehensive</u>	<u>retained</u>	<u>accumulated</u>	<u>total</u>
	<u>shares</u>	<u>amount</u>	<u>paid-in</u>	<u>income</u>	<u>earnings</u>	<u>other</u>	<u>stockholders'</u>
			<u>capital</u>			<u>comprehensive</u>	<u>equity</u>
						<u>income (loss), net</u>	
BALANCE, 12/31/2000	1,133,588 \$	1,134 \$	16,322		\$ 2,613	\$ 56	20,125
Net income				\$ 1,786	1,786		1,786
Other comprehensive income							
Unrealized gain on securities, Net of \$128 tax				249		249	249
Comprehensive income				\$ 2,035			
Common stock redeemed	(20,239)	(20)	(486)				(506)
Cash dividend					(623)		(623)
Common stock exercised							
Under stock option plan	13,401	13	117				130
BALANCE, 12/31/2001	1,126,750	1,127	15,953		3,776	305	21,161
Net income				\$ 2,118	2,118		2,118
Other comprehensive income							
Unrealized gain on securities, Net of \$149 tax				288		288	288
Comprehensive income				\$ 2,406			
Common stock redeemed	(21,824)	(22)	(524)				(546)
Cash dividend					(675)		(675)
Common stock exercised							
Under stock option plan	11,068	11	98				109
BALANCE, 12/31/2002	1,115,994	1,116	15,527		5,219	593	22,455
Net income				\$ 2,049	2,049		2,049
Other comprehensive income							
Unrealized loss on securities, Net of \$115 tax benefit				(222)		(222)	(222)
Comprehensive income				\$ 1,827			
Cash dividend					(675)		(675)
Stock dividend	55,552	55	1,334		(1,389)		
Common stock exercised							
Under stock option plan	3,721	4	42				46
BALANCE, 12/31/2003	<u>1,175,267</u> \$	<u>1,175</u> \$	<u>16,903</u>		<u>5,204</u> \$	<u>371</u> \$	<u>23,653</u>

The accompanying notes are an integral part of these consolidated financial statements.

Valley Community Bancshares, Inc.
consolidated financial statements
consolidated statement of cash flows
(dollars in thousands)

	year ended december 31,		
	2003	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 2,049	\$ 2,118	\$ 1,786
Adjustments to reconcile net income to net cash from operating activities:			
Provisions for loan losses		213	62
Depreciation and software amortization	470	362	462
Deferred income tax	11	4	36
Net amortization on securities	354	200	83
FHLB stock dividends	(21)	(28)	(31)
Gain on sale of securities available-for-sale	(36)	(54)	(54)
Loss on sale of premises and equipment		41	5
Gain on sale of real estate held for investment	211		
Amortization of deferred gain on sale of real estate held for investment	(211)		
Amortization on intangibles	42	29	
Changes in operating assets and liabilities:			
Decrease in accrued interest receivable	46	50	175
Decrease (increase) in other assets	1	(195)	153
Decrease in accrued interest payable	(150)	(95)	(207)
Increase (decrease) in other liabilities	(60)	57	146
Net cash from operating activities	2,706	2,702	2,616
CASH FLOWS FROM INVESTING ACTIVITIES			
Net increase in federal funds sold	(8,031)	(1,734)	
Net increase in interest-bearing deposits with banks	13,688	(8,108)	(3,960)
Purchase of securities available-for-sale	(34,983)	(14,848)	(18,365)
Proceeds from sales of securities available-for-sale	7,607	5,567	3,055
Proceeds from maturities of securities available-for-sale	19,230	9,853	15,070
Redemption of stock in FHLB	47	108	
Net increase in loans	(8,907)	(4,580)	(6,143)
Additions to premises and equipment	(225)	(593)	(586)
Purchase of intangibles		(144)	
Proceeds from the sale of real estate held for investment	224		
Net cash from investing activities	(11,350)	(14,479)	(10,929)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net increase in deposits	9,795	12,736	9,653
Net increase (decrease) in other borrowed funds	(122)	416	(223)
Payment on other borrowed money	(48)		
Cash dividends paid	(675)	(675)	(623)
Common stock redeemed		(546)	(506)
Stock options exercised	46	109	130
Net cash from financing activities	8,996	12,040	8,431
NET INCREASE IN CASH AND DUE FROM BANKS	352	263	118
CASH AND DUE FROM BANKS, beginning of year	4,847	4,584	4,466
CASH AND DUE FROM BANKS, end of year	\$ 5,199	\$ 4,847	\$ 4,584
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash payments for			
Interest	\$ 1,418	\$ 1,978	\$ 3,642
Income taxes	878	971	661
SUPPLEMENTAL DISCLOSURE OF NONCASH ACTIVITIES			
Distribution of five percent stock dividend	\$ 1,389	\$	\$
Unrealized gains (losses) on securities available-for-sale	(337)	437	377
Deferred tax on unrealized gains (losses) on securities available-for-sale	115	(149)	(128)
Held-to-maturity securities transferred to securities available-for-sale			279

The accompanying notes are an integral part of these consolidated financial statements.

notes to consolidated financial statements

NOTE 1 - DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

The Company is a Washington State bank holding company headquartered in Puyallup, Washington. The Company conducts its business primarily through its wholly owned bank subsidiary, Valley Bank.

The Company's main office is located in Puyallup, Washington, which also serves as the main office of Valley Bank. The Company provides a full range of commercial banking services to small and medium-sized businesses, professionals, and other individuals through banking offices located in Puyallup, Auburn, and Kent, Washington, and their environs.

Basis of Presentation

The consolidated financial statements include the accounts of Valley Community Bancshares, Inc. (the "Company") and its wholly owned subsidiary Valley Bank (the "Bank"). All significant intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates

The preparation of the consolidated financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions. These assumptions and estimates affect the reported amounts of assets and liabilities, and disclosures of contingent assets and liabilities at the date of the consolidated financial statements. They also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, and amounts due from banks. Cash and cash equivalents have an original maturity of three months or less.

Interest-Bearing Deposits with Banks

Interest-bearing deposits with banks include interest-bearing deposits at the Federal Home Loan Bank and certificates of deposit in financial institutions located throughout the United States of America. All certificates of deposit are under the FDIC insurance limit.

Investment Securities

Investment securities are classified into one of three categories: (1) held-to-maturity, (2) available-for-sale, or (3) trading. Investment securities are categorized as held-to-maturity when the Company has the positive intent and ability to hold those securities to maturity. Securities that are held-to-maturity are stated at cost and adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to interest income.

Investment securities categorized as available-for-sale are generally held for investment purposes (to maturity), although unanticipated future events may result in the sale of some securities. Available-for-sale securities are recorded at estimated fair value, with the net unrealized gain or loss included in comprehensive income, net of the related tax effect. Realized gains or losses on dispositions are based on the net proceeds and the adjusted carrying amount of securities sold, using the specific identification method.

Declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost that are other than temporary are recognized by write-downs of the individual securities to their fair value. Such write-downs would be included in earnings as realized losses.

Premiums and discounts are recognized in interest income using the interest method over the period to maturity. The Company had no trading securities at December 31, 2003 and 2002.

Federal Home Loan Bank Stock

The Company's investment in Federal Home Loan Bank (the FHLB) stock is carried at par value (\$100 per share), which reasonably approximates its fair value. As a member of the FHLB system, the Company is required to maintain a minimum level of investment in FHLB stock based on specified percentages of its outstanding FHLB advances. The Company may request redemption at par value of any stock in excess of the amount the Company is required to hold. Stock redemptions are at the discretion of the FHLB.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off, are reported at their outstanding principal, and are adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan.

The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. Interest income on restructured loans is recognized pursuant to the terms of the new loan agreement. Interest income on other impaired loans is monitored and based upon the terms of the underlying loan agreement. However, the recorded net investment in impaired loans, including accrued interest, is limited to the present value of the expected cash flows of the impaired loan or the observable fair market value of the loan, or the fair market value of the loan's collateral.

notes to consolidated financial statements

NOTE 1 - DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Allowance for Loan Loss

The allowance for loan loss is management's best estimate of loan losses incurred at the balance sheet date. The allowance for loan losses is increased by charges to income and decreased by charge-offs (net of recoveries), and established through a provision for credit losses charged to expense. Loans are charged against the allowance for credit losses when management believes that the collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing loans, commitments to extend credit, and standby letters of credit, based on evaluations of collectibility and prior loss experience of loans. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, loan concentrations, specific problem loans, commitments, standby letters of credit, and current economic conditions that may affect the borrowers' ability to pay.

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for losses on loans and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the estimated losses on loans and foreclosed assets held for sale, management obtains independent appraisals for significant properties.

The majority of the Company's loan portfolio consists of commercial loans and single-family residential loans secured by real estate in the Puyallup and Pierce County area and also in the Auburn, Kent, and King County area. Real estate prices in this market are stable at this time. However, the ultimate collectibility of a substantial portion of the Company's loan portfolio may be susceptible to change in local market conditions in the future.

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Company to recognize additional losses based on their judgment about information available to them at the time of their examination.

Management determines the adequacy of the allowance for loan losses by utilizing a loan grading system to determine risk in the loan portfolio and by considering the results of credit reviews. The loan portfolio is separated by quality and then by loan type. Loans of acceptable quality are evaluated as a group, by loan type, with a specific loss rate assigned to the total loans in each type, but unallocated to any individual loan. Conversely, each adversely classified loan is individually analyzed, to determine an estimated loss amount. A valuation allowance is also assigned to these adversely classified loans, but at a higher loss rate due to the greater risk of loss. For those loans where the loss is greater than the background percentage, the estimated loss amount is considered specifically allocated to the allowance.

Although management has allocated a portion of the allowance to the loan categories using the method described above, the adequacy of the allowance must be considered as a whole. To mitigate the imprecision in most estimates of expected loan losses, the allocated component of the allowance is supplemented by an unallocated component. The unallocated portion includes management's judgmental determination of the amounts necessary for qualitative factors such as the consideration of new products and policies, economic conditions, concentrations of credit risk, and the experience and abilities of lending personnel. Loan concentrations, quality, terms, and basic underlying assumptions remained substantially unchanged during the period.

Premises and Equipment

Premises and equipment are stated at cost, less accumulated amortization and depreciation. Leasehold improvements are amortized on a straight-line basis over the lives of the respective leases. Depreciation is computed on the straight-line method over the following estimated useful lives:

Building and improvements	10 – 40 years
Furniture, fixtures, and equipment	3 – 10 years

Real Estate Held for Investment

Real estate held for investment is property that was acquired for resale. The property is recorded at the lower of cost or fair value and is periodically evaluated to determine that the carrying value does not exceed the fair value of the property. The property was sold during 2003.

Income Tax

The Company records its provision for income taxes using the liability method. 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.

Restricted Assets

Federal Reserve Board Regulations require maintenance of certain minimum reserve balances on deposit with the Federal Reserve Bank. The amounts of such balances on deposit were approximately \$2,039,000 and \$1,090,000 at December 31, 2003 and 2002, respectively.

Comprehensive Income

Comprehensive income includes net income and other comprehensive income, which refers to unrealized gains and losses that under accounting principles generally accepted in the United States of America are excluded from net income.

Reclassification

Certain amounts in the 2002 and 2001 consolidated financial statements have been reclassified to conform to the 2003 presentation. These reclassifications had no effect on net income.

notes to consolidated financial statements

NOTE 1 - DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Stock Option Plan

The Company recognizes the financial effects of stock options in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Stock options are issued at a price that approximates the fair value of the Company's stock as of the grant date. Under APB 25, options issued in this manner do not result in the recognition of employee compensation in the Company's financial statements.

At December 31, 2003, the Company has a stock-based employee compensation plan, which is described more fully in Note 14. The Company accounts for the plan under recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations using the intrinsic value method. No stock-based employee compensation cost is reflected in net income, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition method as provided under FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

In thousands, except for per-share amounts

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Pro forma disclosures			
Net income as reported	\$ 2,049	\$ 2,118	\$ 1,786
Additional compensation for fair value of stock options	<u>(12)</u>	<u>(10)</u>	<u>(8)</u>
Pro forma net income	<u>\$ 2,037</u>	<u>\$ 2,108</u>	<u>\$ 1,778</u>
Earnings per share			
Basic			
As reported	<u>\$ 1.75</u>	<u>\$ 1.79</u>	<u>\$ 1.50</u>
Pro forma	<u>\$ 1.74</u>	<u>\$ 1.78</u>	<u>\$ 1.50</u>
Diluted			
As reported	<u>\$ 1.74</u>	<u>\$ 1.77</u>	<u>\$ 1.48</u>
Pro forma	<u>\$ 1.73</u>	<u>\$ 1.76</u>	<u>\$ 1.47</u>

Financial Instruments

In the ordinary course of business, the Company has entered into off-balance-sheet financial instruments consisting of commitments to extend credit, commitments under credit card arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded, or when related fees are incurred or received.

Earnings per Share

Basic earnings per share amounts are computed based on the weighted average number of shares outstanding during the period after giving retroactive effect to stock dividends and stock splits. Diluted earnings per share amounts are computed by determining the number of additional shares that are deemed outstanding due to stock options under the treasury stock method.

Advertising Costs

The Company expenses advertising costs as they are incurred. The amounts expensed during 2003, 2002, and 2001 were \$177,000, \$138,000, and \$115,000, respectively.

notes to consolidated financial statements

NOTE 1 - DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Impact of New Accounting Issues

During the year 2003 the Financial Accounting Standard Board issued the following accounting standards:

In January 2003, FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities* (VIE). It defined a VIE as a corporation, partnership, trust, or any other legal structure used for the business purpose 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 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. The provisions of interpretation No. 46 are required to be applied immediately to VIEs created after January 31, 2003. The Company does not have any VIE and accordingly the implementation of the Interpretation did not result in an impact on its financial position or results of operations.

In April 2003, FASB issued Statement No. 149, *Amendment of Statement 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 FASB Statement 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 the Statement did not result in an impact on the Company's statement of financial position or results of operations.

In May 2003, FASB issued Statement 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 those instruments were previously classified as equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatory redeemable financial instruments of nonpublic entities. Adoption of the Statement did not result in an impact on the Company's statement of financial position or results of operations.

notes to consolidated financial statements

NOTE 2 - INVESTMENT SECURITIES

At December 31, 2003, there are approximately 20 investment securities that have fair values less than amortized cost and therefore contain unrealized losses. The Company has evaluated these securities and has determined that the decline in value is temporary and is related to the change in market interest rates since purchase. The decline in value is not related to any company or industry specific event. The Company anticipates full recovery of amortized cost with respect to these securities at maturity or sooner in the event of a more favorable market interest rate environment.

Investment securities have been classified according to management's intent. The carrying amount of securities and their estimated fair values are as follows (dollars in thousands):

december 31, 2003

securities available-for-sale	amortized cost	gross unrealized gains	gross unrealized losses less than 12 months	12 months or more	estimated fair value
U.S. Treasury and U.S. Government corporations and agencies	\$ 13,614	\$ 109	\$ 2	\$	\$ 13,721
State and political subdivisions	7,421	361	4		7,778
Mortgage-backed securities	16,964	151	54		17,061
	<u>\$ 37,999</u>	<u>\$ 621</u>	<u>\$ 60</u>	<u>\$</u>	<u>\$ 38,560</u>

december 31, 2002

securities available-for-sale	amortized cost	gross unrealized gains	gross unrealized losses less than 12 months	12 months or more	estimated fair value
U.S. Treasury and U.S. Government corporations and agencies	\$ 10,662	\$ 226	\$	\$	\$ 10,888
State and political subdivisions	5,404	323			5,727
Mortgage-backed securities	14,104	350			14,454
	<u>\$ 30,170</u>	<u>\$ 899</u>	<u>\$</u>	<u>\$</u>	<u>\$ 31,069</u>

At December 31, 2003, there are approximately 96 investment securities with an estimated fair value of \$30,457,000 and with estimated unrealized gains of \$621,000.

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

	available-for-sale	
	amortized cost	estimated fair value
Due in one year or less	\$ 1,548	\$ 1,559
Due from one to five years	16,579	16,803
Due from five to ten years	11,476	11,775
Due after ten years	8,396	8,423
Totals	<u>\$ 37,999</u>	<u>\$ 38,560</u>

Proceeds from sales of available-for-sale investment securities were \$7,607,000, \$5,567,000, and \$3,055,000, in 2003, 2002, and 2001, respectively.

Gross gains from the sales of available-for-sale investment securities were \$65,000, \$64,000, and \$54,000 in 2003, 2002, and 2001, respectively. The Company incurred gross losses of \$29,000, \$10,000, and \$0 in 2003, 2002 and 2001, respectively.

Investments in state and political subdivisions represent purchases of municipal bonds located in Washington State. The debt obligations were all within the credit ratings acceptable under the Company's investment policy.

Investment securities with a book value of \$3,484,000 and \$3,398,000 at 2003 and 2002, respectively, have been pledged to secure public deposits, as required by law, and other purposes. The estimated fair value of these pledged securities was \$3,584,000 and \$3,518,000 at December 31, 2003 and 2002, respectively.

notes to consolidated financial statements

NOTE 3 - LOANS

The major classifications of loans at December 31 are summarized as follows (dollars in thousands):

	2003	2002
Real estate		
Construction	\$ 9,913	\$ 9,276
Residential	12,095	15,080
Commercial	65,114	55,266
Commercial	24,872	23,502
Consumer and other	2,409	2,339
Lease	63	83
	114,466	105,546
Less deferred loan fees, net	(205)	(192)
Totals	\$ 114,261	\$ 105,354

Contractual maturities of loans as of December 31, 2003, are as shown below. Actual maturities may differ from contractual maturities because individual borrowers may have the right to prepay loans with or without prepayment penalties.

	within 1 year	1 - 5 years	after 5 years	total
Commercial	\$ 12,852	\$ 10,705	\$ 1,315	\$ 24,872
Real estate, commercial	7,388	43,257	14,469	65,114
Real estate, construction	5,199	4,559	155	9,913
Real estate, residential	1,858	5,386	4,851	12,095
Consumer and other	987	1,330	92	2,409
Lease	22	41		63
	\$ 28,306	\$ 65,278	\$ 20,882	\$ 114,466

	1 - 5 years	after 5 years
Loans maturing after one year with:		
Fixed rates	\$ 51,331	\$ 6,810
Variable rates	13,947	14,072
	\$ 65,278	\$ 20,882

The Company has no loans classified as impaired at December 31, 2003 and 2002, respectively. Therefore, no allocation of the allowance for possible credit losses was considered necessary to allocate to impaired loans at December 31, 2003 and 2002.

notes to consolidated financial statements

NOTE 4 - ALLOWANCE FOR LOAN LOSSES

Changes in the allowance for loan losses are summarized as follows (dollars in thousands):

	2003	2002	2001
Balance, beginning of year	\$ 1,388	\$ 1,156	\$ 1,096
Provision for loan losses		213	62
Additions from recoveries		24	4
Loans charged off		(5)	(6)
	\$ 1,388	\$ 1,388	\$ 1,156

NOTE 5 - PREMISES AND EQUIPMENT

Premises and equipment at December 31 consisted of the following (dollars in thousands):

	2003	2002
Equipment, furniture, and fixtures	\$ 2,736	\$ 2,700
Land and buildings	6,409	6,360
	9,145	9,060
Less accumulated depreciation	(3,295)	(2,964)
	\$ 5,850	\$ 6,096

Depreciation expense on premises and equipment totaled \$392,000 in 2003, \$362,000 in 2002, and \$462,000 in 2001.

NOTE 6 - DEPOSITS

Interest-bearing deposits at December 31 consisted of the following (dollars in thousands):

	2003	2002
Demand accounts	\$ 24,110	\$ 21,733
Money market accounts	39,018	35,506
Savings accounts	16,500	14,343
Certificates of deposit over \$100,000	21,657	21,340
Other certificates of deposit	21,271	25,395
	\$ 122,556	\$ 118,317

At December 31, 2003, the scheduled maturities of certificates of deposit are as follows (dollars in thousands):

2004	\$ 38,881
2005	2,128
2006	346
2007	1,189
2008	384
	\$ 42,928

notes to consolidated financial statements

NOTE 7 - OTHER BORROWED FUNDS

Other borrowed funds at December 31 consist of the following (dollars in thousands):

	2003	2002
Treasury tax and loan note	\$ 532	\$ 654
Other borrowed money	48	96
	\$ 580	\$ 750

Other borrowed money represents a borrowing arrangement made in connection with the purchase of various assets from Puget Sound Mortgage Brokers during 2002. The obligation is unsecured and is scheduled to be repaid in two equal annual installments plus interest at a rate of 2.88 percent.

In addition, the Company participates in the Treasury Tax and Loan Investment Program of the Federal Reserve Bank. In accordance with federal regulation the Bank is permitted to borrow Treasury Tax and Loan funds by executing an open-ended interest-bearing note to the Federal Reserve Bank of San Francisco. Interest is payable weekly, and is computed at 0.25 percent below the Federal Fund interest rate. The note is secured by U.S. Government obligations with a par value of \$1,000,000.

NOTE 8 - CREDIT ARRANGEMENTS

The Bank is a member of the Federal Home Loan Bank of Seattle. As a member, the Bank has a committed line of credit up to 10 percent of total assets. Borrowings generally provide for interest at the then-current published rates. There were no borrowings outstanding at December 31, 2003 and 2002. During 2002, the maximum amount of borrowings outstanding totaled \$395,000. The average amount of borrowings outstanding during 2002 was \$16,000. The average weighted interest rate paid on those borrowings was 2.21 percent during 2002. There were no borrowings outstanding during 2003 and 2001.

At December 31, 2003, committed line-of-credit agreements totaling approximately \$9,500,000 were available to the Company from unaffiliated banks with maturities that range from June 2004 to July 2004. Such lines generally provide for interest at the then-existing federal funds rate. There were no borrowings outstanding under these credit arrangements at December 31, 2003 and 2002. There were no borrowings outstanding during 2003, 2002, and 2001.

NOTE 9 - INCOME TAXES

The components of the provision for federal income tax expense for the years ended December 31, are as follows (dollars in thousands):

	2003	2002	2001
Current	\$ 952	\$ 950	\$ 708
Deferred	11	4	36
	\$ 963	\$ 954	\$ 744

A reconciliation of the effective income tax rate with the federal statutory rate is as follows (dollars in thousands):

	2003		2002		2001	
	amount	rate	amount	rate	amount	rate
Federal income tax at statutory rates	\$ 1,023	34%	\$ 1,044	34%	\$ 860	34%
Effect of tax-exempt interest income	(89)	-3%	(95)	-3%	(89)	-4%
Other	29	1%	5		(27)	-1%
	\$ 963	32%	\$ 954	31%	\$ 744	29%

notes to consolidated financial statements

NOTE 9 - INCOME TAXES (continued)

The following are the significant components of deferred tax assets and liabilities at December 31 (dollars in thousands):

	2003	2002
Deferred tax assets		
Allowance for loan losses	\$ 398	\$ 401
Deferred compensation	100	85
Other	22	15
	520	501
Deferred tax liabilities		
Accumulated depreciation	271	240
Unrealized gain on securities available-for-sale	191	306
Other	80	81
	542	627
Net deferred tax asset (liability)	\$ (22)	\$ (126)

The Company believes, based on available information, that all deferred tax assets will be realized in the normal course of business; therefore, these assets have not been reduced by a valuation allowance.

NOTE 10 - STOCKHOLDERS' EQUITY AND REGULATORY CAPITAL

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

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2003, that the Company meets all capital adequacy requirements to which it is subject.

As of December 31, 2003, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Company must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

notes to consolidated financial statements

NOTE 10 - STOCKHOLDERS' EQUITY AND REGULATORY CAPITAL (continued)

The Company's actual capital amounts and ratios are also presented in the table (dollars in thousands):

	actual		for capital adequacy purposes				to be well capitalized under prompt corrective action provisions				
	amount	ratio	amount	ratio	amount	ratio	amount	ratio			
<i>As of December 31, 2003:</i>											
Total Capital											
(to Risk-weighted assets)											
Valley Community Bancshares	\$	24,597	18.70%	≥	\$	10,524	8.00%	≥	\$	13,154	10.00%
Valley Bank	\$	22,928	17.43%	≥	\$	10,524	8.00%	≥	\$	13,154	10.00%
Tier I Capital											
(to Risk-weighted assets)											
Valley Community Bancshares	\$	23,209	17.64%	≥	\$	5,262	4.00%	≥	\$	7,893	6.00%
Valley Bank	\$	21,540	16.37%	≥	\$	5,262	4.00%	≥	\$	7,893	6.00%
Tier I Capital											
(to Average assets)											
Valley Community Bancshares	\$	23,209	12.68%	≥	\$	7,324	4.00%	≥	\$	9,155	5.00%
Valley Bank	\$	21,540	11.76%	≥	\$	7,324	4.00%	≥	\$	9,155	5.00%
<i>As of December 31, 2002:</i>											
Total Capital											
(to Risk-weighted assets)											
Valley Community Bancshares	\$	23,135	19.09%	≥	\$	9,965	8.00%	≥	\$	12,119	10.00%
Puyallup Valley Bank	\$	15,925	16.01%	≥	\$	7,960	8.00%	≥	\$	9,950	10.00%
Valley Bank	\$	4,113	20.84%	≥	\$	1,579	8.00%	≥	\$	1,973	10.00%
Tier I Capital											
(to Risk-weighted assets)											
Valley Community Bancshares	\$	21,747	17.94%	≥	\$	4,848	4.00%	≥	\$	7,271	6.00%
Puyallup Valley Bank	\$	14,750	14.82%	≥	\$	3,980	4.00%	≥	\$	5,970	6.00%
Valley Bank	\$	3,900	19.76%	≥	\$	789	4.00%	≥	\$	1,184	6.00%
Tier I Capital											
(to Average assets)											
Valley Community Bancshares	\$	21,747	12.64%	≥	\$	6,881	4.00%	≥	\$	8,601	5.00%
Puyallup Valley Bank	\$	14,750	9.94%	≥	\$	5,933	4.00%	≥	\$	7,417	5.00%
Valley Bank	\$	3,900	17.96%	≥	\$	869	4.00%	≥	\$	1,086	5.00%

notes to consolidated financial statements

NOTE 11 - COMMITMENTS AND CONTINGENT LIABILITIES

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

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

	2003	2002
Commitments to extend credit	\$ 21,403	\$ 19,767
Standby letters of credit	120	10
	\$ 21,523	\$ 19,777

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company's experience has been that customers draw upon approximately 75 percent of loan commitments. While approximately all of commercial letters of credit are utilized, a significant portion of such utilization is on an immediate payment basis. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Company 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.

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

(b) **Operating lease commitments** - The Company leases its operating facilities under agreements, which expire between January 2004 and May 2008, subject to the Company's option to extend the lease term under those agreements. The agreements require the Company to pay certain operating expenses. The approximate annual commitment for rental space under these operating leases is summarized as follows (dollars in thousands):

year ending december 31,				
2004	\$	82		
2005		80		
2006		80		
2007		80		
2008		33		
	\$	355		

Rental expense charged to operations was \$111,000, \$80,000, and \$102,000 for the years ended December 31, 2003, 2002, and 2001, respectively.

(c) **Legal Proceedings** - The Company and its subsidiary are from time to time defendants in and are threatened with various legal proceedings arising from their regular business activities. Management, after consulting with legal counsel, is of the opinion that the ultimate liability, if any, resulting from these and other pending or threatened actions and proceedings will not have a material effect on the financial position or results of operation of the Company and its subsidiary.

notes to consolidated financial statements

NOTE 12 - RELATED PARTY TRANSACTIONS

Certain directors, executive officers, principal stockholders, and companies in which they have a beneficial interest, are loan customers of the Company. All loans and loan commitments were made in compliance with applicable laws and regulations on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable transactions with other persons and do not involve more than the normal risk of collectibility or present any other unfavorable features.

Such loans had aggregate balances and activity during 2003, 2002, and 2001 as follows (dollars in thousands):

	2003	2002	2001
Balance at beginning of year	\$ 2,355	\$ 2,926	\$ 2,550
New loans or advances	730	1,071	3,366
Repayments	(1,399)	(1,642)	(2,990)
Balance at end of year	\$ 1,686	\$ 2,355	\$ 2,926

Deposits from related parties totaled approximately \$1,600,000, \$1,605,000, and \$5,332,000 at December 31, 2003, 2002, and 2001, respectively.

NOTE 13 - EMPLOYEE BENEFITS

The Company has a 401(k) defined contribution plan for those employees who meet the eligibility requirements set forth in the plan. Contributions to the plan, adopted in January 1987, are at the discretion of the Company's Board of Directors. Eligible employees can contribute up to the lesser of \$13,000 or 100 percent of compensation. The Company made no contributions to the plan in 2003, 2002, or 2001.

The Company also has a noncontributory profit-sharing plan covering substantially all employees. Contributions to the plan are at the discretion of the Company's Board of Directors, and totaled \$122,900, \$127,100, and \$107,500 in 2003, 2002, and 2001, respectively.

NOTE 14 - STOCK OPTION PLAN

The Company has a qualified incentive stock option plan that provides for the awarding of stock options to certain officers and employees of the Company. The awarding of stock options is at the discretion of the Board of Directors. Options granted under the plan vest under a schedule determined by the Board of Directors and expire up to ten years from the date of the grant. The exercise price of all options granted under the plan is equal to the fair value of the common stock on the date of the grant. Average exercise price per share, number of shares authorized, available for grant, granted, exercised, outstanding, and currently exercisable reflect the dilutive effect of stock dividends and stock splits.

The pro forma information, as reported in Note 1 under the caption Stock Option Plan, regarding net income and earnings per share, is required by Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, as amended. The pro forma information recognizes, as compensation, the estimated fair value of stock options granted using an option valuation model known as the Black-Scholes model. Pro forma earnings per share amounts reflect an adjustment as if the fair value of the options were recognized as compensation for the period.

For the most part, variables and assumptions are used in the model. For the periods 2003, 2002, and 2001, respectively, the risk-free interest rate averaged 3.14 percent, 4.97 percent, and 4.75 percent, the dividend yield rate was 2.0 percent, 2.4 percent, and 2.2 percent, the price volatility was 15.6 percent in 2003 and was not meaningful in 2002 and 2001, and the weighted average expected life of the options has been measured at five years during 2003 and seven years during 2002 and 2001.

The fair value of options issued in 2003, 2002, and 2001 was estimated at \$82,000, \$35,000, and \$5,000, respectively. The remaining unrecognized compensation for fair value of stock options was approximately \$105,000 as of December 31, 2003.

Management believes that the variables and assumptions used in the options-pricing model are subjective and represent only one estimate of possible value.

notes to consolidated financial statements

NOTE 14 - STOCK OPTION PLAN (continued)

Information with respect to option transactions is summarized as follows:

	<u>authorized</u>	<u>exercise price</u>	<u>currently exercised</u>	<u>options outstanding</u>	<u>exercisable</u>
Balance, December 31, 2000	259,070	\$ 19.78	117,304	56,714	31,964
Granted		28.00		5,000	
Exercised		9.70	13,401	(13,401)	(13,401)
Expired and forfeitures					
Vested					
Balance, December 31, 2001	259,070	23.43	130,705	48,313	18,563
Granted		26.00		13,000	
Exercised		9.88	11,068	(11,068)	(11,068)
Expired and forfeitures					
Vested					15,250
Balance, December 31, 2002	259,070	27.08	141,773	50,245	22,745
Granted		30.00		18,376	
Stock dividend distributed	2,510			2,510	1,384
Exercised		12.46	3,721	(3,721)	(3,721)
Expired and forfeitures				(20,476)	(15,750)
Vested					18,650
Balance, December 31, 2003	<u>261,580</u>	<u>\$ 25.63</u>	<u>145,494</u>	<u>46,934</u>	<u>23,308</u>

Additional financial data pertaining to outstanding stock options is as follows:

<u>range of exercise prices</u>	<u>number of option shares</u>	<u>weighted average remaining contractual life (in years)</u>	<u>weighted average exercise price of option shares</u>	<u>number exercisable option shares</u>	<u>weighted average exercise price of exercisable option shares</u>
\$ 11.75 - 11.78	4,146	0.07	\$ 11.76	4,146	\$ 11.76
22.68	5,512	3.89	22.68	5,512	22.68
24.76	13,650	8.46	24.76		
26.67	5,250	7.07	26.67		
30.00	18,376	5.71	30.00	13,650	30.00
	<u>46,934</u>	<u>5.95</u>	<u>\$ 25.63</u>	<u>23,308</u>	<u>\$ 25.02</u>

NOTE 15 - EARNINGS PER SHARE

The numerators and denominators of basic and fully diluted earnings per share are as follows:

Dollars in thousands, except for per-share amounts:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net income (numerator)	\$ <u>2,049</u>	\$ <u>2,118</u>	\$ <u>1,786</u>
Shares used in the calculation (denominator)			
Weighted average shares outstanding	1,172,561	1,182,840	1,187,256
Effect of dilutive stock options	5,700	14,256	19,453
Fully diluted shares	<u>1,178,261</u>	<u>1,197,096</u>	<u>1,206,709</u>
Basic earnings per share	\$ <u>1.75</u>	\$ <u>1.79</u>	\$ <u>1.50</u>
Diluted earnings per share	\$ <u>1.74</u>	\$ <u>1.77</u>	\$ <u>1.48</u>

notes to consolidated financial statements

NOTE 16 - FAIR VALUE OF FINANCIAL INSTRUMENTS

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of SFAS No. 107, *Disclosures About Fair Value of Financial Instruments*. The Company, using available market information and appropriate valuation methodologies, has determined the estimated fair value amounts. However, considerable judgment is necessary to interpret market data in the development of the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. The fair value of commitments to customers is not considered material since they are for relatively short periods of time and subject to customary credit terms. The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

(a) Cash and due from banks, interest-bearing deposits with banks, other borrowed funds, and federal funds sold - For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

(b) Securities - For securities, fair values are based on quoted market prices or dealer quotes, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

(c) Federal Home Loan Bank Stock - The carrying amount is a reasonable estimate of fair value.

(d) Loans - The fair value of loans generally is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. For certain homogeneous categories of loans, such as Small Business Administration guaranteed loans, fair value is estimated using the quoted market prices for securities backed by similar loans, adjusted for differences in loan characteristics.

(e) Deposits - The fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities.

(f) Limitations - The fair value estimates presented herein are based on pertinent information available to management as of the applicable date.

(g) Off-balance-sheet financial instruments - Commitments to extend credit and letters of credit represent the principal categories of off-balance-sheet instruments (Note 11). The fair value of these commitments is not material since they are for a short period of time and subject to customary credit terms.

The estimated fair values of the Company's financial instruments at December 31 are as follows (dollars in thousands):

	2003		2002	
	carrying amount	fair value	carrying amount	fair value
Financial assets:				
Cash and due from banks, interest-bearing deposits with banks, and federal funds sold	\$ 23,467	\$ 23,480	\$ 28,772	\$ 28,772
Securities	38,560	38,560	31,069	31,069
Federal Home Loan Bank stock	372	372	398	398
Loans	114,261	114,237	105,354	107,261
Financial liabilities:				
Deposits	157,231	157,326	147,436	147,674
Other borrowed funds	580	580	750	750

notes to consolidated financial statements

NOTE 17 - PARENT COMPANY (ONLY) FINANCIAL INFORMATION

Condensed balance sheet at December 31, 2003 and 2002 (dollars in thousands):

	2003	2002
ASSETS		
Cash and due from Bank	\$ 1,675	\$ 1,168
Investment in Bank	21,983	19,358
Other assets	1,970	1,970
Total assets	\$ 23,658	\$ 22,496
LIABILITIES		
Accounts payable	\$ 5	\$ 41
Total liabilities	5	41
TOTAL STOCKHOLDERS' EQUITY		
Total liabilities and stockholders' equity	\$ 23,658	\$ 22,496

Condensed statement of income for the years ended December 31, 2003, 2002, and 2001 (dollars in thousands):

	2003	2002	2001
INCOME			
Dividend from Bank	\$ 1,200	\$ 1,200	\$ 1,200
Other income	25	62	77
Total income	1,225	1,262	1,277
EXPENSES			
Other expenses	76	114	99
Total expenses	76	114	99
NET INCOME BEFORE FEDERAL INCOME TAX AND EQUITY IN UNDISTRIBUTED INCOME OF BANK	1,149	1,148	1,178
INCOME TAX BENEFIT	17	3	22
NET INCOME BEFORE EQUITY IN UNDISTRIBUTED INCOME OF BANK	1,166	1,151	1,200
EQUITY IN UNDISTRIBUTED INCOME OF BANK	883	967	586
NET INCOME	\$ 2,049	\$ 2,118	\$ 1,786

notes to consolidated financial statements

NOTE 17 - PARENT COMPANY (ONLY) FINANCIAL INFORMATION (continued)

Condensed statement of cash flows for the years ended December 31, 2003, 2002, and 2001 (dollars in thousands):

	2003	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 2,049	\$ 2,118	\$ 1,786
Adjustments to reconcile net income to net cash from operating activities			
Distributions received in excess of subsidiary bank income	(883)	(967)	(586)
Other operating activities	(30)	67	36
	1,136	1,218	1,236
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of premises and equipment			(6)
			(6)
CASH FLOWS FROM FINANCING ACTIVITIES			
Sale of common stock	46	109	130
Repurchase of common stock		(546)	(506)
Dividend	(675)	(675)	(623)
	(629)	(1,112)	(999)
NET INCREASE IN CASH	507	106	231
CASH, beginning of year	1,168	1,062	831
CASH, end of year	\$ 1,675	\$ 1,168	\$ 1,062

NOTE 18 - BUSINESS SEGMENTS

Beginning January 1999 and through December 2002, the Company owned two community-banking institutions, Puyallup Valley Bank and Valley Bank. These banks were managed at the subsidiary bank level. Each subsidiary bank had a board of directors and an executive management team responsible for the operation and performance of the respective subsidiary bank.

On January 17, 2003, the Company merged the subsidiary banks into one community bank named Valley Bank. In addition, the company consolidated its board of directors and executive management team into a new organizational structure, while converting separated banking systems into a single operation. As a result of these system and organizational changes, the financial information that is used by the chief operating decision maker in allocating resources and assessing performance is only provided for one reportable segment for the year ended December 31, 2003. Prior periods have been restated to reflect the change in segment reporting.

NOTE 19 - SUBSEQUENT EVENTS

Dividends - On January 22, 2004, the Board of Directors of the Company declared a cash dividend of \$0.60 per share and a 5 percent stock dividend. The dividends were paid during February 2004 to those shareholders of record on December 31, 2003. The cash dividend was approximately \$705,000 and the stock dividend was approximately 58,700 shares.

notes to consolidated financial statements

NOTE 20 - SUMMARY OF QUARTERLY FINANCIAL INFORMATION - UNAUDITED

Quarterly financial information for the years ended December 31, 2003 and 2002 is summarized as follows:

valley community bancshares, inc.
(dollars in thousands, except per-share amounts)

2003

	first quarter	second quarter	third quarter	fourth quarter	year ended december 31,
Statement of income data					
Interest income	\$ 2,289	\$ 2,298	\$ 2,246	\$ 2,225	\$ 9,058
Interest expense	379	331	297	261	1,268
Net interest income	<u>1,910</u>	<u>1,967</u>	<u>1,949</u>	<u>1,964</u>	<u>7,790</u>
Provision for loan losses					
Net interest income after provision for loan losses	<u>1,910</u>	<u>1,967</u>	<u>1,949</u>	<u>1,964</u>	<u>7,790</u>
Noninterest income	339	332	460	338	1,469
Noninterest expense	1,604	1,530	1,531	1,582	6,247
Income before provision for income tax	<u>645</u>	<u>769</u>	<u>878</u>	<u>720</u>	<u>3,012</u>
Provision for income tax	200	242	288	233	963
Net income	<u>\$ 445</u>	<u>\$ 527</u>	<u>\$ 590</u>	<u>\$ 487</u>	<u>\$ 2,049</u>

Per-share data

Basic earnings per share	\$ 0.38	\$ 0.45	\$ 0.50	\$ 0.42	\$ 1.75
Diluted earnings per share	\$ 0.38	\$ 0.45	\$ 0.50	\$ 0.41	\$ 1.74
Weighted average shares outstanding	1,171,546	1,171,968	1,173,200	1,173,530	1,172,561
Weighted average diluted shares outstanding	1,176,251	1,176,673	1,177,992	1,182,128	1,178,261

2002

	first quarter	second quarter	third quarter	fourth quarter	year ended december 31,
Statement of income data					
Interest income	\$ 2,416	\$ 2,464	\$ 2,533	\$ 2,473	\$ 9,886
Interest expense	503	477	469	434	1,883
Net interest income	<u>1,913</u>	<u>1,987</u>	<u>2,064</u>	<u>2,039</u>	<u>8,003</u>
Provision for loan losses	31	60	76	46	213
Net interest income after provision for loan losses	<u>1,882</u>	<u>1,927</u>	<u>1,988</u>	<u>1,993</u>	<u>7,790</u>
Noninterest income	244	215	202	343	1,004
Noninterest expense	1,325	1,395	1,430	1,572	5,722
Income before provision for income tax	<u>801</u>	<u>747</u>	<u>760</u>	<u>764</u>	<u>3,072</u>
Provision for income tax	251	239	257	207	954
Net income	<u>\$ 550</u>	<u>\$ 508</u>	<u>\$ 503</u>	<u>\$ 557</u>	<u>\$ 2,118</u>

Per-share data

Basic earnings per share	\$ 0.46	\$ 0.43	\$ 0.43	\$ 0.47	\$ 1.79
Diluted earnings per share	\$ 0.46	\$ 0.43	\$ 0.42	\$ 0.46	\$ 1.77
Weighted average shares outstanding	1,183,088	1,183,088	1,183,116	1,182,068	1,182,840
Weighted average diluted shares outstanding	1,194,410	1,194,275	1,193,927	1,205,771	1,197,096

market price of and dividends on common equity and related stockholder matters

MARKET PRICE OF AND DIVIDENDS ON COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Nature of Trading Market

At February 13, 2004, the Company had approximately 725 shareholders of record. The stock is not traded on any exchange or automated quotation system, and there is no firm that makes a market in the stock. Shareholders who typically purchase stock for investment have held the stock. Therefore, there is no active trading market for the stock and no assurance can be given that an active trading market for the stock will develop. During 2003, there were 39 transfers known to the Company. These transfers involved a total of 9,872 shares. Sales prices have been from \$25 to \$32 per share during 2003 to the Company's best knowledge. The last trade occurred on December 4, 2003, and was for 100 shares of Common Stock at a price of \$32 per share. This price is not necessarily indicative of the fair market value of the stock, nor is the Company necessarily aware of all transfers or the price of those transfers.

On November 21, 2002, the Company adopted a plan to repurchase up to \$1,000,000 of its shares. As of December 31, 2002, the Company had repurchased 17,664 shares under this plan at an aggregate price of \$441,000 (an average price of \$25 per share).

On October 17, 2001, the Company adopted a plan to repurchase up to \$1,000,000 of its shares. As of December 31, 2001, the Company had repurchased 20,239 shares under this plan at an aggregate price of \$506,000 (an average price of \$25 per share).

Dividend History

The Company (Puyallup Valley Bank prior to July 1, 1998) has paid, since Puyallup Valley Bank's inception in 1973, a combination of stock and cash dividends to its shareholders. Since 1993, Puyallup Valley Bank has paid a stock dividend of 5 percent per year and a cash dividend of 50¢ per share per year. Since July 1, 1998, the Company paid a cash dividend of 38¢ during 1998, a 12¢ dividend during 1999, a 50¢ dividend during 2000, a 55¢ dividend during 2001, a 60¢ dividend during 2002, and a 60¢ dividend and a 5 percent stock dividend during 2003. On January 21, 2004, the Board of Directors of the Company declared a cash dividend of 60¢ per share and a 5 percent stock dividend, which was paid during February 2004 to those shareholders of record on December 31, 2003.

Although the Company intends to continue its policy of paying cash dividends on its Common Stock in amounts not less than those paid in recent periods, the ability of the Company to continue to pay such dividends will depend primarily upon the earnings of Valley Bank and its ability to pay dividends to the Company, as to which there can be no assurance.

The ability of the Bank to pay dividends is governed by various statutes. These statutes provide that no bank shall declare or pay any dividend in an amount greater than its retained earnings, without approval from the Director. The Director shall, in his or her discretion, have the power to require any bank to suspend the payment of any and all dividends until all requirements that may have been made by the Director shall have been complied with, and upon such notice to suspend dividends, no bank shall thereafter declare or pay any dividends until such notice has been rescinded in writing.

ANNUAL MEETING

The Company will hold its annual meeting of stockholders on April 29, 2004, at 7:00 p.m., in the Georgian Room at the Best Western Park Plaza Hotel, in Puyallup, Washington.

COPIES OF FORM 10-K

The Company will send the Valley Community Bancshares Annual Report on Form 10-K (including the financial statements filed with the Securities and Exchange Commission) without charge to any shareholder who asks for a copy in writing. Stockholders also can ask for copies of any exhibits to the Form 10-K. Please send requests to:

Corporate Secretary
Valley Community Bancshares, Inc.
P.O. Box 578, Puyallup, WA 98371

NOTICE OF AVAILABILITY

Financial information about this holding company and its banking subsidiaries is available to our shareholders, customers, and other interested parties upon request.

In accordance with federal regulations to facilitate more informed decision-making by depositors, we will provide an Annual Disclosure Statement containing financial information for the last two years. This information will be updated each year-end and be available by March 31. To obtain a copy of the Annual Disclosure Statement, please write to:

Corporate Secretary
Valley Community Bancshares Inc.
P.O. Box 578, Puyallup, WA 98371



This annual report is furnished to shareholders and customers of the Company pursuant to the requirements of the Federal Deposit Insurance Corporation (FDIC) to provide an annual disclosure statement. This statement has not been reviewed or confirmed for accuracy or relevance by the FDIC.