ANNUAL REPORT 2012

Pacific Financial Corporation

FORWARD LOOKING INFORMATION

This document contains forward-looking statements that are subject to risks and uncertainties. These statements are based on the current beliefs and assumptions of our management, and on information currently available to them. Forward-looking statements include the information concerning our possible future results of operations set forth under “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and statements preceded by, followed by or that include the words “believes,” “expects,” “anticipates,” “intends,” “plans,” “estimates” or similar expressions.

Any forward-looking statements in this document are subject to risks relating to, among other things, the factors described under the heading “Risk Factors” in Park I, Item 1A to our Annual Report of Form 10-K for the fiscal year ended December 31, 2012 (the “Form 10-K), as well as the following:

1. changing laws, regulations, standards, and government programs and policies, that may limit our revenue sources, significantly increase our costs, including compliance and insurance costs, cause or contribute to rising interest rates, and place additional burdens on our limited management resources;

2. stagnant economic or business conditions, nationally and in the regions in which we do business, that have resulted in, and may continue to result in, among other things, challenges with respect to credit quality and/or reduced demand for credit and other banking services, and additional workout and other real estate owned (“OREO”) expenses;

3. decreases in real estate and other asset prices, whether or not due to changes in economic conditions, that may reduce the value of the assets that serve as collateral for many of our loans;

4. competitive pressures among depository and other financial institutions that may impede our ability to attract and retain depositors, borrowers and other customers, retain our key employees, and/or maintain and improve our net interest margin and income and non-interest income, such as fee income; and

5. a lack of liquidity in the market for our common stock that may make it difficult or impossible for you to liquidate your investment in our stock or lead to distortions in the market price of our stock.

Our management believes our forward-looking statements are reasonable; however, you should not place undue reliance on them. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions. Many of the factors that will determine our future results, financial condition, and share value are beyond our ability to predict or control. We undertake no obligation to update forward-looking statements.

LETTER TO THE SHAREHOLDERS

Dennis A. Long
President & CEO

My Fellow Shareholders:

Over the past three years, our financial results have consistently improved. In 2012, our net income increased 70% to $4.79 million from $2.82 million in 2011, which was a 72% increase over 2010 profits of $1.63 million.

At the beginning of 2012 we focused upon five primary objectives:

1) The first and most important objective was to continue to improve asset quality, since weak asset quality drags down financial performance in many ways. With the hard work of our entire lending staff, we exceeded our internal objectives for improving asset quality. Classified Assets (which are assets with material weaknesses) declined by $18 million, or 39% during 2012. Repossessed properties, commonly referred to as Other Real Estate Owned, dropped by $3.0 million to $4.7 million from $7.7 million a year ago. We still have more work to do in this important area, and we expect to continue to generate positive trends for asset quality during 2013.

2) Our second primary objective last year was to continue to improve net interest margin (NIM). NIM improved to 4.20% for 2012 from 4.08% for 2011. One basis point of margin increase translates to approximately $57,000 of annual income. NIM compression is an industry wide trend that is a result of the historically low interest rate environment. Unless the Federal Reserve begins pushing interest rates higher, which is very unlikely, we don’t anticipate the pressures on NIM will ease anytime soon. The best way to offset NIM contraction is to accelerate the growth of earning assets while managing the costs associated with the growth.

3) We knew in early 2011 that our NIM was eventually going to top out during 2012. So our third major objective became growing the balance sheet and, in particular, the loan portfolio. Despite a solid marketing campaign and hard work by all our lenders, loan demand in our

markets was soft. After normal payments and loans maturing, our loan portfolio shrank in 2012 by $26.7 million with our year-end balance totaling $448.2 million. Loan demand has begun to improve and we are putting into place strategic initiatives which are already starting to produce results in 2013. First we hired a loan production team for the Clark County market. Second, we purchased three full-service Sterling Savings Bank branches in Aberdeen, Washington and Astoria and Seaside, Oregon. These markets are very familiar to us and will complement our present locations very nicely. We look forward to welcoming the customers and employees from these locations to our team in June, following the expected May 31st closing of the transaction.

4) Another of our primary objectives is to become more efficient. While the numbers for 2012 ended with core net overhead at 2.84%, we began to change from a geographic management structure to a functional alignment. At yearend, our president, John Van Dijk, retired and I assumed his title, with most of his former responsibilities being distributed among our other senior executives. The realignment, coupled with other retirements, offer other cost-saving opportunities that operate with fewer employees while maintaining high-quality service. This reformation includes the addition of the three Sterling branches, two new loan production offices, and a new Warrenton, Oregon, full-service branch which is currently under construction. In essence, by yearend, we expect to add approximately $70 million in assets while minimizing net increases in staffing.

5) The final 2012 objective was to expand into other markets, and clearly we have moved forward on this strategic initiative. We continue to look for other opportunities that are compatible within our footprint in Western Washington and Oregon.

Our balance sheet continues to be very strong and our capital ratios are solid. Comparative yearend capital ratios were as follows:

Capital Ratio	Actual 2012	Actual 2011	Regulatory Well-Capitalized
Tier 1 Leverage	10.7%	10.2%	5.0%
Tier 1 Risk-based	14.9%	13.6%	6.0%
Total Risk-based	16.2%	14.8%	10.0%

We are very pleased that our capital levels are improving and are solidly above regulatory requirements for well-capitalized banks. These strong capital ratios allowed us to purchase the Sterling branches without raising additional capital.

With improving asset quality and strengthening profitability, we were able to resume paying a cash dividend at the end of 2012. The 20-cent cash dividend to all shareholders in December equates to a yield of more than 3.5% at current market levels.

As you can see, Pacific Financial Corporation and its subsidiary, Bank of the Pacific, made significant progress in 2012 toward more normal and sustainable operating results. This achievement would not have been possible without the unwavering hard work and dedication of our employees. As customers and shareholders, the Board of Directors and I want to thank you for your continued support, not only for 2012, but also for the many years we've been together. We are looking forward to 2013 with enthusiasm and optimism.

Sincerely,

Dennis A. Long
President & CEO
March 20, 2013

IN MEMORY

SID SNYDER

July 30, 1926 – October 14, 2012

Founding Director
Bank of the Pacific
1971 – 2004

DAVID WOODLAND

April 22, 1930 – September 10, 2012

Founding Director
The Bank of Grays Harbor
1979 – 2005

SELECTED FINANCIAL DATA

The following selected consolidated five year financial data should be read in conjunction with the Company's audited consolidated financial statements and the accompanying notes presented in this report. Dollars are in thousands, except per share data.

	As of and For the Year Ended December 31,				
	2012	2011	2010	2009	2008
Operations Data					
Net interest income	$24,011	$23,685	$22,879	$21,753	$21,715
Provision (recapture) for credit losses	(1,100)	2,500	3,600	9,944	4,791
Non-interest income	9,391	7,614	8,451	7,025	5,057
Non-interest expense	28,417	25,648	26,400	29,691	21,591
Provision (benefit) for income taxes	1,300	333	(304)	(4,519)	(561)
Net income (loss)	**$4,785**	**$2,818**	**$1,634**	**$(6,338)**	**$951**
Net income (loss) per share:					
Basic (1)	$0.47	$0.28	$0.16	$(0.74)	$0.13
Diluted (1)	0.47	0.28	0.16	(0.74)	0.13
Dividends declared	2,024	- -	- -	- -	333
Dividends declared per share (1)	0.20	- -	- -	- -	0.05
Dividend payout ratio	42%	- -	- -	- -	35%
Performance Ratios					
Interest rate spread	4.34%	4.22%	4.10%	3.76%	4.23%
Net interest margin (2)	4.20%	4.08%	3.96%	3.62%	4.12%
Efficiency ratio (3)	85.08%	81.95%	84.26%	103.17%	80.65%
Return on average assets	0.75%	0.44%	0.25%	(0.96)%	0.16%
Return on average equity	7.28%	4.55%	2.77%	(11.63)%	1.83%
Balance Sheet Data					
Total assets	$643,594	$641,254	$644,403	$668,626	$625,835
Loans, net	438,838	463,766	455,064	471,154	478,695
Total deposits	548,243	548,050	544,954	567,695	511,307
Total borrowings	23,903	24,644	35,328	39,880	60,757
Shareholders' equity	66,721	63,270	59,769	57,649	50,074
Book value per share (1) (4)	6.59	6.25	5.90	5.70	6.84
Tangible book value per share (1) (5)	5.35	5.01	4.66	4.44	5.08
Equity to assets ratio	10.37%	9.87%	9.28%	8.62%	8.00%
Asset Quality Ratios					
Nonperforming loans to total loans	3.37%	2.96%	2.15%	3.36%	3.49%
Allowance for credit losses to total loans	2.09%	2.34%	2.28%	2.30%	1.57%
Allowance for credit losses to nonperforming loans	61.92%	79.28%	106.18%	68.49%	44.97%
Nonperforming assets to total assets	3.08%	3.39%	2.57%	3.42%	3.80%

(1) Retroactively adjusted for a 1.1 to 1 stock split effective January 13, 2009.
(2) Net interest income divided by average earning assets.
(3) Non-interest expense divided by the sum of net interest income and non-interest income.
(4) Shareholder equity divided by shares outstanding.
(5) Shareholder equity less intangibles divided by shares outstanding.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Pacific Financial Corporation
Aberdeen, Washington

We have audited the accompanying consolidated balance sheets of Pacific Financial Corporation and subsidiary (the "Company") as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Pacific Financial Corporation and subsidiary as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Portland, Oregon
March 20, 2013

Pacific Financial Corporation and Subsidiary
December 31, 2012 and 2011
Consolidated Balance Sheets

(Dollars in Thousands, Except Per Share Amounts)

	2012	2011
Assets		
Cash and due from banks (See note 2)	$14,168	$12,607
Interest bearing deposits in banks	42,687	28,525
Certificates of deposits held for investment	2,985	- -
Securities available for sale, at fair value (amortized cost of $59,658 and $47,015)	61,106	47,652
Securities held to maturity (fair value of $6,985 and $7,118)	6,937	7,025
Federal Home Loan Bank stock, at cost	3,126	3,182
Loans held for sale	12,950	14,541
Loans	448,196	474,893
Allowance for credit losses	9,358	11,127
Loans - net	**438,838**	**463,766**
Premises and equipment	14,593	14,884
Other real estate owned	4,679	7,725
Accrued interest receivable	2,079	2,156
Cash surrender value of life insurance	17,784	17,275
Goodwill	11,282	11,282
Other intangible assets	1,268	1,268
Other assets	9,112	9,366
Total assets	**$643,594**	**$641,254**
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Demand, non-interest bearing	$115,138	$108,899
Savings and interest-bearing demand	295,100	286,642
Time, interest-bearing	138,005	152,509
Total deposits	**548,243**	**548,050**
Accrued interest payable	213	1,490
Secured borrowings	- -	741
Short-term borrowings	3,000	- -
Long-term borrowings	7,500	10,500
Junior subordinated debentures	13,403	13,403
Other liabilities	4,514	3,800
Total liabilities	**576,873**	**577,984**
Commitments and Contingencies (See note 13)	**- -**	**- -**
Shareholders' Equity		
Common stock (par value $1); authorized: 25,000,000 shares; issued and outstanding: 2012 and 2011 – 10,121,853 shares	10,122	10,122
Additional paid-in capital	41,366	41,342
Retained earnings	14,812	12,051
Accumulated other comprehensive income (loss)	421	(245)
Total shareholders' equity	**66,721**	**63,270**
Total liabilities and shareholders' equity	**$643,594**	**$641,254**

See notes to consolidated financial statements.

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2012, 2011 and 2010
Consolidated Statements of Income

(Dollars in Thousands, Except Per Share Amounts)

	2012	2011	2010
Interest and Dividend Income			
Loans	$25,635	$27,186	$28,520
Federal funds sold and deposits in banks	84	92	116
Securities available for sale:			
Taxable	756	1,024	1,214
Tax-exempt	711	707	716
Securities held to maturity:			
Taxable	14	18	21
Tax-exempt	295	291	273
Total interest and dividend income	**27,495**	**29,318**	**30,860**
Interest Expense			
Deposits	2,882	4,643	6,574
Short-term borrowings	79	- -	- -
Long-term borrowings	217	597	849
Secured borrowings	20	41	61
Junior subordinated debentures	286	352	497
Total interest expense	**3,484**	**5,633**	**7,981**
Net interest income	**24,011**	**23,685**	**22,879**
Provision for (recapture of) credit losses	(1,100)	2,500	3,600
Net interest income after provision for credit losses	**25,111**	**21,185**	**19,279**
Non-Interest Income			
Service charges on deposit accounts	1,686	1,799	1,783
Net gains (loss) on sale of other real estate owned	331	(83)	260
Net gains from sales of loans	5,058	3,593	4,168
Net gains on sales of securities available for sale	303	698	422
Net other-than-temporary impairment (net of $4, $256 and $0 recognized in other comprehensive income before taxes)	(333)	(330)	- -
Earnings on bank owned life insurance	510	527	541
Other operating income	1,836	1,410	1,277
Total non-interest income	**9,391**	**7,614**	**8,451**
Non-Interest Expense			
Salaries and employee benefits	16,215	13,723	13,530
Occupancy	1,673	1,523	1,544
Equipment	801	1,011	1,222
State taxes	518	473	480
Data processing	1,607	1,415	1,247
Professional services	750	739	767
Other real estate owned write-downs	1,314	1,049	1,272
Other real estate owned operating costs	550	450	614
FDIC assessments	610	938	1,361
Other	4,379	4,327	4,363
Total non-interest expense	**28,417**	**25,648**	**26,400**
Income before income taxes	**6,085**	**3,151**	**1,330**
Provision (benefit) for income taxes	1,300	333	(304)
Net income	**$4,785**	**$2,818**	**$1,634**
Earnings Per Share			
Basic	$0.47	$0.28	$0.16
Diluted	$0.47	$0.28	$0.16
Weighted Average Shares Outstanding:			
Basic	10,121,853	10,121,853	10,121,853
Diluted	10,126,244	10,121,870	10,121,853

See notes to consolidated financial statements.

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2012, 2011 and 2010
Consolidated Statements of Income

(Dollars in Thousands, Except Per Share Amounts)

	2012	2011	2010
Net income	**$4,785**	**$2,818**	**$1,634**
Other comprehensive income, net of tax:			
Net unrealized gains on investment securities (net of tax of $276, $391, and $130, respectively)	536	758	523
Defined benefit plans (net of tax of $44, $34, and $28, respectively)	130	(101)	(83)
Other comprehensive income	**666**	**657**	**440**
Comprehensive income	**$5,451**	**$3,475**	**$2,074**

See notes to consolidated financial statements.

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2012, 2011 and 2010
Consolidated Statements of Shareholders' Equity

(Dollars in Thousands, Except Per Share Amounts)

	Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance at January 1, 2010	**10,121,853**	**$10,122**	**$41,270**	**$7,599**	**$(1,342)**	**$57,649**
Comprehensive income:						
Net income	- -	- -	- -	1,634	- -	1,634
Unrealized holding gain on securities less reclassification adjustment for net gains included in net income	- -	- -	- -	- -	523	523
Amortization of unrecognized prior service costs and net gains/losses	- -	- -	- -	- -	(83)	(83)
Comprehensive income						**2,074**
Stock compensation expense	- -	- -	46	- -	- -	46
Balance at December 31, 2010	**10,121,853**	**$10,122**	**$41,316**	**$9,233**	**$(902)**	**$59,769**
Comprehensive income:						
Net income	- -	- -	- -	2,818	- -	2,818
Unrealized holding gain on securities less reclassification adjustment for net gains included in net income	- -	- -	- -	- -	758	758
Amortization of unrecognized prior service costs and net gains/losses	- -	- -	- -	- -	(101)	(101)
Comprehensive income						**3,475**
Stock compensation expense	- -	- -	26	- -	- -	26
Balance at December 31, 2011	**10,121,853**	**$10,122**	**$41,342**	**$12,051**	**$(245)**	**$63,270**
Comprehensive income:						
Net income	- -	- -	- -	4,785	- -	4,785
Unrealized holding gain on securities less reclassification adjustment for net gains included in net income	- -	- -	- -	- -	536	536
Amortization of unrecognized prior service costs and net gains/losses	- -	- -	- -	- -	130	130
Comprehensive income						**5,451**
Dividend paid ($0.20 per share)	- -	- -	- -	(2,024)	- -	(2,024)
Stock compensation expense	- -	- -	24	- -	- -	24
Balance at December 31, 2012	**10,121,853**	**$10,122**	**$41,366**	**$14,812**	**$421**	**$66,721**

See notes to consolidated financial statements.

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2012, 2011 and 2010
Consolidated Statements of Cash Flows

(Dollars in Thousands)

	2012	**2011**	**2010**
Cash Flows from Operating Activities			
Net income	$4,785	$2,818	$1,634
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,491	1,428	1,585
Provision for (recapture of) credit losses	(1,100)	2,500	3,600
Deferred income taxes	63	(815)	(886)
Originations of loans held for sale	(251,435)	(172,274)	(209,301)
Proceeds from sales of loans held for sale	256,720	170,797	215,548
Net gains on sales of loans	(5,058)	(3,593)	(4,168)
Net gain on sales of securities available for sale	(303)	(698)	(422)
Net OTTI recognized in earnings	333	330	- -
(Gain) loss on sales of other real estate owned	(331)	83	(260)
(Gain) loss on sale of premises and equipment	(6)	23	14
Earnings on bank owned life insurance	(510)	(527)	(541)
Decrease in accrued interest receivable	77	178	203
Increase (decrease) in accrued interest payable	(1,277)	110	255
Other real estate owned write-downs	1,314	1,049	1,272
Additions to other real estate owned	(185)	(260)	- -
Proceeds from Internal Revenue Service tax refund	- -	1,876	- -
Decrease in prepaid expenses	374	801	1,289
Other - net	288	1,869	1,054
Net cash provided by operating activities	**5,240**	**5,695**	**10,876**
Cash Flows from Investing Activities			
Net (increase) decrease in interest bearing deposits in banks	(14,162)	25,805	(19,262)
Net decrease in federal funds sold	- -	- -	5,000
Purchase of certificates of deposits held for investment, net	(2,985)	- -	- -
Activity in securities available for sale:			
Sales	10,917	17,407	17,179
Maturities, prepayments and calls	10,451	7,564	8,069
Purchases	(34,194)	(29,553)	(12,325)
Activity in securities held to maturity:			
Maturities	286	255	1,048
Purchases	(200)	(828)	(56)
Proceeds from sales of government loan pools	1,296	9,845	5,272
(Increase) decrease in loans made to customers, net of principal collections	24,105	(23,505)	114
Purchases of premises and equipment	(844)	(1,019)	(470)
Proceeds from sales of other real estate owned	4,223	1,101	6,440
Net cash provided by (used in) investing activities	**(1,107)**	**7,072**	**11,009**

(continued)

See notes to consolidated financial statements.

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2012, 2011 and 2010
Consolidated Statements of Cash Flows

(concluded) (Dollars in Thousands)

	2012	2011	2010
Cash Flows from Financing Activities			
Net increase (decrease) in deposits	$193	$3,096	$(22,741)
Net decrease in short-term borrowings	- -	(10,500)	(4,500)
Decrease in secured borrowings	(741)	(184)	(52)
Proceeds from issuance of long-term borrowings	2,500	7,500	- -
Prepayments of long-term borrowings	(2,500)	(7,500)	- -
Cash dividends paid	(2,024)	- -	- -
Net cash used in financing activities	**(2,572)**	**(7,588)**	**(27,293)**
Net change in cash and due from banks	**1,561**	**5,179**	**(5,408)**
Cash and Due from Banks			
Beginning of year	12,607	7,428	12,836
End of year	**$14,168**	**$12,607**	**$7,428**
Supplemental Disclosures of Cash Flow Information			
Interest paid	$4,761	$5,523	$7,726
Income taxes paid	1,998	332	725
Supplemental Disclosures of Non-Cash Investing Activities			
Fair value adjustment of securities available for sale, net of tax	$536	$758	$523
Transfer of loans held for sale to loans held for investment	1,295	300	- -
Other real estate owned acquired in settlement of loans	(2,897)	(4,278)	(8,093)
Financed sale of other real estate owned	922	1,160	726
Reclass of current portion of long-term borrowings to short-term borrowings	3,000	- -	10,500

See notes to consolidated financial statements.

Note 1 - Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of Pacific Financial Corporation (the Company), and its wholly owned subsidiary, Bank of the Pacific (the Bank), after elimination of intercompany transactions and balances. The Company has two wholly owned subsidiaries, PFC Statutory Trust I and II (the Trusts), which do not meet the criteria for consolidation, and therefore, are not consolidated in the Company's financial statements. The Company was incorporated in the State of Washington on February 12, 1997, pursuant to a holding company reorganization of the Bank.

Nature of Operations

The Company is a holding company which operates primarily through its subsidiary bank. The Bank operates 16 branches located in Grays Harbor, Pacific, Skagit, Whatcom and Wahkiakum Counties in western Washington and one in Clatsop County, Oregon. The Bank provides loan and deposit services to customers, who are predominately small- and middle-market businesses and middle-income individuals in western Washington and the north coast of Oregon.

In 2006, the Bank completed a deposit transfer and assumption transaction with an Oregon-based bank for a $1,268 premium. In connection with completion of the transaction, the Oregon Department of Consumer and Business Services issued a Certificate of Authority to the Bank authorizing it to conduct a banking business in the State of Oregon. The premium, and the resultant right to conduct business in Oregon, is recorded as an indefinite-lived intangible asset.

Consolidated Financial Statement Presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and practices within the banking industry. The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities, as of the date of the balance sheet, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for credit losses, the valuation of deferred tax assets, the valuation of investments, the valuation of other real estate owned and the evaluation of goodwill and investments for impairment.

Securities Available for Sale

Securities available for sale consist of debt securities that the Company intends to hold for an indefinite period, but not necessarily to maturity. Securities available for sale are reported at fair value. Unrealized gains and losses, net of the related deferred tax effect, are reported net as a separate component of shareholders' equity entitled "accumulated other comprehensive loss." Realized gains and losses on securities available for sale, determined using the specific identification method, are included in earnings. Amortization of premiums and

accretion of discounts are recognized in interest income over the period to maturity. For mortgage-backed securities, actual maturity may differ from contractual maturity due to principal payments and amortization of premiums and accretion of discounts may vary due to prepayment speed assumptions.

Securities Held to Maturity

Debt securities for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized in interest income over the period to maturity.

Declines in the fair value of individual securities held to maturity and available for sale that are deemed to be other than temporary are reflected in earnings when identified. Management evaluates individual securities for other than temporary impairment ("OTTI") on a quarterly basis. OTTI is separated into a credit and noncredit component. Noncredit component losses are recorded in other comprehensive (loss) when the Company a) does not intend to sell the security or b) is not more likely than not it will be required to sell the security prior to the security's anticipated recovery. Credit component losses are reported in non-interest income.

Federal Home Loan Bank Stock

The Company's investment in Federal Home Loan Bank ("FHLB") stock is carried at par value. The Company is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding mortgages, total assets or FHLB advances.

The Company views its investment in the FHLB stock as a long-term investment. Based on the Company's evaluation of the underlying investment, including the long-term nature of the investment, the liquidity position of the FHLB, the actions being taken by the FHLB to address its regulatory situation and the Company's intent and ability to hold the investment for a period of time sufficient to recover the par value, the Company does not believe its investment with the FHLB is impaired. Further, during 2012, the Federal Housing Finance Agency ("Finance Agency") upgraded the FHLB's capital classification to "adequately capitalized" and granted the FHLB authority to repurchase up to $25 million of excess capital stock per quarter at par value, provided they received a non-objection for each quarter's repurchase from the Finance Agency. Even though the Company did not determine its investment in the FHLB stock was impaired at December 31, 2012, future deterioration of the FHLB's financial condition may result in future impairment losses.

Loans Held for Sale

Mortgage loans originated for sale in the foreseeable future in the secondary market are carried at the lower of aggregate cost or estimated fair value. Gains and losses on sales of loans are recognized at settlement date and are determined by the difference between the sales proceeds and the carrying value of the loans. Net unrealized losses are recognized through a valuation allowance established by charges to income. Loans held for sale that are unable to be sold in the secondary market are transferred to loans receivable when identified.

Loans Receivable

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal balances adjusted for any charge-offs, the allowance for credit losses, any deferred fees or costs on originated loans, and unamortized premiums or discounts on purchased loans. Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment of yield over the contractual life of the related loans using the effective interest method.

Interest income on loans is accrued over the term of the loans based upon the principal outstanding. The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they come due. When interest accrual is discontinued, all unpaid accrued interest is reversed against interest income. Interest income is subsequently recognized only to the extent that cash payments are received until, in management's judgment, the borrower has the ability to make contractual interest and principal payments, in which case the loan is returned to accrual status.

Allowance for Credit Losses

The allowance for credit losses is established through a provision that is charged to earnings as probable losses are incurred. Losses are charged against the allowance when management believes the collectability of a loan balance is unlikely. Subsequent recoveries, if any, are credited to the allowance.

The allowance for credit losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of underlying collateral and prevailing economic conditions. The evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available. The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which includes a general formulaic allowance and a specific allowance on impaired loans. The formulaic portion of the general credit loss allowance is established by applying a loss percentage factor to the different loan types based on historical loss experience adjusted for qualitative factors.

A loan is considered impaired when, based on current information and events, it is probable the Company will be unable to collect principal and interest when due according to the contractual terms of the original loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls are generally not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrowers, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial, construction and real estate loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral less estimated selling costs if the loan is collateral dependent. When the net realizable value of an impaired loan is less than the book value of the loan, impairment

is recognized by adjusting the allowance for credit losses. Uncollected accrued interest is reversed against interest income. If ultimate collection of principal is in doubt, all subsequent cash receipts including interest payments on impaired loans are applied to reduce the principal balance.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation, which is computed on the straight-line method over the estimated useful lives of the assets. Asset lives range from 3 to 39 years. 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.

Other Real Estate Owned

Real estate properties acquired through, or in lieu of, foreclosure are to be sold and are initially recorded at the lower of cost or fair value of the properties less estimated costs of disposal. Any write-down to fair value at the time of transfer to other real estate owned ("OREO") is charged to the allowance for credit losses. Properties are evaluated regularly to ensure that the recorded amounts are supported by their current fair values, and that write-downs to reduce the carrying amounts to fair value less estimated costs to dispose are recorded as necessary. Any subsequent reductions in carrying values, and revenue and expense from the operations of properties, are charged to operations.

Goodwill and other intangible assets

At December 31, 2012 the Company had $12,550 in goodwill and other intangible assets. Goodwill is initially recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired. Goodwill is not amortized but is reviewed for potential impairment during the second quarter on an annual basis or, more frequently, if events or circumstances indicate a potential impairment, at the reporting unit level. The Company has one reporting unit, the Bank, for purposes of computing goodwill. The analysis of potential impairment of goodwill requires a two-step process. The first step is a comparison of the reporting unit's fair value to its carrying value. If the reporting unit's fair value is less than its carrying value, the Company would be required to progress to the second step. In the second step the Company calculates the implied fair value of its reporting unit. The Company compares the implied fair value of goodwill to the carrying amount of goodwill on the Company's balance sheet. If the carrying amount of the goodwill is greater than the implied fair value of that goodwill, an impairment loss must be recognized in an amount equal to that excess. The implied fair value of goodwill is determined in the same manner as goodwill recognized in a business combination. The estimated fair value of the Company is allocated to all of the Company's individual assets and liabilities, including any unrecognized identifiable intangible assets, as if the Company had been acquired in a business combination and the estimated fair value of the Company is the price paid to acquire it. The allocation process is performed only for purposes of determining the amount of goodwill impairment, as no assets or liabilities are written up or down, nor are any additional unrecognized identifiable intangible assets recorded as a part of this process.

The results of the Company's annual impairment test determined the reporting unit's fair value exceeded its carrying value and no goodwill impairment existed. As of December 31, 2012 management determined there were no events or circumstances which would more likely than not reduce the fair value of its reporting unit below its carrying value. No assurance can be given that the Company will not record an impairment loss on goodwill in the future.

Impairment of long-lived assets

Management periodically reviews the carrying value of its long-lived assets to determine if an impairment has occurred or whether changes in circumstances have occurred that would require a revision to the remaining useful life, of which there have been none. In making such determination, management evaluates the performance, on an undiscounted basis, of the underlying operations or assets which give rise to such amount.

Transfers of Financial Assets

Transfers of financial assets, including cash, investment securities, loans and loans held for sale, are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through either an agreement to repurchase them before their maturity, or the ability to cause the buyer to return specific assets.

Income Taxes

Deferred tax assets and liabilities result from differences between the financial statement carrying amounts and the tax bases of assets and liabilities, and are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. Deferred tax assets are reduced by a valuation allowance when management determines that it is more likely than not that some portion or all of the deferred tax assets will not be realized. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The Company files a consolidated federal income tax return. The Bank provides for income taxes separately and remits to the Company amounts currently due in accordance with a tax allocation agreement between the Company and the Bank.

As of December 31, 2012, the Company had no unrecognized tax benefits. The Company's policy is to recognize interest and penalties on unrecognized tax benefits in "Income Taxes (Benefit)" in the consolidated statements of income. There were no amounts related to interest and penalties recognized for the year ended December 31, 2012. The tax years that remain subject to examination by federal and state taxing authorities are the years ended December 31, 2011, 2010 and 2009.

Stock-Based Compensation

Accounting guidance requires measurement of compensation cost for all stock based awards based on the grant date fair value and recognition of compensation cost over the service period of stock based awards. The fair value of stock options is determined using the Black-Scholes valuation model. The Company's stock compensation plans are described more fully in Note 15.

Cash Equivalents and Cash Flows

The Company considers all amounts included in the balance sheet caption "Cash and due from banks" to be cash equivalents. Cash and cash equivalents have a maturity of 90 days or less at the time of purchase. Cash flows from loans, interest bearing deposits in banks, federal funds sold, short-term borrowings, secured borrowings and deposits are reported net. The Company maintains balances in depository institution accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

Certificates of Deposit Held for Investment

Certificates of deposit held for investments include amounts invested with financial institutions for a stated interest rate and maturity date. Early withdraw penalties apply, however the Company plans to hold these investments to maturity.

Earnings Per Share

Basic earnings per share excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding. Diluted earnings per share reflect the potential dilution that could occur if common shares were issued pursuant to the exercise of options under the Company's stock option plans. Stock options excluded from the calculation of diluted earnings per share because they are antidilutive, were 532,106, 581,448, and 818,612 in 2012, 2011 and 2010, respectively. Outstanding warrants also excluded were 699,642 for each of the years in 2012 through 2010, respectively.

Comprehensive Income

Recognized revenue, expenses, gains and losses are included in net income. Certain changes in assets and liabilities, such as prior service costs and amortization of prior service costs related to defined benefit plans and unrealized gains and losses on securities available for sale, are reported within equity in other accumulated comprehensive loss in the consolidated balance sheets. Such items, along with net income, are components of comprehensive income. Gains and losses on securities available for sale are reclassified to net income as the gains or losses are realized upon sale of the securities. Other-than-temporary impairment charges are reclassified to net income at the time of the charge.

Business Segment

The Company operates a single business segment. The financial information that is used by the chief operating decision maker in allocating resources and assessing performance is only provided for one reportable segment as of December 31, 2012, 2011 and 2010.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2011-04, *"Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*." This ASU is the result of joint efforts by the FASB and International Accounting Standards Board to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and International Financial Reporting Standards. The amendments are effective for interim and annual periods beginning after December 15, 2011 with prospective application required. The Company adopted the provisions of ASU No. 2011-04 effective January 1, 2012. The fair value measurement provisions had no impact on the Company's consolidated financial statements. See Note 17 for the enhanced disclosures required by ASU No. 2011-04.

In June 2011, FASB issued ASU No. 2011-05, "*Comprehensive Income (Topic 220): Presentation of Comprehensive Income*". This ASU will require companies to present the components of net income and other comprehensive income either as one continuous statement or as two consecutive statements. It eliminates the option to present components of other comprehensive income as part of the statement of changes in shareholders' equity. The standard does not change the items which must be reported in other comprehensive income, how such items are measured or when they must be reclassified to net income. This standard is effective for interim and annual periods beginning after December 15, 2011. The FASB subsequently deferred the effective date of certain provisions of this standard pertaining to the reclassification of items out of accumulated other comprehensive income. A Consolidated Statement of Comprehensive Income has been included as part of the Company's unaudited financial statements, for the years ended December 31, 2012 and 2011. The adoption of ASU No. 2011-05 had no impact on the Company's financial condition, results of operations or cash flows.

In December 2011, FASB issued ASU No. 2011-11, "*Disclosures about Offsetting Assets and Liabilities*". This ASU will require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. Management does not expect the adoption of ASU No. 2011-11 to have a material effect on the Company's Consolidated Financial Statements at the date of adoption.

In February 2013, FASB issued ASU No. 2013-02, *"Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income"*. This ASU requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component and to present either on the face of the statement where net income is presented, or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2012. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company's consolidated financial statements.

Subsequent Event

On January 29, 2013, the Company announced that its wholly owned subsidiary, Bank of the Pacific, entered into a definitive agreement to acquire the Aberdeen, Washington; Astoria, Oregon; and Seaside, Oregon branches of Sterling Savings Bank, a wholly owned subsidiary of Sterling Financial Corporation. The transaction will expand the Bank's operations to 17 branches in Washington and 3 branches in Oregon. Under the terms of the agreement, the Bank will acquire approximately $48 million of deposits, paying a deposit premium of 2.77% on core in-market deposits assumed. Additionally, approximately $5 million of performing loans will be acquired. The transaction, which is subject to regulatory approval and other customary conditions of closing, is expected to be completed during the second quarter of 2013.

Note 2 - Restricted Assets

Federal Reserve Board regulations require that the Bank maintain certain minimum reserve balances in cash on hand and on deposit with the Federal Reserve Bank, based on a percentage of deposits. The average amount of such balances for the years ended December 31, 2012 and 2011 was approximately $577 and $611, respectively.

Note 3 - Securities

Investment securities consist principally of short and intermediate term debt instruments issued by the U.S. Treasury, other U.S. government agencies, state and local governments, other corporations, and mortgaged backed securities ("MBS"). Investment securities have been classified according to management's intent. The amortized cost of securities and their approximate fair value are as follows:

Securities Available for Sale	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2012				
U.S. Government agency securities	$5,922	$36	$6	$5,952
Obligations of states and political subdivisions	25,254	1,691	39	26,906
Agency MBS	22,113	249	203	22,159
Non-agency MBS	2,804	12	272	2,544
Corporate bonds	3,565	--	20	3,545
Total	**$59,658**	**$1,988**	**$540**	**$61,106**
December 31, 2011				
U.S. Government agency securities	$73	$11	$--	$84
Obligations of states and political subdivisions	21,398	1,462	1	22,859
Agency MBS	16,709	255	49	16,915
Non-agency MBS	6,825	25	968	5,882
Corporate bonds	2,010	--	98	1,912
Total	**$47,015**	**$1,753**	**$1,116**	**$47,652**

Securities Held to Maturity	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2012				
State and municipal securities	$6,716	$32	$--	$6,748
Agency MBS	221	16	--	237
Total	**$6,937**	**$48**	**$--**	**$6,985**
December 31, 2011				
State and municipal securities	$6,732	$68	$--	$6,800
Agency MBS	293	25	--	318
Total	**$7,025**	**$93**	**$--**	**$7,118**

Unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in continuous unrealized loss position, as of December 31, 2012 and 2011 are summarized as follows:

	Less than 12 Months		More than 12 Months		Total	
December 31, 2012	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
Available for Sale						
U.S. Government agency	$2,688	$6	$- -	$- -	$2,688	$6
Obligations of states and political subdivisions	1,896	39	- -	- -	1,896	39
Agency MBS	11,890	198	370	5	12,260	203
Non-agency MBS	- -	- -	1,909	272	1,909	272
Corporate bonds	1,957	20	- -	- -	1,957	20
Total	**$18,431**	**$263**	**$2,279**	**$277**	**$20,710**	**$540**

	Less than 12 Months		More than 12 Months		Total	
December 31, 2011	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
Available for Sale						
Obligations of states and political subdivisions	$77	$1	$ - -	$- -	$77	$1
Agency MBS	4,985	49	- -	- -	4,985	49
Non-agency MBS	590	90	4,223	878	4,813	968
Corporate bonds	1,912	98	- -	- -	1,912	98
Total	**$7,564**	**$238**	**$4,223**	**$878**	**$11,787**	**$1,116**

At December 31, 2012, there were 30 investment securities in an unrealized loss position, of which 4 were in a continuous loss position for 12 months or more. The unrealized losses on these securities were caused by changes in interest rates, widening pricing spreads and market illiquidity, causing a decline in the fair value subsequent to their purchase. The Company has evaluated the securities shown above and anticipates full recovery of amortized cost with respect to these securities at maturity or sooner in the event of a more favorable market environment. Based on management's evaluation and because the Company does not have the intent to sell these securities and it is not more likely than not that it will have to sell the securities before recovery of cost basis, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2012, except as described below with respect to one non-agency MBS.

For non-agency MBS the Company estimates expected future cash flows of the underlying collateral, together with any credit enhancements. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which considers current delinquencies, future expected default rates and collateral value by vintage) and prepayments. The expected cash flows of the security are then discounted to arrive at a present value amount. For the year ended December 31, 2012 and 2011, one non-agency MBS was determined to be other-than-temporarily impaired resulting in the Company recording $333 and $330 in impairments related to credit losses through earnings.

The Company did not engage in originating subprime mortgage loans and it does not believe that it has material exposure to subprime mortgage loans or subprime mortgage backed securities. Additionally, the Company does not have any investment in, or exposure to, collateralized debt obligations, structured investment vehicles or Euro zone sovereign debt.

The contractual maturities of investment securities held to maturity and available for sale at December 31, 2012 are shown below. Investments in mortgage-backed securities are shown separately as maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations, with or without call or prepayment penalties.

	Held to Maturity		**Available for Sale**	
	Amortized Cost	**Fair Value**	**Amortized Cost**	**Fair Value**
Due in one year or less	$225	$230	$2,054	$2,066
Due from one year to five years	784	801	8,410	8,464
Due from five to ten years	932	942	6,896	7,128
Due after ten years	4,775	4,775	17,381	18,745
Mortgage-backed securities	221	237	24,917	24,703
Total	**$6,937**	**$6,985**	**$59,658**	**$61,106**

Gross gains realized on sales of securities were $332, $720 and $533 and gross losses realized were $29, $22 and $111 in 2012, 2011 and 2010, respectively.

Securities carried at approximately $44,133 at December 31, 2012 and $44,906 at December 31, 2011 were pledged to secure public deposits and for other purposes required or permitted by law.

Note 4 - Loans

Loans and Leases

Loans (including loans held for sale) at December 31 consist of the following:

	2012	2011
Commercial and agricultural	$87,278	$90,731
Real estate:		
Construction, land development and other land loans	31,411	47,156
Residential 1-4 family	90,447	90,552
Multi-family	7,744	7,682
Commercial real estate – owner occupied	109,783	118,469
Commercial real estate – non owner occupied	103,014	103,005
Farmland	24,544	23,752
Consumer	7,782	8,928
	462,003	**490,275**
Less unearned income	(857)	(841)
Total	**$461,146**	**$489,434**

Allowance for Credit Losses

Changes in the allowance for credit losses for the years ended December 31, 2012, 2011 and 2010 are as follows:

Allowance for Credit Losses:	**Commercial**	**Commercial Real Estate ("CRE")**	**Residential Real Estate**	**Consumer**	**Unallocated**	**2012 Total**
Year ended December 31, 2012						
Beginning balance	$1,012	$6,803	$1,046	$642	$1,624	$11,127
Charge-offs	(67)	(827)	(576)	(309)	- -	(1,779)
Recoveries	23	917	162	8	- -	1,110
Provision for (recapture of) credit losses	(45)	(2,795)	197	190	1,353	(1,100)
Ending balance	**$923**	**$4,098**	**$829**	**$531**	**$2,977**	**$9,358**
Year ended December 31, 2011						
Beginning balance	$ 816	$5,385	$1,754	$690	$1,972	$10,617
Charge-offs	(161)	(2,005)	(665)	(93)	- -	(2,924)
Recoveries	69	750	107	8	- -	934
Provision for (recapture of) credit losses	288	2,673	(150)	37	(348)	2,500
Ending balance	**$1,012**	**$6,803**	**$1,046**	**$642**	**$1,624**	**$11,127**
Year ended December 31, 2010						
Beginning balance	$1,307	$5,864	$2,477	$261	$1,183	$11,092
Charge-offs	(469)	(2,055)	(1,518)	(119)	- -	(4,161)
Recoveries	13	19	48	6	- -	86
Provision for (recapture of) credit losses	(35)	1,557	747	542	789	3,600
Ending balance	**$816**	**$5,385**	**$1,754**	**$690**	**$1,972**	**$10,617**

Recorded investment in loans as of December 31, 2012 and 2011 are as follows:

December 31, 2012	Commercial	Commercial Real Estate ("CRE")	Residential Real Estate	Consumer	Unallocated	Total
Allowance for credit losses:						
Ending balance: individually evaluated for impairment	$- -	$- -	$- -	$- -	$- -	$- -
Ending balance: collectively evaluated for impairment	923	4,098	829	531	2,977	9,358
Loans:						
Ending balance: individually evaluated for impairment	$2,219	$11,697	$868	$- -	$- -	$14,784
Ending balance: collectively evaluated for impairment	85,059	257,055	84,373	7,782	- -	434,269
Loans held for sale	- -	- -	12,950	- -	- -	12,950
Ending Balance	**$87,278**	**$268,752**	**$98,191**	**$7,782**	**$- -**	**$462,003**
Less unearned income						(857)
Ending balance total loans						**$461,146**
December 31, 2011						
Allowance for credit losses:						
Ending balance: individually evaluated for impairment	$- -	$1,987	$45	$- -	$- -	$2,032
Ending balance: collectively evaluated for impairment	1,012	4,816	1,001	642	1,624	9,095
Loans:						
Ending balance: individually evaluated for impairment	$529	$13,076	$827	$- -	$- -	$14,432
Ending balance: collectively evaluated for impairment	90,202	279,306	82,866	8,928	- -	461,302
Loans held for sale	- -	- -	15,541	- -	- -	14,541
Ending balance	**$90,731**	**$292,382**	**$98,234**	**$8,928**	**$- -**	**$490,275**
Less unearned income						(841)
Ending balance total loans						**$489,434**

Credit Quality Indicators

Federal regulations require that the Bank periodically evaluates the risks inherent in its loan portfolios. In addition, the Washington Division of Banks and the FDIC have authority to identify problem loans and, if appropriate, require them to be reclassified. There are three classifications for problem loans: Substandard, Doubtful, and Loss. These terms are used as follows:

- "Substandard" loans have one or more defined weaknesses and are characterized by the distinct possibility some loss will be sustained if the deficiencies are not corrected.
- "Doubtful" loans have the weaknesses of loans classified as "Substandard", with additional characteristics that suggest the weaknesses make collection or recovery in full after liquidation of collateral questionable on the basis of currently existing facts, conditions and values. There is a high possibility of loss in loans classified as "Doubtful".
- "Loss" loans are considered uncollectible and of such little value that continued classification of the credit as a loan is not warranted. If a loan or a portion thereof is classified as "Loss", it must be charged-off, meaning the amount of the loss is charged against the allowance for credit losses, thereby reducing the reserve.

The Bank also classifies some loans as "Pass" or Other Loans Especially Mentioned ("OLEM"). Within the Pass classification certain loans are "Watch" rated because they have elements of risk that require more monitoring that other performing loans. Pass grade loans include a range of loans from very high credit quality to acceptable credit quality. These borrowers generally have strong to acceptable capital levels and consistent earnings and debt service capacity. Loans with higher grades within the Pass category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Overall, loans with a Pass grade show no immediate loss exposure. Loans classified as OLEM continue to perform but have shown deterioration in credit quality and require close monitoring.

Loans by credit quality risk rating at December 31, 2012 are as follows:

	Pass	Other Loans Especially Mentioned	Substandard	Doubtful	Total
Commercial	$82,899	$979	$3,368	$32	$87,278
Real estate:					
Construction and development	27,209	603	3,355	244	31,411
Residential 1-4 family	85,364	2,016	3,067	- -	90,447
Multi-family	7,744	- -	- -	- -	7,744
CRE – owner occupied	103,444	1,844	4,495	- -	109,783
CRE – non owner occupied	84,610	12,346	6,058	- -	103,014
Farmland	23,511	- -	1,033	- -	24,544
Total real estate	331,882	16,809	18,008	244	366,943
Consumer	7,740	- -	42	- -	7,782
Subtotal	**$422,521**	**$17,788**	**$21,418**	**$276**	**$462,003**
Less unearned income					(857)
Total loans					**$461,146**

Loans by credit quality risk rating at December 31, 2011 are as follows:

	Pass	Other Loans Especially Mentioned	Substandard	Doubtful	Total
Commercial	$83,920	$2,232	$4,579	$- -	$90,731
Real estate:					
Construction and development	37,804	1,394	7,958	- -	47,156
Residential 1-4 family	86,239	741	3,572	- -	90,552
Multi-family	7,682	- -	- -	- -	7,682
CRE – owner occupied	111,028	1,856	5,585	- -	118,469
CRE – non owner occupied	77,414	13,877	11,714	- -	103,005
Farmland	22,543	110	1,099	- -	23,752
Total real estate	342,710	17,978	29,928	- -	390,616
Consumer	8,804	53	63	8	8,928
Subtotal	**$435,434**	**$20,263**	**$34,570**	**$8**	**$490,275**
Less unearned income					(841)
Total loans					**$489,434**

Aging Analysis

The following table illustrates an age analysis of past due loans as of December 31, 2012.

	Current	30-59 DaysPast Due	60-89 Days Past Due	Greater Than 90 Days Past Due and Still Accruing	Total Past Due	Non-accrual Loans	Total Loans
Commercial	$85,243	$107	$ 27	$ - -	$134	$1,901	$87,278
Real estate:							
Construction & development	29,619	- -	- -	- -	- -	1,792	31,411
Residential 1-4 family	88,052	1,505	90	- -	1,595	800	90,447
Multi-family	7,744	- -	- -	- -	- -	- -	7,744
CRE - owner occupied	105,936	- -	- -	- -	- -	3,847	109,783
CRE - non-owner occupied	96,567	652	- -	- -	652	5,795	103,014
Farmland	23,435	133	- -	- -	133	976	24,544
Total real estate	351,353	2,290	90	- -	2,380	13,210	366,943
Consumer	7,773	8	- -	- -	8	1	7,782
Less unearned income	(857)	- -	- -	- -	- -	- -	(857)
Total	**$443,512**	**$2,405**	**$117**	**$- -**	**$2,522**	**$15,112**	**$461,146**

The following table illustrates an age analysis of past due loans as of December 31, 2011.

	Current	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due and Still Accruing	Total Past Due	Non-accrual Loans	Total Loans
Commercial	$89,981	$220	$- -	$- -	$220	$530	$90,731
Real estate:							
Construction & development	41,570	76	- -	- -	76	5,510	47,156
Residential 1-4 family	88,661	880	184	299	1,363	528	90,552
Multi-family	7,682	- -	- -	- -	- -	- -	7,682
CRE - owner occupied	116,979	508	353	- -	861	629	118,469
CRE - non-owner occupied	96,332	134	- -	- -	134	6,539	103,005
Farmland	23,752	- -	- -	- -	- -	- -	23,752
Total real estate	374,976	1,598	537	299	2,434	13,206	390,616
Consumer	8,869	59	- -	- -	59	- -	8,928
Less unearned income	(841)	- -	- -	- -	- -	- -	(841)
Total	**$472,985**	**$1,877**	**$537**	**$299**	**$2,713**	**$13,736**	**$489,434**

Interest income on non-accrual loans that would have been recorded had those loans performed in accordance with their initial terms was $1,213, $752, and $2,568 for 2012, 2011, and 2010, respectively.

Insider Loans

Certain related parties of the Company, principally directors and their affiliates, were loan customers of the Bank in the ordinary course of business during 2012 and 2011. Total related party loans outstanding at December 31, 2012 and 2011 to executive officers and directors were $385 and $982, respectively. During 2012 and 2011, new loans of $454 and $3, respectively, were made, and repayments totaled $1,051 and $440, respectively. In management's opinion, these loans and transactions were on the same terms as those for comparable loans and transactions with non-related parties. No loans to related parties were on non-accrual, past due or restructured at December 31, 2012.

Impaired Loans

Following is a summary of information pertaining to impaired loans at December 31, 2012:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$2,219	$2,219	$- -	$966	$30
Consumer	- -	- -	- -	45	- -
Residential real estate	868	1,100	- -	756	17
Commercial real estate:					
CRE – owner occupied	3,134	3,166	- -	1,259	2
CRE – non-owner occupied	5,795	6,401	- -	3,272	84
Farmland	976	976	- -	195	- -
Construction and development	1,792	4,053	- -	2,707	81
With an allowance recorded:					
Residential real estate	- -	- -	- -	97	- -
Commercial real estate:					
CRE – non-owner occupied	- -	- -	- -	2,845	- -
Construction and development	- -	- -	- -	189	12
Total:					
Commercial	2,219	2,219	- -	966	30
Consumer	- -	- -	- -	45	- -
Residential real estate	868	1,100	- -	853	17
Commercial real estate:					
CRE – owner occupied	3,134	3,166	- -	1,259	2
CRE – non-owner occupied	5,795	6,401	- -	6,117	84
Farmland	976	976	- -	195	- -
Construction and development	1,792	4,053	- -	2,896	93

Following is a summary of information pertaining to impaired loans at December 31, 2011:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$530	$556	$- -	$355	$15
Residential real estate	528	620	- -	1,314	16
Commercial real estate:					
CRE – owner occupied	629	719	- -	971	7
CRE – non-owner occupied	2,912	2,912	- -	3,181	21
Construction and development	5,335	7,501	- -	5,868	188
With an allowance recorded:					
Commercial	- -	- -	- -	202	5
Residential real estate	298	298	45	74	- -
Commercial real estate:					
CRE – non-owner occupied	3,627	3,997	1,782	725	- -
Construction and development	573	573	205	716	3
Total:					
Commercial	530	556	- -	557	20
Residential real estate	826	918	45	1,388	16
Commercial real estate:					
CRE – owner occupied	629	719	- -	971	7
CRE – non-owner occupied	6,539	6,909	1,782	3,906	21
Construction and development	5,908	8,074	205	6,584	191

Modifications

A modification of a loan constitutes a troubled debt restructuring (“TDR”) when a borrower is experiencing financial difficulty and the modification constitutes a concession. There are various types of concessions when modifying a loan, however, forgiveness of principal is rarely granted by the Company. Commercial and industrial loans modified in a TDR may involve term extensions, below market interest rates and/or interest-only payments wherein the delay in the repayment of principal is determined to be significant when all elements of the loan and circumstances are considered. Additional collateral, a co-borrower, or a guarantor is often required. Commercial mortgage and construction loans modified in a TDR often involve reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, or substituting or adding a new borrower or guarantor. Construction loans modified in a TDR may also involve extending the interest-only payment period. Residential mortgage loans modified in a TDR are primarily comprised of loans where monthly payments are lowered to accommodate the borrowers’ financial needs. Land loans are typically structured as interest-only monthly payments with a balloon payment

due at maturity. Land loans modified in a TDR typically involve extending the balloon payment by one to three years, and providing an interest rate concession. Home equity modifications are made infrequently and are uniquely designed to meet the specific needs of each borrower.

Loans modified in a TDR are typically already on non-accrual status and partial charge-offs have in some cases already been taken against the outstanding loan balance. As a result, loans modified in a TDR for the Company may have the financial effect of increasing the specific allowance associated with the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the estimated fair value of the collateral, less any selling costs, if the loan is collateral dependent. The Company's practice is to re-appraise collateral dependent loans semi-annually. During the twelve months ended December 31, 2012, there was no impact on the allowance from TDRs during the periods, as the loans classified as TDRs during the periods did not have a specific reserve and were already considered impaired loans at the time of modification.

The Company closely monitors the performance of modified loans for delinquency, as delinquency is considered an early indicator of possible future default. The allowance may be increased, adjustments may be made in the allocation of the allowance, or partial charge-offs may be taken to further write-down the carrying value of the loan.

The following tables present TDRs for the twelve months ended December 31, 2012 all of which were modified due to financial stress of the borrower.

	Current TDRs			**Subsequently Defaulted TDRs**		
	Number of Contracts	**Pre-TDR Outstanding Recorded Investment**	**Post-TDR Outstanding Recorded Investment**	**Number of Contracts**	**Pre-TDR Outstanding Recorded Investment**	**Post-TDR Outstanding Recorded Investment**
Commercial and agriculture	1	$335	$319	- -	$- -	$- -
Construction & development	3	2,972	1,547	- -	- -	- -
Residential real estate	3	342	299	- -	- -	- -
CRE - owner occupied	1	59	57	- -	- -	- -
CRE - non-owner occupied	1	2,180	2,152	- -	- -	- -
Ending balance (1)	**9**	**$5,888**	**$4,374**	**- -**	**$- -**	**$- -**

(1) The period end balances are inclusive of all partial paydowns and charge-offs since the modification date.

There were no loans modified as a TDR within the previous 12 months that subsequently defaulted during the year ended December 31, 2012. Loans classified as TDRs are considered impaired loans. The Company had no commitments to lend additional funds for loans classified as troubled debt restructured at December 31, 2012.

TDRs as of December 31, 2011 are as follows:

	Current TDRs			**Subsequently Defaulted TDRs**		
	Number of Contracts	**Pre-TDR Outstanding Recorded Investment**	**Post-TDR Outstanding Recorded Investment**	**Number of Contracts**	**Pre-TDR Outstanding Recorded Investment**	**Post-TDR Outstanding Recorded Investment**
Commercial and agriculture	1	$335	$335	- -	$- -	$- -
Construction & development	7	5,931	5,296	2	2,561	2,465
Residential real estate	2	264	263	- -	- -	- -
CRE - owner occupied	1	59	58	- -	- -	- -
CRE - non-owner occupied	1	2,180	2,180	- -	- -	- -
Ending balance (1)	**12**	**$8,769**	**$8,132**	**2**	**$2,561**	**$2,465**

The construction and development loan TDRs that subsequently defaulted were modified by extending the maturity date. Both loans were on non-accrual status prior to and after the TDR. The subsequent default reported above occurred during the three months ended September 30, 2011 and the loans were subsequently transferred to other real estate owned during the year ended December 31, 2012. There were no other loans modified as a TDR within the previous 12 months that subsequently defaulted during the year ended December 31, 2012.

Note 5 - Premises and Equipment

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

	2012	**2011**
Land and premises	$17,999	$17,882
Equipment, furniture and fixtures	7,648	7,421
Construction in progress	159	60
	25,806	**25,363**
Less accumulated depreciation and amortization	11,213	10,479
Total premises and equipment	**$14,593**	**$14,884**

Depreciation expense was $989, $1,022, and $1,134 for 2012, 2011 and 2010, respectively. The Bank leases premises under operating leases. Rental expense of leased premises was $442, $375 and $356 for 2012, 2011 and 2010, respectively, which is included in occupancy expense.

Minimum net rental commitments under non-cancelable operating leases having an original or remaining term of more than one year for future years ending December 31 are as follows:

2013	$337
2013	247
2014	177
2015	97
2016	83
Total minimum payments required	**$941**

Certain leases contain renewal options from five to ten years and escalation clauses based on increases in property taxes and other costs.

Note 6 – Other Real Estate Owned

The following table presents the activity related to OREO for the years ended December 31:

	2012	**2011**
Balance at beginning of year	$7,725	$6,580
Additions	3,082	4,539
Dispositions	(4,814)	(2,345)
Fair value write-downs	(1,314)	(1,049)
Balance at end of year	**$4,679**	**$7,725**

At December 31, 2012, OREO consisted of 26 properties as follows: 12 land acquisition and development properties totaling $1,757; one residential construction properties totaling $103; nine commercial real estate properties totaling $2,312; and four residential real estate properties totaling $507. Net gains and (losses) on sales of OREO totaled $331, $(83) and $260 for the years ended December 31, 2012, 2011 and 2010, respectively.

Note 7 - Deposits

The composition of deposits at December 31 is as follows:

	2012	**2011**
Demand deposits, non-interest bearing	$115,138	$108,899
NOW and money market accounts	232,607	221,191
Savings deposits	62,493	65,451
Time certificates, $100,000 or more	87,355	95,028
Other time certificates	50,650	57,481
Total	**$548,243**	**$548,050**

Scheduled maturities of time certificates of deposit are as follows for future years ending December 31:

2013	$70,993
2014	24,278
2015	16,816
2016	16,659
2017	8,259
2018	1,000
Total	**$138,005**

Note 8 - Borrowings

Long-term borrowings at December 31, 2012 and 2011 represent advances from the Federal Home Loan Bank of Seattle ("FHLB"). Advances at December 31, 2012 bear interest at 2.24% to 2.94% and mature in various years as follows: 2015 - $5,000 and 2016 - $2,500. The Bank has pledged $156,955 of loans as collateral for these borrowings at December 31, 2012.

Short-term borrowings represent FHLB term borrowings with scheduled maturity dates within one year. Short-term borrowings may also include federal funds purchased that generally mature within one to four days from the transaction date; however there were no federal funds purchased at December 31, 2012, and 2011. The following is a summary of short-term borrowings for the years ended:

	2012	**2011**
Amount outstanding at end of year	$3,000	$- -
Weighted average interest rate at December 31	2.94%	- -%
Maximum month-end balance during the year	3,000	10,500
Average balance during the year	2,697	6,885
Average interest rate during the year	2.94%	3.84%

Note 9 – Junior Subordinated Debentures

At December 31, 2012, two wholly-owned subsidiary grantor trusts established by the Company had outstanding $13,000 of Trust Preferred Securities ("trust preferred securities"). Trust preferred securities accrue and pay distributions periodically at specified annual rates as provided in the indentures. The trusts used the net proceeds from the offering of trust preferred securities to purchase a like amount of Junior Subordinated Debentures (the "Debentures") of the Company. The Debentures are the sole assets of the trusts. The Company's obligations under the Debentures and the related documents, taken together, constitute a full and unconditional guarantee by the Company of the obligations of the trusts. The trust preferred securities are mandatorily redeemable upon the maturity of the Debentures, or upon earlier redemption as provided in the indentures. The Company has the right to redeem the Debentures in whole or in part on or after specified dates, at a redemption price specified in the indentures plus any accrued but unpaid interest to the redemption date.

The following table is a summary of the trust preferred securities and debentures at December 31, 2012:

Issuance Trust	Issuance Date	Preferred Security	Rate Type	Initial Rate	Rate at 12/31/12	Maturity Date
PFC Statutory Trust I	12/2005	$5,000	Variable (1)	6.39%	1.76%	3/2036
PFC Statutory Trust II	6/2006	$8,000	Variable (1)	7.02%	1.94%	7/2036

(1) The variable rate preferred securities reprice quarterly based on the three month LIBOR rate.

The Company has the right to redeem the debentures issued in the December 2005 offering beginning March 2011, and the June 2006 offering beginning July 2011, subject to regulatory approval.

The Debentures issued by the Company to the grantor trusts totaling $13,000 are reflected in the consolidated balance sheet in the liabilities section under the caption "junior subordinated debentures." The Company records interest expense on the corresponding junior subordinated debentures in the consolidated statements of income. The Company recorded $403 in the consolidated balance sheet at December 31, 2012 and 2011, respectively, for the common capital securities issued by the issuer trusts.

During the year ended December 31, 2012, the Company paid all accrued interest, including deferred interest on PFC Trust I and II, which had accrued since the Company elected, in 2009, to exercise its right to defer interest on its trust preferred debentures, as permitted by the terms thereof. As of December 31, 2012, regular accrued interest on TRUPs totaled $41 and is included in accrued interest payable on the balance sheet. As of December 31, 2011, deferred interest totaled $1,252.

Note 10 - Income Taxes

Income taxes for the years ended December 31 is as follows:

	2012	2011	2010
Current	$1,237	$1,148	$582
Deferred	63	(815)	(886)
Total income tax benefit	**$1,300**	**$333**	**$(304)**

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities at December 31 are:

	2012	2011
Deferred Tax Assets		
Allowance for credit losses	$3,238	$3,850
Deferred compensation	116	132
Supplemental executive retirement plan	922	799
Loan fees/costs	297	290
OREO write-downs	657	600
OREO operating expenses	161	161
Tax credit carry-forwards	156	447
Non-accrual loan interest	194	45
OTTI write-downs	229	- -
Other	96	192
Total deferred tax assets	**6,066**	**6,516**
Deferred Tax Liabilities		
Depreciation	$127	$214
Loan fees/costs	1,150	1,402
Unrealized gain on securities available for sale	493	217
Prepaid expenses	111	108
FHLB dividends	143	143
Other	29	81
Total deferred tax liabilities	**2,053**	**2,165**
Net deferred tax assets	**$4,013**	**$4,351**

Net deferred tax assets are recorded in other assets in the consolidated financial statements.

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

	2012 Amount	Percent of Pre-tax Income	2011 Amount	Percent of Pre-tax Income	2010 Amount	Percent of Pre-tax Income
Income (loss) tax at statutory rate	$2,130	35.0%	$1,103	35.0%	$466	35.0%
Adjustments resulting from:						
Tax-exempt income	(542)	(8.9)	(519)	(16.5)	(530)	(39.8)
Net earnings on life insurance policies	(178)	(2.9)	(171)	(5.4)	(176)	(13.3)
Low income housing tax credit	(109)	(1.8)	(108)	(3.4)	(108)	(8.1)
Other	(1)	0.0	28	0.9	44	3.3
Total income tax (benefit) expense	**$1,300**	**21.4%**	**$ 333**	**10.6%**	**$(304)**	**(22.9)%**

Note 11 - Employee Benefits

Incentive Compensation Plan

The Bank has a plan that provides incentive compensation to key employees if the Bank meets certain performance criteria established by the Board of Directors. The cost of this plan was $400, $80, and $210 in 2012, 2011 and 2010, respectively.

401(k) Plans

The Bank has established a 401(k) profit sharing plan for those employees who meet the eligibility requirements set forth in the plan. Eligible employees may contribute up to 15% of their compensation. Matching contributions by the Bank are at the discretion of the Board of Directors. Contributions totaled $152, $58 and $60 for 2012, 2011 and 2010, respectively.

Director and Employee Deferred Compensation Plans

The Company has director and employee deferred compensation plans. Under the terms of the plans, a director or employee may participate upon approval by the Board. The participant may then elect to defer a portion of his or her earnings (directors' fees or salary) as designated at the beginning of each plan year. Payments begin upon retirement, termination, death or permanent disability, sale of the Company, the ten-year anniversary of the participant's participation date, or at the discretion of the Company. There are currently no participants in the director or employee deferred compensation plan. Total deferrals plus earnings in the employee deferred compensation plan were $0, $35 and $35 at December 31, 2012, 2011 and 2010, respectively. There is no ongoing expense to the Company for these plans.

The directors of a bank acquired by the Company in 1999 adopted two deferred compensation plans for directors - one plan providing retirement income benefits for all directors and the other, a deferred compensation plan, covering only those directors who have chosen to participate in the plan. At the time of adopting these plans, the Bank purchased life insurance policies on directors participating in both plans which may be used to fund payments to them under these plans. Cash surrender values on these policies were $3,804 and $3,694 at December 31, 2012 and 2011, respectively. In 2012, 2011 and 2010, the net benefit recorded from these plans, including the cost of the related life insurance, was $396, $402 and $377, respectively. Both of these plans were fully funded and frozen as of September 30, 2001. Plan participants were given the option to either remain in the plan until reaching the age of 70 or to receive a lump-sum distribution. Participants electing to remain in the plan will receive annual payments over a ten-year period upon reaching 70 years of age. The liability associated with these plans totaled $334 and $347 at December 31, 2012 and 2011, respectively.

Executive Long-Term Compensation Agreements

The Company has executive long-term compensation agreements to selected employees that provide incentive for those covered employees to remain employed with the Company for a defined period of time. The cost of this plan was $95, $79 and $39 in 2012, 2011 and 2010, respectively.

Supplemental Executive Retirement Plan

Effective January 1, 2007, the Company adopted a non-qualified Supplemental Executive Retirement Plan (SERP) that provides retirement benefits to its executive officers. The SERP is unsecured and unfunded and there are no plan assets. The post-retirement benefit provided by the SERP is designed to supplement a participating officer's retirement benefits from social security, in order to provide the officer with a certain percentage of final average income at retirement age. The benefit is generally based on average earnings, years of service and age at retirement. At the inception of the SERP, the Company recorded a prior service cost to accumulated other comprehensive income of $704. The Company has purchased bank owned life insurance covering all participants in the SERP. The cash surrender value of these policies totaled $5,736 and $5,622 at December 31, 2012 and 2011, respectively.

The following table sets forth the net periodic pension cost and obligation assumptions used in the measurement of the benefit obligation for the years ended December 31:

	2012	2011	2010
Net periodic pension cost:			
Service Cost	$167	$143	$122
Interest Cost	106	97	86
Amortization of prior service cost	90	90	90
Amortization of net (gain)/loss	27	3	(15)
Net periodic pension cost	**$390**	**$333**	**$283**
Weighted average assumptions:			
Discount rate	4.47%	5.12%	5.90%
Rate of compensation increases	n/a	n/a	n/a

The following table sets forth the change in benefit obligation at December 31:

	2012	2011
Change in Benefit Obligation:		
Benefit obligation at beginning of year	$2,082	$1,648
Service cost	167	143
Interest cost	106	97
Actuarial loss	(13)	194
Benefit obligation at end of year	**$2,342**	**$2,082**

Amounts recognized in accumulated other comprehensive loss at December 31 are as follows:

	2012	2011
(Gain) loss	$173	$213
Prior service cost	362	452
Total recognized in accumulative other comprehensive loss	**$535**	**$665**

The following table summarizes the projected and accumulated benefit obligations at December 31:

	2012	2011
Projected benefit obligation	$2,342	$2,082
Accumulated benefit obligation	2,342	2,082

Estimated future benefit payments as of December 31, 2012 are as follows:

2013 – 2017	$349
2018 – 2022	1,287

Note 12 – Dividend Reinvestment Plan

In November 2005, the Company instituted a dividend reinvestment plan which allows for all or part of cash dividends to be reinvested in shares of Company common stock based upon participant elections. Under the plan, 1,100,000 shares were authorized for dividend reinvestment, of which 89,771 shares have been issued through December 31, 2012.

Note 13 - Commitments and Contingencies

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

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as they do for on-balance-sheet instruments. A summary of the Bank's commitments at December 31 is as follows:

	2012	**2011**
Commitments to extend credit	$84,493	$91,596
Standby letters of credit	1,975	1,310

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Many of the commitments expire without being drawn upon; therefore total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

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

Certain executive officers have entered into employment contracts with the Bank which provide for contingent payments subject to future events.

In connection with certain loans held for sale, the Bank typically makes representations and warranties that the underlying loans conform to specified guidelines. If the underlying loans do not conform to the specifications, the Bank may have an obligation to repurchase the loans or indemnify the purchaser against loss. The Bank believes that the potential for loss under these arrangements is remote. Accordingly, no contingent liability is recorded in the consolidated financial statements.

The Bank has agreements with commercial banks for lines of credit totaling $16,000, of which none was used at December 31, 2012. In addition, the Bank has a credit line with the Federal Home Loan Bank of Seattle totaling 20% of assets, $10,500 of which was used at December 31, 2012. These borrowings are collateralized under blanket pledge and custody agreements. The Bank also has a borrowing arrangement with the Federal Reserve

Bank under the Borrower-in-Custody program. Under this program, the Bank has an available credit facility of $46,704, subject to pledged collateral. As of December 31, 2012, loans carried at $71,484 were pledged as collateral to the Federal Reserve Bank.

The Company is currently not party to any material pending litigation. However, because of the nature of its activities, the Company may be subject to or threatened with legal actions 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 financial condition, results of operations or cash flows of the Company.

Note 14 - Significant Concentrations of Credit Risk

Most of the Bank's business activity is with customers and governmental entities located in the state of Washington, including investments in state and municipal securities. Loans to any single borrower or group of borrowers are generally limited by state banking regulations to 20% of the Bank's shareholder's equity, excluding accumulated other comprehensive income (loss). Standby letters of credit were granted primarily to commercial borrowers. The Bank, as a matter of practice, generally does not extend credit to any single borrower or group of borrowers in excess of $7,500.

Note 15 - Stock Based Compensation

Stock Options

The Company's 2000 Stock Incentive Plan provided for incentive and non-qualified stock options and other types of stock based awards, as defined under current tax laws, to key personnel. Under the plan, the Company was authorized to issue up to 1,100,000 shares; however the plan expired January 1, 2011. On April 27, 2011, the shareholders of the Company approved the 2011 Equity Incentive Plan, pursuant to which the Company is authorized to issue up to 900,000 shares of common stock in connection with awards under the plan (868,441 shares are available for grant at December 31, 2012). Under the plan, options either become exercisable ratably over five years or vest fully five years from the date of grant.

The Company uses the Black-Scholes option pricing model to calculate the fair value of stock-based awards based on assumptions noted in the following table. Expected volatility is based on historical volatility of the Company's common shares. The expected term of stock options granted is based on the simplified method, which is the simple average between contractual term and vesting period. The risk-free rate is based on the expected term of stock options and the applicable U.S. Treasury yield in effect at the time of grant.

Grant period ended	Expected Life	Risk Free Interest Rate	Expected Volatility	Dividend Yield	AverageFair Value
December 31, 2012	6.5 years	1.34%	22.43%	- - %	$0.77
December 31, 2011	6.5 years	1.50%	22.51%	- - %	$1.05
December 31, 2010	6.5 years	3.20%	18.95%	- - %	$0.34

A summary of the status of the Company's stock option plans as of December 31, 2012, 2011 and 2010, and changes during the years ending on those dates, is presented below:

	2012		2011		2010	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	586,448	$11.32	818,612	$11.07	820,837	$11.08
Granted	10,500	5.00	5,000	3.95	1,000	7.00
Exercised	- -	- -	- -	- -	- -	- -
Expired	(12,550)	10.44	(178,439)	10.10	- -	- -
Forfeited	(47,291)	10.57	(58,725)	10.98	(3,225)	11.27
Outstanding at end of year	**537,107**	$11.28	**586,448**	**$11.32**	**818,612**	**$11.07**
Exercisable at end of year	**389,827**	**$12.98**	**411,708**	**$12.93**	**599,727**	**$12.06**

A summary of the status of the Company's nonvested options as of December 31, 2012 and 2011 and changes during the period then ended are presented below:

	2012		2011	
	Shares	Weighted Average Fair Value	Shares	Weighted Average Fair Value
Non-vested beginning of period	174,740	$0.37	218,885	$0.51
Granted	10,500	0.77	5,000	1.05
Vested	(32,050)	0.83	(20,185)	1.79
Forfeited	(5,910)	0.27	(28,960)	0.49
Non-vested end of period	**147,280**	**$0.31**	**174,740**	**$0.37**

The following information summarizes information about stock options outstanding and exercisable at December 31, 2012:

	Options Outstanding			Options Exercisable		
Range of exercise prices	Number	Weighted average remaining contractual life (years)	Weighted average exercise price	Number	Weighted average remaining contractual life (years)	Weighted average exercise price
0.00 – 11.10	232,187	6.0	$ 7.37	85,787	4.0	$ 8.42
11.11 – 12.49	44,550	3.0	11.80	43,670	3.0	11.81
12.50 – 14.74	139,425	2.8	14.27	139,425	2.8	14.27
14.75 – 16.00	120,945	2.0	15.14	120,945	2.0	15.14
	537,107	**4.0**	**$11.28**	**389,827**	**2.8**	**$12.98**

The aggregate intrinsic value of all options outstanding at December 31, 2012 and 2011 was $0 and $0, respectively. The aggregate intrinsic value of all options that were exercisable at December 31, 2012 and 2011 was $0 and $0, respectively. There were no options exercised during 2011 or 2012. Stock based compensation recognized in 2012 and 2011 was $24 ($16 net of tax) and $26 ($17 net of tax), respectively. Future compensation expense for unvested awards outstanding as of December 31, 2012 is estimated to be $41 recognized over a weighted average period of 1.8 years.

Restricted Stock Units

During 2012, the Company granted restricted stock units ("RSU") to certain employees receiving awards under the Company's Annual Incentive Compensation Plan. Recipients of RSUs will be issued a specified number of shares of the Company's common stock upon the lapse of their applicable restrictions. Restrictions require the employee to continue in employment for a period of three years from the date the RSU is awarded.

The following table summarizes RSU activity during 2012. There was no RSU activity prior to 2012.

	Shares	Weighted average grant price	Weighted average remaining contractual terms (in years)
Outstanding, January 1, 2012	- -	$ - -	- -
Granted	16,604	4.43	2.5
Forfeited	(545)		
Outstanding, December 31, 2012	**16,059**	**$4.43**	**2.5**

For the year ended December 31, 2012, the Company recognized compensation expense related to RSUs of $8 ($5 net of tax). As of December 31, 2012, there was $64 of total unrecognized compensation expense related to non-vested RSUs.

Note 16 - Regulatory Matters

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 and total capital (as defined) to risk-weighted assets (as defined).

As of December 31, 2012, the Bank was well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Company and the Bank's actual capital amounts and ratios are presented in the table below. Management believes, as of December 31, 2012, the Company and the Bank meet all capital requirements to which they are subject.

	Actual		Capital Adequacy Purposes		To be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
December 31, 2012						
Tier 1 capital (to average assets):						
Company	$66,750	10.69%	$24,975	4.00%	NA	NA
Bank	66,712	10.69	24,966	4.00	$31,207	5.00%
Tier 1 capital (to risk-weighted assets):						
Company	66,750	14.95	17,855	4.00	NA	NA
Bank	66,712	14.96	17,842	4.00	26,764	6.00
Total capital (to risk-weighted assets):						
Company	72,376	16.21	35,710	8.00	NA	NA
Bank	72,334	16.22	35,685	8.00	44,606	10.00
December 31, 2011						
Tier 1 capital (to average assets):						
Company	$63,965	10.18%	$25,137	4.00%	NA	NA
Bank	65,022	10.35	25,128	4.00	$31,410	5.00%
Tier 1 capital (to risk-weighted assets):						
Company	63,965	13.56	18,870	4.00	NA	NA
Bank	65,022	13.79	18,860	4.00	28,290	6.00
Total capital (to risk-weighted assets):						
Company	69,926	14.82	37,740	8.00	NA	NA
Bank	70,980	15.05	37,720	8.00	47,150	10.00

The Company and the Bank are subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval.

Note 17 - Fair Value of Financial Instruments

Fair Value Hierarchy

The Company uses an established hierarchy for measuring fair value that is intended to maximize the use of observable inputs and minimize the use of unobservable inputs. This hierarchy uses three levels of inputs to measure the fair value of assets and liabilities as follows:

Level 1 – Valuations based on quoted prices in active exchange markets for identical assets or liabilities; also includes certain corporate debt securities actively traded in over-the-counter markets.

Level 2 – Valuations of assets and liabilities traded in less active dealer or broker markets. Valuations include quoted prices for similar assets and liabilities traded in the same market; quoted prices for identical or similar instruments in markets that are not active; and model–derived valuations whose inputs are observable or whose significant value drivers are observable. Valuations may be obtained from, or corroborated by, third-party pricing services. This category generally includes certain U.S. Government, agency and non-agency securities, state and municipal securities, mortgage-backed securities, corporate securities, and residential mortgage loans held for sale.

Level 3 – Valuation based on unobservable inputs supported by little or no market activity for financial instruments whose value is determined using pricing models, discounted cash flow methodologies, yield curves and similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities, but in all cases are corroborated by external data, which may include third-party pricing services.

Investment Securities available-for-sale

The Company uses an independent pricing service to assist management in determining fair values of investment securities available-for-sale. This service provides pricing information by utilizing evaluated pricing models supported with observable market data. Standard inputs include benchmark yields, reported trades, broker/dealer quotes, credit ratings, bids and offers, relative credit information and reference data from market research publications. Investment securities that are deemed to have been trading in illiquid or inactive markets may require the use of significant unobservable inputs.

The pricing service provides quoted market prices when available. Quoted prices are not always available due to bond market inactivity. For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows. Discounted cash flows are calculated using spread to swap and LIBOR curves that are updated to incorporate loss severities, volatility, credit spread and optionality. Additionally, the pricing service may obtain a broker quote when sufficient information is not available to produce a valuation. Valuations and broker quotes are non-binding and do not represent quotes on which one may execute the disposition of the assets.

The Company generally obtains one value from its primary external third-party pricing service. The Company's third-party pricing service has established processes for us to submit inquiries regarding quoted prices. The Company's third-party pricing service will review the inputs to the evaluation in light of any new market data presented by us. The Company's third-party pricing service may then affirm the original quoted price or may update the evaluation on a going forward basis.

On a quarterly basis, management reviews the pricing information received from the third party-pricing service through a combination of procedures that include an evaluation of methodologies used by the pricing service, analytical reviews and performance analysis of the prices against statistics and trends and maintenance of an investment watch list. Based on this review, management determines whether the current placement of the security in the fair value hierarchy is appropriate or whether transfers may be warranted. As necessary, the Company

compares prices received from the pricing service to discounted cash flow models or through performing independent valuations of inputs and assumptions similar to those used by the pricing service in order to ensure prices represent a reasonable estimate of fair value. Although the Company does identify differences from time to time as a result of these validation procedures, the Company did not make any significant adjustments as of December 31, 2012 or 2011.

The following table presents the balances of assets and liabilities measured at fair value on a recurring basis at December 31, 2012 and December 31, 2011:

December 31, 2012	**Readily Available Market Inputs Level 1**	**Observable Market Inputs Level 2**	**Significant Unobservable Inputs Level 3**	**Total**
Securities available-for-sale				
U.S. Government agency securities	$--	$5,952	$--	$5,952
Obligations of state and political subdivisions	--	25,807	1,099	26,906
Agency MBS	--	22,159	--	22,159
Non-agency MBS	--	2,544	--	2,544
Corporate bonds	1,957	1,588	--	3,545
Total	**$1,957**	**$58,050**	**$1,099**	**$61,106**
December 31, 2011				
Securities available-for-sale				
U.S. Government agency securities	$--	$84	$--	$84
Obligations of state and political subdivisions	--	21,719	1,140	22,859
Agency MBS	--	16,915	--	16,915
Non-agency MBS	--	5,882	--	5,882
Corporate bonds	918	994	--	1,912
Total	**$918**	**$45,594**	**$1,140**	**$47,652**

As of December 31, 2012 and 2011, the Company had two investments classified as Level 3 investments which consist of local non-rated municipal bonds for which the Company is the sole owner of the entire bond issue. The valuation of these securities is supported by analysis prepared by an independent third party. Their approach to determining fair value involves using recently executed transactions and market quotations for similar securities. As these securities are not rated by the rating agencies and there is no trading volume, observable market data is limited and, management determined that these securities should be classified as Level 3 within the fair value hierarchy. These securities are considered sensitive to changes in credit given the unobserved assumed credit ratings.

The following table presents a reconciliation of assets that are measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the years ended December 31, 2012 and 2011, respectively. There were no transfers of assets into or out of Level 1, 2 or 3 during 2012 and 2011.

	2012	2011
Balance beginning of year	$1,140	$1,157
Included in other comprehensive income	(41)	- -
Matured	- -	(17)
Balance end of year	**$1,099**	**$1,140**

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Certain assets and liabilities are measured at fair value on a nonrecurring basis after initial recognition such as loans measured for impairment and other real estate owned ("OREO"). The following methods were used to estimate the fair value of each such class of financial instrument:

Impaired loans – A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (both interest and principal) according to the contractual terms of the loan agreement. Impaired loans are classified as Level 3 in the fair value hierarchy and are measured based on the present value of expected future cash flows or by the net realizable value of the collateral if the loan is collateral dependent. In determining the net realizable value of the underlying collateral, we primarily rely on third party appraisals by qualified licensed appraisers, less costs to sell. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach.

Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available and include consideration for variations in location, size, and income production capacity of the property. The income approach commonly utilizes a discount or cap rate to determine the present value of expected future cash flows. Additionally, the appraisals are periodically further adjusted by the Company in consideration of charges that may be incurred in the event of foreclosure and are based on management's historical knowledge, changes in business factors and changes in market conditions. Such discounts are typically significant, and may range from 10% to 30%.

Impaired loans are reviewed and evaluated quarterly for additional impairment and adjusted accordingly, based on the same factors identified above. Because of the high degree of judgment required in estimating the fair value of collateral underlying impaired loans and because of the relationship between fair value and general economic conditions, we consider the fair value of impaired loans to be highly sensitive to changes in market conditions.

Other real estate owned – OREO is initially recorded at the lower of the carrying amount of the loan or fair value of the property less estimated costs to sell. This amount becomes the property's new basis. Management considers third party appraisals in determining the fair value of particular properties. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach.

Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available and include consideration for variations in location, size, and income production capacity of the property. Additionally, the appraisals are periodically further adjusted by the Company based on management's historical knowledge, changes in business factors and changes in market conditions. Such discounts are typically significant, and may range from 10% to 25%.

Any write-downs based on the property fair value less estimated costs to sell at the date of acquisition are charged to the allowance for credit losses. Management periodically reviews OREO to ensure the property is carried at the lower of its new basis or fair value, net of estimated costs to sell. Any additional write-downs based on re-evaluation of the property fair value are charged to non-interest expense. Because of the high degree of judgment required in estimating the fair value of OREO and because of the relationship between fair value and general economic conditions, we consider the fair value of OREO to be highly sensitive to changes in market conditions.

The following table presents the Company's assets that were accounted for at fair value on a nonrecurring basis at December 31, 2012 and 2011:

	Readily Available Market Inputs Level 1	Observable Market Inputs Level 2	Significant Unobservable Inputs Level 3	Total
December 31, 2012				
Impaired loans	$ - -	$ - -	$5,053	$5,053
OREO	$ - -	$ - -	$4,807	$4,807
December 31, 2011				
Impaired loans	$ - -	$ - -	$7,183	$7,183
OREO	$ - -	$ - -	$6,455	$6,455

Other real estate owned with a pre-foreclosure loan balance of $3,293 was acquired during the year ended December 31, 2012. Upon foreclosure, these assets were written down $213 to their fair value, less estimated costs to sell, which was charged to the allowance for credit losses during the period.

The following table presents quantitative information about Level 3 inputs for financial instruments measured at fair value on a nonrecurring basis at December 31, 2012:

	Fair Value	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)
Impaired loans	$1,568	Appraised value - Sales comparison approach	Adjustment for market conditions	0-10% (0.2%)
	$3,485	Income approach	Discount rate	10.5%
OREO	$4,807	Appraised value - Sales comparison approach	Adjustment for market conditions	0-10% (9%)

Fair Value of Financial Instruments

The following methods and assumptions were used by the Company in estimating the fair values of financial instruments disclosed in these consolidated financial statements:

Cash and due from banks, Interest bearing deposits in banks, and Certificates held for investment
The carrying amounts of cash and interest bearing deposits at other financial institutions approximate their fair value.

Investment Securities Available-for-Sale and Held-to-Maturity
The fair value of all investment securities are based upon the assumptions market participants would use in pricing the security. Such assumptions include observable and unobservable inputs such as quoted market prices, dealer quotes and analysis of discounted cash flows.

Federal Home Loan Bank stock
FHLB stock is carried at cost which approximates fair value and equals its par value because the shares can only be redeemed with the FHLB at par.

Loans, net and Loans held for sale
The fair value of loans is estimated based on comparable market statistics for loans with similar credit ratings. An additional liquidity discount is also incorporated to more closely align the fair value with observed market prices. Fair values of loans held for sale are based on a discounted cash flow calculation using interest rates currently available on similar loans. The fair value was determined on an aggregate loan basis.

Deposits
The fair value of deposits with no stated maturity date is included at the amount payable on demand. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation based on interest rates currently offered on similar certificates.

Short-term borrowings
The fair values of the Company's short-term borrowings are estimated using discounted cash flow analysis based on the Company's incremental borrowing rates for similar types of borrowing arrangements.

Long-term borrowings
The fair values of the Company's long-term borrowings are estimated using discounted cash flow analysis based on the Company's incremental borrowing rates for similar types of borrowing arrangements.

Secured borrowings
For variable rate secured borrowings that reprice frequently and have no significant change in credit risk, fair values are based on carrying values.

Junior subordinated debentures
The fair value of the junior subordinated debentures and trust preferred securities is estimated using discounted cash flow analysis based on interest rates currently available for junior subordinated debentures.

Off-Balance-Sheet Instruments
The fair value of commitments to extend credit and standby letters of credit was estimated using the rates currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the customers. Since the majority of the Company's off-balance-sheet instruments consist of non-fee producing, variable-rate commitments, the Company has determined they do not have a material fair value.

The estimated fair values of the Company's financial instruments at December 31, 2012 and December 31, 2011 are as follows:

December 31, 2012	Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets					
Cash and cash equivalents	$56,855	$56,855	$- -	$- -	$56,855
Certificates of deposits held for investment	2,985	2,985	- -	- -	2,985
Securities available-for sale	61,106	1,957	58,050	1,099	61,106
Securities held-to-maturity	6,937	- -	6,985	- -	6,985
Federal Home Loan Bank stock	3,126	- -	3,126	- -	3,126
Loans held for sale	12,950	- -	12,977	- -	12,977
Loans, net	438,838	- -	- -	401,224	401,224
Financial Liabilities					
Deposits	$548,243	$- -	$549,504	$- -	$549,504
Short-term borrowings	3,000	- -	3,042	- -	3,042
Long-term borrowings	7,500	- -	7,765	- -	7,765
Junior subordinated debentures	13,403	- -	- -	8,318	8,318

December 31, 2011	Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets					
Cash and cash equivalents	$41,132	$41,132	$- -	$- -	$41,132
Securities available-for sale	47,652	918	45,594	1,140	47,652
Securities held-to-maturity	7,025	- -	7,118	- -	7,118
Federal Home Loan Bank stock	3,182	- -	3,182	- -	3,182
Loans held for sale	14,541	- -	14,808	- -	14,808
Loans, net	463,766	- -	- -	419,059	419,059
Financial Liabilities					
Deposits	$548,050	$- -	$549,472	$- -	$549,472
Short-term borrowings	- -	- -	- -	- -	- -
Long-term borrowings	10,500	- -	10,867	- -	10,867
Secured borrowings	741	- -	741	- -	741
Junior subordinated debentures	13,403	- -	- -	6,691	6,691

Note 18 - Earnings Per Share Disclosures

Following is information regarding the calculation of basic and diluted earnings per share for the years indicated.

	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
Year Ended December 31, 2012			
Basic earnings per share:	$4,785	10,121,853	$0.47
Effect of dilutive securities:	- -	4,391	- -
Diluted earnings per share:	**$4,785**	**10,126,244**	**$0.47**
Year Ended December 31, 2011			
Basic earnings per share:	$2,818	10,121,853	$0.28
Effect of dilutive securities:	- -	17	- -
Diluted earnings per share:	**$2,818**	**10,121,870**	**$0.28**
Year Ended December 31, 2010			
Basic earnings per share:	$1,634	10,121,853	$0.16
Effect of dilutive securities:	- -	- -	- -
Diluted earnings per share:	**$1,634**	**10,121,853**	**$0.16**

The number of shares shown for "options" is the number of incremental shares that would result from the exercise of options and use of the proceeds to repurchase shares at the average market price during the year.

Note 19 - Condensed Financial Information - Parent Company Only

Condensed Balance Sheets - December 31,

	2012	2011
Assets		
Cash	$173	$356
Investment in the Bank	79,684	77,327
Other assets	403	438
Total assets	**$80,260**	**$78,121**
Liabilities and Shareholders' Equity		
Junior subordinated debentures	$13,403	$13,403
Due to the Bank	95	196
Other liabilities	41	1,252
Shareholders' equity	66,721	63,270
Total liabilities and shareholders' equity	**$80,260**	**$78,121**

Condensed Statements of Income - Years Ended December 31,

	2012	**2011**	**2010**
Dividend Income from the Bank	$3,500	$- -	$- -
Other Income	10	8	15
Total Income	**3,510**	**8**	**15**
Expenses	(517)	(600)	(759)
Income (loss) before income tax benefit	**2,993**	**(592)**	**(744)**
Income Tax Benefit	101	- -	- -
Income (loss) before equity in undistributed income of the Bank	**3,094**	**(592)**	**(744)**
Equity in Undistributed Income of the Bank	1,691	3,410	2,378
Net income	**$4,785**	**$2,818**	**$1,634**

There are no items of other comprehensive income at the parent company.

Condensed Statements of Cash Flows - Years Ended December 31,

	2012	**2011**	**2010**
Operating Activities			
Net income	$4,785	$2,818	$1,634
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Equity in undistributed income of subsidiary	(1,691)	(3,410)	(2,378)
Net change in other assets	35	(8)	(15)
Net change in other liabilities	(1,312)	352	586
Other - net	24	26	46
Net cash provided by (used in) operating activities	**1,841**	**(222)**	**(127)**
Financing Activities			
Common stock issued	- -	- -	- -
Dividends paid	(2,024)	- -	- -
Net cash used in financing activities	**(2,024)**	**- -**	**- -**
Net decrease in cash	**(183)**	**(222)**	**(127)**
Cash			
Beginning of year	356	578	705
End of year	**$173**	**$356**	**$578**

Quarterly Data (Unaudited)

Year Ended December 31, 2012	**First Quarter**	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Interest income	$7,034	$7,037	$6,751	$6,673
Interest expense	984	907	829	764
Net interest income	**6,050**	**6,130**	**5,922**	**5,909**
Provision for (recapture of) credit losses	100	300	- -	(1,500)
Non-interest income	1,848	2,409	2,443	2,691
Non-interest expenses	6,599	6,910	7,070	7,838
Income before income taxes	**1,199**	**1,329**	**1,295**	**2,262**
Income taxes	181	256	280	583
Net income	**$1,018**	**$1,073**	**$1,015**	**$1,679**
Earnings per common share:				
Basic	$.10	$.11	$.10	$.16
Diluted	.10	.11	.10	.16
Year Ended December 31, 2011				
Interest income	$7,365	$7,313	$7,406	$7,234
Interest expense	1,680	1,548	1,336	1,069
Net interest income	**5,685**	**5,765**	**6,070**	**6,165**
Provision for credit losses	500	- -	1,050	950
Non-interest income	1,333	1,374	2,455	2,452
Non-interest expenses	6,142	6,594	6,060	6,852
Income before income taxes	**376**	**545**	**1,415**	**815**
Income taxes (benefit)	(56)	(58)	211	236
Net income	**$432**	**$603**	**$1,204**	**$579**
Earnings per common share:				
Basic	$.04	$.06	$.12	$.06
Diluted	.04	.06	.12	.06

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

The following discussion and analysis should be read in conjunction with Pacific's audited consolidated financial statements and related notes appearing elsewhere in this report. In addition, please refer to Pacific's forward-looking statement disclosure included elsewhere in this report.

Pacific is a bank holding company providing full-service community banking through 16 branches in Washington and one in Oregon. In addition, Pacific has one loan production office in Washington and a residential real estate mortgage department. The principal business of the Bank consists of making loans to and accepting deposits from businesses and individuals. Our Bank provides full service commercial and retail banking, primarily in its branch communities. Both our loans and our deposits are generated primarily through strong banking and community relationships, and through management that is locally active. Our lending and investment activities are funded primarily by core deposits. This stable source of funding is achieved by developing strong banking relationships with customers through value-added product offerings, market pricing, convenience and high-touch service.

Our results of operations depend primarily on net interest income, which is the difference between interest income from interest earning assets and interest expense on interest bearing liabilities. Noninterest income, which includes service charges and fees, gain on sale of loans, securities gains and income from bank owned life insurance, also provides a significant contribution to our results of operations. Our principal operating expenses, aside from interest expense, consist of salaries and employee benefits, occupancy and equipment costs, professional fees, data processing, FDIC insurance premiums and the provision for credit losses.

EXECUTIVE OVERVIEW

The following are important factors in understanding the Company financial condition and liquidity:

- Total assets at December 31, 2012, increased by $2,340,000, or 0.4%, to $643,594,000 compared to $641,254,000 at the end of 2011. Increases in interest bearing deposits in banks and investments were the primary contributors to overall asset growth, which were partially offset by decreases in loans and other real estate owned ("OREO").
- The Bank remains well capitalized with a total risk-based capital ratio of 16.22% at December 31, 2012, compared to 15.05% at December 31, 2011. Tier one leverage ratio was 10.69% at December 31, 2012, compared to 10.35% at December 31, 2011. During 2012, the Company paid all deferred interest on junior subordinated debentures current, announced a stock repurchase plan of up to 250,000 shares of its common stock, and paid a cash dividend of $0.20 per share.
- Non-performing assets ("NPAs") totaled $19,791,000 at December 31, 2012, which represents 3.08% of total assets, a decrease from $21,760,000 at December 31, 2011. The decrease is largely due to our continued focus on improving asset quality through proactive management of problem assets, which contributed to the successful liquidation of OREO during the year and continued reduction in our NPAs. NPAs are concentrated in commercial real estate loans and related OREO, which total $11,954,000, or 60.4%, of our NPAs.
- Demand deposits, savings, money market and certificates of deposits less than $100,000, increased during 2012 by $7,866,000, or 1.7%, to $460,888,000 and comprise 84.1% of total deposits at year-end, as part of our strategic focus on growing our low cost deposit relationships. The increase in core deposits was mostly driven by increases in commercial demand and money market accounts, coupled with an increase in personal NOW accounts.

- As a result of core deposit growth, lower borrowings and increased interest bearing deposits with banks, the Company's liquidity ratio increased to 46% at December 31, 2012, which translates into over $293 million in available funding for general operations and to meet loan and deposit needs.

The following are significant components of the Company's results of operations for 2012 as compared to 2011.

- Net income for 2012 was $4,785,000, or $0.47 per diluted share, compared to net income of $2,818,000, or $0.28 per diluted share, in 2011.
- Net interest income increased to $24,011,000 compared to $23,685,000 in 2011 due to decreases in rates paid on deposits and an increase in non-interest bearing demand deposits. Net interest margin for 2012 increased 12 basis points to 4.20% compared to 4.08% in 2011.
- The provision for (recapture of) credit losses decreased by $3,600,000, or 144.0%, to ($1,100,000) for 2012, as compared to a charge of $2,500,000 for 2011. The reduction in provision expense is primarily the result of the elimination of a $1.7 million specific impairment reserve that had been established through the provision for loan losses in a previous year and continued overall improvement in credit quality, as evidenced by decreases in net charge-offs and loans classified as substandard or worse.
- Net charge-offs totaled $669,000 during 2012 compared to $1,990,000 in 2011. Loans classified as substandard or worse totaled $21,694,000 at December 31, 2012, a decrease of $12,884,000, or 37.3%, compared to $34,578,000 one year ago. While credit quality improved during the year, non-performing loans remain elevated compared to long-term historical levels and are concentrated primarily in commercial real estate loans.
- Non-interest income increased $1,777,000, or 23.3%, to $9,391,000 for 2012 due to increased gains on sale of loans and OREO. Gain on sale of loans during 2012 hit a record high at $5,058,000, an increase of $1,465,000, or 40.8%, over the $3,593,000 recorded in 2011, as the market for residential mortgages accelerated as market conditions improved and interest rates fell to historically low levels.
- Non-interest expense increased $2,769,000, or 10.8%, to $28,417,000 for 2012. The increase is primarily attributable to increases in salaries and employee benefits, OREO write-downs and operating costs, and data processing expenses.
- In 2012, return on average assets and return on average equity increased to 0.75% and 7.28%, respectively, compared to 0.44% and 4.55%, respectively, in 2011.

BUSINESS OVERVIEW

The Company's financial performance generally, and in particular the ability of borrowers to pay interest on and repay principal of outstanding loans and the value of collateral securing those loans, is highly dependent on the economy in our markets. Although economic conditions in general appear to be stabilizing, the Company's future operating results and financial performance may be significantly affected by the prolonged weak economy in the Company's market area and any changes in the course of the recovery.

According to the U.S. Bureau of Labor Statistics, the unemployment rate in Washington was 7.6% at December 31, 2012, compared to 8.5% in 2011 and 9.3% in 2010, and in Oregon the unemployment rate was 8.4% for 2012, compared to 8.9% in 2011 and 2010. The unemployment rate in Oregon is higher than the national unemployment rate of 7.8% at December 31, 2012. According to the Washington State Employment Security Department and the Oregon Employment Department, unemployment rates over the last three years in the principal counties in which we operate were as follows:

Unemployment Rate at December 31,

County	2012	2011	2010
Clatsop	7.6%	7.8%	9.2%
Grays Harbor	12.4%	13.5%	13.1%
Pacific	11.8%	11.9%	11.8%
Skagit	9.1%	10.2%	10.3%
Wahkiakum	12.2%	11.9%	13.8%
Whatcom	6.9%	8.1%	8.1%

Excluding Whatcom County, all Washington counties in which the Company operates have unemployment rates greater than the state and national rates.

Closed sales activity for single-family homes and condominiums had been on a declining trend in recent years; however, sales activity began to rebound in 2011 and continued in 2012 in selective counties within our geographic footprint. Year over year changes in closed sales activity in Grays Harbor, Skagit and Whatcom counties were (0.7%), 11.0%, and 17.2%, respectively, during 2012. The home price growth rate during 2012 is also indicative of a positive trend in the same counties, rising 7.8%, 11.8%, and 15.7%, respectively. Limited data is available on sales activity and sales prices for Pacific, Wahkiakum and Clatsop counties.

Commercial real estate has performed better than residential real estate, but is generally affected by a slow economy as well. After experiencing a sharp decline in the period 2008 through 2011, sales rebounded significantly in 2012. As an example, according to data provided by Real Estats, commercial sales in Whatcom County totaled $367.1 million in 2012 compared to $140.3 million in 2011 and $139.6 million in 2010. Limited data is available on commercial real estate sales in the smaller, more rural counties in which we operate.

OPERATING STRATEGY

The Company's vision is to achieve and maintain balanced growth in loans and deposits while maintaining top peer group financial performance; to consistently exceed all internal and external customer expectations by listening, understanding and identifying customers' needs; to provide timely products and services through a cost effective delivery system while maintaining customer value expectations; and positively impacting our community through our passion and being a model corporate citizen.

In order to achieve long-term growth and accomplish our long-term financial objectives, the Company seeks to successfully execute its long-term strategies. Operating strategies for 2013 are as follows:

- Focus on improving profitability with asset growth and reductions in net overhead and controllable operating expenses through fiscal restraint and increased emphasis on non-interest income and efficiencies.

- Continue to improve asset quality through proactive management of problem loans, monitoring existing performing loans, and selling of OREO properties.
- Grow loans and deposits organically by increasing our customer base in the markets we serve and in markets adjacent to our current footprint. We will seek to capture more of each customer's banking relationship by cross selling our loan and deposit products to our customers and emphasizing our local ownership and decision making authority.
- Successfully complete and effectively manage and integrate the opening of a loan production office in Vancouver, Washington in the first quarter of 2013, the acquisition of three branches (two of which are in Oregon) from Sterling Savings Bank, which is expected to close in the second quarter of 2013, and the opening of a new branch in Warrenton, Oregon, which is expected in fourth quarter 2013.
- Control the expected decrease in net interest margin through the use of rate floors in loans and continued decreases in deposit rates where possible.

The degree to which we will be able to execute on these strategies will depend to a large degree on the local and national economy, improvement in the local markets for residential real estate, limited deterioration in the credit quality of our commercial real estate loans, and satisfaction of all conditions to our current expansion initiatives, including receipt of any required regulatory approvals.

RESULTS OF OPERATIONS

Years ended December 31, 2012, 2011, and 2010

General. The following table presents condensed consolidated statements of income for the Company for each of the years in the three-year period ended December 31, 2012.

(dollars in thousands)	2012	Increase (Decrease) Amount	%	2011	Increase (Decrease) Amount	%	2010
Interest and dividend income	$27,495	$(1,823)	(6.2)	$29,318	$(1,542)	(5.0)	$30,860
Interest expense	3,484	(2,149)	(38.2)	5,633	(2,348)	(29.4)	7,981
Net interest income	24,011	326	1.4	23,685	806	3.5	22,879
Provision for (recapture of) credit losses	(1,100)	(3,600)	(144.0)	2,500	(1,100)	(30.6)	3,600
Net interest income after provision for credit losses	25,111	3,926	18.5	21,185	1,906	9.9	19,279
Other operating income	9,391	1,777	23.3	7,614	(837)	9.9	8,451
Other operating expense	28,417	2,769	10.8	25,648	(752)	(2.9)	26,400
Income before income taxes	6,085	2,934	93.1	3,151	1,821	136.9	1,330
Income taxes (benefit)	1,300	967	290.4	333	637	209.5	(304)
Net income	$4,785	$1,967	69.8	$2,818	$1,184	72.5	$1,634

Net income. For the year ended December 31, 2012, net income was $4,785,000 compared to $2,818,000 in 2011. The improvement in net income for 2012 was primarily related to an increase in net interest income, a substantial decrease in provision for credit losses, and an increase in gain on sale of loans, which were partially offset by an increase in commissions paid on loans sold. Net income of $2,818,000 for 2011 was up from net income of $1,634,000 for the year ended December 31, 2010. The increase in net income for 2011 was primarily due to increased net interest income and decreased provisions for credit losses, OREO write-downs and FDIC assessments.

Net Interest Income. The Company derives the majority of its earnings from net interest income, which is the difference between interest income earned on interest earning assets and interest expense incurred on interest bearing liabilities. The Company's net interest income is affected by the change in the level and mix of interest-earning assets and interest-bearing liabilities, referred to as volume changes. The Company's net interest income is also affected by changes in the yields earned on assets and rates paid on liabilities, referred to as rate changes. Interest rates charged on loans are affected principally by the demand for such loans, the supply of money available for lending purposes and competitive factors. Those factors are, in turn, affected by general economic conditions and other factors beyond the Company's control, such as federal economic policies, legislative tax policies and actions by the Federal Open Market Committee of the Federal Reserve ("FOMC"). Interest rates on deposits are affected primarily by rates charged by competitors and actions by the FOMC.

The FOMC heavily influences market interest rates, including deposit and loan rates offered by many financial institutions. Also, as rates near zero, it becomes more difficult to match decreases in rates on interest earning assets with decreases in rates paid on interest bearing liabilities. Approximately 78% of the Company's loan portfolio is tied to short-term rates, and therefore, re-price immediately when interest rate changes occur. The Company's funding sources also re-price when rates change; however, there is a meaningful lag in the timing of the re-pricing of deposits as compared to loans and decreases in interest rates become less easily matched by decreases in deposit rates as rates approach zero. Because of its focus on commercial lending, the Company will continue to have a high percentage of floating rate loans. Because deposit rates are near the bottom, and because the reinvestment rates on maturing securities have fallen dramatically and loan rates are impacted by competition for new loans, the Company anticipates that the prolonged low rate environment will put pressure on net interest margin in 2013.

The following table sets forth information with regard to average balances of interest earning assets and interest bearing liabilities and the resultant yields or cost, net interest income, and the net interest margin.

	Year Ended December 31,								
	2012			2011			2010		
(dollars in thousands)	Average Balance	Interest Income (Expense)	Avg Rate	Average Balance	Interest Income (Expense)	Avg Rate	Average Balance	Interest Income (Expense)	Avg Rate
Assets									
Earning assets:									
Loans (1)	$479,036	$25,953	5.42%	$483,974	$27,481	5.68%	$485,872	$28,835	5.93%
Investment securities:									
Taxable	29,993	770	2.57	29,844	1,042	3.49	26,451	1,235	4.67
Tax-Exempt (1)	27,590	1,525	5.53	24,613	1,512	6.14	24,421	1,498	6.13
Total investment securities	**57,583**	**2,295**	**3.99**	**54,457**	**2,554**	**4.69**	**50,872**	**2,733**	**5.37**
Federal Home Loan Bank Stock	3,173	- -	- -	3,183	- -	- -	3,183	- -	- -
Federal funds sold and deposits in banks	32,089	84	0.26	38,535	92	0.24	37,885	116	0.31
Total earning assets / interest income	**$571,881**	**$28,332**	**4.95%**	**$580,149**	**$30,127**	**5.19%**	**$577,812**	**$31,684**	**5.48%**
Cash and due from banks	10,751			10,280			10,399		
Premises and equipment (net)	14,753			15,065			15,580		
Other real estate owned	6,880			7,579			8,071		
Other assets	42,427			41,845			43,782		
Allowance for credit losses	(11,022)			(11,028)			(11,413)		
Total assets	**$635,670**			**$643,890**			**$644,231**		
Liabilities and Shareholders' Equity									
Interest bearing liabilities:									
Deposits:									
Savings and interest-bearing demand	$288,984	$(1,084)	0.38%	$275,630	$(1,612)	0.58%	$238,123	$(1,729)	0.73%
Time certificates	144,486	(1,798)	1.24	176,631	(3,031)	1.72	220,618	(4,845)	2.20
Total deposits	**433,470**	**(2,882)**	**0.66**	**452,261**	**(4,643)**	**1.03**	**458,741**	**(6,574)**	**1.43**
Short-term borrowings	2,697	(79)	2.93	6,885	(264)	3.84	7,502	(204)	2.72
Long-term borrowings	7,803	(217)	2.78	10,500	(333)	3.17	15,674	(645)	4.12
Secured borrowings	448	(20)	4.46	777	(41)	5.28	951	(61)	6.41
Junior subordinated debentures	13,403	(286)	2.13	13,403	(352)	2.63	13,403	(497)	3.71
Total borrowings	**24,351**	**(602)**	**2.47**	**31,565**	**(990)**	**3.14**	**37,530**	**(1,407)**	**3.75**
Total interest-bearing liabilities/ Interest expense	**$457,821**	**$(3,484)**	**0.76%**	**$483,826**	**$(5,633)**	**1.16%**	**$496,271**	**$ (7,981)**	**1.61%**
Demand deposits	107,048			93,413			84,556		
Other liabilities	5,058			4,709			4,361		
Shareholders' equity	65,743			61,942			59,043		
Total liabilities and shareholders' equity	**$635,670**			**$643,890**			**$644,231**		
Net interest income (1)		**$24,848**			**$24,494**			**$23,703**	
Net interest income as a percentage of average earning assets									
Interest income			4.95 %			5.19%			5.48%
Interest expense			0.61 %			0.97%			1.38%
Net interest income			**4.34%**			**4.22%**			**4.10%**
Net interest margin (2)			**4.20%**			**4.08%**			**3.96%**
Tax equivalent adjustment (1)		$837			$809			$824	

(1) Interest earned on tax-exempt loans and securities has been computed on a 34% tax equivalent basis.
(2) Net interest income divided by average interest earning assets.

For purposes of computing the average rate, the Company used historical cost balances which do not give effect to changes in fair value that are reflected as a component of shareholders' equity. Nonaccrual loans and loans held for sale are included in "loans." Interest income on loans includes loan fees of $569,000, $480,000, and $575,000 in 2012, 2011, and 2010, respectively.

The net interest margin increased to 4.20% for the year ended December 31, 2012, up from 4.08% in the prior year. Net interest income for the year ended December 31, 2012 increased $326,000, or 1.38%, which is primarily the result of an improvement in funding costs, a change in the mix of deposits with a greater concentration in demand accounts than higher cost certificates of deposits, and a decrease in the average level of FHLB advances. The average cost of funds decreased to 0.76% at December 31, 2012 from 1.16% one year ago, which was only partially offset by a decline in the Company's average yield earned on assets from 5.19% for year ended December 31, 2011 to 4.95% for the current year. The decline in yield is due to a decrease in overall market rates. In 2011, decreasing levels of nonperforming loans placed on nonaccrual status positively affected our net interest margin which improved to 4.08% from 3.96% in 2010.

Net interest income on a tax equivalent basis totaled $24,848,000 for the year ended December 31, 2012, an increase of $354,000, or 1.4%, compared to 2011. Net interest income on a tax equivalent basis increased 3.3% to $24,494,000 in 2011 compared to 2010. The Company's tax equivalent interest income decreased 6.0% to $28,332,000 in 2012, from $30,127,000 in 2011 and $31,684,000 in 2010. The decrease in interest income in 2012 and 2011 was primarily due to the decline in yield earned on our loan and investment portfolios; however, this decline was more than offset by decreases in interest expense during these years.

Average interest earning balances with banks at December 31, 2012, decreased to $32.1 million with an average yield of 0.26% compared to $38.5 million with an average yield of 0.24% for the same period in 2011. Net interest margin continued to be negatively affected in 2012 and 2011 by increased levels of interest bearing cash invested at relatively low yields. The average yield in both periods is comparable to the federal funds target rate of 0.25% set by the Federal Open Market Committee of the Federal Reserve.

The Company's average loan portfolio decreased $4,938,000, or 1.0%, from year end 2011 to year end 2012, and decreased $1,898,000, or 0.4%, from 2010 to 2011. The decrease in 2012 is due to decreases in construction and land development loans and commercial real estate loans. The decrease in 2011 is due to decreases in multi-family and non-owner occupied commercial real estate loans. These were partially offset by growth in commercial and owner-occupied commercial real estate loans in the second half of the year. Overall, loan demand remains soft in the current economic environment, and there is fierce competition for new loans.

The Company's average investment portfolio increased $3,126,000, or 5.7%, from 2011 to 2012, and increased $3,585,000, or 7.0%, from 2010 to 2011. Interest and dividend income on investment securities for the year ended December 31, 2012, on a tax-equivalent basis, decreased $259,000, or 10.1%, compared to the same period in 2011. The average tax equivalent yield on investment securities decreased to 3.99% at December 31, 2012, from 4.69% at December 31, 2011 and 5.37% at year-end 2010. The decrease in 2012 and 2011 is attributable to the reduction in yield from accelerated prepayments on mortgage-backed securities and the maturity and sale of higher yielding securities that cannot be replaced in the current low rate environment.

The Company's average interest-bearing deposits decreased $18,791,000, or 4.2%, from 2011 to 2012, and decreased $6,480,000, or 1.4%, in 2011 from 2010. The Company attributes the decrease in 2012 and 2011 to the planned runoff of certificates of deposits which was partially offset by growth in all other deposit categories. Additionally, fewer retail customers have been willing to lock in low interest rates on certificates of deposits for an extended period of time. Average borrowings decreased during 2012 by $7,214,000, or 22.9%, and decreased by $5,965,000, or 15.9%, during 2011. The decrease in average borrowing balances outstanding is primarily

due to the maturity of $10,500,000 in FHLB advances in the latter part of 2011. The pay down in borrowings was funded by growth in lower cost demand deposits, which contributed to the increase in interest margin during 2012. Average short-term borrowings in 2012 and 2011 represent FHLB term borrowings which had been reclassified as short-term borrowings due to scheduled maturity dates within one year.

Interest expense for the year ended December 31, 2012, decreased $2,149,000, or 38.2%, compared to the same period in 2011. During 2011, interest expense declined $2,348,000, or 29.4%, compared to 2010. Interest rates paid on our deposits decreased significantly during 2012 and 2011. Additionally, average balances of higher cost certificates and other borrowings decreased during both periods. The average rate paid on deposits declined to 0.66% in 2012 compared to 1.03% in 2011 and 1.43% in 2010. The opportunity for continued downward repricing of maturing certificates of deposits has diminished. For the next twelve months, the amount of certificates maturing is $70,993,000 at a weighted average rate of 0.83%. Additionally, we believe that rates currently paid on non-maturity deposits are effectively near the floor and that we will have less flexibility to pay lower rates on these deposits in the future. The Company's overall cost of interest-bearing liabilities decreased to 0.76% in 2012 from 1.16% and 1.61% in 2011 and 2010, respectively.

The following table presents changes in net interest income, on a tax-equivalent basis, attributable to changes in volume or rate. Changes not solely due to volume or rate are allocated to volume and rate based on the absolute values of each.

	2012 compared to 2011 Increase (decrease) due to			2011 compared to 2010 Increase (decrease) due to		
(dollars in thousands)	**Volume**	**Rate**	**Net**	**Volume**	**Rate**	**Net**
Interest earned on:						
Loans	$(278)	$(1,250)	$(1,528)	$(112)	$(1,242)	$(1,354)
Securities:						
Taxable	5	(277)	(272)	145	(338)	(193)
Tax-exempt	173	(160)	13	12	2	14
Total securities	178	(437)	(259)	157	(336)	(179)
Fed funds sold and interest bearing deposits in other banks	(16)	8	(8)	2	(26)	(24)
Total interest earning assets	**(116)**	**(1,679)**	**(1,795)**	**47**	**(1,604)**	**(1,557)**
Interest paid on:						
Savings and interest bearing demand deposits	75	(603)	(528)	249	(366)	(117)
Time deposits	(491)	(742)	(1,233)	(865)	(949)	(1,814)
Total borrowings	(201)	(187)	(388)	(206)	(211)	(417)
Total interest bearing liabilities	**(617)**	**(1,532)**	**(2,149)**	**(822)**	**(1,526)**	**(2,348)**
Change in net interest income	**$501**	**$(147)**	**$354**	**$869**	**$(78)**	**$791**

Non-Interest Income. Non-interest income was $9,391,000 for 2012, an increase of $1,777,000, or 23.3%, from 2011 when it totaled $7,614,000. Categories contributing to the increase during 2012 compared to 2011 were gains on sale of loans and OREO. Non-interest income was $7,614,000 during 2011, a decrease of $837,000, or 9.9%, compared to the 2010 total of $8,451,000. Negatively affecting non-interest income during 2011 were OTTI losses, and reductions in gain on sale of loans and OREO. A portion of these decreases were offset by increases in gains on securities and other operating income.

The following table represents the principal categories of non-interest income for each of the years in the three-year period ended December 31, 2012.

(dollars in thousands)	2012	Increase (Decrease) Amount	%	2011	Increase (Decrease) Amount	%	2010
Service charges on deposit accounts	$1,686	$(113)	(6.3)	$1,799	$16	0.9	$1,783
Net gain (loss) on sale of other real estate owned	331	414	498.8	(83)	(343)	(131.9)	260
Net gains on sales of loans	5,058	1,465	40.8	3,593	(575)	(13.8)	4,168
Net gain (loss) on sales of securities	303	(395)	(56.6)	698	276	65.4	422
Net OTTI losses	(333)	(3)	(0.9)	(330)	330	n/a	- -
Earnings on bank owned life insurance	510	(17)	(3.2)	527	(14)	(2.6)	541
Other operating income	1,836	426	30.2	1,410	133	10.4	1,277
Total non-interest income	**$9,391**	**$1,777**	**23.3**	**$7,614**	**$(837)**	**(9.9)**	**$8,451**

Service charges on deposits decreased $113,000, or 6.3%, during 2012 due to a decline in overdraft revenue as a result of regulatory opt-in requirements that affect the Bank's ability to charge overdraft fees for ATM withdrawals and debit card transactions. Service charge revenue was relatively flat in 2011 when it increased slightly by $16,000, or 0.9%. The Company continues to emphasize the importance of exceptional customer service and believes this emphasis will contribute to an increase in service charge revenue in 2013.

The Company continues to sell long-term fixed and adjustable rate residential real estate loans into the secondary market, which is an important source of non-interest income. Gain on sales of loans, the largest component of non-interest income, totaled $5,058,000 for the year ended December 31, 2012, compared to $3,593,000 for the same period in 2011. The increase during the current year was due to increased mortgage refinancing activity driven by the low rate environment. Originations of loans held for sale were $251,435,000 for the year ended December 31, 2012, compared to $172,274,000 for the same period in 2011. Also contributing to the growth in volume was the addition of origination staff during the second and third quarters of 2012. The Company plans to continue to expand its mortgage origination staff to capitalize on the opportunities in its local markets. Management expects gain on sale of loans to continue at a robust pace for the first half of 2013 in part due to its expectation that the low interest rate environment will continue and local economies will continue to improve.

The $575,000 decrease in income from gains on sales of loans in 2011 was due to a decline in mortgage refinancing activity and secondary market volume due to the expiration of government incentive programs including tax credits previously in place during 2010.

The Bank continues to have success in liquidating OREO properties. As a result, net gain on sale of OREO totaled $331,000 on seventeen properties sold during 2012 compared to a net loss on sale of OREO of $83,000 for the year ended December 31, 2011. The gain on sale of OREO in 2010 of $260,000 was largely due to a gain recognized on the sale of one commercial land lot.

The Bank recorded net gains on sale of securities available-for-sale of $303,000, $698,000 and $422,000, for the years ended December 31, 2012, 2011 and 2010, respectively. During 2012 and 2011, one non-agency mortgage-backed security was determined to be other-than-temporarily-impaired resulting in the Company recording $333,000 and $330,000, respectively, in impairment charges related to credit losses through earnings. There were no additional OTTI securities at December 31, 2012 or December 31, 2011.

Income from other sources totaled $2,346,000 in 2012, an increase of $409,000 from 2011, or 21.1%, due primarily to increases in foreign exchange revenue, visa debit card interchange revenue and automated teller machine fees, and other miscellaneous fees associated with loans sold in the secondary market. Income from other sources in 2011 increased $119,000 to $1,937,000 as the result of increases in visa debit card interchange revenue and automated teller machine fees, which were partially offset by a decrease in earnings on BOLI due to lower earnings credit rates.

Non-Interest Expense. Total non-interest expense in 2012 was $28,417,000, an increase of $2,769,000, or 10.8%, compared to $25,648,000 in 2011. Contributing to this increase in non-interest expense were increases in salaries and employee benefits (including commissions), OREO expenses, and data processing expenses. The effect of these increases was partially mitigated by decreases in FDIC insurance assessments, marketing costs and occupancy expenses. In 2011, non-interest expense decreased $752,000, or 2.8%, compared to $26,400,000 in 2010. The decrease in 2011 was mostly related to reductions in FDIC assessments, OREO write-downs and operating costs, and occupancy and equipment expenses. These were partially offset by increases in expenses for data processing, marketing and salaries and employee benefits.

The following table shows the principal categories of non-interest expense for each of the years in the three-year period ended December 31, 2012.

(dollars in thousands)	2012	Increase (Decrease) Amount	%	2011	Increase (Decrease) Amount	%	2010
Salaries and employee benefits	$16,215	$2,492	18.2	$13,723	$193	1.4	$13,530
Occupancy and equipment	2,474	(60)	(2.4)	2,534	(232)	(8.4)	2,766
State taxes	518	45	9.5	473	(7)	(1.5)	480
Data processing	1,607	192	13.6	1,415	168	13.5	1,247
Professional services	750	11	1.5	739	(28)	(3.7)	767
FDIC and state assessments	610	(328)	(35.0)	938	(423)	(31.1)	1,361
OREO write-downs	1,314	265	25.3	1,049	(223)	(17.5)	1,272
OREO operating expenses	550	100	22.2	450	(164)	(26.7)	614
Marketing and advertising	441	(82)	15.7	523	114	27.9	409
Other expense	3,938	134	3.5	3,804	(150)	(3.8)	3,954
Total non-interest expense	**$28,417**	**$2,769**	**10.8**	**$25,648**	**$(752)**	**(2.8)**	**$26,400**

Salary and employee benefits costs, which are the largest component of non-interest expense, increased by $2,492,000, or 18.2%, in 2012 to $16,215,000 and increased by $193,000, or 1.4%, in 2011 compared to 2010. The increase in 2012 is largely attributable to increases in salaries and employee benefits related to an increase in commissions paid on the sale of loans held for sale as part of the expansion of residential mortgage loan origination. Additionally, annual performance and merit increases coupled with increases in incentive compensation and an eleven percent increase in medical insurance also contributed to the increase in salaries and benefits for 2012. The increase in 2011 is attributable to annual performance and merit increases, as well as temporary additions to staff to assist with a core system conversion that occurred in April 2011. Full time equivalent employees at December 31, 2012, were 237 compared to 213 at December 31, 2011. Also included in salaries and benefits for 2012 and 2011 was stock compensation expense of $24,000 and $26,000, respectively. For more information regarding stock options, see Note 15 - "Stock Based Compensation" to the Company's audited consolidated financial statements included elsewhere in this report.

Occupancy and equipment expenses decreased $60,000 and $232,000 to $2,474,000 and $2,534,000, respectively, in 2012 and 2011 compared with $2,766,000 for 2010, due primarily to reductions in depreciation expense, building repair and maintenance, and annual equipment hardware maintenance.

Data processing expense increased $192,000, or 13.6%, in 2012 compared to 2011 due mostly to the investment in technology for mobile apps, contact management software, compliance management software and enhanced financial monitoring tools. Data processing expense increased $168,000, or 13.5%, in 2011 compared to 2010. In order to improve technology capabilities, processing time and efficiency, management converted its core operating system in April 2011. The Company expects to continue to invest in new technology when appropriate to support future growth and address changing customer preferences.

FDIC assessment expense totaled $610,000 in 2012 compared with $938,000 in 2011 and $1,361,000 in 2010. The decrease in 2012 and 2011 is mostly attributable to a decrease in assessment rates effective April 2011 due to changes implemented by the FDIC under the Dodd-Frank Act to assess premiums based on average assets rather than on domestic deposits. This change had a favorable impact on community banks, including Bank of the Pacific.

OREO write-downs and operating costs increased $365,000, or 24.3%, during 2012 compare to 2011 due to an increase in the number of OREO properties held during the year and valuation adjustments from reductions in land and commercial real estate values. OREO write-downs and operating costs decreased in 2011 by $387,000 which was due to less severe declines in real estate market values in 2011 compared to the previous two years.

Marketing and advertising expense decreased by $82,000, or 15.7%, in 2012 compared to $523,000 in 2011. The decrease was due to reduction in the number of sponsorships, coupled with better allocation of marketing dollars dedicated to print and radio advertising. Marketing and advertising expense increased by 27.9% to $523,000 in 2011 compared with $409,000 in 2010 due to campaigns associated with e-delivery services, annuity sales and communications related to the core system conversion. The Company anticipates the marketing and advertising expense will increase in 2013 as the Company seeks to promote brand awareness particularly in our new markets in Vancouver, Washington and Astoria and Seaside, Oregon.

Other operating expense increased 3.5% to $3,938,000 in 2012 compared with $3,804,000 for 2011, primarily due to small increases in a broad range of categories with the most notable in credit reports and loan origination expense associated with the ramp up of mortgage origination operations. Other operating expense decreased 3.8% to $3,804,000 in 2011 compared with $3,954,000 in 2010, primarily due to decreases in directors and office insurance and core deposit intangible amortization, which declined $125,000 and $106,000, respectively.

Income Taxes (Benefit). For the years ended December 31, 2012, 2011, and 2010, income taxes (benefit) totaled $1,300,000, $333,000 and ($304,000), respectively, representing effective tax rates of 21.4%, 10.6% and (22.9)%, respectively. The effective tax rate differs from the statutory rate of 34.6% due to tax exempt income representing an increasing share of income as investments in municipal securities and loans, income earned on BOLI, and tax credits received on investments in low income housing partnerships remained at historical levels.

Deferred income tax assets or liabilities reflect the estimated future tax effects attributable to differences as to when certain items of income or expense are reported in the financial statements versus when they are reported in the tax returns. At December 31, 2012 and 2011, the Company had a net deferred tax asset of $4,013,000 and $4,351,000, respectively.

See “Critical Accounting Policies” in this section below.

FINANCIAL CONDITION

At December 31, 2012 and 2011

Total assets were $643,594,000 at December 31, 2012, a slight increase of $2,340,000, or 0.4%, over year-end 2011. Increases in interest-bearing cash and investments were the primary contributors to overall asset growth, which were partially offset by a decrease in loans and OREO.

Cash and Cash Equivalents

Total cash and cash equivalents, including federal funds sold, increased to $59,840,000 at December 31, 2012, from $41,132,000 at December 31, 2011, due to proceeds received from loan maturities and pay-offs during 2012 of loans with planned exit strategies, coupled with reduced loan demand. It is anticipated that cash and cash equivalents will decrease in 2013 as the Company increases lending through new loan production offices and deploys excess cash balances into higher yielding investments.

Investment Portfolio

The composition of our investment portfolio is managed to maximize total return on the portfolio while considering the impact it has on asset/liability position and liquidity needs. The majority of securities are classified as available-for-sale and carried at fair value with a small amount classified as held-to-maturity and carried at amortized cost. The Company regularly reviews its portfolio in conjunction with overall balance sheet management strategies. From time to time securities may be sold to reposition the portfolio in response to strategies developed by the Company’s asset liability committee or to realize gains within the portfolio. The Company’s investment securities portfolio increased $13,366,000, or 24.4%, during 2012 to $68,043,000 due to investment in municipal, government agency and mortgage-backed securities as an alternative to cash. The Company’s investment securities portfolio increased $6,330,000, or 13.1%, during 2011 to $54,677,000 from $48,347,000 at year end 2010. Additional securities were purchased during both years as loan growth slowed.

The Company regularly reviews its investment portfolio to determine whether any of its securities are other than temporarily impaired. In addition to accounting and regulatory guidance, in determining whether a security is other than temporarily impaired, the Company considers whether it intends to sell the security and if it does not intend to sell the security, whether it is more likely than not it will be required to sell the security before recovery of its amortized cost basis. The Company also considers cash flow analysis for mortgage-backed securities under various prepayment, default, and loss severity scenarios in determining whether a mortgage-backed security is other than temporarily impaired. At December 31, 2012, the Company owned 4 securities in a continuous unrealized loss position for twelve months or longer, with an amortized cost of $2,556,000 and fair value of $2,279,000. These securities that have been in a continuous unrealized loss position for twelve

months or longer at December 31, 2012, had investment grade ratings upon purchase. Following its evaluation of factors deemed relevant, management determined, in part because the Company does not have the intent to sell these securities and it is not more likely than not that it will have to sell the securities before recovery of cost basis, which may be at maturity, the Company does not have any other than temporarily impaired securities at December 31, 2012, with the exception of one non-agency mortgage-backed security. For more information regarding our investment securities and analysis of the value of securities in our investment portfolio, see Note 3 - "Securities" and Note 17 – "Fair Value of Financial Instruments" to the Company's audited consolidated financial statements included elsewhere in this report.

The carrying values of investment securities at December 31 in each of the last three years are as follows:

Held to Maturity

(dollars in thousands)	2012	2011	2010
Obligations of states and political subdivisions	$6,716	$6,732	$6,084
Mortgage-backed securities	221	293	370
Total	**$6,937**	**$7,025**	**$6,454**

Available For Sale

	2012	2011	2010
U.S. Government agency securities	$5,952	$84	$1,109
Obligations of states and political subdivisions	26,906	22,859	21,152
Mortgage-backed securities	24,703	22,797	16,614
Corporate bonds	3,545	1,912	3,018
Total	**$61,106**	**$47,652**	**$41,893**

The following table presents the maturities of investment securities at December 31, 2012. Taxable equivalent values are used in calculating yields assuming a tax rate of 34%.

Held To Maturity

(dollars in thousands)	Due in one year or less	Due after one through five years	Due after five through ten years	Due after ten years	Total
Obligations of states and political subdivisions	$225	$784	$932	$4,775	$6,716
Weighted average yield	5.84%	5.98%	6.36%	6.76%	
Mortgage-backed securities	- -	- -	157	64	221
Weighted average yield	- -	- -	5.22%	5.95%	
Total	**$225**	**$784**	**$1,089**	**$4,839**	**$6,937**

Available For Sale

	Due in one year or less	Due after one through five years	Due after five through ten years	Due after ten years	Total
U.S. Agency securities	$ - -	$3,704	$1,037	$1,211	$5,952
Weighted average yield	- -	0.60%	1.09%	2.75%	
Obligations of states and political subdivisions	1,066	2,215	6,091	17,534	26,906
Weighted average yield	3.56%	4.38%	3.68%	5.01%	
Mortgage-backed securities	1	- -	2,097	22,605	24,703
Weighted average yield	1.67%	- -	1.98%	1.26%	
Corporate bonds	1,000	2,545	- -	- -	3,545
Weighted average yield	1.84%	2.40%	- -	- -	
Total	**$2,067**	**$8,464**	**$9,225**	**$41,350**	**$61,106**

Loan Portfolio

General. Total loans were $461,146,000 at December 31, 2012, a decrease of $28,288,000, or 5.8%, compared to December 31, 2011. The decrease in total loans was driven primarily by a decline of $15,745,000 in construction and land development loans and $8,677,000 in commercial real estate loans that were largely a result of continued loan payoffs prior to maturity, which the Company believes are reflective of the current low interest rate environment and economic conditions. Competition for commercial loans in the markets we serve is fierce and loan demand has been soft. Management expects the loan portfolio will grow in 2013, although it believes the uncertainty surrounding various aspects of the economy is causing many customers to wait for even more clarity before borrowing additional funds to expand their businesses or purchase assets.

The following table sets forth the composition of the Company's loan portfolio (including loans held for sale) at December 31 in each of the past five years.

(dollars in thousands)	2012	2011	2010	2009	2008
Commercial and agricultural	$ 87,278	$ 90,731	$ 84,575	$ 93,125	$91,888
Construction, land development and other land loans	31,411	47,156	46,256	64,812	100,725
Residential real estate 1-4 family	90,447	90,552	89,212	91,821	82,468
Multi-family	7,744	7,682	9,113	8,605	7,860
Farmland	24,544	23,752	22,354	22,824	18,092
Commercial real estate	212,797	221,474	216,015	205,184	188,444
Installment	5,465	6,772	7,029	7,216	7,293
Credit cards and overdrafts	2,317	2,156	2,099	1,929	1,959
Less unearned income	(857)	(841)	(828)	(881)	(925)
Total	**$461,146**	**$489,434**	**$475,825**	**$494,635**	**$497,804**

The Company's strategy is to originate loans primarily in its local markets. Depending on the purpose of a loan, loans may be secured by a variety of collateral, including real estate, business assets, and personal assets. Loans, including loans held for sale, represent 72% and 76% of total assets as of December 31, 2012 and 2011, respectively. The majority of the Company's loan portfolio is comprised of commercial and agricultural loans (commercial loans) and real estate loans. The commercial and agricultural loans are a diverse group of loans to small, medium, and large businesses for purposes ranging from working capital needs to term financing of equipment.

The commercial and commercial real estate loan categories continue to be the primary focus for the Bank. Our commercial real estate portfolio generally consists of a wide cross-section of retail, small office, warehouse, and industrial type properties. Loan to value ratios for the Company's commercial real estate loans generally did not exceed 75% at origination and debt service ratios were generally 125% or better. While we have significant balances within this lending category, we believe that our lending policies and underwriting standards are sufficient to reduce risk even in a downturn in the commercial real estate market. Additionally, this is a sector in which we have significant and long-term management experience. It is our strategic plan to seek growth in commercial and small business loans where available and owner occupied commercial real estate loans.

We remain conservative in underwriting while active in managing our existing construction loan and land development portfolios. While these segments have historically played a significant role in our loan portfolio, balances have declined over the last three years. Construction and land development loans represented 6.8% and 9.6% of total loans outstanding at December 31, 2012 and 2011, respectively. We believe this segment will remain challenged into 2013, although to a lesser extent than the previous three years.

It is the Company's strategic objective to maintain concentrations in land and residential construction and total commercial real estate below the regulatory guidelines of 100% and 300% of risk based capital, respectively. As of December 31, 2012, concentration in land and residential construction as a percentage of risk based capital was 37% and total concentration in non-owner occupied commercial real estate plus land and residential construction as a percentage of risk-based capital stood at 201%.

Loan Maturities and Sensitivity in Interest Rates. The following table presents information related to maturity distribution and interest rate sensitivity of loans outstanding, based on scheduled repayments at December 31, 2012.

(dollars in thousands)	Due in one year or less	Due after one through five years	Due after five years	Total
Commercial	$44,468	$36,557	$6,253	$87,278
Construction, land development and other land loans	19,846	11,392	173	31,411
Residential real estate 1-4 family	41,376	24,240	24,831	90,447
Multi-family	1,127	5,903	714	7,744
Farmland	9,988	13,038	1,518	24,544
Commercial real estate	68,858	134,992	8,947	212,797
Installment	550	4,520	476	5,546
Credit cards and overdrafts	2,236	- -	- -	2,236
Total	**$188,449**	**$230,642**	**$42,912**	**$462,003**
Less unearned income				(857)
Total loans				**$461,146**
Total loans maturing after one year with				
Predetermined interest rates (fixed)		$45,673	$41,247	$86,920
Floating or adjustable rates (variable)		184,969	1,665	186,634
Total		**$230,642**	**$42,912**	**$273,554**

At December 31, 2012, 40.9% of the total loan portfolio was due in one year or less.

Nonperforming Assets. Nonperforming assets are defined as loans on non-accrual status, loans past due ninety days or more and still accruing interest, and OREO. The Company's policy for placing loans on non-accrual status is based upon management's evaluation of the ability of the borrower to meet both principal and interest payments as they become due. Generally, loans with interest or principal payments which are ninety or more days past due are placed on non-accrual (unless they are well-secured and in the process of collection) and previously accrued interest is reversed against income.

Non-performing assets totaled $19,791,000 at December 31, 2012. This represents 3.08% of total assets, compared to $21,760,000, or 3.39%, at December 31, 2011, and $16,579,000, or 2.57%, at December 31, 2010. Commercial real estate loans are the primary component of non-performing assets, representing $11,954,000, or 60.4%, of non-performing assets.

The following table presents information related to the Company's non-accrual loans and other non-performing assets at December 31 in each of the last five years.

(dollars in thousands)	2012	2011	2010	2009	2008
Accruing loans past due 90 days or more	$ - -	$ 299	$ - -	$ 547	$ 2,274
Non-accrual loans:					
Construction, land development and other land loans	1,792	5,510	5,529	9,886	11,787
Residential real estate 1-4 family	800	528	2,246	1,323	615
Multi-family real estate	- -	- -	- -	353	- -
Commercial real estate (4)	9,642	7,168	803	2,949	1,477
Farmland	976	- -	170	87	- -
Commercial	1,901	530	1,251	1,049	797
Installment	1	- -	- -	- -	- -
Total non-accrual loans (1)	**15,112**	**13,736**	**9,999**	**15,647**	**14,676**
Total non-performing loans	**15,112**	**14,035**	**9,999**	**16,194**	**16,950**
OREO:					
Construction, land development and other land loans	1,860	4,150	4,043	4,850	5,443
Residential real estate 1-4 family	507	1,427	540	220	1,367
Commercial real estate	2,312	2,148	1,997	1,595	- -
Total OREO	**4,679**	**7,725**	**6,580**	**6,665**	**6,810**
Total non-performing assets (2)	**$19,791**	**$21,760**	**$16,579**	**$22,859**	**$23,760**
Troubled debt restructured loans on accrual status	$444	$ 398	$ - -	$ - -	$ - -
Allowance for credit losses	$9,358	$11,127	$10,617	$11.092	$7,623
Allowance to non-performing loans	61.92%	79.28%	106.18%	68.49%	44.97%
Allowance to non-performing assets	47.28%	51.14%	64.04%	48.52%	32.08%
Non-performing loans to total loans (3)	3.37%	2.96%	2.15%	3.36%	3.49%
Non-performing assets to total assets	3.08%	3.39%	2.57%	3.42%	3.80%

(1) Includes $3,930,000, $7,734,000 and $932,000 in non-accrual troubled debt restructured loans ("TDRs") as of December 31, 2012, 2011 and 2010, respectively, which are also considered impaired loans. There were no TDRs as of December 31, 2008 through 2009.

(2) Does not include TDRs on accrual status.

(3) Excludes loans held for sale

(4) Includes one loan totaling $3,485,000 at December 31, 2012 of which $3,198,000 is guaranteed by the United States Department of Agriculture.

Non-performing loans increased $1,077,000, or 7.7%, from the balance at December 31, 2011 due to increases in non-accrual commercial and commercial real estate loans that were only partially offset by a significant decrease in construction, land development and other land loans. The increase in non-accrual commercial is made up primarily of one loan totaling $1,587,000. The level of non-performing loans is still elevated by historical standards and reflects the continued weakness in the real estate market and economy in our region. OREO, however, decreased by $3,046,000, or 39.4%, from the balance at December 31, 2011, due to the successful liquidation of a 13-lot subdivision and two mixed-use commercial real estate buildings which combined totaled $2,513,000.

Non-performing loans increased $4,036,000, or 40.4%, in 2011 from the balance at December 31, 2010 due to an increase in non-accrual commercial real estate loans. The increase was made up primarily of one loan totaling $3,627,000.

The Company continues to aggressively identify and monitor non-performing assets and take action based upon available information. The balance of non-performing loans at year end 2012 is equal to 3.37% of total loans, excluding loans held for sale, compared to 2.96% at December 31, 2011. The totals are net of charge-offs based on the difference between carrying value on our books and management's estimate of fair market value after taking into account the result of appraisals and other factors. Delinquencies continue to be well-managed and no significant adverse trends have been identified. Past due loans represented 2.4% and 2.4% of total loans outstanding at December 31, 2012 and 2011, respectively.

The Company had troubled debt restructures totaling $4,374,000, $8,132,000, and $932,000 at December 31, 2012, 2011 and 2010, respectively, which were on non-accrual status. A TDR is a loan for which the terms have been modified in order to grant a concession to a borrower that is experiencing financial difficulty. Troubled debt restructurings are considered impaired loans and reported as such. For more information regarding TDRs, see Note 4 - "Loans" to the Company's audited financial statements included elsewhere in this report.

Interest income on non-accrual loans that would have been recorded had those loans performed in accordance with their initial terms was $1,213,000, $752,000 and $2,568,000 for 2012, 2011, and 2010, respectively. Interest income recognized on impaired loans was $226,000, $255,000 and $593,000 for 2012, 2011, and 2010, respectively.

Currently, it is our practice to obtain new appraisals on non-performing collateral dependent loans and/or OREO semi-annually on land and every nine months on improved properties. Based upon the appraisal review for non-performing loans, the Company will record the loan at the lower of carrying value or fair value of collateral (less costs to sell) by recording a charge-off to the allowance for credit losses or by designating a specific reserve. Generally, the Company will record the charge-off rather than designate a specific reserve. During 2012 and 2011, as a result of these appraisals and other factors, the Company recorded OREO write-downs of $1,314,000 and $1,049,000, respectively. The Company will continue to reevaluate non-performing assets over the coming months as market conditions change.

OREO at December 31, 2012 totaled $4,679,000 and includes: twelve land or land development properties totaling $1,757,000; one residential construction property totaling $103,000; nine commercial real estate properties totaling $2,312,000; and four single family residences collectively valued at $507,000. The balances are recorded at the estimated net realizable value less selling costs. Liquidation strategies have been identified for all the assets held in OREO. Management continues to market these properties through an orderly liquidation process rather than engaging in immediate liquidation that it believes would result in discounts greater than the projected carrying costs.

Loan Concentrations. The Company has credit risk exposure related to real estate loans. The Company makes loans for acquisition, construction and other purposes that are secured by real estate. At December 31, 2012, loans secured by real estate totaled $366,943,000, which represents 79.6% of the total loan portfolio. Real estate construction loans comprised $31,411,000 of that amount, while real estate loans secured by residential properties totaled $90,447,000. As a result of these concentrations of loans, the loan portfolio is susceptible to deteriorating economic and market conditions in the Company's market areas. The Company generally requires collateral on all real estate exposures and typically originates loans at loan-to-value ratios at loan origination of no greater than 80%. See "Risk Factors" appearing in the Form 10-K.

Allowance and Provision for Credit Losses. The allowance for credit losses reflects management's current estimate of the amount required to absorb probable losses on loans in its loan portfolio based on factors present as of the end of the period. Loans deemed uncollectible are charged against and reduce the allowance.

Periodic provisions for credit losses are charged to current expense to replenish the allowance for credit losses in order to maintain the allowance at a level that management considers adequate. The amount of provision is based on an analysis of various factors including historical loss experience based on volumes and types of loans, volumes and trends in delinquencies and non-accrual loans, trends in portfolio volume, results of internal and independent external credit reviews, and anticipated economic conditions. Estimated loss factors used in the allowance for credit loss analysis are established based in part on historic charge-off data by loan category, portfolio migration analysis, economic conditions and other qualitative factors. During the year ended December 31, 2012, based upon charge-off experience and other factors considered by management, the loss factors used in the allowance for credit losses were updated specifically on pass rated commercial loans from 0.60% to 0.50%, on commercial real estate loans from 0.65% to 0.50%, on land and land development loans from 5.50% to 5.00% and on speculative residential construction from 1.75% to 1.25%, resulting in a decrease in the estimate for the allowance for credit losses. These were partially offset by increases in loss rates on residential real estate from 0.75% to 0.80% and personal lines of credit from 4.00% to 6.00%. See "Critical Accounting Policies" in this section below, as well as "Risk Factors" in the Form 10-K.

Transactions in the allowance for credit losses for the years ended December 31 are as follows:

(dollars in thousands)	2012	2011	2010	2009	2008
Balance at beginning of year	$11,127	$10,617	$11,092	$7,623	$5,007
Charge-offs:					
Construction and land development	348	790	1,891	4,687	2,039
Residential real estate 1-4 family	576	665	1,518	940	14
Commercial real estate	479	1,215	164	505	- -
Commercial	67	161	469	238	18
Credit card	17	38	38	80	66
Installment	292	55	81	74	89
Total charge-offs	**1,779**	**2,924**	**4,161**	**6,524**	**2,226**
Recoveries:					
Construction and land development	896	630	2	- -	- -
Residential real estate 1-4 family	162	107	48	2	3
Commercial real estate	21	120	17	17	37
Commercial	23	69	13	17	- -
Credit card	5	3	3	4	2
Installment	3	5	3	9	9
Total recoveries	**1,110**	**934**	**86**	**49**	**51**
Net charge-offs	669	1,990	4,075	6,475	2,175
Provision for (recapture of) credit losses	(1,100)	2,500	3,600	9,944	4,791
Balance at end of year	**$9,358**	**$11,127**	**$10,617**	**$11,092**	**$7,623**
Ratio of net charge-offs to average loans outstanding	0.14%	0.41%	0.84%	1.29%	0.46%

During the year ended December 31, 2012, provision for (recapture of) credit losses totaled ($1,100,000) compared to $2,500,000 and $3,600,000 for the same periods in 2011 and 2010, respectively. During the fourth quarter of 2012, the Company received a final determination in favor of the Bank in its appeal of a United States Department of Agriculture decision to revoke a guaranty on a loan to one of the Bank's borrowers. As a result of the decision, the guaranty was reinstated, and resulted in the elimination of a $1.7 million impairment reserve that had been established through the provision for credit losses in the previous year based on the original revocation of the United States Department of Agriculture guarantee. In addition, credit quality has improved as evidenced by decreases in net charge-offs and loans rated substandard or worse. Net charge-offs totaled $669,000 for the twelve months ended December 31, 2012, compared to $1,990,000 for the same period in 2011, and loans classified as substandard decreased $13,153,000, or 38.0%, from year end 2011 to $21,418,000 at December 31, 2012.

The decrease in provision for credit losses in 2011 was due to improving credit quality as evidenced by decreases in net charge-offs, substandard loans, and impaired loans. Loans classified as substandard decreased $5,285,000 to $34,570,000 at December 31, 2011. Impaired loans decreased $241,000 to $14,432,000 at December 31, 2011. The provision reflects management's continuing evaluation of the loan portfolio's credit quality, which is affected by a broad range of economic metrics.

The allowance for credit losses was $9,358,000 at December 31, 2012, compared with $11,127,000 at December 31, 2011, a decrease of $1,769,000, or 15.9%. The decrease in 2012 is due to the elimination of a $1.7 impairment reserve discussed above and a decrease in estimated loss factors used in determining the allowance for credit losses also discussed above. The allowance for credit losses increased to $11,127,000 at year-end 2011 compared to $10,617,000 at year-end 2010. The increase in 2011 was due to provision expense of $2,500,000 which exceeded net charge-offs of $1,990,000, and was reflective of the $1.7 million impairment reserve discussed above, and management's review of qualitative factors including the continued uncertainty in the economy and financial industry, pervasive high unemployment rates, and continued deterioration in real estate values.

The ratio of the allowance for credit losses to total loans outstanding (excluding loans held for sale) was 2.09%, 2.34% and 2.28% at December 31, 2012, 2011 and 2010, respectively. The Company's loan portfolio contains a significant portion of government guaranteed loans which are fully guaranteed by the United States Government. Government guaranteed loans were $49,966,000 and $52,928,000 at December 31, 2012 and 2011, respectively. The ratio of the allowance for credit losses to total loans outstanding excluding the government guaranteed loans was 2.35% and 2.64%, respectively.

There is no precise method of predicting specific credit losses or amounts that ultimately may be charged off. The determination that a loan may become uncollectible, in whole or in part, is a matter of significant management judgment. Similarly, the adequacy of the allowance for credit losses is a matter of judgment that requires consideration of many factors, including (a) economic conditions and the effect on particular industries and specific borrowers; (b) a review of borrowers' financial data, together with industry data, the competitive situation, the borrowers' management capabilities and other factors; (c) a continuing evaluation of the loan portfolio, including monitoring by lending officers and staff credit personnel of all loans which are identified as being of less than acceptable quality; (d) an in-depth review, at a minimum of quarterly or more frequently as considered necessary, of all loans judged to present a possibility of loss (if, as a result of such quarterly review, the loan is judged to be not fully collectible, the carrying value of the loan is reduced to that portion considered collectible); and (e) an evaluation of the underlying collateral for secured lending, including the use of independent appraisals of real estate properties securing loans. An analysis of the adequacy of the allowance is conducted by management quarterly and is reviewed by the Board of Directors. Based on this analysis and applicable accounting standards, management considers the allowance for credit losses of $9,358,000 to be adequate at December 31, 2012.

The Financial Accounting Standards Board (FASB) has issued accounting guidance relating to 1) accounting by creditors for impairment of a loan and 2) accounting by creditors for impairment of a loan for income recognition disclosures. The Company measures impaired loans based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair market value of the collateral if the loan is collateral dependent. The Company excludes loans that are currently measured at fair value or at the lower of cost or fair value, and certain large groups of smaller balance homogeneous loans that are collectively measured for impairment.

The following table summarizes the Bank's impaired loans at December 31:

(dollars in thousands)	2012	2011	2010	2009	2008
Total impaired loans	$14,784	$14,432	$14,673	$25,738	$22,117
Total impaired loans with valuation allowance	- -	4,498	508	2,962	462
Valuation allowance related to impaired loans	- -	2,032	142	638	118

No valuation allowance was considered necessary for the remaining impaired loans. The balance of the allowance for credit losses in excess of these specific reserves is available to absorb losses from all non-impaired loans.

It is the Company's policy to charge-off any loan or portion of a loan that is deemed uncollectible in the ordinary course of business. The entire allowance for credit losses is available to absorb such charge-offs.

The Company allocates its allowance for credit losses among major loan categories primarily on the basis of historical data. Based on certain characteristics of the portfolio and management's analysis, losses can be estimated for major loan categories. The following table presents the allocation of the allowance for credit losses among the major loan categories based primarily on historical net charge-off experience and other considerations at December 31 in each of the last five years.

(dollars in thousands)	2012 Reserve	% of Total Loans*	2011 Reserve	% of Total Loans*	2010 Reserve	% of Total Loans*	2009 Reserve	% of Total Loans*	2008 Reserve	% of Total Loans*
Commercial loans	$923	19%	$1,012	18%	$816	18%	$1,308	19%	$1,392	18%
Real estate loans	4,927	79%	7,849	80%	7,139	80%	8,341	79%	5,975	80%
Consumer loans	531	2%	642	2%	690	2%	260	2%	256	2%
Unallocated	2,977	- -	1,624	- -	1,972	- -	1,183	- -	- -	- -
Total allowance	**$9,358**	**100%**	**$11,127**	**100%**	**$10,617**	**100%**	**$11,092**	**100%**	**$7,623**	**100%**
Ratio of allowance for credit losses to loans outstanding at end of year		2.09%		2.34%		2.28%		2.30%		1.57%

* Represents the total of all outstanding loans in each category as a percent of total loans outstanding.

The table indicates decreases of $89,000, $2,922,000 and $111,000 during 2012 in the allowance related to commercial, real estate and consumer loans which were partially offset by an increase in the unallocated portion. The significant decline in the real estate portion is due to the elimination of a $1.7 impairment reserve previously mentioned. The changes in other categories, as well as, changes in 2011 and 2010 are attributable to changes in the loan loss rates.

Deposits

The Company's primary source of funds has historically been customer deposits. A variety of deposit products are offered to attract customer deposits. These products include non-interest bearing demand accounts, NOW accounts, savings accounts, and time deposits. Interest-bearing accounts earn interest at rates established by management based on competitive market factors and the need to increase or decrease certain types or maturities

of deposits. The Company has succeeded in growing its deposit base over the last three years despite increasing competition for deposits in our markets. The Company believes that it has benefited from its local identity and superior customer service. Attracting deposits remains integral to the Company's business as it is the primary source of funds for loans and a major decline in deposits or failure to attract deposits in the future could have an adverse effect on results of operations and financial condition. The Company's strategic plan contemplates and focuses on continued growth in non-interest bearing accounts, which contribute to higher levels of non-interest income and net interest margin, through increased sales efforts and continued focus on customer service and emphasis on our expanded electronic services. We expect significant competition for deposits of this nature to continue for the foreseeable future and our ability to attract and retain non-interest bearing demand deposits may be influenced by the expiration in 2012 of government programs providing expanded insurance coverage for such deposits.

Deposit detail by category as of December 31, 2012, 2011 and 2010, respectively, follows:

(dollars in thousands)	2012	2011	2010
Demand, non-interest bearing	$115,138	$108,899	$95,115
Interest bearing demand (NOW)	125,758	122,160	103,358
Money market deposits	106,849	99,031	93,996
Savings deposits	62,493	65,451	55,993
Time, interest bearing (CDs)	138,005	152,509	196,492
Total	**$548,243**	**$548,050**	**$544,954**

Total deposits were flat at $548,243,000 at December 31, 2012 and 2011. Increases in demand and money market accounts were offset by a similar decrease in time certificates of deposits (CDs). Non-interest bearing demand deposits increased $6,239,000, or 5.7% mostly in commercial and public demand accounts. The increase in NOW accounts of $3,598,000 and money market accounts of $7,818,000 was attributable to an increased emphasis on growing our customer base in non-maturity deposit products instead of higher cost CDs. The Bank prices CDs competitively to retain existing relationship-based customers, but not to retain CD only customers or to attract new CD customers. Additionally, due to the low interest rate environment, many CD customers opted to place their maturing balances in checking or money market accounts while waiting for interest rates to improve. CDs decreased $14,504,000, or 9.5%, to $138,005,000 at December 31, 2012.

During 2011 interest bearing demand deposits increased $18,802,000, or 18.2%, due to increases in public funds and interest bearing rewards checking accounts. Money market and savings accounts increased $5,035,000 and $9,458,000, respectively, primarily due to continued growth in the Whatcom County market. Time deposits decreased $43,983,000, or 22.4%, due to a combination of decreases in retail deposits of $29,763,000 and decreases in brokered deposits of $14,220,000.

Brokered deposits, excluding CDARS, totaled $19,239,000, $13,000,000 and $27,220,000 at December 31, 2012, 2011 and 2010, respectively. The Bank increased brokered deposits during 2012 in order to lock in a low-cost source of funds for an extended maturity to help insulate the Bank in a rising rate environment. Longer term CDs are generally not available in the retail market as customers generally desire to keep funds more liquid and accessible. The decrease in brokered deposits in 2011 was due to management's strategy to roll off brokered deposits as they came due during the year, of which $14.2 million matured in 2011. This was achievable due to excess cash balances and growth in core deposits. Changes in the market or new regulatory restrictions could limit our ability to maintain or acquire brokered deposits in the future.

The ratio of non-interest bearing deposits to total deposits was 21.0%, 19.9% and 17.5% at December 31, 2012, 2011 and 2010, respectively.

The following table sets forth the average balances for each major category of deposits and the weighted average interest rate paid for deposits for the periods indicated.

	2012		2011		2010	
(dollars in thousands)	**Average Deposits**	**Rate**	**Average Deposits**	**Rate**	**Average Deposits**	**Rate**
Non-interest bearing demand Deposits	$107,048	0.00%	$93,413	0.00%	$84,556	0.00%
Interest bearing demand deposits	120,472	0.48%	113,399	0.72%	97,820	0.93%
Savings and money market deposits	168,512	0.30%	162,231	0.49%	140,303	0.58%
Time deposits	144,486	1.24%	176,631	1.72%	220,618	2.20%
Total	**$540,518**	**0.53%**	**$545,674**	**0.85%**	**$543,297**	**1.21%**

Maturities of time certificates of deposit as of December 31, 2012 are summarized as follows:

(dollars in thousands)	Under $100,000	Over $100,000	Total
3 months or less	$12,210	$13,580	$25,790
Over 3 through 6 months	8,521	8,348	16,869
Over 6 through 12 months	11,538	16,796	28,334
Over 12 months	18,381	48,631	67,012
Total	**$50,650**	**$87,355**	**$138,005**

Short-Term Borrowings

The following is information regarding the Company's short-term borrowings for the years ended December 31, 2012, 2011 and 2010.

(dollars in thousands)	2012	2011	2010
Amount outstanding at end of period	$3,000	$- -	$10,500
Weighted average interest rate thereon	2.94%	- -%	3.85%
Maximum month-end balance during the year	3,000	10,500	10,500
Average balance during the year	2,697	6,885	7,502
Average interest rate during the year	2.94%	3.84%	2.72%

CONTRACTUAL OBLIGATIONS

The Company is party to many contractual financial obligations at December 31, 2012, including without limitation, borrowings from the FHLB, junior subordinated debentures associated with trust preferred securities and operating leases for branch locations. The following is information regarding the dates payments of such obligations are due.

	Payments due by Period				
Contractual obligations	**Less than 1 year**	**1 – 3 years**	**3 – 5 years**	**More than 5 years**	**Total**
Operating leases	$337	$424	$180	$- -	$941
Total deposits	481,231	41,094	24,918	1,000	548,243
Federal Home Loan Bank borrowings	3,000	5,000	2,500	- -	10,500
Secured borrowings	- -	- -	- -	- -	- -
Junior subordinated debentures	- -	- -	- -	13,403	13,403
Total long-term obligations	**$484,568**	**$46,518**	**$27,598**	**$14,403**	**$573,087**

COMMITMENTS AND CONTINGENCIES AND OFF-BALANCE SHEET ARRANGEMENTS

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

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as they do for on-balance-sheet instruments. A summary of the Bank's commitments at December 31 is as follows:

	2012	**2011**
Commitments to extend credit	$84,493	$91,596
Standby letters of credit	1,975	1,310

KEY FINANCIAL RATIOS

Year ended December 31,	**2012**	**2011**	**2010**	**2009**	**2008**
Return on average assets	.75%	.44%	.25%	(.96)%	.16%
Return on average equity	7.28%	4.45%	2.77%	(11.63)%	1.83%
Average equity to average assets ratio	10.34%	9.62%	9.16%	8.23%	8.89%
Dividend payout ratio	42%	- -%	- -%	- -%	35%

LIQUIDITY AND CAPITAL RESOURCES

Liquidity. The primary concern of depositors, creditors and regulators is the Company's ability to have sufficient funds readily available to repay liabilities as they mature. In order to evaluate whether adequate funds are and will be available at all times, the Company monitors and projects the amount of funds required on a daily basis. The Bank's primary source of liquidity is deposits from its customer base, which has historically provided a stable source of "core" demand and consumer deposits. Other sources of liquidity are available, including borrowings from the FHLB, the Federal Reserve Bank, and from correspondent banks. Liquidity requirements can also be met through disposition of short-term assets. In management's opinion, the Company maintains an adequate level of liquid assets for its known and reasonably foreseeable liquidity requirements, consisting of cash and amounts due from banks, interest bearing deposits and federal funds sold to support daily cash flow requirements.

Management expects to continue to rely on customer deposits as the primary source of liquidity, but may also obtain liquidity from maturity of its investment securities, sale of securities currently available for sale, loan sales, brokered deposits, government sponsored programs, loan repayments, net income, and other borrowings. Although deposit balances have shown historical growth, deposit habits of customers may be influenced by changes in the financial services industry, interest rates available on other investments, general economic conditions, consumer confidence, changes to government insurance programs, and competition. Competition for deposits is presently quite intense, even in our traditional markets of operations in Western Washington, making deposit retention challenging and new deposit growth quite difficult. Any significant reduction in deposits could adversely affect the Company's financial condition, results of operations, and liquidity. See "Risk Factors" in the Form 10-K.

Borrowings may be used on a short-term basis to compensate for reductions in deposits, but are generally not considered a long term solution to liquidity issues. Long-term borrowings at December 31, 2012 and 2011 represent advances from the FHLB of Seattle. Advances at December 31, 2012 bear interest at 2.24% to 2.94% and mature in various years as follows: 2015 - $5,000,000, and 2016 - $2,500,000. The Bank has pledged $156,955,000 of loans as collateral for these borrowings at December 31, 2012. Based on pledged collateral, at December 31, 2012, the Bank had $111,437,000 of available borrowing capacity on its line at the FHLB, although each advance is subject to prior consent. The Bank also has a borrowing facility of $46,704,000 at the Federal Reserve Bank, of which none was used at December 31, 2012. The Bank has pledged $71,484,000 of loans as collateral to the Federal Reserve Bank.

The holding company specifically relies on dividends from the Bank, proceeds from the exercise of stock options, and proceeds from the issuance of trust preferred securities for its funds, which are used for various corporate purposes. Dividends from the Bank are the holding company's most important source of funds, and are subject to regulatory restrictions and the capital needs of the Bank, which are always primary. Sales of trust preferred securities ("TRUPs") were also a historical source of liquidity for the holding company and capital for both the holding company and the Bank; however, we have not issued TRUPs since 2006 and do not anticipate TRUPs will be a source of liquidity in 2013 or beyond.

At December 31, 2012, two wholly-owned subsidiary grantor trusts established by the Company had issued and outstanding $13,403,000 of trust preferred securities. During 2012, the Company paid all accrued interest, including deferred interest, which had accrued since the Company elected, in 2009, to exercise its right to defer interest payments on trust preferred debentures, as permitted by the terms thereof. As of December 31, 2012 and 2011, accrued interest totaled $41,000 and $1,252,000, respectively, and is included in accrued interest payable on the balance sheet.

On July 2, 2003, the Federal Reserve Bank issued Supervisory Letter SR 03-13 clarifying that Bank Holding Companies should continue to report trust preferred securities in accordance with current Federal Reserve Bank instructions which allows trust preferred securities to be counted in Tier 1 capital subject to certain limitations. The Federal Reserve has indicated it will review the implications of any accounting treatment changes and, if necessary or warranted, will provide appropriate guidance. For additional information regarding trust preferred securities, see our audited consolidated financial statements and related notes included elsewhere in this report, including Note 9 – "Junior Subordinated Debentures".

Capital. The Company conducts its business through the Bank. Thus, the Company needs to be able to provide capital and financing to the Bank should the need arise. The primary sources for obtaining capital are additional stock sales and retained earnings. Total shareholders' equity was $66,721,000 at December 31, 2012, an increase of $3,451,000, or 5.5%, compared to December 31, 2011. The increase is largely attributable to earnings retention. Total shareholders' equity averaged $65,743,000 in 2012, which includes $11,282,000 of goodwill. Shareholders' equity averaged $61,942,000 in 2011, compared to $59,043,000 in 2010.

The Company's Board of Directors considers financial results, growth plans, and anticipated capital needs in formulating its dividend policy. The payment of dividends is subject to adequate financial resources at the Bank, which depend in part on operating results and limitations imposed by law and governmental regulations or actions of regulators.

The Federal Reserve has established guidelines for risk-based capital requirements for bank holding companies. Under the guidelines, one of four risk weights is applied to balance sheet assets, each with different capital requirements based on the credit risk of the asset. The Company's capital ratios include the assets of the Bank on a consolidated basis in accordance with the requirements of the Federal Reserve. The Company's capital ratios have exceeded the minimum required to be classified "well capitalized" during each of the past three years.

The following table sets forth the minimum required capital ratios and actual ratios for December 31, 2012 and 2011.

(dollars in thousands)	Actual Amount	Ratio	Requirements for Adequately Capitalized Amount	Ratio
December 31, 2012				
Tier 1 capital (to average assets)				
Consolidated	$66,750	10.69%	$24,975	4.00%
Bank	66,712	10.69%	24,966	4.00%
Tier 1 capital (to risk-weighted assets)				
Consolidated	66,750	14.95%	17,855	4.00%
Bank	66,712	14.96%	17,842	4.00%
Total capital (to risk-weighted assets)				
Consolidated	72,376	16.21%	35,710	8.00%
Bank	72,334	16.22%	35,685	8.00%
December 31, 2011				
Tier 1 capital (to average assets)				
Consolidated	$63,965	10.18%	$25,137	4.00%
Bank	65,022	10.35%	25,128	4.00%
Tier 1 capital (to risk-weighted assets)				
Consolidated	63,965	13.56%	18,870	4.00%
Bank	65,022	13.79%	18,860	4.00%
Total capital (to risk-weighted assets)				
Consolidated	69,926	14.82%	37,740	8.00%
Bank	70,980	15.05%	37,720	8.00%

Goodwill Valuation. Goodwill is assigned to reporting units for purposes of impairment testing. The Company has one reporting unit, the Bank, for purposes of computing goodwill. The Company performs an annual review in the second quarter of each fiscal year, or more frequently if indications of potential impairment exist, to determine if the recorded goodwill is impaired. As of December 31, 2012, management determined there were no events or circumstances which would more likely than not reduce the fair value of its reporting unit below its carrying value.

A significant amount of judgment is involved in determining if an indicator of impairment has occurred. Such indicators may include, among others: a significant decline in expected future cash flows; a sustained, significant decline in our stock price and market capitalization; a significant adverse change in legal factors or in the business climate; adverse assessment or action by a regulator; and unanticipated competition. Any adverse change in these factors could have a significant impact on the recoverability of such assets and could have a material impact on the Company's Consolidated Financial Statements.

The goodwill impairment test involves a two-step process. The first step is a comparison of the reporting unit's fair value to its carrying value. If the reporting unit's fair value is less than its carrying value, the Company is required to progress to the second step. In the second step the Company calculates the implied fair value of its reporting unit and, in accordance with applicable GAAP standards, compares the implied fair value of goodwill to the carrying amount of goodwill on the Company's balance sheet. If the carrying amount of the goodwill is

greater than the implied fair value of that goodwill, an impairment loss must be recognized in an amount equal to that excess. The implied fair value of goodwill is determined in the same manner as goodwill recognized in a business combination. The estimated fair value of the Company is allocated to all of the Company's individual assets and liabilities, including any unrecognized identifiable intangible assets, as if the Company had been acquired in a business combination and the estimated fair value of the Company is the price paid to acquire it. The allocation process is performed only for purposes of determining whether a goodwill impairment exists and the amount of any such impairment. No assets or liabilities are written up or down, nor are any additional unrecognized identifiable intangible assets recorded as a part of this process.

The Company estimates fair value using the best information available, including market information and a discounted cash flow analysis, which is also referred to as the income approach. The income approach uses a reporting unit's projection of estimated operating results and cash flows that is discounted using a rate that reflects current market conditions. The projection uses management's best estimates of economic and market conditions over the projected period including growth rates in loans and deposits, estimates of future expected changes in net interest margins and cash expenditures. The market approach estimates fair value by applying cash flow multiples to the reporting unit's operating performance. The multiples are derived from comparable publicly traded companies with similar operating and investment characteristics of the reporting unit. We validate our estimated fair value by comparing the fair value estimates using the income approach to the fair value estimates using the market approach.

As part of our process for performing the step one impairment test of goodwill, the Company estimated the fair value of the reporting unit utilizing the income approach and the market approach in order to derive an enterprise value of the Company. In determining the discount rate for the discounted cash flow model, the Company used a modified capital asset pricing model that develops a rate of return utilizing a risk-free rate and equity risk premium resulting in a discount rate of 14.0%. This approach also includes adjustments for the industry the Company operates in and size of the Company. In addition, assumptions used by the Company in its discounted cash flow model (income approach) included an average annual revenue growth rate that approximated 2%; an asset growth of 2% in year one, 3% in year two, 3.5% annually in years three through five and 4% in year six; net interest margin ranging from 4.38% in the base year to 4.26% in year five; and a return on assets that ranged from 0.4% to 1.1%.

In applying the market approach method, the Company considered all acquired banks between January 1, 2011 and June 30, 2012, with total assets between $100 million and $2 billion and non-performing assets to total assets between 1% and 6%. This resulted in selecting 28 comparable institutions which were analyzed based on a variety of financial metrics (tangible equity, return on assets, return on equity, net interest margin, efficiency ratio, nonperforming assets, and reserves for loan losses). After selecting comparable institutions, the Company derived the fair value of the reporting unit by completing a comparative analysis of the relationship between their financial metrics listed above and their market values utilizing various market multiples. Focus was placed on the price to tangible book value of equity multiple as this multiple generally reflects returns on the capital employed within the industry and is generally correlated with the profitability of each individual company.

The Company concluded a fair value of its reporting unit of $68.0 million, by giving similar consideration to the values derived from 1) the income approach of $68.1 million weighted at 65%, and 2) the market approach of $66.8 million weighted at 35%; compared to a carrying value of its reporting unit of $65.5 million. The results of the Company's step one test indicated that the reporting unit's fair value exceeded its carrying value and no goodwill impairment existed.

Even though the Company determined that there was no goodwill impairment, continued declines in the value of our stock price as well as values of others in the financial industry, declines in revenue for the Bank or significant adverse changes in the operating environment for the financial industry may result in a future impairment charge. It is possible that changes in circumstances existing at the measurement date or at other times in the future, or in the numerous estimates associated with management's judgments, assumptions and estimates made in assessing the fair value of our goodwill, could result in an impairment charge of a portion or all of our goodwill. If the Company recorded an impairment charge, its financial position and results of operations would be adversely affected, however, such an impairment charge would have no impact on our liquidity, operations or regulatory capital.

New Accounting Pronouncements. For a discussion of new accounting pronouncements and their impact on the Company, see Note 1 of the Notes to the audited consolidated financial statements included elsewhere in this report.

CRITICAL ACCOUNTING POLICIES

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. The financial information contained within these statements is, to a significant extent, financial information that is based on approximate measures of the financial effects of transactions and events that have already occurred. Based on its evaluation of accounting policies that involve the most complex and subjective decisions and assessments, management has identified the following as its most critical accounting policies. This discussion and analysis should be read in conjunction with the Company's financial statements and the accompanying notes presented elsewhere herein, as well as the related discussions of each topic in this Management's Discussion and Analysis section above. See also "Risk Factors" appearing in the Form 10-K for a discussion of certain risks faced by the Company.

Allowance for Credit Losses

The Company's allowance for credit losses methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for credit losses that management believes is appropriate at each reporting date. Quantitative factors include the Company's historical loss experience, delinquency and charge-off trends, collateral values, changes in nonperforming loans, and other factors. Quantitative factors also incorporate known information about individual loans, including borrowers' sensitivity to interest rate movements. Qualitative factors include the general economic environment in the Company's markets, including economic conditions and, in particular, the state of certain industries. Size and complexity of individual credits in relation to loan structure, existing loan policies and pace of portfolio growth are other qualitative factors that are considered in the methodology. As the Company adds new products and increases the complexity of its loan portfolio, it intends to enhance its methodology accordingly. A materially different amount could be reported for the provision for credit losses in the statement of operations to change the allowance for credit losses if management's assessment of the above factors were different.

Goodwill

Goodwill is initially recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired. Goodwill is presumed to have an indefinite useful life and is tested for impairment no less than annually. The Company has one reporting unit, the Bank, for purposes of computing goodwill. The Company performs an annual review each year, or more frequently if indicators of potential impairment exist, to determine if the recorded goodwill is impaired. The analysis of potential impairment of goodwill requires a two-step process. The first step is the estimation of fair value.

If step one indicates that impairment potentially exists, the second step is performed to measure the amount of impairment, if any. Goodwill impairment exists when the estimated fair value of goodwill is less than its carrying value. The results of the Company's annual second quarter impairment test determined the reporting unit's fair value exceeds its carrying value on the Company's balance sheet and no goodwill impairment existed. As of December 31, 2012 management determined there were no events or circumstances which would more likely than not reduce the fair value of its reporting unit below its carrying value. No assurance can be given that the Company will not record an impairment loss on goodwill in the future.

Investment Valuation and Other-Than-Temporary-Impairment ("OTTI")

The Company records investments in securities available-for-sale at fair value and securities held-to-maturity at amortized cost. Fair value is determined based on quoted prices for similar assets and liabilities traded in the same market; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable. Declines in fair value below amortized cost are reviewed to determine if they are other than temporary. If the decline in fair value is judged to be other than temporary, the impairment loss is separated into a credit and noncredit component. Noncredit losses are recorded in other comprehensive income (loss) when the Company a) does not intend to sell the security or b) is not more likely than not it will be required to sell the security prior to the security's anticipated recovery. Credit component losses are reported in non-interest income. The Company regularly reviews its investment portfolio to determine whether any of its securities are other-than-temporarily impaired.

Valuation of OREO

Real estate properties acquired through foreclosure or by deed-in-lieu of foreclosure (OREO) are recorded at the lower of cost or fair value less estimated costs to sell. Fair value is generally determined by management based on a number of factors, including third-party appraisals of fair value in an orderly sale. Accordingly, the valuation of OREO is subject to significant external and internal judgment. Any differences between management's assessment of fair value, less estimated costs to sell, and the carrying value of the loan at the date a particular property is transferred into OREO are charged to the allowance for credit losses. Management periodically reviews OREO values to determine whether the property continues to be carried at the lower of its recorded book value or fair value, net of estimated costs to sell. Any further decreases in the value of OREO are considered valuation adjustments and trigger a corresponding charge to non-interest expense in the Consolidated Statements of Income. Expenses from the maintenance and operations of OREO are included in other non-interest expense.

Income Taxes

Deferred tax assets and liabilities result from differences between the financial statement carrying amounts and the tax basis of assets and liabilities, and are reflected at currently enacted income taxes rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled.

The Company had net deferred tax assets ("DTAs") of $4,013,000 at December 31, 2012, compared to $4,351,000 at December 31, 2011. The most significant portions of the deductible temporary differences relate to the allowance for credit losses, supplemental executive retirement plan, and fair value adjustments or impairment write-downs related to OREO. As of December 31, 2012, the Company believes that it is more likely than not that it will be able to fully realize its DTA and therefore has not recorded a valuation allowance.

Assessing the need for, and the amount of, a valuation allowance requires significant judgment and analysis of both positive and negative evidence regarding realization of the DTA. The realization of the DTA is dependent upon the Company generating a sufficient level of taxable income in future periods, which can be difficult to predict. If future taxable income should prove non-existent or less than the amount of temporary differences giving rise to the net DTAs within the tax years to which they may be applied, the assets will not be realized and net income will be reduced. An extended period of losses could result in the Company establishing a valuation allowance against its DTA. The establishment of a valuation allowance would be accounted for as a charge against income and could have a material effect on our results of operations in a particular period.

ASSET AND LIABILITY MANAGEMENT

The largest component of the Company's earnings is net interest income. Interest income and interest expense are affected by general economic conditions, competition in the market place, market interest rates and repricing and maturity characteristics of the Company's assets and liabilities. Exposure to interest rate risk is primarily a function of differences between the maturity and repricing schedules of assets (principally loans and investment securities) and liabilities (principally deposits). Assets and liabilities are described as interest rate sensitive for a given period of time when they mature or can reprice within that period. The difference between the amount of interest sensitive assets and interest sensitive liabilities is referred to as the interest sensitivity "GAP" for any given period. The "GAP" may be either positive or negative. If positive, more assets reprice than liabilities. If negative, the reverse is true.

Certain shortcomings are inherent in the interest sensitivity "GAP" method of analysis. Complexities such as prepayment risk and customer responses to interest rate changes are not taken into account in the "GAP" analysis. Accordingly, management also utilizes a net interest income simulation model to measure interest rate sensitivity. Simulation modeling gives a broader view of net interest income variability, by providing various rate shock exposure estimates. Management regularly reviews the interest rate risk position and provides measurement reports to the Board of Directors.

The following table shows the dollar amount of interest sensitive assets and interest sensitive liabilities at December 31, 2012 and differences between them for the maturity or repricing periods indicated.

(dollars in thousands)	Due in one year or less	Due after one through five years	Due after five years	Total
Interest earning assets				
Loans, including loans held for sale	$187,592	$230,642	$42,912	$461,146
Investment securities	6,969	19,235	41,839	68,043
Fed Funds sold and interest bearing balances with banks	45,672	- -	- -	45,672
Federal Home Loan Bank stock	- -	- -	3,126	3,126
Total interest earning assets	**$240,233**	**$249,877**	**$87,877**	**$577,987**
Interest bearing liabilities				
Interest bearing demand deposits	$125,758	$ - -	$ - -	$125,758
Savings and money market deposits	169,342	- -	- -	169,342
Time deposits	70,993	66,012	1,000	138,005
Short term borrowings	3,000	- -	- -	3,000
Long term borrowings	- -	7,500	- -	7,500
Secured borrowings	- -	- -	- -	- -
Junior subordinated debentures	13,403	- -	- -	13,403
Total interest bearing liabilities	**$382,496**	**$73,512**	**$1,000**	**$457,008**
Net interest rate sensitivity GAP	$(142,263)	$176,365	$86,877	$120,979
Cumulative interest rate sensitivity GAP		34,102	120,979	120,979
Cumulative interest rate sensitivity GAP as a % of earning assets		5.9%	20.9%	20.9%

Effects of Changing Prices. The results of operations and financial condition presented in this report are based on historical cost information, and are unadjusted for the effects of inflation. Since the assets and liabilities of financial institutions are primarily monetary in nature, the performance of the Company is affected more by changes in interest rates than by inflation. Interest rates generally increase as the rate of inflation increases, but the magnitude of the change in rates may not be the same.

The effects of inflation on financial institutions are normally not as significant as its influence on businesses which have investments in plants and inventories. During periods of high inflation there are normally corresponding increases in the money supply, and financial institutions will normally experience above-average growth in assets, loans and deposits. Inflation does increase the price of goods and services, and therefore operating expenses increase during inflationary periods.

GENERAL CORPORATE AND SHAREHOLDER INFORMATION

Administrative Headquarters
1101 S. Boone Street
Aberdeen, WA 98520
(360) 533-8870

Transfer Agent and Registrar
Computer Shareowner Services LLC
250 Royall St.
Canton, MA 02021
Telephone: 1-877-870-2422

Independent Accountants
Deloitte & Touche LLP
Portland, Oregon

Shareholder Services
BNY Mellon Shareholder Services, our transfer agent, maintains the records for our registered shareholders and can help you with a variety of shareholder related services at no charge including:

Change of name or address
Consolidation of accounts
Duplicate mailings
Lost stock certificates
Transfer of stock to another person
Additional administrative services

As a Pacific Financial Corporation shareholder, you are invited to take advantage of our convenient shareholder services. You can access your investor statements online 24 hours a day, 7 days a week at www.computershare.com/Investor.

Annual Meeting
The annual meeting of shareholders will be held on April 24, 2013 at 7 p.m. at 1101 S. Boone Street, Aberdeen, WA 98520.

Form 10-K
Our report on Form 10-K, including the financial statements and financial statement schedules, is available without charge to shareholders or beneficial owners of our common stock upon written request to Sandra Clark, Executive Secretary, Pacific Financial Corporation, P.O. Box 1826, Aberdeen, Washington 98520.

Stock Information
Pacific Financial Corporation is a reporting company with the Securities and Exchange Commission (SEC). The company stock is traded on the OTC Bulletin Board exchange under the symbol PFLC.OB. Historically, trading in our stock has been very limited and the trades that have occurred cannot be characterized as amounting to an established public trading market. At December 31, 2013, there were approximately 1,058 shareholders of record.

	2012 Stock Prices		2011 Stock Prices	
Quarter Ended	**High**	**Low**	**High**	**Low**
March 31	$5.88	$4.50	$7.00	$4.50
June 30	4.75	4.13	4.55	4.06
September 30	5.67	4.01	4.25	3.75
December 31	4.25	3.69	4.25	3.60

The Company's Board of Directors declared and paid a cash dividend on its common stock in December 2012 of $0.20 per share. There were no dividends declared or paid in 2011. Under federal banking law, the payment of dividends by the Company and the Bank is subject to capital adequacy requirements established by the Federal Reserve and the FDIC. In addition, payment of dividends by either entity is subject to regulatory limitations. Payment of dividends on the Common Stock is also affected by statutory limitations, which restrict the ability of the Bank to pay upstream dividends to the Company.

BOARD OF DIRECTORS

Gary C. Forcum, Chairman
Private Investor

Douglas M. Schermer
Owner
Schermer Construction Inc.

G. Dennis Archer, Vice Chairman
Founder and Director of Tax Services
Archer Group

Randy W. Rognlin
Co-Owner
Rognlins, Inc.

Randy J. Rust
Private Investor

Susan C. Freese
Pharmacist

Dwayne M. Carter
President
Brooks Manufacturing Co.

Edwin W. Ketel
Owner
Oceanside Animal Clinic

Dennis A. Long
President & CEO
Pacific Financial Corporation

OFFICERS

Dennis A. Long
President & CEO
CEO, Bank of the Pacific

Bruce MacNaughton
Vice President
Executive Vice President & CCO, Bank of the Pacific

Denise J. Portmann
Treasurer & Secretary
Executive Vice President & CFO, Bank of the Pacific

SUBSIDIARIES

Bank of the Pacific
300 E. Market Street
Aberdeen, WA 98520
360-533-8870
www.bankofthepacific.com

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

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Member FDIC