

STERLING FINANCIAL CORP /WA/  
Form 10-Q  
November 15, 2002

[QuickLinks](#) -- Click here to rapidly navigate through this document

---

---

**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 September 30, 2002**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 0-20800**

**STERLING FINANCIAL CORPORATION**

(Exact name of registrant as specified in its charter)

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

**91-1572822**  
(I.R.S. Employer  
Identification No.)

**111 North Wall Street, Spokane, Washington 99201**

(Address of principal executive offices) (Zip Code)

**(509) 458-2711**

(Registrant's telephone number, including area code)

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

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

<u>Class</u>	<u>Outstanding as of October 31, 2002</u>
Common Stock (\$1.00 par value)	11,958,948

---

---

---

**STERLING FINANCIAL CORPORATION**

**FORM 10-Q**  
**For the Quarter Ended September 30, 2002**

**TABLE OF CONTENTS**

	<b>Page</b>
<b>PART I Financial Information</b>	<b>1</b>
Item 1 Financial Statements	1
Consolidated Balance Sheets	1
Consolidated Statements of Income	2
Consolidated Statements of Cash Flows	3
Consolidated Statements of Comprehensive Income	5
Notes to Consolidated Financial Statements	6
Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3 Quantitative and Qualitative Disclosures About Market Risk	27
Item 4 Disclosure Controls and Procedures	27
<b>PART II Other Information</b>	<b>28</b>
Item 1 Legal Proceedings	28
Item 2 Changes in Securities and Use of Proceeds	28
Item 3 Defaults Upon Senior Securities	28
Item 4 Submission of Matters to a Vote of Security Holders	28
Item 5 Other Information	28
Item 6 Exhibits and Reports on Form 8-K	28
Signatures	29
Certifications	30

---

---

**PART I Financial Information**

**Item 1 Financial Statements**

**STERLING FINANCIAL CORPORATION**

## Consolidated Balance Sheets

(Unaudited)

	September 30, 2002	December 31, 2001
	<u>                    </u>	<u>                    </u>
	(Dollars in thousands)	
<b>ASSETS:</b>		
Cash and cash equivalents:		
Interest bearing	\$ 34	\$ 3,938
Non-interest bearing and vault	69,156	61,716
Restricted	1,818	1,527
Investments and asset-backed securities ("ABS"):		
Available for sale	803,784	686,995
Held to maturity	6,667	7,053
Loans and leases receivable, net	2,243,164	2,109,479
Loans held for sale	18,616	12,077
Accrued interest receivable	15,472	15,302
Real estate owned, net	5,336	2,982
Office properties and equipment, net	47,347	48,305
Goodwill, net	43,977	43,977
Mortgage servicing rights, net	1,789	1,638
Bank-owned life insurance ("BOLI")	58,543	30,988
Prepaid expenses and other assets, net	13,872	12,616
	<u>                    </u>	<u>                    </u>
Total assets	\$ 3,329,575	\$ 3,038,593
	<u>                    </u>	<u>                    </u>
<b>LIABILITIES:</b>		
Transaction deposits	626,037	368,636
Savings and money market deposits	328,741	422,659
Certificates of deposit	1,063,646	1,062,241
	<u>                    </u>	<u>                    </u>
Total deposits	2,018,424	1,853,536
Advances from Federal Home Loan Bank of Seattle ("FHLB Seattle")	738,086	633,054
Securities sold subject to repurchase agreements and funds purchased	221,960	218,549
Other borrowings	119,000	127,500
Cashiers checks issued and payable	14,016	16,057
Borrowers' reserves for taxes and insurance	2,580	1,197
Accrued interest payable	7,577	8,187
Accrued expenses and other liabilities	11,454	14,823
	<u>                    </u>	<u>                    </u>
Total liabilities	3,133,097	2,872,903
	<u>                    </u>	<u>                    </u>
<b>SHAREHOLDERS' EQUITY:</b>		
Preferred stock, \$1 par value; 10,000,000 shares authorized; no shares issued and outstanding	0	0
	11,957	10,545

Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

	September 30, 2002	December 31, 2001
Common stock, \$1 par value; 20,000,000 shares authorized; 11,957,448 and 10,544,653 shares issued and outstanding		
Additional paid-in capital	125,166	98,439
Unrealized gains (losses) on investments and ABS available-for-sale, net of deferred income taxes of \$(2,834) and \$2,473	3,916	(4,596)
Retained earnings	55,439	61,302
<b>Total shareholders' equity</b>	<b>196,478</b>	<b>165,690</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 3,329,575</b>	<b>\$ 3,038,593</b>

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

1

**STERLING FINANCIAL CORPORATION**

**Consolidated Statements of Income**

**(Unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
(Dollars in thousands, except per share data)				
<b>Interest income:</b>				
Loans and leases	\$ 40,260	\$ 39,714	\$ 118,340	\$ 126,050
ABS	8,797	8,617	24,384	19,924
Investments and cash equivalents	1,052	1,361	3,252	5,174
<b>Total interest income</b>	<b>50,109</b>	<b>49,692</b>	<b>145,976</b>	<b>151,148</b>
<b>Interest expense:</b>				
Deposits	11,175	15,347	34,025	51,049
Short-term borrowings	2,144	2,390	5,419	6,100
Long-term borrowings	10,926	11,350	33,911	32,851
<b>Total interest expense</b>	<b>24,245</b>	<b>29,087</b>	<b>73,355</b>	<b>90,000</b>
<b>Net interest income</b>	<b>25,864</b>	<b>20,605</b>	<b>72,621</b>	<b>61,148</b>
Provision for losses on loans and leases	(3,277)	(1,525)	(7,590)	(4,400)
<b>Net interest income after provision</b>	<b>22,587</b>	<b>19,080</b>	<b>65,031</b>	<b>56,748</b>

Other income (expense):

Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

	Three Months Ended September 30,		Nine Months Ended September 30,	
Fees and service charges	4,352	3,416	12,281	9,799
Mortgage banking operations	1,307	723	3,663	2,451
Loan servicing fees	271	314	865	899
Net gains on sales of securities	1,399	1,072	1,796	1,429
Real estate owned operations	(8)	(138)	(202)	(445)
BOLI	731	454	2,433	532
Other noninterest income (expense)	15	(99)	(195)	(93)
<b>Total other income</b>	<b>8,067</b>	<b>5,742</b>	<b>20,641</b>	<b>14,572</b>
<b>Operating expenses</b>	<b>21,119</b>	<b>18,757</b>	<b>60,538</b>	<b>53,918</b>
Income before income taxes	9,535	6,065	25,134	17,402
Income tax provision	(2,906)	(1,994)	(7,188)	(5,947)
Net income	\$ 6,629	\$ 4,071	\$ 17,946	\$ 11,455
Income per share basic	\$ 0.55	\$ 0.34	\$ 1.52	\$ 0.96
Income per share diluted	\$ 0.54	\$ 0.33	\$ 1.47	\$ 0.95
Weighted average shares outstanding basic	11,950,633	11,913,571	11,804,806	11,885,089
Weighted average shares outstanding diluted	12,243,940	12,174,789	12,208,035	12,065,541

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

2

STERLING FINANCIAL CORPORATION

Consolidated Statements of Cash Flows

(Unaudited)

	Nine Months Ended September 30,	
	2002	2001
(Dollars in thousands)		
Cash flows from operating activities:		
Net income	\$ 17,946	\$ 11,455
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provisions for losses on loans, leases and real estate owned	7,828	4,734
Stock dividends on FHLB Seattle stock	(1,808)	(3,468)
Net gain on sales of loans, investments and ABS	(5,074)	(1,928)
Other losses (gains)	491	(95)
Change in cash surrender value of BOLI	(2,555)	(532)

	Nine Months Ended September 30,	
Depreciation and amortization	8,276	9,243
Change in:		
Accrued interest receivable	(170)	1,354
Prepaid expenses and other assets	(6,633)	(2,042)
Cashiers checks issued and payable	(2,041)	(1,028)
Accrued interest payable	(159)	(1,510)
Accrued expenses and other liabilities	(3,815)	5,920
Proceeds from sales of loans	184,406	220,680
Real estate loans originated for sale	(181,128)	(218,642)
Net cash provided by operating activities	15,564	24,141
<b>Cash flows from investing activities:</b>		
Change in restricted cash	(290)	(258)
Loans funded	(1,140,121)	(730,809)
Loan and lease principal received	984,737	722,201
Purchase of investments	(32,039)	(24)
Proceeds from maturities of investments	29,929	82,396
Proceeds from sales of available-for-sale investments	1,410	9,953
Purchase of BOLI	(25,000)	(30,000)
Cash and cash equivalents acquired as part of acquisitions	0	1,498
Purchase of ABS	(592,031)	(520,428)
Principal payments on ABS	142,560	74,066
Proceeds from sales of ABS	345,290	143,240
Purchase of office properties and equipment	(2,216)	(1,797)
Improvements and other changes to real estate owned	(866)	180
Proceeds from sales and liquidation of real estate owned	6,065	7,158
Net cash used in investing activities	(282,572)	(242,624)

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

**STERLING FINANCIAL CORPORATION**  
**Consolidated Statements of Cash Flows (continued)**  
**(Unaudited)**

Nine Months Ended September 30,	
2002	2001
(Dollars in thousands)	

Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

	Nine Months Ended September 30,	
<b>Cash flows from financing activities:</b>		
Net change in checking, passbook and money market deposits	\$ 157,785	\$ 67,803
Proceeds from issuance of certificates of deposit	858,652	530,261
Payments for maturing certificates of deposit	(884,527)	(630,166)
Interest credited to deposits	32,978	52,980
Advances from FHLB Seattle	221,875	184,000
Repayment of FHLB Seattle advances	(116,843)	(76,031)
Net change in securities sold subject to repurchase agreements and funds purchased	3,410	81,174
Payments for fractional shares	(19)	0
Proceeds from other borrowings	0	54,000
Repayment of other borrowings	(5,000)	(40,000)
Proceeds from exercise of stock options, net of repurchases	851	78
Other	1,382	690
	<b>270,544</b>	<b>224,789</b>
<b>Net cash provided by financing activities</b>		
Net change in cash and cash equivalents	3,536	6,306
Cash and cash equivalents, beginning of period	65,654	60,595
<b>Cash and cash equivalents, end of period</b>	<b>\$ 69,190</b>	<b>\$ 66,901</b>
<b>Supplemental disclosures:</b>		
<b>Cash paid during the period for:</b>		
Interest	\$ 49,629	\$ 88,292
Income taxes	8,798	4,377
<b>Noncash financing and investing activities:</b>		
Loans converted into real estate owned	7,570	4,722
Common stock issued upon business combination	0	9,141
Common stock dividend	23,809	12,837

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

**STERLING FINANCIAL CORPORATION**

**Consolidated Statements of Comprehensive Income**

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net income	\$ 6,629	\$ 4,071	\$ 17,946	\$ 11,455

(Dollars in thousands)

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
Other comprehensive income:				
Change in net unrealized gains/losses on investments and ABS available-for-sale	4,450	9,283	13,094	10,806
Deferred income taxes	(1,558)	(3,249)	(4,582)	(3,782)
Net other comprehensive income	<u>2,892</u>	<u>6,034</u>	<u>8,512</u>	<u>7,024</u>
Comprehensive income	<u>\$ 9,521</u>	<u>\$ 10,105</u>	<u>\$ 26,458</u>	<u>\$ 18,479</u>

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

5

## STERLING FINANCIAL CORPORATION

### Notes to Consolidated Financial Statements

#### 1. Basis of Presentation:

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission. Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2001. In the opinion of management, the unaudited interim consolidated financial statements furnished herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented.

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities known to exist as of the date the financial statements are published, and the reported amounts of revenues and expenses during the reporting period. Uncertainties with respect to such estimates and assumptions are inherent in the preparation of Sterling Financial Corporation's ("Sterling's") consolidated financial statements; accordingly, it is possible that the actual results could differ from these estimates and assumptions, which could have a material effect on the reported amounts of Sterling's consolidated financial position and results of operations.

#### 2. Interim Financial Statements:

The financial information set forth in the unaudited interim consolidated financial statements reflects the adjustments, all of which are of a normal and recurring nature, which, in the opinion of management, are necessary for a fair presentation of the periods reported.

#### 3. Other Borrowings:

The components of other borrowings are as follows (in thousands):

	<u>September 30, 2002</u>	<u>December 31, 2001</u>
Term note payable(1)	\$ 25,000	\$ 30,000
Advances on revolving line of credit(2)	0	0
Sterling obligated mandatorily redeemable preferred capital securities of subsidiary trusts holding solely junior subordinated deferrable interest debentures of Sterling(3)(4)	64,000	64,000
Floating Rate Notes Due 2006(5)	30,000	30,000



Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

	September 30, 2002	December 31, 2001
Convertible Subordinated Debentures Due 2008	0	3,500
Total other borrowings	\$ 119,000	\$ 127,500

- (1) Sterling has a variable-rate term note with U.S. Bank, N.A. ("U.S. Bank") with a balance of \$25.0 million outstanding at September 30, 2002. This note matures on September 17, 2007. Interest accrues at the 30-day London Interbank Offering Rate ("LIBOR") plus 2.50% (4.32%) and is payable monthly. This note is collateralized by a majority of the Common and Preferred Stock of Sterling Savings Bank.
- (2) Sterling has a \$5.0 million revolving line-of-credit with U.S. Bank. This line of credit matures on September 15, 2003. The interest rate is adjustable monthly at the 30-day LIBOR plus 2.50% (4.32%) and is payable monthly. This note is collateralized by a majority of the Common and Preferred Stock of Sterling Savings Bank. At September 30, 2002, no amounts were outstanding under this line.
- (3) Sterling has outstanding \$41.2 million of 9.50% junior subordinated deferrable interest debentures ("Junior Subordinated Debentures-I") to Sterling Capital Trust I ("Trust-I"), a Delaware business trust, of which Sterling owns all of the common equity. The sole asset of Trust-I is the Junior Subordinated Debentures-I. Trust-I issued \$40.0 million of 9.50% Cumulative Capital Securities ("Trust-I Preferred Securities") to investors. Sterling's obligations under the Junior Subordinated Debentures-I and related documents, taken together, constitute a full and unconditional guarantee by Sterling of Trust-I's obligations under the Trust-I Preferred Securities. The Trust-I Preferred Securities are treated as debt of Sterling. Although Sterling, as a savings and loan holding company, is not subject to the Federal Reserve capital requirements for bank holding companies, the Trust-I Preferred Securities have been structured to qualify as Tier I capital, subject to certain limitations, if Sterling were to become regulated as a bank holding company. The Junior Subordinated Debentures-I and related Trust-I Preferred Securities mature in 2027 and are redeemable at the option of Sterling under certain conditions. The Trust-I Preferred Securities must be redeemed upon maturity of the Junior Subordinated Debentures-I in 2027.
- (4) Sterling has outstanding \$24.7 million of 10.25% junior subordinated deferrable interest debentures ("Junior Subordinated Debentures-II") to Sterling Capital Trust II ("Trust-II"), a Delaware business trust, in which Sterling owns all of the common equity. The sole asset of Trust-II is the Junior Subordinated Debentures-II. Trust-II issued \$24.0 million of 10.25% Cumulative Capital Securities ("Trust-II Preferred Securities") to investors. Sterling's obligations under Junior Subordinated Debentures-II and related documents, taken together, constitute a full and unconditional guarantee by Sterling of Trust-II's obligations under the Trust-II Preferred Securities. The Trust-II Preferred Securities are treated as debt of Sterling. Although Sterling, as a savings and loan holding company, is not subject to the Federal Reserve capital requirements for bank holding companies, the Trust-II Preferred Securities have been structured to qualify as Tier 1 capital, subject to certain limitations, if Sterling were to become regulated as a bank holding company. The Junior Subordinated Debentures-II and related Trust-II Preferred Securities mature in 2031 and are redeemable at the option of Sterling under certain conditions. The Trust-II Preferred Securities must be redeemed upon maturity of the Junior Subordinated Debentures-II in 2031.
- (5) Sterling has outstanding \$30.0 million of Floating Rate Notes Due 2006. These notes are unsecured general obligations of Sterling and are subordinated to certain other existing and future indebtedness. Under terms of the notes, Sterling is limited in the amount of certain long-term debt that it may incur, and the notes restrict Sterling, under certain circumstances, as to the amount of cash dividends on its preferred or common stock and capital distributions which can be made. At September 30, 2002, Sterling could have incurred approximately \$28.4 million of additional long-term debt. At September 30, Sterling could have paid up to approximately \$24.4 million in additional dividends. Interest accrues at the 90-day LIBOR plus 2.50% (4.32%) and is adjustable and payable quarterly. The notes mature in 2006 and may be redeemed under certain conditions.

**4. Income Per Share:**

The following table presents the basic and diluted income per share computations including the effects of the 10% stock dividends which were paid in both November 2001 and May 2002:

	Three Months Ended September 30,					
	2002			2001		
	Net Income	Weighted Avg. Shares	Per Share Amount	Net Income	Weighted Avg. Shares	Per Share Amount
Basic computations	\$ 6,629,000	11,950,633	\$ 0.55	\$ 4,071,000	11,913,571	\$ 0.34
Effect of dilutive securities:						
Common stock options	0	293,307	(0.01)	0	258,215	(0.01)
Convertible subordinated debt	0	0	0.00	0	3,003	0.00
Diluted computations	\$ 6,629,000	12,243,940	\$ 0.54	\$ 4,071,000	12,174,789	\$ 0.33
Antidilutive options not included in diluted income per share		0			101,190	
	Nine Months Ended September 30,					
	2002			2001		
	Net Income	Weighted Avg. Shares	Per Share Amount	Net Income	Weighted Avg. Shares	Per Share Amount
Basic computations	\$ 17,946,000	11,804,806	\$ 1.52	\$ 11,455,000	11,885,089	\$ 0.96
Effect of dilutive securities:						
Common stock options	0	302,875	(0.04)	0	179,440	(0.01)
Convertible subordinated debt	43,000	100,354	(0.01)	0	1,012	0.00
Diluted computations	\$ 17,989,000	12,208,035	\$ 1.47	\$ 11,455,000	12,065,541	\$ 0.95
Antidilutive options not included in diluted income per share		0			237,501	

8

**5. Operating Expenses:**

The following table details Sterling's components of total operating expenses:

Three Months Ended September 30,		Nine Months Ended September 30,	
2002	2001	2002	2001

(Dollars in thousands)

Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

	Three Months Ended September 30,		Nine Months Ended September 30,	
Employee compensation and benefits	\$ 11,076	\$ 8,927	\$ 32,103	\$ 25,453
Occupancy and equipment	3,152	2,796	9,320	8,319
Depreciation	1,047	1,142	3,173	3,396
Amortization of goodwill	0	956	0	2,889
Amortization of other intangibles	0	383	644	1,149
Advertising	1,553	973	3,050	2,190
Data processing	1,597	1,297	4,626	3,955
Insurance	159	187	431	557
Legal and accounting	621	336	1,479	1,087
Acquisition and conversion costs	0	185	0	185
Travel and entertainment	464	434	1,513	1,264
Goodwill litigation costs	270	255	790	770
Other	1,180	886	3,409	2,704
<b>Total operating expenses</b>	<b>\$ 21,119</b>	<b>\$ 18,757</b>	<b>\$ 60,538</b>	<b>\$ 53,918</b>

**6. Segment Information:**

Sterling has identified its business segments as residential loan production and commercial real estate production.

Sterling operates residential loan production offices primarily in the Spokane and Seattle, Washington; Portland, Oregon; and Boise, Idaho metropolitan areas through its subsidiary Action Mortgage Company. Residential mortgage banking operations include revenues from servicing-released and servicing-retained sales of originated residential loans, bulk sales of loan servicing rights and other fees.

Sterling also operates commercial real estate loan production offices primarily in the Spokane and Seattle, Washington; and Portland, Oregon metropolitan areas through its subsidiary INTERVEST-Mortgage Investment Company. Commercial real estate mortgage banking operations include revenues from sales of commercial real estate loans and participation interests in commercial real estate loans, loan fees and servicing fees.

9

The following table presents certain financial information regarding Sterling's segments and provides a reconciliation to Sterling's consolidated totals for the three and nine-month periods ended September 30, 2002 and 2001 (in thousands).

	Mortgage Banking Operations			
	Banking Operations	Residential	Commercial Real Estate	Total
(Dollars in thousands)				
As of and for the three months ended September 30, 2002:				
Interest income	\$ 46,742	\$ 2,075	\$ 1,292	\$ 50,109
Other fee income	3,828	330	194	4,352
Gains on sales of loans	0	783	0	783
Expenses	18,687	1,762	670	21,119
Income before taxes	6,637	1,979	919	9,535
Total assets	3,299,159	15,785	14,631	3,329,575

As of and for the three months ended

**Mortgage Banking  
Operations**

---

September 30, 2001:

Interest income	\$ 47,016	\$ 1,471	\$ 1,205	\$ 49,692
Other fee income	2,981	108	327	3,416
Gains on sales of loans	360	305	103	768
Expenses	16,943	1,203	611	18,757
Income before taxes	4,006	941	1,118	6,065
Total assets	2,923,995	9,703	11,912	2,945,610

As of and for the nine months ended

September 30, 2002:

Interest income	\$ 136,974	\$ 5,434	\$ 3,568	\$ 145,976
Other fee income	10,996	810	475	12,281
Gains on sales of loans	900	1,802	576	3,278
Expenses	53,704	5,109	1,725	60,538
Income before taxes	17,725	4,195	3,214	25,134
Total assets	3,299,159	15,785	14,631	3,329,575

As of and for the nine months ended

September 30, 2001:

Interest income	\$ 143,511	\$ 4,434	\$ 3,203	\$ 151,148
Other fee income	8,907	246	646	9,799
Gains on sales of loans	930	780	329	2,039
Expenses	49,207	3,141	1,570	53,918
Income before taxes	11,516	3,025	2,861	17,402
Total assets	2,923,995	9,703	11,912	2,945,610

**7. Goodwill and Intangible Assets:**

In June 2001, the Financial Accounting Standards Board ("FASB") approved for issuance Statement of Financial Accounting Standards No. 142 ("SFAS No. 142"), "Goodwill and Intangible Assets," which revises the accounting for purchased goodwill and intangible assets. Under SFAS

10

No. 142, goodwill and intangible assets with indefinite lives will no longer be amortized, but will be tested for impairment at least annually. If goodwill is found to be impaired, it will be written down to its fair market value. Sterling adopted SFAS No. 142 on January 1, 2002. Sterling tested its goodwill and found no impairment as of June 30, 2002. The net effect of adopting this accounting standard was to increase net income by \$669,000 or \$0.06 per diluted share for the quarter ended September 30, 2002. For the nine months ended September 30, 2002, the increase to net income was \$2.1 million or \$0.18 per diluted share.

In accordance with SFAS No. 142, the effect of this accounting change is reflected prospectively. Comparative disclosure as if the change had been retroactively applied to the prior year is as follows:

<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
<b>2002</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>

(Dollars in thousands)

Reported net income	\$ 6,629	\$ 4,071	\$ 17,946	\$ 11,455
---------------------	----------	----------	-----------	-----------

Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

	Three Months Ended September 30,		Nine Months Ended September 30,	
Add back: goodwill amortization, net of tax	0	641	0	1,907
<b>Total</b>	<b>\$ 6,629</b>	<b>\$ 4,712</b>	<b>\$ 17,946</b>	<b>\$ 13,362</b>
Basic earnings per share				
Reported net income	\$ 0.55	\$ 0.34	\$ 1.52	\$ 0.96
Goodwill amortization	0.00	0.06	0.00	0.16
<b>Adjusted earnings per share</b>	<b>\$ 0.55</b>	<b>\$ 0.40</b>	<b>\$ 1.52</b>	<b>\$ 1.12</b>
Diluted earnings per share:				
Reported net income	\$ 0.54	\$ 0.33	\$ 1.47	\$ 0.95
Goodwill amortization	0.00	0.06	0.00	0.16
<b>Adjusted earnings per share</b>	<b>\$ 0.54</b>	<b>\$ 0.39</b>	<b>\$ 1.47</b>	<b>\$ 1.11</b>

**8. Other Accounting Policies:**

In June 2001, the Financial Accounting Standards Board approved for issuance Statement of Financial Accounting Standards No. 143 ("SFAS No. 143"), "Accounting for Asset Retirement Obligations," which addresses the accounting for legal obligations associated with the retirement of tangible long-lived assets. Under SFAS No. 143, the fair value of a liability for an asset retirement obligation shall be recognized in the period in which the obligation is incurred. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002, with early adoption permitted. Sterling is currently analyzing the financial impact that the adoption of SFAS No. 143 will have on its consolidated financial statements. Sterling will adopt SFAS No. 143 on or before January 2003. Sterling anticipates that the adoption of SFAS No. 143 will have no material effect on operations.

In August 2001, the FASB approved for issuance Statement of Financial Accounting Standards No. 144 ("SFAS No. 144"), "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 was issued to resolve implementation issues that had been created under Statement of Financial Accounting Standards No. 121. Under SFAS No. 144, one accounting model is required to be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired, and certain additional disclosures are required. The adoption of SFAS No. 144 on January 1, 2002 did not have a material effect on Sterling's consolidated financial statements.

In April 2002, the FASB issued Statement of Financial Accounting Standards No. 145 ("SFAS No. 145"), "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 145 updates, clarifies and simplifies existing accounting pronouncements, by rescinding SFAS No. 4, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. As a result, the criteria in Accounting Principles Board Opinion No. 30 will now be used to classify those gains and losses. Additionally, SFAS No. 145 amends SFAS No. 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. Finally, SFAS No. 145 also makes technical corrections to existing pronouncements. The adoption of SFAS No. 145 did not have a material impact on Sterling's consolidated financial statements.

In July 2002, the FASB issued Statement of Financial Accounting Standards No. 146 ("SFAS No. 146"), "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by the standard include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity. SFAS No. 146 replaces the prior guidance that was provided by EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS No. 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002.

## Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

In October 2002, the FASB issued Statement of Financial Accounting Standards No. 147 ("SFAS No. 147"), "Acquisitions of Certain Financial Institutions," an amendment of FASB Statements No. 72 and No. 144 and FASB Interpretation No. 9. SFAS No. 147 amends SFAS No. 144 to include in its scope long-term customer-relationship intangible assets of financial institutions such as depositor- and borrower-relationship intangible assets and credit cardholder intangible assets. SFAS No. 147 also removes acquisitions of financial institutions from the scope of both Statement No. 72 and Interpretation No. 9. As a result, the excess of the fair values of liabilities assumed over the fair value of tangible and identifiable intangible assets acquired in a business combination represents goodwill that should be accounted for under SFAS No. 142. SFAS No. 147 will be applied prospectively to future business combinations.

### **9. Derivative Financial Instruments:**

Sterling adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS Nos. 137 and 138, effective January 1, 2001. This Statement establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. The Statement requires that Sterling recognize all derivatives as either assets or liabilities in the balance sheet and measure those instruments at fair value. Changes in the fair value of the derivatives are reported in either earnings or other comprehensive income (loss), depending on the use of the derivative and whether or not it qualifies for hedge accounting.

Sterling enters into interest rate lock commitments ("rate locks") with prospective borrowers in advance of origination of readily marketable mortgage loans held for sale. To mitigate the interest rate risk inherent in rate locks, Sterling enters into best efforts forward commitments to sell individual mortgage loans ("forward commitments"). Rate locks and forward commitments are considered to be derivatives under SFAS No. 133. In April 2002, the FASB issued DIG comment C13 in order to address

12

---

the accounting for rate locks relating to the acquisition of mortgage loans held for resale beginning July 2002. Sterling adopted the DIG C13 guidance on July 1, 2002. Sterling has recorded the estimated fair values of the rate locks and forward commitments on its balance sheet in either other assets or other liabilities. Changes in the fair values of these derivative instruments are recorded in net gain on sales of mortgage loans in the income statement as the changes occur.

The fair value of rate locks associated with optional ("best efforts") forward commitments is estimated based on the pricing specified in the related forward commitment. At September 30, 2002, Sterling had rate locks with a fair value of approximately \$20,000 recorded as an asset in its balance sheet, and best efforts forward commitments with a fair value of approximately \$20,000 recorded as a liability in its balance sheet.

### **10. Proposed Business Combination:**

On September 19, 2002, Sterling announced that it had entered into an Agreement and Plan of Merger (the "Empire Merger") with Empire Federal Bancorp, Inc., a Delaware Corporation ("Empire"). Empire will be merged with and into Sterling, with Sterling being the surviving corporation in the merger. Empire's wholly-owned subsidiary, Empire Bank, will be merged with and into Sterling's wholly-owned subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution. As of September 30, 2002, Empire had 5 branches in Montana along the I-90 corridor. As of September 30, 2002, Empire had approximately \$220.2 million in total assets, approximately \$177.0 million in deposits, approximately \$75.9 million in loans and approximately \$28.7 million of equity.

Under the terms of the Empire Merger, each share of Empire common stock will be converted into shares of Sterling common stock at an initial price of approximately \$19.25 per share on the date of the definitive agreement. The initial price will float within a range based upon the trading prices of Sterling's common stock prior to the completion of the merger, with a maximum and minimum number of shares to be issued by Sterling in exchange for all outstanding shares of Empire common stock. The merger will be structured as a tax-free reorganization and is expected to be completed in the first quarter of 2003, subject to the approval of Empire's shareholders and regulators.

13

---

## **Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operation**

**STERLING FINANCIAL CORPORATION**  
**Comparison of the Three and Nine Months Ended September 30, 2002 and 2001**

*This report contains forward-looking statements, which are not historical facts and pertain to our future operating results. These forward-looking statements are within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements contained in this report that are not historical facts. When used in this report, the words "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," and similar expressions are generally intended to identify forward-looking statements. These forward-looking statements are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change. Actual results may differ materially from the results discussed in these forward-looking statements because of numerous possible risks and uncertainties. These include but are not limited to: the possibility of adverse economic developments which may, among other things, increase default and delinquency risks in Sterling's loan portfolios; shifts in interest rates which may result in lower interest rate margins; shifts in the demand for Sterling's loan and other products; lower than expected revenue or cost savings in connection with acquisitions; changes in accounting policies; changes in the monetary and fiscal policies of the federal government; changes in laws, regulations and the competitive environment. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes presented elsewhere in this report and in Sterling's current annual report on Form 10-K.*

**General**

Sterling Financial Corporation ("Sterling") is a unitary savings and loan holding company, the significant operating subsidiary of which is Sterling Savings Bank. The significant operating subsidiaries of Sterling Savings Bank are Action Mortgage Company ("Action Mortgage"), INTERVEST-Mortgage Investment Company ("INTERVEST") and Harbor Financial Services, Inc. ("Harbor Financial").

Sterling provides personalized, quality financial services to its customers as exemplified by its "Hometown Helpful" philosophy. Sterling believes that this dedication to personalized service has enabled it to maintain a stable retail deposit base. With \$3.33 billion in total assets at September 30, 2002, Sterling attracts Federal Deposit Insurance Corporation ("FDIC") insured deposits from the general public through 77 retail branches located primarily in rural and suburban communities in Washington, Oregon, Idaho and Montana. Sterling originates loans through its branch offices as well as Action Mortgage residential loan production offices in the metropolitan areas of Spokane and Seattle, Washington; Portland, Oregon; and Boise, Idaho; and through INTERVEST commercial real estate lending offices located in the metropolitan areas of Spokane and Seattle, Washington; and Portland, Oregon. Sterling also markets tax-deferred annuities, mutual funds and other financial products through Harbor Financial.

Sterling continues to enhance its presence as a community bank by increasing its commercial real estate, business banking, consumer and construction lending while increasing its retail deposits, particularly transaction accounts. Commercial real estate, business banking, consumer and construction loans generally produce higher yields than residential loans. Such loans, however, generally involve a higher degree of risk than financing residential real estate. Sterling's revenues are derived primarily from interest earned on loans, investments and asset-backed securities ("ABS"), from fees and service charges and from mortgage banking operations. The operations of Sterling Savings Bank, and savings institutions generally, are influenced significantly by general economic conditions and by policies of its

primary regulatory authorities: the Office of Thrift Supervision ("OTS"); the FDIC and the State of Washington Department of Financial Institutions ("Washington Supervisor").

Management believes that a community bank mix of assets and liabilities will enhance its net interest income ("NII") (the difference between the interest earned on loans and investments and the interest paid on liabilities) and other fee income will increase, although there can be no assurance in this regard. Sterling intends to continue to pursue an aggressive growth strategy, which may include acquiring other financial institutions, businesses or branches thereof or other substantial assets or deposit liabilities. Sterling may not be successful in identifying further acquisition candidates, integrating acquired businesses or preventing deposit erosion or loan quality deterioration at acquired businesses. There is significant competition for acquisitions in Sterling's market area, and Sterling may not be able to acquire other institutions or businesses on attractive terms. Furthermore, the success of Sterling's growth strategy will depend on increasing and maintaining sufficient levels of regulatory capital, obtaining necessary regulatory approvals, generating appropriate growth and favorable economic and market conditions. There can be no assurance that Sterling will be successful in implementing its growth strategy.

On September 19, 2002, Sterling announced that it had entered into an Agreement and Plan of Merger (the "Empire Merger") with Empire Federal Bancorp, Inc., a Montana corporation ("Empire"). Empire will be merged with and into Sterling, with Sterling being the surviving

## Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

corporation in the merger. Empire's wholly-owned subsidiary, Empire Bank, will be merged with and into Sterling's wholly-owned subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution.

Under the terms of the Empire Merger, each share of Empire common stock will be converted into the right to receive \$19.25 per share in the form of Sterling common stock, provided the average closing price thereof within the ten-day trading period preceding the fifth trading day prior to the closing date is between \$17.01 and \$22.68. The merger exchange ratio provides that, regardless of the closing price of Sterling common stock, Sterling will issue no less than 0.849 and no more than 1.132 of a share of Sterling common stock for each share of Empire common stock outstanding. The merger will be structured as a tax-free reorganization and is expected to be completed in the first quarter of 2003. See Note 10 of "Notes to Consolidated Financial Statements."

### Critical Accounting Policies

Various elements of our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, we have identified five policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of our financial statements. These policies relate to the determination of our allowance for loan and lease losses, the valuation of our goodwill and other intangibles, the valuation of investments, the valuation of and accounting for stock options, valuation of real estate held for sale, derivatives and the prepayment speeds on asset-backed securities. These policies and the judgments, estimates and assumptions are described in greater detail in subsequent sections of Management's Discussion and Analysis, in the Consolidated Financial Statements included herein, and in the "Summary of Significant Accounting Policies" presented in Sterling's current annual report on Form 10-K. We believe that the judgments, estimates and assumptions used in the preparation of our Consolidated Financial Statements are appropriate given the factual circumstances at the time. However, given the sensitivity of our Consolidated Financial Statements to these critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in our results of operations or financial condition.

15

---

### Results of Operations

**Overview.** Sterling recorded net income of \$6.6 million, or \$0.54 per diluted share, for the three months ended September 30, 2002, compared with net income of \$4.1 million, or \$0.33 per diluted share, for the three months ended September 30, 2001. Sterling recorded net income of \$17.9 million, or \$1.47 per diluted share, for the nine months ended September 30, 2002. This compares with net income of \$11.5 million, or \$0.95 per diluted share, for the nine months ended September 30, 2001. The increase in net income for both periods reflected an increase in net interest income, other income and a discontinuation of the amortization of goodwill.

The annualized return on average assets was 0.82% and 0.57% for the three months ended September 30, 2002 and 2001, respectively. For the nine months ended September 30, 2002 and 2001, the annualized return on average assets was 0.77% and 0.56%, respectively. The increases in the ratios were primarily due to the increase in net income.

The annualized return on average equity was 13.8% and 10.6% for the three months ended September 30, 2002 and 2001, respectively. For the nine months ended September 30, 2002 and 2001, the annualized return on average equity was 13.4% and 10.3%, respectively. The increases in the ratios were primarily due to the increase in net income.

**Net Interest Income.** The most significant component of earnings for a financial institution typically is NII, which is the difference between interest income, primarily from loan, ABS and investment portfolios, and interest expense, primarily on deposits and borrowings. During the three months ended September 30, 2002 and 2001, NII was \$25.9 million and \$20.6 million, respectively, representing an increase of approximately 26%. During the nine months ended September 30, 2002 and 2001, NII was \$72.6 million and \$61.1 million, respectively, an increase of approximately 19%. The increase in NII during the three and nine months ended September 30, 2002, compared to the same periods in 2001, was primarily due to an approximate 14% increase in the volume of average interest-earning assets and to a significant decrease in the cost of funds.

Changes in NII result from changes in volume, net interest spread and net interest margin. Volume refers to the dollar level of interest-earning assets and interest-bearing liabilities. Net interest spread refers to the difference between the yield on interest-earning assets and the rate paid on interest-bearing liabilities. Net interest margin refers to NII divided by total interest-earning assets and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities.

During the three months ended September 30, 2002 and 2001, the volume of average interest-earning assets was \$2.98 billion and \$2.61 billion, respectively. For the three months ended September 30, 2002, average loans increased by \$292.6 million, while average



Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

investments and ABS increased by \$71.7 million over the same period in 2001. Net interest spread during these periods was 3.44% and 3.14%, respectively. The net interest margin for the three months ended September 30, 2002 and 2001 was 3.44% and 3.13%, respectively. Net interest spread increased due to a greater decrease in the cost of funds relative to the yields on average interest-earning assets and the acquisition of higher yielding assets from Source Capital Corporation ("Source Capital"). Sterling's lower cost of funds was driven primarily by an increase in business checking deposits and the effect of interest rate reductions on other sources of funds.

During the nine months ended September 30, 2002 and 2001, the volume of average interest-earnings assets was \$2.90 billion and \$2.53 billion, respectively. Net interest spread during these periods was 3.35% and 3.21%, respectively. The net interest margin for the nine months ended September 30, 2002 and 2001 was 3.35% and 3.23%, respectively. The increase in the net interest spread for the nine months ended September 30, 2002, compared with the same period in 2001, was primarily due to a greater decrease in the cost of funds relative to the yields on average interest-earning assets.

**Provision for Losses on Loans and Leases.** Management's policy is to establish valuation allowances for estimated losses by charging corresponding provisions against income. The evaluation of the adequacy of specific and general valuation allowances is an ongoing process. This process includes information derived from many factors including historical loss trends, trends in classified assets, trends in delinquency and nonaccrual loans, trends in portfolio volume, diversification as to type of loan, size of individual credit exposure, current and anticipated economic conditions, loan policies, collection policies and effectiveness, quality of credit personnel, effectiveness of policies, procedures and practices, and recent loss experience of peer banking institutions.

Sterling recorded provisions for losses on loans and leases of \$3.3 million and \$1.5 million for the three months ended September 30, 2002 and 2001, respectively. Sterling recorded provisions for losses on loans of \$7.6 million and \$4.4 million for the nine months ended September 30, 2002 and 2001. The provision reflects the analysis and assessment of the relevant factors mentioned in the preceding paragraph. Management anticipates that its provisions for losses on loans and leases will continue to increase, reflecting Sterling's strategic direction of originating more commercial real estate, construction, business banking and consumer loans which have a somewhat higher loss profile than the traditional thrift institution mix of loans, which primarily include residential real estate.

The following table summarizes loan and lease loss allowance activity for the periods indicated.

	2002	2001
	(Dollars in thousands)	
Allowance for losses on loans and leases:		
Balance at January 1:	\$ 20,599	\$ 16,740
Quarter ended March 31:		
Provision for losses on loans and leases	2,086	1,400
Amounts written off net of recoveries	(1,370)	(1,076)
Balance at March 31	21,315	17,064
Quarter ended June 30:		
Provision for losses on loans and leases	2,227	1,475
Amounts written off net of recoveries	(2,007)	(797)
Balance at June 30	21,535	17,742
Quarter ended September 30:		
Provision for losses on loans and leases	3,277	1,525
Amounts written off net of recoveries	(697)	(723)
Balance at September 30	\$ 24,115	\$ 18,544

2002	2001
_____	_____
_____	_____

At September 30, 2002, Sterling's total classified assets were \$72.3 million, compared with \$32.5 million at September 30, 2001. Total nonperforming loans and leases were \$25.9 million at September 30, 2002 or 0.78% of total assets, compared with \$16.5 million at September 30, 2001 or 0.56% of total assets. The increase in nonperforming loans and leases and classified assets was primarily attributable to the nonperforming loans, leases and classified assets acquired in the business combination with Source Capital. At September 30, 2002, Sterling's loan and lease delinquency rate (60 days or more) as a percentage of total loans and leases was 0.82%, compared with 0.51% at September 30, 2001.

The increase in the provision for loan and lease losses reflects both the continuing change in Sterling's loan mix to a greater emphasis on commercial and consumer loans and the soft economic activity in the region. Management believes that Sterling's emphasis on originating higher-risk

17

commercial real estate, construction, business banking and consumer loans is appropriate and will endeavor to maintain asset quality at acceptable levels.

**Other Income.** Other income was \$8.1 million and \$5.7 million for the three months ended September 30, 2002 and 2001, respectively. The increase for the three months ended September 30, 2002, compared with the three months ended September 30, 2001 was primarily due to increases in fees from higher transaction account volumes, service charges, income from mortgage banking operations and the cash surrender value of BOLI. For the nine months ended September 30, 2002, other income was \$20.6 million compared with \$14.6 million for the nine months ended September 30, 2001. The reasons for the increase were the same as those for the three-month period increase.

Fee and service charge income increased by approximately 29% to \$4.4 million for the quarter from \$3.4 million in the same period one year ago. For the nine months ended September 30, 2002, fees and service charges increased nearly 26% to \$12.3 million, compared with \$9.8 million for the same period in 2001. This increase is primarily due to an increase in the volume of business checking and other transaction accounts. The growth in checking accounts is attributed to the increase in corporate banking activities and promotional efforts for retail account growth.

The increase in income from mortgage banking operations for the nine months ended September 30, 2002 compared to the same period in 2001, was primarily due to increased refinancing activity and loan sales driven by lower interest rates. The following table summarizes sales of residential and commercial real estate loans for the periods indicated.

Three Months Ended September 30,		Nine Months Ended September 30,	
2002	2001	2002	2001

(Dollars in millions)

Sales of residential loans	\$ 49.3	\$ 25.0	\$ 121.7	\$ 173.5
Sales of commercial real estate loans	0	6.9	59.5	45.2

**Operating Expenses.** Operating expenses were \$21.1 million and \$18.8 million for the three months ended September 30, 2002 and 2001, respectively. During nine months ended September 30, 2002 and 2001, operating expenses were \$60.5 million and \$53.9 million, respectively. The higher level of operating expenses was primarily a result of expanded staffing in Sterling's branch delivery network, an increase in employee benefits, data processing, occupancy costs and advertising costs.

Employee compensation and benefits were \$11.1 million and \$8.9 million for the three months ended September 30, 2002 and 2001, respectively. During the nine months ended September 30, 2002 and 2001, employee compensation and benefits were \$32.1 million and \$25.5 million, respectively. The employee costs reflected increased mortgage banking staff and additional staff for Sterling's cash management operations and Portland Corporate Banking Center. At September 30, 2002, full-time-equivalent employees were 940, compared with 872 at September 30, 2001.

## Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

Data processing expense was \$1.6 million and \$1.3 million for the three months ended September 30, 2002 and 2001, respectively. During the nine months ended September 30, 2002 and 2001, data processing expense was \$4.6 million and \$4.0 million, respectively. The increase in both periods was primarily due to an increase in costs associated with a higher volume of transaction accounts.

Goodwill litigation expenses were \$270,000 and \$255,000 for the three months ended September 30, 2002 and 2001, respectively. During the nine months ended September 30, 2002 and 2001, goodwill litigation expenses were \$790,000 and \$770,000, respectively. Because of the effort required to bring the case to conclusion, Sterling likely will continue to incur legal expenses at recent levels over the next one to two years.

18

---

Amortization of goodwill was \$0 and \$956,000 for the three months ended at September 30, 2002 and 2001, respectively, reflecting the cessation of goodwill amortization. For the nine months ended September 30, 2002 and 2001, respectively, amortization of goodwill was \$0 and \$2.9 million. Pursuant to SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized, but will be tested annually for impairment. See Note 7 of "Notes to Consolidated Financial Statements."

Advertising expenses were \$1.6 million and \$973,000 for the three months ended September 30, 2002 and 2001, respectively. During the nine months ended September 30, 2002 and 2001, advertising expenses were \$3.1 million and \$2.2 million, respectively. The increase in both periods reflected additional advertising for Sterling's image campaign.

**Income Tax Provision.** Sterling recorded federal and state income tax provisions of \$2.9 million and \$2.0 million for the three months ended September 30, 2002 and 2001, respectively. Tax provisions were \$7.2 million and \$5.9 million for the nine months ended September 30, 2002 and 2001, respectively. The income tax provision in 2002 reflects an increase in taxable earnings. The decrease in the effective tax rate for the 2002 periods is due to the tax effect of (1) the change in the cash surrender value of BOLI, which is excluded from taxable earnings, (2) the tax treatment relating to certain discounts of the Source Capital acquisition and (3) tax-exempt municipal bond interest.

### Financial Position

**Assets.** At September 30, 2002, Sterling's assets were \$3.33 billion, up \$291.0 million from \$3.04 billion at December 31, 2001.

**Investments and ABS.** Sterling's investment and ABS portfolio at September 30, 2002 was \$810.5 million, an increase of \$116.5 million from the December 31, 2001 balance of \$694.0 million. The increase was primarily due to the purchase of ABS.

**Loans and Leases Receivable.** At September 30, 2002, gross loans and leases receivable were \$2.27 billion, up \$138.6 million from \$2.13 billion at December 31, 2001. The increase was primarily due to increases in loan originations, primarily in business banking, corporate banking, commercial real estate and consumer lending. During the three months ended September 30, 2002, total loan originations were \$475.7 million compared with \$351.2 million for the prior year's comparable quarter. Approximately 75% of these were construction, business banking, corporate banking and consumer loans. During the nine months ended September 30, 2002 and 2001, total loan originations were \$1.28 billion and \$971.5 million, respectively, approximately 78% of which were construction, business banking, corporate banking and consumer loans.

19

---

The following table sets forth the composition of Sterling's loan and lease portfolio at the dates indicated. Loan and lease balances exclude deferred loan and lease origination costs and fees and allowances for loan and lease losses.

September 30, 2002		December 31, 2001	
Amount	%	Amount	%

(Dollars in thousands)

Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

	September 30, 2002		December 31, 2001	
Residential real estate	\$ 344,337	15.1	\$ 315,242	14.8
Multifamily real estate	140,803	6.2	155,250	7.3
Commercial real estate	435,458	19.1	439,519	20.6
Real estate construction	456,671	20.1	395,915	18.5
Consumer direct	249,494	11.0	244,097	11.4
Consumer indirect	55,241	2.4	63,822	3.0
Business banking	526,599	23.2	515,587	24.2
Corporate banking	61,192	2.7	0	0.0
Commercial leases receivable	3,469	0.2	5,279	0.2
Gross loans and leases receivable	\$ 2,273,264	100.0	\$ 2,134,711	100.0
Net deferred origination fees/other	(5,985)		(4,633)	
Allowance for losses on loans and leases	(24,115)		(20,599)	
Net loans and leases receivable, net	\$ 2,243,164		\$ 2,109,479	

Weighted average yield at end of period 6.80% 7.30%

The following table sets forth Sterling's loan originations for the periods indicated.

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2002	2001	% Change	2002	2001	% Change
(Dollars in thousands)						
Residential real estate	\$ 87,556	\$ 43,819	99.81	\$ 203,684	\$ 115,052	77.04
Multifamily real estate	14,929	7,400	101.74	32,737	18,436	77.57
Commercial real estate	15,167	45,760	(66.86)	46,892	114,669	(59.11)
Real estate construction	169,567	115,006	47.44	455,260	338,015	34.69
Consumer direct	30,593	56,819	(46.16)	106,573	108,751	(2.00)
Consumer indirect	17,059	16,232	5.09	50,345	46,116	9.17
Business banking	116,464	66,170	76.01	291,719	230,443	26.59
Corporate banking	24,318	0	N/A	92,681	0	N/A
Total loans originated	\$ 475,653	\$ 351,206	35.43	\$ 1,279,891	\$ 971,482	31.75

**BOLI and All Other Assets.** BOLI and other assets increased to \$89.7 million at September 30, 2002 from \$60.5 million at December 31, 2001. The increase was primarily due to the purchase of additional BOLI.

**Deposits.** Total deposits increased \$164.9 million to \$2.02 billion at September 30, 2002 from \$1.85 billion at December 31, 2001, primarily due to increases in noninterest and NOW checking accounts.

The following table sets forth the composition of Sterling's deposits at the dates indicated.

September 30, 2002		December 31, 2001	
Amount	%	Amount	%

Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

	September 30, 2002		December 31, 2001	
	(Dollars in thousands)			
Noninterest checking	\$ 232,057	11.5	\$ 140,654	7.6
NOW checking	393,980	19.5	227,982	12.3
Savings and money market	328,741	16.3	422,659	22.8
Certificates of deposit	1,063,646	52.7	1,062,241	57.3
<b>Total deposits</b>	<b>\$ 2,018,424</b>	<b>100.0</b>	<b>\$ 1,853,536</b>	<b>100.0</b>

Annualized cost of deposits 2.34% 2.75%

The shift in the mix of deposits since December 2001 reflects: (1) a shift from money market accounts to interest-bearing checking accounts to take advantage of rate promotions and (2) a strong increase in new business checking deposits driven by the Portland Corporate Banking Center. At September 30, 2002, the number of business checking accounts has increased by approximately 7,900 from a year ago, an increase of approximately 22%.

**Borrowings.** Deposit accounts are Sterling's primary source of funds. Sterling does, however, rely upon advances from the Federal Home Loan Bank of Seattle ("FHLB Seattle"), reverse repurchase agreements and other borrowings to supplement its funding and to meet deposit withdrawal requirements. At September 30, 2002, the total of such borrowings was \$1.08 billion, compared with \$979.1 million at December 31, 2001, an increase of \$99.9 million. The increase was used to help fund purchases of ABS and investments. See "Liquidity and Sources of Funds."

#### Asset and Liability Management

The results of operations for financial institutions may be materially and adversely affected by changes in prevailing economic conditions, including rapid changes in interest rates, declines in real estate market values and the monetary and fiscal policies of the federal government. Like all financial institutions, Sterling's NII and the net present value of assets, liabilities and off-balance sheet contracts ("NPV"), or estimated fair value, are subject to fluctuations in interest rates. For example, some of Sterling's adjustable rate mortgages are indexed to the one-year or five-year U.S. Treasury index or periodic fixed-rate LIBOR swaps curve. When interest-earning assets such as loans are funded by interest-bearing liabilities such as deposits, FHLB Seattle advances and other borrowings, a changing interest rate environment may have a dramatic effect on Sterling's earnings. Currently, Sterling's interest-earning assets mature or reprice more frequently, or on different terms, than do its interest-bearing liabilities. The fact that assets mature or reprice more frequently on average than liabilities may be beneficial in times of increasing interest rates; however, such an asset/liability structure may result in declining NII during periods of falling interest rates.

Additionally, the extent to which borrowers prepay loans is affected by prevailing interest rates. When interest rates increase, borrowers are less likely to prepay loans; whereas when interest rates decrease, borrowers are more likely to prepay loans. Prepayments may affect the levels of loans retained in an institution's portfolio as well as its NII.

Sterling maintains an asset and liability management program intended to manage NII through interest rate cycles and to protect its NPV by controlling its exposure to changing interest rates. Sterling uses a simulation model designed to measure the sensitivity of NII and NPV to changes in interest rates. This simulation model is designed to enable Sterling to generate a forecast of NII and NPV given various interest rate forecasts and alternative strategies. The model is also designed to measure the anticipated impact that prepayment risk, basis risk, customer maturity preferences, volumes of new business and changes in the relationship between long-term and short-term interest

rates have on the performance of Sterling. The model calculates the present value of assets, liabilities, off-balance sheet financial instruments, and equity at current interest rates and at hypothetical higher and lower interest rates at various intervals. The present value of each major category of financial instruments is calculated using estimated cash flows based on weighted-average contractual rates and terms, then discounted at the estimated current market interest rate for similar financial instruments. The present value of longer term fixed-rate financial instruments is more difficult to estimate because such instruments are susceptible to changes in market interest rates. Present value estimates of adjustable-rate financial instruments are more reliable since they represent the difference between the contractual and discounted rates until the next interest rate repricing date.

## Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

The calculations of present value have certain shortcomings. The discount rates utilized for loans, investments and ABS are based on estimated nationwide market interest rate levels for similar loans and securities, with prepayment assumptions based on historical experience and market forecasts. The unique characteristics of Sterling's loans and ABS may not necessarily parallel those in the model. The discount rates utilized for deposits and borrowings are based upon available alternative types and sources of funds which are not necessarily indicative of the market value of deposits and FHLB Seattle advances since such deposits and advances are unique to and have certain price and customer relationship advantages for depository institutions. The present values are determined based on the discounted cash flows over the remaining estimated lives of the financial instruments on the assumption that the resulting cash flows are reinvested in financial instruments with virtually identical terms.

The total measurement of Sterling's exposure to interest rate risk ("IRR") as presented in the following table may not be representative of the actual values which might result from a higher or lower interest rate environment. A higher or lower interest rate environment most likely will result in different investment and borrowing strategies by Sterling designed to further mitigate the effect on the value of and the net earnings generated from Sterling's net assets from any change in interest rates.

The following table presents Sterling's estimates of changes in NPV for the periods indicated. The results indicate the potential effects of instantaneous, parallel shifts in the market yield curve. These calculations are highly subjective and technical and are relative measurements of IRR which do not necessarily reflect any expected rate movement.

<b>Change in Interest Rate in Basis Points (Rate Shock)</b>	<b>September 30, 2002</b>			<b>December 31, 2001</b>		
	NPV(1)	Ratio of NPV to the Present Value of Total Assets	% Change in NPV	NPV(1)	Ratio of NPV to the Present Value of Total Assets	% Change in NPV
(Dollars in thousands)						
+300	\$ 191,885	5.8	(13.8)	\$ 28,769	1.00	(72.7)
+200	216,108	6.5	(2.9)	55,326	1.89	(47.5)
+100	235,306	6.9	5.7	75,598	2.55	(28.3)
Static	222,658	6.5	N/A	105,406	3.48	N/A
-100	171,507	5.1	(23.0)	125,865	4.10	19.4
-200	134,660	4.0	(39.5)	117,709	3.80	11.7
-300	127,121	3.7	(42.9)	120,002	3.85	13.8

(1) The NPV calculation at September 30, 2002 includes a change in modeling assumptions adopted by management during the third quarter of 2002. Deposit valuations have been refined from a historic single-premium rate to an evaluation of the present value, given wholesale borrowing rates and considering average life, rate paid and effective duration by category of deposits. The changes in modeling assumptions more closely reflect market valuations and overall interest rate risk measures more in line with OTS evaluations.

For comparison purposes under Sterling's prior modeling method, NPV would have been reported at \$162.4 million, with that value decreasing by 24.2% and 44.5% if interest rates were to increase by 2% and 3%, respectively. This compares with an NPV of \$105.4 million at December 31, 2001, which would decline by 47.5% and 72.7% if interest rates generally were to increase by 2% and 3%, respectively.

Sterling also uses gap analysis, a traditional analytical tool designed to measure the difference between the amount of interest-earning assets and the amount of interest-bearing liabilities expected to mature or reprice in a given period. Sterling calculated its one-year cumulative gap positions to be positive 6.5% and positive 1.4% at September 30, 2002 and 2001, respectively. Sterling calculated its three-year gap positions to be positive 7.4% and positive 0.3% at September 30, 2002 and 2001, respectively. The changes in the gap positions were primarily due to the shortening of asset maturities and extending liability maturities. Management attempts to maintain Sterling's gap position between positive 10% and negative 25%. At September 30, 2002, Sterling's gap positions were within limits established by its Board of Directors.

Sterling is continuing to pursue strategies to manage the level of its IRR while increasing its NII and NPV through the origination and retention of variable-rate consumer, business banking, construction and commercial real estate loans, which generally have higher yields than

residential permanent loans, by the sale of certain long-term fixed-rate loans and investments and by increasing the level of its core deposits, which are generally a lower-cost funding source than borrowings. There can be no assurance that Sterling will be successful in implementing any of these strategies or that, if implemented, they will have the intended effect of reducing IRR or increasing NII.

### **Liquidity and Sources of Funds**

As a financial institution, Sterling's primary sources of funds are investing and financing activities, including the collection of loan principal and interest payments. Financing activities consist primarily of customer deposits, advances from FHLB Seattle and other borrowings. Deposits increased to \$2.02 billion at September 30, 2002 from \$1.85 billion at December 31, 2001, primarily due to an increase in checking deposits. The net increase in deposits was primarily used to fund loans, purchase ABS and pay down other borrowings. At September 30, 2002 and December 31, 2001, securities sold subject to repurchase agreements were \$215.8 million and \$218.5 million, respectively. These borrowings are required to be collateralized by investments and ABS with a market value exceeding the face value of the borrowings. Under certain circumstances, Sterling could be required to pledge additional securities or reduce the borrowings.

During the nine months ended September 30, 2002, cash used in investing activities consisted primarily of the funding of loans and the purchase of ABS. The levels of these payments increase or decrease depending on the size of the loan and ABS portfolios and the general trend and level of interest rates, which influences the level of refinancing and mortgage prepayments. During the same period, cash provided by investing activities consisted primarily of principal payments on loans and proceeds from sales of ABS. During the nine months ended September 30, 2002, cash provided by operating activities consisted primarily of proceeds from sales of loans.

Sterling Savings Bank's credit line with FHLB Seattle provides for borrowings up to a percentage of its total assets subject to collateralization requirements. At September 30, 2002, this credit line represented a total borrowing capacity of \$850.5 million, of which \$112.4 million was available. Sterling Savings Bank also borrows on a secured basis from major broker/dealers and financial entities by selling securities subject to repurchase agreements. At September 30, 2002, Sterling Savings Bank had \$215.8 million in outstanding borrowings under reverse repurchase agreements and had securities available for additional secured borrowings of approximately \$124.2 million.

23

---

Sterling, on a parent company-only basis, had cash and other resources of approximately \$7.8 million and a revolving line of credit from U.S. Bank of \$5.0 million at September 30, 2002 with no funds drawn on this line of credit. This line of credit as well as a \$25.0 million term note are secured by a majority of the Common and Preferred Stock of Sterling Savings Bank. See Note 3 of "Notes to Consolidated Financial Statements."

At September 30, 2002 and December 31, 2001, Sterling had investments of \$106.2 million in the Common Stock and \$110.1 million in the Preferred Stock of Sterling Savings Bank. Sterling received cash dividends on Sterling Savings Bank Preferred Stock of \$8.7 million during the nine months ended September 30, 2002. These resources were sufficient to meet the operating needs of Sterling, including interest expense on its long-term debt. Sterling Savings Bank's ability to pay dividends is limited by its earnings, financial condition and capital requirements, as well as rules and regulations imposed by the OTS. See Note 3 of "Notes to Consolidated Financial Statements."

OTS regulations require savings institutions such as Sterling Savings Bank to maintain sufficient liquidity to ensure safe and sound operations. At September 30, 2002 and December 31, 2001, Sterling Savings Bank's liquidity ratio was 3.3% and 3.6%, respectively. Sterling Savings Bank's strategy generally is to maintain its liquidity ratio at or near the level necessary to support expected and potential loan fundings and deposit withdrawals. Sterling Savings Bank tries to minimize liquidity levels in order to maximize its yield on alternative investments. The regulatory liquidity ratio does not take into account certain other sources of liquidity, such as funds invested through Sterling Savings Bank subsidiaries, potential borrowings against investments and ABS and other potential financing alternatives. The required minimum liquidity ratio may vary from time to time, depending on economic conditions, savings flows and loan funding needs.

### **Capital Resources**

Sterling's total shareholders' equity was \$196.5 million at September 30, 2002 compared with \$165.7 million at December 31, 2001. The increase in total shareholders' equity was primarily due to the increase in net income and the conversion of outstanding debentures to common equity. Shareholders' equity was 5.9% of total assets at September 30, 2002 compared with 5.5% at December 31, 2001.

At September 30, 2002, Sterling had an unrealized gain of \$3.9 million, net of related income taxes, on investments and ABS classified as available for sale. At December 31, 2001, Sterling had an unrealized loss of \$4.6 million, net of related income taxes, on investments and ABS classified as available for sale. Fluctuations in prevailing interest rates continue to cause volatility in this component of accumulated comprehensive income or loss in shareholders' equity and may continue to do so in future periods.

## Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

Sterling has outstanding \$30.0 million of Floating Rate Notes Due 2006. The notes mature in 2006 and may be redeemed subject to certain conditions. These notes are general unsecured obligations of Sterling and are subordinate to certain other existing and future indebtedness. The indenture governing the notes limits the ability of Sterling under certain circumstances to incur additional indebtedness, to pay cash dividends or to make other capital distributions. See Note 3 of "Notes to Consolidated Financial Statements."

Sterling has issued and outstanding \$40.0 million of Trust-I Preferred Securities. The indenture governing the Trust-I Preferred Securities limits the ability of Sterling under certain circumstances to pay dividends or to make other capital distributions. The Trust-I Preferred Securities are treated as debt of Sterling. The Trust-I Preferred Securities mature in 2027 and are redeemable at the option of Sterling under certain conditions. See Note 3 of "Notes to Consolidated Financial Statements."

24

---

Sterling has issued and outstanding \$24.0 million of Trust-II Preferred Securities. The indenture contains the same limitations as the indenture governing the Trust-I Securities. The Trust-II Securities are treated as debt of Sterling. The Trust-II Securities mature in 2031 and are redeemable under certain conditions.

Sterling anticipates total capital expenditures of approximately \$5.6 million for the remainder of the year ending December 31, 2002. Sterling anticipates continuing to fund these expenditures from various sources, including retained earnings and borrowings with various maturities. Sterling continually explores opportunities to sell certain developed properties and enter into lease arrangements. There can be no assurance that Sterling's estimates of capital expenditures or the funding thereof are accurate.

Sterling Savings Bank is required by applicable regulations to maintain certain minimum capital levels with respect to core (Tier 1) capital, core (Tier 1) risk-based capital and total risk-based capital. Sterling Savings Bank anticipates that it will continue to enhance its capital resources and regulatory capital ratios through the retention of earnings and the management of the level and mix of assets, although there can be no assurance in this regard. At September 30, 2002, Sterling Savings Bank exceeded all such regulatory capital requirements for well-capitalized institutions.

### **Goodwill Litigation**

In connection with Sterling Savings Bank's acquisition of three insolvent savings institutions between 1985 and 1988, the U.S. government agreed that Sterling could use \$13.5 million of cash assistance and \$38.0 million of "supervisory goodwill" associated with the acquisitions to help meet its regulatory capital and liquidity requirements. In 1989, Congress enacted FIRREA which provided, among other things, that savings institutions such as Sterling Savings Bank were no longer permitted to include supervisory goodwill in their regulatory capital. Consequently, Sterling Savings Bank was required to discontinue use of its supervisory goodwill in calculating its capital ratios, which resulted in Sterling Savings Bank's failing to comply with its minimum regulatory capital requirements from 1989 through 1991.

In May 1990, Sterling sued the U.S. Government with respect to the loss of the goodwill treatment and other matters relating to Sterling's past acquisitions of troubled thrift institutions (the "Goodwill Litigation"). In the Goodwill Litigation, Sterling seeks damages for, among other things, breach of contract and for deprivation of property without just compensation.

On September 12, 2002, the U.S. Court of Federal Claims granted Sterling Savings Bank's motion for summary judgment as to liability, holding that the United States government owed contractual obligations to Sterling with respect to its acquisition of three failing regional thrifts during the 1980's and had breached its contracts with Sterling. It is anticipated that the Court will now establish a date to determine the amount of damages to Sterling, which is likely to be in 2003. The outcome of the Goodwill Litigation cannot be predicted with certainty.

Sterling's Goodwill Litigation, which had been stayed for almost ten years, has proceeded through the fact discovery phase. Recently, the expert witness discovery phase of the case commenced. During this phase, Sterling will present to the Court of Federal Claims Sterling's experts' damages calculations. Although it is impossible to accurately predict when this effort will be concluded, management anticipates that the expert witness discovery stage will be completed by the end of 2002. Because of the effort required to bring the case to conclusion, Sterling likely will continue to incur legal expenses at recent levels over the next one to two years.

25

---

### **New Accounting Policies**



In June 2001, the Financial Accounting Standards Board approved for issuance Statement of Financial Accounting Standards No. 143 ("SFAS No. 143"), "Accounting for Asset Retirement Obligations," which addresses the accounting for legal obligations associated with the retirement of tangible long-lived assets. Under SFAS No. 143, the fair value of a liability for an asset retirement obligation shall be recognized in the period in which the obligation is incurred. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002, with early adoption permitted. Sterling is currently analyzing the financial impact that the adoption of SFAS No. 143 will have on its consolidated financial statements. Sterling will adopt SFAS No. 143 on or before January 2003. Sterling anticipates that the adoption of SFAS No. 143 will have no material effect on operations.

In August 2001, the FASB approved for issuance Statement of Financial Accounting Standards No. 144 ("SFAS No. 144"), "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 was issued to resolve implementation issues that had been created under Statement of Financial Accounting Standards No. 121. Under SFAS No. 144, one accounting model is required to be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired, and certain additional disclosures are required. The adoption of SFAS No. 144 on January 1, 2002 did not have a material effect on Sterling's consolidated financial statements.

In April 2002, the FASB issued Statement of Financial Accounting Standards No. 145 ("SFAS No. 145"), "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 145 updates, clarifies and simplifies existing accounting pronouncements, by rescinding SFAS No. 4, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. As a result, the criteria in Accounting Principles Board Opinion No. 30 will now be used to classify those gains and losses. Additionally, SFAS No. 145 amends SFAS No. 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. Finally, SFAS No. 145 also makes technical corrections to existing pronouncements. The adoption of SFAS No. 145 did not have a material impact on Sterling's consolidated financial statements.

In July 2002, the FASB issued Statement of Financial Accounting Standards No. 146 ("SFAS No. 146"), "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by the standard include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity. SFAS No. 146 replaces the prior guidance that was provided by EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS No. 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002.

In October 2002, the FASB issued Statement of Financial Accounting Standards No. 147 ("SFAS No. 147"), "Acquisitions of Certain Financial Institutions," an amendment of FASB Statements No. 72 and No. 144 and FASB Interpretation No. 9. SFAS No. 147 amends SFAS No. 144 to include in its scope long-term customer-relationship intangible assets of financial institutions such as depositor- and borrower-relationship intangible assets and credit cardholder intangible assets. SFAS No. 147 also removes acquisitions of financial institutions from the scope of both Statement No. 72 and Interpretation No. 9. As a result, the excess of the fair values of liabilities assumed over the fair value of tangible and identifiable intangible assets acquired in a business combination represents goodwill that should be accounted for under SFAS No. 142. SFAS No. 147 will be applied prospectively to future business combinations.

---

## Regulation and Compliance

Sterling is subject to many laws and regulations applicable to banking activities. As a thrift holding company, Sterling is subject to comprehensive examination and regulation by the OTS. Sterling Savings Bank, as a Washington State-chartered savings association, is subject to comprehensive regulation and examination by the Washington Supervisor as its chartering authority, the OTS as its primary federal regulator, and by the FDIC, which administers the Savings Association Insurance Fund, which insures Sterling Savings Bank's deposits to the maximum extent permitted by law. Sterling Savings Bank is a member of FHLB Seattle, which is one of the twelve regional banks which comprise the FHLB System. Sterling Savings Bank is further subject to regulations of the Board of Governors of the Federal Reserve System governing reserves required to be maintained against deposits and certain other matters.

In July 2002, the Sarbanes-Oxley Act of 2002 (the "SOA") was enacted. The SOA overhauls corporate governance and auditing rules with the intent of protecting investors by improving the accuracy and reliability of corporate disclosures. The SOA, among other things, demands greater independence of audit functions and requires the principal executive officer and principal financial officer of public companies to evaluate the effectiveness of their company's disclosure controls and procedures. The officers must present their conclusions about the effectiveness of such controls and procedures and certify their evaluation of their company's controls and procedures as well as the financial statements filed with the SEC. The SOA also requires enhanced financial disclosures regarding off-balance sheet transactions and relationships, generally prohibits a corporation from making loans to corporate executives and reduces the mandatory period for principal stockholders or senior executives to disclose changes in ownership of securities.

**Item 3 Quantitative and Qualitative Disclosures About Market Risk**

For a discussion of Sterling's market risks, see "Management's Discussion and Analysis Asset and Liability Management."

**Item 4 Disclosure Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures.**

Sterling's principal executive officer and principal financial officer are responsible for establishing and maintaining disclosure controls and procedures for Sterling. Such disclosure controls and procedures are designed to ensure that material information relating to Sterling and its consolidated subsidiaries are made known to the officers who must certify that they have evaluated the effectiveness of the disclosure controls and procedures within ninety days prior to the filing of the quarterly report. Sterling's certifying officers have concluded that as of September 30, 2002, the material information they use in evaluating Sterling's performance and operations has been effectively provided by Sterling's disclosure controls and procedures.

**Changes in Internal Controls.**

There have not been any significant changes in Sterling's internal controls or in other factors that could significantly affect these controls subsequent to the date of the certifying officers' evaluation. The certifying officers are not aware of any significant deficiencies or material weaknesses, therefore no corrective actions were taken.

27

---

**PART II Other Information**

**Item 1 Legal Proceedings**

Periodically various claims and lawsuits are brought against Sterling and its subsidiaries, such as claims to enforce liens, condemnation proceedings involving properties on which Sterling holds security interests, claims involving the making and servicing of real property loans and other issues incidental to Sterling's business. No material loss is expected from any of such pending claims or lawsuits.

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

Not applicable.

**Item 3 Defaults Upon Senior Securities**

Not applicable.

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

Not applicable.

**Item 5 Other Information**

Not applicable.

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

(a)

Exhibit No.	Exhibit
3.1	Restated Articles of Incorporation of Registrant and Articles of Amendment of Restated Articles of Incorporation. Filed as Exhibits 3.1 and 3.2, respectively, to Registrant's Form S-4 dated November 7, 1994 and incorporated by reference herein.
3.2	Copy of Bylaws of Registrant (amended and restated as of May 24, 1999). Filed as Exhibit 3.3 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1999 and incorporated by reference herein.
4.1	Reference is made to Exhibits 3.1 through 3.3.
4.2	The Registrant has outstanding certain long-term debt. None of such debt exceeds ten percent of Registrant's total assets; therefore, copies of the constituent instruments defining the rights of the holders of such debt are not included as exhibits. Copies of instruments with respect to such long-term debt will be furnished to the Securities and Exchange Commission upon request.
10.1	Agreement and Plan of Merger between Sterling Financial Corporation and Empire Federal Bancorp, Inc.
99.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350.
99.2	Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350.

(b)

Reports on Form 8-K. During the quarter ended September 30, 2002, there was one report filed on Form 8-K on September 19, 2002.

28

**Signatures**

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

**STERLING FINANCIAL CORPORATION**  
(Registrant)

November 13, 2002

Date

By: /s/ DANIEL G. BYRNE

**Daniel G. Byrne**  
Senior Vice President Finance, Assistant Secretary,  
and Principal Financial Officer

November 13, 2002

Date

By: /s/ WILLIAM R. BASOM

**William R. Basom**  
Vice President, Treasurer, and

---

**Certifications**

I, Harold B. Gilkey, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Sterling Financial Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: November 13, 2002

/s/ HAROLD B. GILKEY

---

---

I, Daniel G. Byrne, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Sterling Financial Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: November 13, 2002

/s/ DANIEL G. BYRNE

---

**Daniel G. Byrne**

*Senior Vice President Finance, Assistant Secretary,  
and Principal Financial Officer*

QuickLinks

TABLE OF CONTENTS

PART I Financial Information

Item 1 Financial Statements

STERLING FINANCIAL CORPORATION Consolidated Balance Sheets (Unaudited)

STERLING FINANCIAL CORPORATION Consolidated Statements of Income (Unaudited)

STERLING FINANCIAL CORPORATION Consolidated Statements of Cash Flows (Unaudited)

STERLING FINANCIAL CORPORATION Consolidated Statements of Cash Flows (continued) (Unaudited)

STERLING FINANCIAL CORPORATION Consolidated Statements of Comprehensive Income (Unaudited)

STERLING FINANCIAL CORPORATION Notes to Consolidated Financial Statements

Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operation

Item 3 Quantitative and Qualitative Disclosures About Market Risk

Item 4 Disclosure Controls and Procedures

PART II Other Information

Item 1 Legal Proceedings

Item 2 Changes in Securities and Use of Proceeds

Item 3 Defaults Upon Senior Securities

Item 4 Submission of Matters to a Vote of Security Holders

Item 5 Other Information

Item 6 Exhibits and Reports on Form 8-K

Signatures