

2013

ANNUAL REPORT



**Pacific Financial
Corporation**

To Our Shareholders

March 21, 2014

My Fellow Shareholders:



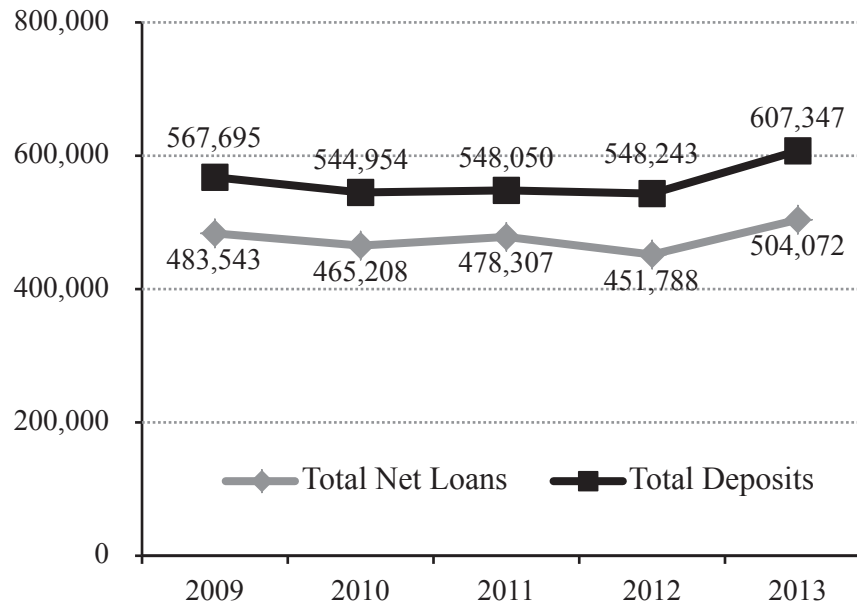
Dennis A. Long
President & CEO

In 2013 we continued to build on our momentum by remaining disciplined with our business strategy and investing for our future by growing our capabilities and our capacity. At year-end we delivered our sixteenth consecutive quarter of solid earnings, generating net income of \$3.7 million for the year, or \$0.37 per share. We again rewarded our shareholders with a 20-cent cash dividend in December, equating to a yield of more than 2.98% at current market levels.

Our solid financial results were driven by positive year-over-year loan growth, steady deposit inflows, substantial improvements in credit quality and a strong capital position. We achieved several milestones in 2013, and positioned the company to continue building our franchise and profitability. Highlights include:

- At the beginning of 2013, our growth objectives were enhanced through the acquisition of three branches from Sterling Savings Bank in Aberdeen, Washington, Astoria, Oregon and Seaside, Oregon. As part of the transaction, we acquired 2,800 new accounts, \$37 million in deposits, and \$4 million in performing loans. This transaction was completed in the second quarter of 2013, when we consolidated 2 of the 3 branches to maximize efficiencies. These acquisitions have assimilated nicely into our franchise and are now fully integrated into our operations.
- During the first quarter of 2013, we also opened a new loan production office in Vancouver, WA, and in the third quarter opened another loan production office in DuPont, WA, adding to the LPO we opened in Burlington, WA in 2012.
- At the same time, we began construction to open a full-service branch in Warrenton, Oregon, which was completed at the end of 2013 -- further expanding our presence in the coastal communities of Washington and Oregon.

Total Net Loans and Deposits (Dollars in Millions)



- We strengthened our balance sheet during the year. Total assets increased 10% year-over-year, and total deposits were up 11%, while noninterest-bearing demand deposits grew 26% from a year ago. Although much of our deposit growth was acquired from the Sterling acquisition, we also generated substantial organic deposit growth.
- Total net loans grew 13% year-over-year, reaching all-time highs. We believe that, despite the headwinds created by low interest rates and the uncertainties of the regulatory environment, there are still solid opportunities ahead.
- The trends in our asset quality metrics are continuing to improve. Nonperforming assets (NPAs) declined 19% year-over-year, and fell 128% over a 5-year period. Other-real-estate-owned and repossessed assets dropped 69% from a year ago, reflecting an overall improvement in the quality of our loan portfolio. Pacific Financial, as well as the industry as a whole, is expected to benefit from a fairly stable credit environment as the economy steadily improves.
- Although our net interest margin (NIM) contracted 21 basis points from a year ago, it expanded 11 basis points in the fourth quarter of 2013. The contraction in NIM year-over-year was primarily due to the downward pressure on asset yields. However, the steady redeployment of lower yielding securities into higher yielding loans throughout the year led to the improvement in NIM for the fourth quarter. That being said, we continue to maintain a strong NIM at 3.91% and expect the NIM to improve in 2014 through anticipated loan growth.
- Our capital ratios remain solid and well above the regulatory requirements for a well-capitalized financial institution, again demonstrating our strong balance sheet. As a result of our strong capital, we are well-positioned to strategically and effectively deploy our capital.

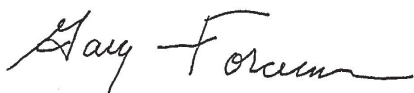
<u>Capital Ratios</u> <u>December 31</u>	<u>Pacific Financial Corporation</u> <u>2013</u>	<u>Pacific Financial Corporation</u> <u>2012</u>	<u>Well-Capitalized Financial Institutional Regulatory Guidelines</u>
Total Risk-based	14.1%	16.2%	10.0%
Tier 1 Risk-based	12.9%	14.9%	6.0%
Tier 1 Leverage	9.8%	10.7%	5.0%

- As part of our strategic transition plan, and to further strengthen our franchise, we promoted Denise Portmann to the position of President and Chief Executive Officer of Bank of the Pacific on January 1, 2014. At the beginning of February 2014, we hired an outstanding Chief Financial Officer, Doug Biddle, to fill the position that Ms. Portmann had previously held for twelve years.

Looking forward, we are optimistic about the coming year and the economic environment in the Northwest. The business communities in which we operate are continuing to improve, and we are seeing new opportunities to serve and build our banking franchise. The investments we made this year, while reducing our efficiencies in the short run, should begin to generate new revenues and additional operating effectiveness in the coming years. Our goals are to continue to grow loans and deposits, and improve our operating efficiencies, which will fuel profitability in the coming years.

We have an outstanding management team, exceptional Board of Directors and highly engaged employees who have been resilient and dedicated in both strong and difficult economic cycles. With our sound business strategies and prudent business model, we are in an excellent position to continue building for the future and create additional shareholder value. We thank you for your ongoing support and loyalty to Pacific Financial Corporation, and look forward to you joining us at our annual meeting on Wednesday, April 23, 2014, at 7:00 p.m. Pacific Time, at 1101 South Boone Street, Aberdeen, Washington.

Sincerely,



Gary C. Foreman
Chairman of the Board
Pacific Financial Corporation



Dennis A. Long
President and Chief Executive Officer
Pacific Financial Corporation

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

- Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 2013; or
- Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission file number 000-29829

PACIFIC FINANCIAL CORPORATION

(Exact Name of Registrant as specified in its Charter)

Washington
(State or Other Jurisdiction of
Incorporation or Organization)

91-1815009
(IRS Employer
Identification No.)

1101 S. Boone Street
Aberdeen, Washington 98520-5244
(Address of Principal Executive Offices) (Zip Code)

Registrant's telephone number, including area code: **(360) 533-8870**

Securities Registered Pursuant to Section 12(b) of the Exchange Act: **None**

Securities Registered Pursuant to Section 12(g) of the Exchange Act:
Common Stock, par value \$1.00 per share

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

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

Indicate by checkmark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in rule 12b of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of the common stock held by non-affiliates of the registrant at June 30, 2013, was \$49,989,017.

The number of shares outstanding of the registrant's common stock, \$1.00 par value as of February 28, 2014, was 10,182,083 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement filed in connection with its annual meeting of shareholders to be held April 23, 2014 are incorporated by reference into Part III of this Form 10-K.

**PACIFIC FINANCIAL CORPORATION
ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR
ENDED DECEMBER 31, 2013**

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PART I

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 Item 1A below, 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.
6. integration of three bank branches and related assets acquired from Sterling Savings Bank that may cost more or be less beneficial to us than expected.

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.

ITEM 1. Business

Pacific Financial Corporation (the “Company” or “Pacific”) is a bank holding company headquartered in Aberdeen, Washington. The Company owns one bank, Bank of the Pacific (the “Bank”), which is also located in Washington. The Company was incorporated in the State of Washington in February, 1997, pursuant to a holding company reorganization of the Bank.

The Company conducts its banking business through the Bank, which operates 16 branches located in communities in Grays Harbor, Pacific, Whatcom, Skagit and Wahkiakum counties in the state of Washington and three in Clatsop County, Oregon. In addition, the Bank operates three loan production offices in Burlington, Dupont and Vancouver, Washington and has a residential real estate mortgage department. During second quarter 2013, the Bank completed the acquisition of three branches from Sterling Savings Bank. Total deposits assumed were \$37,634,000 and loans acquired totaled \$3,989,000. Of the three branches purchased, two were consolidated into existing Pacific branches to maximize branch efficiencies resulting in one new branch in Astoria, Oregon. Separately, the Company opened a full-service branch in Warrenton, Oregon in October 2013 that further expands operations on the northern Oregon coast.

Pacific Financial Corporation is a reporting company with the Securities and Exchange Commission (“SEC”), and the Company’s common stock is listed on the OTC Bulletin Board™ under the symbol PFLC.OB. Revenue, net income and total assets for the Company for the years ended December 31, 2013, 2012, and 2011 are presented below:

(dollars in thousands)	For Year Ended December 31,		
	2013	2012	2011
Revenue:			
Net Interest Income	\$ 23,800	\$ 24,011	\$ 23,685
Non-interest Income	9,955	9,391	7,614
Total Revenue	<u>33,755</u>	<u>33,402</u>	<u>31,299</u>
Net Income	<u>\$ 3,731</u>	<u>\$ 4,785</u>	<u>\$ 2,818</u>
Total Assets	\$705,039	\$643,594	\$641,254

For additional selected financial information, please see “Item 6. Selected Financial Data” below.

Pacific’s filings with the SEC, including its annual report on Form 10-K, quarterly reports on Form 10-Q, periodic current reports on Form 8-K and amendments to these reports, are available free of charge through links from our website at <http://www.bankofthepacific.com> to the SEC’s site at <http://www.sec.gov>, as soon as reasonably practicable after filing with the SEC. You may also access our filings with the SEC directly from the EDGAR database found on the SEC’s website. By making reference to our website above and elsewhere in this report, we do not intend to incorporate any information from our site into this report.

The Bank

Bank of the Pacific was organized in 1978 and opened for business in 1979 to meet the need for a regional community bank with local interests to serve the small to medium-sized businesses and professionals in the coastal region of western Washington. The Bank initially focused on coastal communities in western Washington, but it has expanded into the Bellingham, Washington area and, more recently, communities along the northern Oregon coast and Vancouver, Washington. Products and services offered by the Bank include personal and business deposit products and services and various loan and credit products as described in greater detail below.

Deposit Products and Services

The Bank's primary sources of deposits are individuals and businesses in its local markets. Bank management has made a concerted effort to attract deposits in our local market areas through competitive pricing and delivery of quality products. The Bank offers a traditional array of deposit products, including non-interest bearing checking accounts, interest-bearing checking and savings accounts, money market accounts, and certificates of deposits. These accounts earn interest at rates established by management based on competitive market factors and management's strategic objectives in regards to the types or maturities of deposit liabilities from time to time. Services which accompany the deposit products include sweep accounts, wire services, safety deposit boxes, online banking, mobile banking, and cash management and other treasury management services.

The Bank provides 24-hour online banking to its customers with access to account balances and transaction histories, plus an electronic check register to make account management and reconciliation easier. The online banking system is compatible with budgeting software like Intuit's Quicken® or Microsoft's Money®. In addition, the online banking system includes the ability to transfer funds, make loan payments, reorder checks, and request statement reprints, provides loan calculators and allows for e-mail exchanges with representatives of the Bank. Also, for a nominal fee, customers can request stop payments and pay an unlimited number of bills online. These services, along with rate and other information, can be accessed through the Bank's website at <http://www.bankofthepacific.com>.

In addition to providing accounts and services to local customers, the Bank utilizes brokered deposits from time to time, which are deposits that are acquired from outside the region. The Bank also participates in the Certificate of Deposit Account Registry Service ("CDARS") which uses a deposit-matching program to distribute deposit balances in excess of insurance or other limits across participating banks. Our participation in CDARS is intended to enhance our ability to attract and retain customers and increase deposits by providing additional FDIC coverage to customers. Due to the nature of the placement of the funds, CDARS deposits are classified as "brokered deposits" by regulatory agencies. Brokered deposits for the three years ended December 31, 2013, 2012 and 2011 were as follows:

<u>Year Ended</u>	<u>Brokered Deposits</u>	<u>CDARS</u>	<u>Total Outstanding</u>	<u>Percentage of Total Deposits</u>
2013	\$17,788,000	\$3,903,000	\$21,691,000	3.6%
2012	\$19,239,000	\$5,191,000	\$24,430,000	4.5%
2011	\$13,000,000	\$5,294,000	\$18,294,000	3.3%

In determining whether to take brokered deposits, the Bank considers current market interest rates, profitability to the Bank, and matching deposits and loan products. Brokered deposits in excess of ten percent of total deposits are subject to additional FDIC assessment premiums. Our balance of brokered deposits (excluding CDARS) bears interest at 0.65% to 1.70% and matures as follows: 2014 — \$809,000; 2015 — \$5,000,000; 2016 — \$7,000,000; 2017 — \$3,239,000; 2018 — \$1,245,000 and 2019 — \$495,000.

The Bank's deposits are insured by the Federal Deposit Insurance Corporation ("FDIC") up to applicable legal limits under the Deposit Insurance Fund. The Bank is a member of the Federal Home Loan Bank ("FHLB") and is regulated by the Washington Department of Financial Institutions, Division of Banks ("Washington Division"), and the FDIC.

The Company is not dependent on any significant individual customers, entities or group of related entities for deposits. There are no deposit relationships exceeding two percent of total deposits.

Lending Activities

General. Lending products offered by the Bank include real estate loans, commercial loans, agriculture loans, installment loans, and residential mortgage loans. The majority of the Company's loan portfolio is comprised of real estate loans, which constitute \$388,729,000, or 75.9%, of total loans outstanding. Commercial real estate loans represent \$222,888,000, or 51.2%, and residential construction, land development and other land loans represent \$29,096,000, or 5.7% at December 31, 2013. See "Footnote 4 — Loans" in the audited consolidated financial statements included under Item 15 of this report for balances in each of our lending categories as of December 31, 2013 and 2012.

The Bank originates loans primarily in its local markets. Loans to borrowers outside of Washington and Oregon total \$67,181,000, or 13.1%, of total loans at December 31, 2013. Of this amount, \$37,823,000, or 7.4% of total loans, are government guaranteed loans purchased in the secondary market that were not originated by us. Additionally, our loan portfolio includes \$3,302,000 in loans purchased from and originated by other financial institutions, representing 0.6% of total loans.

Underwriting and Credit Administration. The Bank's lending activities are guided by policies that are reviewed and approved annually by our board of directors. These policies address the types of loans, underwriting standards, structure and pricing considerations, and compliance with laws, regulations and internal lending limits. As part of our credit administration process, we routinely engage external loan specialists to perform asset quality reviews. These reviews consist of sampling loans to review individual borrower loan files for adherence to policy and underwriting standards, proper loan administration, and asset quality. In addition, the management executive committee and credit administration staff meet quarterly with loan personnel to review loan risk assessments on loans greater than \$500,000 with an internal risk rating of watch or worse. See the subheading "Classification of Loans" in this section below.

Our loan policies also establish loan approval authority for certain officers individually. Loan officer lending authority ranges from \$5,000 to \$500,000 for certain loan officers. Credit risk officers can approve loans up to \$2,500,000. The chief credit officer can approve loans up to \$3,000,000. Loans greater than \$3,000,000 must be approved by a five member Management Loan Committee made up of the chief credit officer, credit risk officers, commercial lending manager, and commercial team leader. Additionally, loans with a risk rating of substandard or worse, with balances of \$2,000,000 or greater, must also be approved by the Management Loan Committee. The Loan Committee of our Board of Directors meets at least quarterly to review the allowance for credit losses, summary of loans reviewed by the Management Loan Committee, loan policy exceptions, and various key credit metrics. The Bank's legal lending limit was \$15,946,000 at December 31, 2013. The internal lending limit is \$7,500,000 and represents the maximum lending limit to individual borrowers and related entities. The Bank does not have significant loan concentrations to any individual customer, entity or group of related entities.

The Bank's underwriting policies focus on assessment of each borrower's ability to service and repay the debt, and the availability of collateral to secure the loan. Depending on the nature of the borrower and the purpose and amount of the loan, the Bank's loans may be secured by a variety of collateral, including real estate, business assets, and personal assets. The value of our collateral is subject to change. See the discussion under the subheading "Lending Activities — Classification of Loans" for additional information regarding our periodic evaluation of collateral values. Analysis of whether to make a loan to a particular borrower requires consideration of (1) the borrower's character, (2) the borrower's financial condition as reflected in current financial statements, (3) the borrower's management capability, (4) the borrower's industry, and (5) the economic environment in which the loan will be repaid. Before closing a loan, the Bank's loan documentation files will include financial statements of the borrower, guarantors, endorsers and co-makers. We seek income verification on loans other than homogenous non-real estate consumer loans. Tax returns are considered an excellent source of financial information. Applicable credit reports (Dunn & Bradstreet, Equifax or credit bureau reports) are also required on all loans. Financial statements reviewed by third party accountants are required for commercial loans between \$3 million and \$5 million. Audited financial statements are required on commercial credits of \$5 million or more. In addition, in instances where a borrower or guarantor maintains liquidity that is a material factor in loan approval, verification of that liquidity is sought.

The Bank generally requires guarantor support on commercial real estate loans, commercial and industrial loans to entities, where applicable, and certain consumer loans. Loans to closely held corporations will normally be guaranteed by the major stockholders. On occasion, we may choose to make exceptions to this policy for long-standing customers and others. However, we seek to keep these exceptions to the minimum necessary to retain good customers, and exceptions must be approved by credit administration. In addition, as a policy, loans that are to legal entities formed for the limited purpose of the business or project being financed require personal guarantees in support of the loan. Similarly, the Bank's policy is not to engage in non-recourse financing on commercial and commercial real estate loans. Before extending credit to a business, the Bank looks closely at its evaluation of the borrower's management ability, financial history, including cash flow of the borrower and all guarantors (referred to as "global cash flow" in our industry), and the liquidation value of the collateral. Emphasis is placed on having a comprehensive understanding of the borrower's and guarantors' cash flow and on financial due diligence.

The Company's loan portfolio does not include permanent residential mortgage loans originated as subprime loans, "Alt-A" loans, or no documentation, interest only or option adjustable rate loans.

Commercial Lending. The Bank's commercial and agricultural loans consist primarily of secured revolving operating lines of credit, equipment financing, accounts receivable and inventory financing and business term loans, some of which may be partially guaranteed by the Small Business Administration or the U.S. Department of Agriculture. The Company's credit policies determine advance rates against the different forms of collateral that can be pledged against commercial loans. Typically, the majority of loans will be limited to a percentage of the underlying collateral values such as equipment, eligible accounts receivable and finished inventory. Individual advance rates may be higher or lower depending upon the financial strength of the borrower, quality of the collateral and/or term of the loan.

The Bank provides secured and unsecured loans to commercial borrowers. Unsecured loans totaled \$3,015,000 at December 31, 2013, or 0.6% of total loans as of that date.

Commercial Real Estate. The Bank originates commercial real estate and multifamily loans within its primary market areas. Owner-occupied commercial real estate loans are preferred. Underwriting standards require that commercial and multifamily real estate loans not exceed 65 – 80% of the lower of appraised value at origination or cost of the underlying collateral, depending upon specific property type. The cash flow coverage to debt servicing requirement is generally that annual cash flow be a minimum of between 1.25 – 1.35 times debt service for commercial real estate loans and 1.25 times debt service for multifamily loans. Cash flow coverage is calculated using a market interest rate.

Commercial real estate and multifamily loans typically involve a greater degree of risk than single-family residential mortgage loans. Payments on loans secured by multifamily and commercial real estate properties are dependent on successful operation and management of the properties and repayment of these loans is affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks by scrutinizing the financial condition of the borrower, the quality and value of the collateral, and the management of the property securing the loan. In addition, the Bank reviews the commercial real estate loan portfolio annually to evaluate the performance of individual loans greater than \$500,000 and for potential changes in interest rates, occupancy, and collateral values.

Non-owner occupied commercial real estate loans are loans in which less than 50% of the property is occupied by the owner and include loans such as apartment complexes, hotels and motels, retail centers and mini-storage facilities. Repayment of non-owner occupied commercial real estate loans is dependent upon the lease or resale of the subject property. Loan amortizations range from 10 to 30 years, although terms typically do not exceed 10 years. Interest rates can be either floating or fixed. Floating rates are typically indexed to the prime rate or Federal Home Loan Bank advance rates plus a defined margin. Fixed rates are generally set for periods of three to five years with either a rate reset provision or a payment due at maturity. Prepayment penalties are sought on term commercial real estate loans. The penalties are designed to protect the Bank from refinancing of the loan during the early years of the transaction.

Construction Loans. The Bank originates single-family residential construction loans for custom homes where the home buyer is the borrower. It has also provided financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Because of the higher risks involved in the residential construction industry in today's economic climate, the Bank is not currently engaging in new land acquisition and site development financing.

The Bank endeavors to limit construction lending risks through adherence to specific underwriting guidelines and procedures. Repayment of construction loans is dependent upon the sale of individual homes to consumers or in some cases to other developers. Terms on construction loans are generally short-term in nature and most loans mature in one to three years. Interest rates are usually floating and fully indexed to a short-term rate index. The Bank's credit policies address maximum loan to value, cash equity requirements, inspection requirements, and overall credit strength.

Single-Family Residential Real Estate Lending. The majority of our one-to-four family residential loans are secured by single-family residences located in our primary market areas. Our underwriting standards require that single-family portfolio loans are generally owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms typically range from 15 to 30 years. Repayment of these loans comes from the borrower's personal cash flows and liquidity, and collateral values are a function of residential real estate values in the markets we serve. These loans include primary residences, second homes, rental homes and home equity loans and home equity lines of credit.

Origination and Sales of Residential Mortgage Loans. The Bank also originates mortgage loans for sale into the secondary market. Commitments to sell mortgage loans are generally made during the period between the loan application and the closing of the mortgage loan. Most of these sale commitments are made on a "best efforts" basis whereby the Bank is only obligated to sell the mortgage if the mortgage loan is approved and closed. As a result, management believes that market risk is minimal. When we sell mortgage loans, we sell the rights to service the loans as well (i.e., collection of principal and interest payments). Mortgage loans originated for sale are underwritten in accordance with standards of the loan purchaser, as a result, underwriting standards vary. The Bank's loans held for sale portfolio does not include mortgage loans originated as subprime loans, "Alt-A" loans, or no documentation or option adjustable rate loans.

Consumer. Consumer installment loans and other loans represent a small percentage of total outstanding loans and include new and used auto loans, boat loans, and personal lines of credit.

Classification of Loans. Federal regulations require that the Bank periodically evaluate the risks inherent in its loan portfolios. In addition, the Washington Division and the FDIC have authority to identify classified or problem loans and, if appropriate, require them to be reclassified. There are three classifications for classified loans: Substandard, Doubtful, and Loss. Substandard loans have one or more defined weaknesses and are characterized by the distinct possibility that 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. A loan classified as Loss is 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 that reserve. The Bank also classifies loans as Pass or Other Loans Especially Mentioned (“OLEM”). 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; however within the Pass classification certain loans are Watch rated because they have elements of risk that require more monitoring than other performing loans. Some loans within the Pass category are to 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 are assets that continue to perform but have shown deterioration in credit quality and require closer monitoring.

On an ongoing basis, the Bank reviews borrower financial results, collateral values, and compliance with payment terms and covenant requirements in order to identify problems in loan relationships. When management believes that the collection of all or a portion of principal and interest is no longer probable, the loan is placed on “non-accrual” status, accrual of interest is suspended, previously accrued interest is reversed, and interest payments are applied to principal until the Company determines that all remaining principal and interest can be recovered. This may occur at any time regardless of delinquency, however it is the policy of the Bank that a loan past due 90 days or more and not in the process of collection be placed on non-accrual status. 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. When all or a portion of the contractual cash flows are not expected to be collected, the loan is considered impaired. 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. The Company estimates and records impairment based on the estimated net realizable value of the collateral on collateral dependent loans. Large groups of small balance homogeneous loans are collectively evaluated for impairment. The Company does not make additional loans to a borrower or any related interest of the borrower when a loan is past due in principal or interest more than 90 days.

The Company reviews the net realizable values of the underlying collateral for collateral dependent impaired loans on at least a quarterly basis. To determine the collateral value, management utilizes independent appraisals and internal evaluations. These valuations are reviewed to determine whether an additional discount should be applied given the age of market information or other factors such as costs to carry and sell an asset. Currently it is our practice to obtain new appraisals on non-performing collateral dependent loans and/or other real estate owned (“OREO”) semi-annually for land and every nine months on improved property. Based upon the appraisal, the Company will, if an appraisal suggests a reduced value, adjust the recorded loan balance to the lower of cost or market value (less costs to sell) and record a charge-off to the allowance for credit losses or designate a specific reserve within the allowance per accounting principles generally accepted in the United States. Generally, the Company will record the charge-off rather than designate a specific reserve.

OREO. OREO is classified as other real estate owned until it is sold. When property is acquired, it is recorded at the estimated fair value (less costs to sell) at the date of acquisition and any resulting write-down is charged to the allowance for credit losses. Subsequent write-downs based upon re-evaluation of the property are charged to non-interest expense. Upon acquisition of a particular property, all costs incurred in maintaining the property are expensed. Costs relating to the development and improvement of the property, however, are capitalized to the extent they do not result in the recorded amount exceeding the property’s net realizable value. Net charge-offs to the allowance for credit losses on OREO properties totaled \$64,000 and \$212,000, for the years ended December 31, 2013 and 2012, respectively. In addition, the Company recorded OREO write-downs in non-interest expense in the income statement based upon subsequent re-evaluations totaling \$946,000, \$1,314,000, and \$1,049,000 for the years ended December 31, 2013, 2012 and 2011, respectively.

Troubled Debt Restructures. 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 for the loan. 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.

When the Company makes a decision to grant an extension or renew a loan, it does so based on the information available with respect to the borrower’s ability to repay the loan. Such extensions are made only after renewed credit analysis and with the approval of the appropriate credit administration personnel who must be independent of the lending officer/relationship manager in a particular loan. The Company may renew a loan or grant an extension when the maturity date is imminent and the borrower may be experiencing some level of financial stress but it is not evident at the time of the extension that the loan or a portion of the loan is not collectible.

TDRs are considered impaired and are reported as impaired loans. Additionally, 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. 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 at approximate six month intervals for land and nine months for improved properties.

TDRs totaled \$4,088,000 and \$4,374,000 at December 31, 2013 and 2012, respectively. See Note 4 — “Loans” in the audited consolidated financial statements included under Item 15 of this report for more information on TDRs as of December 31, 2013 and 2012.

PFC Statutory Trusts I and II

PFC Statutory Trust I and II are wholly owned subsidiary trusts of the Company formed to facilitate the issuance of trust preferred securities (TRUPs). The trusts were organized in December 2005 and June 2006 in connection with two offerings of trust preferred securities. During the year ended December 31, 2012, the Company paid all interest that had accrued with respect to its TRUPs since the Company elected, in 2009, to exercise its right to defer interest on its trust preferred debentures, as permitted by the terms thereof. The Company is currently making regular interest payments when due. As of December 31, 2013 and 2012, interest on TRUPs totaled \$40,000 and \$41,000 respectively, and is included in accrued interest payable on the balance sheet. For more information regarding the Company’s issuance of trust preferred securities, see Note 10 “Junior Subordinated Debentures” to the audited consolidated financial statements included under Item 15 of this report.

Competition

Competition in the banking industry is significant. Banks face a number of competitors with respect to providing banking services and attracting deposits. Competition comes from both bank and non-bank sources and from both large national and smaller local institutions. Many of these institutions, such as Wells Fargo Bank, Bank of America, and Chase Bank, have significantly greater resources than the Company and the Bank. As a result, competition for deposits, loan, and other products is significant and may continue to increase, particularly in Pacific's larger market in and around Bellingham, Washington.

The Bank competes in Grays Harbor County with well-established thrifts which are headquartered in the area along with branches of large banks with headquarters outside the area. The Bank also competes with well-established small community banks, branches of large banks, thrifts and credit unions in Pacific and Wahkiakum Counties in the state of Washington and Clatsop County in the state of Oregon. In Whatcom, Clark, Thurston and Skagit Counties, Washington, the Bank also competes with large regional and super-regional financial institutions that do not have a significant presence in the Company's historical market areas. The Company believes Whatcom, Clark and Thurston Counties provides opportunities for expansion, but in pursuing that expansion it faces greater competitive challenges than it faces in its historical market areas.

The adoption of the Gramm-Leach-Bliley Act of 1999 (the Financial Services Modernization Act) eliminated many of the barriers to affiliation among providers of financial services and further opened the door to business combinations involving banks, insurance companies, securities or brokerage firms, and others. This regulatory change has led to further consolidation in the financial services industry and the creation of financial conglomerates which frequently offer multiple financial services, including deposit services, brokerage and others. When combined with technological developments such as the Internet that have reduced barriers to entry faced by companies physically located outside the Company's market area, changes in the market have resulted in increased competition and can be expected to result in further increases in competition in the future.

Consolidation trends among financial institutions may continue. There may be opportunities for Pacific to acquire customers, personnel, and perhaps assets or even branches. The ability to do so will depend on Pacific's financial condition, as well as on its ability to compete successfully with other financial institutions when opportunities arise. Many competitive institutions have greater resources and better access to capital markets than we do, which may make it difficult for us to compete successfully for growth opportunities in our geographic area of operations.

The Company has been able to maintain a competitive advantage in its historical markets as a result of its status as a local institution, offering products and services tailored to the needs of the community. Further, because of the extensive experience of management in its market area and the business contacts of management and the Company's directors, management believes the Company can continue to compete effectively.

According to the Market Share Report compiled by the FDIC, as of June 30, 2013, the Company held a deposit market share of 41.3% in Pacific County, 56.8% in Wahkiakum County, 28.4% in Grays Harbor County, 4.4% in Whatcom County, 1.3% in Skagit County and 7.1% in Clatsop County (Oregon).

Employees

As of December 31, 2013, the Bank employed 234 full time equivalent employees. We place a high priority on staff development. New employees are selected based upon their technical skills and customer service capabilities. None of our employees are covered by a collective bargaining agreement. We offer a variety of employee benefits and management believes relations with its employees are good.

Supervision and Regulation

The following is a general description of certain significant statutes and regulations affecting the banking industry. The laws and regulations applicable to the Company and its subsidiaries are primarily intended to protect depositors and borrowers of the Bank and not stockholders of the Company. Various proposals to change the laws and regulations governing the banking industry are pending in Congress, in state legislatures and before the various bank regulatory agencies and new or amended proposals are expected. In the current economic climate and regulatory environment, the likelihood of enactment of new banking legislation and promulgation of new banking regulations is significantly greater than it has been in recent years. The potential impact of new laws and regulations on the Company and its subsidiaries cannot be determined, but any such laws and regulations may materially affect the business and prospects of the Company and its subsidiaries. Violation of the laws and regulations applicable to the Company and its subsidiaries may result in assessment of substantial civil monetary penalties, the imposition of a cease and desist or similar order, and other regulatory sanctions, as well as private litigation.

The Company

General

As a bank holding company, the Company is subject to the Bank Holding Company Act of 1956, as amended (BHCA), which places the Company under the primary supervision of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Company must file annual reports with the Federal Reserve and must provide it with such additional information as it may require. In addition, the Federal Reserve periodically examines the Company and the Bank.

Bank Holding Company Regulation

General. The BHCA restricts the direct and indirect activities of the Company to banking, managing or controlling banks and other subsidiaries authorized under the BHCA, and activities that are closely related to banking or managing or controlling banks. The Company must obtain approval of the Federal Reserve before it: (1) acquires direct or indirect ownership or control of any voting shares of any bank or bank holding company that results in total ownership or control, directly or indirectly, of more than 5% of the outstanding shares of any class of voting securities of such bank or bank holding company; (2) merges or consolidates with another bank holding company; or (3) acquires substantially all of the assets of another bank or bank holding company. In acting on applications for such prior approval, the Federal Reserve considers various factors, including, without limitation, the effect of the proposed transaction on competition in relevant geographic and product markets, and each transaction party's financial condition, managerial resources, and the convenience and needs of the communities to be served, including the performance record under the Community Reinvestment Act.

Source of Strength. Under Federal Reserve policy, the Company must act as a source of financial and managerial strength to the Bank. This means that the Company is required to commit, as necessary, resources to support the Bank, and that under certain conditions, the Federal Reserve may conclude that certain actions of Company, such as payment of cash dividends, would constitute unsafe and unsound banking practices.

Dodd-Frank Act. In addition, under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), the FDIC has back-up enforcement authority over a depository institution holding company, such as the Company, if the conduct or threatened conduct of a holding company poses a risk to the Deposit Insurance Fund, subject to certain limitations.

Effects of Government Monetary Policy

Banking is a business which depends on interest rate differentials. In general, the major portions of a bank’s earnings derives from the differences between: (i) interest received by a bank on loans extended to its customers and the yield on securities held in its investment portfolio; and (ii) the interest paid by a bank on its deposits and its other borrowings (the bank’s “cost of funds”). Thus, our earnings and growth are constantly subject to the influence of economic conditions generally, both domestic and foreign, and also to the monetary, fiscal and related policies of the United States and its agencies, particularly the Federal Reserve and the U.S. Treasury. The nature and timing of changes in such policies and their impact cannot be predicted.

The Bank

General

The Bank, as an FDIC insured state-chartered bank, is subject to regulation and examination by the FDIC and the Washington Division. The federal laws that apply to the Bank regulate, among other things, the scope of its business activities, its investments, its reserves against deposits, the timing of the availability of deposited funds and the nature and amount of and collateral for loans.

CRA. The Community Reinvestment Act (the CRA) requires that the FDIC evaluate the Bank’s record in meeting the credit needs of its local community, including low and moderate income neighborhoods, consistent with the safe and sound operation of those banks. These factors are also considered in evaluating mergers, acquisitions, and applications to open a branch or facility. In connection with the FDIC’s assessment of the record of financial institutions under the CRA, it assigns a rating of either, “outstanding,” “satisfactory,” “needs to improve,” or “substantial noncompliance” following an examination. The Bank received a CRA rating of “satisfactory” during its most recent examination.

Insider Credit Transactions. Banks are also subject to certain restrictions imposed by the Federal Reserve Act on extensions of credit to executive officers, directors, principal shareholders, or any related interests of such persons. Extensions of credit (i) must be made on substantially the same terms, including interest rates and collateral, and follow credit underwriting procedures that are not less stringent than those prevailing at the time for comparable transactions with persons not covered above and who are not employees and (ii) must not involve more than the normal risk of repayment or present other unfavorable features. Banks are also subject to certain lending limits and restrictions on overdrafts to such persons.

FDICIA. Under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), each federal banking agency has prescribed, by regulation, noncapital safety and soundness standards for institutions under its authority. These standards cover internal controls, information systems, and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, such other operational and managerial standards as the agency determines to be appropriate, and standards for asset quality, earnings and stock valuation. An institution which fails to meet these standards must develop a plan acceptable to the agency, specifying the steps that the institution will take to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. Management believes that the Bank meets all such standards and, therefore, does not believe that these regulatory standards will materially affect the Company’s business or operations.

Safety and Soundness Standards. The federal banking agencies have adopted guidelines that establish operational and managerial standards to promote the safety and soundness of federally insured depository institutions. The guidelines set forth standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings. In general, the safety and soundness guidelines prescribe the goals to be achieved in each area, and each institution is responsible for establishing its own procedures to achieve those goals. If an institution fails to comply with any of the standards set forth in the guidelines, the institution's primary federal regulator may require the institution to submit a plan for achieving and maintaining compliance. If an institution fails to submit an acceptable compliance plan, or fails in any material respect to implement a compliance plan that has been accepted by its primary federal regulator, the regulator is required to issue an order directing the institution to cure the deficiency. Until the deficiency cited in the regulator's order is cured, the regulator may restrict the institution's rate of growth, require the institution to increase its capital, restrict the rates the institution pays on deposits or require the institution to take any action the regulator deems appropriate under the circumstances. Noncompliance with the standards established by the safety and soundness guidelines may also constitute grounds for other enforcement action by the federal banking regulators, including cease and desist orders and civil money penalty assessments. Management of the Bank is not aware of any conditions relating to these safety and soundness standards which would require submission of a plan of compliance.

Dodd-Frank Act

On July 21, 2010, the Dodd-Frank Act was signed into law and implements far-reaching changes across the financial regulatory landscape, including provisions that, among other things, will:

- Centralize responsibility for consumer financial protection by creating a new agency within the Federal Reserve, the Bureau of Consumer Financial Protection, with broad rule making, supervision and enforcement authority for a wide range of consumer protection laws that would apply to all banks and thrifts. Smaller financial institutions, including the Bank, will be subject to the supervision and enforcement of their primary federal banking regulator with respect to the federal consumer financial protection laws.
- Require the federal banking regulators to promulgate new capital regulations and seek to make their capital requirements countercyclical, so that capital requirements increase in times of economic expansion and decrease in times of economic contraction.
- Provide for new disclosures and other requirements relating to executive compensation and corporate governance.
- Change the assessment base for federal deposit insurance from deposits to average total assets minus tangible equity.

Many aspects of the Dodd-Frank Act are subject to ongoing rule-making. These rules are expected to increase regulation of the financial services industry and impose restrictions on the ability of firms within the industry to conduct business consistent with historical practices. These rules will, as examples, impact the ability of financial institutions to charge certain banking and other fees, allow interest to be paid on demand deposits, impose new restrictions on lending practices and require depository institution holding companies to maintain capital levels at levels not less than the levels required for insured depository institutions. Compliance with such legislation or regulation may, among other effects, significantly increase our costs, limit our product offerings and operating flexibility, decrease our revenue opportunities, require significant adjustments in our internal business processes, and possibly require us to maintain our regulatory capital at levels above historical levels.

Jumpstart Our Business Startups (“JOBS”) Act

On April 5, 2012, the JOBS Act was signed into law. Among other things, the JOBS act contains provisions that reduce certain reporting requirements for qualifying public companies. The JOBS Act also allows banks and bank holding companies to terminate the registration of a class of securities under Section 12(g) and Section 12(b) of the Exchange Act if such class is held of record by less than 1,200 persons, an increase from the prior 300 person threshold. Although the Company has considered the possible benefits of deregistering its common stock under the JOBS Act, it has not made any determination to do so.

The Volcker Rule

The Dodd-Frank Act implements the “Volcker Rule,” which prohibits banking entities such as the Company and the Bank from engaging in certain short-term proprietary trading activities and investments. Transactions in certain instruments, including obligations of the U.S. Government or U.S. Government agency, government-sponsored enterprises, and state and local governments will be exempt from the prohibitions. The Volcker Rule also prohibits the Company and the Bank from owning, sponsoring, or having certain relationships with any hedge funds or private equity funds subject to certain exemptions. The prohibitions and restrictions of the Volcker Rule will not take effect until after publication of final interagency rules implementing the Volcker Rule. Upon effectiveness of the final interagency rules, the Company and the Bank will be afforded a two-year conformance period during which they can wind down, sell, or otherwise conform their respective activities, investments and relationships to the requirements of the Volcker Rule. The Volcker Rule is scheduled to be effective April 1, 2014. As finalized, the Company and the Bank do not believe the final interagency rules will have a material impact on its investment activities since it does not engage in the transactions covered by the regulation.

Deposit Insurance

The deposits of the Bank are insured to a maximum of \$250,000 per depositor through the Deposit Insurance Fund administered by the FDIC. All insured banks are required to pay semi-annual deposit insurance premium assessments to the FDIC. A bank’s assessment is calculated by multiplying its assessment rate (see below) by its assessment base. A bank’s assessment base is its average consolidated total assets minus its average tangible equity.

The FDIC currently assesses deposit insurance premiums on each FDIC-insured institution quarterly based on annualized rates for one of four risk categories applied to its deposits, subject to certain adjustments. Each institution is assigned to one of four risk categories based on its capital, supervisory ratings and other factors. Well capitalized institutions that are financially sound with only a few minor weaknesses are assigned to Risk Category I. Risk Categories II, III and IV present progressively greater perceived risks to the DIF. Under FDIC’s current risk-based assessment rules for institutions with less than \$10 billion in assets, the initial base assessment rates prior to adjustments range from 5 to 9 basis points for Risk Category I, 14 basis points for Risk Category II, 23 basis points for Risk Category III, and 35 basis points for Risk Category IV.

Initial base assessment rates are subject to adjustments based on an institution’s unsecured debt and brokered deposits, such that the total base assessment rates after adjustments range from 2.5 to 9 basis points for Risk Category I, 9 to 24 basis points for Risk Category II, 18 to 33 basis points for Risk Category III, and 30 to 45 basis points for Risk Category IV. The FDIC’s regulations include authority to increase or decrease total base assessment rates in the future by as much as three basis points without a formal rulemaking proceeding.

The FDIC may make special assessments on insured depository institutions in amounts determined by the FDIC to be necessary to give it adequate assessment income to repay amounts borrowed from the U.S. Treasury and other sources, or for any other purpose the FDIC deems necessary.

Dividends

Dividends from the Bank constitute the major source of liquidity for the Company, from which the Company may cover its expenses, pay interest on its obligations, including its debentures issued in connection with trust preferred securities, and declare and pay dividends to shareholders. The amount of dividends payable by the Bank to the Company depends on the Bank's earnings and capital position, and is limited by federal and state laws, regulations and policies.

Electronic Funds Transfer Act.

The electronic Funds Transfer Act (the EFTA) provides a basic framework for establishing the rights, liabilities, and responsibilities of participants in electronic funds transfer (EFT) systems. The EFTA is implemented by the Federal Reserve's Regulation E which governs transfers initiated through ATMs, point-of-sale terminals, payroll cards, automated clearinghouse (ACH) transactions, telephone bill-payment plans, or remote banking services. Regulation E was amended to require bank customers in 2010 to opt in (affirmatively consent) to participation in overdraft service programs for ATM and one-time debit card transactions before overdraft fees may be assessed on the customer's account and provides an ongoing right to revoke consent to participation. For customers who do not affirmatively consent to overdraft service for ATM and one-time debit card transactions, a bank must provide those customers with the same account terms, conditions, and features that it provides to consumers who do affirmatively consent, except for the overdraft service.

Real Estate Concentration Guidance

Banks are subject to real estate concentration guidelines issued by federal banking agencies regarding sound risk management practices for concentrations in commercial real estate lending. The particular focus is on exposure to commercial real estate loans that are dependent on the cash flow from the real estate held as collateral and that are likely to be sensitive to conditions in the commercial real estate market (as opposed to real estate collateral held as a secondary source of repayment or as an abundance of caution). The purpose of the guidance is not to limit a bank's commercial real estate lending but to guide banks in developing risk management practices and capital levels commensurate with the level and nature of real estate concentrations. Real estate concentration guidelines are as follows:

- Total reported loans for construction, land development and other land representing 100% or more of the bank's capital; or
- Total commercial real estate loans representing 300% or more of the bank's total capital.

The strength of an institution's lending and risk management practices with respect to such concentrations will be taken into account in supervisory evaluation of capital adequacy. At December 31, 2013 and 2012, the Bank was under the guidelines described above.

Capital Adequacy

Federal bank regulatory agencies use capital adequacy guidelines in the examination and regulation of bank holding companies and banks. If capital falls below minimum levels, the bank holding company or bank may be denied approval to acquire or establish additional banks or non-bank businesses or to open new facilities.

The FDIC and Federal Reserve use risk-based capital guidelines for banks and bank holding companies. Risk-based guidelines are designed to make capital requirements more sensitive to differences in risk profiles among banks and bank holding companies, to account for off-balance sheet exposure and to minimize disincentives for holding liquid low-risk assets. Assets and off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items. The guidelines are minimums and the FDIC or the Federal Reserve may require that a holding company or bank, as applicable, maintain ratios in excess of the minimums, particularly organizations contemplating significant expansion. Current guidelines require all bank holding companies and federally-regulated banks to maintain a minimum total risk-based capital ratio equal to 8%, of which at least 4% must be Tier I capital. Tier I capital for bank holding companies includes common shareholders' equity, certain qualifying preferred stock and minority interests in equity accounts of consolidated subsidiaries, minus certain deductions, including, without limitation, goodwill, other identifiable intangible assets, and certain deferred tax assets.

The FDIC or the Federal Reserve also employ a leverage ratio, calculated as Tier I capital as a percentage of total assets minus certain deductions, including, without limitation, goodwill, mortgage servicing assets, other identifiable intangible assets, and certain deferred tax assets, to be used as a supplement to risk-based guidelines. The principal objective of the leverage ratio is to constrain the maximum degree to which a bank holding company may leverage its equity capital base. The Company and the Bank must maintain a minimum leverage ratio of 3%.

Under regulations adopted by the Federal Reserve and the FDIC, each bank holding company and bank is assigned to one of five capital categories depending on, among other things, its total risk-based capital ratio, Tier I risk-based capital ratio, and leverage ratio, together with certain subjective factors. Institutions which are deemed to be undercapitalized depending on the category to which they are assigned are subject to certain mandatory supervisory corrective actions. Under these guidelines, the Company and the Bank are each considered well capitalized as of the end of the fiscal year.

Effective in 2015 (with some changes generally transitioned into full effectiveness over two to four years), the Bank will be subject to new capital requirements adopted by the FDIC. These new requirements create a new required ratio for common equity Tier 1 ("CET1") capital, increases the leverage and Tier 1 capital ratios, changes the risk-weights of certain assets for purposes of the risk-based capital ratios, creates an additional capital conservation buffer over the required capital ratios and changes what qualifies as capital for purposes of meeting these various capital requirements. Beginning in 2016, failure to maintain the required capital conservation buffer will limit the ability of the Bank to pay dividends, repurchase shares or pay discretionary bonuses.

When these new requirements to be considered well-capitalized become effective in 2015, the Bank's leverage ratio of 4% of adjusted total assets and total capital ratio of 8% of risk-weighted assets will remain the same; however, the Tier 1 capital ratio requirement will increase from 4.0% to 6.0% of risk-weighted assets. In addition, the Bank will have to meet the new CET1 capital ratio of 4.5% of risk-weighted assets, with CET1 consisting of qualifying Tier 1 capital less all capital components that are not considered common equity.

For all of these capital requirements, there are a number of changes in what constitutes regulatory capital, some of which are subject to a two-year transition period. These changes include the phasing-out of certain instruments as qualifying capital. The Bank does not have any of these instruments. Under the new requirements for total capital, Tier 2 capital is no longer limited to the amount of Tier 1 capital included in total capital.

Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of common stock will be deducted from capital, subject to a two-year transition period. In addition, Tier 1 capital will include accumulated other comprehensive income (loss), which includes all unrealized gains and losses on available for sale debt and equity securities, subject to a two-year transition period. Because of its asset size, the Bank has the one-time option of deciding in the first quarter of 2015 whether to permanently opt-out of the inclusion of accumulated other comprehensive income (loss) in its capital calculations. The Bank is considering whether to take advantage of this opt-out to reduce the impact of market volatility on its regulatory capital levels.

The new requirements also include changes in the risk-weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and for non-residential mortgage loans that are 90 days past due or otherwise on non-accrual status; a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at 0%); a 250% risk weight (up from 100%) for mortgage servicing rights and deferred tax assets that are not deducted from capital; and increased risk-weights (0% to 600%) for equity exposures.

In addition to the minimum CET1, Tier 1 and total capital ratios, the Bank will have to maintain a capital conservation buffer consisting of additional CET1 capital equal to 2.5% of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. This new capital conservation buffer requirement is being phased in beginning in January 2016 at 0.625% of risk-weighted assets and increasing each year until fully implemented at 2.5% in January 2019.

The FDIC's prompt corrective action standards will change when these new capital ratios become effective. Under the new standards, in order to be considered well-capitalized, the Bank would be required to have a CET1 ratio of 6.5% (new), a Tier 1 ratio of 8% (increased from 6%), a total capital ratio of 10% (unchanged) and a leverage ratio of 5% (unchanged). The Bank has conducted a pro forma analysis of the application of the new capital requirements as of September 30, 2013. We have determined that the Bank meets all new requirements and would remain well-capitalized, even if these new requirements had been in effect on that date. Pacific has also conducted a pro forma analysis of the application of these new capital requirements as of December 31, 2013. We have determined that the Company meets all new requirements and would remain well-capitalized, even if these new requirements had been in effect on that date.

The application of these stringent capital requirements could, among other things, result in lower returns on invested capital, over time require the raising of additional capital, and result in regulatory actions if we were to be unable to comply with such requirements. Implementation of changes to asset risk weightings for risk based capital calculations, items included or deducted in calculating regulatory capital and/or additional capital conservation buffers could result in management modifying its business strategy and could limit our ability to make distributions, including paying out dividends or repurchasing shares. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to lengthen the term of our funding, restructure our business models, and/or increase our holdings of liquid assets. Any additional changes in our regulation and oversight, in the form of new laws, rules and regulations could make compliance more difficult or expensive or otherwise materially adversely affect our business, financial condition or prospects.

ITEM 1A. Risk Factors

The following are material risks that management believes are specific to our business. This should not be viewed as an all-inclusive list or in any particular order.

Weak economic conditions in the market areas we serve may adversely impact our earnings and could increase the credit risk associated with our loan portfolio.

Substantially all of our loans are to businesses and individuals in the states of Washington and Oregon. A decline in the economies of our local market areas could have a material adverse effect on our business, financial condition, results of operations and prospects. In particular, in recent years Washington and Oregon experienced substantial home price declines and increased foreclosures and above average unemployment rates, as discussed further under “Business Overview” in Item 7 of this report.

Although conditions have improved, any economic deterioration that affects household and or business incomes in the markets in which we do business could have one or more of the following adverse effects on our business:

- An increase in loan delinquencies, problem assets and foreclosures;
- A decrease in the demand for loans and other fee-based products and services;
- An increase or decrease in the usage of unfunded commitments; or
- A decrease in the value of loan collateral, especially real estate, which in turn may reduce a customer’s borrowing power and significantly increase our exposure to particular loans.

A large percentage of our loan portfolio is secured by real estate, in particular commercial real estate, and as a result, we are susceptible to deterioration in the real estate market in our local areas. If this were to occur, it would lead to increased delinquencies and related losses in our loan portfolio, which could have a material adverse effect on our business, financial condition and results of operations.

Our current business strategy is heavily focused on commercial real estate lending, which is already a significant portion of our loans. This type of lending activity is generally more sensitive to regional and local economic conditions, making loss levels more difficult to predict. Collateral evaluation and financial statement analysis in these types of loans requires a more detailed analysis at the time of loan underwriting and on an ongoing basis. Further downturns in the real estate market, could increase loan delinquencies, defaults and foreclosures, and significantly impair the value of our collateral and our ability to sell the collateral upon foreclosure.

As of December 31, 2013, we had \$222.9 million of commercial real estate loans, representing 51.2% of total loans, an increase of \$10.1 million, or 4.0%, from December 31, 2012. These types of loans typically involve higher principal amounts than other types of loans, and repayment is dependent upon income generated, or expected to be generated, by the property securing the loan, which may be adversely affected by changes in the economy or local market conditions. Commercial real estate loans also expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans typically cannot be sold as easily as residential real estate. In addition, many of our commercial real estate loans are not fully amortizing and may require balloon payments upon maturity. Such balloon payments may force the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default.

A secondary market for most types of commercial real estate loans is not readily liquid, so we have less opportunity to mitigate credit risk by selling part or all of our interest in these loans. As a result of these characteristics, if we foreclose on a commercial real estate loan, our holding period of the collateral typically is longer than for residential mortgage loans. Accordingly, charge-offs on commercial real estate loans may be larger as a percentage of the total principal outstanding than those incurred with our residential or consumer loan portfolios.

Future credit losses may exceed our allowance for credit losses.

We are subject to credit risk, which is the risk of losing principal or interest due to borrowers' failure to repay loans in accordance with their terms. A continued or sustained downturn in the economy or the real estate market in our market areas or a rapid change in interest rates would have a negative effect on borrowers' ability to repay loans and on collateral values. This deterioration could result in losses to the Company in excess of the allowance for credit losses. To the extent loans are not paid timely by borrowers, the loans are placed on non-accrual status, thereby reducing interest income or even requiring reversals of previously recorded income. To the extent loan charge-offs exceed our financial models, increased amounts will be charged to the provision for credit losses, which would further reduce income.

Our provision for credit losses remains volatile and we may be required to increase our provision for credit losses and charge-off additional loans in the future, which could adversely affect our financial condition and results of operations.

For the year ended December 31, 2013, we recorded a provision for (recapture of) credit losses of \$(450,000), compared to \$(1,110,000) for the year ended December 31, 2012. We also recorded net loan charge-offs of \$549,000 for the year ended December 31, 2013, compared to \$669,000 for the year ended December 31, 2012. Past due loans represented 1.4% and 2.4% of total loans outstanding at December 31, 2013 and 2012, respectively.

While current economic conditions have improved modestly, we may experience higher than normal volatility in delinquencies and credit losses if these improvements falter. As a result, we may experience additional provision for credit losses and charge offs, which could have a material adverse effect on our financial condition and results of operations. Further, our portfolio contains construction and land loans and commercial and commercial real estate loans, all of which have a higher risk of loss than residential real estate loans.

See "Business Overview" in Part II, Item 7 of this report for further discussion of real estate values.

We hold and acquire other real estate owned ("OREO") properties as part of our business, which can lead to increased operating expenses and vulnerability to additional declines in the market value of real estate in our areas of operations.

We foreclose on and take title to the real estate serving as collateral for many of our loans as part of our business. During 2013, we continued to acquire OREO and at December 31, 2013, the Bank had 17 OREO properties with an aggregate book value of \$2,771,000, as compared to 26 OREO properties with an aggregate book value of \$4,679,000 at December 31, 2012. OREO balances have led to increased expenses, as we have incurred costs to manage, maintain, improve in some cases, and dispose of our OREO properties. We expect that our earnings in 2014 will continue to be negatively affected, albeit to a lesser extent, by various expenses associated with OREO, including personnel costs, insurance and taxes, completion and repair costs, valuation adjustments, and other expenses associated with property ownership. Also, at the time that we foreclose on a loan and take possession of a property we estimate the value of that property using third party appraisals and opinions and internal judgments. OREO property is valued on our books at the estimated market value of the property, less the estimated costs to sell (or "fair value"). Upon foreclosure, a charge-off to the allowance for credit losses is recorded for any excess between the value of the asset on our books over its fair value. Thereafter, we periodically reassess our judgment of fair value based on updated appraisals or other factors, including, at times, at the request of our regulators. Any further declines in our estimate of fair value for OREO will result in additional charges, with a corresponding expense in our statements of income that is recorded under the line item for "OREO Write-downs." As such, our results of operations are vulnerable to declines in the market for residential and commercial real estate in the areas in which we operate. The expenses associated with OREO and any further property write downs could have a material adverse effect on our results of operations and financial condition. We currently have \$7,243,000 in nonaccrual loans, which may lead to increases in our OREO balance in the future, if not resolved.

We face liquidity risks in the operation of our business and our funding sources may prove insufficient to support growth opportunities or satisfy our liabilities.

Liquidity is crucial to the operation of the Company and the Bank. Liquidity risk is the potential that we will be unable to fund increases in assets or meet payment obligations, including obligations to depositors, as they become due because of an inability to obtain adequate funding or liquidate assets. For example, funding illiquidity may arise if we are unable to attract core deposits or are unable to renew at acceptable pricing long-term or short-term borrowings. Illiquidity may also arise if our regulatory capital levels decrease, our lenders require additional collateral to secure our repayment obligations, or a large amount of our deposits are withdrawn.

We rely on customer deposits and advances from the FHLB of Seattle and other borrowings to fund our operations. Although we have historically been able to replace maturing deposits and advances if desired, we may not be able to replace such funds in the future if our financial condition or the financial condition of the FHLB of Seattle or market conditions were to change. If we are required to rely more heavily on more expensive funding sources to support operations, our revenues may not increase proportionately to cover our costs. In this case, our net interest margin would be adversely affected, making it even more difficult for our businesses to operate profitably.

Rapidly changing interest rate environments could reduce our net interest margin, net interest income, fee income and net income.

Interest and fees on loans and securities, net of interest paid on deposits and borrowings, are a large part of our net income. Interest rates are key drivers of our net interest margin and subject to many factors beyond the control of management. As interest rates change, net interest income is affected. Rapid increases in interest rates in the future could result in interest expense increasing faster than interest income because of mismatches in financial instrument maturities, which would result in reduced spreads between the interest rates earned on assets and the rates of interest paid on liabilities. Further, substantially higher interest rates generally reduce loan demand and may hinder loan growth, particularly in commercial real estate lending, an important factor in the Company's revenue over the past two years.

Gain on sale of loans held for sale represents a significant source of our non-interest income and may be adversely affected by any changes in the programs offered by secondary market investors or our ability to qualify for such programs, as well as by any increases in market interest rates.

The sale of residential mortgage loans classified as loans held for sale provides a significant portion of our non-interest income. Changes in programs applicable to the resale of residential mortgages or our eligibility to participate in such programs could materially adversely affect our results of operations. Further, in a rising interest rate environment, our originations of mortgage loans held for sale may decrease, resulting in fewer loans that are available to be sold. This would result in a decrease in gain on sale of loans sold and a corresponding decrease in non-interest income. During periods of reduced loan demand, our results of operations may be further adversely affected if we are unable to reduce our expenses proportionately to the decline in the volume of loan originations and sales. For 2014, we expect residential mortgage loan demand to continue to decline to the extent that interest rates stay above prior record lows.

We may elect or be required to seek additional capital in the future, but that capital may not be available when it is needed.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. In addition, we may elect to raise capital to support our business or to finance acquisitions, if any. Our ability to raise additional capital, if needed, will depend on conditions in the capital markets, economic conditions and a number of other factors, many of which are outside our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital on terms acceptable to us, or at all. If we do raise capital, equity financing may be dilutive to existing shareholders and any debt financing may include covenants or other restrictions that limit our operating flexibility. If we cannot raise additional capital when needed on favorable terms, it may have a material adverse effect on our financial condition, results of operations and prospects.

We operate in a highly regulated environment and changes of or increases in, or supervisory enforcement of, banking or other laws and regulations could adversely affect us.

As discussed more fully in the section entitled “Supervision and Regulation” in Item 1 above, we are subject to extensive regulation, supervision and examination by federal and state banking authorities. Additional legislation and regulations that could significantly affect our powers, authority and operations may be enacted or adopted in the future. Further, regulators have significant discretion and authority to prevent or remedy unsafe or unsound practices or violations of laws or regulations in the performance of their supervisory and enforcement duties. Any failure to comply with laws, regulations or interpretations could result in sanctions by regulatory agencies or damage to our reputation. Any changes in applicable regulations or federal, state or local legislation, in regulatory policies or interpretations, or in regulatory approaches to compliance and enforcement could have a substantial impact on our financial condition and our result of operations, for example, by leading to additional fees or taxes or restrictions on our operations.

Recent legislation has impacted our operations, and additional legislation and rulemaking could have an adverse impact on our business.

The Dodd-Frank Act has significantly changed the current bank regulatory structure and will affect the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. Among other things, the Dodd-Frank Act:

- establishes the Bureau of Consumer Financial Protection with broad authority to administer and enforce a new federal regulatory framework of consumer financial regulation;
- changes the base for deposit insurance assessments;
- introduces regulatory rate-setting for interchange fees charged to merchants for debit card transactions;
- enhances the regulation of consumer mortgage banking; and
- changes the methods and standards for resolution of troubled institutions.

Many of the provisions of the Dodd-Frank Act have extended implementation periods and delayed effective dates and will require additional rulemaking by various regulatory agencies, and many could have far reaching implications on our operations. Accordingly, we expect that the legislation may have a detrimental impact on revenues and expenses, require the Company to change certain of its business practices, increase capital levels and have other adverse effects on our business. Moreover, compliance obligations will expose us to additional reputational risk in the event of noncompliance and could divert management's focus from the business of banking.

The short-term and long-term impact of the changing regulatory capital requirements and anticipated new capital rules is uncertain.

As mentioned under the heading "Supervision and Regulation" in Item 1 above, effective January 1, 2015, the Company and the Bank will each be subject to new capital requirements under regulations adopted by the federal banking regulators to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. We have conducted a pro forma analysis of these new requirements as of December 31, 2013 and concluded on a preliminary basis that if these requirements had been in effect as of that date, Pacific and the Bank would be considered well-capitalized, although there is no assurance that each will continue to do so.

In addition, in the current economic and regulatory environment, regulators of banks and bank holding companies have become more likely to impose capital requirements that are more stringent than those required by existing regulations. The application of more stringent capital requirements for the Company and the Bank could, among other things, result in lower returns on invested capital, require the raising of additional capital, and result in regulatory actions if we were unable to comply with such requirements. Furthermore, the imposition of liquidity requirements in connection with Basel III could result in our having to lengthen the terms of our funding, restructure our business models, and/or increase our holdings of liquid assets. Implementation of changes to asset risk weightings for risk based capital calculations, and/or additional capital conservation buffers could result in management modifying its business strategy and could limit our ability to make distributions, including paying dividends or buying back shares. Any additional changes in our regulation and oversight, in the form of new laws, rules and regulations could make compliance more difficult or expensive or otherwise materially adversely affect our business, financial condition or prospects.

We rely on dividends from subsidiaries for substantially all of our liquidity.

The Company is a separate and distinct legal entity from the Bank. The Company receives substantially all of its liquidity from dividends from the Bank. These dividends are the principal source of funds to pay interest and principal on our debt, other expenses, or dividends on our common stock, if any. Various federal and state laws and regulations limit the amount of dividends that the Bank may pay to the Company, as may the actions of regulators. If the Bank is unable to pay dividends to the Company, it may not be able to service debt, pay any other obligations or pay dividends on common stock. The Company paid a cash dividend of \$0.20 per share for both 2013 and 2012, respectively.

The financial services industry is very competitive.

We face competition in attracting and retaining deposits, making loans, and providing other financial services. Our competitors include other community banks, larger banking institutions, and a wide range of other financial institutions such as credit unions, government-sponsored enterprises, mutual fund companies, insurance companies and other non-bank businesses. Many of these competitors have substantially greater resources than we have. For a more complete discussion of our competitive environment, see “Business–Competition” in Item 1 above. If we are unable to compete effectively, we will lose market share, including deposits, and face a reduction in our income from our lending activities.

If there is unauthorized disclosure of sensitive or confidential client, customer or employee information, whether through a breach of our computer systems or otherwise, it could harm our business.

As part of our business, we collect, process and retain sensitive and confidential client, customer and employee information. Despite the various security measures we have in place, our facilities and systems may be vulnerable to security breaches, computer viruses, data retention failures, human errors, or other similar events. In particular, any security breach involving the misappropriation, loss or other unauthorized disclosure of confidential customer information could expose us to the risk of private litigation or regulatory actions, damage our reputation, and disrupt our operations, resulting in a material adverse effect on our results of operations.

We may experience difficulties in managing our growth and our growth strategy involves risks that may negatively impact our net income.

As part of our general growth strategy, we may acquire branches, banks and establish new branches that we believe provide a strategic and geographic fit with our business. We cannot predict the number, size or timing of growth opportunities. To the extent that we grow through acquisitions, we cannot assure you that we will be able to adequately and profitably integrate these new assets and manage this growth. Acquiring other branches and businesses will involve risks commonly associated with acquisitions, including:

- Potential exposure to unknown or contingent liabilities we acquire;
- Exposure to potential asset quality issues;
- Difficulty and expense of integrating the operations and personnel of banks and businesses we acquire;
- Potential disruption to our business;
- Potential restrictions on our business resulting from the regulatory approval process;
- Potential diversion of our management's time and attention; and
- The possible loss of key employees and customers of the bank and businesses we acquire.

In addition to acquisitions, we may expand into additional communities or attempt to strengthen our position in our current markets by undertaking additional de novo bank formations or branch openings. Based on our experience, we believe that it generally takes three years or more for new banking facilities to first achieve operational profitability, due to the impact of organization and overhead expenses and the start-up phase of generating loans and deposits. To the extent that we undertake additional branching and de novo bank and business formations, we are likely to continue to experience the effects of higher operating expenses relative to operating income from the new operations, which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets.

Impairment of investment securities, goodwill, other intangible assets, or deferred tax assets could require charges to earnings, which could result in a negative impact on our results of operations.

The Bank has \$101.3 million, or 14.4% of assets, in investments and FHLB stock at December 31, 2013, and must periodically test our investment securities for impairment in value. In assessing whether the impairment of investment securities is other-than-temporary, we consider the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability to retain our investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value in the near term. Under current accounting standards, goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. Although we do not presently anticipate goodwill impairment charges, if we conclude that our goodwill may be impaired, a non-cash charge for the amount of such impairment would be recorded against earnings. Such a charge would have no impact on tangible capital. A decline in our stock price or occurrence of a triggering event could, under certain circumstances, cause us to perform a goodwill impairment test and result in an impairment charge being recorded for that period. At December 31, 2013, we had goodwill of \$12.2 million, representing approximately 18.1% of shareholders' equity.

Further, our balance sheet reflects approximately \$4.6 million of net deferred tax assets at December 31, 2013, recorded in other assets on the balance sheet, which represents differences in the timing of the benefit of deductions, credits and other items for accounting purposes and the benefit for tax purposes. To the extent we conclude that the value of this asset is not more likely than not to be realized, we would be obligated to record a valuation allowance against the asset, impacting our earnings during the period in which the valuation allowance is recorded. Assessing the need for, or the sufficiency of, a valuation allowance requires management to evaluate all available evidence, both negative and positive. If the positive evidence is not sufficient to exceed the negative evidence, a valuation allowance for deferred tax assets is established. The impact of each of these impairment matters could have a material adverse effect on our business, results of operations, and financial condition.

We may be subject to environmental and other liability risks associated with lending activities.

We foreclose on and take title to real estate in the regular course of our business. Property ownership increases our expenses due to the costs of managing and disposing of properties. Although environmental site assessments are completed on properties that are considered an environment risk before such properties are accepted as collateral, there remains a risk that hazardous or toxic substances will be found on properties, in which case we may be liable for remediation costs and related personal injury and property damage and the value of the property may be materially reduced. The costs and financial liabilities associated with property ownership could have a material adverse effect on our results of operations and financial condition.

Our common stock is not listed on a securities exchange and trading in our stock on the OTC Bulletin Board is limited, making it difficult for shareholders to sell shares in open-market transactions and may cause our stock price to be volatile.

Our common stock trades in very low trading volumes on the OTC Bulletin Board under the trading symbol "PFLC.OB." As a result, it may be difficult to liquidate your investment in our shares and can cause wide fluctuations in our stock price. Also, because of this lack of liquidity in the market for our common stock, the quoted price of our common stock from time to time may not reflect its fair value as would be determined in an active trading market.

Our directors and executive officers own a significant percentage of our common stock and this concentration of ownership could adversely affect our other shareholders.

Our directors and executive officers beneficially own approximately 13.2% of our common stock. As a result, these individuals could, as a group, exert a significant degree of influence over our management and affairs and over matters requiring shareholder approval, in addition to the influence they already have as directors and executive officers. This concentration of ownership may limit the ability of other shareholders to influence corporate matters and, as a result, we may take actions that our other shareholders do not view as beneficial. For example, this concentration of ownership could have the effect of delaying or preventing a change in control or otherwise discouraging a potential acquirer from attempting to obtain control of our company, which could limit your ability to sell your shares at a premium in connection with a merger or other transaction resulting in a change in control of our company.

We depend on the accuracy and completeness of information about customers and counterparties.

In deciding whether to extend credit or enter into other transactions, we may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports, and other financial information. We may also rely on representations of those customers, counterparties, or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports, or other financial information could cause us to enter into unfavorable transactions, which could have a material adverse effect on our financial condition and results of operations.

We rely on other companies to provide key components of our business infrastructure.

Third party vendors provide key components of our business infrastructure such as internet connections, network access and core application processing. While we have selected these third party vendors carefully, we do not control their actions. Any problems caused by these third parties, including as a result of their not providing us their services for any reason or their performing their services poorly, could adversely affect our ability to deliver products and services to our customers and otherwise to conduct our business. Replacing these third party vendors could also entail significant delay and expense.

ITEM 1.B. Unresolved Staff Comments

None.

ITEM 2. Properties

The Company's administrative offices are located in Aberdeen, Washington. The building located at 300 East Market Street is owned by the Bank and houses the main branch. The administrative offices of the Bank and the Company, which are leased from an unaffiliated third party, are located at 1101 S. Boone Street.

Pacific owns the land and buildings occupied by its sixteen branches in Grays Harbor, Pacific, Skagit, Whatcom and Wahkiakum Counties in Washington as well as Clatsop County in Oregon. The remaining locations operate in leased facilities, which are leased from unaffiliated third parties, except for one building leased from a limited liability company in which Lori Reece, a director appointed in February 2014, is a member. The aggregate monthly lease payment for all leased space is approximately \$48,000.

In addition to the land and buildings owned by Pacific, it also owns all of its furniture, fixtures and equipment, including data processing equipment. The net book value of the Company's premises and equipment was \$16,790,000 at December 31, 2013.

Management believes that the facilities are of sound construction and in good operating condition, are appropriately insured and are adequately equipped for carrying on the business of the Bank.

ITEM 3. Legal Proceedings

The Company and the Bank from time to time are party to various legal proceedings arising in the ordinary course of business. Management believes that there are no threatened or pending proceedings against the Company or the Bank that will have a material adverse effect on its business, financial condition or results of operations.

ITEM 4. Mine Safety Disclosures

None.

PART II

ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities

The Company's common stock is presently traded on the OTC Bulletin BoardTM under the trading 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. As a result, the trading prices of our common stock may not reflect the price that would result if our stock was actively traded at high volumes.

The following are high and low bid prices quoted on the OTC Bulletin Board during the periods indicated. The quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions:

	2013			2012		
	Estimated No. Shares Traded	High	Low	Estimated No. Shares Traded	High	Low
First Quarter	131,400	\$5.50	\$4.56	108,700	\$5.88	\$4.50
Second Quarter	92,300	\$6.50	\$5.42	188,600	\$4.75	\$4.13
Third Quarter	124,600	\$6.99	\$5.59	134,200	\$5.67	\$4.01
Fourth Quarter	83,900	\$6.75	\$6.40	102,500	\$4.25	\$3.69

As of December 31, 2013, there were approximately 1,041 shareholders of record of the Company's common stock. Computershare serves as the transfer agent for our common stock.

The Company's Board of Directors declared dividends on its common stock in December 2013 and 2012 in the amount of \$0.20 per share. The Board of Directors has adopted a dividend policy which is reviewed annually. There can be no assurance as to whether or when the Company will pay cash dividends again in the future.

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. Under Washington general corporate law as it applies to the Company, no cash dividend may be declared or paid if, after giving effect to the dividend, the Company would not be able to pay its liabilities as they become due or its liabilities exceed its assets. 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. Under Washington banking law as it applies to the Bank, no dividend may be declared or paid in amount greater than net profits then available, and after a portion of such net profits have been added to the surplus funds of the Bank.

Issuer Purchases of Equity Securities

In September 2012, the Company's board of directors approved a share repurchase program authorizing the purchase of up to 250,000 shares of its common stock. There were no purchases of common stock by the Company during the year ended December 31, 2013. The maximum number of shares that may yet be purchased under the plan is 250,000 at December 31, 2013.

ITEM 6. 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,				
	2013	2012	2011	2010	2009
Operations Data					
Net interest income	\$ 23,800	\$ 24,011	\$ 23,685	\$ 22,879	\$ 21,753
Provision (recapture) for credit losses	(450)	(1,100)	2,500	3,600	9,944
Non-interest income	9,955	9,391	7,614	8,451	7,025
Non-interest expense	29,502	28,417	25,648	26,400	29,691
Provision (benefit) for income taxes	972	1,300	333	(304)	(4,519)
Net income (loss)	\$ 3,731	\$ 4,785	\$ 2,818	\$ 1,634	\$ (6,338)
Net income (loss) per share:					
Basic ⁽¹⁾	\$ 0.37	\$ 0.47	\$ 0.28	\$ 0.16	\$ (0.74)
Diluted ⁽¹⁾	0.37	0.47	0.28	0.16	(0.74)
Dividends declared	2,036	2,024	—	—	—
Dividends declared per share ⁽¹⁾	0.20	0.20	—	—	—
Dividend payout ratio	55%	42%	—	—	—
Performance Ratios					
Interest rate spread	3.88%	4.20%	4.03%	3.88%	3.50%
Net interest margin ⁽²⁾	4.00%	4.34%	4.22%	4.10%	3.76%
Efficiency ratio ⁽³⁾	87.40%	85.08%	81.95%	84.26%	103.17%
Return on average assets	0.55%	0.75%	0.44%	0.25%	(0.96)%
Return on average equity	5.48%	7.28%	4.55%	2.77%	(11.63)%
Balance Sheet Data					
Total assets	\$705,039	\$643,594	\$641,254	\$644,403	\$668,626
Loans, net	496,307	438,838	463,766	455,064	471,154
Total deposits	607,347	548,243	548,050	544,954	567,695
Total borrowings	23,403	23,903	24,644	35,328	39,880
Shareholders' equity	67,137	66,721	63,270	59,769	57,649
Book value per share ⁽¹⁾⁽⁴⁾	6.63	6.59	6.25	5.90	5.70
Tangible book value per share ⁽¹⁾⁽⁵⁾	5.31	5.35	5.01	4.66	4.44
Equity to assets ratio	9.52%	10.37%	9.87%	9.28%	8.62%
Asset Quality Ratios					
Nonperforming loans to total loans	1.98%	3.37%	2.96%	2.15%	3.36%
Allowance for credit losses to total loans	1.65%	2.09%	2.34%	2.28%	2.30%
Allowance for credit losses to nonperforming loans	115.40%	61.92%	79.28%	106.18%	68.49%
Nonperforming assets to total assets	1.42%	3.08%	3.39%	2.57%	3.42%

(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.

ITEM 7. 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 in Part I of 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 three loan production offices 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, 2013, increased by \$61,445,000, or 9.6%, to \$705,039,000 compared to \$643,594,000 at the end of 2012. Increases in investments and loans were the primary contributors to overall asset growth, which were partially offset by decreases in interest bearing deposits in banks and loans held for sale. Total loans of \$504,666,000 at December 31, 2013, increased \$56,470,000, or 12.6%, compared to year-end 2012.
- The Bank remains well capitalized with a total risk-based capital ratio of 14.03% at December 31, 2013, compared to 16.22% at December 31, 2012. Tier one leverage ratio was 9.77% at December 31, 2013, compared to 10.69% at December 31, 2012. The asset growth mentioned above outpaced the growth in retained earnings during 2013, resulting in the decline in capital ratios.
- Non-performing assets ("NPAs") totaled \$10,014,000 at December 31, 2013, which represents 1.42% of total assets, a decrease from \$19,791,000 at December 31, 2012. The decrease is largely due to our continued focus on improving asset quality through proactive management of problem assets, which contributed to the decline in non-performing loans and OREO during the year. NPAs are concentrated in commercial real estate loans and related OREO, which total \$6,003,000, or 59.9%, of our NPAs.
- Demand deposits, savings, money market and certificates of deposits less than \$100,000, increased during 2013 by \$69,831,000, or 15.2%, to \$530,719,000 and comprise 87.4% of total deposits at year-end, driven by the Sterling branch acquisition, in addition to organic deposit growth. The organic increase in core deposits was mostly in commercial demand and money market accounts, coupled with an increase in public 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 41% at December 31, 2013, which translates into over \$288 million available to fund general operations and meet fluctuations in loans and deposits.

The following are significant components of the Company's results of operations for 2013 as compared to 2012.

- Net income for 2013 was \$3,731,000, or \$0.37 per diluted share, compared to net income of \$4,785,000, or \$0.47 per diluted share, in 2012.
- In 2013, return on average assets ("ROAA") and return on average equity ("ROAE") decreased to 0.55% and 5.48%, respectively, compared to 0.75% and 7.28%, respectively, in 2012. The reductions in ROAA and ROAE were primarily driven by a decrease in recapture of provision for credit losses, a decrease in net interest income and an increase in non-interest expense.
- Net interest income decreased to \$23,800,000 compared to \$24,011,000 in 2012. The Company experienced growth in loans and investments during the period. However, lower yields earned on these assets, due to competition and decreased reinvestment rates on securities, resulted in a decline in net interest income. Consequently, net interest margin for 2013 decreased 34 basis points to 4.00%, as compared to 4.34% in 2012.
- Provision for (recapture of) credit losses was (\$450,000) for 2013, compared to (\$1,100,000) for 2012. The recapture of prior provision in the current year is primarily the result of the continued overall improvement in credit quality, as evidenced by decreases in net charge-offs, non-performing loans and performing loans classified as substandard or worse. During 2012, the recapture was mostly due to the elimination of a \$1.7 million specific impairment reserve.
- Net charge-offs totaled \$549,000 during 2013 compared to \$669,000 in 2012. Loans classified as substandard or worse totaled \$12,763,000 at December 31, 2013, a decrease of \$8,931,000, or 41.2%, compared to \$21,694,000 one year ago.
- Non-interest income increased \$564,000, or 6.0%, to \$9,955,000 for 2013 primarily due to increases in gains on sale of loans, ATM/debit card fees and annuity commission income. While gains on sale of loans grew by \$113,000, or 2.2%, to \$5,171,000, this revenue source moderated during the latter portion of the period as increases in mortgage rates slowed refinance activity. ATM/debit card fees grew by \$113,000, or 24.2%, to \$581,000, due to growth in deposit account relationships and increased usage of this payment method by existing customers. Annuity commission revenue increased to \$303,000, up from \$17,000. The current year was the first full year these products were sold, having been introduced in late 2012.
- Non-interest expense increased \$1,085,000, or 3.8%, to \$29,502,000 for 2013. The increase is primarily attributable to increases in salaries and employee benefits and data processing and occupancy and equipment expenses associated with the acquisition of Sterling Bank branches in Oregon and Washington, the denovo opening of the Warrenton, Oregon branch and opening of loan production offices in Clark and Thurston Counties.

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 a return of recessionary economic conditions in the Company's market area.

According to the U.S. Bureau of Labor Statistics, the unemployment rate in Washington was 6.6% at December 31, 2013, compared to 7.6% in 2012 and 8.5% in 2011, and in Oregon the unemployment rate was 7.0% for 2013, compared to 8.4% in 2012 and 8.9% in 2011. These rates compare to the national unemployment rate of 6.7% at December 31, 2013. 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	2013	2012	2011
Clatsop	6.1%	7.6%	7.8%
Grays Harbor	11.6%	12.4%	13.5%
Pacific	10.5%	11.8%	11.9%
Skagit	8.1%	9.1%	10.2%
Wahkiakum	10.4%	12.2%	11.9%
Whatcom	6.4%	6.9%	8.1%

Excluding Whatcom County, all Washington counties in which the Company operates have unemployment rates greater than the state and national rates. In addition, the unemployment rate in Clatsop County is below the Oregon state and national rate. Overall, the unemployment rate in all our markets has steadily improved over the last three years.

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 to increase 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 15.2%, 26.6%, and 14.8% (Gardner Rpt), respectively, during 2013. However, home prices declined during 2013 in Grays Harbor and Whatcom counties by -10.9% and -5.1% (Gardner Rpt), respectively. We believe the decline was due primarily to the rise in mortgage interest rates experienced during 2013, impacting the prices buyers were willing to pay for housing in these markets. Home price growth continued in Skagit County, up 26.9%, due to differences in housing supply and demand within that market. Limited data is available on sales activity and sales prices for Pacific, Wahkiakum and Clatsop counties.

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 2014 are as follows:

- Grow loans and increase core 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.
- 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.
- Limit exposure to increasing interest rates. The majority of our loans are relatively short term in nature with interest rates tied to a market index such as the prime rate. The substantial majority of the fixed rate residential mortgage loans we originate are sold in the secondary market which reduces the interest rate and credit risk associated with fixed rate residential lending. The investment portfolio is made up of fixed and adjustable rate securities with duration less than five years.
- Continue to improve asset quality through proactive management of problem loans, monitoring existing performing loans, and selling of OREO properties.
- Successfully expand on the opportunities available to garner additional profitable banking relationships thorough our branches and loan production offices in Skagit, Thurston and Clark Counties due to continued merger-related market disruption in these markets. We will also look to grow our banking relationships in Oregon, capitalizing on our acquisition of two branches from Sterling Savings Bank and our newly opened branch in Warrenton, Oregon.

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, 2013, 2012, and 2011

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, 2013.

(dollars in thousands)	2013	Increase (Decrease) Amount	%	2012	Increase (Decrease) Amount	%	2011
Interest and dividend income	\$26,290	\$(1,205)	(4.4)	\$27,495	\$(1,823)	(6.2)	\$29,318
Interest expense	2,490	(994)	(28.3)	3,484	(2,149)	(38.2)	5,633
Net interest income	23,800	(211)	(0.9)	24,011	326	1.4	23,685
Provision for (recapture of) credit losses	(450)	(650)	(59.1)	(1,100)	(3,600)	(144.0)	2,500
Net interest income after provision for credit losses	24,250	(861)	(3.4)	25,111	3,926	18.5	21,185
Other operating income	9,955	564	6.0	9,391	1,777	23.3	7,614
Other operating expense	29,502	1,085	3.8	28,417	2,769	10.8	25,648
Income before income taxes	4,703	(1,382)	(22.7)	6,085	2,934	93.1	3,151
Income taxes	972	(328)	(25.2)	1,300	967	290.4	333
Net income	\$ 3,731	\$(1,054)	(22.0)	\$ 4,785	\$ 1,967	69.8	\$ 2,818

Net income. For the year ended December 31, 2013, net income was \$3,731,000 compared to \$4,785,000 in 2012. The decrease in net income for 2013 was primarily related to an increase in noninterest expenses associated with the expansion of loan production offices and assimilation of branches purchased from Sterling Savings Bank, which was offset partially by an increase in non-interest income from ATM/Debit card and annuity commission fee income. Net income was also impacted by a reduction in recapture of provision for loan losses as compared to the prior period. Net income of \$4,785,000 for 2012 was up from net income of \$2,818,000 for the year ended December 31, 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 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 continue to impact net interest margin in 2014.

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.

(dollars in thousands)	Year Ended December 31,								
	2013			2012			2011		
	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⁾	\$485,623	\$24,614	5.07%	\$479,036	\$25,953	5.42%	\$483,974	\$27,481	5.68%
Investment securities:									
Taxable	53,505	778	1.45	29,993	770	2.57	29,844	1,042	3.49
Tax-Exempt ⁽¹⁾	32,650	1,508	4.62	27,590	1,525	5.53	24,613	1,512	6.14
Total investment securities	86,155	2,286	2.65	57,583	2,295	3.99	54,457	2,554	4.69
Federal Home Loan Bank Stock	3,078	2	0.06	3,173	—	—	3,183	—	—
Federal funds sold and deposits in banks	38,848	114	0.29	32,089	84	0.26	38,535	92	0.24
Total earnings assets/interest income	\$613,705	\$27,016	4.40%	\$571,881	\$28,332	4.95%	\$580,149	\$30,127	5.19%
Cash and due from banks	11,636			10,751			10,280		
Premises and equipment (net)	15,831			14,753			15,065		
Other real estate owned	4,030			6,880			7,579		
Other assets	40,909			42,427			41,845		
Allowance for credit losses	(9,065)			(11,022)			(11,028)		
Total assets	\$677,046			\$635,670			\$643,890		
Liabilities and Shareholders' Equity									
Interest bearing liabilities:									
Deposits:									
Savings and interest-bearing demand	\$316,184	\$ (699)	0.22%	\$288,984	\$ (1,084)	0.38%	\$275,630	\$ (1,612)	0.58%
Time certificates	135,447	(1,321)	0.98	144,486	(1,798)	1.24	176,631	(3,031)	1.72
Total deposits	451,631	(2,020)	0.45	433,470	(2,882)	0.66	452,261	(4,643)	1.03
Short-term borrowings	304	(9)	2.96	2,697	(79)	2.93	6,885	(264)	3.84
Long-term borrowings	9,745	(214)	2.20	7,803	(217)	2.78	10,500	(333)	3.17
Secured borrowings	—	—	—	448	(20)	4.46	777	(41)	5.28
Junior subordinated debentures	13,403	(247)	1.84	13,403	(286)	2.13	13,403	(352)	2.63
Total borrowings	23,452	(470)	2.00	24,351	(602)	2.47	31,565	(990)	3.14
Total interest-bearing liabilities/Interest expense	\$475,083	\$ (2,490)	0.52%	\$457,821	\$ (3,484)	0.76%	\$483,826	\$ (5,633)	1.16%
Demand deposits	129,218			107,048			93,413		
Other liabilities	4,688			5,058			4,709		
Shareholders' equity	68,057			65,743			61,942		
Total liabilities and shareholders' equity	\$677,046			\$635,670			\$643,890		
Net interest income/spread⁽¹⁾		\$24,526	3.88%		\$24,848	4.20%		\$24,494	4.03%
Net interest income as a percentage of average earning assets									
Interest income			4.40%			4.95%			5.19%
Interest expense			0.40%			0.61%			0.97%
Net interest margin⁽²⁾			4.00%			4.34%			4.22%
Tax equivalent adjustment ⁽¹⁾		\$ 726			\$ 837			\$ 809	

(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 \$547,000, \$569,000, and \$480,000 in 2013, 2012, and 2011, respectively.

The net interest margin decreased to 4.00% for the year ended December 31, 2013, down from 4.34% in the prior year. Net interest income for the year ended December 31, 2013 decreased \$211,000, or 0.9%. While the Company generated an increase in the volume of both loans and investment securities, the yields earned on these assets declined as compared to 2012. Competitive demand for credit worthy borrowers, along with Federal Reserve Bank's continued effort to keep interest rates low, negatively impact yields in the current period. This was partially offset by an improvement in funding costs, a change in the mix of deposits with a greater concentration in demand and savings accounts than higher cost certificates of deposits. The average cost of funds decreased to 0.52% at December 31, 2013 from 0.76% one year ago, which was only partially offset by a decline in the Company's average yield earned on assets from 4.95% for year ended December 31, 2012 to 4.40% for the current year. In 2012, decreasing levels of nonperforming loans placed on nonaccrual status positively affected our net interest margin which improved to 4.34% from 4.22% in 2011.

Net interest income on a tax equivalent basis totaled \$24,526,000 for the year ended December 31, 2013, a decrease of \$322,000, or 1.3%, compared to 2012. Net interest income on a tax equivalent basis increased 1.4% to \$24,848,000 in 2012 compared to 2011. The Company's tax equivalent interest income decreased 4.6% to \$27,016,000 in 2013, from \$28,332,000 in 2012 and \$30,127,000 in 2011. The decline from 2012 is associated with competitive loan environment and general interest rate conditions mentioned above. The increase in net 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, 2013, increased to \$38.8 million with an average yield of 0.29% compared to \$32.1 million with an average yield of 0.26% for the same period in 2012. Net interest margin continued to be negatively affected in 2013 and 2012 by the relatively low yields earned by balances used to support the bank's short-term liquidity needs. 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 increased \$6,587,000, or 1.4%, from year end 2012 to year end 2013, and decreased \$4,938,000, or 1.0%, from 2011 to 2012. Current period growth was generated primarily in the commercial and industrial and commercial real estate sectors, as well as one-to-four-unit residential investment properties. The decrease in 2012 is due to decreases in construction and land development loans and commercial real estate loans. Overall, loan demand is beginning to increase as the economy slowly improves and consolidations in the industry have provided opportunities to garner additional business from larger financial institutions.

The Company's average investment portfolio increased \$28,572,000, or 49.6%, from 2012 to 2013, and increased \$3,126,000, or 5.7%, from 2011 to 2012. Interest and dividend income on investment securities for the year ended December 31, 2013, on a tax-equivalent basis, decreased \$55,000, or 5.2%, compared to the same period in 2012. The average tax equivalent yield on investment securities decreased to 2.65% at December 31, 2013, from 3.99% at December 31, 2012 and 4.69% at year-end 2011. The decrease in 2013 and 2012 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. Additionally, new securities purchases during 2013 are at substantially lower yields than existing bonds in the portfolio.

The Company's average interest-bearing deposits increased \$18,161,000, or 4.2%, from 2012 to 2013, and decreased \$18,791,000, or 4.2%, in 2012 from 2011. The Company attributes the increase in 2013 primarily to the acquisition of branches from Sterling Savings Bank, which was offset by planned runoff of higher cost certificates of deposits. The Company attributes the decrease in 2012 to the planned runoff of higher cost certificates of deposits, 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 2013 by \$899,000, or 3.7%, and decreased by \$7,214,000, or 22.9%, during 2012. The decrease in average borrowing balances outstanding in 2012 was 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.

Interest expense for the year ended December 31, 2013, decreased \$994,000, or 28.5%, compared to the same period in 2012. During 2012, interest expense declined \$2,149,000, or 38.2%, compared to 2011. While interest rates paid on our deposits decreased significantly during 2012, the decline in rates paid in 2013 moderated as opportunities to reduce deposit rates diminished due to fewer opportunities to reprice higher cost certificates of deposits. Additionally, average balances of higher cost certificates and other borrowings decreased during both periods. The average rate paid on deposits declined to 0.45% in 2013 compared to 0.66% in 2012 and 1.03% in 2011. The opportunity for continued downward repricing of maturing certificates of deposits has diminished. For the next twelve months, the amount of certificates maturing is \$65,367,000 at a weighted average rate of 0.59%. 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 0.52% in 2013 from 0.76% and 1.16% in 2012 and 2011, 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.

(dollars in thousands)	2013 compared to 2012 Increase (decrease) due to			2012 compared to 2011 Increase (decrease) due to		
	Volume	Rate	Net	Volume	Rate	Net
Interest earned on:						
Loans	\$ 353	\$(1,692)	\$(1,339)	\$(278)	\$(1,250)	\$(1,528)
Securities:						
Taxable	435	(427)	8	5	(277)	(272)
Tax-exempt	255	(272)	(17)	173	(160)	13
Total securities	911	(920)	(9)	178	(437)	(259)
Fed funds sold and interest bearing						
deposits in other banks	19	11	30	(16)	8	(8)
Total interest earning assets	1,062	(2,380)	(1,318)	(116)	(1,679)	(1,795)
Interest paid on:						
Savings and interest bearing demand						
deposits	(94)	479	385	75	(603)	(528)
Time deposits	107	370	477	(491)	(742)	(1,233)
Total borrowings	22	110	132	(201)	(187)	(388)
Total interest bearing liabilities	34	960	994	(617)	(1,532)	(2,149)
Change in net interest income	\$1,097	\$(1,421)	\$ (324)	\$ 501	\$ (147)	\$ 354

Non-Interest Income. Non-interest income was \$9,955,000 for 2013, an increase of \$564,000, or 6.0%, from 2012 when it totaled \$9,391,000. Categories contributing to the increase during 2013 compared to 2012 were increases in non-interest income from ATM/Debit card and annuity commission fee income and a reduction in OTTI losses, which were partially offset by a decrease in gain on sale of OREO. Non-interest income was \$9,391,000 during 2012, an increase of \$1,777,000, or 23.3%, compared to the 2011 total of \$7,614,000 due to increases in gains on sale of loans and OREO.

The following table represents the principal categories of non-interest income for each of the years in the three-year period ended December 31, 2013.

(dollars in thousands)	2013	Increase (Decrease) Amount	%	2012	Increase (Decrease) Amount	%	2011
Service charges on deposit Accounts . .	\$1,731	\$ 45	2.7	\$1,686	\$ (113)	(6.3)	\$1,799
Net gain (loss) on sale of other real estate owned	40	(291)	(87.9)	331	414	498.8	(83)
Net gains on sales of loans	5,171	113	2.23	5,058	1,465	40.8	3,593
Net gain (loss) on sales of Securities . .	405	102	33.7	303	(395)	(56.6)	698
Net OTTI losses	(37)	296	(88.9)	(333)	(3)	(0.9)	(330)
Earnings on bank owned life							
Insurance	452	(58)	(11.4)	510	(17)	(3.2)	527
Other operating income	2,193	357	19.4	1,836	426	30.2	1,410
Total non-interest income	<u>\$9,955</u>	<u>\$ 564</u>	<u>6.0</u>	<u>\$9,391</u>	<u>\$1,777</u>	<u>23.3</u>	<u>\$7,614</u>

Service charges on deposits increased \$45,000, or 2.7%, during 2013 due to growth in core deposits, primarily due to the acquisition of the Sterling Savings Bank branches. 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. 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 2014.

The Company sells 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 \$5,171,000 for the year ended December 31, 2013, compared to \$5,058,000 for the same period in 2012. This increase in income during the current year was due to increased mortgage refinancing activity driven by the low rate environment and recovering housing market, particularly earlier in the year. Originations of loans held for sale were \$225,068,000 for the year ended December 31, 2013, compared to \$251,435,000 for the same period in 2012. Also contributing to the growth in volume was the addition of origination staff during 2012. However, management expects gain on sale of loans to decline in 2014 due to its expectation that the low interest rates experienced prior to the latter part of 2013, which had spurred an increase in refinance activity, will not return, and is making adjustments to its operations accordingly.

The Bank continues to have success in liquidating OREO properties. As a result, net gain on sale of OREO totaled \$40,000 on twenty-one properties sold during 2013 compared to a net gain on sale of OREO of \$331,000 for the year ended December 31, 2012.

The Bank recorded net gains on sale of securities available-for-sale of \$405,000, \$303,000 and \$698,000, for the years ended December 31, 2013, 2012 and 2011, respectively. During each of these years, one non-agency mortgage-backed security was determined to be other-than-temporarily-impaired resulting in the Company recording \$37,000, \$333,000, and \$330,000, respectively, in impairment charges related to credit losses through earnings. There were no additional OTTI securities at December 31, 2013 or December 31, 2012.

Other operating income totaled \$2,193,000 in 2013, an increase of \$357,000 from 2012, or 19.4%, due primarily to increases in wire fees, check cashing fees, debit card interchange revenue, and annuity commission revenue. Other operating income grew to \$1,836,000 in 2012, an increase of \$426,000 from the previous year, due primarily to growth in gains on sale of OREO and residential mortgage loans, offset by a decrease in gains on sale of securities.

Non-Interest Expense. Total non-interest expense in 2013 was \$29,502,000, an increase of \$1,085,000, or 3.8%, compared to \$28,417,000 in 2012. Contributing to this increase in non-interest expense were costs associated with integration of the three coastal branches acquired from Sterling Savings Bank early in 2013. The effect of these increases was partially mitigated by decreases in FDIC insurance assessments, expenses related to other-real-estate-owned and other related costs. In 2012, non-interest expense increased \$2,769,000, or 10.8%, compared to \$25,648,000 in 2011. The increase in 2012 was mostly related to 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.

The following table shows the principal categories of non-interest expense for each of the years in the three-year period ended December 31, 2013.

(dollars in thousands)	2013	Increase (Decrease) Amount	%	2012	Increase (Decrease) Amount	%	2011
Salaries and employee benefits . . .	\$17,013	\$ 798	4.9	\$16,215	\$2,492	18.2	\$13,723
Occupancy and equipment	2,699	225	9.1	2,474	(60)	(2.4)	2,534
State taxes	458	(60)	(11.6)	518	45	9.5	473
Data processing	2,268	661	41.1	1,607	192	13.6	1,415
Professional services	935	185	24.7	750	11	1.5	739
FDIC and state assessments	535	(75)	(12.3)	610	(328)	(35.0)	938
OREO write-downs	946	(368)	(28.0)	1,314	265	25.3	1,049
OREO operating expenses	408	(142)	(25.8)	550	100	22.2	450
Marketing and advertising	393	(48)	(10.9)	441	(82)	15.7	523
Other expense	3,847	(91)	(2.3)	3,938	134	3.5	3,804
Total non-interest expense	<u>\$29,502</u>	<u>\$1,085</u>	<u>3.8</u>	<u>\$28,417</u>	<u>\$2,769</u>	<u>10.8</u>	<u>\$25,648</u>

Salary and employee benefits costs, which are the largest component of non-interest expense, increased by \$798,000, or 4.9%, in 2013 to \$17,013,000 and increased by \$2,492,000, or 18.2%, in 2012 compared to 2011. The increase in 2013 is largely attributable to increases in commissions paid on the sale of loans held for sale as part of increased residential mortgage loan production during the first part of the year, and increases in loan production personnel which tend to be more highly compensated. Additionally, annual performance and merit increases coupled with a 3.0% increase in medical insurance premiums also contributed to the increase in salaries and benefits for 2013. Employees hired for the loan production offices and acquired branches were more than offset by reductions in other positions throughout the Company. 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. Additionally, increases in incentive compensation and an 11.0% increase in medical insurance also contributed to the increase in salaries and benefits for 2012. Full time equivalent employees at December 31, 2013, were 234, a decrease from 237 at December 31, 2012, and an increase from 213 at December 31, 2011. Also included in salaries and benefits for 2013 and 2012 was stock compensation expense of \$117,000 and \$24,000, respectively. For more information regarding stock options, see Note 16 — “Stock Based Compensation” to the Company’s audited consolidated financial statements included in Item 15 of this report.

Occupancy and equipment expenses increased/(decreased) \$225,000 and \$(60,000) to \$2,699,000 and \$2,474,000, respectively, in 2013 and 2012 compared with \$2,534,000 for 2011. The increase in 2013 was associated primarily with the branch acquisitions noted above. The decline in 2012 was due primarily to reductions in depreciation expense, building repair and maintenance, and annual equipment hardware maintenance.

Data processing expense increased \$661,000, or 41.1%, in 2013 compared to 2012 due mostly to the one-time conversion expenses and increased account processing costs associated with the aforementioned branch acquisitions. Data processing expense increased \$192,000, or 13.6%, in 2012 compared to 2011. The increase in 2012 was due mostly to the investment in technology for mobile apps, contact management software, compliance management software and enhanced financial monitoring tools. 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 \$535,000 in 2013 compared with \$610,000 in 2012 and \$938,000 in 2011. The decreases in 2013 and 2012 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 decreased \$510,000, or 27.4%, during 2013 compared to 2012 due to a decrease in the number of OREO properties held during the year. OREO write-downs and operating costs increased in 2012 by \$365,000 which was due to an increase in the number of OREO properties held during the year and valuation adjustments arising out of decreases in land and commercial real estate values.

Marketing and advertising expense decreased by \$48,000, or 10.9%, in 2013 compared to \$441,000 in 2012. The decrease was due to reductions in corporate donations and print advertising, which was partially offset by promotional expenses associated with our branch expansion. Marketing and advertising expense decreased by 15.7% to \$441,000 in 2012 compared with \$523,000 in 2011 due reduction in the number of sponsorships, coupled with better allocation of marketing dollars dedicated to print and radio advertising. The Company anticipates the marketing and advertising expense will increase in 2014 as the Company promotes heightened brand awareness particularly in its new markets in Vancouver and DuPont, Washington, and Astoria and Seaside, Oregon.

Other operating expense decreased 2.3% to \$3,847,000 in 2013 compared with \$3,938,000 for 2012, primarily due to small decreases in a broad range of categories with the most notable in credit card expenses and education and training. Other operating expense increased 3.5% to \$3,938,000 in 2012 compared with \$3,804,000 in 2011, primarily due 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.

Income Taxes. For the years ended December 31, 2013, 2012, and 2011, income taxes totaled \$972,000, \$1,300,000 and \$333,000, respectively, representing effective tax rates of 20.7%, 21.4% and 10.6%, respectively. The effective tax rate differs from the statutory rate of 34.6% due to tax exempt income from investments in municipal securities and loans, income earned on BOLI, and tax credits received on investments in low income housing partnerships.

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, 2013 and 2012, the Company had a net deferred tax asset of \$4,546,000 and \$4,013,000, respectively.

See “Critical Accounting Policies” in this section below.

FINANCIAL CONDITION

At December 31, 2013 and 2012

Total assets were \$705,039,000 at December 31, 2013, an increase of \$61,445,000, or 9.6%, over year-end 2012. Increases in investment securities and loans were the primary contributors to overall asset growth, which were partially offset by a decrease in cash and cash equivalents, loans held for sale and OREO.

Cash and Cash Equivalents

Total cash and cash equivalents decreased to \$38,675,000 at December 31, 2013, from \$59,840,000 at December 31, 2012, due to increased lending through new loan production offices and deployment of 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 \$30,232,000, or 44.4%, during 2013 to \$98,276,000 due to investment in municipal, government agency and mortgage-backed securities from proceeds received from the Sterling branch acquisition. 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 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, 2013, the Company owned 20 securities in a continuous unrealized loss position for twelve months or longer, with an amortized cost of \$13,219,000 and fair value of \$12,348,000. These securities that have been in a continuous unrealized loss position for twelve months or longer at December 31, 2013, 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, 2013. For more information regarding our investment securities and analysis of the value of securities in our investment portfolio, see Note 3 — "Securities" and Note 18 — "Fair Value of Financial Instruments" to the Company's audited consolidated financial statements included in Item 15 of this report.

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

(dollars in thousands)			
Held to Maturity			
	2013	2012	2011
State and municipal securities	\$1,973	\$6,716	\$6,732
Mortgage-backed securities	159	221	293
Total	\$2,132	\$6,937	\$7,025
Available For Sale			
	2013	2012	2011
U.S. Government agency securities	\$ 8,811	\$ 5,952	\$ 84
State and municipal securities	32,160	26,906	22,859
Mortgage-backed securities	54,191	24,703	22,797
Corporate bonds	982	3,545	1,912
Total	\$96,144	\$61,106	\$47,652

The following table presents the maturities of investment securities at December 31, 2013. Taxable equivalent values are used in calculating yields assuming a tax rate of 34%.

(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
Held To Maturity					
State and municipal securities	\$ 190	\$—	\$ 914	\$ 869	\$1,973
Weighted average yield	6.02%	—	6.36%	6.57%	
Mortgage-backed securities	—	—	113	46	159
Weighted average yield	—	—	5.22%	6.17%	—
Total	\$ 190	\$—	\$1,027	\$ 915	\$2,132
Available For Sale					
U.S. Agency securities	\$1,021	\$ 6,690	\$ 61	\$ 1,039	\$ 8,811
Weighted average yield	0.33%	1.14%	8.16%	2.80%	
State and municipal securities	462	5,768	8,821	17,109	32,160
Weighted average yield	5.43%	2.74%	3.92%	4.57%	
Mortgage-backed securities	—	1,940	11,220	41,031	54,191
Weighted average yield	—	1.76%	1.98%	1.95%	
Corporate bonds	—	982	—	—	982
Weighted average yield	—	1.00%	—	—	—
Total	\$1,483	\$15,380	\$20,102	\$59,179	\$96,144

Loan Portfolio

General. Total loans were \$512,431,000 at December 31, 2013, an increase of \$51,285,000, or 11.1%, compared to December 31, 2012. The increase in total loans was driven primarily by growth in several loan categories, notably commercial and agricultural, multi-family, commercial real estate and installment loans. While competition for commercial loans in the markets we serve is strong, loan demand is beginning to grow. In addition, recent merger and acquisition activity in our market area by larger institutions has enabled the Bank to acquire commercial relationships that desire to deal with a local community bank. Management expects the loan portfolio will continue to grow in 2014, 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)	2013	2012	2011	2010	2009
Commercial and agricultural	\$104,111	\$ 87,278	\$ 90,731	\$ 84,575	\$ 93,125
Construction, land development and other land loans	29,096	31,411	47,156	46,256	64,812
Residential real estate 1 – 4 family . . .	95,527	90,447	90,552	89,212	91,821
Multi-family	17,520	7,744	7,682	9,113	8,605
Farmland	23,698	24,544	23,752	22,354	22,824
Commercial real estate	222,888	212,797	221,474	216,015	205,184
Installment	18,160	5,465	6,772	7,029	7,216
Credit cards and overdrafts	2,568	2,317	2,156	2,099	1,929
Less unearned income	(1,137)	(857)	(841)	(828)	(881)
Total	<u>\$512,431</u>	<u>\$461,146</u>	<u>\$489,434</u>	<u>\$475,825</u>	<u>\$494,635</u>

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 73% and 72% of total assets as of December 31, 2013 and 2012, 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 5.7% and 6.8% of total loans outstanding at December 31, 2013 and 2012, respectively. We believe this segment will remain challenged into 2014, although to a lesser extent than in previous 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, 2013, concentration in land and residential construction as a percentage of risk based capital was 40.1% and total concentration in non-owner occupied commercial real estate plus land and residential construction as a percentage of risk-based capital stood at 230.7%.

Loan Maturities and Sensitivity in Interest Rates. The following table presents information related to maturity distribution and interest rate sensitivity of loans outstanding (excluding residential mortgages held for sale), based on scheduled repayments at December 31, 2013.

(dollars in thousands)	Due in one year or less	Due after one through five years	Due after five years	Total
Commercial	\$ 55,033	\$ 22,814	\$ 8,368	\$ 86,215
Construction, land development and other land loans	18,201	16,264	77	34,542
Residential real estate 1 – 4 family	47,564	41,436	7,001	96,001
Multi-family	717	6,105	10,698	17,520
Farmland	9,489	8,254	251	17,994
Commercial real estate	97,824	134,693	758	233,275
Installment	3,435	7,881	6,549	17,865
Credit cards and overdrafts	2,396	—	—	2,236
Total	\$234,659	\$237,447	\$33,702	\$505,808
Less unearned income				(1,137)
Total loans				<u>\$504,671</u>
Total loans maturing after one year with				
Predetermined interest rates (fixed)		\$ 55,100	\$20,230	\$ 75,330
Floating or adjustable rates (variable)		182,347	13,675	196,022
Total		\$237,447	\$33,702	<u>\$271,149</u>

At December 31, 2013, 46.8% of the total loan portfolio was due in one year or less, up from 40.9% at December 31, 2012. This increase is part of management's efforts to mitigate the Company's interest rate risk in the near term.

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 \$10,014,000 at December 31, 2013. This represents 1.42% of total assets, compared to \$19,791,000, or 3.08%, at December 31, 2012, and \$21,760,000, or 3.39%, at December 31, 2011. Commercial real estate loans are the primary component of non-performing assets, representing \$6,003,000, or 59.9%, 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)	2013	2012	2011	2010	2009
Accruing loans past due 90 days or more	\$ —	\$ —	\$ 299	\$ —	\$ 547
Non-accrual loans:					
Construction, land development and other land loans	1,408	1,792	5,510	5,529	9,886
Residential real estate 1-4 family	400	800	528	2,246	1,323
Multi-family real estate	—	—	—	—	353
Commercial real estate ⁽⁴⁾	4,141	9,642	7,168	803	2,949
Farmland	955	976	—	170	87
Commercial	286	1,901	530	1,251	1,049
Installment	53	1	—	—	—
Total non-accrual loans⁽¹⁾	7,243	15,112	13,736	9,999	15,647
Total non-performing loans	7,243	15,112	14,035	9,999	16,194
OREO:					
Construction, land development and other land loans	237	1,860	4,150	4,043	4,850
Residential real estate 1 – 4 family	672	507	1,427	540	220
Commercial real estate	1,862	2,312	2,148	1,997	1,595
Total OREO	2,771	4,679	7,725	6,580	6,665
Total non-performing assets⁽²⁾	\$10,014	\$19,791	\$21,760	\$16,579	\$22,859
Troubled debt restructured loans on accrual status . . .	\$ 2,680	\$ 444	\$ 398	\$ —	\$ —
Allowance for credit losses	\$ 8,359	\$ 9,358	\$11,127	\$10,617	\$11,092
Allowance to non-performing loans	115.41%	61.92%	79.28%	106.18%	68.49%
Allowance to non-performing assets	83.47%	47.28%	51.14%	64.04%	48.52%
Non-performing loans to total loans ⁽³⁾	1.44%	3.37%	2.96%	2.15%	3.36%
Non-performing assets to total assets	1.42%	3.08%	3.39%	2.57%	3.42%

(1) Includes \$1,408,000, \$3,930,000, \$7,734,000 and \$932,000 in non-accrual troubled debt restructured loans (“TDRs”) as of December 31, 2013, 2012, 2011 and 2010, respectively, which are also considered impaired loans. There were no TDRs as of December 31, 2009.

(2) Does not include TDRs on accrual status.

(3) Excludes loans held for sale

(4) Includes one loan totaling \$1,831,000 at December 31, 2013 of which \$1,465,000 is guaranteed by the United States Department of Agriculture.

Non-performing loans decreased \$7,869,000, or 52.1%, from the balance at December 31, 2012 due to decreases in all non-accrual loan categories except installment. The decline in non-accrual commercial real estate is primarily the result of partial or full payoffs totaling \$3,389,000 from six borrowing relationships. The decrease in non-accrual commercial is made up primarily of a partial payoff of one loan relationship totaling \$1,446,000. The level of non-performing loans reflects recent improvements in the real estate market and economy in our region. OREO decreased by \$1,908,000, or 40.8%, from the balance at December 31, 2012. Six properties, primarily residential real estate totaling \$1,756,000, were taken into OREO during the year. However, twenty properties totaling \$2,753,000 were liquidated in the period, most of which were commercial real estate.

Non-performing loans at December 31, 2012 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 in 2012 was made up primarily of one loan totaling \$1,587,000.

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 2013 is equal to 1.44% of total loans, excluding loans held for sale, compared to 3.37% at December 31, 2012. 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 1.4% and 2.4% of total loans outstanding at December 31, 2013 and 2012, respectively.

The Company had troubled debt restructures totaling \$4,088,000, \$4,374,000, and \$8,132,000 at December 31, 2013, 2012 and 2011, 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 in Item 15 of this report.

Interest income on non-accrual loans that would have been recorded had those loans performed in accordance with their initial terms was \$1,130,000, \$1,213,000 and \$752,000 for 2013, 2012, and 2011, respectively. Interest income recognized on impaired loans was \$177,000, \$226,000 and \$255,000 for 2013, 2012, and 2011, 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 2013 and 2012, as a result of these appraisals and other factors, the Company recorded OREO write-downs of \$946,000 and \$1,314,000, respectively. The Company will continue to reevaluate non-performing assets over the coming months as market conditions change.

OREO at December 31, 2013 totaled \$2,771,000 and includes: five land or land development properties totaling \$237,000; eight commercial real estate properties totaling \$1,862,000; and four single family residences collectively valued at \$672,000. 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, 2013, loans secured by real estate totaled \$380,964,000, which represents 75.5% of the total loan portfolio. Real estate construction loans comprised \$29,096,000 of that amount, while real estate loans secured by residential properties totaled \$87,762,000. 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" under Item 1A of this report.

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, 2013, based upon charge-off experience and other factors considered by management, the loss factors used in the allowance for credit losses were updated from 0.50% to 0.40% on pass rated commercial loans, from 0.50% to 0.40% on non owner-occupied commercial real estate loans, and from 0.60% to 0.55% on owner-occupied commercial real estate. Loss factors for land and land development loans, speculative residential construction, residential real estate, personal lines of credit and other consumer loans remained unchanged. As a result, the estimate for the allowance for credit losses decreased. See “Critical Accounting Policies” in this section below, as well as “Risk Factors” under Item 1A. above.

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

<u>(dollars in thousands)</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>
Balance at beginning of year	\$9,358	\$11,127	\$10,617	\$11,092	\$ 7,623
Charge-offs:					
Construction and land development	26	348	790	1,891	4,687
Residential real estate 1-4 family	453	576	665	1,518	940
Commercial real estate	64	479	1,215	164	505
Commercial	131	67	161	469	238
Credit card	80	17	38	38	80
Installment	74	292	55	81	74
Total charge-offs	828	1,779	2,924	4,161	6,524
Recoveries:					
Construction and land development	7	896	630	2	—
Residential real estate 1 – 4 family	14	162	107	48	2
Commercial real estate	219	21	120	17	17
Commercial	36	23	69	13	17
Credit card	0	5	3	3	4
Installment	3	3	5	3	9
Total recoveries	279	1,110	934	86	49
Net charge-offs	549	669	1,990	4,075	6,475
Provision for (recapture of) credit losses	(450)	(1,100)	2,500	3,600	9,944
Balance at end of year	<u>\$8,359</u>	<u>\$ 9,358</u>	<u>\$11,127</u>	<u>\$10,617</u>	<u>\$11,092</u>
Ratio of net charge-offs to average loans outstanding	0.11%	0.14%	0.41%	0.84%	1.29%

During the year ended December 31, 2013, provision for (recapture of) credit losses totaled (\$450,000) compared to (\$1,100,000) and \$2,500,000 for the same periods in 2012 and 2011, respectively. The recapture of prior provision in the current year is primarily the result of the continued overall improvement in credit quality, as evidenced by decreases in net charge-offs, non-performing loans and performing loans classified as substandard or worse. During 2012, the recapture of provision was mostly due to the elimination of a \$1.7 million specific impairment reserve as a result of a favorable ruling with respect to a government guaranty. Net charge-offs totaled \$549,000 for the twelve months ended December 31, 2013, compared to \$669,000 for the same period in 2012, and loans classified as substandard decreased \$8,655,000, or 40.4%, from year end 2012 to \$12,763,000 at December 31, 2013.

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 \$8,359,000 at December 31, 2013, compared with \$9,358,000 at December 31, 2012, a decrease of \$999,000, or 10.7%. The decrease in 2013 is due to a decrease in classified loans and estimated loss factors used in determining the allowance for credit losses due to improving credit quality metrics and economic conditions discussed above. The allowance for credit losses decreased to \$9,358,000 at year-end 2012 compared to \$11,127,000 at year-end 2011. 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 ratio of the allowance for credit losses to total loans outstanding (excluding loans held for sale) was 1.66%, 2.09% and 2.34% at December 31, 2013, 2012 and 2011, 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 \$37,823,000 and \$49,966,000 at December 31, 2013 and 2012, respectively. The ratio of the allowance for credit losses to total loans outstanding excluding the government guaranteed loans was 1.76% and 2.35%, 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 \$8,359,000 to be adequate at December 31, 2013.

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)	2013	2012	2011	2010	2009
Total impaired loans	\$9,922	\$14,784	\$14,432	\$14,673	\$25,738
Total impaired loans with valuation allowance . . .	—	—	4,498	508	2,962
Valuation allowance related to impaired loans . . .	—	—	2,032	142	638

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)	2013 Reserve	% of Total Loans*	2012 Reserve	% of Total Loans*	2011 Reserve	% of Total Loans*	2010 Reserve	% of Total Loans*	2009 Reserve	% of Total Loans*
Commercial loans	\$ 775	19%	\$ 923	19%	\$ 1,012	18%	\$ 816	18%	\$ 1,308	19%
Real estate loans	4,181	79%	4,927	79%	7,849	80%	7,139	80%	8,341	79%
Consumer loans	744	2%	531	2%	642	2%	690	2%	260	2%
Unallocated	2,659	—	2,977	—	1,624	—	1,972	—	1,183	—
Total allowance	<u>\$8,359</u>	<u>100%</u>	<u>\$9,358</u>	<u>100%</u>	<u>\$11,127</u>	<u>100%</u>	<u>\$10,617</u>	<u>100%</u>	<u>\$11,092</u>	<u>100%</u>
Ratio of allowance for credit losses to loans outstanding at end of year		1.66%		2.09%		2.34%		2.28%		2.30%

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

The table indicates decreases of \$148,000 and \$746,000 during 2013 in the portion of the allowance related to commercial and real estate loans, respectively, which were partially offset by an increase in the portion related to consumer loans. The significant decline in 2013 in the commercial, real estate and unallocated portions of the reserve is due to the reduction in loss factors associated with these loan categories and the overall improvement in credit quality as previously mentioned. The increase in the allowance related to consumer loans resulted from a growth in loans in this sector during 2013. The significant decline in 2012 in the real estate portion of the reserve is due to the elimination of a \$1.7 million impairment reserve.

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 as loan demand improves within our markets.

Deposit detail by category as of December 31, 2013, 2012 and 2011, respectively, follows:

<u>(dollars in thousands)</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>
Demand, non-interest bearing	\$145,028	\$115,138	\$108,899
Interest bearing demand (NOW)	144,221	125,758	122,160
Money market deposits	118,627	106,849	99,031
Savings deposits	73,412	62,493	65,451
Time, interest bearing (CDs)	<u>126,059</u>	<u>138,005</u>	<u>152,509</u>
Total	<u>\$607,347</u>	<u>\$548,243</u>	<u>\$548,050</u>

Total deposits increased to \$607,347,000 at December 31, 2013 compared to 2012. 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 \$29,890,000, or 26.0%, mostly in commercial and public demand accounts. The increase in NOW accounts of \$18,463,000 and money market accounts of \$11,778,000 was attributable to an increased emphasis on growing our customer base in non-maturity deposit products instead of higher cost CDs. Growth in all categories was also the result of the acquisition of Sterling Savings Bank branches in second quarter 2013, representing \$37,636,000 in deposits. 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 \$11,946,000, or 8.7%, to \$126,059,000 at December 31, 2013.

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 again attributable to an increased emphasis on growing our customer base in non-maturity deposit products. CDs decreased \$14,504,000, or 9.5%, to \$138,005,000 at December 31, 2012.

Brokered deposits, excluding CDARS, totaled \$17,788,000, \$19,239,000 and \$13,000,000 at December 31, 2013, 2012 and 2011, respectively. The Bank increased brokered deposits during 2013 and 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. 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 23.9%, 21.0% and 19.9% at December 31, 2013, 2012 and 2011, 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.

(dollars in thousands)	2013		2012		2011	
	Average Deposits	Rate	Average Deposits	Rate	Average Deposits	Rate
Non-interest bearing demand Deposits . . .	\$129,218	0.00%	\$107,048	0.00%	\$ 93,413	0.00%
Interest bearing demand deposits	131,179	0.30%	120,472	0.48%	113,399	0.72%
Savings and money market deposits	185,005	0.27%	168,512	0.30%	162,231	0.49%
Time deposits	135,447	0.98%	144,486	1.24%	176,631	1.72%
Total	<u>\$580,849</u>	<u>0.35%</u>	<u>\$540,518</u>	<u>0.53%</u>	<u>\$545,674</u>	<u>0.85%</u>

Maturities of time certificates of deposit as of December 31, 2013 are summarized as follows:

(dollars in thousands)	Under \$100,000	Over \$100,000	Total
3 months or less	\$11,616	\$ 9,145	\$ 20,761
Over 3 through 6 months	8,681	7,858	16,539
Over 6 through 12 months	10,488	17,578	28,066
Over 12 months	18,664	42,029	60,693
Total	<u>\$49,449</u>	<u>\$76,610</u>	<u>\$126,059</u>

Short-Term Borrowings

The following is information regarding the Company's short-term borrowings for the years ended December 31, 2013, 2012 and 2011.

(dollars in thousands)	2013	2012	2011
Amount outstanding at end of period	\$ —	\$3,000	\$ —
Weighted average interest rate thereon	—%	2.94%	—%
Maximum month-end balance during the year	3,000	3,000	10,500
Average balance during the year	303	2,697	6,885
Average interest rate during the year	2.94%	2.94%	3.84%

CONTRACTUAL OBLIGATIONS

The Company is party to many contractual financial obligations at December 31, 2013, 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.

Contractual obligations	Payments due by Period				Total
	Less than 1 year	1 – 3 years	3 – 5 years	More than 5 years	
Operating leases	\$ 461	\$ 785	\$ 157	\$ —	\$ 1,403
Total deposits	546,655	45,846	14,122	724	607,347
Federal Home Loan Bank borrowings	—	10,000	—	—	10,000
Junior subordinated debentures	—	—	—	13,403	13,403
Total long-term obligations	<u>\$547,116</u>	<u>\$56,631</u>	<u>\$14,279</u>	<u>\$14,127</u>	<u>\$632,153</u>

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:

	<u>2013</u>	<u>2012</u>
Commitments to extend credit	\$106,017	\$84,493
Standby letters of credit	1,733	1,975

KEY FINANCIAL RATIOS

<u>Year ended December 31,</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>
Return on average assets . . . . .	.55%	.75%	.44%	.25%	(.96)%
Return on average equity	5.48%	7.28%	4.45%	2.77%	(11.63)%
Dividend payout ratio	55%	42%	—%	—%	—%

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" under Item 1A. above.

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, 2013 and 2012 represent advances from the FHLB of Seattle. Advances at December 31, 2013 bear interest at 0.47% to 2.94% and mature in various years as follows: 2015 — \$5,000,000, and 2016 — \$5,000,000. The Bank has pledged \$168,136,000 of loans as collateral for these borrowings at December 31, 2013. Based on pledged collateral, at December 31, 2013, the Bank had \$113,849,000 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 \$53,187,000 at the Federal Reserve Bank, of which none was used at December 31, 2013. The Bank has pledged \$79,422,000 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 2014 or beyond.

At December 31, 2013, 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. The Company is currently making regular interest payments when due. As of December 31, 2013 and 2012, interest on TRUPs totaled \$40,000 and \$41,000 respectively, and is included in accrued interest payable on the balance sheet. For more information regarding the Company's issuance of trust preferred securities, see Note 10 "Junior Subordinated Debentures" to the audited consolidated financial statements included under Item 15 of this report.

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 \$67,137,000 at December 31, 2013, an increase of \$416,000, or 0.6%, compared to December 31, 2012. The increase is largely attributable to earnings retention. Total shareholders' equity averaged \$68,057,000 in 2013, which includes \$12,168,000 of goodwill. Shareholders' equity averaged \$65,743,000 in 2012, compared to \$61,942,000 in 2011.

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, 2013 and 2012.

(dollars in thousands)	Actual Amount	Ratio	Requirements for Well-Capitalized	
			Amount	Ratio
December 31, 2013				
<i>Tier 1 capital (to average assets)</i>				
Consolidated	\$67,856	9.83%	\$27,604	4.00%
Bank	67,420	9.77%	27,591	4.00%
<i>Tier 1 capital (to risk-weighted assets)</i>				
Consolidated	67,856	12.85%	21,119	4.00%
Bank	67,420	12.78%	21,101	4.00%
<i>Total capital (to risk-weighted assets)</i>				
Consolidated	74,477	14.11%	42,237	8.00%
Bank	74,036	14.03%	42,202	8.00%
December 31, 2012				
<i>Tier 1 capital (to average assets)</i>				
Consolidated	\$66,750	10.69%	\$24,975	4.00%
Bank	66,712	10.69%	24,966	4.00%
<i>Tier 1 capital (to risk-weighted assets)</i>				
Consolidated	66,750	14.95%	17,855	4.00%
Bank	66,712	14.96%	17,842	4.00%
<i>Total capital (to risk-weighted assets)</i>				
Consolidated	72,376	16.21%	35,710	8.00%
Bank	72,334	16.22%	35,685	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, 2013, 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 4.5% in years one through six; net interest margin ranging from 3.88% in the base year to 4.28% in year six; and a return on assets that ranged from 0.4% to 1.1%.

In applying the market approach method, the Company considered all banks acquired between January 1, 2012 and June 30, 2013, with total assets between \$200 million and \$2 billion, and non-performing assets to total assets between 1% and 5%. This resulted in selecting 32 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 its reporting unit had a fair value of \$72.5 million, after giving similar consideration to the values derived from 1) the income approach, which was \$68.0 million weighted at 50%, and 2) the market approach, which was \$80.4 million and also weighted at 50%, compared to a carrying value of its reporting unit of \$66.8 million. Accordingly, following step one of the goodwill impairment test, the Company concluded that its 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, 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 in Item 15 of 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" under Item 1A above 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, 2013, 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 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 \$4,546,000 at December 31, 2013, compared to \$4,013,000 at December 31, 2012. 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, 2013, 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, 2013 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	\$ 239,585	\$251,299	\$ 20,066	\$512,431
Investments and bank owned life insurance	19,874	11,036	89,972	119,526
Fed Funds sold and interest bearing balances with banks	23,448	—	—	234,481
Federal Home Loan Bank stock	—	—	3,103	3,103
Total interest earning assets	\$ 285,956	\$262,335	\$110,038	\$658,418
Interest bearing liabilities				
Interest bearing demand deposits	\$ 144,220	\$ —	\$ —	\$144,220
Savings and money market deposits	192,039	—	—	192,039
Time deposits	65,873	59,465	722	126,060
Borrowings	—	10,000	—	10,000
Secured borrowings	—	—	—	—
Junior subordinated debentures	13,403	—	—	13,403
Total interest bearing liabilities	\$ 415,535	\$ 69,465	\$ 722	\$485,722
Net interest rate sensitivity GAP	\$(129,579)	\$192,870	\$109,316	\$172,607
Cumulative interest rate sensitivity GAP		63,291	172,607	
Cumulative interest rate sensitivity GAP as a % of earning assets		9.6%	26.2%	

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.

ITEM 8. Financial Statements and Supplementary Data

Information required for this item is included in Item 15 of this report.

ITEM 9. Changes in and disagreements with accountants on accounting and financial disclosure

None.

ITEM 9A. Controls and Procedures

Disclosure Controls and Procedures. Our management has evaluated, with the participation and under the supervision of our chief executive officer (CEO) and chief financial officer (CFO), the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act) as of the end of the period covered by this report. Based on this evaluation, our CEO and CFO have concluded that, as of such date, the Company's disclosure controls and procedures are effective in ensuring that information relating to the Company, including its consolidated subsidiaries, required to be disclosed in reports that it files under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosures.

Management's Report on Internal Control Over Financial Reporting. The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control system is designed to provide reasonable assurance to our management and the board of directors regarding the preparation and fair presentation of published financial statements. Nonetheless, all internal control systems, no matter how well designed, have inherent limitations. Because of these inherent limitations, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected. Even systems determined to be effective as of a particular date can provide only reasonable assurance with respect to financial statement preparation and presentation and may not eliminate the need for restatements.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2013. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control — *Integrated Framework* (1992). Based on our assessment, we believe that, as of December 31, 2013, the Company's internal control over financial reporting is effective based on those criteria.

Changes in Internal Control Over Financial Reporting. There have not been any changes in the Company's internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, during the Company's fiscal quarter ended December 31, 2013 that have materially affected, or are reasonable likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B. Other Information

None.

Part III

ITEM 10. Directors and Executive Officers of the Registrant

Information concerning directors and executive officers requested by this item is contained in the Company's Proxy Statement for its 2014 annual meeting of shareholders to be held on April 23, 2014 (2014 Proxy Statement), in the sections entitled "CURRENT EXECUTIVE OFFICERS," "PROPOSAL NO. 1 — ELECTION OF DIRECTORS," and "SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE" and is incorporated into this report by reference.

The Board of Directors adopted a Code of Ethics for the Company's executive officers that requires the Company's officers to maintain the highest standards of professional conduct. A copy of the Executive Officer Code of Ethics is available on the Company's Web site www.bankofthepacific.com under the link for Investor Info and Governance Documents.

The Company has a separately designated Audit Committee established in accordance with Section 3(a)(58)(A) of the Exchange Act. The committee is composed of Directors John Van Dijk, Gary C. Forcum, Randy Rust, and Dwayne Carter. Messrs. Forcum, Rust and Carter are independent applying the definition of independence for audit committee members found in the Nasdaq listing standards. Director John VanDijk is considered independent per the Exchange Act rules, but he is not independent under the Nasdaq listing standards.

The Company's Board of Directors has determined that Gary C. Forcum, Randy Rust and John Van Dijk are audit committee financial experts as defined in Item 401(h) of the SEC's Regulation S-K.

ITEM 11. Executive Compensation

Information concerning executive and director compensation and certain matters regarding participation in the Company's compensation committee required by this item is contained in the registrant's 2014 Proxy Statement in the sections entitled "DIRECTOR COMPENSATION FOR 2013" and "EXECUTIVE COMPENSATION," and is incorporated into this report by reference.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information concerning security ownership of certain beneficial owners and management requested by this item is incorporated by reference to the material contained in the registrant's 2014 Proxy Statement in the section entitled "SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT" and under the caption "Equity Compensation Plan Information" in the section entitled "EXECUTIVE COMPENSATION."

ITEM 13. Certain Relationships and Related Transactions, and Director Independence

Information concerning certain relationships and related transactions requested by this item is contained in the registrant's 2014 Proxy Statement in the section "RELATED PERSON TRANSACTIONS" and is incorporated into this report by reference. The current members of the Compensation and Management Development Committee, who were also members throughout 2013, are Douglas Schermer (Chair), John VanDijk, Gary Forcum and Randy Rognlin.

Information concerning director independence requested by this item is contained in the registrant's 2014 Proxy Statement in the section entitled "PROPOSAL NO. 1 — ELECTION OF DIRECTORS" and is incorporated into this report by reference.

ITEM 14. Principal Accountant Fees and Services

Information concerning fees paid to our independent public accountants required by this item is included under the heading "AUDITORS — Fees Paid to Auditors" in the registrant's 2014 Proxy Statement and is incorporated into this report by reference.

Part IV

ITEM 15. Exhibits and Financial Statement Schedules

- (a) (1) The following financial statements are filed below:

Report of Independent Registered Public Accounting Firm — Deloitte & Touche LLP . . .	F-1
Consolidated Balance Sheets	F-2
Consolidated Statements of Income.	F-3
Consolidated Statements of Shareholders' Equity	F-5
Consolidated Statements of Cash Flows.	F-6
Notes to Consolidated Financial Statements	F-8

- (a) (2) Schedules: None

- (a) (3) Exhibits: See Exhibit Index immediately following the signature page.

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, 2013 and 2012, 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, 2013. 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, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America.

/s/ Deloitte & Touche LLP
Portland, Oregon
March 21, 2014

Pacific Financial Corporation and Subsidiary
December 31, 2013 and 2012
Consolidated Balance Sheets
(Dollars in Thousands, Except Per Share Amounts)

	2013	2012
Assets		
Cash and due from banks (See note 2)	\$ 12,214	\$ 14,168
Interest bearing deposits in banks	23,734	42,687
Certificates of deposits held for investment	2,727	2,985
Securities available for sale, at fair value (amortized cost of \$97,536 and \$59,658)	96,144	61,106
Securities held to maturity (fair value of \$2,158 and \$6,985)	2,132	6,937
Federal Home Loan Bank stock, at cost	3,013	3,126
Loans held for sale	7,765	12,950
Loans	504,666	448,196
Allowance for credit losses	(8,359)	(9,358)
Loans – net	496,307	438,838
Premises and equipment	16,790	14,593
Other real estate owned	2,771	4,679
Accrued interest receivable	2,307	2,079
Cash surrender value of life insurance	18,237	17,784
Goodwill	12,168	11,282
Other intangible assets	1,481	1,268
Other assets	7,249	9,112
Total assets	<u>\$705,039</u>	<u>\$643,594</u>
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Demand, non-interest bearing	\$145,028	\$115,138
Savings and interest-bearing demand	336,260	295,100
Time, interest-bearing	126,059	138,005
Total deposits	607,347	548,243
Accrued interest payable	167	213
Short-term borrowings	—	3,000
Long-term borrowings	10,000	7,500
Junior subordinated debentures	13,403	13,403
Other liabilities	6,985	4,514
Total liabilities	637,902	576,873
Commitments and Contingencies (See note 14)	—	—
Shareholders' Equity		
Common stock (par value \$1); authorized: 25,000,000 shares; issued and outstanding: 2013 – 10,182,083 and 2012 – 10,121,853 shares	10,182	10,122
Additional paid-in capital	41,817	41,366
Retained earnings	16,507	14,812
Accumulated other comprehensive income (loss)	(1,369)	421
Total shareholders' equity	67,137	66,721
Total liabilities and shareholders' equity	<u>\$705,039</u>	<u>\$643,594</u>

See notes to consolidated financial statements.

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2013, 2012 and 2011
Consolidated Statements of Income
(Dollars in Thousands, Except Per Share Amounts)

	2013	2012	2011
Interest and Dividend Income			
Loans	\$ 24,401	\$ 25,635	\$ 27,186
Deposits in banks	114	84	92
Securities available for sale:			
Taxable	769	756	1,024
Tax-exempt	798	711	707
Securities held to maturity:			
Taxable	10	14	18
Tax-exempt	198	295	291
Total interest and dividend income	26,290	27,495	29,318
Interest Expense			
Deposits	2,020	2,882	4,643
Short-term borrowings	9	79	—
Long-term borrowings	214	217	597
Secured borrowings	—	20	41
Junior subordinated debentures	247	286	352
Total interest expense	2,490	3,484	5,633
Net interest income	23,800	24,011	23,685
Provision for (recapture of) credit losses	(450)	(1,100)	2,500
Net interest income after provision for credit losses	24,250	25,111	21,185
Non-Interest Income			
Service charges on deposit accounts	1,731	1,686	1,799
Net gains (loss) on sale of other real estate owned	40	331	(83)
Net gains from sales of loans	5,171	5,058	3,593
Net gains on sales of securities available for sale	405	303	698
Net other-than-temporary impairment (net of \$3, \$4 and \$256 recognized in other comprehensive income before taxes)	(37)	(333)	(330)
Earnings on bank owned life insurance	452	510	527
Other operating income	2,193	1,836	1,410
Total non-interest income	9,955	9,391	7,614
Non-Interest Expense			
Salaries and employee benefits	17,013	16,215	13,723
Occupancy	1,839	1,673	1,523
Equipment	860	801	1,011
State taxes	458	518	473
Data processing	2,268	1,607	1,415
Professional services	935	750	739
Other real estate owned write-downs	946	1,314	1,049
Other real estate owned operating costs	408	550	450
FDIC assessments	535	610	938
Other	4,240	4,379	4,327
Total non-interest expense	29,502	28,417	25,648
Income before income taxes	4,703	6,085	3,151
Provision for income taxes	972	1,300	333
Net income	\$ 3,731	\$ 4,785	\$ 2,818
Earnings Per Share			
Basic	\$ 0.37	\$ 0.47	\$ 0.28
Diluted	\$ 0.37	\$ 0.47	\$ 0.28
Weighted Average Shares Outstanding:			
Basic	10,121,738	10,121,853	10,121,853
Diluted	10,189,888	10,126,244	10,121,870

See notes to consolidated financial statements.

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2013, 2012 and 2011
Consolidated Statements of Comprehensive Income
(Dollars in Thousands, Except Per Share Amounts)

	2013	2012	2011
Net income	\$ 3,731	\$4,785	\$2,818
Other comprehensive income, net of tax:			
Net unrealized (losses) gains on investment securities (net of tax of \$(966), \$276, and \$391, respectively)	(1,875)	536	758
Defined benefit plans (net of tax of \$29, \$44, and \$34, respectively)	85	130	(101)
Other comprehensive income	(1,790)	666	657
Comprehensive income	\$ 1,941	\$5,451	\$3,475

See notes to consolidated financial statements.

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2013, 2012 and 2011
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, 2011	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
Comprehensive income:						
Net income	—	—	—	3,731	—	3,731
Unrealized holding gain on securities less reclassification adjustment for net gains included in net income	—	—	—	—	(1,875)	(1,875)
Amortization of unrecognized prior service costs and net gains/losses	—	—	—	—	85	85
Comprehensive income						1,790
Issuance of common stock	60,230	60	334	—	—	394
Dividend declared (\$0.20 per share)	—	—	—	(2,036)	—	(2,036)
Stock compensation expense	—	—	117	—	—	117
Balance at December 31, 2013	10,182,083	\$10,182	\$41,817	\$16,507	\$(1,369)	\$67,137

See notes to consolidated financial statements.

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2013, 2012 and 2011
Consolidated Statements of Cash Flows
(Dollars in Thousands)

	2013	2012	2011
Cash Flows from Operating Activities			
Net income	\$ 3,731	\$ 4,785	\$ 2,818
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,328	1,491	1,428
Provision for (recapture of) credit losses	(450)	(1,100)	2,500
Deferred income taxes	386	63	(815)
Originations of loans held for sale	(225,068)	(251,435)	(172,274)
Proceeds from sales of loans held for sale	234,194	256,720	170,797
Net gains on sales of loans	(5,171)	(5,058)	(3,593)
Net gain on sales of securities available for sale	(405)	(303)	(698)
Net OTTI recognized in earnings	37	333	330
(Gain) loss on sales of other real estate owned	(40)	(331)	83
(Gain) loss on sale of premises and equipment	36	(6)	23
Earnings on bank owned life insurance	(452)	(510)	(527)
(Increase) decrease in accrued interest receivable	(228)	77	178
Increase (decrease) in accrued interest payable	(48)	(1,277)	110
Other real estate owned write-downs	946	1,314	1,049
Additions to other real estate owned	—	(185)	(260)
Proceeds from Internal Revenue Service tax refund	—	—	1,876
Decrease in prepaid expenses	2,157	374	801
Other – net	1,003	288	1,869
Net cash provided by operating activities	12,956	5,240	5,695
Cash Flows from Investing Activities			
Net (increase) decrease in interest bearing deposits in banks	18,953	(14,162)	25,805
Purchase of certificates of deposits held for investment, net	258	(2,985)	—
Activity in securities available for sale:			
Sales	7,832	10,917	17,407
Maturities, prepayments and calls	11,265	10,451	7,564
Purchases	(57,521)	(34,194)	(29,553)
Activity in securities held to maturity:			
Maturities	4,804	286	255
Purchases	—	(200)	(828)
Proceeds from sales of government loan pools	6,266	1,296	9,845
(Increase) decrease in loans made to customers, net of principal collections	(60,004)	24,105	(23,505)
Purchases of premises and equipment	(2,728)	(844)	(1,019)
Proceeds from sales of other real estate owned	2,660	4,223	1,101
Cash received in acquisition, net of cash paid	31,941	—	—
Net cash provided by (used in) investing activities	(36,274)	(1,107)	7,072

(continued)

See notes to consolidated financial statements.

Pacific Financial Corporation and Subsidiary

Years Ended December 31, 2013, 2012 and 2011
Consolidated Statements of Cash Flows
(concluded) (Dollars in Thousands)

	2013	2012	2011
Cash Flows from Financing Activities			
Net increase in deposits	\$21,470	\$ 193	\$ 3,096
Net decrease in short-term borrowings	(3,000)	—	(10,500)
Decrease in secured borrowings	—	(741)	(184)
Proceeds from issuance of long-term borrowings	2,500	2,500	7,500
Prepayments of long-term borrowings	—	(2,500)	(7,500)
Common stock issued	394	—	—
Cash dividends paid	—	(2,024)	—
Net cash provided by (used in) financing activities	21,364	(2,572)	(7,588)
Net change in cash and due from banks	(1,954)	1,561	5,179
Cash and Due from Banks			
Beginning of year	14,168	12,607	7,428
End of year	<u>12,214</u>	<u>14,168</u>	<u>12,607</u>
Supplemental Disclosures of Cash Flow Information			
Interest paid	\$ 2,536	\$ 4,761	\$ 5,523
Income taxes paid	690	1,998	332
Supplemental Disclosures of Non-Cash Investing Activities			
Fair value adjustment of securities available for sale, net of tax	\$(1,875)	\$ 536	\$ 758
Transfer of loans held for sale to loans held for investment . .	986	1,295	300
Other real estate owned acquired in settlement of loans	(1,756)	(2,897)	(4,278)
Financed sale of other real estate owned	98	922	1,160
Reclass of current portion of long-term borrowings to short- term borrowings	—	3,000	—

See notes to consolidated financial statements.

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011 Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

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 communities in Grays Harbor, Pacific, Whatcom, Skagit and Wahkiakum counties in the state of Washington and three in Clatsop County, Oregon. In addition, the Bank operates three loan production offices in Burlington, DuPont and Vancouver, Washington and has a residential real estate mortgage department. 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.

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.

Certain prior year disclosures have been reclassified to conform to the 2013 presentation with no change to net income or shareholders' equity as previously reported. Loans held for sale have been excluded from the loan and credit quality tables in Note 4 — Loans.

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.

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011 Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

Note 1 — Summary of Significant Accounting Policies – (continued)

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 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.

Federal Home Loan Bank Stock

The Company’s investment in Federal Home Loan Bank (“FHLB”) stock is carried at cost. 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. Even though the Company did not determine its investment in the FHLB stock was impaired at December 31, 2013, 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.

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011 Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

Note 1 — Summary of Significant Accounting Policies – (continued)

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 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.

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011 Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

Note 1 — Summary of Significant Accounting Policies – (continued)

Goodwill and other intangible assets

At December 31, 2013 the Company had \$13,649 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, 2013 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.

Core deposit intangibles are amortized to non-interest expenses using an accelerated method over ten years. Net unamortized core deposit intangible totaled \$213 at December 31, 2013. Amortization expense related to core deposit intangible totaled \$28 during the year ended December 31, 2013.

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.

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.

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011 Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

Note 1 — Summary of Significant Accounting Policies – (continued)

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, 2013, the Company had no unrecognized tax benefits. The Company's policy is to recognize interest and penalties on unrecognized tax benefits in "Income Taxes" in the consolidated statements of income. There were no amounts related to interest and penalties recognized for the year ended December 31, 2013. The tax years that remain subject to examination by federal and state taxing authorities are the years ended December 31, 2012, 2011 and 2010.

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 16.

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 436,495, 532,106, and 581,448 in 2013, 2012 and 2011, respectively. Outstanding warrants also excluded were 638,920, 699,642, and 699,642 for the years ended 2013, 2012, and 2011, respectively.

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011 Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

Note 1 — Summary of Significant Accounting Policies – (continued)

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, 2013, 2012 and 2011.

Recent Accounting Pronouncements

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. The adoption of ASU No. 2011-11 did not have a significant impact 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 disclosures required from adoption of this ASU have been included in these financial statements.

In July 2013, FASB issued ASU No. 2013-11, “*Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*.” The provisions of ASU No. 2013-11 require an entity to present an unrecognized tax benefit, or portion thereof, in the statement of financial position as a reduction to a deferred tax asset for a net operating loss carryforward or a tax credit carryforward, with certain exceptions related to availability. ASU No. 2013-11 is effective for interim and annual reporting periods beginning after December 15, 2013. The adoption of ASU No. 2013-11 is not expected to have a material impact on the Company’s Consolidated Financial Statements.

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, 2013 and 2012 was approximately \$953 and \$577, respectively.

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

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, 2013				
U.S. Government agency securities	\$ 8,859	\$ 34	\$ 82	\$ 8,811
State and municipal securities	31,973	774	587	32,160
Agency MBS	53,462	267	1,549	52,180
Non-agency MBS	2,251	3	243	2,011
Corporate bonds	991	—	9	982
Total	<u>\$97,536</u>	<u>\$1,078</u>	<u>\$2,470</u>	<u>\$96,144</u>
December 31, 2012				
U.S. Government agency securities	\$ 5,922	\$ 36	\$ 6	\$ 5,952
State and municipal securities	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	<u>\$59,658</u>	<u>\$1,988</u>	<u>\$ 540</u>	<u>\$61,106</u>
Securities Held to Maturity				
Securities Held to Maturity	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2013				
State and municipal securities	\$1,973	\$13	\$—	\$1,986
Agency MBS	159	13	—	172
Total	<u>\$2,132</u>	<u>\$26</u>	<u>\$—</u>	<u>\$2,158</u>
December 31, 2012				
State and municipal securities	\$6,716	\$32	\$—	\$6,748
Agency MBS	221	16	—	237
Total	<u>\$6,937</u>	<u>\$48</u>	<u>\$—</u>	<u>\$6,985</u>

Pacific Financial Corporation and Subsidiary

**December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts**

Note 3 — Securities – (continued)

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, 2013 and 2012 are summarized as follows:

	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
December 31, 2013						
Available for Sale						
U.S. Government agency securities . .	\$ 5,550	\$ 82	\$ —	\$ —	\$ 5,550	\$ 82
State and municipal securities	11,551	485	1,821	102	13,372	587
Agency MBS	28,795	996	8,908	553	37,703	1,549
Non-agency MBS	389	27	1,619	216	2,008	243
Corporate bonds	982	9	—	—	982	9
Total	<u>\$47,267</u>	<u>\$1,599</u>	<u>\$12,348</u>	<u>\$871</u>	<u>\$59,615</u>	<u>\$2,470</u>
	Less than 12 Months	More than 12 Months	Total			
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
December 31, 2012						
Available for Sale						
U.S. Government agency securities . .	\$ 2,688	\$ 6	\$ —	\$ —	\$ 2,688	\$ 6
State and municipal securities	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	<u>\$18,431</u>	<u>\$263</u>	<u>\$2,279</u>	<u>\$277</u>	<u>\$20,710</u>	<u>\$540</u>

At December 31, 2013, there were 81 investment securities in an unrealized loss position, of which 20 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, 2013, 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, 2013 and 2012, one non-agency MBS was determined to be other-than-temporarily impaired resulting in the Company recording \$37 and \$333 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.

Pacific Financial Corporation and Subsidiary

**December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts**

Note 3 — Securities – (continued)

The contractual maturities of investment securities held to maturity and available for sale at December 31, 2013 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	\$ 190	\$ 192	\$ 1,481	\$ 1,483
Due from one year to five years	—	—	11,108	11,037
Due from five to ten years	915	926	7,810	7,801
Due after ten years	868	868	21,424	21,632
Mortgage-backed securities	159	172	55,713	54,191
Total	<u>\$2,132</u>	<u>\$2,158</u>	<u>\$97,536</u>	<u>\$96,144</u>

Gross gains realized on sales of securities were \$448, \$332 and \$720 and gross losses realized were \$43, \$29 and \$22 in 2013, 2012 and 2011, respectively.

Securities carried at approximately \$57,418 at December 31, 2013 and \$44,133 at December 31, 2012 were pledged to secure public deposits and for other purposes required or permitted by law.

Note 4 — Loans

Loans and Leases

Loans at December 31 consist of the following:

	2013	2012
Commercial and agricultural	\$104,111	\$ 87,278
Real estate:		
Construction and development	29,096	31,411
Residential 1-4 family	87,762	77,497
Multi-family	17,520	7,744
Commercial real estate – owner occupied	105,594	109,783
Commercial real estate – non owner occupied	117,294	103,014
Farmland	23,698	24,544
Consumer	20,728	7,782
	<u>505,803</u>	<u>449,053</u>
Less unearned income	(1,137)	(857)
Total	<u>\$504,666</u>	<u>\$448,196</u>

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

Note 4 — Loans – (continued)

Allowance for Credit Losses

Changes in the allowance for credit losses for the years ended December 31, 2013, 2012 and 2011 are as follows:

Allowance for Credit Losses:	Commercial	Commercial Real Estate ("CRE")	Residential Real Estate	Consumer	Unallocated	2013 Total
Year ended December 31, 2013						
Beginning balance	\$ 923	\$ 4,098	\$ 829	\$ 531	\$2,977	\$ 9,358
Charge-offs	(131)	(90)	(453)	(154)	—	(828)
Recoveries	36	226	14	3	—	279
Provision for (recapture of) credit losses	(53)	(728)	285	364	(318)	(450)
Ending balance	<u>\$ 775</u>	<u>\$ 3,506</u>	<u>\$ 675</u>	<u>\$ 744</u>	<u>\$2,659</u>	<u>\$ 8,359</u>
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	<u>\$ 923</u>	<u>\$ 4,098</u>	<u>\$ 829</u>	<u>\$ 531</u>	<u>\$2,977</u>	<u>\$ 9,358</u>
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	<u>\$1,012</u>	<u>\$ 6,803</u>	<u>\$1,046</u>	<u>\$ 642</u>	<u>\$1,624</u>	<u>\$11,127</u>

Pacific Financial Corporation and Subsidiary

**December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts**

Note 4 — Loans – (continued)

Recorded investment in loans as of December 31, 2013 and 2012 are as follows:

<u>December 31, 2013</u>	<u>Commercial</u>	<u>Commercial Real Estate ("CRE")</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Unallocated</u>	<u>Total</u>
Allowance for credit losses:						
Ending balance: individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Ending balance: collectively evaluated for impairment	775	3,506	675	744	2,659	8,359
Loans:						
Ending balance: individually evaluated for impairment	\$ 587	\$ 8,656	\$ 626	\$ 53	\$ —	\$ 9,922
Ending balance: collectively evaluated for impairment	103,524	267,026	104,656	20,675	—	495,881
Ending Balance	<u>\$104,111</u>	<u>\$275,682</u>	<u>\$105,282</u>	<u>\$20,728</u>	<u>\$ —</u>	<u>\$505,803</u>
Less unearned income						(1,137)
Ending balance total loans						<u>\$504,666</u>
<u>December 31, 2012</u>	<u>Commercial</u>	<u>Commercial Real Estate ("CRE")</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Unallocated</u>	<u>Total</u>
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
Ending Balance	<u>\$87,278</u>	<u>\$268,752</u>	<u>\$85,241</u>	<u>\$7,782</u>	<u>\$ —</u>	<u>\$449,053</u>
Less unearned income						(857)
Ending balance total loans						<u>\$448,196</u>

Pacific Financial Corporation and Subsidiary

**December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts**

Note 4 — Loans – (continued)

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 than 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, 2013 are as follows:

	<u>Pass</u>	<u>Other Loans Especially Mentioned</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
Commercial	\$100,262	\$ 2,858	\$ 991	\$—	\$104,111
Real estate:					
Construction and development	26,587	1,101	1,408	—	29,096
Residential 1 – 4 family	84,407	554	2,801	—	87,762
Multi-family	17,520	—	—	—	17,520
CRE – owner occupied	100,612	1,019	3,963	—	105,594
CRE – non owner occupied	98,044	16,752	2,498	—	117,294
Farmland	20,228	2,464	1,006	—	23,698
Total real estate	<u>347,398</u>	<u>21,890</u>	<u>11,676</u>	<u>—</u>	<u>380,964</u>
Consumer	20,570	62	96	—	20,728
Subtotal	<u>\$468,230</u>	<u>\$24,810</u>	<u>\$12,763</u>	<u>\$—</u>	<u>\$505,803</u>
Less unearned income					(1,137)
Total loans					<u>\$504,666</u>

Pacific Financial Corporation and Subsidiary

**December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts**

Note 4 — Loans – (continued)

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	72,414	2,016	3,067	—	77,497
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	318,932	16,809	18,008	244	353,993
Consumer	7,740	—	42	—	7,782
Subtotal	\$409,571	\$17,788	\$21,418	\$276	\$449,053
Less unearned income					(857)
Total loans					\$448,196

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Note 4 — Loans – (continued)

Aging Analysis

The following table illustrates an age analysis of past due loans as of December 31, 2013.

	<u>Current</u>	<u>30 – 59 Days Past Due</u>	<u>60 – 89 Days Past Due</u>	<u>Greater Than 90 Days Past Due and Still Accruing</u>	<u>Total Past Due</u>	<u>Non- accrual Loans</u>	<u>Total Loans</u>
Commercial	\$103,811	\$ 14	\$—	\$—	\$ 14	\$ 286	\$104,111
Real estate:							
Construction & development . . .	27,688	—	—	—	—	1,408	29,096
Residential 1 – 4 family	87,029	333	—	—	333	400	87,762
Multi-family	17,520	—	—	—	—	—	17,520
CRE – owner occupied	103,935	—	—	—	—	1,659	105,594
CRE – non-owner occupied . . .	114,812	—	—	—	—	2,482	117,294
Farmland	21,868	875	—	—	875	955	23,698
Total real estate	372,852	1,208	—	—	1,208	6,904	380,964
Consumer	20,507	165	3	—	168	53	20,728
Less unearned income	(1,137)	—	—	—	—	—	(1,137)
Total	<u>\$496,033</u>	<u>\$1,387</u>	<u>\$ 3</u>	<u>\$—</u>	<u>\$1,390</u>	<u>\$7,243</u>	<u>\$504,666</u>

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

	<u>Current</u>	<u>30 – 59 Days Past Due</u>	<u>60 – 89 Days Past Due</u>	<u>Greater Than 90 Days Past Due and Still Accruing</u>	<u>Total Past Due</u>	<u>Non- accrual Loans</u>	<u>Total Loans</u>
Commercial	\$ 85,243	\$ 107	\$ 27	\$—	\$ 134	\$ 1,901	\$ 87,278
Real estate:							
Construction & development . . .	29,619	—	—	—	—	1,792	31,411
Residential 1 – 4 family	75,102	1,505	90	—	1,595	800	77,497
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	338,403	2,290	90	—	2,380	13,210	353,993
Consumer	7,773	8	—	—	8	1	7,782
Less unearned income	(857)	—	—	—	—	—	(857)
Total	<u>\$430,562</u>	<u>\$2,405</u>	<u>\$117</u>	<u>\$—</u>	<u>\$2,522</u>	<u>\$15,112</u>	<u>\$448,196</u>

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Note 4 — Loans – (continued)

Interest income on non-accrual loans that would have been recorded had those loans performed in accordance with their initial terms was \$1,130, \$1,213, and \$752 for 2013, 2012, and 2011, 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 2013 and 2012. Total related party loans outstanding at December 31, 2013 and 2012 to executive officers and directors were \$66 and \$385, respectively. During 2013 and 2012, new loans of \$5 and \$454, respectively, were made, and repayments totaled \$324 and \$1,051, 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, 2013.

Impaired Loans

Following is a summary of information pertaining to impaired loans at December 31, 2013, and for the year then ended:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
With no related allowance recorded:					
Commercial	\$ 587	\$ 608	\$—	\$ 1,270	\$ 9
Consumer	53	53	—	11	1
Residential real estate	626	815	—	1,045	25
Commercial real estate:					
CRE – owner occupied	1,714	1,714	—	2,482	24
CRE – non-owner occupied	4,579	6,776	—	5,195	40
Farmland	955	955	—	959	—
Construction and development	1,408	3,685	—	1,582	78
With an allowance recorded:					
Consumer	—	—	—	2	—
Residential real estate	—	—	—	40	—
Total:					
Commercial	\$ 587	\$ 608	—	1,270	9
Consumer	53	53	—	13	1
Residential real estate	626	815	—	1,085	25
Commercial real estate:					
CRE – owner occupied	1,714	1,714	—	2,482	24
CRE – non-owner occupied	4,579	6,776	—	5,195	40
Farmland	955	955	—	959	—
Construction and development	1,408	3,685	—	1,582	78
Total	<u>\$9,922</u>	<u>\$14,606</u>	<u>\$—</u>	<u>\$12,586</u>	<u>\$177</u>

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**December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
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Note 4 — Loans – (continued)

Following is a summary of information pertaining to impaired loans at December 31, 2012, and for the year then ended:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
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
Total	<u>\$14,784</u>	<u>\$17,915</u>	<u>\$—</u>	<u>\$12,331</u>	<u>\$226</u>

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.

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Note 4 — Loans – (continued)

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, 2013 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	\$ 302	—	\$—	\$—
Construction & development . . .	3	2,972	1,408	—	—	—
Residential real estate	2	272	227	—	—	—
CRE – owner occupied	1	59	55	—	—	—
CRE – non-owner occupied	1	2,180	2,096	—	—	—
Ending balance⁽¹⁾	<u>8</u>	<u>\$5,818</u>	<u>\$4,088</u>	<u>—</u>	<u>\$—</u>	<u>\$—</u>

(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, 2013. 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, 2013.

TDRs as of December 31, 2012 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	\$ 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	<u>9</u>	<u>\$5,888</u>	<u>\$4,374</u>	<u>—</u>	<u>\$—</u>	<u>\$—</u>

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**December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
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Note 5 — Accumulated Other Comprehensive Loss

The following table presents the changes in each component of accumulated other comprehensive income, net of tax, for the twelve months ended December 31, 2013 and 2012:

	Net Unrealized Gains and Losses on Investment Securities	Defined Benefit Plans	Total
Balance, January 1, 2013	\$ 956	\$(535)	\$ 421
Other comprehensive loss before reclassifications	(1,632)	85	(1,547)
Amounts reclassified from AOCI	(243)	—	(243)
Net current period other comprehensive income (loss)	(1,875)	85	(1,790)
Balance, December 31, 2013	<u>\$ (919)</u>	<u>\$(450)</u>	<u>\$(1,369)</u>
Balance, January 1, 2012	\$ 420	\$(665)	\$ (245)
Other comprehensive loss before reclassifications	556	130	686
Amounts reclassified from AOCI	(20)	—	(20)
Net current period other comprehensive income (loss)	536	130	666
Balance, December 31, 2012	<u>\$ 956</u>	<u>\$(535)</u>	<u>\$ 421</u>

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (“AOCI”) for the twelve months ended December 31, 2013:

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from AOCI Twelve Months Ended December 31, 2013	Affected Line Item in the Statement Where Net Income is Presented
Net Unrealized Gains and Losses on Investment Securities	\$(405)	Gain on sales of investments available for sale
	37	Net OTTI losses
	125	Income tax expense
	<u>\$(243)</u>	Net of tax

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Note 5 — Accumulated Other Comprehensive Loss – (continued)

The following table presents the components of other comprehensive income (loss) for the twelve months ended December 31, 2013 and 2012.

	<u>Before Tax</u>	<u>Tax Effect</u>	<u>Net of Tax</u>
Twelve Months Ended December 31, 2013			
Net unrealized losses on investment securities:			
Net unrealized losses arising during the period	\$(2,473)	\$(841)	\$(1,632)
Less: reclassification adjustment for net gains including OTTI losses realized in net income	(368)	(125)	(243)
Net unrealized losses on investment securities	(2,841)	(966)	(1,875)
Defined Benefit Plans:			
Amortization of unrecognized prior service costs and net actuarial gains/ losses	129	44	85
Other Comprehensive Loss	<u>\$(2,712)</u>	<u>\$(922)</u>	<u>\$(1,790)</u>
Twelve Months Ended December 31, 2012			
Net unrealized gains on investment securities:			
Net unrealized gains arising during the period	\$ 842	\$ 286	\$ 556
Less: reclassification adjustment for net gains realized in net income . .	30	10	20
Net unrealized gains on investment securities	812	276	536
Defined Benefit Plans:			
Amortization of unrecognized prior service costs and net actuarial gains/ losses	197	67	130
Other Comprehensive Income	<u>\$ 1,009</u>	<u>\$ 343</u>	<u>\$ 666</u>

Note 6 — Premises and Equipment

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

	<u>2013</u>	<u>2012</u>
Land and premises	\$19,859	\$17,999
Equipment, furniture and fixtures	8,142	7,648
Construction in progress	167	159
	<u>28,168</u>	<u>25,806</u>
Less accumulated depreciation and amortization	11,378	11,213
Total premises and equipment	<u>\$16,790</u>	<u>\$14,593</u>

Depreciation expense was \$1,013, \$989, and \$1,022 for 2013, 2012 and 2011, respectively. The Bank leases premises under operating leases. Rental expense of leased premises was \$544, \$442 and \$375 for 2013, 2012 and 2011, respectively, which is included in occupancy expense.

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Note 6 — Premises and Equipment – (continued)

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:

2014	\$ 461
2015	397
2016	236
2017	152
2018	<u>157</u>
Total minimum payments required	<u>\$1,403</u>

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

Note 7 — Other Real Estate Owned

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

	<u>2013</u>	<u>2012</u>
Balance at beginning of year	\$ 4,679	\$ 7,725
Additions	1,756	3,082
Dispositions	(2,718)	(4,814)
Fair value write-downs	<u>(946)</u>	<u>(1,314)</u>
Balance at end of year	<u>\$ 2,771</u>	<u>\$ 4,679</u>

At December 31, 2013, OREO consisted of 17 properties as follows: five land acquisition and development properties totaling \$237; eight commercial real estate properties totaling \$1,862; and four residential real estate properties totaling \$672. Net gains and (losses) on sales of OREO totaled \$40, \$331 and \$(83) for the years ended December 31, 2013, 2012 and 2011, respectively.

Note 8 — Deposits

The composition of deposits at December 31 is as follows:

	<u>2013</u>	<u>2012</u>
Demand deposits, non-interest bearing	\$145,028	\$115,138
NOW and money market accounts	262,848	232,607
Savings deposits	73,412	62,493
Time certificates, \$100,000 or more	76,628	87,355
Other time certificates	<u>49,431</u>	<u>50,650</u>
Total	<u>\$607,347</u>	<u>\$548,243</u>

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Note 8 — Deposits – (continued)

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

2014	\$ 65,367
2015	25,537
2016	20,309
2017	8,288
2018	5,834
2019	724
Total	<u>\$126,059</u>

Note 9 — Borrowings

Long-term borrowings at December 31, 2013 and 2012 represent advances from the Federal Home Loan Bank of Seattle (“FHLB”). Advances at December 31, 2013 bear interest at 0.47% to 2.94% and mature in various years as follows: 2015 — \$5,000 and 2016 — \$5,000. The Bank has pledged \$168,136 of loans as collateral for these borrowings at December 31, 2013.

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, 2013, and 2012. The following is a summary of short-term borrowings for the years ended:

	<u>2013</u>	<u>2012</u>
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	3,000
Average balance during the year	303	2,697
Average interest rate during the year	2.94%	2.94%

Note 10 — Junior Subordinated Debentures

At December 31, 2013, 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, at a redemption price specified in the indentures plus any accrued but unpaid interest to the redemption date.

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Note 10 — Junior Subordinated Debentures – (continued)

The following table is a summary of the trust preferred securities and debentures at December 31, 2013:

Issuance Trust	Issuance Date	Preferred Security	Rate Type	Initial Rate	Rate at 12/31/13	Maturity Date
PFC Statutory Trust I	12/2005	\$5,000	Variable ⁽¹⁾	6.39%	1.69%	3/2036
PFC Statutory Trust II	6/2006	\$8,000	Variable ⁽¹⁾	7.02%	1.84%	7/2036

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

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, 2013 and 2012, respectively, for the common capital securities issued by the issuer trusts.

As of December 31, 2013, regular accrued interest on junior subordinated debentures totaled \$40 and is included in accrued interest payable on the balance sheet. As of December 31, 2012, accrued interest totaled \$41.

Note 11 — Income Taxes

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

	<u>2013</u>	<u>2012</u>	<u>2011</u>
Current	\$586	\$1,237	\$1,148
Deferred	386	63	(815)
Total income tax benefit	<u>\$972</u>	<u>\$1,300</u>	<u>\$ 333</u>

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

	<u>2013</u>	<u>2012</u>
Deferred Tax Assets		
Allowance for credit losses	\$2,892	\$3,238
Deferred compensation	111	116
Supplemental executive retirement plan	1,039	922
Unrealized loss on securities available for sale	473	—
Loan fees/costs	393	297
OREO write-downs	305	657
OREO operating expenses	174	161
Tax credit carry-forwards	534	156
Non-accrual loan interest	108	194
OTTI write-downs	—	229
Other	170	96
Total deferred tax assets	<u>6,199</u>	<u>6,066</u>

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Note 11 — Income Taxes – (continued)

	<u>2013</u>	<u>2012</u>
Deferred Tax Liabilities		
Depreciation	\$ 172	\$ 127
Loan fees/costs	1,185	1,150
Unrealized gain on securities available for sale	—	493
Prepaid expenses	108	111
FHLB dividends	137	143
Other	51	29
Total deferred tax liabilities	<u>1,653</u>	<u>2,053</u>
Net deferred tax assets	<u>\$4,546</u>	<u>\$4,013</u>

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:

	<u>2013</u> <u>Amount</u>	<u>Percent of</u> <u>Pre-tax</u> <u>Income</u>	<u>2012</u> <u>Amount</u>	<u>Percent of</u> <u>Pre-tax</u> <u>Income</u>	<u>2011</u> <u>Amount</u>	<u>Percent of</u> <u>Pre-tax</u> <u>Income</u>
Income (loss) tax at statutory rate	\$1,646	35.0%	\$2,130	35.0%	\$1,103	35.0%
Adjustments resulting from:						
Tax-exempt income	(483)	(10.3)	(542)	(8.9)	(519)	(16.5)
Net earnings on life insurance policies . . .	(152)	(3.2)	(178)	(2.9)	(171)	(5.4)
Low income housing tax credit	(101)	(2.1)	(109)	(1.8)	(108)	(3.4)
Other	62	1.3	(1)	0.0	28	0.9
Total income tax (benefit) expense	<u>\$ 972</u>	<u>20.7%</u>	<u>\$1,300</u>	<u>21.4%</u>	<u>\$ 333</u>	<u>10.6%</u>

As of December 31, 2013, 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.

Note 12 — 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 \$272, \$400, and \$80 in 2013, 2012 and 2011, 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 \$161, \$152 and \$58 for 2013, 2012 and 2011, 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, \$0 and \$35 at December 31, 2013, 2012 and 2011, respectively. There is no ongoing expense to the Company for these plans.

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Note 12 — Employee Benefits – (continued)

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 \$3,911 and \$3,804 at December 31, 2013 and 2012, respectively. In 2013, 2012 and 2011, the net benefit recorded from these plans, including the cost of the related life insurance, was \$354, \$396 and \$402, 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 \$322 and \$334 at December 31, 2013 and 2012, 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 these agreements was \$107, \$95 and \$79 in 2013, 2012 and 2011, 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 \$5,817 and \$5,736 at December 31, 2013 and 2012, 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:

	<u>2013</u>	<u>2012</u>	<u>2011</u>
Net periodic pension cost:			
Service Cost	\$ 145	\$ 167	\$ 143
Interest Cost	104	106	97
Amortization of prior service cost	90	90	90
Amortization of net (gain)/loss	<u>22</u>	<u>27</u>	<u>3</u>
Net periodic pension cost	<u>\$ 361</u>	<u>\$ 390</u>	<u>\$ 333</u>
Weighted average assumptions:			
Discount rate	4.37%	4.47%	5.12%
Rate of compensation increases	n/a	n/a	n/a

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Note 12 — Employee Benefits – (continued)

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

	<u>2013</u>	<u>2012</u>
Change in Benefit Obligation:		
Benefit obligation at beginning of year	\$2,342	\$2,082
Service cost	145	167
Interest cost	104	106
Benefits paid	(45)	—
Actuarial gain (loss)	27	(13)
Benefit obligation at end of year	<u>\$2,573</u>	<u>\$2,342</u>

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

	<u>2013</u>	<u>2012</u>
(Gain) loss	\$179	\$173
Prior service cost	271	362
Total recognized in accumulative other comprehensive income (loss) . .	<u>\$450</u>	<u>\$535</u>

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

	<u>2013</u>	<u>2012</u>
Projected benefit obligation	\$2,573	\$2,342
Accumulated benefit obligation	2,573	2,342

Estimated future benefit payments as of December 31, 2013 are as follows:

2014 – 2018	\$ 505
2019 – 2023	1,356

Note 13 — 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, 2013. The plan is currently suspended.

Note 14 — 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.

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Note 14 — Commitments and Contingencies – (continued)

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:

	<u>2013</u>	<u>2012</u>
Commitments to extend credit	\$106,017	\$84,493
Standby letters of credit	1,733	1,975

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, 2013. In addition, the Bank has a credit line with the Federal Home Loan Bank of Seattle totaling 20% of assets, \$10,000 of which was used at December 31, 2013. These borrowings are collateralized under blanket pledge and custody agreements. As of December 31, 2013, loans carried at \$168,136 were pledged as collateral to the Federal Home Loan Bank. 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 \$53,187, subject to pledged collateral. As of December 31, 2013, loans carried at \$79,422 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.

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Note 15 — Significant Concentrations of Credit Risk

Most of the Bank's business activity is with customers and governmental entities located in the states of Washington and Oregon, 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 16 — 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 (803,869 shares are available for grant at December 31, 2013). 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.

<u>Grant period ended</u>	<u>Expected Life</u>	<u>Risk Free Interest Rate</u>	<u>Expected Volatility</u>	<u>Dividend Yield</u>	<u>Average Fair Value</u>
December 31, 2013	6.5 years	1.36%	23.05%	4.13%	\$0.58
December 31, 2012	6.5 years	1.34%	22.43%	—%	\$0.77
December 31, 2011	6.5 years	1.50%	22.51%	—%	\$1.05

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Note 16 — Stock Based Compensation – (continued)

A summary of the status of the Company's stock option plans as of December 31, 2013, 2012 and 2011, and changes during the years ending on those dates, is presented below:

	2013		2012		2011	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year . . .	537,107	\$11.28	586,448	\$11.32	818,612	\$11.07
Granted	186,000	5.05	10,500	5.00	5,000	3.95
Exercised	—	—	—	—	—	—
Expired	(64,337)	11.36	(12,550)	10.44	(178,439)	10.10
Forfeited	(33,275)	9.25	(47,291)	10.57	(58,725)	10.98
Outstanding at end of year	<u>625,495</u>	<u>\$ 9.53</u>	<u>537,107</u>	<u>\$11.28</u>	<u>586,448</u>	<u>\$11.32</u>
Exercisable at end of year	<u>328,845</u>	<u>\$12.95</u>	<u>389,827</u>	<u>\$12.98</u>	<u>411,708</u>	<u>\$12.93</u>

A summary of the status of the Company's nonvested options as of December 31, 2013 and 2012 and changes during the period then ended are presented below:

	2013		2012	
	Shares	Weighted Average Fair Value	Shares	Weighted Average Fair Value
Non-vested beginning of period	147,280	\$0.31	174,740	\$0.37
Granted	186,000	0.57	10,500	0.77
Vested	(17,875)	0.32	(32,050)	0.83
Forfeited	(18,755)	0.40	(5,910)	0.27
Non-vested end of period	<u>296,650</u>	<u>\$0.47</u>	<u>147,280</u>	<u>\$0.31</u>

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Note 16 — Stock Based Compensation – (continued)

The following information summarizes information about stock options outstanding and exercisable at December 31, 2013:

Range of exercise prices	Options Outstanding			Options Exercisable		
	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	361,000	7.6	\$ 5.94	64,350	6.0	\$ 6.92
11.11 – 12.49	26,125	4.0	12.11	26,125	4.0	12.11
12.50 – 14.74	125,675	2.0	14.29	125,675	2.0	14.29
14.75 – 16.00	112,695	1.0	15.10	112,695	1.0	15.10
	<u>625,495</u>	<u>5.1</u>	<u>\$ 9.53</u>	<u>328,845</u>	<u>2.6</u>	<u>\$12.95</u>

The aggregate intrinsic value of all options outstanding at December 31, 2013 and 2012 was \$303 and \$0, respectively. The aggregate intrinsic value of all options that were exercisable at December 31, 2013 and 2012 was \$0 and \$0, respectively. There were no options exercised during 2012 or 2013. Stock based compensation recognized in 2013 and 2012 was \$50 (\$33 net of tax) and \$24 (\$16 net of tax), respectively. Future compensation expense for unvested awards outstanding as of December 31, 2013 is estimated to be \$80 recognized over a weighted average period of 1.8 years.

Restricted Stock Units

During 2012 and 2013, 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 the years ended December 31, 2013 and 2012. There was no RSU activity prior to 2012.

	Shares	Weighted average grant price	Weighted average remaining contractual terms (in years)
Outstanding, January 1, 2013	16,059		
Granted	35,476	\$4.93	
Forfeited	(1,511)		
Outstanding, December 31, 2013	<u>50,024</u>	<u>\$4.93</u>	<u>2.0</u>
Outstanding, January 1, 2012	—		
Granted	16,604	\$4.43	
Forfeited	(545)		
Outstanding, December 31, 2012	<u>16,059</u>	<u>\$4.43</u>	<u>2.5</u>

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Note 16 — Stock Based Compensation – (continued)

For the years ended December 31, 2013 and 2012, the Company recognized compensation expense related to RSUs of \$66 (\$44 net of tax) and \$8 (\$5 net of tax), respectively. As of December 31, 2013, there was \$172 of total unrecognized compensation expense related to non-vested RSUs.

Note 17 — 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, 2013, 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, 2013, the Company and the Bank meet all capital requirements to which they are subject.

	<u>Actual Amount</u>	<u>Ratio</u>	<u>Capital Adequacy Purposes Amount</u>	<u>Ratio</u>	<u>To be Well Capitalized Under Prompt Corrective Action Provisions Amount</u>	<u>Ratio</u>
December 31, 2013						
<i>Tier 1 capital (to average assets):</i>						
Company	\$67,856	9.83%	\$27,604	4.00%	NA	NA
Bank	67,420	9.77	27,591	4.00	\$34,489	5.00%
<i>Tier 1 capital (to risk-weighted assets):</i>						
Company	67,856	12.85	21,119	4.00	NA	NA
Bank	67,420	12.78	21,101	4.00	31,652	6.00
<i>Total capital (to risk-weighted assets):</i>						
Company	74,477	14.11	42,237	8.00	NA	NA
Bank	74,036	14.03	42,202	8.00	52,753	10.00

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Note 17 — Regulatory Matters – (continued)

	<u>Actual Amount</u>	<u>Ratio</u>	<u>Capital Adequacy Purposes Amount</u>	<u>Ratio</u>	<u>To be Well Capitalized Under Prompt Corrective Action Provisions Amount</u>	<u>Ratio</u>
December 31, 2012						
<i>Tier 1 capital (to average assets):</i>						
Company	\$66,750	10.69%	\$24,975	4.00%	NA	NA
Bank	66,712	10.69	24,966	4.00	\$31,207	5.00%
<i>Tier 1 capital (to risk-weighted assets):</i>						
Company	66,750	14.95	17,855	4.00	NA	NA
Bank	66,712	14.96	17,842	4.00	26,764	6.00
<i>Total capital (to risk-weighted assets):</i>						
Company	72,376	16.21	35,710	8.00	NA	NA
Bank	72,334	16.22	35,685	8.00	44,606	10.00

The primary source for dividends paid to our shareholders is dividends paid to us from our subsidiary Bank of the Pacific. There are regulatory restrictions on the ability of our subsidiary bank to pay dividends. Under federal regulations, the dollar amount of dividends the bank may pay depends upon its capital position and recent net income. Generally, if an institution satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed under state law and FDIC regulations. In addition, the Company is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval.

Note 18 — 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.

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Note 18 — Fair Value of Financial Instruments – (continued)

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, 2013 or 2012.

The following table presents the balances of assets and liabilities measured at fair value on a recurring basis at December 31, 2013 and December 31, 2012:

December 31, 2013	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	\$—	\$ 8,811	\$ —	\$ 8,811
State and municipal securities	—	30,741	1,419	32,160
Agency MBS	—	52,180	—	52,180
Non-agency MBS	—	2,011	—	2,011
Corporate bonds	—	982	—	982
Total	\$—	\$94,725	\$1,419	\$96,144

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Note 18 — Fair Value of Financial Instruments – (continued)

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
State and municipal securities	—	25,807	1,099	26,906
Agency MBS	—	22,159	—	22,159
Non-agency MBS	—	2,544	—	2,544
Corporate bonds	<u>1,957</u>	<u>1,588</u>	<u>—</u>	<u>3,545</u>
Total	<u>\$1,957</u>	<u>\$58,050</u>	<u>\$1,099</u>	<u>\$61,106</u>

As of December 31, 2013 and 2012, 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, 2013 and 2012, respectively. There were no transfers of assets into or out of Level 1, into level 2, or out of level 3 during 2013. During 2013, the Company concluded that certain municipal securities were valued a discount rate that was a significant unobservable input due to the lack of liquidity and observable information related to the credit spread for these securities and transferred these assets from Level 2 to Level 3. There were no transfers into or out of Level 1, 2, or 3 during 2012.

	<u>2013</u>	<u>2012</u>
Balance beginning of year	\$1,099	\$1,140
Transfers in to Level 3	464	—
Change in FV included in other comprehensive income	(144)	(41)
Matured	<u>—</u>	<u>—</u>
Balance end of year	<u>\$1,419</u>	<u>\$1,099</u>

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.

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Note 18 — Fair Value of Financial Instruments – (continued)

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 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.

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Note 18 — Fair Value of Financial Instruments – (continued)

The following table presents the Company's assets that were accounted for at fair value on a nonrecurring basis at December 31, 2013 and 2012:

	Readily Available Market Inputs Level 1	Observable Market Inputs Level 2	Significant Unobservable Inputs Level 3	Total
December 31, 2013				
Impaired loans	\$—	\$—	\$ 162	\$ 162
OREO	\$—	\$—	\$1,960	\$1,960
December 31, 2012				
Impaired loans	\$—	\$—	\$5,053	\$5,053
OREO	\$—	\$—	\$4,807	\$4,807

Other real estate owned with a pre-foreclosure loan balance of \$1,821 was acquired during the year ended December 31, 2013. Upon foreclosure, these assets were written down \$64 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, 2013:

	Fair Value	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)
Impaired loans	\$ 162	Appraised value	Adjustment for market conditions	0 – 10% (1.9%)
OREO	\$1,960	Appraised value	Adjustment for market conditions	0 – 10% (4.2%)

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.

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

Note 18 — Fair Value of Financial Instruments – (continued)

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.

Pacific Financial Corporation and Subsidiary

**December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts**

Note 18 — Fair Value of Financial Instruments – (continued)

The estimated fair values of the Company's financial instruments at December 31, 2013 and December 31, 2012 are as follows:

December 31, 2013	Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets					
Cash and interest bearing deposits in banks	\$ 35,948	\$35,948	\$ —	\$ —	\$ 35,948
Certificates of deposits held for investment	2,727	2,727	—	—	2,727
Securities available-for sale	96,144	—	94,725	1,419	96,144
Securities held-to-maturity	2,132	—	2,158	—	2,158
Federal Home Loan Bank stock	3,013	—	3,013	—	3,013
Loans held for sale	7,765	—	7,765	—	7,765
Loans, net	496,307	—	—	473,224	473,224
Financial Liabilities					
Deposits	\$607,347	\$ —	\$606,654	\$ —	\$606,645
Short-term borrowings	—	—	—	—	—
Long-term borrowings	10,000	—	10,195	—	10,195
Junior subordinated debentures	13,403	—	—	7,646	7,646
December 31, 2012	Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets					
Cash and interest bearing deposits in banks	\$ 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					
Short-term borrowings	\$548,243	\$ —	\$549,504	\$ —	\$549,504
Long-term borrowings	3,000	—	3,042	—	3,042
Secured borrowings	7,500	—	7,765	—	7,765
Junior subordinated debentures	13,403	—	—	8,318	8,318

Pacific Financial Corporation and Subsidiary

**December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts**

Note 19 — 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, 2013			
Basic earnings per share:	\$3,731	10,121,738	\$0.37
Effect of dilutive securities:	—	66,150	—
Diluted earnings per share:	\$3,731	10,189,888	\$0.37
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

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 20 — Business Combination

On January 28, 2013, the Bank and Sterling Savings Bank, a Washington state-chartered bank (“Sterling”), entered into a Purchase and Assumption Agreement (the “Agreement”) pursuant to which the Bank agreed to purchase from Sterling three branches located in Aberdeen, Washington; Astoria, Oregon; and Seaside, Oregon, including certain deposit liabilities, loans and other assets and liabilities associated with such branch locations. The actual amount of loans and deposits, the value of other assets and liabilities transferred to the Bank and the actual price paid were determined at the time of the closing of the transaction on June 1, 2013, in accordance with the terms of the Agreement. The purchase price was \$976 and exceeded the estimated fair value of tangible net assets acquired by approximately \$1,127, which was recorded as goodwill and intangible assets.

Cash flow information relative to the asset purchase agreement is as follows (in thousands):

Fair value of tangible net assets acquired	\$ 37,533
Cash paid for deposit premium	(976)
Liabilities assumed	(37,684)
Goodwill and intangible assets recorded	\$ 1,127

The primary purpose of the acquisition is to expand the Company’s market share in the northern Oregon coast, to provide existing customers with added convenience and service, and to provide our new customers with the opportunity to enjoy the outstanding personalized service and commitment of our community-based bank.

Pacific Financial Corporation and Subsidiary

**December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts**

Note 20 — Business Combination – (continued)

Fair value adjustments and related goodwill were recorded in the statement of financial condition of the Company. The following is a condensed balance sheet disclosing the estimated fair value amounts of the acquired branches of Sterling assigned to the major consolidated asset and liability captions at the acquisition date (in thousands):

Cash and cash equivalents	\$31,941
Loans receivable	3,989
Premises and equipment	604
Goodwill and intangible assets	1,127
Other assets	23
Total assets	<u>\$37,684</u>
Deposits and accrued interest payable	\$37,636
Deferred tax liability	47
Other liabilities	1
Equity	—
Total liabilities and shareholders' equity	<u>\$37,684</u>

The core deposit intangible asset that was recognized as part of the business combination was \$242 and will be amortized over its estimated useful life of approximately ten years utilizing an accelerated method. The goodwill of \$885 will not be amortized for financial statement purposes; instead, it will be reviewed annually for impairment.

The fair value of savings and transaction deposit accounts acquired from Sterling was assumed to approximate the carrying value as these accounts have no stated maturity and are payable on demand. Certificates of deposit were valued by comparing the contractual cost of the portfolio to an identical portfolio bearing current market rates. The projected cash flows from maturing certificates were calculated based on contractual rates. The fair value of certificates of deposit was calculated by discounting their contractual cash flows at a market rate for a certificate of deposit with a corresponding maturity.

Direct costs related to the Sterling acquisition will be expensed as incurred in the year ended December 31, 2013. These acquisition and integration expenses will include salaries and benefits, technology and communications, occupancy and equipment, professional services and other noninterest expenses. For the year ended December 31, 2013, the Company incurred \$615,000 of expenses related to acquisition costs.

The following table presents an unaudited pro forma balance sheet of the Company as if the acquisition of the Sterling branches had occurred on December 31, 2012. The pro forma balance sheet does not necessarily reflect the combined balance sheet that resulted as of the closing of the branch acquisition of the Sterling branches.

	<u>December 31, 2012</u>
ASSETS	
Cash and cash equivalents	\$ 91,781
Investment securities	68,043
Loans receivable, net	455,777
Premises and equipment	15,197
Goodwill and intangible assets	13,677
Other assets	36,803
Total assets	<u>\$681,278</u>
LIABILITIES AND SHAREHOLDERS' EQUITY	
Deposits and accrued interest payable	\$586,092
Borrowings	23,903
Other liabilities	4,562
Equity	66,721
Total liabilities and shareholders' equity	<u>\$681,278</u>

Pacific Financial Corporation and Subsidiary

**December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts**

Note 20 — Business Combination – (continued)

The following table presents the unaudited pro forma results of operations for the twelve months ended December 31, 2012 as if the acquisition of the Sterling branches had occurred on January 1, 2012. This pro forma information gives effect to certain adjustments, including purchase accounting fair value adjustments and amortization of the core deposit intangible asset. Significant assumptions utilized include the acquisition cost noted above, accretion of interest rate fair value adjustment, amortization of the core deposit intangible asset and a 21% effective tax rate. The pro forma information does not necessarily reflect the results of operations that would have occurred had the Company purchased and assumed the assets and liabilities of the Sterling branches at January 1, 2012. Cost savings are also not reflected in the unaudited pro forma amounts for the twelve months ended December 31, 2012.

	Twelve Months Ended December 31, 2012
Net interest income	\$25,357
Noninterest income	9,776
Noninterest expense	30,131
Income taxes	<u>1,072</u>
Net income	<u>\$ 3,930</u>
 Pro forma earnings per share	
Basic	\$ 0.39
Diluted	\$ 0.39

Operations of the branches acquired have been included in the consolidated financial statements since June 1, 2013. The Company does not consider these branches a separate reporting unit and does not track the amount of revenue and net income attributable to these branches since the acquisition, two of which were subsequently consolidated into existing operations. As such, it is impracticable to determine such amounts for the twelve months ended December 31, 2013 for both the balance sheet and income statement.

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

Note 21 — Condensed Financial Information — Parent Company Only

Condensed Balance Sheets — December 31,

	2013	2012
Assets		
Cash	\$ 2,483	\$ 173
Investment in the Bank	79,701	79,684
Other assets	432	403
Total assets	<u>\$82,616</u>	<u>\$80,260</u>
Liabilities and Shareholders' Equity		
Junior subordinated debentures	\$13,403	\$13,403
Due to the Bank	—	95
Dividends payable	2,036	—
Other liabilities	40	41
Shareholders' equity	67,137	66,721
Total liabilities and shareholders' equity	<u>\$82,616</u>	<u>\$80,260</u>

Condensed Statements of Income — Years Ended December 31,

	2013	2012	2011
Dividend Income from the Bank	\$2,400	\$3,500	\$ —
Other Income	7	10	8
Total Income	<u>2,407</u>	<u>3,510</u>	<u>8</u>
Expenses	<u>(608)</u>	<u>(517)</u>	<u>(600)</u>
Income (loss) before income tax benefit	<u>1,799</u>	<u>2,993</u>	<u>(592)</u>
Income Tax Benefit	124	101	—
Income (loss) before equity in undistributed			
Income of the Bank	<u>1,923</u>	<u>3,094</u>	<u>(592)</u>
Equity in Undistributed Income of the Bank	<u>1,808</u>	<u>1,691</u>	<u>3,410</u>
Net income	<u>\$3,731</u>	<u>\$4,785</u>	<u>\$2,818</u>

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

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

Note 21 — Condensed Financial Information — Parent Company Only – (continued)

Condensed Statements of Cash Flows — Years Ended December 31,

	2013	2012	2011
Operating Activities			
Net income	\$ 3,731	\$ 4,785	\$ 2,818
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Equity in undistributed income of subsidiary	(1,808)	(1,691)	(3,410)
Net change in other assets	(29)	35	(8)
Net change in other liabilities	(96)	(1,312)	352
Other – net	117	24	26
Net cash provided by (used in) operating activities	1,915	1,841	(222)
Financing Activities			
Common stock issued	394	—	—
Dividends paid	—	(2,024)	—
Net cash used in financing activities	394	(2,024)	—
Net decrease in cash	2,309	(183)	(222)
Cash			
Beginning of year	173	356	578
End of year	\$ 2,483	\$ 173	\$ 356

Pacific Financial Corporation and Subsidiary

December 31, 2013 and 2012 and for the three years ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

Note 21 — Condensed Financial Information — Parent Company Only – (continued)

Quarterly Data (Unaudited)

Year Ended December 31, 2013	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Interest income	\$6,271	\$6,600	\$6,605	\$ 6,814
Interest expense	689	648	590	563
Net interest income	5,582	5,952	6,015	6,251
Provision for (recapture of) credit losses	—	(450)	—	—
Non-interest income	2,626	3,175	2,232	1,922
Non-interest expenses	7,419	7,872	7,089	7,122
Income before income taxes	789	1,705	1,158	1,051
Income taxes	88	373	249	262
Net income	<u>\$ 701</u>	<u>\$1,332</u>	<u>\$ 909</u>	<u>\$ 789</u>
Earnings per common share:				
Basic	\$.07	\$.13	\$.09	\$.08
Diluted . . . . .	.07	.13	.09	.08
Year Ended December 31, 2012				
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	<u>\$1,018</u>	<u>\$1,073</u>	<u>\$1,015</u>	<u>\$ 1,679</u>
Earnings per common share:				
Basic	\$.10	\$.11	\$.10	\$.16
Diluted . . . . .	.10	.11	.10	.16

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 21th day of March, 2014.

PACIFIC FINANCIAL CORPORATION
(Registrant)

/s/ Dennis A. Long

Dennis A. Long, President and CEO

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated, on the 21th day of March, 2014.

Principal Executive Officer and Director

/s/ Dennis A. Long

Dennis A. Long, President and CEO and Director

Principal Financial and Accounting Officer

/s/ Douglas N. Biddle

Douglas N. Biddle, Treasurer

Remaining Directors

/s/ Gary C. Forcum

Gary C. Forcum (Chairman of the Board)

/s/ Randy W. Rognlin

Randy W. Rognlin

/s/ Randy Rust

Randy Rust

/s/ Douglas M. Schermer

Douglas M. Schermer

/s/ Denise Portmann

Denise Portmann

/s/ John Van Dijk

John Van Dijk

/s/ Edwin Ketel

Edwin Ketel

/s/ Dwayne Carter

Dwayne Carter

/s/ Susan C. Freese

Susan C. Freese

/s/ Lori Reece

Lori Reece

Exhibit Index

EXHIBIT NO.	EXHIBIT
3.1	Restated Articles of Incorporation. Incorporated by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2000.
3.2	Bylaws. Incorporated by reference to Exhibit 2b to Form 8-A filed by the Company and declared effective on March 7, 2000 (Registration No. 000-29329).
4.1	Form of Warrant to purchase shares of Common Stock issued to Ithan Creek Master Investors (Cayman) L.P. (the Purchaser). Incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K dated August 25, 2009 (the 2009 8-K).
4.2	Form of Warrant to purchase shares of Common Stock issued to investors in 2009 private placement other than the Purchaser referred to in Exhibit 4.1. Incorporated by reference to Exhibit 4.2 to the Company's Annual Report on Form 10-K for the year ended December 31, 2009.
10.1	Amended and Restated Employment Agreement with Dennis A. Long dated December 29, 2008. Incorporated by reference to Exhibit 10.1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2008 (the 2008 10-K).*
10.2	First Amendment to Amended and Restated Employment Agreement with Dennis A. Long dated January 11, 2013. Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K dated January 11, 2013.*
10.3	Amended and Restated Employment Agreement with Bruce D. MacNaughton dated December 29, 2008. Incorporated by reference to Exhibit 10.3 to the 2008 10-K.*
10.4	First Amendment to Amended and Restated Employment Agreement with Bruce D. MacNaughton dated January 11, 2013. Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K dated January 11, 2013.*
10.5	Amended and Restated Employment Agreement with Denise Portmann dated December 29, 2008. Incorporated by reference to Exhibit 10.4 to the 2008 10-K.*
10.6	First Amendment to Amended and Restated Employment Agreement with Denise J. Portmann dated January 11, 2013. Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K dated January 11, 2013.*
10.7	Employment Agreement with Douglas N. Biddle dated February 10, 2014. Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K dated February 10, 2014.
10.8	2000 Stock Incentive Compensation Plan, as amended (the 2000 Plan). Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2007 (the March 2007 10-Q).*
10.9	Forms of stock option agreements under the 2000 Plan. Incorporated by reference to Exhibits 10.2 and 10.3 to the March 2007 10-Q.*
10.10	Supplemental Executive Retirement Plan effective January 1, 2007. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated March 13, 2008 (the March 2008 8-K).*
10.11	Individual Participation Agreement (SERP) dated March 13, 2008, between the Company and Dennis A. Long. Incorporated by reference to Exhibit 10.2 to the March 2008 8-K.*
10.12	Individual Participation Agreement (SERP) dated March 13, 2008, between the Company and John Van Dijk. Incorporated by reference to Exhibit 10.3 to the March 2008 8-K.*
10.13	Individual Participation Agreement (SERP) dated March 13, 2008, between the Company and Bruce MacNaughton. Incorporated by reference to Exhibit 10.4 to the March 2008 8-K.*
10.14	Individual Participation Agreement (SERP) dated March 13, 2008, between the Company and Denise Portmann. Incorporated by reference to Exhibit 10.5 to the March 2008 8-K.*

EXHIBIT NO.	EXHIBIT
10.15	Pacific Financial Corporation Annual Incentive Compensation Plan, approved March 9, 2011. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated March 9, 2011.*
10.16	Pacific Financial Corporation Amended and Restated 2011 Equity Incentive Plan. Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2013
10.17	Forms of nonqualified option, incentive option and restricted unit award statements for use under the 2011 Plan.*
21	Subsidiaries of Registrant
23.1	Consent of Deloitte & Touche LLP, Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)
32	Certification Pursuant to 18 U.S.C. 1350

* Listed document is a management contract, compensation plan or arrangement.

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**Forms of Nonqualified Stock Option, Incentive Stock Option and Restricted Unit
Award Statements under 2011 Equity Incentive Plan**

**PACIFIC FINANCIAL CORPORATION
2011 EQUITY INCENTIVE PLAN
NONQUALIFIED STOCK OPTION AWARD STATEMENT**

- (A) Name of Holder:
 (B) Grant Date:
 (C) Number of Shares:
 (D) Exercise Price:
 (E) Expiration Date:

THIS NONQUALIFIED STOCK OPTION AWARD STATEMENT (this "Statement") is made and entered into as of the date set forth in Item (B) above (the "Grant Date") between Pacific Financial Corporation, a Washington corporation (the "Company"), and the person named in Item (A) above ("Holder").

THE PARTIES AGREE AS FOLLOWS:

1. Grant of Option; Grant Date. The Company hereby grants to Holder pursuant to the Company's 2011 Equity Incentive Plan, as amended from time to time (the "Plan"), a copy of which is available from the Company on request, the right (the "Option") to purchase up to the number of shares of the Company Stock listed in Item (C) above (the "Option Shares") at the price per share set forth in Item (D) above (the "Exercise Price"), on the terms and conditions set forth in this Statement and in the Plan, the terms and conditions of the Plan being incorporated into this Statement by reference. This Option is not intended to qualify as an incentive stock option for purposes of Section 422 of the Internal Revenue Code of 1986, as amended. The number and kind of Option Shares and the Exercise Price may be adjusted in certain circumstances in accordance with the provisions of Section 10.2 of the Plan.

2. Definitions. The following terms, as used in this Statement, shall have these meanings:

"Cause" has the meaning set forth in Holder's employment agreement with the Company, and if not so defined means dishonesty, fraud, misconduct, disclosure of confidential information, conviction of, or a plea of guilty or no contest to, a felony under the laws of the United States or any state thereof, habitual absence from work for reasons other than illness, intentional conduct which causes significant injury to the Company, habitual abuse of alcohol or a controlled substance, in each case as determined by the Committee, and its determination shall be conclusive and binding.

"Disability" means a medically determinable mental or physical impairment or condition of the Holder that is expected to result in death or which has lasted or is expected to last for a continuous period of 12 months or more and which causes the Holder to be unable, in the opinion of the Committee on the basis of evidence acceptable to it, to perform his or her duties to the Company. Upon making a determination of Disability, the Committee shall, for purposes of this Statement, determine the date of the Holder's termination of employment or service.

Terms used but not otherwise defined in this Statement have the meanings set forth in the Plan.

3. Exercise of Options

3.1 Exercise Schedule. The Option shall vest and be exercisable according to the following schedule: (a) 20% on the date one year after the Grant Date; and (b) an additional 20% each successive year thereafter, so that 100% of the Option shall be fully vested and exercisable on and after the date which is five years after the Grant Date. The unvested portion of the Option, if any, shall terminate

immediately upon the Holder's termination of employment by or service to the Company for any reason whatsoever. This Agreement and the Option shall be subject to the change in control provisions of Article IX of the Plan.

[*Alternative:* 3.1 **Exercise Schedule.** The Option shall be fully vested and exercisable on and after the date which is **five** (5) years after the Grant Date. The Option shall terminate immediately upon the Holder's termination of employment, prior to the five (5) years vesting period, or service to the Company for any reason whatsoever. This Agreement and the Option shall be subject to the change in control provisions of Article IX of the Plan.]

3.2 **Manner of Exercise.** Holder may exercise the Option as provided in Section 5.4 of the Plan. The Option may only be exercised to purchase that number of Shares having an aggregate Fair Market Value on the date of exercise greater than or equal to \$2,500 (or the lesser number of remaining shares covered by this Statement).

4. **Termination of Option.** Any vested portion of the Option shall terminate, to the extent not previously exercised, upon the first to occur of the following events:

(a) ten years from the Grant Date;

(b) the expiration of three months from the date of Holder's termination of employment by or services to the Company for any reason other than death or Disability;

(c) the expiration of one year from (i) the date of Holder's death or (ii) Holder's termination of employment by or service to the Company coincident with Disability; or

(d) immediately upon Holder's termination of employment by or service to the Company for Cause.

5. **Nonassignability of Option.** The Option is not assignable or transferable by Holder except in accordance with Section 10.1 of the Plan. Any attempt to assign, pledge, transfer, hypothecate or otherwise dispose of the Option in a manner not herein permitted, and any levy of execution, attachment, or similar process on the Option, shall be null and void.

6. **Restriction on Issuance of Shares.**

6.1 **Legality of Issuance.** The Company shall not be obligated to issue any Option Shares pursuant to this Statement if such sale or issuance, in the judgment of the Company and the Company's counsel, might constitute a violation by the Company of any provision of law, including without limitation the provisions of the Securities Act of 1933, as amended (the "Securities Act").

6.2 **Registration or Qualification of Securities.** The Company may, but shall not be required to, register or qualify the sale of any Option Shares under the Securities Act or any other applicable law. The Company shall not be obligated to take any affirmative action in order to cause the grant or exercise of this Option or the issuance or sale of any Option Shares pursuant thereto to comply with any law.

7. **Restriction on Transfer.** Regardless of whether a sale of the Option Shares has been registered under the Securities Act or has been registered or qualified under the securities laws of any state, the Company may impose restrictions upon the sale, pledge, or other transfer of Option Shares (including the placement of appropriate legends on stock certificates) if, in the judgment of the Company and the Company's counsel, such restrictions are necessary or desirable in order to achieve compliance with the provisions of the Securities Act, the securities laws of any state, or any other law, or if the Company does not desire to have a trading market develop for its securities.

8. **Professional Advice.** The acceptance and exercise of the Option and the sale of Option Shares has consequences under federal and state tax and securities laws which may vary depending upon the individual circumstances of the Holder. Accordingly, Holder acknowledges that he or she has been advised to consult his or her personal legal and tax advisor in connection with this Statement and Holder's dealings with respect to the Option and the Option Shares. Holder further acknowledges that the Company has made no warranties or

representations to Holder with respect to the income tax consequences of the grant and exercise of this Option or the sale of the Option Shares and Holder is in no manner relying on the Company or its representatives for an assessment of such consequences.

9. Assignment; Binding Effect. Subject to the limitations set forth in this Statement, this Statement shall be binding upon and inure to the benefit of the executors, administrators, heirs, legal representatives, and successors of the parties hereto; provided, however, that Holder may not assign any of Holder's rights under this Statement.

10. Damages. Holder shall be liable to the Company for all costs and damages, including incidental and consequential damages, resulting from a disposition of Option Shares, which is not in conformity with the provisions of this Statement.

11. Governing Law. This Statement shall be governed by, and construed in accordance with, the laws of the State of Washington excluding those laws that direct the application of the laws of another jurisdiction.

12. Notices. All notices and other communications under this Statement shall be in writing. Unless and until Holder is notified in writing to the contrary, all notices, communications, and documents directed to the Company and related to the Statement if not delivered by hand, shall be mailed, addressed as follows:

Pacific Financial Corporation
300 East Market Street
Aberdeen, Washington 98520
c/o Corporate Secretary

Unless and until the Company is notified in writing to the contrary, all notices, communications, and documents intended for Holder and related to this Statement, if not delivered by hand, shall be mailed to Holder's last known address as shown on the Company's books. Notices and communications shall be mailed by first class mail, postage prepaid; documents shall be mailed by registered mail, return receipt requested, postage prepaid. All mailings and deliveries related to this Statement shall be deemed received when actually received, if by hand delivery, and two business days after mailing, if by mail.

13. Arbitration. Any and all disputes or controversies arising out of this Statement shall be finally settled by arbitration conducted in Seattle, Washington, in accordance with the then existing rules of the American Arbitration Association, and judgment upon the award rendered by the arbitrators may be entered in any court having jurisdiction thereof, provided that nothing in this Section 13 shall prevent a party from applying to a court of competent jurisdiction to obtain temporary relief pending resolution of the dispute through arbitration. The parties hereby agree that service of any notices in the course of such arbitration at their respective addresses as provided for in Section 12 shall be valid and sufficient.

14. Rights of Holder. Neither this Option, the execution of this Statement nor the exercise of any portion of this Option shall confer upon Holder any right to, or guarantee of, continued employment by, or service as a director or consultant to, the Company, or in any way limit the right of the Company to terminate Holder's relationship with the Company.

15. Statement Subject to Plan. This Statement and the Option are subject to the terms and conditions set forth in the Plan and in any amendments to the Plan existing now or in the future, which terms and conditions are incorporated herein by reference. This Statement and the Plan set forth the entire and exclusive understanding between the Company and Holder with respect to the Option and shall be deemed to integrate, replace and supersede all previous communications, representations or agreements between the parties, whether written or oral, regarding the grant of stock options or the purchase by or issuances of shares to Holder. Neither this Statement nor any term hereof may be changed, waived, discharged or terminated except by an instrument in writing signed by the Company and the Holder.

IN WITNESS WHEREOF, the parties have executed this Statement as of the Grant Date.

PACIFIC FINANCIAL CORPORATION

By: _____

Name: Dennis Long

Title: CEO

Holder hereby accepts and agrees to be bound by all of the terms and conditions of this Statement and the Plan.

Holder: _____

Dated Signed: _____

**PACIFIC FINANCIAL CORPORATION
2011 EQUITY INCENTIVE PLAN
INCENTIVE STOCK OPTION AWARD STATEMENT**

(A) Name of Holder: _____

(B) Grant Date: _____

(C) Number of Shares: _____

(D) Exercise Price: _____

THIS INCENTIVE STOCK OPTION AWARD STATEMENT (this "Statement") is made and entered into as of the date set forth in Item (B) above (the "Grant Date") between Pacific Financial Corporation, a Washington corporation (the "Company"), and the person named in Item A above ("Holder").

THE PARTIES AGREE AS FOLLOWS:

1. Grant of Option; Grant Date. The Company hereby grants to Holder pursuant to the Company's 2011 Equity Incentive Plan, as amended from time to time (the "Plan"), a copy of which is available from the Company on request, the right (the "Option") to purchase up to the number of shares of the Company Stock listed in Item (C) above (the "Option Shares") at the price per share set forth in Item (D) above (the "Exercise Price"), on the terms and conditions set forth in this Statement and in the Plan, the terms and conditions of the Plan being incorporated into this Statement by reference. This Option is intended to qualify as an incentive stock option for purposes of Section 422 of the Internal Revenue Code of 1986, as amended. The number and kind of Option Shares and the Exercise Price may be adjusted in certain circumstances in accordance with the provisions of Section 10.2 of the Plan.

2. Definitions. The following terms, as used in this Statement, shall have these meanings:

"Cause" has the meaning set forth in Holder's employment agreement with the Company, and if not so defined means dishonesty, fraud, misconduct, disclosure of confidential information, conviction of, or a plea of guilty or no contest to, a felony under the laws of the United States or any state thereof, habitual absence from work for reasons other than illness, intentional conduct which causes significant injury to the Company, habitual abuse of alcohol or a controlled substance, in each case as determined by the Committee, and its determination shall be conclusive and binding.

"Disability" means a medically determinable mental or physical impairment or condition of the Holder that is expected to result in death or which has lasted or is expected to last for a continuous period of 12 months or more and which causes the Holder to be unable, in the opinion of the Committee on the basis of evidence acceptable to it, to be engaged in any substantial gainful activity. Upon making a determination of Disability, the Committee shall, for purposes of this Statement, determine the date of the Holder's termination of employment or service.

Terms used but not otherwise defined in this Statement have the meanings set forth in the Plan.

3. Exercise of Options

3.1 Exercise Schedule. The Option shall vest and be exercisable according to the following schedule: (a) 20% on the date one year after the Grant Date; and (b) an additional 20% each successive year thereafter, so that 100% of the Option shall be fully vested and exercisable on and after the date which is five years after the Grant Date. The unvested portion of the Option, if any, shall terminate immediately upon the Holder's termination of employment by or service to the Company for any reason whatsoever. This Agreement and the Option shall be subject to the change in control provisions of Article IX of the Plan.

3.2 Manner of Exercise. Holder may exercise the Option as provided in Section 5.4 of the Plan. The Option may only be exercised to purchase that number of Shares having an aggregate Fair Market Value on the date of exercise greater than or equal to \$2,500 (or the lesser number of remaining shares covered by this Statement).

4. Termination of Option. Any vested portion of the Option shall terminate, to the extent not previously exercised, upon the first to occur of the following events:

(a) ten years from the Grant Date;

(b) the expiration of three months from the date of Holder's termination of employment by or services to the Company for any reason other than death or Disability;

(c) the expiration of one year from (i) the date of Holder's death or (ii) Holder's termination of employment by or service to the Company coincident with Disability; or

(d) immediately upon Holder's termination of employment by or service to the Company for Cause.

5. Nonassignability of Option. The Option is not assignable or transferable by Holder except in accordance with Section 10.1 of the Plan. Any attempt to assign, pledge, transfer, hypothecate or otherwise dispose of the Option in a manner not herein permitted, and any levy of execution, attachment, or similar process on the Option, shall be null and void.

6. Restriction on Issuance of Shares.

6.1 Legality of Issuance. The Company shall not be obligated to issue any Option Shares pursuant to this Statement if such sale or issuance, in the judgment of the Company and the Company's counsel, might constitute a violation by the Company of any provision of law, including without limitation the provisions of the Securities Act of 1933, as amended (the "Securities Act").

6.2 Registration or Qualification of Securities. The Company may, but shall not be required to, register or qualify the sale of any Option Shares under the Securities Act or any other applicable law. The Company shall not be obligated to take any affirmative action in order to cause the grant or exercise of this Option or the issuance or sale of any Option Shares pursuant thereto to comply with any law.

7. Restriction on Transfer. Regardless of whether a sale of the Option Shares has been registered under the Securities Act or has been registered or qualified under the securities laws of any state, the Company may impose restrictions upon the sale, pledge, or other transfer of Option Shares (including the placement of appropriate legends on stock certificates) if, in the judgment of the Company and the Company's counsel, such restrictions are necessary or desirable in order to achieve compliance with the provisions of the Securities Act, the securities laws of any state, or any other law, or if the Company does not desire to have a trading market develop for its securities.

8. Professional Advice. The acceptance and exercise of the Option and the sale of Option Shares has consequences under federal and state tax and securities laws which may vary depending upon the individual circumstances of the Holder. Accordingly, Holder acknowledges that he or she has been advised to consult his or her personal legal and tax advisor in connection with this Statement and Holder's dealings with respect to the Option and the Option Shares. Holder further acknowledges that the Company has made no warranties or representations to Holder with respect to the income tax consequences of the grant and exercise of this Option or the sale of the Option Shares and Holder is in no manner relying on the Company or its representatives for an assessment of such consequences.

9. Assignment; Binding Effect. Subject to the limitations set forth in this Statement, this Statement shall be binding upon and inure to the benefit of the executors, administrators, heirs, legal representatives, and successors of the parties hereto; provided, however, that Holder may not assign any of Holder's rights under this Statement.

10. Damages. Holder shall be liable to the Company for all costs and damages, including incidental and consequential damages, resulting from a disposition of Option Shares, which is not in conformity with the provisions of this Statement.

11. **Governing Law.** This Statement shall be governed by, and construed in accordance with, the laws of the State of Washington excluding those laws that direct the application of the laws of another jurisdiction.

12. **Notices.** All notices and other communications under this Statement shall be in writing. Unless and until Holder is notified in writing to the contrary, all notices, communications, and documents directed to the Company and related to the Statement if not delivered by hand, shall be mailed, addressed as follows:

Pacific Financial Corporation
300 East Market Street
Aberdeen, Washington 98520
c/o Corporate Secretary

Unless and until the Company is notified in writing to the contrary, all notices, communications, and documents intended for Holder and related to this Statement, if not delivered by hand, shall be mailed to Holder's last known address as shown on the Company's books. Notices and communications shall be mailed by first class mail, postage prepaid; documents shall be mailed by registered mail, return receipt requested, postage prepaid. All mailings and deliveries related to this Statement shall be deemed received when actually received, if by hand delivery, and two business days after mailing, if by mail.

13. **Arbitration.** Any and all disputes or controversies arising out of this Statement shall be finally settled by arbitration conducted in Seattle, Washington, in accordance with the then existing rules of the American Arbitration Association, and judgment upon the award rendered by the arbitrators may be entered in any court having jurisdiction thereof, provided that nothing in this Section 13 shall prevent a party from applying to a court of competent jurisdiction to obtain temporary relief pending resolution of the dispute through arbitration. The parties hereby agree that service of any notices in the course of such arbitration at their respective addresses as provided for in Section 12 shall be valid and sufficient.

14. **Rights of Holder.** Neither this Option, the execution of this Statement nor the exercise of any portion of this Option shall confer upon Holder any right to, or guarantee of, continued employment by, or service as a director or consultant to, the Company, or in any way limit the right of the Company to terminate Holder's relationship with the Company.

15. **Statement Subject to Plan.** This Statement and the Option are subject to the terms and conditions set forth in the Plan and in any amendments to the Plan existing now or in the future, which terms and conditions are incorporated herein by reference. This Statement and the Plan set forth the entire and exclusive understanding between the Company and Holder with respect to the Option and shall be deemed to integrate, replace and supersede all previous communications, representations or agreements between the parties, whether written or oral, regarding the grant of stock options or the purchase by or issuances of shares to Holder. Neither this Statement nor any term hereof may be changed, waived, discharged or terminated except by an instrument in writing signed by the Company and the Holder.

IN WITNESS WHEREOF, the parties have executed this Statement as of the Grant Date.

PACIFIC FINANCIAL CORPORATION

By: _____

Name: _____

Title: _____

Holder hereby accepts and agrees to be bound by all of the terms and conditions of this Statement and the Plan.

Holder: _____

Dated Signed: _____

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**PACIFIC FINANCIAL CORPORATION
2011 EQUITY INCENTIVE PLAN
RESTRICTED UNIT AWARD STATEMENT**

(A) Name of Holder: _____

(B) Grant Date: _____

(C) Number of Restricted Units: _____

THIS RESTRICTED UNIT AWARD STATEMENT (this “Statement”) is made and entered into as of the date set forth in Item (B) above (the “Grant Date”) between Pacific Financial Corporation, a Washington corporation (the “Company”) and the person named in Item (A) above (“Holder”).

THE PARTIES AGREE AS FOLLOWS:

1. Terms of Restricted Unit Award.

1.1 Restricted Unit Award. The Company hereby grants to Holder pursuant to the Company’s 2011 Equity Incentive Plan, as amended from time to time (the “Plan”), a copy of which is available from the Company on request, the number of Restricted Units specified in Item (C) above (the “RSUs”). Each RSU represents a hypothetical share of Company Stock. As a holder of RSUs, Holder will have only the rights of a general unsecured creditor of the Company until delivery of shares of Company Stock is made as specified in this Statement. Any capitalized term used in this Statement but not otherwise defined herein shall have the meaning ascribed to it in the Plan.

1.2 Restriction Period. The “Restriction Period” commences on the Grant Date and ends on the third anniversary of the Grant Date.

1.3 Vesting of RSUs. The RSUs are initially unvested and, if not previously forfeited, will become fully vested and non-forfeitable upon the earlier of the expiration of the Restriction Period or the occurrence of an Acceleration Event.

1.4 Forfeiture of RSUs. In the event that during the Restriction Period Holder either (a) ceases to be an employee of the Company for any reason other than an Acceleration Event or (b) is placed on probation by the Company, all RSUs will be forfeited (unless previously vested due to the occurrence of an Acceleration Event).

1.5 Acceleration. The RSUs will become immediately fully vested and non-forfeitable upon the occurrence of the following “Acceleration Events”:

(i) The death or Disability of the Holder; or

(ii) The Holder is involuntarily terminated by the Company without Cause within 24 months following a Change in Control of the Company.

2. Definitions. The following terms, as used in this Statement, shall have these meanings:

(a) “Cause” has the meaning set forth in Holder’s employment agreement with the Company, and if not so defined means dishonesty, fraud, misconduct, disclosure of confidential information, conviction of, or a plea of guilty or no contest to, a felony under the laws of the United States or any state thereof, habitual absence from work for reasons other than illness, intentional conduct which causes significant injury to the Company, habitual abuse of alcohol or a controlled substance, in each case as determined by the Committee, and its determination shall be conclusive and binding.

(b) “Disability” means a medically determinable mental or physical impairment or condition of Holder that is expected to result in death or which has lasted or is expected to last for a continuous period of 12 months or more and which causes Holder to be unable, in the opinion of the Committee on the basis of evidence acceptable to it, to perform his or her duties for the Company.

3. Settlement of Restricted Unit Award.

3.1 Settlement Date. The RSUs will be settled by the Company on the earlier of (a) the first business day following the expiration of the Restriction Period or (b) the 30th calendar day following the occurrence of an Acceleration Event (in either case, the “Settlement Date”)

3.2 Form of Settlement. Unless previously forfeited pursuant to Section 1.4, on the Settlement Date, the Company will deliver to Holder an unrestricted certificate or other evidence of ownership used by the Company’s transfer agent for a number of shares of Company Stock equal to the number of RSUs granted pursuant to this Statement. Shares issued upon settlement of RSUs may be subject to additional transfer restrictions as provided in this Statement.

3.3 Withholding Taxes.

(a) General. Holder will be responsible for payment of all federal, state, and local withholding taxes and Holder’s portion of any applicable payroll taxes imposed in connection with the settlement of the RSUs and the issuance of shares (collectively, the “Applicable Taxes”). The Company’s obligation to issue shares of Company Stock in settlement of the RSUs is expressly conditioned on Holder’s making arrangements satisfactory to the Company, in its sole and absolute discretion, for the payment of all Applicable Taxes.

(b) Method of Payment. Holder may pay to the Company (in cash or by check) an amount equal to the Applicable Taxes. In the event that Holder does not submit payment of the entire amount of Applicable Taxes, Holder expressly authorizes the Company to withhold a number of unrestricted shares (thus reducing the number of unrestricted shares to be issued to Holder) having a fair market value (as of the Settlement Date) equal to the remaining balance of the Applicable Taxes.

4. **Stock Award Not Transferable.** Neither the RSUs nor any interest or right in the RSUs or this Statement may be sold, pledged, assigned, or transferred in any manner other than by will or the laws of descent and distribution, unless and until the RSUs have been settled as provided in this Statement. The RSUs will not be applicable to the debts, obligations, contracts or engagements of Holder or his or her successors in interest or be subject to disposition by transfer, alienation, pledge, encumbrance, assignment or any other means whether such disposition be voluntary or involuntary or by operation of law by judgment, levy, attachment, garnishment or any other legal or equitable proceedings (including bankruptcy), and any attempted disposition will be null and void and of no effect, except to the extent that such disposition is permitted by the preceding sentence.

5. **Rights as Shareholder.** Prior to the issuance of a certificate for shares of Company Stock in settlement of the RSUs, Holder will have no rights as a shareholder of the Company with respect to this Statement or the RSUs.

6. **Shares to Be Reserved.** The Company will at all times during the term of the RSUs reserve and keep available under the Plan such number of shares of Company Stock as will be sufficient to satisfy the requirements of this Statement.

7. **Exemption from Code Section 409A.** This Statement is intended to be exempt from the requirements of Section 409A of the Internal Revenue Code by reason of all payments under this Statement being “short-term deferrals” within the meaning of Treasury Regulation Section 1.409A-1(b)(4). All provisions of this Statement shall be interpreted in a manner consistent with preserving this exemption. In no event will the Company be liable for any tax, interest, or penalties that may be imposed on Holder by Code Section 409A or any damages for failing to comply with Code Section 409A. “Ceases to be an employee,” as used in Section 1.4, and similar terms mean “separation from service” as defined and interpreted in Treasury Regulation Section 1.409A-1(h) or in subsequent regulations or other guidance issued by the Internal Revenue Service.

8. **Compliance With Securities Laws.** Holder acknowledges that the RSUs are intended to conform to the extent necessary with all provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and any and all regulations and rules promulgated by the Securities and Exchange Commission thereunder, including without limitation Rule 144 under the Securities Act of 1933 and Rule 16b-3 under the Securities

Exchange Act of 1934. Notwithstanding anything herein to the contrary, the RSUs are granted only in such a manner as to conform to such laws, rules and regulations. To the extent permitted by applicable law, this Statement will be deemed amended to the extent necessary to conform to such laws, rules and regulations. The Company shall not be obligated to issue any Company Stock pursuant to this Statement if such sale or issuance, in the judgment of the Company and the Company's counsel, might constitute a violation by the Company of any provision of law, including without limitation the provisions of the Securities Act of 1933.

9. Clawback/Recovery. The RSUs and any Company Stock issued in settlement of the RSUs will be subject to recoupment in accordance with any clawback policy that the Company is required to adopt pursuant to the listing standards of any national securities exchange or association on which the Company's securities are listed or as is otherwise required by the Dodd-Frank Wall Street Reform and Consumer Protection Act or other applicable law, including the Sarbanes-Oxley Act of 2002. No recovery of compensation under such a clawback policy will be an event giving rise to a right to resign for "good reason" or "constructive termination" (or similar term) under any agreement with the Company.

10. Professional Advice. The acceptance and settlement of the RSUs has consequences under federal and state tax and securities laws which may vary depending upon the individual circumstances of the Holder. Accordingly, Holder acknowledges that he or she has been advised to consult his or her personal legal and tax advisor in connection with this Statement and Holder's dealings with respect to the RSUs. Holder further acknowledges that the Company has made no warranties or representations to Holder with respect to the income tax consequences of the grant and settlement of the RSUs and Holder is in no manner relying on the Company or its representatives for an assessment of such consequences.

11. Assignment; Binding Effect. Subject to the limitations set forth in this Statement, this Statement shall be binding upon and inure to the benefit of the executors, administrators, heirs, legal representatives, and successors of the parties hereto; provided, however, that Holder may not assign any of Holder's rights under this Statement.

12. Governing Law. This Statement shall be governed by, and construed in accordance with, the laws of the State of Washington excluding those laws that direct the application of the laws of another jurisdiction.

13. Notices. All notices and other communications under this Statement shall be in writing. Unless and until Holder is notified in writing to the contrary, all notices, communications, and documents directed to the Company and related to the Statement if not delivered by hand, shall be mailed, addressed as follows:

Pacific Financial Corporation
300 East Market Street
Aberdeen, Washington 98520
c/o Corporate Secretary

Unless and until the Company is notified in writing to the contrary, all notices, communications, and documents intended for Holder and related to this Statement, if not delivered by hand, shall be mailed to Holder's last known address as shown on the Company's books. Notices and communications shall be mailed by first class mail, postage prepaid; documents shall be mailed by registered mail, return receipt requested, postage prepaid. All mailings and deliveries related to this Statement shall be deemed received when actually received, if by hand delivery, and two business days after mailing, if by mail.

14. Arbitration. Any and all disputes or controversies arising out of this Statement shall be finally settled by arbitration conducted in Seattle, Washington, in accordance with the then existing rules of the American Arbitration Association, and judgment upon the award rendered by the arbitrators may be entered in any court having jurisdiction thereof, provided that nothing in this Section 13 shall prevent a party from applying to a court of competent jurisdiction to obtain temporary relief pending resolution of the dispute through arbitration. The parties hereby agree that service of any notices in the course of such arbitration at their respective addresses as provided for in Section 12 shall be valid and sufficient.

15. **Rights of Holder.** Neither this RSU, the execution of this Statement nor the vesting of any portion of this RSU shall confer upon Holder any right to, or guarantee of, continued employment by, or service as a director or consultant to, the Company, or in any way limit the right of the Company to terminate Holder's relationship with the Company.

16. **Statement Subject to Plan.** This Statement and the RSUs are subject to the terms and conditions set forth in the Plan and in any amendments to the Plan existing now or in the future, which terms and conditions are incorporated herein by reference. This Statement and the Plan set forth the entire and exclusive understanding between the Company and Holder with respect to the RSUs and shall be deemed to integrate, replace and supersede all previous communications, representations or agreements between the parties, whether written or oral, regarding the grant of RSUs or issuance of shares to Holder. Neither this Statement nor any term hereof may be changed, waived, discharged or terminated except by an instrument in writing signed by the Company and Holder.

IN WITNESS WHEREOF, the parties have executed this Restricted Unit Award Statement as of the Grant Date.

PACIFIC FINANCIAL CORPORATION

By: _____

Name: _____

Title: _____

Holder hereby accepts and agrees to be bound by all of the terms and conditions of this Statement and the Plan.

Holder: _____

Dated Signed: _____

SCHEDULE OF SUBSIDIARIES

The following is a list of the registrant's subsidiaries at March 20, 2014.

Name of Organization	State of Incorporation or Organization
Bank of the Pacific	Washington
PFC Statutory Trust I	Connecticut
PFC Statutory Trust II	Delaware
Coastal Holdings LLC	Washington
Coastal Holdings One LLC	Oregon
Coastal Holdings Two LLC	Oregon
Opportunity Holdings LLC	Washington

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statement Nos. 333-113224, 333-51524, and 333-175723 on Form S-8 and in Registration Statement No. 333-129860 on Form S-3 of our report dated March 21, 2014, relating to the consolidated financial statements of Pacific Financial Corporation and subsidiary, appearing in this Annual Report on Form 10-K of Pacific Financial Corporation for the year ended December 31, 2013.

/s/ Deloitte & Touche LLP
Portland, Oregon
March 21, 2014

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
UNDER RULE 13a-14(a)**

I, Dennis A. Long, certify that:

1. I have reviewed this annual report on Form 10-K of Pacific Financial Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be signed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most-recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2014

/s/ Dennis A. Long

Dennis A. Long
President and Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
UNDER RULE 13a-14(a)**

I, Douglas N. Biddle, certify that:

1. I have reviewed this annual report on Form 10-K of Pacific Financial Corporation;
- a. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be signed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most-recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - (c) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (d) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2014

/s/ Douglas N. Biddle

Douglas N. Biddle
Chief Financial Officer

CERTIFICATIONS UNDER 18 U.S.C. §1350

The undersigned certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that the preceding Annual Report on Form 10-K fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained therein fairly presents, in all material respects, the financial condition and results of operations of Pacific Financial Corporation.

/s/ Dennis A. Long

Dennis A. Long
President and Chief Executive Officer
March 21, 2014

/s/ Douglas N. Biddle

Douglas N. Biddle
Chief Financial Officer
March 21, 2014

GENERAL CORPORATE AND SHAREHOLDER INFORMATION

Administrative Headquarters

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

Independent Accountants

Deloitte & Touche LLP
Portland, Oregon

Transfer Agent and Registrar

Computershare
P.O. BOX 30170
College Station, TX 77842-3170
Telephone: 1-877-870-2422
Outside the US: 201-680-6578
Hearing Impaired: 800-952-9245
www.computershare.com/investor

Shareholder Services

Computershare, 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 or request more information about Pacific Financial Corporation. Access your investor statements online 24 hours a day, 7 days a week with MLink. For more information, go to www.envisionreports.com/PFLC.

Annual Meeting

The annual meeting of shareholders will be held on April 23, 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, Asst. Corporate Secretary, Pacific Financial Corporation, P.O. Box 1826, Aberdeen, Washington 98520.

BOARD OF DIRECTORS

Gary C. Forcum, Chairman
Private Investor

Douglas M. Schermer
Owner
Schermer Construction Inc.

Denise Portmann
President & CEO
Bank of the Pacific

Randy W. Rognlin, Vice Chairman
Co-Owner
Rognlins, Inc.

Randy J. Rust
Private Investor

Lori Reece
Owner
RE/MAX Whatcom County, Inc.

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

John Van Dijk
Retired President & COO
Bank of the Pacific

OFFICERS

Dennis A. Long
President & CEO
Pacific Financial Corporation

Denise J. Portmann
Corporate Secretary
President & CEO, Bank of the Pacific

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

Douglas N. Biddle
Treasurer
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.



Pacific Financial Corporation

1101 S. Boone Street

Aberdeen, WA 98520

360.533.8873

BankofthePacific.com

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