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Member F.D.I.C. And The Human Race.

3/3/87

Consolidated Financial Highlights

Peoples Bancorporation and Subsidiaries

(In Thousands, Except Per Share)

1986

1985

1984

For the Year

Net income (loss)	\$(1,768)	\$14,267	\$15,077
Cash dividends declared	3,805	3,776	3,772

Per Share

Net income (loss)	\$ (.46)	\$ 3.78	\$ 4.00
Cash dividends declared	1.00	1.00	1.00
Book value	35.49	36.96	34.19

At Year-End

Assets	\$2,437,914	\$2,380,341	\$2,173,333
Loans	1,626,549	1,566,543	1,395,484
Deposits	2,102,619	1,993,990	1,786,551
Shareholders' equity	135,162	139,750	128,889

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With PeoplesBank's support, many of our business customers have grown into successful enterprises, such as Molbak's, Inc. of Woodinville, Washington, which has been a longtime PeoplesBank customer.

Letter to Shareholders



A year ago, I reported to you that Peoples was making significant pro-

gress in becoming a major corporate banking competitor in the Pacific Northwest, with emphasis on Washington's middle-market

companies. We have experienced substantial growth in business loans, growth that we believe is consistent with an effective long-term strategy for the bank. Throughout this period, we have continued to emphasize loan quality. Nevertheless, substantial loan charge-offs and additions to the reserve for bad debts resulted in a net loss for 1986 of \$1.8 million. The loan losses occurred for two reasons: 1) failure within the bank to adhere to established credit policy in certain specialized departments, and 2) economic conditions in certain regional industries. As the severity of our loan quality problems increased, we began an intensive evaluation of

all the commercial loans in our bank and an equally intensive analysis of all of our credit processes.

Based on all the information these efforts have generated to date, I believe that we have recognized and conservatively reserved for our credit problems. In addition, we have retained an independent consulting firm, Furash & Company of Washington, D.C., to assist management in assuring that we have identified all of our credit problems and that our credit systems are effective and up-to-date. Their final report is due before the end of the first quarter.

Like many other PeoplesBank managers, Gayle Ebler, Vice President, who manages seven banking offices in the Yakima area, lives in the community to better understand and respond to the individual needs of our customers.



Apples are one of the many agricultural products that PeoplesBank will continue to support and finance in the coming year.



Thirty-nine of PeoplesBank's 75 offices are in the Greater Seattle area, which is one of the strongest growth areas in Washington.

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e are very determined, through all of these efforts, to prevent a recurrence of the problems we experienced in 1986.

Other than in the credit area, a tremendous amount of progress has been made in strengthening our earnings potential this year. We anticipate 1987 should set record earnings for the bank.

Early in 1986, we announced the appointment of David E. Thatcher as the new president of Peoples Mortgage Company. Under Mr. Thatcher's leadership, the mortgage company is focus-

ing on the Washington State market. Serving PeoplesBank's customers and cross-selling PeoplesBank's services to mortgage customers has become a primary effort. Residential loans booked grew from \$143 million in 1985 to \$278 million in 1986. Commercial transactions grew from \$25 million to \$102 million and net earnings increased 123% to \$1.4 million. With a significant number of loans already in process, we are optimistic that 1987 will show additional improvement on 1986's earnings.

Our Trust Department has also enjoyed record earnings. Its staff, which includes 36 officers with an average

length of service of 14 years, has booked \$150 million of new business in 1986 as compared to \$64 million in 1985. Total Trust assets expanded from \$1.2 billion in 1985 to \$1.4 billion in 1986 and net department earnings increased 71%.

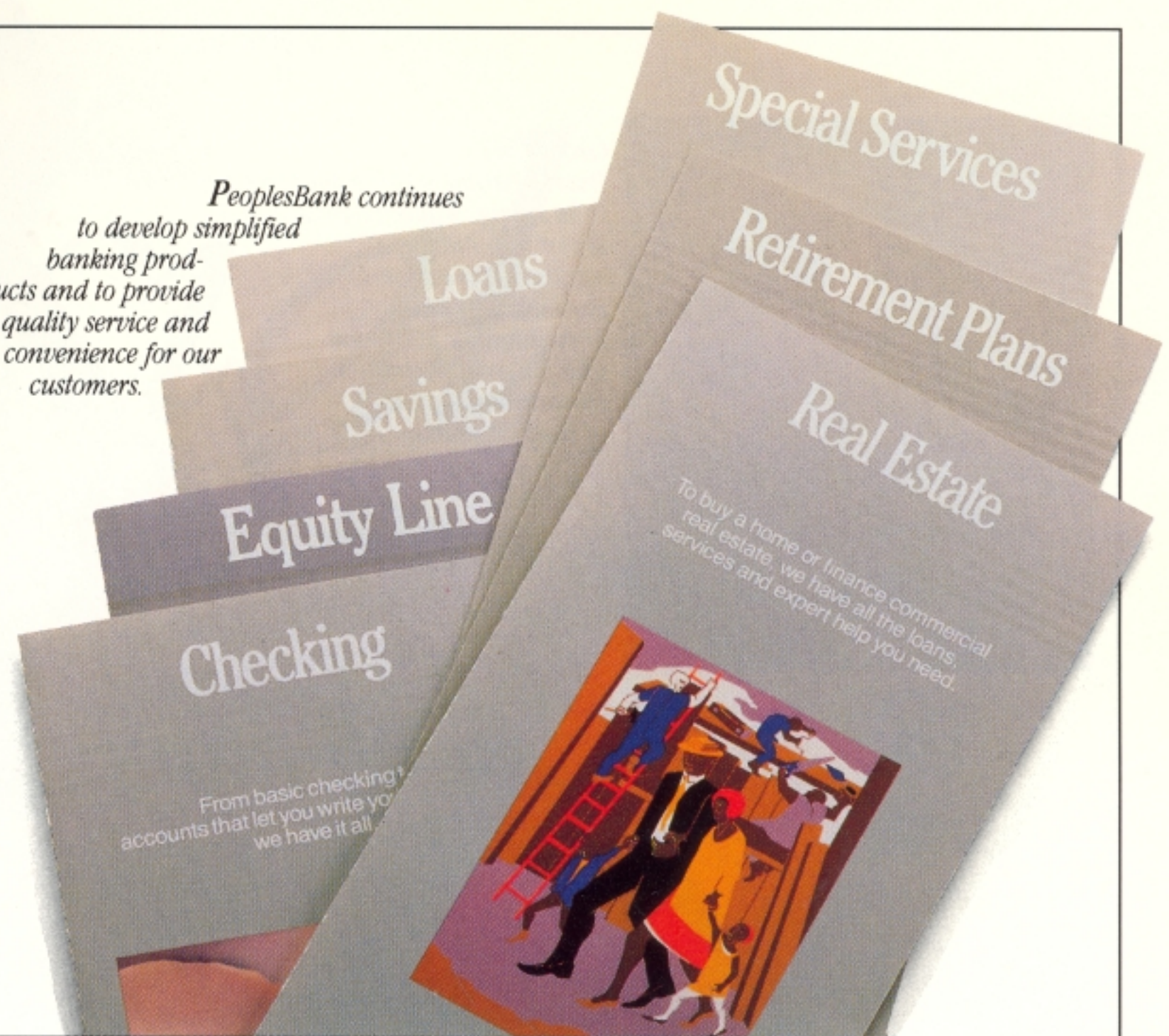
Our Operations Department has undergone a major philosophical change this year. Recognizing the difficulty in matching the innovations of all of our financial services competitors, we have decided to make sure that we are operating as efficiently and error free as



Ken Kirkpatrick, Vice President, manages one of several Financial Centers in the state which provide specialized banking services for our corporate middle market customers.

PeoplesBank has successfully established nine Business Banking Centers staffed with specialists to meet the credit and other financial service needs of our small business customers.

PeoplesBank continues to develop simplified banking products and to provide quality service and convenience for our customers.



possible by only offering those services truly in demand by our customers. Our 1987 budget for operations has been reduced by more than \$2 million from 1986 actual costs.

Perhaps the most dramatic change in our bank this year was in our branches. For many years, PeoplesBank has made significant profits by offering personalized services to its customers in many small offices throughout the state. With high loan rates and low costs of savings, this approach was highly profitable. With changes in the state's branch banking laws permitting any Washington State bank to branch anywhere in the state and with deregulation permitting us to

pay competitive interest on our deposits, our philosophies necessarily changed. It no longer makes sense to retain an office in a small community where we have no hope of making profits in the foreseeable future. Now, as a community grows, we are always able to start a branch. Recognizing these changes, we analyzed each branch and each group of branches for its immediate and long-term potential to the bank. As a result of this analysis, we closed two of our six offices in the Tri-Cities, three of our ten offices in the Yakima area, our Soap Lake and Mattawa offices, our 19th & Mildred and 6th Avenue

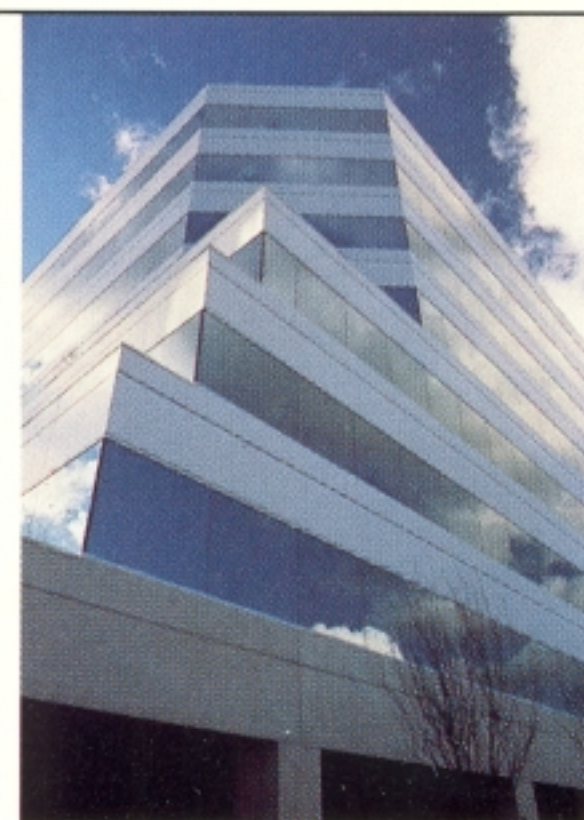
offices in Tacoma and our Hadlock office on the Olympic Peninsula. We are very proud that thanks to the loyalty of our customers, the salesmanship of our staff and the efficiency of electronic banking, we have been able to retain more than 80% of the deposits of all of these offices and more than 90% of the deposits of several. In addition, we have agreed to sell all four of our Clark County offices to First Interstate Bank of Washington. This transaction is expected to be completed in February of 1987. In January we announced the closure of our SeaTac Mall banking office. Our Federal Way office is located only seven blocks away and we anticipate that

we will be able to retain most of the deposits of this unprofitable office.

Our Issaquah office celebrated its first anniversary in September this year with deposits approximately 33% ahead of expectations and our new Lynnwood office, located two blocks from our outgrown existing facility, is scheduled to open this February. These dramatic changes in our branch system have been painful for those of us who worked so hard to build some of the offices we are now closing.



Growth in earnings for the Trust Department continued to be strong. Walter Bagnall, Senior Vice President, attributes this success to hard working and knowledgeable employees who focus on meeting the individual needs of our customers.



Peoples Mortgage Company enjoyed a record year in earnings. PMC concentrates on financing projects in the Northwest ranging in size from affordable housing to projects such as the new Boeing Aerospace Center pictured above.

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owever, we are committed to entering 1987 as a restructured bank capable of meeting existing competition and with a strong earnings capability. 1986 has been a hectic and disappointing year, but I am convinced we have met our objective of entering 1987 with a strong institution.

In order to reassign the duties of our past president Mr. Cairns, who resigned last December, and in contemplation of the retire-

ment of Elmer Anderson, who retired in October after 45 years of service, the following senior management changes took place in April: Thomas G. Andrew, Jr. was promoted to Executive Vice President of retail banking and was appointed to membership on the Administrative Committee, Daniel J. Doyle was made Executive Vice President of corporate banking and a member of the Administrative Committee, L. Michael Riley was promoted

to Vice Chairman of Peoples Bancorporation and Charles E. Riley was promoted to Vice Chairman of PeoplesBank.

Our shareholders' and directors' support during this time of rapid change and unsatisfactory earnings announcements has been deeply appreciated and we believe that your faithfulness will be rewarded with a strong earnings performance in 1987.

*Joshua Green III
Chairman of the Board, Chief Executive Officer and President, Peoples Bancorporation and PeoplesBank*

Financial Review

Peoples Bancorporation reported a net loss in 1986 of \$1.8 million. This compared to net income of \$14.3 million in 1985 and \$15.1 million in 1984.

1986 earnings were severely impacted by a record high level of loan losses. Net charge-offs for the year totaled \$32.5 million compared to \$7.9 million in 1985. In addition, the reserve for loan losses was increased by \$10.3 million, to 1.79% of loans outstanding at year-end. The increase in loan losses stemmed primarily from the bank's commercial loan portfolio. Management has taken numerous steps to strengthen credit controls and improve loan quality.

While loan losses had the most visible impact on earnings, our 1986 performance included a number of very positive factors:

- Emphasis on consolidating operations and increasing productivity resulted in an increase in noninterest expenses of only 1.2%. As a result, our ratio of noninterest expenses to earning assets decreased from 6.1% in 1985 to 5.9% in 1986.

- Through careful asset/liability management and growth in earning assets, the corporation increased net interest income by 3.2%. A decrease in interest rates normally reduces our net interest margin because of our interest sensitivity position. Net interest income as a percent of average earning

assets decreased only 8 basis points in 1986, despite a significant decline in interest rates.

- Noninterest income decreased 2.4% in comparison to 1985. However, when 1985 results are adjusted to exclude gains on the sale of bank premises and loan servicing, 1986 noninterest income was 5.1% above 1985.

- Average deposits increased 5.7% in 1986, reaching over \$2 billion by year-end. Loans increased 8.8% and total assets were up 4.2%. Despite a decrease in period-end shareholders' equity, the corporation's ratio of primary capital to total assets

was 6.66% at December 31, 1986, well above the minimum regulatory requirements.

- Our mortgage subsidiary, Peoples Mortgage Company, reported an increase in earnings of 123%, from \$.6 million in 1985 to \$1.4 million in 1986. Loan originations more than doubled, totaling over \$380 million in 1986.

The following pages provide a more detailed discussion and analysis of the corporation's financial condition and results of operations in 1986.

Selected Financial Data

(In Thousands, Except Per Share)	1986	1985	1984	1983	1982	Change 86/85	
						\$	%
Earnings Summary							
Net interest income	\$ 96,469	\$ 93,463	\$ 88,117	\$ 74,429	\$80,177	\$ 3,006	3.2 %
Provision for loan losses	42,847	11,650	8,901	6,099	5,684	31,197	267.8
Noninterest income	47,244	48,398	44,518	37,452	33,986	(1,154)	(2.4)
Noninterest expense	114,832	113,500	105,642	102,477	92,465	1,332	1.2
Net income (loss)	(1,768)	14,267	15,077	6,032	13,423	(16,035)	(112.4)
Per Share							
Net income (loss):							
Primary	\$ (.46)	\$ 3.78	\$ 4.00	\$ 1.59	\$ 3.51	\$(4.24)	(112.2)%
Fully diluted	(.46)	3.76	3.81	1.56	3.33	(4.22)	(112.2)
Cash dividends declared	1.00	1.00	1.00	1.00	1.00	—	—
Book value	35.49	36.96	34.19	31.17	30.44	(1.47)	(4.0)
Balance Sheet Averages							
Total assets	\$2,291,729	\$2,198,374	\$2,063,096	\$2,046,031	\$1,841,848	\$ 93,355	4.2 %
Loans	1,625,866	1,494,565	1,245,157	1,066,155	979,971	131,301	8.8
Deposits	1,936,512	1,832,538	1,689,086	1,626,013	1,372,593	103,974	5.7
Long-term debt	7,914	9,234	20,650	21,502	18,906	(1,320)	(14.3)
Shareholders' equity	142,375	134,986	122,606	116,049	112,286	7,389	5.5
Key Ratios							
Return on average assets	(.08)%	.65%	.73%	.29%	.73%		
Return on average equity	(1.24)	10.57	12.30	5.20	11.95		
Average equity to average assets	6.21	6.14	5.94	5.67	6.10		
Average loans to average deposits	83.96	81.56	73.72	65.57	71.40		
Cash dividends declared divided by primary net income (loss) per share	(217.39)	26.46	25.00	62.89	28.49		

Net Interest Income

Net interest income increased \$3.0 million or 3.2% in 1986. On a fully taxable equivalent basis, the increase was \$3.8 million or 3.7%. This compares to growth of 5.8% in 1985 and 17.1% in 1984.

Growth in the volume of average assets and liabilities increased net interest income by \$9.4 million. A \$97.4 million increase in average earning assets increased interest income by \$12.7 million, while a \$56.5 million increase in interest bearing liabilities added \$3.3 million to interest expense. The remaining \$40.9 million increase in earning assets was funded by growth in noninterest bearing deposits.

While changes in volume increased net interest income by \$9.4 million, changes in rate reduced net interest income by \$5.6 million. During 1986, interest rates declined significantly as evidenced by a 200 basis point decrease in the average National Prime Lending Rate. The lower rate environment resulted in decreases in the rates earned and paid on interest sensitive assets and liabilities. Because the volume of the corporation's interest sensitive assets exceeded the volume of its interest sensitive liabilities, these changes had more of an impact on interest income than interest expense. Inter-

est income decreased \$22.3 million due to changes in rate, while interest expense decreased only \$16.7 million. As a result, the net interest margin decreased from 5.46% of average earning assets in 1985 to 5.38% of average earning assets in 1986.

The impact of changes in rates was less than that experienced in 1985, despite a sharper decline in interest rates. The total increase in net interest income was \$1.8 million more in 1985 than 1986, due to stronger growth in earning assets. The 17.1% increase in net interest income in 1984 reflected growth in earning assets and rising rates.

Noninterest Income

Noninterest income decreased \$1.2 million or 2.4% in comparison to the prior year. However, it should be noted that 1985 included a \$1.4 million gain on the sale of bank premises and \$2.6 million of profits on the sale of mortgage loan servicing. No major sales of premises or loan servicing occurred in 1986. Excluding these gains, noninterest income increased \$2.3 million or 5.1% in 1986, following increases of 8.7% in 1985 and 18.9% in 1984. (1984 included \$3.2 million of unusual gains.)

During 1986, significant growth occurred in trust income, service charges on deposit accounts, fees from investment services and gains on the sale of loans.

Trust fees and commissions showed particularly strong growth, up \$1.4 million or 22.6%. This follows an increase of 10.5% in 1985.

Service charges on deposit accounts increased \$1.0 million or 7.4% in 1986, due to growth in deposit volumes and new fee structures.

Noninterest Income

Year Ended December 31 (In Thousands)	1986	1985	1984	Change 86/85	
				\$	%
Trust fees and commissions	\$ 7,429	\$ 6,058	\$ 5,483	\$ 1,371	22.6 %
Service charges on deposit accounts	14,208	13,232	13,041	976	7.4
Loan servicing fees	4,784	5,154	5,592	(370)	(7.2)
Service charges on credit card services	4,818	4,928	4,323	(110)	(2.2)
Service charges on computer services	2,853	2,990	4,255	(137)	(4.6)
Gains on sale of loan servicing	330	2,649	1,773	(2,319)	(87.5)
Gains on sale of bank premises and equipment	258	1,364	1,472	(1,106)	(81.1)
Securities gains	742	629	10	113	18.0
Trading account profits	1,596	1,723	1,556	(127)	(7.4)
Other	10,226	9,671	7,013	555	5.7
<i>Total</i>	<i>\$47,244</i>	<i>\$48,398</i>	<i>\$44,518</i>	<i>\$(1,154)</i>	<i>(2.4)%</i>

Noninterest Expense

Year Ended December 31 (In Thousands)	1986	1985	1984	Change 86/85	
				\$	%
Salaries	\$ 50,714	\$ 49,075	\$ 43,989	\$1,639	3.3%
Employee benefits	10,845	10,272	9,984	573	5.6
Occupancy	7,752	7,641	6,550	111	1.5
Furniture and equipment	9,393	10,112	11,092	(719)	(7.1)
Professional and other fees	8,301	7,700	6,627	601	7.8
Stationery and supplies	2,551	3,004	2,524	(453)	(15.1)
State and local taxes	4,463	4,331	3,961	132	3.0
Other real estate owned	2,433	3,215	2,812	(782)	(24.3)
Marketing	1,753	2,500	2,173	(747)	(29.9)
Telecommunications	2,751	2,395	2,744	356	14.9
Other	13,876	13,255	13,186	621	4.7
<i>Total</i>	<i>\$114,832</i>	<i>\$113,500</i>	<i>\$105,642</i>	<i>\$1,332</i>	<i>1.2%</i>

Noninterest Expense

As a retail-oriented institution, Peoples Bancorporation has historically had a comparatively high ratio of noninterest expenses to earning assets. With the advent of deregulation and the subsequent increase in our cost of funds, we have strived to improve our profitability by decreasing the level of noninterest expenses relative to our earning asset base.

In 1986, noninterest expenses were held at virtually the same level as in the previous year, increasing only \$1.3 million or 1.2%. This follows increases of 7.4% in 1985 and 3.1% in 1984. The ratio of noninterest expenses to earning assets has decreased from 6.3% in 1982 to 5.9% in 1986.

Fees from investment services increased 11.6%, from \$1.8 million in 1985 to \$2.0 million in 1986.

Additional noninterest income was also generated by gains on sales of real estate loans, which totaled \$1.6 million in 1986 compared to \$.8 million in 1985. (Fees from investment services and gains on sales of loans are included in the category titled "Other" in the schedule below.)

The corporation will continue to seek growth in noninterest income through the development of new fee-generating services, and the review of pricing for existing products and services.

During 1986, we consolidated operations in our branch network as well as in several other areas of the bank. As a result, the number of full time equivalent employees decreased from 2,244 at December 31, 1985 to 2,058 at December 31, 1986. Salary and benefit expense increased \$2.2 million or 3.7% in 1986, primarily due to merit increases. This follows an increase of \$5.4 million or 10.0% in 1985. Growth in salaries and benefits was only 2.4% in 1984, due to the reorganization of our lending functions during the previous year.

Occupancy expense increased \$.1 million or 1.5% in 1986, compared to an increase of \$1.1 million or 16.7% in 1985. 1985 expenses

included an unusually high amount of charges related to repair and upkeep of branch facilities.

Furniture and equipment costs decreased \$.7 million or 7.1% in 1986. This follows a decline of \$1.0 million or 8.8% in 1985. During the last two years, we have been able to reduce computer equipment costs while maintaining the same level of data processing and management information services.

Other noninterest expenses decreased a total of \$.3 million or .7% in 1986. Increases in fees, state and local taxes, and telecommunications expenses were offset by decreases in charges related to other real estate owned, stationery, supplies and marketing. In comparison, other noninterest expenses were up \$2.4 million or 7.0% in 1985, with increases in nearly all major categories.

Income Taxes

The corporation recorded an income tax benefit of \$12.2 million in 1986, which represented 87.3% of pretax loss. The income tax benefit at the statutory rate of 46% would have been \$6.4 million. The difference between this amount and the actual tax benefit of \$12.2 million was due to the \$4.1 million tax effect of tax-exempt income, investment tax credits of \$.7 million and a \$1.0 million refund of previously disallowed investment tax credits.

During the year, the Tax Reform Act of 1986 was passed into law. Certain provisions of the Act may have a significant impact on the corporation's future earnings performance. The statutory rate applied to taxable income will be reduced from 46% in 1986 to 40% in 1987 and 34% for subsequent years.

The investment tax credit was repealed under the Act for items acquired after 1985. The corporation realized \$.2 million of investment tax credits on purchases made in 1986, however, relating to items for which binding contracts existed at the end of 1985. The 1986 tax provision was also reduced by the amortization of \$.5 million of investment tax credits whose recognition had been deferred from prior years. The loss of the investment tax credit should have little or no impact on future investment in premises and equipment, since such items are generally not acquired for their tax benefits. This may lead to an increase in the level of activity in the equipment leasing area, however, since the loss of the tax benefits of equipment purchases may make leasing relatively more attractive to customers.

The Act also reduced the tax benefit realized on tax-exempt loans and securities acquired after 1986. This could significantly curtail our investment in such assets. In addition, computation of the alternative minimum tax was altered to effectively include a provision to tax interest income from tax-exempt assets. This may result in an increase in tax expense in years of relatively low income.

Beginning in 1987, Peoples Bancorporation will be required, for tax purposes, to use the specific charge-off method of accounting for bad debts. This does not represent a change because the corporation was using the charge-off method for the previous four years. Prior to that time, however, the corporation had used the reserve method. The bad debt reserve accumulated under the reserve method must be recaptured over the four year period beginning in 1987.

Beginning in 1987, the deduction for personal interest will be reduced and eventually eliminated. Interest on mortgages secured by personal and secondary residences will continue to be deductible. Accordingly, we expect that consumer loan activity will decrease, and that this decrease will be partially offset by increased activity in second mortgage lending.

Uses and Sources of Funds

The following discussion of uses and sources of funds is based on year-to-date average balances (unless otherwise indicated) which are generally more meaningful for comparative purposes than December 31 balances.

Uses of Funds

Average earning assets increased \$97.4 million or 5.3% in 1986, following an increase of 9.4% in 1985.

During 1985 and 1984, growth in earning assets was focused primarily on commercial loans, which increased approximately 30% in each of these two years. The increase in average commercial loans slowed to \$83.5 million or 9.5% in 1986, following this period of record growth.

Growth in consumer loans continued to be relatively strong, however, with average volumes increasing \$46.4 million or 14.7%. This follows an increase of \$51.4 million or 19.4% in 1985.

Although our mortgage subsidiary reported a record number of loan originations in 1986, average real estate loan volumes did not change significantly due to the resale of these loans to outside investors.

Total average loans were up \$131.3 million in comparison to 1985, increasing from 80.7% to 83.4% of total earning assets.

As indicated in the chart on page 9, total loans outstanding at year-end were \$1.627 billion compared to \$1.567 billion at the end of 1985. At year-end 1986, the balance of commercial loans was \$26.5 million below the figure for year-end 1985, reflecting both the impact of charge-offs and a significant slowdown in growth during fourth quarter 1986. Although average real estate loan volumes showed little change from 1985, year-end balances were up \$31.8 million.

Increases in loans during 1986 were funded partially by reductions in investment securities and trading account assets. Investment securities decreased \$31.0 million or 16.1% and trading account assets were down \$15.0 million or 42.9%.

Investment Portfolio (Book Value)

<i>December 31 (In Thousands)</i>	<i>1986</i>	<i>1985</i>	<i>1984</i>
U.S. Treasury and other U.S.			
Government agencies and corporations	\$107,773	\$125,169	\$223,060
State and political subdivisions	43,223	54,193	67,477
Other taxable securities	2,162	2,545	2,333
<i>Total</i>	<u>\$153,158</u>	<u>\$181,907</u>	<u>\$292,870</u>

Loan Portfolio by Purpose

December 31 (In Thousands)	1986	1985	1984	1983	1982
Commercial, financial and agricultural	\$ 922,162	\$ 948,617	\$ 785,488	\$ 547,436	\$ 507,868
Real estate construction	44,280	29,977	32,892	32,815	21,332
Real estate mortgage	236,786	219,263	251,523	238,783	270,378
Consumer	393,635	339,344	296,775	240,921	239,728
Lease financing	35,019	36,283	37,095	30,656	34,704
Less unearned income	(5,333)	(6,941)	(8,289)	(7,979)	(9,820)
Total	\$1,626,549	\$1,566,543	\$1,395,484	\$1,082,632	\$1,064,190

Sources of Funds

Year-to-date average deposits increased \$104.0 million or 5.7% in 1986. This follows growth of \$143.5 million or 8.5% in 1985. At year-end, total deposits were \$2.103 billion compared to \$1.994 billion at year-end 1985.

With the decline in interest rates, the marginal benefit of holding funds in term deposits decreased in 1986, and depositors began putting new funds into savings or demand accounts. Average consumer time deposits increased only \$.5 million or .1% compared to an increase of \$56.9 million or 11.7% in 1985. Growth in money market accounts also slowed, totaling \$22.5 million or 5.8% compared to \$67.0 million or 20.9% in 1985. In contrast, savings and interest checking accounts increased \$39.0 million or 11.6% in 1986, compared to only \$2.0 million or .6% in 1985. Noninterest bearing deposits were up \$41.8 million or 8.4%, following a decline of \$9.5 million in 1985.

Other sources of funds include large certificates of deposit, federal funds purchased, security repurchase agreements, other short-term borrowings and long-term debt. Large certificates of deposit increased only slightly in 1986, averaging \$67.2 million for the year. Federal funds purchased and security repurchase agreements averaged \$134.7 million compared to \$140.5 million in 1985. Other short-term borrowings increased \$1.4 million to \$19.8 million, while long-term debt declined from \$9.2 million to \$7.9 million, due to the maturity of the bank's 8¾% subordinated capital note.

Shareholders' Equity

As a result of the loss recorded in the fourth quarter, period-end shareholders' equity declined to \$135.2 million. This was \$4.6 mil-

lion below the balance at year-end 1985. Despite this decrease, the corporation's average and period-end capital ratios were both well within regulatory guidelines and above the comparable figures for 1985. The regulatory guidelines for bank holding companies prescribe a minimum ratio of primary capital to assets of 5.50%. The corporation's average primary capital ratio in 1986 was 7.05%, up from 6.84% in 1985. Our primary capital ratio at December 31, 1986 was 6.66%, up from 6.61% at year-end 1985.

A return to profitability, coupled with controlled asset growth, will strengthen our capital position in 1987.

Liquidity

Maintaining adequate liquidity is an essential part of asset/liability management. Liquidity is defined as the ability to provide sufficient cash to fund operations and meet obligations and commitments on a timely basis.

Asset liquidity is provided through asset maturities, the sale of federal funds, security resale agreements and the potential sale of marketable investment securities. The book value and market value of investment securities was \$153.2 million and \$154.6 million, respectively, at year-end 1986. This compares to a book value and a market value of \$181.9 million and \$179.9 million, respectively, at December 31, 1985. At year-end 1986, \$68.5 million or 45.4% of the portfolio had remaining maturities of one year or less, and \$70.2 million or 46.5% had maturities between one and five years. Only 8.1% of the portfolio had maturities exceeding five years, compared to 13.8% at December 31, 1985.

In addition to marketable investment securities, the corporation's year-end balance sheet included federal funds sold and security resale agreements of \$236.7 million. Federal funds sold

Investment Portfolio

December 31, 1986 (In Thousands)	U.S. Treasury and Other U.S. Government Agencies and Corporations		State and Political Subdivisions		Other Bonds, Notes and Debentures	
	Amount	Yield	Amount	Yield*	Amount**	Yield
Remaining maturities:						
Maturities within 1 year	\$ 56,020	7.53%	\$12,463	9.99%	\$59	11.31%
After 1 year but within 5 years	46,151	7.11	24,092	9.85	—	—
After 5 years but within 10 years	—	—	5,909	11.56	15	5.50
After 10 years	5,602	6.90	759	15.53	—	—
Total	\$107,773	7.32%	\$43,223	10.23%	\$74	10.13%

*Weighted average yields on tax-exempt obligations were computed on a fully taxable equivalent basis assuming a tax rate of 46%.

**Excludes \$2,088,000 of equity holdings.

and security resale agreements averaged \$141.9 million during the year compared to \$129.8 million in 1985.

Liquidity is also provided by maturing loans. At December 31, 1986, \$705.9 million or 58.7% of outstanding commercial and real estate loans were scheduled to mature within one year, and another \$296.5 million or 24.6% were scheduled to mature between one and five years.

Liability liquidity is defined as the ability to raise new funds and renew liabilities as they mature. The corporation's large core deposit base provides a very stable source of funds, which lessens the need to raise funds in the large C.D. and federal fund markets. The ratio of average core deposits to total average deposits was 96.5% in 1986, up slightly from a ratio of 96.3% a year ago. Time deposits of \$100,000 or more totaled \$53.4 million at December 31,

1986, down from \$83.2 million at year-end 1985. Federal funds purchased and security repurchase agreements totaled \$129.4 million and \$144.7 million at December 31, 1986 and 1985, respectively.

Time Deposits of \$100,000 or More

December 31, 1986 (In Thousands)

Remaining maturities:	
Maturities within 3 months	\$45,268
After 3 months but within 6 months	2,176
After 6 months but within 12 months	1,946
After 12 months	3,997
Total	\$53,387

Remaining Maturity and Interest Rate Sensitivity of Selected Loans

December 31, 1986 (In Thousands)

Commercial, financial and agricultural
Real estate construction
Real estate mortgage

Total*

Loans with predetermined rates

Loans with floating rates

Total*

	<i>Maturities</i>			<i>Total</i>
	<i>Within 1 Year</i>	<i>1 to 5 Years</i>	<i>After 5 Years</i>	
Commercial, financial and agricultural	\$639,827	\$237,466	\$ 44,869	\$ 922,162
Real estate construction	44,280	—	—	44,280
Real estate mortgage	21,798	59,049	155,939	236,786
Total*	\$705,905	\$296,515	\$200,808	\$1,203,228
Loans with predetermined rates	\$141,247	\$144,985	\$170,707	\$ 456,939
Loans with floating rates	564,658	151,530	30,101	746,289
Total*	\$705,905	\$296,515	\$200,808	\$1,203,228

*Excludes loans for consumer purposes and lease financing.

Interest Rate Sensitivity

The growth of interest sensitive liabilities and the increase in interest rate volatility has made the analysis of interest sensitivity a very important part of asset/liability management. The corporation's Asset/Liability Committee monitors the interest sensitivity position of the corporation on a regular basis.

In analyzing interest rate sensitivity, assets and liabilities are categorized based on the time periods in which they reprice. Repricing occurs either due to maturity or because rates are tied to market rates of interest. The difference between the amount of assets and the amount of liabilities repricing within a specified time period is known as the "Interest Rate Sensitivity Gap." A positive gap indicates interest sensitive assets are greater than interest sensitive liabilities, and a negative gap arises when interest sensitive liabilities

are greater than interest sensitive assets.

Historically, Peoples Bancorporation has had a positive short-term gap because of its relatively large base of noninterest bearing deposits and nonrate sensitive savings accounts.

At December 31, 1986, the corporation had a cumulative positive gap of \$363.7 million for the period of 0-365 days. This compares to a cumulative positive gap of \$207.4 million at December 31, 1985. The increase in our short-term gap primarily reflects growth in noninterest bearing and savings accounts.

The corporation uses various strategies and tools to minimize the mismatches in its interest sensitivity position. One of the tools utilized during 1986 was interest rate swap transactions. The notional value of interest rate swaps outstanding at December 31, 1986 was \$35.0 million.

Interest Rate Sensitivity Analysis

<i>December 31, 1986 (In Thousands)</i>	<i>0-30 Days</i>	<i>31-90 Days</i>	<i>91-180 Days</i>	<i>181-365 Days</i>	<i>Over 1 Year</i>	<i>Total</i>
Total earning assets	\$1,098,333	\$ 83,863	\$ 60,385	\$143,495	\$ 636,092	\$2,022,168
Total interest bearing liabilities	680,592	128,222	113,717	99,830	571,524	1,593,885
Noninterest bearing sources of funds	—	—	—	—	428,283	428,283
Total sources of funds for earning assets	680,592	128,222	113,717	99,830	999,807	2,022,168
Interest sensitivity gap	\$ 417,741	\$ (44,359)	\$ (53,332)	\$ 43,665	\$(363,715)	\$ —
Cumulative gap	\$ 417,741	\$373,382	\$320,050	\$363,715	\$ —	\$ —

Credit Risk Management

Peoples Bancorporation maintains a system of credit quality control which includes careful screening and analysis of all potential credits, monitoring the continuing soundness of credits and close review and evaluation of problem credits in order to minimize losses.

It is the corporation's policy to maintain a diversified portfolio and to limit foreign exposure. No single industry constitutes more than 10% of the loan portfolio, and foreign credits represent less than 1% of outstanding loans.

Our system of credit quality control also includes the examination of off-balance sheet credit risks to insure that such items do not have potential for future losses.

Credit Losses

Despite our system of credit quality control, we experienced a dramatic increase in net loan losses in 1986. These losses resulted from the failure within the bank to adhere to established credit policy in certain specialized departments and economic conditions in certain regional industries.

Total net charge-offs were \$32.5 million or 2.00% of average loans in 1986, increasing from \$7.9 million or .53% of average loans in 1985 and \$4.6 million or .37% of average loans in 1984. Net

charge-offs on commercial loans increased from \$4.4 million to \$28.1 million. Net charge-offs on consumer loans were also up, increasing from \$2.6 million or .81% of average consumer loans in 1985 to \$3.6 million or .99% of average consumer loans in 1986. This increase was primarily related to credit cards and other revolving lines of credit. Net charge-offs on real estate loans totaled \$.7 million in 1986 compared to \$.6 million in 1985.

The provision for loan losses totaled \$42.8 million in 1986 compared to \$11.7 million in 1985 and \$8.9 million in 1984. The provision exceeded net charge-offs by \$10.3 million in 1986. This excess resulted in an increase in the allowance for loan losses from \$18.7 million at December 31, 1985 to \$29.1 million at December 31, 1986. The ratio of the allowance to outstanding loans at year-end increased from 1.20% to 1.79%. The increase in the allowance for loan losses follows an intensive evaluation of the quality of the corporation's outstanding loans and the policies and procedures related to its system of loan quality control. Management feels it has adequately reserved for potential future losses, based on a very careful and prudent assessment, which included: an estimation of losses on a loan-by-loan basis for specific current problem credits; analysis of historical loss experience; analysis of current trends in delinquencies and nonaccruals; and analysis of trends in loan growth and composition.

Summary of Allowance for Loan Losses

(In Thousands)

	1986	1985	1984	1983	1982
Balance at beginning of year	\$18,743	\$15,005	\$10,697	\$10,432	\$9,682
Charge-offs:					
Commercial, financial and agricultural	29,089	5,240	3,115	4,387	3,272
Real estate construction	112	195	1,121	—	—
Real estate mortgage	622	399	646	678	371
Consumer	4,908	3,744	1,908	2,554	1,903
Lease financing	226	450	25	777	921
Total	34,957	10,028	6,815	8,396	6,467
Recoveries:					
Commercial, financial and agricultural	1,010	793	1,209	995	628
Real estate construction	—	—	—	—	—
Real estate mortgage	—	—	10	127	26
Consumer	1,313	1,184	761	1,135	634
Lease financing	116	139	242	305	245
Total	2,439	2,116	2,222	2,562	1,533
Net charge-offs	32,518	7,912	4,593	5,834	4,934
Provision charged against earnings	42,847	11,650	8,901	6,099	5,684
Balance at end of year	\$29,072	\$18,743	\$15,005	\$10,697	\$10,432
Loans outstanding at December 31 (net of unearned income)	\$1,626,549	\$1,566,543	\$1,395,484	\$1,082,632	\$1,064,190
Average loans outstanding (net of unearned income)	1,625,866	1,494,565	1,245,157	1,066,155	979,971
Ratio of net charge-offs to average loans	2.00%	.53%	.37%	.55%	.50%
Ratio of allowance for loan losses to loans outstanding at December 31	1.79	1.20	1.08	.99	.98

The table below presents an allocation of the allowance for loan losses by major loan category for the past five years. As the table indicates, the amount allocated to commercial, financial and agricultural loans increased from \$7.6 million in 1985 to \$21.4 million

in 1986. It should be noted, however, that the allowance is a composite reserve available for all types of loans and it should not be construed that the indicated amount for each category is the maximum amount available for loans in that category.

Allocation of Allowance for Loan Losses to Loan Categories

<i>December 31 (In Millions)</i>	<i>1986</i>		<i>1985</i>		<i>1984</i>		<i>1983</i>		<i>1982</i>	
	\$	%	\$	%	\$	%	\$	%	\$	%
Allowance for loan losses:										
Commercial, financial and agricultural	\$21.4	73.6%	\$ 7.6	40.5%	\$ 4.3	28.7%	\$ 4.5	42.1%	\$ 4.7	45.2%
Real estate construction	0.2	0.7	0.5	2.6	1.1	7.3	—	—	—	—
Real estate mortgage	1.2	4.1	2.6	14.0	1.9	12.7	2.0	18.7	2.0	19.2
Consumer	4.4	15.1	5.4	29.0	3.4	22.7	3.2	29.9	2.9	27.9
Lease financing	0.3	1.0	0.3	1.4	0.3	2.0	0.6	5.6	0.5	4.8
Unallocated	1.6	5.5	2.3	12.5	4.0	26.6	0.4	3.7	0.3	2.9
Total	\$29.1	100.0%	\$18.7	100.0%	\$15.0	100.0%	\$10.7	100.0%	\$10.4	100.0%

Loan categories (by purpose) as a percentage of total loans:

Commercial, financial and agricultural	56.7%	60.5%	56.3%	50.6%	47.7%
Real estate construction	2.7	1.9	2.3	3.0	2.0
Real estate mortgage	14.6	14.0	18.0	22.1	25.4
Consumer	24.2	21.7	21.3	22.2	22.5
Lease financing	2.1	2.3	2.7	2.8	3.3
Less unearned income	(0.3)	(0.4)	(0.6)	(0.7)	(0.9)
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Nonperforming Assets

Nonperforming assets totaled \$36.8 million or 1.5% of total assets at December 31, 1986, decreasing from \$38.8 million or 1.6% of total assets at December 31, 1985. Nonperforming loans decreased \$4.6 million, from 1.3% to 1.0% of total assets. However, other real estate and personal property owned, principally representing collateral acquired through foreclosure, increased \$2.6 million or from .3% to .5% of total assets. Loans past due 90 days or more totaled \$13.6 million at December 31, 1986, up \$4.4 million from the comparable figure at December 31, 1985.

It should be noted that nonperforming status does not necessarily indicate an anticipated loss of principal or ultimate loss of

interest, as assets in this category are generally well-secured by collateral or guaranties.

Management has carefully reviewed all problem credits on the books at December 31, 1986 and has reserved for any possible losses estimated to be inherent in these assets. There are currently no commitments to lend additional funds to customers whose loans were classified as nonperforming at December 31, 1986.

It is management's policy to place a credit on nonaccrual status whenever circumstances indicate that collection is questionable. At the time an asset is placed on nonaccrual status, any interest income previously accrued but uncollected is reversed against earnings. The interest income which would have been recorded, under origi-

Nonperforming Assets and Past Due Loans

<i>December 31 (In Thousands)</i>	<i>1986</i>	<i>1985</i>	<i>1984</i>	<i>1983</i>	<i>1982</i>
Nonperforming loans:					
Nonaccrual	\$19,107	\$26,967	\$14,665	\$17,642	\$7,212
Real estate in process of foreclosure	6,370	3,175	1,957	3,489	4,724
Total	25,477	30,142	16,622	21,131	11,936
Other real estate and personal property owned	11,295	8,668	6,152	10,556	4,566
Total nonperforming assets	\$36,772	\$38,810	\$22,774	\$31,687	\$16,502
Loans past due 90 days or more	\$13,636	\$ 9,205	\$ 4,735	\$ 6,700	\$10,855

nal terms on loans which were on nonaccrual status at year-end, totaled \$3.2 million in 1986. The interest income actually recorded on such loans in 1986 was \$1.1 million. The total effect of interest income lost on all nonperforming assets in 1986 was a reduction in the net interest margin of approximately 16 basis points.

Effects of Changing Prices on Financial Statements

Changing prices can impact key financial data included in the corporation's financial statements. Those items most affected by changing prices are premises and equipment and monetary assets and liabilities.

In periods of general inflation, the nominal dollar value of non-monetary assets, such as premises and equipment purchased in prior years, would be less than their value adjusted for the effects of inflation. The result of restating premises and equipment would be an increase to depreciation expense and a decrease in net income. Inflation will also cause a loss in the purchasing power of net monetary assets.

Inflation can be measured by computing the change in the average Consumer Price Index (CPI) from one period to another. The average CPI was 329.2 in 1986 compared to 322.2 in 1985.

The depreciation expense reported in 1986 adjusted for inflation would have been \$1,651,000 more than the depreciation expense as reported in the consolidated statement of income.

It should be noted that a bank's asset and liability structure is substantially different from that of an industrial company, in that virtually all assets and liabilities of a bank are monetary in nature. Accordingly, changes in interest rates may have a significant impact on a bank's performance. Interest rates do not necessarily move in

the same direction or magnitude as the prices of other goods and services.

Quarterly Financial Information

A net loss of \$8.4 million was recorded for fourth quarter 1986. This compares to net income of \$3.5 million for the previous quarter and \$3.1 million for fourth quarter 1985. The loss in fourth quarter 1986 was due to the unusually high provision for loan losses of \$25.0 million. In comparison, the provision for loan losses was \$6.1 million and \$4.5 million in third quarter 1986 and fourth quarter 1985, respectively. The provision for loan losses for each of the four quarters of 1986 was up over the comparable quarter of 1985.

The tax benefit recorded in third quarter 1986 included a \$1.0 million refund of previously disallowed investment credits.

Noninterest income for second and fourth quarter 1985 included gains of \$1.0 million and \$1.3 million, respectively, from the sale of mortgage loan servicing. In addition, fourth quarter 1985 included a \$1.4 million gain from the sale of bank premises. No major sales of premises or loan servicing occurred in 1986.

Peoples Bancorporation's common stock is traded in the over-the-counter market under the NASDAQ symbol PEOB and quoted daily in leading financial publications. There were approximately 1495 shareholders of record as of December 31, 1986. The payment of dividends on common stock is subject to the restrictions described in Note 8.

The bid quotations below were compiled by the National Quotation Bureau, Inc.

Quarterly Statement of Operations and Common Stock Data

<i>(In Thousands, Except Per Share)</i>	1986				1985			
	<i>First</i>	<i>Second</i>	<i>Third</i>	<i>Fourth</i>	<i>First</i>	<i>Second</i>	<i>Third</i>	<i>Fourth</i>
Interest income	\$50,126	\$49,947	\$48,515	\$47,272	\$50,934	\$51,912	\$51,771	\$51,664
Interest expense	27,032	25,499	24,124	22,736	28,575	28,246	28,050	27,947
Net interest income	23,094	24,448	24,391	24,536	22,359	23,666	23,721	23,717
Provision for loan losses	7,957	3,768	6,112	25,010	1,974	2,839	2,352	4,485
Noninterest income	12,094	11,417	12,188	11,545	11,476	11,841	11,682	13,399
Noninterest expense	29,624	28,598	27,990	28,620	26,953	28,097	28,353	30,097
Income (loss) before taxes	(2,393)	3,499	2,477	(17,549)	4,908	4,571	4,698	2,534
Income tax expense (benefit)	(2,498)	488	(1,062)	(9,126)	1,147	812	1,029	(544)
<i>Net income (loss)</i>	<i>\$ 105</i>	<i>\$ 3,011</i>	<i>\$ 3,539</i>	<i>\$ (8,423)</i>	<i>\$ 3,761</i>	<i>\$ 3,759</i>	<i>\$ 3,669</i>	<i>\$ 3,078</i>
Net income (loss) per share	\$.03	\$.79	\$.93	\$(2.21)	\$1.00	\$.99	\$.98	\$.81
Market bid price:								
High	\$56	\$55½	\$55¼	\$52¼	\$31¾	\$40½	\$42¾	\$57
Low	46¼	51¼	46¼	47	26¾	31¾	39¾	42¾
Dividends declared per share	\$.25	\$.25	\$.25	\$.25	\$.25	\$.25	\$.25	\$.25

Average Balances/Interest Income and Expense/Rates

(In Thousands)	1986			1985			1984			
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	
Assets										
Investment securities:										
Taxable	\$ 115,951	\$ 9,222	7.95%	\$ 137,541	\$ 14,007	10.18%	\$ 215,415	\$ 22,273	10.34%	
Nontaxable	44,844	4,558	10.16	54,210	5,637	10.40	78,541	8,593	10.94	
Total investment securities	160,795	13,780	8.57	191,751	19,644	10.24	293,956	30,866	10.50	
Interest bearing deposits with banks	—	—	—	—	—	—	246	27	11.18	
Trading account assets	19,959	1,547	7.75	34,981	3,255	9.31	21,152	2,463	11.64	
Federal funds sold and security resale agreements	141,863	9,751	6.87	129,753	10,560	8.14	131,401	13,661	10.40	
Loans:										
Commercial	959,584	95,835	9.99	876,092	100,046	11.42	675,799	89,876	13.30	
Consumer	362,655	42,864	11.82	316,213	39,887	12.61	264,815	35,846	13.54	
Real estate	273,678	28,037	10.24	272,774	29,363	10.76	278,045	29,648	10.66	
Lease financing	29,949	2,953	9.86	29,486	2,979	10.10	26,498	3,001	11.33	
Total loans	1,625,866	169,689	10.44	1,494,565	172,275	11.53	1,245,157	158,371	12.72	
Loan fees	—	9,509	.59	—	8,189	.55	—	8,614	.69	
Total—including loan fees	1,625,866	179,198	11.03	1,494,565	180,464	12.08	1,245,157	166,985	13.41	
Total earning assets	1,948,483	\$204,276	10.48%	1,851,050	\$213,923	11.55%	1,691,912	\$214,002	12.65%	
Less allowance for loan losses	(20,567)	—	—	(16,467)	—	—	(12,365)	—	—	
Cash and due from banks	233,857	—	—	220,763	—	—	234,581	—	—	
Other nonearning assets	129,956	—	—	143,028	—	—	148,968	—	—	
Total Assets	\$2,291,729			\$2,198,374			\$2,063,096			
Liabilities and Shareholders' Equity										
Interest bearing deposits:										
Savings and interest checking	\$ 374,465	\$ 18,611	4.97%	\$ 335,493	\$ 17,898	5.33%	\$ 333,495	\$ 17,849	5.35%	
Money market accounts	409,259	22,790	5.57	386,752	26,622	6.88	319,792	27,598	8.63	
Time certificates over \$100,000	67,206	4,599	6.84	66,982	5,572	8.32	39,892	4,271	10.71	
Other time deposits	543,755	43,099	7.92	543,290	50,238	9.25	486,410	50,063	10.29	
Total interest bearing deposits	1,394,685	89,099	6.39	1,332,517	100,330	7.53	1,179,589	99,781	8.46	
Federal funds purchased and security repurchase agreements	134,695	7,900	5.87	140,452	9,983	7.11	151,677	14,383	9.48	
Other short-term borrowings	19,783	1,581	8.00	18,386	1,605	8.73	20,145	2,120	10.52	
Long-term debt	7,914	811	10.25	9,234	900	9.74	20,650	2,188	10.59	
Total interest bearing liabilities	1,557,077	\$ 99,391	6.38%	1,500,589	\$112,818	7.52%	1,372,061	\$118,472	8.63%	
Noninterest bearing deposits	541,827	—	—	500,021	—	—	509,497	—	—	
Other liabilities	50,450	—	—	62,778	—	—	58,932	—	—	
Shareholders' equity	142,375	—	—	134,986	—	—	122,606	—	—	
Total Liabilities and Shareholders' Equity	\$2,291,729			\$2,198,374			\$2,063,096			
Yield on earning assets		\$204,276	10.48%		\$213,923	11.55%		\$214,002	12.65%	
Interest expense related to earning assets		99,391	5.10		112,818	6.09		118,472	7.00	
Net Interest Margin		\$104,885	5.38%		\$101,105	5.46%		\$ 95,530	5.65%	

The above table is presented on a fully taxable equivalent basis assuming a 46 % income tax rate. Nonaccrual loans are included in average loan balances. Changes in net interest margin not due solely to changes in volume or rate have been allocated to rate.

Analysis of Changes in Net Interest Margin

Year Ended 1986 over 1985			Year Ended 1985 over 1984		
Volume	Rate	Total	Volume	Rate	Total
\$ (2,199)	\$ (2,586)	\$ (4,785)	\$ (8,052)	\$ (214)	\$ (8,266)
(974)	(105)	(1,079)	(2,662)	(294)	(2,956)
(3,173)	(2,691)	(5,864)	(10,714)	(508)	(11,222)
—	—	—	(27)	—	(27)
(1,398)	(310)	(1,708)	1,609	(817)	792
986	(1,795)	(809)	(171)	(2,930)	(3,101)
9,534	(13,745)	(4,211)	26,637	(16,467)	10,170
5,858	(2,881)	2,977	6,957	(2,916)	4,041
97	(1,423)	(1,326)	(562)	277	(285)
47	(73)	(26)	338	(360)	(22)
15,536	(18,122)	(2,586)	33,370	(19,466)	13,904
719	601	1,320	1,725	(2,150)	(425)
16,255	(17,521)	(1,266)	35,095	(21,616)	13,479
\$12,670	\$(22,317)	\$ (9,647)	\$ 25,792	\$(25,871)	\$ (79)
\$ 9,396	\$ (5,616)	\$ 3,780	\$13,611	\$ (8,036)	\$ 5,575

Consolidated Balance Sheet

Peoples Bancorporation and Subsidiaries

December 31 (In Thousands)

	1986	1985
Assets		
Cash and due from banks	\$ 312,818	\$ 332,819
Investment securities (market value of \$154,590 and \$179,928, respectively)—Note 2	153,158	181,907
Trading account assets	5,802	30,921
Federal funds sold and security resale agreements	236,659	143,660
Loans (net of unearned income of \$5,333 and \$6,941, respectively)—Note 3	1,626,549	1,566,543
Allowance for loan losses—Note 4	(29,072)	(18,743)
Net loans	1,597,477	1,547,800
Premises and equipment—Note 5	53,592	53,759
Due from customers on acceptances	19,779	34,899
Other assets	58,629	54,576
Total Assets	\$2,437,914	\$2,380,341
Liabilities and Shareholders' Equity		
Deposits:		
Noninterest bearing	\$ 670,479	\$ 600,872
Interest bearing	1,432,140	1,393,118
Total deposits	2,102,619	1,993,990
Federal funds purchased and security repurchase agreements	129,353	144,695
Other short-term borrowings	27,942	31,163
Acceptances outstanding	19,779	34,899
Other liabilities	18,609	27,860
Long-term debt—Note 6	4,450	7,984
Total Liabilities	2,302,752	2,240,591
Shareholders' Equity		
Common stock (par value \$5)—authorized 10,000,000 shares, issued 3,850,051 shares and 3,845,696 shares, respectively—Note 7	19,250	19,229
Surplus	24,229	23,646
Retained earnings	92,493	98,066
	135,972	140,941
Less common stock in treasury, at cost—42,000 shares and 64,200 shares, respectively	(810)	(1,191)
Total Shareholders' Equity	135,162	139,750
Total Liabilities and Shareholders' Equity	\$2,437,914	\$2,380,341

See notes to consolidated financial statements.

Consolidated Statement of Operations

Peoples Bancorporation and Subsidiaries

<i>Year Ended December 31 (In Thousands, Except Per Share)</i>	<i>1986</i>	<i>1985</i>	<i>1984</i>
<i>Interest Income</i>			
Interest and fees on loans	\$173,198	\$176,163	\$164,130
Interest on deposits with banks	—	—	27
Interest on federal funds sold and security resale agreements	9,751	10,560	13,661
Interest on investment securities:			
Taxable	9,222	14,007	22,273
Exempt from federal income taxes	2,461	3,044	4,640
Interest on trading account assets	1,228	2,507	1,858
<i>Total Interest Income</i>	195,860	206,281	206,589
<i>Interest Expense</i>			
Interest on deposits	89,099	100,330	99,781
Interest on federal funds purchased and security repurchase agreements	7,900	9,983	14,383
Interest on short-term borrowings	1,581	1,605	2,120
Interest on long-term debt	811	900	2,188
<i>Total Interest Expense</i>	99,391	112,818	118,472
<i>Net Interest Income</i>	96,469	93,463	88,117
Provision for loan losses—Note 4	42,847	11,650	8,901
<i>Net Interest Income After Provision for Loan Losses</i>	53,622	81,813	79,216
<i>Noninterest Income</i>			
Trust fees and commissions	7,429	6,058	5,483
Service charges on deposit accounts	14,208	13,232	13,041
Securities gains	742	629	10
Other	24,865	28,479	25,984
<i>Total Noninterest Income</i>	47,244	48,398	44,518
<i>Noninterest Expense</i>			
Salaries	50,714	49,075	43,989
Employee benefits—Note 9	10,845	10,272	9,984
Occupancy—Note 5	7,752	7,641	6,550
Furniture and equipment—Note 5	9,393	10,112	11,092
Other	36,128	36,400	34,027
<i>Total Noninterest Expense</i>	114,832	113,500	105,642
Income (loss) before income taxes	(13,966)	16,711	18,092
Income tax expense (benefit)—Note 10	(12,198)	2,444	3,015
<i>Net Income (Loss)</i>	\$ (1,768)	\$ 14,267	\$ 15,077
<i>Net Income (Loss) Per Share</i>			
Primary	\$(.46)	\$3.78	\$4.00
Fully diluted	(.46)	3.76	3.81

See notes to consolidated financial statements.

Consolidated Statement of Changes in Financial Position

Peoples Bancorporation and Subsidiaries

Year Ended December 31 (In Thousands)	1986	1985	1984
<i>Financial resources were provided by (applied to):</i>			
Operations:			
Net income (loss)	\$ (1,768)	\$ 14,267	\$ 15,077
Noncash charges (credits):			
Depreciation and amortization	9,258	7,770	8,942
Provision for loan losses	42,847	11,650	8,901
Deferred tax benefit	(6,092)	(1,810)	(1,066)
Financial resources provided by operations	44,245	31,877	31,854
Cash dividends declared	(3,805)	(3,776)	(3,772)
Net financial resources provided by operations	40,440	28,101	28,082
Deposits and other financing activities:			
Deposits	108,629	207,439	42,502
Federal funds purchased and security repurchase agreements	(15,342)	(14,743)	123,717
Other short-term borrowings	(3,221)	6,977	3,086
Long-term debt	(3,534)	(2,467)	(12,040)
Treasury stock acquired	(105)	(134)	(329)
Treasury stock reissued	839	—	—
Common stock issued under stock option plans	104	—	—
Conversion of convertible debentures to common stock	147	504	68
Total deposits and other financing activities	87,517	197,576	157,004
Other activities:			
Cash and due from banks	20,001	(109,769)	61,556
Premises and equipment	(6,047)	(5,508)	(6,825)
Other, net	(8,219)	10,238	4,431
Total other activities	5,735	(105,039)	59,162
<i>Increase in financial resources invested in earning assets</i>	<u>\$ 133,692</u>	<u>\$ 120,638</u>	<u>\$ 244,248</u>
<i>Increase (decrease) in earning assets:</i>			
Interest bearing deposits with banks	\$ —	\$ —	\$ (45,000)
Investment securities	(26,563)	(110,192)	(27,432)
Trading account assets	(25,119)	(8,147)	21,567
Federal funds sold and security resale agreements	92,999	60,150	(22,064)
Loans	92,375	178,827	317,177
<i>Increase in earning assets</i>	<u>\$ 133,692</u>	<u>\$ 120,638</u>	<u>\$ 244,248</u>

See notes to consolidated financial statements.

Consolidated Statement of Changes in Shareholders' Equity

Peoples Bancorporation and Subsidiaries

<i>(In Thousands)</i>	<i>Common Stock</i>	<i>Surplus</i>	<i>Retained Earnings</i>	<i>Treasury Stock</i>	<i>Total</i>
<i>Balance at December 31, 1983</i>	\$19,139	\$23,164	\$76,270	\$ (728)	\$117,845
Net income	—	—	15,077	—	15,077
Cash dividends declared (\$1.00 per share)	—	—	(3,772)	—	(3,772)
Treasury stock acquired	—	—	—	(329)	(329)
Conversion of convertible debentures to common stock	12	56	—	—	68
<i>Balance at December 31, 1984</i>	19,151	23,220	87,575	(1,057)	128,889
Net income	—	—	14,267	—	14,267
Cash dividends declared (\$1.00 per share)	—	—	(3,776)	—	(3,776)
Treasury stock acquired	—	—	—	(134)	(134)
Conversion of convertible debentures to common stock	78	426	—	—	504
<i>Balance at December 31, 1985</i>	19,229	23,646	98,066	(1,191)	139,750
Net loss	—	—	(1,768)	—	(1,768)
Cash dividends declared (\$1.00 per share)	—	—	(3,805)	—	(3,805)
Treasury stock acquired	—	—	—	(105)	(105)
Treasury stock reissued	—	457	—	382	839
Common stock issued under stock option plans	—	—	—	104	104
Conversion of convertible debentures to common stock	21	126	—	—	147
<i>Balance at December 31, 1986</i>	\$19,250	\$24,229	\$92,493	\$ (810)	\$135,162

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Peoples Bancorporation and Subsidiaries

Note 1—Summary of Significant Accounting Policies

The accounting and reporting policies of Peoples Bancorporation (the "corporation") and its subsidiaries conform to generally accepted accounting principles and to predominant practice within the banking industry. The following is a description of significant accounting policies:

Consolidation: The consolidated financial statements of Peoples Bancorporation include the accounts of the corporation and its wholly-owned subsidiaries, including Peoples National Bank of Washington (the "bank"), the corporation's principal subsidiary. Significant intercompany transactions and balances are eliminated.

Certain amounts in the 1985 and 1984 financial statements have been reclassified to conform with the 1986 presentation.

Investment Securities: Investment securities are carried at cost, adjusted for amortization of premiums and accretion of discounts. Gains and losses on the sale of securities are computed principally on the specific identification method.

Trading account assets are carried at market value.

Loans: Interest on commercial, real estate and certain types of consumer loans is accrued and credited to income based upon the principal amount outstanding. Interest on other consumer loans is accrued and credited to income on the sum-of-the-month's-digits method.

It is the policy of management to discontinue the accrual of interest on loans when circumstances indicate that collection is questionable. At the time an asset is placed on nonaccrual status, the accrued and unpaid interest is reversed against current income.

Material loan fees in excess of estimated costs are deferred and amortized to income over the estimated terms of the loans except certain construction loan fees which are deferred and recognized as income based on the percentage of loan disbursements made.

The financing method of accounting is used for direct lease contract receivables. Under this method, income is recognized during the term of the lease in proportion to the unrecovered investment.

Real estate and other personal property held for resale, acquired principally through foreclosure, is carried at the lower of cost or market value and is included in other assets.

Allowance for Loan Losses: The allowance for loan losses is increased by provisions charged to expenses and reduced by loans charged-off, net of recoveries. The allowance is based on management's evaluation of potential losses in the loan portfolio after consideration of historical loss experience, current problem credits, economic conditions and other risks inherent in the portfolio.

Premises and Equipment: Premises and equipment are stated at cost less accumulated depreciation and amortization, which are computed on the straight-line and accelerated methods over the estimated useful lives of the assets. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is less. Gains or losses on dispositions are reflected in earnings.

Intangibles: Deposit intangibles recorded in purchase transactions are amortized on a straight-line basis over lives ranging from 6 months to 4 years; safe deposit box intangibles are amortized on a straight-line basis over 20 years; and goodwill is amortized over periods ranging from 15 years to 40 years on a straight-line basis. Mortgage servicing rights are amortized on a straight-line basis over lives ranging from 5 to 8 years.

Net intangibles were \$9,231,000 and \$8,977,000 at December 31, 1986 and 1985, respectively, including accumulated amortization of \$7,730,000 and \$7,058,000 at December 31, 1986 and 1985, respectively.

Mortgage Commitments: Gains or losses on mortgage standby contracts and mortgage forward contracts are recognized when the transactions are consummated. Standby contract fees are recognized as an expense when loans are delivered, the standby period expires or when a determination has been made that the standby contract will not be used.

Trust Income: Income from trust services is recognized on the cash basis in accordance with predominant industry practice. The results of trust operations would not be materially different if reported on the accrual method.

Income Taxes: The provision for income taxes is based on income and expense reported for financial statement purposes after adjustment for permanent differences (principally tax-exempt income) and tax credits. Deferred income taxes are provided on timing differences when income and expenses are recognized in different periods for financial and income tax reporting purposes. Investment tax credits related to assets acquired for use by the corporation and subsidiaries are accounted for under the flow through method, which recognizes the benefit in the year in which the asset is placed in service. Investment tax credits relating to certain equipment leases are amortized over the terms of the respective leases.

Earnings Per Share: Primary earnings per share are computed based on the weighted average number of shares outstanding during the year, which were 3,802,440 in 1986, 3,772,975 in 1985 and 3,773,374 in 1984. Per share amounts on a fully diluted basis assume conversion of all outstanding convertible debentures and elimination of related interest expense net of the applicable income tax effect. The computations exclude shares issuable under stock grants and stock options because their effect would not be material.

Note 2—Investment Securities

The following table reflects the book and market values of investment securities at December 31:

(In Thousands)	1986		1985	
	Book	Market	Book	Market
U.S. Treasury and other U.S. Government agencies and corporations	\$107,773	\$108,988	\$125,169	\$125,506
State and political subdivisions	43,223	43,440	54,193	51,764
Other taxable securities	2,162	2,162	2,545	2,658
Total investment securities	\$153,158	\$154,590	\$181,907	\$179,928

At December 31, 1986 and 1985, securities with a book value of approximately \$139,169,000 and \$162,056,000, respectively, were pledged to secure public and trust deposits, securities sold under repurchase agreements and other funds as required for other purposes.

Note 3—Loans

Loans by purpose at December 31 were as follows:

(In Thousands)	1986	1985
Commercial, financial and agricultural	\$ 922,162	\$ 948,617
Real estate construction	44,280	29,977
Real estate mortgage	236,786	219,263
Consumer	393,635	339,344
Lease financing	35,019	36,283
Less unearned income	(5,333)	(6,941)
Total loans	\$1,626,549	\$1,566,543

Certain related parties of Peoples Bancorporation, principally directors of the corporation and their associates, were loan customers of the corporation and its subsidiaries in the ordinary course of business during 1986 and 1985. Activity related to these loans during 1986 was as follows:

(In Thousands)	
Balance at December 31, 1985	\$ 6,595
New loans	11,092
Repayments	(13,007)
Balance at December 31, 1986	\$ 4,680

The average balance of loans outstanding to related parties during 1986 was approximately \$3.4 million. The new loans and repayments shown above reflect recurring transactions under existing lines of credit.

Note 4—Allowance for Loan Losses

Changes in the allowance for loan losses for the years ended December 31, 1986, 1985 and 1984 were as follows:

(In Thousands)	1986	1985	1984
Balance at beginning of year	\$18,743	\$15,005	\$10,697
Provision charged against earnings	42,847	11,650	8,901
Charge-offs	(34,957)	(10,028)	(6,815)
Recoveries	2,439	2,116	2,222
Net charge-offs	(32,518)	(7,912)	(4,593)
Balance at December 31	\$29,072	\$18,743	\$15,005

Note 5—Premises and Equipment

The components of premises and equipment at December 31 were as follows:

(In Thousands)	1986	1985
Land	\$ 8,633	\$ 8,990
Buildings	41,465	39,899
Leasehold improvements	9,281	9,650
Furniture and equipment	39,789	36,670
	99,168	95,209
Less accumulated depreciation	(45,576)	(41,450)
Total premises and equipment	\$53,592	\$53,759

Depreciation expense on premises and equipment totaled \$6,223,000, \$6,101,000 and \$5,588,000 for the years ended December 31, 1986, 1985 and 1984, respectively.

Rental expense of leased premises and equipment was \$5,542,000, \$6,035,000 and \$7,323,000 for the years ended December 31, 1986, 1985 and 1984, respectively. The corporation principally leases equipment and premises under operating leases.

Occupancy expense has been reduced by rental income received. Such income amounted to \$1,932,000, \$2,197,000 and \$2,189,000 for the years ended December 31, 1986, 1985 and 1984, respectively.

Minimum net rental commitments under noncancellable leases having an original or remaining term of more than one year were as follows as of December 31, 1986:

(In Thousands)	
1987	\$ 2,954
1988	2,099
1989	1,339
1990	1,091
1991	922
1992 and subsequent	4,138
Total minimum payments required	\$12,543

Certain leases contain renewal options from 2 to 20 years and escalation clauses based upon increases in property taxes and other costs.

Note 6—Long-Term Debt

Long-term debt at December 31 consisted of the following:

(In Thousands)	1986	1985
8¾ % Subordinated Capital Note	\$ —	\$3,500
8¾ % Series B Subordinated Convertible Debentures	508	655
Mortgages payable and other contractual indebtedness	3,942	3,829
Total long-term debt	\$4,450	\$7,984

Subordinated Convertible Debentures: The subordinated convertible debentures are due on December 15, 1989. They are convertible into common stock at the option of the holders. The conversion rate is the higher of (a) \$13.375 per share or (b) 95% of the consolidated book value per share at the end of the most recent calendar quarter, less the unamortized excess of the purchase price over the net assets acquired reestablished on the books of the parent company at the time of its formation. At December 31, 1986, the conversion rate was \$32.30 per share. During 1986 and 1985, debentures with a face value of \$147,000 and \$504,000 were converted into 4,355 shares and 15,588 shares of common stock, respectively. The convertible debentures are unsecured and are subordinate to the rights of depositors and other creditors.

Mortgages Payable and Other Contractual Indebtedness: These are primarily mortgages on bank premises and other real estate owned, which had a book value of \$2.7 million at December 31, 1986. Interest rates range from 7% to 14½ % and remaining maturities range from 2 to 21 years.

The aggregate maturities for long-term debt are as follows:

(In Thousands)	
1987	\$ 417
1988	253
1989	761
1990	266
1991	283
1992 and subsequent	2,470
Total	\$4,450

Note 7—Common Stock and Employee Stock Plans

Peoples Bancorporation has an incentive stock option plan and a nonqualified stock grant plan, which provide for stock-based awards to key employees. A maximum of 100,000 shares are authorized to be awarded under these plans.

During 1985 and 1984, incentive stock options to purchase 15,200 and 13,000 shares were awarded at an option price of \$29.75 and \$24.25 per share, respectively. No options were awarded in 1986. One-quarter of the options awarded become exercisable on each of the second through fifth anniversaries of the date of award at a price not less than 100% of the award. As of December 31, 1986, options to purchase 30,000 shares were outstanding at prices ranging from \$16.00 to \$29.75 per share, of which 5,000 and 2,250 were exercisable at a price of \$16.00 and \$24.25 per share, respectively. During 1986, options to purchase 6,500 shares at \$16.00 per share were exercised. No stock options were exercised in 1985 or 1984.

The nonqualified stock grant plan provides for the granting of rights to receive shares of the corporation's common stock as consideration for the employees' continued employment with and efforts on behalf of the corporation. The stock is to be presented in equal amounts on each of the sixth through tenth anniversaries of the date of award. During 1985, grants in the amount of 1,000 shares were awarded. No grants were awarded in 1986 or 1984. As of December 31, 1986, grants in the amount of 11,000 shares were outstanding, of which none were exercisable.

The Peoples Bancorporation Long-Term Incentive Plan provides for the granting of stock appreciation rights to key employees. These stock appreciation rights (SARs) are cash awards which vest according to prescribed schedules. The actual value of the SAR is the difference between the base value and the fair market value of the corporation's common stock on the date the SAR is exercised, plus dividends paid on the stock during the period the award was held. The base value is tied to the fair market value of the stock during the quarter preceding that in which the award is made. A total of 75,000 SARs are authorized to be awarded under the program. During 1985, 10,000 SARs were awarded with a base value of \$29.75. No SARs were awarded in 1986 or 1984. As of December 31, 1986, 30,000 SARs were outstanding at base values ranging from \$20.625 to \$29.75. One-quarter of these SARs become exercisable on each of the second through fifth anniversaries of the date of award. At December 31, 1986, 10,000 SARs were exercisable at a base value of \$20.625 each. As of December 31, 1986, no SARs had been exercised.

Costs associated with stock grants and SARs are accrued as they vest.

At December 31, 1986, 698,909 shares of common stock were reserved for the conversion of convertible debentures discussed in Note 6 and 41,000 shares of treasury stock were reserved for issuance under the stock option and stock grant plans described above.

The following table summarizes changes in the number of shares outstanding for the years ended December 31, 1986, 1985 and 1984:

	<i>Common Stock</i>	<i>Treasury Stock</i>
Balance at December 31, 1983	3,827,818	47,000
Conversion of convertible debentures to common stock	2,290	—
Treasury stock acquired	—	13,000
Balance at December 31, 1984	3,830,108	60,000
Conversion of convertible debentures to common stock	15,588	—
Treasury stock acquired	—	4,200
Balance at December 31, 1985	3,845,696	64,200
Conversion of convertible debentures to common stock	4,355	—
Treasury stock acquired	—	2,173
Treasury stock reissued	—	(17,873)
Common stock issued under stock option plans	—	(6,500)
<i>Balance at December 31, 1986</i>	<u>3,850,051</u>	<u>42,000</u>

Note 8—Restricted Assets

Certain restrictions exist regarding the ability of the bank to transfer funds to its affiliates, including the parent company. The approval of the Comptroller of the Currency is required to pay dividends which exceed the bank's net profits for that year plus its retained net profits for the preceding two years. Under this restriction, the bank could have paid additional dividends of \$16.6 million to the parent company as of December 31, 1986.

The Federal Reserve Act limits the extent to which the bank may make loans or advances to, purchase assets from, or invest in the securities of its affiliates. Transactions with any single affiliate cannot exceed 10% of the bank's capital, surplus and retained earnings (net assets). The total of such transactions with all affiliates may not exceed 20% of the bank's net assets.

As a result of these restrictions, approximately \$29.0 million of the \$125.7 million of net assets of the bank which were included in consolidated net assets of the corporation were available to be transferred to the parent company at December 31, 1986.

Federal Reserve Board regulations require that the bank maintain certain minimum reserve balances on deposit with the Federal Reserve Bank. The average amounts of such balances for the years ended December 31, 1986 and 1985 were approximately \$28,958,000 and \$19,599,000, respectively.

Note 9—Employee Benefits

The corporation has a noncontributory pension plan covering substantially all employees of Peoples Bancorporation and its subsidiaries. Total annual pension expense was \$2,262,000 in 1986, \$2,263,000 in 1985 and \$1,800,000 in 1984. The corporation makes annual contributions to the plan equal to the amount accrued for pension expense, including amortization of past service cost over 30 years. The actuarially determined value of benefits and pension fund net assets as of the most recent valuation date of January 1, 1985 were as follows:

(In Thousands)

Actuarial present value of accumulated plan benefits:	
Vested	\$16,249
Nonvested	1,204
<i>Total</i>	<u>\$17,453</u>
Net assets available for benefits	<u>\$22,972</u>

The actuarial assumption of investment earnings rate used in determining pension expense was 7% and the actuarial assumption of salary escalation was 6%.

In addition to providing pension benefits, the corporation provides certain health care and life insurance benefits for retired employees. Substantially all of the corporation's employees may become eligible for these benefits if they reach normal retirement age while working for the corporation. The cost of health care benefits for both retirees and active employees and the cost of basic life insurance benefits for retirees are recognized as expense when claims are paid. Life insurance benefits for active employees and supplemental life insurance benefits for retirees are provided through an insurance company whose premiums are based on the benefits paid during the year. The corporation recognizes the cost of providing such benefits by expensing the annual insurance premiums. For 1986, 1985 and 1984, the cost of providing health care and life insurance benefits was \$1,956,000, \$1,576,000 and \$1,797,000, respectively. The costs for 286 retirees are not separable from the costs for the 2,154 active employees.

The corporation also offers its employees an incentive savings plan. Eligible employees may elect to have from 2% to 6% of their base pay deferred and contributed to the plan. The amount deferred is not subject to federal income tax at the time of deferral. The corporation matches 50% of the employees' contribution. The corporation's expense related to the plan was \$747,000, \$656,000 and \$577,000 in 1986, 1985 and 1984, respectively.

Note 10—Income Taxes

The components of income tax expense (benefit) for the years ended December 31 were as follows:

(In Thousands)	1986	1985	1984
Current income tax expense (benefit)	\$ (6,106)	\$4,254	\$4,081
Deferred taxes resulting from:			
Accrual method for reporting purposes and cash method for tax purposes	(511)	(1,380)	(666)
Leasing income recognized on financing method for reporting purposes and on operating method for tax purposes	(412)	874	847
Provision for loan losses for reporting purposes in excess of that recognized for tax purposes	(4,750)	(1,659)	(2,275)
Differences in method of recognizing installment loan interest income for reporting purposes and for tax purposes	(255)	(281)	(339)
Pension plan costs recognized for tax purposes and deferred for reporting purposes	(11)	71	621
Depreciation recognized for tax purposes and deferred for reporting purposes	334	515	552
Investment tax credits recognized for tax purposes and deferred for reporting purposes	2	689	637
Amortization of deferred investment tax credits	(544)	(530)	(429)
Other deferred items	55	(109)	(14)
Deferred income tax benefit	(6,092)	(1,810)	(1,066)
Total income tax expense (benefit)	\$(12,198)	\$2,444	\$ 3,015
Tax expense included above related to securities transactions	\$294	\$289	\$5

The following is a reconciliation between the statutory federal income tax rate and the effective income tax rate for the years ended December 31:

(In Thousands)	1986		1985		1984	
	Amount	Percent of Pretax Loss	Amount	Percent of Pretax Income	Amount	Percent of Pretax Income
Income tax expense (benefit) at statutory rates	\$ (6,424)	(46.0)%	\$ 7,687	46.0 %	\$ 8,322	46.0 %
Increase (decrease) resulting from:						
Tax-exempt income	(4,141)	(29.6)	(4,147)	(24.8)	(4,134)	(22.9)
Nondeductible amortization	183	1.3	183	1.1	183	1.0
Investment tax credits	(748)	(5.3)	(1,081)	(6.5)	(1,081)	(6.0)
Refund of previously disallowed investment tax credits	(1,000)	(7.2)	—	—	—	—
Capital (gains) losses tax rate differential	16	0.1	(245)	(1.5)	(232)	(1.2)
Other	(84)	(0.6)	47	0.3	(43)	(0.2)
Total income tax expense (benefit)	\$(12,198)	(87.3)%	\$ 2,444	14.6%	\$ 3,015	16.7 %

The corporation's liability (receivable) for income taxes included in other liabilities in 1985 and in other assets in 1986 consisted of the following:

December 31 (In Thousands)	1986	1985
Taxes currently receivable	\$(6,382)	\$ (541)
Deferred taxes payable	565	7,570
Total tax liability (receivable)	\$(5,817)	\$7,029

Note 11—Commitments and Contingent Liabilities

In the normal course of business there are various commitments outstanding and contingent liabilities, such as letters of credit, interest rate swaps, guaranties and commitments to extend credit, which are not reflected in the consolidated financial statements. Management does not anticipate any material losses as a result of these transactions.

Because of the nature of their activities, the corporation and its subsidiaries are subject to various pending and threatened legal actions which arise in the ordinary course of business. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on the consolidated financial position of the corporation.

The following is a summary of significant commitments and contingencies at December 31:

(In Thousands)	1986	1985
Standby letters of credit	\$ 36,043	\$ 44,272
Commitments to extend credit	385,711	466,857
Interest rate swap transactions—notional value	35,000	—

Note 12—Peoples Bancorporation (Parent Company Only) Financial Information

Balance Sheet

December 31 (In Thousands)

	1986	1985
Assets		
Cash	\$ 307	\$ 1,539
Equity in net assets of subsidiaries:		
Peoples National Bank of Washington	123,987	125,515
Other subsidiaries	3,213	9,450
Total	127,200	134,965
Loans	800	11
Other assets	8,608	8,969
Total Assets	\$136,915	\$145,484
Liabilities and Shareholders' Equity		
Short-term commercial paper	\$ 800	\$ 11
Note payable to Peoples National Bank of Washington	—	4,375
Other liabilities	953	1,348
Total liabilities	1,753	5,734
Shareholders' equity	135,162	139,750
Total Liabilities and Shareholders' Equity	\$136,915	\$145,484

Statement of Operations

Year Ended December 31 (In Thousands)

	1986	1985	1984
Income			
Dividends from subsidiaries:			
Peoples National Bank of Washington	\$ 1,903	\$ 3,775	\$ 3,152
Other subsidiaries	363	747	810
Interest on loans	7	23	223
Total Income	2,273	4,545	4,185
Expense			
Interest (\$176, \$439 and \$453 paid to subsidiary in 1986, 1985 and 1984, respectively)	183	462	670
Amortization	350	355	806
Other	6	5	31
Total Expense	539	822	1,507
Income before income tax benefit and equity in undistributed net income (loss) of subsidiaries	1,734	3,723	2,678
Income tax benefit	61	184	407
Income before equity in undistributed net income (loss) of subsidiaries	1,795	3,907	3,085
Equity in undistributed net income (loss) of subsidiaries:			
Peoples National Bank of Washington	(4,398)	9,562	11,409
Other subsidiaries	835	798	583
Total	(3,563)	10,360	11,992
Net Income (Loss)	\$ (1,768)	\$14,267	\$15,077

Statement of Changes in Financial Position

Year Ended December 31 (In Thousands)

	1986	1985	1984
<i>Financial resources were provided by (applied to):</i>			
Operations:			
Net income (loss)	\$(1,768)	\$ 14,267	\$ 15,077
Noncash charges (credits):			
Amortization	350	355	806
Undistributed net (income) loss of subsidiaries	3,563	(10,360)	(11,992)
Financial resources provided by operations	2,145	4,262	3,891
Cash dividends declared	(3,805)	(3,776)	(3,772)
Net financial resources provided by (applied to) operations	(1,660)	486	119
Financing activities:			
Short-term commercial paper	789	(1,241)	(2,944)
Note payable to Peoples National Bank of Washington	(4,375)	(129)	(117)
Treasury stock acquired	(105)	(134)	(329)
Treasury stock reissued	839	—	—
Common stock issued under stock option plans	104	—	—
Conversion of convertible debentures to common stock	147	504	68
Total financing activities	(2,601)	(1,000)	(3,322)
Other activities:			
Cash	1,232	(625)	266
Other, net	(354)	364	81
Total other activities	878	(261)	347
Decrease in financial resources invested in earning assets	\$(3,383)	\$ (775)	\$ (2,856)
Increase (decrease) in earning assets:			
Loans	\$ 789	\$ (1,241)	\$ (2,944)
Investments in subsidiaries	(4,202)	416	68
Other investments	30	50	20
Decrease in earning assets	\$(3,383)	\$ (775)	\$ (2,856)

Guarantee of Debt of Subsidiaries: Peoples Bancorporation has guaranteed the 8¾ % Series B Subordinated Convertible Debentures issued by Peoples National Bank of Washington. Significant provisions of the debentures are disclosed in Note 6.

Dividends from Subsidiaries: Cash dividends of \$2,266,000, \$4,522,000 and \$3,962,000 were declared payable from consoli-

dated subsidiaries to Peoples Bancorporation for the years ended December 31, 1986, 1985 and 1984, respectively. Approximately \$1,315,000, \$3,577,000 and \$3,019,000 of such dividends were received by Peoples Bancorporation as of December 31, 1986, 1985 and 1984, respectively, with the remainder recorded as an accrued receivable.

Report of Ernst & Whinney, Independent Auditors

Board of Directors
Peoples Bancorporation
Seattle, Washington

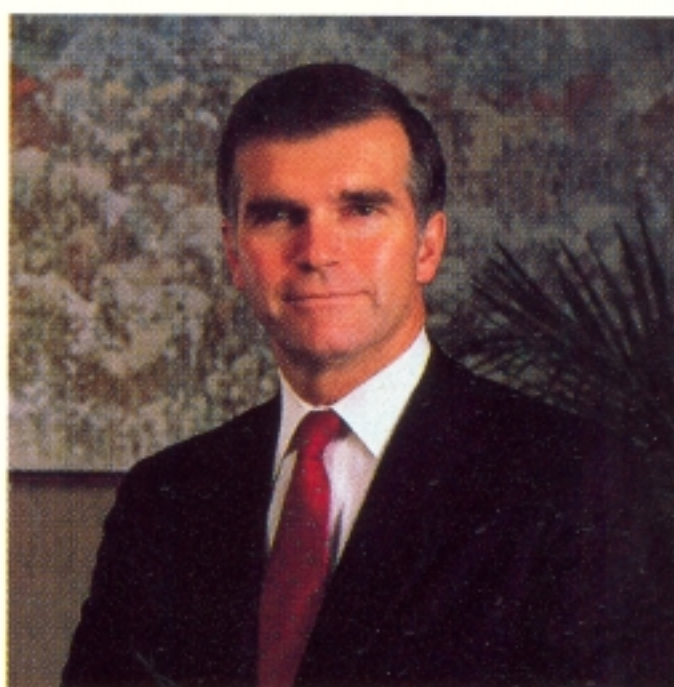
We have examined the consolidated balance sheet of Peoples Bancorporation and subsidiaries as of December 31, 1986 and 1985, and the related consolidated statements of operations, changes in shareholders' equity, and changes in financial position for each of the three years in the period ended December 31, 1986. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Peoples Bancorporation and subsidiaries at December 31, 1986 and 1985, and the consolidated results of their operations and changes in their financial position for each of the three years in the period ended December 31, 1986, in conformity with generally accepted accounting principles applied on a consistent basis.

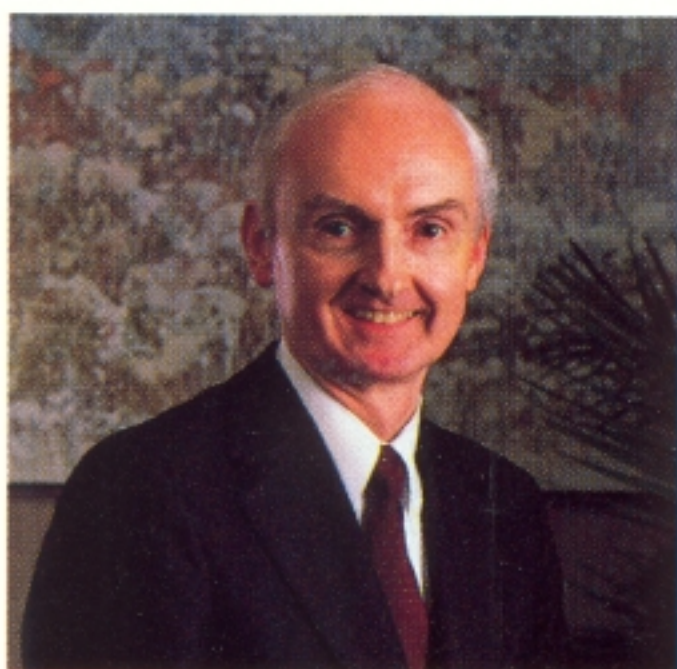
Seattle, Washington
January 23, 1987

Ernst & Whinney

Administrative Committee



Joshua Green III
Chairman of the Board, Chief Executive Officer and President, Peoples Bancorporation and PeoplesBank



Charles E. Riley
Executive Vice President, Peoples Bancorporation, and Vice Chairman, PeoplesBank



L. Michael Riley
Vice Chairman, Peoples Bancorporation, and Executive Vice President, PeoplesBank



Thomas G. Andrew, Jr.
Executive Vice President, PeoplesBank



Daniel J. Doyle
Executive Vice President, PeoplesBank

Board of Directors

Joshua Green III
Chairman of the Board, Chief Executive Officer and President

M. Lamont Bean
M. Lamont Bean Investments

John M. Bloxom, Jr.
President and Chief Executive Officer
Mt. Adams Orchards Corporation

Charles P. Burnett III
Investor

Sidney D. Campbell
Retired Chairman of the Board
Foss Launch and Tug Company
An Affiliate of Dillingham Corporation

Garrett Eddy
Chairman of the Board
The Port Blakely Company

John M. Fluke, Jr.
Chairman of the Board and Chief Executive Officer
John Fluke Mfg. Co., Inc.

E.P. Garrett
President
Welco Lumber Company
Chairman of the Board
Merrill and Ring, Inc.

William Golding
Chief Executive Officer
Forest Grove Industries

Isabelle S. Lamb
President
Enterprises International, Inc.

Thomas H. Macbride*
Attorney at Law

Harry H. Masto*
Retired

Robert G. Perry*
Retired

Ward L. Sax
Attorney at Law
Karr, Tuttle, Koch, Campbell
Mawer, Morrow and Sax, P.S.

James B. Scroggs
Retired

John E. Steiner
Aerospace Consultant
Retired Vice President
Corporate Product Development
The Boeing Company

E.C. Underhill*
Retired

Corydon Wagner, Jr.
Chairman and Chief Executive Officer
R.D. Merrill Company

James E. Warjone
President and General Partner
Port Blakely Tree Farms

Thomas P. Youell
President
The Northwest Company
Chairman
Canadian Auto Carriers, Ltd.

* Advisory Directors to the Board

General Information

Peoples Bancorporation is a bank holding company organized in Washington State in 1981. Its principal subsidiary is Peoples National Bank of Washington, founded in 1889, which is engaged in a general banking business through its head office in Seattle and 75 other banking offices throughout the state of Washington. Other subsidiaries are engaged in mortgage banking, escrow services and credit life insurance.

Annual Meeting

The annual meeting of shareholders will be held in the West Room, the Seattle Sheraton, Sixth and Pike, Seattle, Washington, on March 31, 1987 at 3:00 p.m.

Transfer Agent

Corporate Trust Department
Peoples National Bank
of Washington
P.O. Box 720
1414 Fourth Avenue
Seattle, Washington 98111

Stock Listing

Peoples Bancorporation common stock is traded Over-the-Counter. NASDAQ symbol: PEOP.

Form 10-K

Copies of Peoples Bancorporation's annual report to the Securities and Exchange Commission, Form 10-K, will be mailed to shareholders upon written request to:

L. Michael Riley
Vice Chairman and
Secretary-Treasurer
P.O. Box 720
1414 Fourth Avenue
Seattle, Washington 98111

For additional information, write or call:

Peoples Bancorporation
P.O. Box 720
1414 Fourth Avenue
Seattle, Washington 98111
From Seattle: (206) 344-2300
From Washington State outside
of Seattle: 1-800-552-7138
From outside of Washington
State in the continental United
States: 1-800-426-0648

Peoples Bancorporation

1414 Fourth Avenue, Seattle, Washington 98111
Member FDIC