

COLUMBIA BANKING SYSTEM INC  
Form 10-Q  
August 08, 2006  
Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

\_\_\_\_\_  
**FORM 10-Q**  
\_\_\_\_\_

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended June 30, 2006.

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 0-20288

\_\_\_\_\_  
**COLUMBIA BANKING SYSTEM, INC.**

(Exact name of issuer as specified in its charter)

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

**91-1422237**  
(I.R.S. Employer  
Identification Number)

**1301 A Street**  
**Tacoma, Washington**  
(Address of principal executive offices)

**(253) 305-1900**

**98402-2156**  
(Zip Code)

(Issuer's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

---

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of shares of common stock outstanding at July 31, 2006 was 16,045,173

---

**Table of Contents**

TABLE OF CONTENTS

|  | <b>Page</b> |
|--|-------------|
| <b>PART I FINANCIAL INFORMATION</b>  |             |
| Item 1. Financial Statements (unaudited)   |             |
| <u>Consolidated Condensed Statements of Operations - three months and six months ended June 30, 2006 and 2005</u>                            | 2           |
| <u>Consolidated Condensed Balance Sheets - June 30, 2006 and December 31, 2005</u>   | 3           |
| <u>Consolidated Condensed Statements of Shareholders' Equity - twelve months ended December 31, 2005, and six months ended June 30, 2006</u> | 4           |
| <u>Consolidated Condensed Statements of Cash Flows - six months ended June 30, 2006 and 2005</u>   | 5           |
| <u>Notes to Consolidated Condensed Financial Statements</u>  | 6           |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>   | 13          |
| Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>  | 25          |
| Item 4. <u>Controls and Procedures</u>   | 25          |
| <b>PART II OTHER INFORMATION</b>   |             |
| Item 1. <u>Legal Proceedings</u>   | 26          |
| Item 1A. <u>Risk Factors</u>   | 26          |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 26          |
| Item 3. <u>Defaults Upon Senior Securities</u>   | 26          |
| Item 4. <u>Submission of Matters to a Vote of Security Holders</u>   | 26          |
| Item 5. <u>Other Information</u>   | 27          |
| Item 6. <u>Exhibits</u>  | 27          |
| <u>Signatures</u>  | 28          |

**Table of Contents****CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS***Columbia Banking System, Inc.**(Unaudited)*

| <i>(in thousands except per share)</i>                               | <b>Three Months Ended<br/>June 30,</b> |               | <b>Six Months Ended<br/>June 30,</b> |               |
|--|--|---------------|--------------------------------------|---------------|
|  | <b>2006</b>                            | <b>2005</b>   | <b>2006</b>                          | <b>2005</b>   |
| <b>Interest Income</b>   |  |               |                                      |               |
| Loans  | \$ 30,328                              | \$ 24,313     | \$ 58,972                            | \$ 46,135     |
| Taxable securities   | 5,208                                  | 4,492         | 10,166                               | 9,148         |
| Tax-exempt securities  | 1,753                                  | 1,109         | 3,180                                | 2,192         |
| Deposits with banks  | 103                                    | 15            | 132                                  | 24            |
| Federal funds sold   | 18                                     |               | 29                                   |               |
| <b>Total interest income</b>   | <b>37,410</b>                          | <b>29,929</b> | <b>72,479</b>                        | <b>57,499</b> |
| <b>Interest Expense</b>  |  |               |                                      |               |
| Deposits   | 9,408                                  | 5,820         | 17,899                               | 11,002        |
| Federal Home Loan Bank advances                                      | 3,206                                  | 1,345         | 4,974                                | 2,051         |
| Long-term obligations  | 492                                    | 381           | 951                                  | 728           |
| Other borrowings   | 2                                      | 37            | 47                                   | 71            |
| <b>Total interest expense</b>  | <b>13,108</b>                          | <b>7,583</b>  | <b>23,871</b>                        | <b>13,852</b> |
| <b>Net Interest Income</b>   | <b>24,302</b>                          | <b>22,346</b> | <b>48,608</b>                        | <b>43,647</b> |
| Provision for loan and lease losses                                  | 250                                    | 370           | 465                                  | 1,260         |
| <b>Net interest income after provision for loan and lease losses</b> | <b>24,052</b>                          | <b>21,976</b> | <b>48,143</b>                        | <b>42,387</b> |
| <b>Noninterest Income</b>  |  |               |                                      |               |
| Service charges and other fees                                       | 2,907                                  | 2,797         | 5,741                                | 5,433         |
| Mortgage banking   | 109                                    | 336           | 256                                  | 758           |
| Merchant services fees   | 2,174                                  | 2,248         | 4,212                                | 4,037         |
| Net gain on sale of securities available for sale                    |  |               | 10                                   |               |
| Bank owned life insurance ( BOLI )                                   | 434                                    | 354           | 833                                  | 727           |
| Other  | 643                                    | 393           | 1,188                                | 847           |
| <b>Total noninterest income</b>                                      | <b>6,267</b>                           | <b>6,128</b>  | <b>12,240</b>                        | <b>11,802</b> |
| <b>Noninterest Expense</b>   |  |               |                                      |               |
| Compensation and employee benefits                                   | 9,426                                  | 9,438         | 19,095                               | 18,706        |
| Occupancy  | 2,685                                  | 2,577         | 5,333                                | 4,909         |
| Merchant processing  | 887                                    | 841           | 1,671                                | 1,548         |
| Advertising and promotion  | 854                                    | 535           | 1,506                                | 1,039         |
| Data processing  | 520                                    | 729           | 1,320                                | 1,436         |
| Legal and professional services                                      | 737                                    | 934           | 967                                  | 1,698         |
| Taxes, licenses and fees   | 640                                    | 486           | 1,236                                | 951           |
| Gain on sale of other real estate owned                              | (11)                                   | (7)           | (11)                                 | (9)           |
| Interest rate floor valuation adjustment                             | 1,775                                  |               | 1,775                                |               |
| Other  | 3,623                                  | 2,981         | 6,584                                | 5,513         |
| <b>Total noninterest expense</b>                                     | <b>21,136</b>                          | <b>18,514</b> | <b>39,476</b>                        | <b>35,791</b> |
| <b>Income before income taxes</b>                                    | <b>9,183</b>                           | <b>9,590</b>  | <b>20,907</b>                        | <b>18,398</b> |
| Provision for income taxes   | 1,944                                  | 2,792         | 5,480                                | 5,302         |

Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

|  |          |          |           |           |
|--|----------|----------|-----------|-----------|
| <b>Net Income</b>  | \$ 7,239 | \$ 6,798 | \$ 15,427 | \$ 13,096 |
| Net income per common share:   |          |          |           |           |
| Basic  | \$ .45   | \$ 0.44  | \$ .97    | \$ 0.84   |
| Diluted  | .45      | 0.43     | .96       | 0.83      |
| Dividends paid per common share  | \$ .14   | \$ 0.09  | \$ .27    | \$ 0.16   |
| Average number of common shares outstanding                            | 15,937   | 15,664   | 15,907    | 15,635    |
| Average number of diluted common shares outstanding                    | 16,115   | 15,898   | 16,095    | 15,862    |
| See accompanying notes to consolidated condensed financial statements. |          |          |           |           |

**Table of Contents****CONSOLIDATED CONDENSED BALANCE SHEETS**

Columbia Banking System, Inc.

(Unaudited)

| <i>(in thousands)</i>   | June 30,<br>2006    | December 31,<br>2005 |
|---|---------------------|----------------------|
| <b>ASSETS</b>   |                     |                      |
| Cash and due from banks   | \$ 107,010          | \$ 96,787            |
| Interest-earning deposits with banks  | 28,328              | 3,619                |
| Total cash and cash equivalents   | 135,338             | 100,406              |
| Securities available for sale at fair value (amortized cost of \$654,047 and \$576,919, respectively) | 637,977             | 572,355              |
| Securities held to maturity at cost (fair value of \$2,577 and \$2,587, respectively)                 | 2,525               | 2,524                |
| Federal Home Loan Bank stock at cost  | 10,453              | 10,453               |
| Loans held for sale   | 1,288               | 1,850                |
| Loans, net of deferred loan fees of (\$2,282) and (\$2,870), respectively                             | 1,625,255           | 1,564,704            |
| Less: allowance for loan and lease losses   | 20,990              | 20,829               |
| Loans, net  | 1,604,265           | 1,543,875            |
| Interest receivable   | 11,541              | 11,671               |
| Premises and equipment, net   | 44,837              | 44,690               |
| Real estate owned   |                     | 18                   |
| Goodwill  | 29,723              | 29,723               |
| Other   | 66,651              | 59,757               |
| <b>Total Assets</b>   | <b>\$ 2,544,598</b> | <b>\$ 2,377,322</b>  |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                     |                      |
| Deposits:   |                     |                      |
| Noninterest-bearing   | \$ 446,568          | \$ 455,838           |
| Interest-bearing  | 1,516,180           | 1,549,651            |
| Total deposits  | 1,962,748           | 2,005,489            |
| Federal Home Loan Bank advances   | 303,000             | 94,400               |
| Other borrowings  | 227                 | 2,572                |
| Long-term subordinated debt   | 22,345              | 22,312               |
| Other liabilities   | 24,037              | 26,307               |
| Total liabilities   | 2,312,357           | 2,151,080            |
| Commitments and contingent liabilities  |                     |                      |
| Shareholders' equity:   |                     |                      |
| Preferred stock (no par value) Authorized, 2 million shares; none outstanding                         |                     |                      |
|   | <b>June 30,</b>     | <b>December 31,</b>  |
|   | <b>2006</b>         | <b>2005</b>          |
| Common stock (no par value)   |                     |                      |
| Authorized shares   | 63,034              | 63,034               |
| Issued and outstanding  | 16,024              | 15,831               |
| Retained earnings   | 77,175              | 66,051               |
|   | (10,398)            | (2,782)              |

Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

|  |  |              |              |
|--|--|--------------|--------------|
| Accumulated other comprehensive loss       | Unrealized losses on securities available for sale, net of tax |              |              |
| Total shareholders' equity                 |  | 232,241      | 226,242      |
| Total Liabilities and Shareholders' Equity |  | \$ 2,544,598 | \$ 2,377,322 |

See accompanying notes to consolidated condensed financial statements.

**Table of Contents****CONSOLIDATED CONDENSED STATEMENTS OF SHAREHOLDERS EQUITY***Columbia Banking System, Inc.**(Unaudited)*

|   | Common stock        |            | Accumulated                                |             | Total<br>Shareholders<br>Equity |
|---|---------------------|------------|--|-------------|---------------------------------|
|   |                     |            | Other                                      |             |                                 |
|   | Number of<br>Shares | Amount     | Comprehensive<br>Income (Loss)             |             |                                 |
|   |                     |            | Deferred<br>Compensation<br>(in thousands) |             |                                 |
| <b>Balance at January 1, 2005</b>   | 15,594              | \$ 159,693 | \$ 42,552                                  | \$ 909      | \$ 203,154                      |
| Comprehensive income:   |                     |            |  |             |                                 |
| Net income  |                     |            | 29,631                                     |             | 29,631                          |
| Reclassification of net gains on securities available<br>for sale included in net income, net of tax of \$2 |                     |            |  | (4)         | (4)                             |
| Unrealized losses on securities available for sale,<br>net of tax of \$1,949                                |                     |            |  | (3,687)     | (3,687)                         |
| Total comprehensive income  |                     |            |  |             | 25,940                          |
| Issuance of stock under equity compensation plan  | 221                 | 2,208      |  |             | 2,208                           |
| Issuance of restricted stock under equity<br>compensation plan  | 16                  | 389        |  | (389)       |                                 |
| Amortization of deferred compensation restricted<br>stock   |                     |            |  | 297         | 297                             |
| Tax benefit associated with exercise of stock<br>options  |                     | 775        |  |             | 775                             |
| Cash dividends paid on common stock   |                     |            | (6,132)                                    |             | (6,132)                         |
| <b>Balance at December 31, 2005</b>   | 15,831              | 163,065    | 66,051                                     | (2,782)     | 226,242                         |
| Comprehensive income:   |                     |            |  |             |                                 |
| Net income  |                     |            | 15,427                                     |             | 15,427                          |
| Reclassification of net gains on securities available<br>for sale included in net income, net of tax of \$4 |                     |            |  | (6)         | (6)                             |
| Unrealized losses on securities available for sale,<br>net of tax of \$4,191                                |                     |            |  | (7,610)     | (7,610)                         |
| Total comprehensive income  |                     |            |  |             | 7,811                           |
| Transition adjustment related to adoption of SFAS<br>123(R)   |                     | (92)       |  | 92          |                                 |
| Issuance of stock under equity compensation plan  | 122                 | 1,433      |  |             | 1,433                           |
| Equity compensation awards  | 71                  | 328        |  |             | 328                             |
| Tax benefit associated with exercise of stock<br>options  |                     | 730        |  |             | 730                             |
| Cash dividends paid on common stock   |                     |            | (4,303)                                    |             | (4,303)                         |
| <b>Balance at June 30, 2006</b>   | 16,024              | \$ 165,464 | \$ 77,175                                  | \$ (10,398) | \$ 232,241                      |

See accompanying notes to consolidated condensed financial statements.





**Table of Contents****CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS***Columbia Banking System, Inc.**(Unaudited)*

| <i>(in thousands)</i>   | Six Months Ended |                  |
|---|------------------|------------------|
|   | 2006             | June 30,<br>2005 |
| <b>Operating Activities</b>   |                  |                  |
| Net income  | \$ 15,427        | \$ 13,096        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                  |
| Provision for loan losses   | 465              | 1,260            |
| Deferred income tax benefit   | (4,323)          | (144)            |
| Stock based compensation expense  | 328              |                  |
| Tax benefit associated with stock compensation plan                               | 730              | (199)            |
| Gains on sale of real estate owned and other personal property owned              | (11)             | (9)              |
| Depreciation and amortization   | 3,121            | 4,917            |
| Net realized gain on sale of assets   | (292)            | (215)            |
| (Increase)decrease in loans held for sale   | 562              | (8,381)          |
| (Increase) decrease in interest receivable  | 130              | (825)            |
| Increase in interest payable  | 798              | 579              |
| Stock dividends from Federal Home Loan Bank stock                                 |                  | (44)             |
| Interest rate floor valuation adjustment  | 1,775            |                  |
| Net changes in other assets and liabilities                                       | (3,091)          | (1,482)          |
| <b>Net cash provided by operating activities</b>                                  | <b>15,619</b>    | <b>8,553</b>     |
| <b>Investing Activities</b>   |                  |                  |
| Proceeds from maturities of securities available for sale                         | 38,770           | 3,375            |
| Purchases of securities available for sale  | (63,008)         | (5,908)          |
| Proceeds from sales of securities available for sale                              | 3,865            | 1,618            |
| Proceeds from maturities of mortgage-backed securities available for sale         |                  | 29,677           |
| Purchases of mortgage-backed securities available for sale                        | (73,069)         |                  |
| Proceeds from maturities of securities held to maturity                           | 14,483           |                  |
| Purchases of Federal Home Loan Bank stock   |                  | (2,565)          |
| Proceeds from sales of Federal Home Loan Bank stock                               |                  | 2,917            |
| Loans originated and acquired, net of principal collected                         | (59,885)         | (150,154)        |
| Purchases of premises and equipment   | (2,401)          | (2,385)          |
| Proceeds from disposal of premises and equipment                                  | 88               | 1,009            |
| Proceeds from sales of real estate and other personal property owned              | 29               | 689              |
| <b>Net cash used in investing activities</b>                                      | <b>(141,128)</b> | <b>(121,727)</b> |
| <b>Financing Activities</b>   |                  |                  |
| Net increase (decrease) in deposits   | (42,741)         | 34,997           |
| Repayment of other borrowings   | (2,500)          |                  |
| Proceeds from Federal Home Loan Bank advances                                     | 1,369,220        | 593,850          |
| Repayment of Federal Home Loan Bank advances                                      | (1,160,620)      | (491,550)        |
| Cash dividends paid on common stock   | (4,303)          | (2,502)          |
| Proceeds from other borrowings  |                  | 349              |
| Proceeds from issuance of common stock, net                                       | 1,433            | 1,493            |
| Other, net  | (48)             | (44)             |
| <b>Net cash provided by financing activities</b>                                  | <b>160,441</b>   | <b>136,593</b>   |
| <b>Increase in cash and cash equivalents</b>                                      | <b>34,932</b>    | <b>23,419</b>    |

Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

|   |            |           |
|---|------------|-----------|
| Cash and cash equivalents at beginning of period                        | 100,406    | 54,656    |
| Cash and cash equivalents at end of period                              | \$ 135,338 | \$ 78,075 |
| Supplemental disclosures of cash flow information:                      |            |           |
| Cash paid for interest  | \$ 23,073  | \$ 13,228 |
| Cash paid for income taxes  | 8,660      | 4,764     |
| Supplemental disclosures of noncash investing and financing activities: |            |           |
| Purchase of equipment under capital lease                               | \$         | \$ 80     |
| See accompanying notes to consolidated condensed financial statements.  |            |           |

---

**Table of Contents**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

*Columbia Banking System, Inc.*

***1. Basis of Presentation***

The interim unaudited consolidated condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for condensed interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain financial information and footnotes have been omitted or condensed. The consolidated condensed financial statements include the accounts of the Company, and its wholly owned banking subsidiaries Columbia Bank and Bank of Astoria ( Astoria ). All significant intercompany transactions and accounts have been eliminated in consolidation. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair statement of the results for the interim periods presented have been included. The results of operations for the six months ended June 30, 2006 are not necessarily indicative of results to be anticipated for the year ending December 31, 2006. The accompanying interim unaudited consolidated condensed financial statements should be read in conjunction with the financial statements and related notes contained in the Company s 2005 Annual Report on Form 10-K.

***2. Summary of Significant Accounting Policies***

The significant accounting policies used in preparation of our consolidated financial statements are disclosed in our 2005 Annual Report on Form 10-K. January 1, 2006, the Company started recognizing compensation expense for stock options and other share-based payments with the adoption of Statement of Financial Accounting Standards ( SFAS ) No. 123(R), Share-Based Payment, ( SFAS 123(R) ), as described in note 3 below. There have not been any other material changes in our critical accounting policies compared to those contained in our 2005 10-K disclosure for the year ended December 31, 2005.

***3. Stock Based Compensation Plans***

Effective January 1, 2006, the Company adopted SFAS 123(R) using the modified prospective method, which establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, over the requisite service period. Previously, the Company applied Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees ( APB 25 ) and related interpretations, as permitted by SFAS No. 123, Accounting for Stock Based Compensation.

*Determining Fair Value under SFAS 123(R)*

Valuation and Amortization Method. The Company estimates the fair value of stock-based awards granted using the Black-Scholes option valuation model. The fair value of all awards is amortized on a straight-line basis over the requisite service periods, which are generally the vesting periods.

Expected Life. The expected life of awards granted represents the period of time that they are expected to be outstanding. The expected life is determined based on historical experience with similar awards, giving consideration to the contractual terms and vesting schedules.

Expected Volatility. Volatility of our common stock is estimated at the date of grant based on the historical volatility of the stock. The volatility factor used in the Black-Scholes option valuation model is based on historical stock prices over the most recent period commensurate with the estimated expected life of the award.

Risk-Free Interest Rate. The risk-free interest rate used in the Black-Scholes option valuation model is based on the U.S. Treasury curve in effect at the time of the award.

Expected Dividend Yield. The expected dividend is based on dividend trends and the market value of the Company s stock price at the time of the award.

Expected Forfeitures. Historical data is used to estimate pre-vesting forfeitures. Stock-based compensation expense is recorded for those awards that are expected to vest.



**Table of Contents**

|                                    | <b>For The Three and Six<br/>Months Ended</b> |
|------------------------------------|---|
| <i>(Black-Scholes Assumptions)</i> | <b>6/30/2005</b>                              |
| Expected Life (in years)           | 5.10  |
| Expected Volatility                | 36.99%  |
| Risk-free Interest Rate            | 4.00%   |
| Expected Dividend Yield            | 1.55%   |
| Weighted Average Fair Value        | \$ 8.99                                       |

*Stock-based Compensation Under SFAS 123(R)*

Total stock-based compensation expense recognized in the consolidated statement of operations for the three and six months ended June 30, 2006 was \$133,000 and \$328,000, respectively, before income taxes. Total stock-based compensation for the three months ended June 30, 2006 consisted of stock option and restricted stock expense of \$20,000 and \$113,000, respectively. For the six months ended June 30, 2006, total stock-based compensation expense consisted of stock option and restricted stock expense of \$113,000 and \$215,000 respectively. The related estimated tax benefit was \$47,000 and \$115,000 for the three and six months ended June 30, 2006.

At June 30, 2006 there were 154,425 non-vested stock options and awards that had a weighted average grant date fair value of \$19.00. As of June 30, 2006, we had \$2.1 million of total unrecognized compensation cost related to non-vested stock-based awards granted under our equity compensation plan. Total unrecognized compensation cost will be adjusted for any future changes in estimated forfeitures and new awards. The Company expects to recognize this cost ratably over a period of 4.50 years.

The following table shows the effect on the second quarter 2005 net earnings and earnings per share had compensation cost been recognized based upon the estimated fair value on the grant date of stock options and restricted stock, in accordance with SFAS 123, as amended by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure (in thousands, except earnings per share):

|  | <b>For The<br/>Three<br/>Months Ended</b> | <b>For The Six<br/>Months Ended</b> |
|--|---|-------------------------------------|
|  | <b>6/30/2005</b>                          | <b>6/30/2005</b>                    |
| Net income attributable to common stock:   |   |                                     |
| As reported  | \$ 6,798                                  | \$ 13,096                           |
| Add: Total stock-based compensation expense included in reported net income, net of tax effect               | 103                                       | 103                                 |
| Deduct: Total stock based compensation expense determined under fair value method for all awards, net of tax | (173)                                     | (680)                               |
| <b>Pro forma net income</b>  | <b>\$ 6,728</b>                           | <b>\$ 12,519</b>                    |
| Net income per common share:   |   |                                     |
| Basic:   |   |                                     |
| As reported  | \$ 0.44                                   | \$ 0.84                             |
| Pro forma  | 0.43                                      | 0.80                                |
| Diluted:   |   |                                     |
| As reported  | \$ 0.43                                   | \$ 0.83                             |
| Pro forma  | 0.42                                      | 0.79                                |

Disclosures for the period ended June 30, 2006 are not presented because the amounts are recognized in the consolidated condensed financial statements.

*Stock Activity Under Plan*

## Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

At June 30, 2006, the Company had one equity compensation plan that provides for the granting of stock options and restricted stock awards to eligible employees and directors. Additional information regarding this plan is disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005. At June 30, 2006, a maximum of 2,191,482 shares were authorized under the plan, of which a net 1,810,233 were granted, 1,361,234 have been exercised, and 381,249 were available for future grants.

**Table of Contents**

Options and awards granted, exercised, canceled and expired under our equity compensation plan are summarized as follows:

|                                    | Stock Option<br>Activity | Restricted Share<br>Activity | Weighted-Average<br>Exercise Price |
|------------------------------------|--------------------------|------------------------------|------------------------------------|
| Balance at January 1, 2006         | 474,360                  | 12,000                       | \$ 15.08                           |
| Granted                            |                          | 75,775                       |                                    |
| Forfeited                          | (2,000)                  | (4,850)                      | 6.80                               |
| Exercised                          | (106,286)                |                              | 13.46                              |
| <b>Balance at June 30, 2006</b>    | <b>366,074</b>           | <b>82,925</b>                | <b>\$ 13.04</b>                    |
| Total Exercisable at June 30, 2006 | 282,574                  | 12,000                       | \$ 13.44                           |

**4. Earnings Per Share**

The following table sets forth the computation of basic and diluted earnings per share for the three and six month periods ended June 30, 2006 and 2005 (in thousands, except for per share data):

|  | For The<br>Three<br>Months Ended<br>6/30/2006 | For The<br>Three<br>Months Ended<br>6/30/2005 | For The Six<br>Months Ended<br>6/30/2006 | For The Six<br>Months Ended<br>6/30/2005 |
|--|---|---|--|--|
| Net income   | \$ 7,239                                      | \$ 6,798                                      | \$ 15,427                                | \$ 13,096                                |
| Weighted average common shares outstanding (for basic calculation)                               | 15,937  | 15,664  | 15,907                                   | 15,635                                   |
| Dilutive effect of outstanding common stock options  | 178   | 234   | 188                                      | 227                                      |
| Weighted average common stock and common equivalent shares outstanding (for diluted calculation) | 16,115  | 15,898  | 16,095                                   | 15,862                                   |
| Earnings per common share basic  | \$ 0.45                                       | \$ 0.44                                       | \$ 0.97                                  | \$ 0.84                                  |
| Earnings per common share diluted  | \$ 0.45                                       | \$ 0.43                                       | \$ 0.96                                  | \$ 0.83                                  |

Potential dilutive shares consist of the incremental common shares issuable upon the exercise of outstanding stock options using the treasury stock method. Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three- and six-month periods ended June 30, 2006, there were no anti-dilutive shares outstanding related to options to acquire common stock. For the three- and six-month periods ended June 30, 2005, anti-dilutive shares outstanding related to options to acquire common stock totaled 41,500 and 45,000, respectively.

**5. Dividends**

On January 26, 2006, the Company declared a quarterly cash dividend of \$0.13 per share, payable on February 22, 2006 to shareholders of record as of the close of business on February 8, 2006. On April 26, 2006, the Company declared a quarterly cash dividend of \$0.14 per share, payable on May 24, 2006, to shareholders of record at the close of business May 10, 2006. Subsequent to quarter end, on July 27, 2006, the Company declared a quarterly cash dividend of \$0.15 per share, payable on August 23, 2006, to shareholders of record at the close of business August 9, 2006. The payment of cash dividends is subject to Federal regulatory requirements for capital levels and other restrictions. In addition,



the cash dividends paid by Columbia Bank and Bank of Astoria to the Company are subject to both Federal and State regulatory requirements.

**Table of Contents**

**6. Business Segment Information**

Within Washington State, the Company is managed along three major lines of business: commercial banking, retail banking, and real estate lending. In Oregon, the Company operates as one segment through the Astoria banking subsidiary. The treasury function of the Company, included in the Other category, although not considered a line of business, is responsible for the management of investments and interest rate risk.

The Company generates segment results that include balances directly attributable to business line activities. The financial results of each segment are derived from the Company's general ledger system. Overhead, including sales and back office support functions, and other indirect expenses are not allocated to the major lines of business. Since the Company is not specifically organized around lines of business, most reportable segments comprise more than one operating activity.

The principal activities conducted by commercial banking are the origination of commercial business loans and private banking services. Retail banking includes all deposit products, with their related fee income, and all consumer loan products as well as commercial loan products offered in the Company's branch offices. Real estate lending offers single-family residential, multi-family residential, and commercial real estate loans.

The organizational structure of the Company and its business line financial results are not necessarily comparable with information from other financial institutions.

Financial highlights by lines of business are as follows:

**Condensed Statements of Operations:**

|   | Three Months Ended June 30, 2006 |                       |                    |                   |            |              |       |
|---|----------------------------------|-----------------------|--------------------|-------------------|------------|--------------|-------|
|   | Oregon                           |                       | Washington<br>Real |                   |            |              | Total |
|   | Astoria                          | Commercial<br>Banking | Retail<br>Banking  | Estate<br>Lending | Other      |              |       |
| <i>(in thousands)</i>                             |                                  |                       |                    |                   |            |              |       |
| Net interest income after provision for loan loss | \$ 2,073                         | \$ 4,745              | \$ 17,710          | \$ 921            | \$ (1,397) | \$ 24,052    |       |
| Other income                                      | 404                              | 358                   | 1,552              | 92                | 3,861      | 6,267        |       |
| Other expense                                     | (1,495)                          | (1,807)               | (4,468)            | (471)             | (12,895)   | (21,136)     |       |
| Contribution to overhead and profit               | 982                              | 3,296                 | 14,794             | 542               | (10,431)   | 9,183        |       |
| Income taxes                                      |                                  |                       |                    |                   |            | (1,944)      |       |
| Net income  |                                  |                       |                    |                   |            | \$ 7,239     |       |
| Total assets                                      | \$ 213,993                       | \$ 894,082            | \$ 453,398         | \$ 227,627        | \$ 755,498 | \$ 2,544,598 |       |

|   | Three Months Ended June 30, 2005 |                       |                    |                   |          |           |       |
|---|----------------------------------|-----------------------|--------------------|-------------------|----------|-----------|-------|
|   | Oregon                           |                       | Washington<br>Real |                   |          |           | Total |
|   | Astoria                          | Commercial<br>Banking | Retail<br>Banking  | Estate<br>Lending | Other    |           |       |
| <i>(in thousands)</i>                             |                                  |                       |                    |                   |          |           |       |
| Net interest income after provision for loan loss | \$ 2,055                         | \$ 5,090              | \$ 12,974          | \$ 1,783          | \$ 74    | \$ 21,976 |       |
| Other income                                      | 250                              | 260                   | 1,569              | 291               | 3,758    | 6,128     |       |
| Other expense                                     | (1,468)                          | (1,774)               | (4,587)            | (544)             | (10,141) | (18,514)  |       |

Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

|                                     |            |            |            |            |            |              |
|-------------------------------------|------------|------------|------------|------------|------------|--------------|
| Contribution to overhead and profit | 837        | 3,576      | 9,956      | 1,530      | (6,309)    | 9,590        |
| Income taxes                        |            |            |            |            |            | (2,792)      |
| Net income                          |            |            |            |            |            | \$ 6,798     |
| Total assets                        | \$ 209,310 | \$ 734,034 | \$ 469,992 | \$ 276,480 | \$ 636,436 | \$ 2,326,252 |

**Table of Contents**

|   | Six Months Ended June 30, 2006 |            |                    |            |            |              |
|---|--------------------------------|------------|--------------------|------------|------------|--------------|
|   | Oregon                         |            | Washington<br>Real |            |            |              |
|   |                                | Commercial | Retail             | Estate     |            |              |
| (in thousands)                                    | Astoria                        | Banking    | Banking            | Lending    | Other      | Total        |
| Net interest income after provision for loan loss | \$ 4,141                       | \$ 9,468   | \$ 34,990          | \$ 1,937   | \$ (2,393) | \$ 48,143    |
| Other income                                      | 776                            | 717        | 3,092              | 216        | 7,439      | 12,240       |
| Other expense                                     | (2,888)                        | (3,975)    | (8,955)            | (880)      | (22,778)   | (39,476)     |
| Contribution to overhead and profit               | 2,029                          | 6,210      | 29,127             | 1,273      | (17,732)   | 20,907       |
| Income taxes                                      |                                |            |                    |            |            | (5,480)      |
| Net income  |                                |            |                    |            |            | \$ 15,427    |
| Total assets                                      | \$ 213,993                     | \$ 894,082 | \$ 453,398         | \$ 227,627 | \$ 755,498 | \$ 2,544,598 |

|   | Six Months Ended June 30, 2005 |            |                    |            |            |              |
|---|--------------------------------|------------|--------------------|------------|------------|--------------|
|   | Oregon                         |            | Washington<br>Real |            |            |              |
|   |                                | Commercial | Retail             | Estate     |            |              |
| (in thousands)                                    | Astoria                        | Banking    | Banking            | Lending    | Other      | Total        |
| Net interest income after provision for loan loss | \$ 3,987                       | \$ 9,993   | \$ 24,424          | \$ 3,689   | \$ 294     | \$ 42,387    |
| Other income                                      | 507                            | 521        | 3,085              | 686        | 7,003      | 11,802       |
| Other expense                                     | (2,804)                        | (4,013)    | (8,962)            | (962)      | (19,050)   | (35,791)     |
| Contribution to overhead and profit               | 1,690                          | 6,501      | 18,547             | 3,413      | (11,753)   | 18,398       |
| Income taxes                                      |                                |            |                    |            |            | (5,302)      |
| Net income  |                                |            |                    |            |            | \$ 13,096    |
| Total assets                                      | \$ 209,310                     | \$ 734,034 | \$ 469,992         | \$ 276,480 | \$ 636,436 | \$ 2,326,252 |

**7. Securities**

The following table presents the composition and carrying value of the Company's available for sale investment portfolio:

|   | June 30,       |                      |
|---|----------------|----------------------|
|   | 2006           | December 31,<br>2005 |
|   | (in thousands) |                      |
| <b>Securities Available for Sale</b>  |                |                      |
| U.S. Government agency  | \$ 115,374     | \$ 154,860           |
| U.S. Government agency mortgage-backed securities and collateralized mortgage obligations | 338,634        | 288,790              |
| State and municipal securities  | 182,243        | 126,951              |
| Other securities  | 1,726          | 1,754                |
| Total   | \$ 637,977     | \$ 572,355           |

Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

Unrealized losses and fair values of securities available for sale, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of June 30, 2006 are summarized as follows:

| <i>(in thousands)</i>   | Less than 12 Months |            | 12 Months or More |             | Total      |             |
|---|---------------------|------------|-------------------|-------------|------------|-------------|
|   | Fair                | Unrealized | Fair              | Unrealized  | Fair       | Unrealized  |
|   | Value               | Losses     | Value             | Losses      | Value      | Losses      |
| U.S. Government agency  | \$                  | \$         | \$ 115,373        | \$ (2,833)  | \$ 115,373 | \$ (2,833)  |
| U.S. Government agency mortgage-backed securities and collateralized mortgage obligations | 92,628              | (4,062)    | 227,048           | (9,500)     | 319,676    | (13,562)    |
| State and municipal securities  | 99,273              | (1,939)    | 12,197            | (426)       | 111,470    | (2,365)     |
| Total   | \$ 191,901          | \$ (6,001) | \$ 354,618        | \$ (12,759) | \$ 546,519 | \$ (18,760) |

**Table of Contents**

At June 30, 2006, there were 24 U.S. Government agency securities in an unrealized loss position, all of which were in a continuous loss position for 12 months or more. The unrealized losses on U.S. Government agency securities were caused by interest rate increases subsequent to the purchase of the individual securities. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than par. Because the Company has the ability and intent to hold these investments until a recovery of market value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2006.

At June 30, 2006, there were 151 state and municipal government securities in an unrealized loss position, of which 33 were in a continuous loss position for 12 months or more. The unrealized losses on state and municipal securities were caused by interest rate increases subsequent to the purchase of the individual securities. Management monitors published credit ratings of these securities for adverse changes. As of June 30, 2006 none of the obligations of state and local government entities held by the Company had an adverse credit rating. Because the decline in fair value is attributable to changes in interest rates rather than credit quality, and because the Company has the ability and intent to hold these investments until a recovery of market value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2006.

At June 30, 2006, there were 82 U.S. Government agency mortgage-backed securities & collateralized mortgage obligations securities in an unrealized loss position, of which 59 were in a continuous loss position for 12 months or more. The unrealized losses on U.S. Government agency mortgage-backed securities & collateralized mortgage obligations were caused by interest rate increases subsequent to the purchase of the securities. It is expected that the securities would not be settled at a price less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates rather than credit quality, and because the Company has the ability and intent to hold these investments until a recovery of market value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2006.

**8. Comprehensive Income**

The components of comprehensive income are as follows:

| <i>(in thousands)</i>  | <b>Three Months Ended<br/>June 30,</b> |                  |
|--|--|------------------|
|  | <b>2006</b>                            | <b>2005</b>      |
| Net income as reported   | \$ 7,239                               | \$ 6,798         |
| Unrealized gains (losses) on securities available for sale:                          |  |                  |
| Unrealized holding gains (losses) arising during the period                          | (7,722)                                | 5,661            |
| Tax (expense) benefit  | 2,726                                  | (1,963)          |
| <b>Net unrealized gains (losses) on securities available for sale, net of tax</b>    | <b>(4,996)</b>                         | <b>3,698</b>     |
| <b>Total comprehensive income</b>  | <b>\$ 2,243</b>                        | <b>\$ 10,496</b> |
|  |  |                  |
| <i>(in thousands)</i>  | <b>Six Months Ended<br/>June 30,</b>   |                  |
|  | <b>2006</b>                            | <b>2005</b>      |
| Net income as reported   | \$ 15,427                              | \$ 13,096        |
| Unrealized gains (losses) on securities available for sale:                          |  |                  |
| Unrealized holding losses arising during the period                                  | (11,801)                               | (697)            |
| Tax benefit  | 4,191                                  | 244              |
| <b>Net unrealized losses on securities available for sale, net of tax</b>            | <b>(7,610)</b>                         | <b>(453)</b>     |
| Less: reclassification adjustment of realized gains on securities available for sale | (10)                                   |                  |
| Tax benefit  | 4                                      |                  |
| <b>Net realized gains on sale of securities available for sale, net of tax</b>       | <b>(6)</b>                             |                  |
| <b>Total comprehensive income</b>  | <b>\$ 7,811</b>                        | <b>\$ 12,643</b> |



**Table of Contents****9. Allowance for Loan and Lease Losses**

The Company maintains an allowance for loan and lease losses to absorb losses inherent in the loan portfolio. The size of the allowance is determined through quarterly assessments of the estimated probable losses in the loan portfolio. The Company's methodology for making such assessments and determining the adequacy of the allowance includes a general valuation allowance consistent with SFAS No. 5, "Accounting for Contingencies" and criticized/classified loss reserves on specific relationships. Specific allowances for identified problem loans are determined in accordance with SFAS No. 114, "Accounting by Creditors for Impairment of a Loan".

On a quarterly basis the Chief Credit Officer of the Company reviews with Executive Management and the Board of Directors the various additional factors that management considers when determining the adequacy of the allowance, including economic and business condition reviews. These factors include existing general economic and business conditions affecting the Company's market place, credit quality trends, including trends in nonperforming loans, collateral values, seasoning of the loan portfolio, bank regulatory examination results, findings of internal credit examiners and the duration of current business cycles. The allowance is increased by provisions charged to operations, and is reduced by loans charged-off, net of recoveries. While management believes it uses the best information available to determine the allowance for loan losses, unforeseen market conditions could result in adjustments to the allowance, and net income could be affected, if circumstances differ from the assumptions used in determining the allowance.

The following table presents activity in the allowance for loan losses for the three and six months ended June 30, 2006 and 2005:

| <i>(in thousands)</i>        | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|------------------------------|--|-------------|--------------------------------------|-------------|
|                              | <b>2006</b>                            | <b>2005</b> | <b>2006</b>                          | <b>2005</b> |
| Beginning balance            | \$ 20,691                              | \$ 20,179   | \$ 20,829                            | \$ 19,881   |
| Provision charged to expense | 250                                    | 370         | 465                                  | 1,260       |
| Loans charged-off            | (140)                                  | (120)       | (581)                                | (1,025)     |
| Recoveries                   | 189                                    | 158         | 277                                  | 471         |
| Ending balance               | \$ 20,990                              | \$ 20,587   | \$ 20,990                            | \$ 20,587   |

Changes in the allowance for unfunded loan commitments and letters of credit are summarized as follows:

| <i>(in thousands)</i>  | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|--|--|-------------|--------------------------------------|-------------|
|  | <b>2006</b>                            | <b>2005</b> | <b>2006</b>                          | <b>2005</b> |
| Beginning balance  | \$ 339                                 | \$ 339      | \$ 339                               | \$ 289      |
| Net changes in the allowance for unfunded loan commitments and letters of credit |  |             |                                      | 50          |
| Ending balance   | \$ 339                                 | \$ 339      | \$ 339                               | \$ 339      |

**10. Goodwill and Intangible Assets**

The Company had \$29.7 million in goodwill at June 30, 2006 and December 31, 2005. At June 30, 2006 and December 31, 2005, the Company had a core deposit intangible ( CDI ) asset of \$3.2 million and \$3.4 million, respectively. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets", goodwill is not amortized but is reviewed for potential impairment during the third quarter on an annual basis, or if events or circumstances indicate a potential impairment, at the reporting unit level. An impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. The CDI is evaluated for impairment if events and circumstances indicate a possible impairment based on undiscounted cash flow projections. The CDI is amortized on an accelerated basis over an estimated life of approximately 10 years. Amortization expense related to the CDI was \$113,000 and \$226,000 for the three and six months ended June 30, 2006, respectively, and \$134,000 and \$268,000 for the three and six months ended June 30, 2005, respectively. Amortization expense related to the CDI is included in other noninterest expense on the consolidated condensed statements of operations.





---

## **Table of Contents**

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

*Columbia Banking System, Inc.*

This discussion should be read in conjunction with the unaudited consolidated condensed financial statements of Columbia Banking System, Inc. (referred to in this report as *we*, *our*, and *the Company*) and notes thereto presented elsewhere in this report and with the December 31, 2005 audited consolidated financial statements and its accompanying notes included in our recent Annual Report on Form 10-K. In the following discussion, unless otherwise noted, references to increases or decreases in average balances in items of income and expense for a particular period and balances at a particular date refer to the comparison with corresponding amounts for the period or date one year earlier.

### **NOTE REGARDING FORWARD LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q may be deemed to include forward looking statements, which management believes to be a benefit to shareholders. These forward looking statements describe management's expectations regarding future events and developments such as future operating results, growth in loans and deposits, continued success of our style of banking and the strength of the local economy. The words *will*, *believe*, *expect*, *should*, and *anticipate* and words of similar construction are intended in part to help identify forward looking statements. Future events are difficult to predict, and the expectations described above are necessarily subject to risk and uncertainty that may cause actual results to differ materially and adversely. In addition to discussions about risks and uncertainties set forth from time to time in our filings with the SEC, factors that may cause actual results to differ materially from those contemplated by such forward looking statements include, among others, the following possibilities: (1) local, national, and international economic conditions are less favorable than expected or have a more direct and pronounced effect on us than expected and adversely affect our ability to continue internal growth at historical rates and maintain the quality of our earning assets; (2) changes in interest rates reduce interest margins more than expected and negatively affect funding sources; (3) projected business increases following strategic expansion or opening or acquiring new branches are lower than expected; (4) costs or difficulties related to the integration of acquisitions are greater than expected; (5) competitive pressure among financial institutions increases significantly; (6) legislation or regulatory requirements or changes adversely affect the businesses in which we are engaged; and (7) our ability to realize the efficiencies we expect to receive from our investments in personnel and infrastructure.

### **CRITICAL ACCOUNTING POLICIES**

Management has identified the accounting policies related to the allowance for loan and lease losses as critical to an understanding of our financial statements. These policies and related estimates are discussed in Item 7. Management Discussion and Analysis of Financial Condition and Results of Operations under the heading Allowance for Loan and Lease Losses and Unfunded Loan Commitments and Letters of Credit in our 2005 Annual Report on Form 10-K. There have not been any material changes in our critical accounting policies relating to the allowance for loan and lease losses as compared to those disclosed in our 2005 Annual Report on Form 10-K.

### **SECOND QUARTER HIGHLIGHTS**

Net income of \$7.2 million, up 6% from 2<sup>nd</sup> quarter 2005.

Diluted earnings per share of \$0.45, up 5% from the prior year.

Total loans were \$1.63 billion, an increase of \$60.5 million, or 4%, from December 31, 2005

Net interest margin improved to 4.47%, up from 4.36% in 2005.

### **RESULTS OF OPERATIONS**

Our results of operations are dependent to a large degree on our net interest income. We also generate noninterest income through service charges and fees, mortgage banking operations, merchant services fees, and bank owned life insurance. Our operating expenses consist primarily of compensation and employee benefits, occupancy, merchant card processing, data processing and legal and professional fees. Like most

## Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

financial institutions, our interest income and cost of funds are affected significantly by general economic conditions, particularly changes in market interest rates, and by government policies and actions of regulatory authorities.

### **Net Interest Income**

Net interest income for the second quarter of 2006 increased 9% to \$24.3 million, from \$22.3 million in the second quarter of 2005.

The Federal Reserve Bank's Target Federal Funds Rate, which has risen 2.00% over the last twelve months, has contributed to the increase in our interest income. In addition to the increase in rates our interest income was enhanced by an increase in both average

## **Table of Contents**

total loans of \$114.3 million and average investment securities of \$32.9 million from June 30, 2005 to June 30, 2006. Total interest income for the second quarter of 2006 was \$37.4 million, an increase of \$7.5 million, or 25%, over the same period in 2005.

Total interest expense for the second quarter of 2006 was \$13.1 million, an increase of \$5.5 million as compared to the same period in 2005. The increase in interest expense is primarily due to rate increases in deposits and an increase in Federal Home Loan Bank ( FHLB ) advances. In a changing rate environment, rates on FHLB advances reset much quicker than traditional deposits. Average deposits increased \$75.4 million or 4% while average FHLB advances increased \$78.8 million, or 46%, during the second quarter of 2006, as compared to the same period in 2005.

### **Net Interest Margin**

Our net interest margin (net interest income divided by average interest-earning assets) increased to 4.47% in the second quarter of 2006 from 4.36% in the second quarter of 2005. Average interest-earning assets and average interest bearing liabilities grew 7% and 8%, respectively, from the same period a year ago. For the first six months of 2006, the yield on average interest-earning assets increased 101 basis points to 6.71% when compared with the same period of 2005. Meanwhile, the average cost of interest-bearing liabilities increased 105 basis points over the same time period.

The increase in our net interest margin for the first six months of 2006, as compared to the same period in 2005, is primarily due to increased loan volume coupled with rising short-term interest rates. Our yield on earning assets has benefited from the rising rate environment, as in excess of 43% of our loans are variable with rates tied to prime or other common indexes. We have experienced decreased volume in core deposits, due in part to the adherence to our pricing discipline. Core deposits declined \$59.8 million for the first six months of 2006. Our net interest margin experienced downward pressure in the second quarter, a trend likely to continue in coming quarters due to the increasingly competitive lending environment created by the reemergence of lending to small and medium sized businesses by the national and super-regional banks coupled with deposits migrating from financial institutions to the equities markets and other investment alternatives. Despite our strong core deposit base we have had to increase our reliance on higher cost and more rate sensitive FHLB advances to fund loan growth exposing us to additional margin pressure. Some of the downward pressure on our net interest margin could be partially relieved by additional increases in interest rates.

### **Purchased Prime Rate Floors**

At June 30, 2006, management estimates that our balance sheet is asset sensitive over a short-term horizon of three months, which means that interest-earning assets mature or reprice more rapidly than interest-bearing liabilities. Therefore, all variables being constant our net interest margin may increase during a rising rate environment and may decrease in a declining rate environment. At the end of the first quarter of 2006 we entered into an agreement to purchase \$200 million in five year prime rate floors for a deferred transaction fee of \$3.1 million in an effort to reduce the potential impact declining rates would have on our earnings. The floors contain a strike price ranging from 7.75% to 7.25%. If the prime rate decreases below the strike price at anytime during the term of our agreement, we will receive a monthly payment for the difference between the strike price and the prime rate. The floors enable a portion of our assets to temporarily take on the attributes of a fixed rate instrument assisting us in our efforts to minimize the impact of declining rates on our earnings. However, in an increasing rate environment in which the prime rate remains above the purchased floor rate, the purchase cost of the floors will result in a negative impact to our earnings. Under a rising rate scenario in which the prime rate never drops below the strike price of the floors during their five year life, we will experience an increase in other expense of \$3.1 million, which is the cost of the transaction fee associated with the floors. We did not designate this transaction as a hedge for accounting purposes. Designating this transaction as a cash flow hedge would not have resulted in a change to the cash flow impact nor would it have impacted our economic strategy for entering into the transaction. Hedge accounting treatment would have altered the timing of the recognition of the transaction fee through expense but not reduced that total expense over the life of the floors. The market value of these floors can vary greatly on a quarter over quarter basis. In the second quarter we recognized the \$1.8 million decrease in market value through noninterest income and expense. Had we utilized hedge accounting a portion of this change in market value would have flown through the balance sheet as a change in accumulated other comprehensive income. Beginning in July we intend to utilize hedge accounting treatment for these floors on a prospective basis. For future quarters, the hedge designation of these floors will eliminate the earnings volatility experienced during the current period.

**Table of Contents****CONSOLIDATED AVERAGE BALANCES NET CHANGES***Columbia Banking System, Inc.*

| <i>(in thousands)</i>                      | Three Months Ended<br>June 30, |              | Increase<br>(Decrease) | Six Months Ended June 30, |              | Increase<br>(Decrease) |
|--|--------------------------------|--------------|------------------------|---------------------------|--------------|------------------------|
|  | 2006                           | 2005         | Amount                 | 2006                      | 2005         | Amount                 |
| <b>ASSETS</b>                              |                                |              |                        |                           |              |                        |
| Loans                                      | \$ 1,613,253                   | \$ 1,498,990 | \$ 114,263             | \$ 1,590,560              | \$ 1,454,303 | \$ 136,257             |
| Securities                                 | 645,343                        | 612,455      | 32,888                 | 632,457                   | 622,377      | 10,080                 |
| Interest earnings deposits with banks      | 9,663                          | 1,939        | 7,724                  | 6,762                     | 1,665        | 5,097                  |
| Total interest-earning assets              | 2,268,259                      | 2,113,384    | 154,875                | 2,229,779                 | 2,078,345    | 151,434                |
| Other earning assets                       | 37,502                         | 35,909       | 1,593                  | 37,308                    | 35,716       | 1,592                  |
| Noninterest-earning assets                 | 174,824                        | 148,004      | 26,820                 | 167,800                   | 145,972      | 21,828                 |
| Total assets                               | \$ 2,480,585                   | \$ 2,297,297 | \$ 183,288             | \$ 2,434,887              | \$ 2,260,033 | \$ 174,854             |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b> |                                |              |                        |                           |              |                        |
| Interest-bearing deposits                  | \$ 1,520,786                   | \$ 1,464,816 | \$ 55,970              | \$ 1,516,002              | \$ 1,465,821 | \$ 50,181              |
| Federal Home Loan Bank advances            | 250,812                        | 172,050      | 78,762                 | 201,486                   | 140,512      | 60,974                 |
| Long-term subordinated debt                | 22,334                         | 22,268       | 66                     | 22,326                    | 22,260       | 66                     |
| Other borrowings                           |                                | 2,500        | (2,500)                | 1,188                     | 2,507        | (1,319)                |
| Other interest bearing liabilities         | 246                            | 328          | (82)                   | 266                       | 347          | (81)                   |
| Total interest-bearing liabilities         | 1,794,178                      | 1,661,962    | 132,216                | 1,741,268                 | 1,631,447    | 109,821                |
| Noninterest-bearing deposits               | 428,822                        | 409,392      | 19,430                 | 436,711                   | 403,615      | 33,096                 |
| Other noninterest-bearing liabilities      | 24,970                         | 16,079       | 8,891                  | 25,056                    | 16,774       | 8,282                  |
| Shareholders equity                        | 232,615                        | 209,864      | 22,751                 | 231,852                   | 208,197      | 23,655                 |
| Total liabilities and shareholders equity  | \$ 2,480,585                   | \$ 2,297,297 | \$ 183,288             | \$ 2,434,887              | \$ 2,260,033 | \$ 174,854             |

**Noninterest Income**

Noninterest income increased \$139,000 or 2% to \$6.27 million for the second quarter of 2006 from \$6.13 million for the second quarter of 2005. The increase in noninterest income is due in part to increased service charges and fees that offset decreases in merchant services and mortgage banking income. Service charges and other fees were \$110,000, or 4%, greater during the second quarter 2006 as compared to the same period in 2005. Merchant services revenue decreased \$74,000 during the second quarter of 2006 as compared to the same period in 2005. This decrease is due, in part, to increased competition in the marketplace and higher interchange fees. Our mortgage banking income decreased \$227,000, or 68% when compared with the second quarter of 2005. The decrease of \$502,000 in mortgage banking income for the first six months of 2006 is due to declining trends in refinance activity and increases in competitive pricing in the secondary market. In addition, during the second quarter of 2006, our mortgage banking department transitioned to a processing system designed to expand product offerings, enhance service levels, and improve efficiencies. In anticipation of this transition, mortgage loan volumes during the quarter were reduced to assist in ensuring quality customer service delivery. We anticipate this origination platform to enable us to take advantage of cyclical volume increases without the overhead burden during down cycles in mortgage banking activity.

During the second quarter of 2006 and 2005 we did not sell any available for sale securities. In accordance with the Company's investment strategy, management monitors market conditions with a view to realizing gains on its available for sale securities portfolio as market conditions allow.

**Noninterest Expense**

## Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

Total noninterest expense increased \$2.6 million, or 14%, for the second quarter of 2006 from \$18.5 million for the second quarter of 2005. This increase is primarily attributable to the prime rate floor market valuation adjustment of \$1.8 million, increased occupancy expenses of \$108,000, and \$300,000 associated with the production expense for new television commercials. We expect to utilize the new television commercials for up to 3 years. The increase in occupancy expenses from the second quarter of 2005 is due to additional branch locations, increased rent, repairs and maintenance, and depreciation expenses. These increases were partially offset by lower legal and professional services fees which decreased \$197,000.

*Share-Based Payments:* During the first quarter of 2006, we began recording the fair value of our share-based compensation in our financial statements in accordance with SFAS 123(R). Previous financial periods were not required to be revised to reflect this

**Table of Contents**

change. Pretax share-based compensation recognized under SFAS 123(R) for the six months ended June 30, 2006 was \$328,000 which reduced both basic and diluted earnings per share by \$0.02. Stock-based compensation recorded during this period related to both stock options and restricted stock awards. We anticipate an additional \$2.1million in pre-tax share-based compensation through 2011 for awards outstanding as of June 30, 2006. Additional impact resulting from adoption of this statement on our financial position and results of operations will be determined by stock-based awards granted in future periods and the assumptions on which the value of those stock-based awards is based. Our tax accounting may also be impacted by actual exercise behavior and the relative market prices at exercise.

The following table presents selected items included in other noninterest expense and the associated change from period to period:

|   | Three months ended |                 | Increase<br>(Decrease) | Six months ended |                 | Increase<br>(Decrease) |
|---|--------------------|-----------------|------------------------|------------------|-----------------|------------------------|
|   | June 30,           |                 | Amount                 | June 30,         |                 | Amount                 |
|   | 2006               | 2005            |                        | 2006             | 2005            |                        |
| Core deposit intangible amortization    | \$ 113             | \$ 134          | \$ (21)                | \$ 226           | \$ 268          | \$ (42)                |
| Software support & maintenance          | 192                | 135             | 57                     | 351              | 261             | 90                     |
| Telephone & network communications      | 275                | 261             | 14                     | 575              | 546             | 29                     |
| Federal Reserve Bank processing fees    | 229                | 152             | 77                     | 432              | 290             | 142                    |
| Supplies                                | 257                | 284             | (27)                   | 607              | 532             | 75                     |
| Postage                                 | 291                | 285             | 6                      | 643              | 570             | 73                     |
| Investor relations                      | 90                 | 124             | (34)                   | 135              | 153             | (18)                   |
| Travel                                  | 89                 | 99              | (10)                   | 144              | 151             | (7)                    |
| ATM network                             | 143                | 127             | 16                     | 297              | 249             | 48                     |
| Sponsorships & charitable contributions | 269                | 217             | 52                     | 432              | 371             | 61                     |
| Regulatory premiums                     | 68                 | 85              | (17)                   | 138              | 169             | (31)                   |
| Directors fees                          | 108                | 109             | (1)                    | 219              | 221             | (2)                    |
| Employee expenses                       | 160                | 130             | 30                     | 304              | 268             | 36                     |
| Insurance                               | 115                | 121             | (6)                    | 236              | 242             | (6)                    |
| CRA equity investment loss              | 369                |                 | 369                    | 369              |                 | 369                    |
| Other                                   | 855                | 718             | 137                    | 1,476            | 1,222           | 254                    |
| <b>Total other non-interest expense</b> | <b>\$ 3,623</b>    | <b>\$ 2,981</b> | <b>\$ 642</b>          | <b>\$ 6,584</b>  | <b>\$ 5,513</b> | <b>\$ 1,071</b>        |

During the first quarter of 2006, our banking subsidiary, Columbia Bank, underwent a conversion of core processing systems. The conversion was primarily attributable to \$169,000 of supplies and postage expense during the first six months of 2006. In addition, we completed a conversion of our lending and internet banking software platforms. These systems will give us greater flexibility in transaction processing, management reporting, and will provide the necessary technological infrastructure to support our plans for future growth. During the second quarter we wrote off approximately \$39,000 of prepaid maintenance contracts associated with the software abandoned after our mortgage banking conversion. We recognized \$369,000 in noninterest expense resulting from the write down of our equity investment in CRA qualified low-income housing partnerships. A substantial portion, \$238,000, of the write down was offset by credits taken as a reduction in our current period income tax expense.

Our efficiency ratio [noninterest expense divided by the sum of net interest income and noninterest income on a tax equivalent basis, excluding gain (loss) on sale of investment securities, net cost (gain) of OREO, and mark-to-market adjustments of interest rate floor instruments] was 61.0% for the second quarter 2006 and was 59.8% for the first six months of 2006, compared to 63.2% and 62.7% for the second quarter and first six months of 2005, respectively. The year-to-date improvement (decrease) in the efficiency ratio is due to increases in net interest income relative to noninterest expense.

**Table of Contents****Reconciliation of Financial Data to GAAP Financial Measures**

| <i>(in thousands)</i>   | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|---|--------------------------------|-----------|------------------------------|-----------|
|   | 2006                           | 2005      | 2006                         | 2005      |
| Net interest income (1)   | \$ 24,302                      | \$ 22,346 | \$ 48,608                    | \$ 43,647 |
| Tax equivalent adjustment for non-taxable investment securities interest income (2) | 968                            | 627       | 1,761                        | 1,239     |
| Adjusted net interest income  | \$ 25,270                      | \$ 22,973 | \$ 50,369                    | \$ 44,886 |
| Noninterest income  | \$ 6,267                       | \$ 6,128  | \$ 12,240                    | \$ 11,802 |
| Gain on sale of investment securities, net  |                                |           | (10)                         |           |
| Tax equivalent adjustment for BOLI income (2)                                       | 234                            | 191       | 449                          | 392       |
| Adjusted noninterest income   | \$ 6,501                       | \$ 6,319  | \$ 12,679                    | \$ 12,194 |
| Noninterest expense   | \$ 21,136                      | \$ 18,514 | \$ 39,476                    | \$ 35,791 |
| Net gain on sale of OREO  | 11                             | 7         | 11                           | 9         |
| Interest rate floor valuation adjustment  | (1,775)                        |           | (1,775)                      |           |
| Adjusted noninterest expense  | \$ 19,372                      | \$ 18,521 | \$ 37,712                    | \$ 35,800 |
| Efficiency ratio (fully taxable-equivalent)   | 61.0%                          | 63.2%     | 59.8%                        | 62.7%     |
| Statutory Tax Rate  | 35.0%                          | 35.0%     | 35.0%                        | 35.0%     |

(1) Amount represents net interest income before provision for loan losses.

(2) Fully Taxable-equivalent basis: Non taxable revenue is increased by the statutory tax rate to recognize the income tax benefit of the income realized.

**Income Taxes**

We recorded an income tax provision of \$1.9 million and \$5.5 million for the second quarter and first six months of 2006, respectively, compared with a provision of \$2.8 million and \$5.3 million for the same periods in 2005. The effective tax rate for the second quarter of 2006 and 2005 was 21% and 29%, respectively, as well as 26% and 29% for the six months ended June 30, 2006 and 2005. The decrease in the Company's effective tax rate from the prior year is due to a significant increase in the amount of tax-exempt municipal securities held in the investment portfolio and an increased amount of low income housing tax credits. For the remainder of the current year we expect our effective tax rate should be in a range of 26%-29%. For additional information, refer to the Company's annual report on Form 10-K for the year ended December 31, 2005.

**Credit Risk Management**

The extension of credit in the form of loans or other credit products to individuals and businesses is one of our principal business activities. Our policies and applicable laws and regulations require risk analysis as well as ongoing portfolio and credit management. We manage our credit risk through lending limit constraints, credit review, approval policies, and extensive, ongoing internal monitoring. We also manage credit risk through diversification of the loan portfolio by type of loan, type of industry, type of borrower and by limiting the aggregation of debt limits to a single borrower. In analyzing our existing portfolio, we review our consumer and residential loan portfolios by their performance as a pool of loans since no single loan is individually significant or judged by its risk rating, size, or potential risk of loss. In contrast, the monitoring process for the commercial business, private banking, real estate construction, and commercial real estate portfolios includes periodic reviews of individual loans with risk ratings assigned to each loan and performance judged on a loan by loan basis. We review these loans to assess the ability of the borrower to service all of its interest and principal obligations and, as a result, the risk rating may be adjusted accordingly. In the event that full collection of principal and interest is not reasonably assured, the loan is appropriately downgraded and, if warranted, placed on nonaccrual status even though the loan may be current as to principal and interest payments. Additionally, we review these types of loans for



## Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

impairment in accordance with SFAS No. 114, Accounting by Creditors for the Impairment of a Loan . Impaired loans are considered for nonaccrual status and will typically remain as such until all principal and interest payments are brought current and the prospects for future payments in accordance with the loan agreement appear relatively certain.

**Table of Contents**

Loan policies, credit quality criteria, portfolio guidelines and other controls are established under the guidance of our Chief Credit Officer and approved, as appropriate, by the Board. Credit Administration, together with the loan committee, has the responsibility for administering the credit approval process. As another part of its control process, we use an internal credit review process independent of the lending and credit administration functions to provide assurance that loans and commitments are made and maintained as prescribed by its credit policies. This includes a review of documentation when the loan is initially extended and subsequent monitoring to assess continued performance and proper risk assessment.

**Loan Portfolio Analysis**

We are a full service commercial bank, which originates a wide variety of loans, and concentrates its lending efforts on originating commercial business and commercial real estate loans.

The following table sets forth the Company's loan portfolio by type of loan for the dates indicated:

| <i>(in thousands)</i>  | <b>June 30,<br/>2006</b> | <b>% of<br/>Total</b> | <b>December 31,<br/>2005</b> | <b>% of<br/>Total</b> |
|--|--------------------------|-----------------------|------------------------------|-----------------------|
| <b>Commercial business</b>   | \$ 595,363               | 36.6%                 | \$ 556,589                   | 35.6%                 |
| <b>Lease financing</b>   | 12,278                   | 0.8                   | 14,385                       | 0.9                   |
| <b>Real estate:</b>  |                          |                       |                              |                       |
| One-to-four family residential                                       | 83,290                   | 5.1                   | 74,930                       | 4.8                   |
| Commercial and five or more family residential commercial properties | 690,790                  | 42.5                  | 651,393                      | 41.6                  |
| Total real estate  | 774,080                  | 47.6                  | 726,323                      | 46.4                  |
| <b>Real estate construction:</b>                                     |                          |                       |                              |                       |
| One-to-four family residential                                       | 31,260                   | 1.9                   | 41,033                       | 2.6                   |
| Commercial and five or more family residential commercial properties | 71,587                   | 4.4                   | 89,134                       | 5.7                   |
| Total real estate construction                                       | 102,847                  | 6.3                   | 130,167                      | 8.3                   |
| <b>Consumer</b>  | 142,969                  | 8.8                   | 140,110                      | 9.0                   |
| Sub-total loans  | 1,627,537                | 100.1                 | 1,567,574                    | 100.2                 |
| Less: Deferred loan fees   | (2,282)                  | (0.1)                 | (2,870)                      | (0.2)                 |
| Total loans  | \$ 1,625,255             | 100%                  | \$ 1,564,704                 | 100%                  |
| Loans held for sale  | \$ 1,288                 |                       | \$ 1,850                     |                       |

Total loans (excluding loans held for sale) at June 30, 2006 increased \$60.56 million, to \$1.63 billion from \$1.56 billion at year-end 2005.

*Commercial Loans:* As of June 30, 2006, commercial loans increased \$38.8 million, or 7%, to \$595.4 million from \$556.6 million at year-end 2005, representing 36.6% of total loans at June 30, 2006 as compared with 35.6% of total loans at December 31, 2005. Management is committed to providing competitive commercial lending in the Company's primary market areas. Management believes that increases in commercial lending during the first six months of 2006 were due to increased confidence of business owners in response to an improving economy. Management expects to continue to expand its commercial lending products and to emphasize in particular its relationship banking with businesses, and business owners.

*Lease Financing:* Due primarily to contractual repayments, our lease financing portfolio decreased \$2.1 million or, 15%, to \$12.3 million from \$14.4 million at year-end 2005, representing 0.8% of total loans at June 30, 2006 as compared with 0.9% of total loans at December 31, 2005. The addition of equipment leasing is the result of a portfolio acquisition made in late 2005. The bulk of the portfolio, approximately 96%, consists of titled transportation type equipment. This segment of the portfolio is documented through an open-end vehicle lease agreement that specifies a monthly stream of rental payments along with a stipulated equipment residual value at lease end. We hold vehicle title to the equipment contained in these leases. The remaining portfolio, which constitutes approximately 4% of the portfolio, is made up of other miscellaneous, non-titled equipment. This equipment is documented through a non-vehicle, standard lease agreement and further secured with personal guarantees and standard UCC filings. Transportation related industries are influenced primarily by fuel, maintenance and insurance

## Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

type costs. It is anticipated that this segment of the portfolio will generate future financing opportunities that will be predicated at least in part to these outside influences.

*Real Estate Loans:* Residential one-to-four family loans increased \$8.4 million to \$83.3 million at June 30, 2006, representing 5.1% of total loans, compared with \$74.9 million, or 4.8%, of total loans at December 31, 2005. These loans are used by the Company to collateralize outstanding advances from the FHLB. Generally, the Company's policy is to originate residential loans for sale to third parties. Those residential loans are secured by properties located within the Company's primary market areas, and

## **Table of Contents**

typically have loan-to-value ratios of 80% or lower. However, the loan amounts may exceed 80% with private mortgage insurance and other underwriting criteria.

Commercial and five-or-more family residential real estate lending increased \$39.4 million, or 6%, to \$690.8 million at June 30, 2006, representing 42.5% of total loans, from \$651.4 million, or 41.6% of total loans at December 31, 2005. Generally, commercial and five-or-more family residential real estate loans are made to borrowers who have existing banking relationships with the Company. The Company's underwriting standards generally require that the loan-to-value ratio for these loans not exceed 75% of appraised value, cost, or discounted cash flow value, as appropriate, and that commercial properties maintain debt coverage ratios (net operating income divided by annual debt servicing) of 1.2 or better. However, underwriting standards can be influenced by competition and other factors. The Company endeavors to maintain the highest practical underwriting standards while balancing the need to remain competitive in its lending practices.

*Real Estate Construction Loans:* The Company originates a variety of real estate construction loans. One-to-four family residential construction loans are originated for the construction of custom homes (where the home buyer is the borrower) and provide financing to builders for the construction of pre-sold homes and speculative residential construction. Construction loans on one-to-four family residences decreased \$9.7 million, or 24%, to \$31.3 million at June 30, 2006, representing 1.9% of total loans, from \$41.0 million, or 2.6% of total loans at December 31, 2005. Commercial and five-or-more family real estate construction loans decreased \$17.5 million, or 20%, to \$71.6 million at June 30, 2006, representing 4.4% of total loans, from \$89.1 million, or 5.7% of total loans at December 31, 2005. The Company endeavors to limit its construction lending risk during both robust and slower building cycles through adherence to strict underwriting procedures.

*Consumer Loans:* At June 30, 2006, the Company had \$143.0 million of consumer loans outstanding, representing 8.8% of total loans, an increase of \$2.9 million, or 2%, compared with \$140.1 million at December 31, 2005. Consumer loans made by the Company include automobile loans, boat and recreational vehicle financing, home equity and home improvement loans and miscellaneous personal loans.

*Foreign Loans:* The Company's banking subsidiaries are not involved with loans to foreign companies or foreign countries.

## **Nonperforming Assets**

Nonperforming assets consist of: (i) nonaccrual loans, which generally are loans placed on a nonaccrual basis when the loan becomes past due 90 days or when there are otherwise serious doubts about the collectibility of principal or interest; (ii) in most cases 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 (interest on restructured loans is accrued at the restructured rates when it is anticipated that no loss of original principal will occur); (iii) real estate owned; and (iv) personal property owned.

Total nonperforming assets increased \$0.9 million to \$5.8 million, or 0.23% of period-end assets at June 30, 2006 from \$4.9 million, or 0.21% of period-end assets at December 31, 2005.

**Table of Contents**

The following tables set forth, at the dates indicated, information with respect to nonaccrual loans, restructured loans, total nonperforming loans (nonaccrual loans plus restructured loans), real estate owned, other personal property owned, and total nonperforming assets of the Company:

|                                   | June 30,        | December 31,    |
|-----------------------------------|-----------------|-----------------|
| <i>(in thousands)</i>             | 2006            | 2005            |
| <b>Nonaccrual:</b>                |                 |                 |
| Commercial business               | \$ 4,005        | \$ 4,316        |
| Leases                            | 134             |                 |
| <b>Real estate:</b>               |                 |                 |
| One-to-four family residential    | 239             | 376             |
| Commercial                        | 126             |                 |
| Consumer                          | 71              | 41              |
| <b>Total nonaccrual loans</b>     | <b>4,575</b>    | <b>4,733</b>    |
| <b>Restructured:</b>              |                 |                 |
| Commercial business               | 1,197           | 124             |
| <b>Total nonperforming loans</b>  | <b>5,772</b>    | <b>4,857</b>    |
| Real estate owned                 |                 | 18              |
| <b>Total nonperforming assets</b> | <b>\$ 5,772</b> | <b>\$ 4,875</b> |

*Nonperforming Loans:* The consolidated financial statements are prepared according to the accrual basis of accounting. This includes the recognition of interest income on the loan portfolio, unless a loan is placed on a nonaccrual basis, which occurs when there are serious doubts about the collectibility of principal or interest. The policy of the Company generally is to discontinue the accrual of interest on all loans past due 90 days or more and place them on nonaccrual status.

Nonperforming loans were \$5.8 million, or 0.36% of total loans (excluding loans held for sale) at June 30, 2006, compared to \$4.9 million, or 0.31% of total loans at December 31, 2005. Nonaccrual loans decreased \$158,000, or 3% from year-end 2005 to \$4.6 million at June 30, 2006.

Nonaccrual loans and other nonperforming assets are centered in a small number of lending relationships which management considers adequately reserved. Generally, these relationships are well collateralized though loss of principal on certain of these loans will remain in question until the loans are paid or collateral is liquidated. The Company will continue its collection efforts and liquidation of collateral to recover as large a portion of the nonaccrual assets as possible. Substantially, all nonperforming loans are to borrowers within the state of Washington.

*Other Real Estate Owned:* Other Real estate owned ( OREO ), is comprised of property from foreclosed real estate loans. During the second quarter of 2006, the Company did not acquire any OREO. During the second quarter of 2006 and for the six months ended June 30, 2006 the Company sold \$18,000 of OREO for net realized gains of \$11,000, compared to net realized gains of \$7,000 for the second quarter of 2005 and net realized gains of \$9,000 for the six months ended June 30, 2005. There were no foreclosures, recoveries of previously charged-off balances or write-downs during the first six months of 2006.

*Other Personal Property Owned:* Other personal property owned ( OPPO ) is comprised of other, non-real estate property from foreclosed loans. The Company had no outstanding OPPO balance at June 30, 2006 and December 31, 2005. There were no foreclosures, additions or charge-offs of OPPO during the first six months of 2006.

**Provision and Allowance for Loan and Lease Losses**

At June 30, 2006, the Company's allowance for loan and lease losses was \$21.0 million, or 1.29% of total loans (excluding loans held for sale), 364% of nonperforming loans, and 364% of nonperforming assets. This compares with an allowance of \$20.8 million, or 1.33% of the total loan

## Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

portfolio, excluding loans held for sale, 429% of nonperforming loans, and 427% of nonperforming assets at December 31, 2005. During the second quarter and the first six months of 2006, the Company allocated \$250,000 and \$465,000 to its provision for loan and lease losses, respectively. During the second quarter of 2005 and for the first six months of 2005 the Company allocated \$370,000 and \$1.3 million to its provision for loan and lease losses, respectively. The decrease in the provision for loan and lease losses is due to stable credit quality and slower growth in the Company's loan portfolio.

**Table of Contents**

There have been no significant changes during the first six months of 2006 in estimation methods or assumptions that affected the Company's methodology for assessing the appropriateness of the allowance for loan and lease losses. Adjustments to the percentages of the allowance allocated to loan categories are made based on trends with respect to delinquencies and problem loans within each pool of loans. The Company maintains a conservative approach to credit quality and will continue to prudently add to its loan and lease loss allowance as necessary in order to maintain adequate reserves. The Company's credit quality measures continue to improve into the second quarter of 2006 from the year-ended 2005 and are some of the strongest in the Company's history. Management carefully monitors the loan portfolio and continues to emphasize credit quality and strengthening of its loan monitoring systems and controls.

The following table provides an analysis of the Company's allowance for loan and lease losses at the dates and the periods indicated:

| <i>(in thousands)</i>                                    | Three Months Ended |              | Six Months Ended |              |
|--|--------------------|--------------|------------------|--------------|
|  | June 30,           |              | June 30,         |              |
|  | 2006               | 2005         | 2006             | 2005         |
| Beginning balance  | \$ 20,691          | \$ 20,179    | \$ 20,829        | \$ 19,881    |
| Charge-offs:   |                    |              |                  |              |
| Commercial business                                      | (90)               | (20)         | (106)            | (241)        |
| Commercial real estate                                   |                    |              |                  | (665)        |
| Consumer   | (50)               | (100)        | (475)            | (119)        |
| Total charge-offs  | (140)              | (120)        | (581)            | (1,025)      |
| Recoveries:  |                    |              |                  |              |
| Commercial business                                      | 136                | 29           | 165              | 107          |
| Commercial real estate                                   | 47                 | 60           | 55               | 270          |
| Real estate construction: One-to-four family residential |                    |              | 7                |              |
| Consumer   | 6                  | 69           | 50               | 94           |
| Total recoveries   | 189                | 158          | 277              | 471          |
| Net recoveries (charge-offs)                             | 49                 | 38           | (304)            | (554)        |
| Provision charged to expense                             | 250                | 370          | 465              | 1,260        |
| Ending balance   | \$ 20,990          | \$ 20,587    | \$ 20,990        | \$ 20,587    |
| Total loans, net at end of period (1)                    | \$ 1,625,255       | \$ 1,510,043 | \$ 1,625,255     | \$ 1,510,043 |
| Allowance for loan losses to total loans                 | 1.29%              | 1.36%        | 1.29%            | 1.36%        |

(1) Excludes loans held for sale

During the second quarter of 2006, the Company had net loan recoveries of \$49,000, compared to \$38,000 in the same period of 2005. For the first six months of 2006, the Company had net loan charge-offs of \$304,000, compared to \$554,000 during the same period of 2005. The net charge-offs during the first six months of 2006 were comprised of several loans.

**Securities**

At June 30, 2006, the Company's securities (securities available for sale and securities held to maturity) increased \$65.6 million, or 11% to \$640.5 million from \$574.9 million at year-end 2005. During the first six months of 2006, the Company purchased securities totaling \$136.1 million and received principal payments inclusive of maturities of \$53.3 million. There were no sales of securities during the second quarter of 2006 or 2005. During the first six months of 2006 the Company sold \$3.8 million of securities available for sale at their carrying value resulting in a gain of \$10,000. Approximately 99% of the Company's securities are classified as available for sale and carried at fair value. These securities are used by management as part of its asset/liability management strategy and may be sold in response to changes in interest rates or significant prepayment risk. In accordance with the Company's investment strategy, management monitors market conditions with a view to realize gains on

## Edgar Filing: COLUMBIA BANKING SYSTEM INC - Form 10-Q

its available for sale securities portfolio when prudent. At June 30, 2006, the market value of securities available for sale had an unrealized loss of \$10.4 million (net of tax) as compared to an unrealized loss of \$2.8 (net of tax) at December 31, 2005. The change in market value of securities available for sale is due primarily to fluctuations in interest rates.



**Table of Contents**

The following table sets forth our securities portfolio by type for the dates indicated:

|   | June 30,<br>2006 | December 31,<br>2005 |
|---|------------------|----------------------|
|   | (in thousands)   |                      |
| <b>Securities Available for Sale</b>  |                  |                      |
| U.S. Government agency  | \$ 115,374       | \$ 154,860           |
| U.S. Government agency mortgage-backed securities and collateralized mortgage obligations | 338,634          | 288,790              |
| State and municipal securities  | 182,243          | 126,951              |
| Other securities  | 1,726            | 1,754                |
| Total   | \$ 637,977       | \$ 572,355           |

|                                    | June 30,<br>2006 | December 31,<br>2005 |
|------------------------------------|------------------|----------------------|
|                                    | (in thousands)   |                      |
| <b>Securities Held to Maturity</b> |                  |                      |
| State & municipal securities       | \$ 2,525         | \$ 2,524             |

**Liquidity and Sources of Funds**

The Company's primary sources of funds are customer deposits and advances from the Federal Home Loan Bank of Seattle (the FHLB). These funds, together with loan repayments, loan sales, retained earnings, equity and other borrowed funds, are used to make loans, to acquire securities and other assets, and to fund continuing operations.

*Deposit Activities*

Our deposit products include a wide variety of transaction accounts, savings accounts and time deposit accounts. Total deposits decreased \$42.7 million, or 2%, to \$1.96 billion at June 30, 2006 from \$2.01 billion at December 31, 2005. Core deposits (demand deposit, savings, and money market accounts) decreased \$59.8 million, or 4% during the first six months of 2006 while certificate of deposit balances increased \$17 million, or 3% compared to year-end 2005. Average core deposits decreased to \$1.41 billion during the second quarter of 2006, from \$1.47 billion in the fourth quarter 2005 but increased from \$1.40 billion in the second quarter of 2005.

With higher consumer confidence in the equity markets, we recognize that some of the deposit growth that occurred during the past several years is likely migrating back to those markets. Competitive pressure from banks in our market areas with a strained liquidity posture has also slowed our deposit growth. However, in the long-term we anticipate continued growth in our core deposits through the addition of new product offerings, new customers and from our current client base.

We have established a branch system to serve its consumer and business depositors. In addition, management's strategy for funding growth is to make use of brokered and other wholesale deposits. At June 30, 2006, brokered and other wholesale deposits (excluding public deposits) totaled \$10.6 million, less than 1% of total deposits, down from \$10.9 million at December 31, 2005. The brokered deposits have varied maturities.

**Table of Contents**

The following table sets forth the Company's deposit base by type of product for the dates indicated:

| <b>Deposit Composition</b>           | <b>June 30,<br/>2006</b> | <b>June 30,<br/>2005</b> | <b>Dec. 31,<br/>2005</b> |
|--------------------------------------|--------------------------|--------------------------|--------------------------|
| Demand and other noninterest bearing | \$ 446,568               | \$ 422,410               | \$ 455,838               |
| Interest bearing demand              | 367,891                  | 321,618                  | 339,686                  |
| Money market                         | 488,615                  | 560,450                  | 563,973                  |
| Savings                              | 115,239                  | 113,121                  | 118,604                  |
| Certificates of deposit              | 544,435                  | 481,434                  | 527,388                  |
| <b>Total deposits</b>                | <b>\$ 1,962,748</b>      | <b>\$ 1,899,033</b>      | <b>\$ 2,005,489</b>      |

**Borrowings**

We rely on FHLB advances to supplement our funding sources. The FHLB serves as another source of both short and long-term borrowings. FHLB advances are secured by one-to-four family real estate mortgages and certain other assets including our investment securities. At June 30, 2006, the Company had FHLB advances of \$303 million, compared to advances of \$94.4 million at December 31, 2005. Management anticipates that the Company will continue to rely on the same sources of funds in the future primarily to make loans and purchase securities.

During 2001, the Company, through a special purpose trust (the Trust) participated in a pooled trust preferred offering, whereby the Trust issued \$22.0 million of 30 year floating rate capital securities. The capital securities constitute guaranteed preferred beneficial interests in debentures issued by the Trust. The debentures had an initial rate of 7.29% and a rate of 8.73% at June 30, 2006. The floating rate is based on the 3-month LIBOR plus 3.58% and is adjusted quarterly. Through the Trust we may call the debentures after five years for a premium and after ten years at par, allowing us to retire the debt early if conditions are favorable.

The trust preferred obligations are classified as long-term subordinated debt and our related investment in the Trust is recorded in other assets on the consolidated balance sheet. The balance of the long-term subordinated debt was \$22.3 million at June 30, 2006 and \$22.3 million at December 31, 2005. The subordinated debt payable to the Trust is on the same interest and payment terms as the trust preferred obligations issued by the Trust.

**Contractual Obligations & Commitments**

The Company is party to many contractual financial obligations, including repayment of borrowings, operating and equipment lease payments, commitments to extend credit and investments in affordable housing partnerships. At June 30, 2006, the Company had commitments to extend credit of \$776.9 million compared to \$698.6 million at December 31, 2005.

**Capital Resources**

Shareholders' equity at June 30, 2006 was \$232.2 million, up 3% from \$226.2 million at December 31, 2005. The increase is due primarily to net income of \$15.4 million for the first six months of 2006. Shareholders' equity was 9.1% and 9.5% of total period-end assets at June 30, 2006, and December 31, 2005, respectively.

*Capital Ratios:* Banking regulations require bank holding companies to maintain a minimum leverage ratio of core capital to adjusted quarterly average total assets of at least 3%. In addition, banking regulators have adopted risk-based capital guidelines, under which risk percentages are assigned to various categories of assets and off-balance sheet items to calculate a risk-adjusted capital ratio. Tier I capital generally consists of common shareholders' equity and trust preferred obligations, less goodwill and certain identifiable intangible assets, while Tier II capital includes the allowance for loan losses and subordinated debt, both subject to certain limitations. Regulatory minimum risk-based capital guidelines require Tier I capital of 4% of risk-adjusted assets and total capital (combined Tier I and Tier II) of 8% to be considered adequately capitalized.

Federal Deposit Insurance Corporation regulations set forth the qualifications necessary for a bank to be classified as well capitalized, primarily for assignment of FDIC insurance premium rates. To qualify as well capitalized, banks must have a Tier I risk-adjusted capital ratio of at least 6%, a total risk-adjusted capital ratio of at least 10%, and a leverage ratio of at least 5%. Failure to qualify as well capitalized can negatively impact a bank's ability to expand and to engage in certain activities.



**Table of Contents**

The Company and its subsidiaries qualify as well-capitalized at June 30, 2006 and December 31, 2005.

|                                 | Company   |            | Columbia Bank |            | Astoria   |            | Requirements              |                      |
|---------------------------------|-----------|------------|---------------|------------|-----------|------------|---------------------------|----------------------|
|                                 | 6/30/2006 | 12/31/2005 | 6/30/2006     | 12/31/2005 | 6/30/2006 | 12/31/2005 | Adequately<br>capitalized | Well-<br>capitalized |
| Total risk-based capital ratio  | 13.09%    | 12.97%     | 12.44%        | 12.52%     | 11.61%    | 14.79%     | 8%                        | 10%                  |
| Tier 1 risk-based capital ratio | 11.99%    | 11.82%     | 11.34%        | 11.38%     | 10.47%    | 13.61%     | 4%                        | 6%                   |
| Leverage ratio                  | 9.47%     | 9.54%      | 8.96%         | 9.32%      | 8.19%     | 10.23%     | 4%                        | 5%                   |

*Stock Repurchase Program*

In March 2002 the Board of Directors approved a stock repurchase program whereby the Company may systematically repurchase up to 500,000 of its outstanding shares of Common Stock. The Company may repurchase shares from time to time in the open market or in private transactions, under conditions which allow such repurchases to be accretive to earnings while maintaining capital ratios that exceed the guidelines for a well-capitalized financial institution. As of June 30, 2006 the Company had not repurchased any shares of common stock in this current stock repurchase program.

**Table of Contents**

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

A number of measures are used to monitor and manage interest rate risk, including income simulations and interest sensitivity (gap) analyses. An income simulation model is the primary tool used to assess the direction and magnitude of changes in net interest income resulting from changes in interest rates. Basic assumptions in the model include prepayment speeds on mortgage-related assets, cash flows and maturities of other investment securities, loan and deposit volumes and pricing. These assumptions are inherently subjective and, as a result, the model cannot precisely estimate net interest income or precisely predict the impact of higher or lower interest rates on net interest income. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes and changes in market conditions and management strategies, among other factors. At June 30, 2006, based on the measures used to monitor and manage interest rate risk, there has not been a material change in the Company's interest rate risk since December 31, 2005. For additional information, refer to Management's Discussion and Analysis of Financial Condition and Results of Operations referenced in the Company's 2005 Annual Report on Form 10-K.

**Item 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

An evaluation was carried out under the supervision and with the participation of the Company's management, including the Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), of the effectiveness of our disclosure controls and procedures as required by Rule 13a-15(b) of the Securities Exchange Act of 1934. Based on that evaluation, the CEO and CFO have concluded that as of the end of the period covered by this report, our disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and timely reported as provided in the SEC's rules and forms.

**Changes in Internal Controls Over Financial Reporting**

There was no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

**Table of Contents****PART II - OTHER INFORMATION****Item 1. LEGAL PROCEEDINGS**

The Company and its banking subsidiaries are parties to routine litigation arising in the ordinary course of business. Management believes that, based on the information currently known to them, any liabilities arising from such litigation will not have a material adverse impact on the Company's financial condition, results of operations or cash flows.

**Item 1A. RISK FACTORS**

There have been no material changes from risk factors previously disclosed in the Company's 2005 Annual Report on Form 10-K.

**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

**Item 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

The Company held its annual shareholders meeting on April 26, 2006. The following is a brief description and vote count of all proposals voted upon at the annual meeting.

## Proposal 1. ELECTION OF DIRECTORS

All nine persons nominated were elected to hold office for the ensuing year.

| <b>Nominee</b>          | <b>Votes For</b> | <b>Votes Withheld</b> |
|-------------------------|------------------|-----------------------|
| Melanie J. Dressel      | 14,937,506       | 91,471                |
| John P. Folsom          | 13,843,218       | 645,759               |
| Frederick M. Goldberg   | 14,383,998       | 104,979               |
| Thomas M. Hulbert       | 13,991,118       | 497,859               |
| Thomas L. Matson, Sr.   | 14,397,774       | 91,203                |
| Daniel C. Regis         | 13,958,972       | 530,005               |
| Donald Rodman           | 14,145,802       | 343,175               |
| William T. Weyerhaeuser | 14,397,105       | 91,872                |
| James M. Will           | 10,210,681       | 4,278,296             |

## Proposal 2. AMENDMENTS TO EMPLOYEE STOCK PURCHASE PLAN

**Shares Voted For**  
10,886,151

**Shares Voted Against**  
216,344

**Abstentions**  
72,206



**Table of Contents**

**Item 5. OTHER INFORMATION**

Our outside directors are compensated through a combination of cash payments and equity grants. A summary of the outside director compensation effective July 1, 2006 is described in Exhibit 10.1 of the Quarterly Report.

**Item 6. EXHIBITS**

- 10.1 Summary Description of Non-Management Director Compensation
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32 Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002



**Table of Contents**

SIGNATURES

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

COLUMBIA BANKING SYSTEM, INC.

Date: August 8, 2006

By */s/ MELANIE J. DRESSEL*  
Melanie J. Dressel  
President and Chief Executive Officer  
  
(Principal Executive Officer)

Date: August 8, 2006

By */s/ GARY R. SCHMINKEY*  
Gary R. Schminkey  
Executive Vice President and  
  
Chief Financial Officer  
  
(Principal Financial Officer)

Date: August 8, 2006

By */s/ CLINT E. STEIN*  
Clint E. Stein  
Senior Vice President and  
  
Chief Accounting Officer  
  
(Principal Accounting Officer)