

2014 ANNUAL REPORT

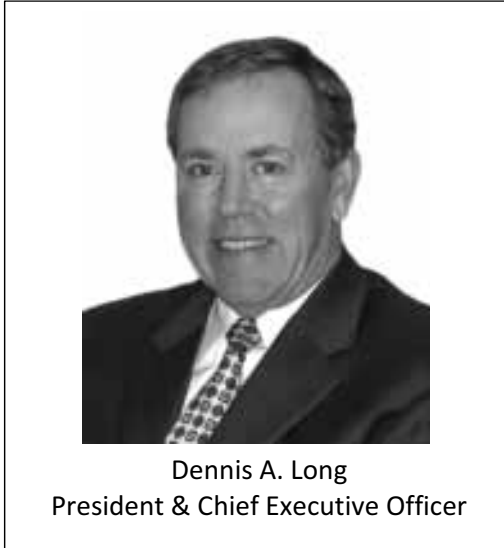


**Pacific Financial
Corporation**

OTCQB: PFLC

To Our Shareholders

March 26, 2015



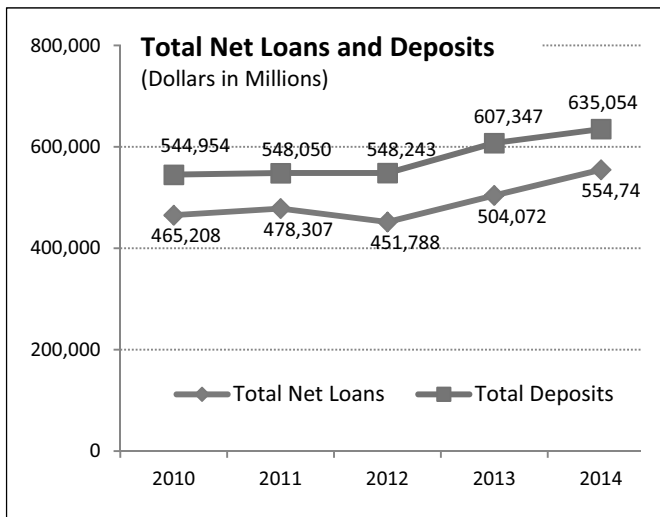
My Fellow Shareholders:

We delivered another solid performance in 2014, executing on our growth strategies, strengthening our balance sheet, and improving the bottom line.

Profits increased 32% for the full year, with earnings growing to \$4.9 million in 2014, compared to \$3.7 million in 2013. The increase in our profitability year-over-year was driven by increases in net interest income, an improved net interest margin, continued strong loan production and better operating efficiencies. As a result of our successes, we were able to raise our annual cash dividend to 21-cents per share at the end of 2014, equating to a yield of more than 3.10% at current market levels.

2014 Accomplishments

- Growing the loan portfolio with quality assets is important for our continued success, and we were able to organically grow loans by 12% to \$563.1 million for the year. Noninterest-bearing deposits also increased 14% and remained strong at 26% of total deposits. Both achievements were key contributors to our strong financial performance.
- Our net interest income increased 14% to \$27.0 million in 2014, from \$23.8 million in 2013, and our net interest margin improved 17 basis points to 4.17%, from 4.00% a year ago.
- At the same time, credit quality continued to improve, with the ratio of nonperforming assets to total assets at 1.36% at year end, compared to 1.42% last year.
- We strategically deployed some of our excess capital this year while maintaining solid capital ratios, which continued to exceed regulatory requirements.



- Our efficiency ratio improved as a result of our ability to grow earnings within our existing capacity.

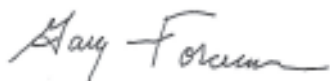
| Capital Ratios | Pacific Financial Corporation | Pacific Financial Corporation | Well-Capitalized Financial Institutional Regulatory Guidelines |
|------------------------|-------------------------------|-------------------------------|--|
| December 31 | 2014 | 2013 | |
| Total Risk-based | 13.61% | 14.11% | 10.0% |
| Tier 1 Risk-based | 12.36% | 12.85% | 6.0% |
| Tier 1 Leverage | 9.80% | 9.83% | 5.0% |
| Tangible Common Equity | 8.05% | 7.74% | n/a |

- As we discussed in last year’s letter, we began the year by hiring Doug Biddle as our Chief Financial Officer, filling the opening that Denise Portmann vacated when she was promoted to President and Chief Executive Officer of Bank of the Pacific, on January 1, 2014. Doug has proven to be a valuable strategic business partner to our senior executive leadership team, and Denise has demonstrated exceptional leadership in running the bank.
- In April of 2014 Bank of the Pacific received its SBA Preferred Lender Status with the U.S. Small Business Administration (“SBA”). A bank that has preferred lender status may grant approval of a small business loan and it is automatically approved by the SBA -- thus speeding funds into the borrower’s hands. It is the highest bank designation granted by the SBA and is reserved only for top-tier lenders. In 2014, the Bank originated \$8.5 million in 7(a) small business loans, ranking 20th in the Seattle/Spokane region in number of loans funded.
- The following month, we received approval to convert our loan production office (“LPO”) in Vancouver, Washington, into a full-service commercial banking center. The LPO was originally opened in March 2013, and total loans have grown to \$38.0 million as of December 31, 2014.
- In August, Daniel J. Tupper, a successful business leader in the Twin Harbors region of Washington State, was appointed to the Board of Directors of Pacific Financial Corporation. Additionally, we kicked off 2015 by appointing Kristi Gundersen, a partner of Knutzen Farms, LP, to the Company’s Board of Directors.
- Finally, and most notably, in January 2015 we expanded our presence in Oregon, with a seasoned commercial lending team led by Dan Ebert, Senior Vice President and Manager, launching a new loan production office in Salem, Oregon. We continue to do what we do best: serve our communities and constituents.

After a very successful 18 years with Pacific Financial, Dennis Long’s last day will be June 1, 2015. We have thoroughly enjoyed working together. We are all very comfortable that this thriving franchise is in good hands and is poised to continue to do well financially. We have developed a very capable team of internal successors, as we continue our efforts to have Pacific Financial remain a top performing institution.

As we head into 2015, we are committed to investing in our strategy centered on responding to the needs of our customers and our communities. At the same time, we will continue to look for ways to improve efficiencies while maintaining strong open communications with our shareholders. On behalf of the Board of Directors and our dedicated employees, thank you for your continuing support. Please join us for our annual shareholders' meeting on Wednesday, April 29, 2015, at 7:00 p.m., Pacific Time, at 1101 South Boone Street, Aberdeen, Washington.

Sincerely,



Gary C. Forcum
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, 2014

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
(I.R.S. Employer
Identification No.)

1101 S. Boone Street
Aberdeen, Washington 98520-5244
(Address of principal executive offices) (Zip Code)

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

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 check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) 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. Yes No

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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 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, 2014, was \$55,342,407.

The number of shares outstanding of the registrant's common stock, \$1.00 par value as of February 28, 2015, was 10,375,460 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 29, 2015 are incorporated by reference into Part III of this Form 10-K.

Form 10-K
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PART I.

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 operates in western Washington and the north coast of Oregon. 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 17 branches located in communities in Grays Harbor, Pacific, Clark, Whatcom, Skagit and Wahkiakum counties in the state of Washington and three in Clatsop County, Oregon. In addition, the Bank operates loan production offices in Burlington and DuPont, Washington and, opened in January 2015, Salem, Oregon. The Company also has a residential real estate mortgage department.

The Company's common stock is listed on the OTCQB® exchange under the symbol PFLC. Revenue, net income and total assets for the Company for the years ended December 31, 2014, 2013, and 2012 are presented below:

PACIFIC FINANCIAL CORPORATION

(Dollars in Thousands)

| | For Year Ended | | |
|---------------------|----------------------|----------------------|----------------------|
| | December 31, 2014 | December 31, 2013 | December 31, 2012 |
| Revenue: | | | |
| Net interest income | \$ 27,033 | \$ 23,800 | \$ 24,011 |
| Non-interest income | 8,079 | 9,955 | 9,391 |
| Total revenue | <u>35,112</u> | <u>33,755</u> | <u>33,402</u> |
| Net income | <u>\$ 4,927</u> | <u>\$ 3,731</u> | <u>\$ 4,785</u> |
| Total assets | <u>\$ 744,807</u> | <u>\$ 705,039</u> | <u>\$ 643,594</u> |

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

The Company is presently a reporting company with the Securities and Exchange Commission (“SEC”). 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 Company intends to terminate its registration with the SEC under the Securities Exchange Act of 1934 during second quarter 2015, terminating its reporting obligations with the SEC.

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, Vancouver, Washington and Salem, Oregon. 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'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 Bank provides 24-hour online and mobile 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 and mobile banking systems include the ability to transfer funds, make loan payments, reorder checks, and request statement reprints, provide 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. Through mobile banking, customers can deposit checks and conduct certain banking activities via text message. 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. In determining whether to take brokered deposits, the Bank considers current market interest rates, profitability to the Bank, and matching deposits and loan products.

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, consumer loans, and residential mortgage loans. The majority of the Company's loan portfolio is comprised of real estate loans, which include commercial real estate, residential construction, land development and other land loans. 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, 2014 and 2013.

The Bank originates loans primarily in its local markets. Loans to borrowers outside of Washington and Oregon total \$85.1 million, or 15.1%, of total loans at December 31, 2014. Of this amount, \$32.8 million, or 5.8% of total loans, are government guaranteed loans purchased in the secondary market that were not originated by us. Additionally, our loan portfolio includes \$687,000 in loans purchased from and originated by other financial institutions, representing 0.1% 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 policy also establishes loan approval authorities for certain officers individually. Loan officer lending authority ranges from \$5,000 to \$500,000 on a Total Family Debt basis (“TFD”). Commercial Banking Team Leaders have approval authorities up to \$1,000,000 TFD. Credit Risk Officers approve loans up to \$3,500,000 TFD. The Chief Credit Officer approves loans up to \$4,500,000 TFD. The Management Loan Committee (“MLC”) approves loans greater than \$4,500,000 TFD. The MLC is chaired by the Chief Credit Officer. Other members include the bank's two Credit Risk Officers, the Commercial Banking Manager and a Commercial Banking Team Leader. Additionally, loans with a risk rating of substandard or doubtful, with balances of \$2,000,000 or more, must also be approved by the MLC. The Board Loan Committee (“BLC”) meets at least quarterly to review the allowance for loan losses, summary of loans reviewed by the MLC, loan policy exceptions, concentration reports, key credit metrics and any loan losses. The Bank's legal lending limit was \$17.0 million at December 31, 2014, however it maintains an internal lending limit of \$8.5 million. This represents the maximum lending limit to individual borrowers and related entities, exceptions from which are made judiciously. 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, which 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.

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.

Commercial Real Estate. The Bank originates owner occupied and non-owner occupied commercial real estate and multifamily loans within its primary market areas. 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 often 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. 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. 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. Single-family portfolio loans are generally owner-occupied and our underwriting standards require that loan amounts 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.

Consumer. Consumer 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 loan 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 loan 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 property acquired in satisfaction of debts previously contracted. 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 loan 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.

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.

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.

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, 2014 and 2013.

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. 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, regional and smaller local institutions. 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, and Salem, Oregon 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, in Washington and the Salem, Oregon area provides opportunities for expansion, but in pursuing that expansion, it faces greater competitive challenges than it faces in its historical market areas.

Large financial conglomerates frequently offer multiple financial services, including deposit services, brokerage and others and 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 areas, have resulted in increased competition.

There has been significant consolidation trends among financial institutions over the last few years, and the trends may continue. While, 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.

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, 2014, the Company held a deposit market share of 40.8% in Pacific County, 66.4% in Wahkiakum County, 28.6% in Grays Harbor County, 4.6% in Whatcom County, 1.3% in Skagit County and 7.0% in Clatsop County (Oregon).

Employees

As of December 31, 2014, 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.

The Company expects to file a Form 15 to terminate the registration of its common stock under the Exchange Act in April 2015, utilizing the increased thresholds under the JOBS Act.

The Volcker Rule

On December 10, 2013, the federal banking agencies jointly issued a final rule implementing the so-called “Volcker Rule” (set forth in Section 619 of the Dodd-Frank Act). The Volcker Rule prohibits depository institutions, companies that control such institutions, bank holding companies, and the affiliates and subsidiaries of such banking entities, from engaging as principal for the trading account of the banking entity in any purchase or sale of one or more covered financial instruments (so-called “proprietary trading”) and imposes limitations upon retaining ownership interests in, sponsoring, investing in and transacting with certain investment funds, including hedge funds and private equity funds. Certain activities involving underwriting, risk mitigation hedging, and transactions on behalf of customers as a fiduciary or riskless principal are not prohibited proprietary trading, including purchases and sales of financial instruments which are either obligations of or issued or guaranteed by (i) the United States or agencies thereof; (ii) a State or political subdivision including municipal securities; or (iii) the FDIC. Notwithstanding these permissible activities, no such activities are permitted if they would (i) involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (iii) pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States. The effective date of the final rule has been extended to July 21, 2016. Neither the Company nor the Bank engages in activities prohibited by the Volcker Rule and does not expect the Volcker Rule to have a material impact upon the Company or the Bank.

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, 2014 and 2013, the Bank was in compliance with 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 must maintain a minimum leverage ratio of 4.0%. The Bank must maintain a minimum leverage ratio of 5.0% in order to meet the regulatory definition of "Well Capitalized".

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 January 1, 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 in order to implement the "Basel III" regulatory capital reforms released by the

Basel Committee on Banking Supervision. 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 has elected to opt-out of the inclusion of accumulated other comprehensive income (loss) in its capital calculations 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. This buffer consists 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 will be 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.

On November 18, 2014, the FDIC adopted the Assessments Final Rule which revises the FDIC's risk-based deposit insurance assessment system to reflect changes in the regulatory capital rules that are effective commencing January 1, 2015. For smaller financial institutions (with total assets less than \$1 billion and which are not custodial banks), the Final Rule revises and conforms capital ratios and ratio thresholds to the new prompt corrective action capital ratios and ratio thresholds for “well capitalized” and “adequately capitalized” evaluations which were adopted by the federal banking agencies as part of the Basel III capital regulations. Consequently, effective January 1, 2015, the prompt corrective action regulations are amended to the extent described above. 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). A pro forma analysis of the application of these new capital requirements as of December 31, 2014 has been conducted on the Company and Bank. We have determined that the Company and Bank meet all new requirements, including the fully phased-in capital conservation buffer requirement, 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.

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. A downturn 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 any foreclosure. Commercial real estate loans also 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 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 loan 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 loan 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.

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, 2014, we recorded a provision for (recapture of) credit losses of \$300,000, compared to (\$450,000) for the year ended December 31, 2013. Whether or not we determine to record a provision in a particular period has a significant effect on our earnings. We recorded net loan charge-offs of \$306,000 for the year ended December 31, 2014, compared to \$549,000 for the year ended December 31, 2013. Past due loans represented 1.3% and 1.4% of total loans outstanding at December 31, 2014 and 2013, respectively.

While current economic conditions have improved modestly, we may experience increased delinquencies and credit losses if these improvements falter, resulting in additional provision for credit losses and charge offs and a possible 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.

We hold and acquire other real estate owned 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 debts previously contracted as part of the problem asset resolution process. OREO balances lead to increased expenses, as we incur costs to manage, maintain, improve in some cases, and dispose of our OREO properties. We expect that earnings in 2015 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. Loans currently in nonaccrual status may lead to increases in our OREO balance in the future, if not resolved. 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 loan 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 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 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 were to change, or market conditions were to deteriorate. 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 2015, 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 revenue and expense, 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. 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 the Bank 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 \$0.21 and \$0.20 per share for 2014 and 2013, 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.

Technology implementation problems, computer system failures or information security breaches could adversely affect us.

Our future growth prospects will be highly dependent on the ability of the Bank to implement changes in technology that affect the delivery of banking services such as the increased demand for computer access to bank accounts and the availability to perform banking transactions electronically. The Bank's ability to compete will depend upon its ability to continue to adapt technology on a timely and cost-effective basis to meet such demands. In addition, our business and operations and those of the Bank could be susceptible to adverse effects from computer failures, communication and energy disruption, and activities such as fraud of unethical individuals with the technological ability to cause disruptions or failures of the Bank's data processing system.

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.

We cannot be certain that the continued implementation of safeguards will eliminate the risk of vulnerability to technological difficulties or failures or ensure the absence of a breach of information security. The Bank will continue to rely on the services of various vendors who provide data processing and communication services to the banking industry. Nonetheless, if information security is compromised or other technology difficulties or failures occur at the Bank or with one of our vendors, information may be lost or misappropriated, services and operations may be interrupted and the Bank could be exposed to claims from its customers, regulatory actions, reputational damage, and disruptions in its operations, resulting in a material adverse effect on the Company's 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 or 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 opening additional de novo branches or new loan production offices. 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 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 \$93.2 million, or 12.5% of assets, in investments and FHLB stock at December 31, 2014, 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. At December 31, 2014, we had goodwill of \$12.2 million, representing approximately 16.8% of shareholders' equity.

Further, our balance sheet reflects approximately \$3.2 million of net deferred tax assets at December 31, 2014, 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, impacting our earnings during the period in which the valuation allowance is recorded.

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 low trading volumes on the OTCQB exchange sponsored by OTC Markets under the trading symbol "PFLC." As a result, it may be difficult to liquidate your investment in our shares, and there may be 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 12.3% 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. The aggregate monthly lease payment for all leased space is approximately \$47,000.

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 \$16.3 million at December 31, 2014.

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

Not Applicable.

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 Board™ 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.

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:

| | 2014 | | | 2013 | | |
|----------------|-----------------------------|---------|---------|-----------------------------|---------|---------|
| | Estimated No. Shares Traded | High | Low | Estimated No. Shares Traded | High | Low |
| First Quarter | 246,000 | \$ 6.75 | \$ 6.10 | 131,400 | \$ 5.50 | \$ 4.56 |
| Second Quarter | 61,200 | \$ 6.50 | \$ 6.07 | 92,300 | \$ 6.50 | \$ 5.42 |
| Third Quarter | 175,800 | \$ 6.75 | \$ 6.06 | 124,600 | \$ 6.99 | \$ 5.59 |
| Fourth Quarter | 101,200 | \$ 6.90 | \$ 6.05 | 83,900 | \$ 6.75 | \$ 6.40 |

As of February 28, 2015, there were approximately 992 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 2014 and 2013 in the amount of \$0.21 and \$0.20 per share, respectively. 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, 2014. The maximum number of shares that may yet be purchased under the plan is 250,000 at December 31, 2014.

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.

PACIFIC FINANCIAL CORPORATION
(Dollars in Thousands, Except per Share Data)

| | For Year Ended | | | | |
|---|----------------------|----------------------|----------------------|----------------------|----------------------|
| | December 31, 2014 | December 31, 2013 | December 31, 2012 | December 31, 2011 | December 31, 2010 |
| Operations Data | | | | | |
| Net interest income | \$ 27,033 | \$ 23,800 | \$ 24,011 | \$ 23,685 | \$ 22,879 |
| Provision (recapture) for credit losses | 300 | (450) | (1,100) | 2,500 | 3,600 |
| Non-interest income | 8,079 | 9,955 | 9,391 | 7,614 | 8,451 |
| Non-interest expense | 28,155 | 29,502 | 28,417 | 25,648 | 26,400 |
| Provision (benefit) for income taxes | 1,730 | 972 | 1,300 | 333 | (304) |
| Net income | \$ 4,927 | \$ 3,731 | \$ 4,785 | \$ 2,818 | \$ 1,634 |
| Net income per share: | | | | | |
| Basic ⁽¹⁾ | \$ 0.48 | \$ 0.37 | \$ 0.47 | \$ 0.28 | \$ 0.16 |
| Diluted ⁽¹⁾ | 0.48 | 0.37 | 0.47 | 0.28 | 0.16 |
| Dividends declared | \$ 2,178 | \$ 2,036 | \$ 2,024 | - | - |
| Dividends declared per share | \$ 0.21 | \$ 0.20 | \$ 0.20 | - | - |
| Dividends payout ratio | 44% | 55% | 42% | - | - |
| Performance Ratios | | | | | |
| Interest rate spread | 4.06% | 3.87% | 4.20% | 4.03% | 3.88% |
| Net interest margin ⁽¹⁾ | 4.17% | 4.00% | 4.34% | 4.22% | 4.10% |
| Efficiency ratio ⁽²⁾ | 80.19% | 87.40% | 85.08% | 81.95% | 84.26% |
| Return on average assets | 0.68% | 0.55% | 0.75% | 0.44% | 0.25% |
| Return on average equity | 6.92% | 5.48% | 7.28% | 4.55% | 2.77% |
| Balance Sheet Data | | | | | |
| Total assets | \$ 744,807 | \$ 705,039 | \$ 643,594 | \$ 641,254 | \$ 644,403 |
| Loans, net | 554,746 | 496,307 | 438,838 | 463,766 | 455,064 |
| Total deposits | 639,054 | 607,347 | 548,243 | 548,050 | 544,954 |
| Total borrowings | 24,856 | 23,403 | 23,903 | 24,644 | 35,328 |
| Shareholders' equity | 72,483 | 67,137 | 66,721 | 63,270 | 59,769 |
| Book value per share ⁽³⁾ | 6.99% | 6.59% | 6.59% | 6.25% | 5.90% |
| Tangible book value per share ⁽⁴⁾ | 5.68% | 5.25% | 5.35% | 5.01% | 4.66% |
| Equity to assets ratio | 9.73% | 9.52% | 10.37% | 9.87% | 9.28% |
| Asset Quality Ratios | | | | | |
| Nonperforming loans to total loans | 1.62% | 1.98% | 3.37% | 2.96% | 2.15% |
| Allowance for loan losses to total loans | 1.48% | 1.66% | 2.09% | 2.34% | 2.28% |
| Allowance for loan losses to nonperforming loans | 91.54% | 115.41% | 61.92% | 79.28% | 106.18% |
| Nonperforming assets to total assets | 1.36% | 1.42% | 3.08% | 3.39% | 2.57% |

⁽¹⁾ Net interest income divided by average earning assets

⁽²⁾ Non-interest expense divided by the sum of net interest income and non-interest income

⁽³⁾ Shareholder equity divided by shares outstanding

⁽⁴⁾ Shareholder equity less intangibles divided by shares outstanding

ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward Looking Information

This report 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 all information concerning our possible future results of operations or other actions, including, without limitation, as set forth under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and can frequently be identified by 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. 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 due to the dependency of repayment of our loans on the cash flows of the borrower and additional workout and other real estate owned 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;
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; and
6. integration and other risks relating to the opening of our Salem, Oregon loan production office 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.

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.

GENERAL

Pacific is a bank holding company providing full-service community banking through 17 branches in Washington and three branches in Oregon operated by its wholly owned banking subsidiary, Bank of the Pacific. In addition, Pacific has two loan production offices in Washington, one loan production office in Oregon 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, 2014, increased by \$39.8 million, or 5.6%, to \$744.8 million compared to \$705.0 million at the end of 2013. Increases in loans were the primary contributors to overall asset growth, which were partially offset by decreases in investments, interest bearing deposits in banks and loans held for sale. Total loans of \$563.1 million at December 31, 2014, increased \$58.4 million, or 11.6%, compared to year-end 2013.
- The Bank remains well capitalized with a total risk-based capital ratio of 13.52% at December 31, 2014, compared to 14.03% at December 31, 2013. Tier one leverage ratio was 9.73% at December 31, 2014, compared to 9.77% at December 31, 2013. The asset growth mentioned above outpaced the growth in retained earnings during 2014, resulting in the decline in capital ratios. The Company declared an annual cash dividend of \$0.21 per share in 2014, up from \$0.20 in 2013.
- Non-performing assets (“NPAs”) totaled \$10.1 million at December 31, 2014, which represents 1.36% of total assets, versus \$10.0 million, or 1.42% of total assets, at December 31, 2013. NPAs are concentrated in commercial real estate loans and related OREO, which total \$7.8 million, or 76.8%, of our NPAs.
- Demand deposits, savings, money market and certificates of deposits less than \$100,000, increased during 2014 by \$32.7 million, or 6.2%, to \$563.4 million and comprise 88.2% of total deposits at year-end. The increase was driven by the Bank’s second quarter 2013 acquisitions of three branches from Sterling Savings Bank (“Sterling”), in which total deposits assumed were \$37,634,000 and loans acquired were \$3,989,000, new deposits generated from growth in commercial banking relationships and organic deposit growth. The increase in deposits was mostly in commercial demand and money market accounts, coupled with an increase in public NOW accounts.

The following are significant components of the Company's results of operations for 2014 as compared to 2013.

- Net income for 2014 was \$4.9 million, or \$0.48 per diluted share, compared to net income of \$3.7 million, or \$0.37 per diluted share, in 2013.
- In 2014, return on average assets (“ROAA”) and return on average equity (“ROAE”) increased to 0.68% and 6.92%, respectively, compared to 0.55% and 5.48%, respectively, in 2013.
- Net interest income increased to \$27.0 million compared to \$23.8 million in 2013. The Company experienced growth in loans during the period. Correspondingly, net interest margin for 2014 increased 17 basis points to 4.17%, as compared to 4.00% in 2013.
- Provision for (recapture of) credit losses was \$300,000 for 2014, compared to (\$450,000) for 2013. Provision expense in the current year was commensurate with growth in the loan portfolio during that same period. The recapture of provision in the prior year was 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.
- Net charge-offs totaled \$306,000 during 2014 compared to \$549,000 in 2013. Loans classified as substandard or worse totaled \$18.7 million at December 31, 2014, an increase of \$5.9 million, compared to \$12.8 million one year ago.
- Non-interest income decreased \$1.9 million to \$8.1 million for 2014, primarily due to decreases in gains on sale of loans and investment securities. Gains on sale of loans fell by \$1.5 million to \$3.7 million. This revenue source moderated during the latter portion of 2013 due to the slowdown in mortgage refinance activity caused by an increase in interest rates. Growth in annuity commission revenue, which increased to \$464,000, from \$320,000, partially offset the decrease.
- Non-interest expense decreased \$1.3 million to \$28.2 million for 2014. This decrease is primarily attributable to decreases in data processing and other conversion expenses associated with the acquisition of the three Sterling Bank branches in 2013 and a reduction in expenses associated with the holding and disposition of OREO.

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 have improved, 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 6.3% at December 31, 2014, compared to 6.6% in 2013 and 7.6% in 2012, and in Oregon the unemployment rate was 6.7% for 2014, compared to 7.0% in 2013 and 8.4% in 2012. These rates compare to the national unemployment rate of 5.6% at December 31, 2014. 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:

| County | 2014 | 2013 | 2012 |
|--------------|-------|-------|-------|
| Clark | 7.2% | 7.4% | 8.3% |
| Clatsop | 5.9% | 6.1% | 7.6% |
| Grays Harbor | 10.6% | 11.6% | 12.4% |
| Marion | 6.6% | 7.8% | 9.2% |
| Pacific | 9.8% | 10.5% | 11.8% |
| Skagit | 7.6% | 8.1% | 9.1% |
| Wahkiakum | 9.7% | 10.4% | 12.2% |
| Whatcom | 6.4% | 6.4% | 6.9% |

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 and Marion Counties is below the Oregon state, but above the national rate. Overall, the unemployment rate in all our markets has steadily improved over the last three years.

Sales activity for single-family homes and condominiums has generally rebounded in 2014 within our geographic footprint. Year over year changes in closed sales activity in Grays Harbor, Pacific, Skagit and Whatcom counties in Washington were 4.0%, 10.8%, -0.5%, and 7.3% (Runstad Center for Real Estate Research – UW), respectively, during 2014. Home prices exhibited similar increases during the period. We believe the general increase was due primarily to the gradual improvement in the local economy during 2014. Conversely, home prices declined in Marion and Clatsop Counties in Oregon in 2014 by 6.9% and 6.5%, respectively. It appears an increased supply in active listings during the period has resulted in a current softening of prices.

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 loan losses

The Company's allowance for loan losses methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for loan 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 loan 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, 2014, 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 loan 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 \$3.2 million at December 31, 2014, compared to \$4.5 million at December 31, 2013. The most significant portions of the deductible temporary differences relate to the allowance for loan losses, supplemental executive retirement plan and loan fees/costs. As of December 31, 2014, 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.

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 2015 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.
- Mitigate 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 durations less than five years.
- Continue to improve asset quality through proactive management of problem loans, monitoring of existing performing loans, and selling of OREO properties.
- Successfully expand on the opportunities available to garner additional profitable banking relationships through 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 branch acquisition from Sterling, newly opened branch in Warrenton, and opening of a loan production office in Salem.

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.

CONSOLIDATED RESULTS OF OPERATIONS

Years ended December 31, 2014, 2013, and 2012

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, 2014.

| | For the Twelve | | 2014 to 2013 | | For the Twelve | | 2013 to 2012 | |
|--|-----------------------------------|-----------------------------------|--------------|-------------|-----------------------------------|------------|--------------|--|
| | Months Ended December 31, 2014 | Months Ended December 31, 2013 | \$ Change | % Change | Months Ended December 31, 2012 | \$ Change | % Change | |
| Interest and dividend income | \$ 29,158 | \$ 26,290 | \$ 2,868 | 11% | \$ 27,495 | \$ (1,205) | -4% | |
| Interest expense | 2,125 | 2,490 | (365) | -15% | 3,484 | (994) | -29% | |
| Net interest income | 27,033 | 23,800 | 3,233 | 14% | 24,011 | (211) | -1% | |
| Loan loss provision | 300 | (450) | 750 | -167% | (1,100) | 650 | -59% | |
| Non-interest income | 8,079 | 9,955 | (1,876) | -19% | 9,391 | 564 | 6% | |
| Non-interest expense | 28,155 | 29,502 | (1,347) | -5% | 28,417 | 1,085 | 4% | |
| INCOME BEFORE PROVISION FOR INCOME TAXES | 6,657 | 4,703 | 1,954 | 42% | 6,085 | (1,382) | -23% | |
| PROVISION FOR INCOME TAXES | 1,730 | 972 | 758 | 78% | 1,300 | (328) | -25% | |
| NET INCOME | \$ 4,927 | \$ 3,731 | \$ 1,196 | 32% | \$ 4,785 | \$ (1,054) | -22% | |
| INCOME PER COMMON SHARE: | | | | | | | | |
| BASIC ⁽¹⁾ | \$ 0.48 | \$ 0.37 | \$ 0.11 | 30% | \$ 0.47 | \$ (0.10) | -21% | |
| DILUTED ⁽²⁾ | \$ 0.48 | \$ 0.37 | \$ 0.11 | 30% | \$ 0.47 | \$ (0.10) | -21% | |
| Average common shares outstanding - basic ⁽¹⁾ | 10,256,242 | 10,121,738 | 134,504 | 1% | 10,121,853 | (115) | 0% | |
| Average common shares outstanding - diluted ⁽²⁾ | 10,347,338 | 10,189,888 | 157,450 | 2% | 10,126,244 | 63,644 | 1% | |

Net income. For the year ended December 31, 2014, net income was \$4.9 million compared to \$3.7 million in 2013. The increase in net income for 2014 was primarily related to increases in net interest income due to growth in loans and a reduction in interest expense paid on deposits. The decline in data processing and other conversion expenses relates to expenses associated with the acquisition of three Sterling branches in 2013 and a reduction in expenses associated with the disposition of OREO. These expense reductions were partially offset by a decline in gain on sale of loans due to the slowdown in mortgage refinance activity caused by an increase in interest rates beginning in the latter half of 2013.

Net income of \$3.7 million for 2013 was down from net income of \$4.8 million for the year ended December 31, 2012. This was primarily due to an increase in noninterest expenses associated with the expansion of loan production offices and integration of the branches purchased from Sterling. This was offset partially by an increase in non-interest income from gain on sale of loans, ATM/Debit card and annuity commission fee income. Net income in 2013 was also impacted by a reduction in recapture of provision for loan losses as compared to the prior period.

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 70% of the Company's loan portfolio is tied to short-term rates, and therefore, re-price 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 2015.

The following tables set 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 on a tax equivalent basis. Non-accrual loans are included in gross loans.

Average Interest Earning Balances:

| | For the Twelve Months Ended | | | | | | | | |
|---|-----------------------------|----------------------------|-------------------------|-------------------|----------------------------|-------------------------|-------------------|----------------------------|-------------------------|
| | December 31, 2014 | | | December 31, 2013 | | | December 31, 2012 | | |
| | Average Balance | Interest Income or Expense | Average Yields or Rates | Average Balance | Interest Income or Expense | Average Yields or Rates | Average Balance | Interest Income or Expense | Average Yields or Rates |
| (Dollars in Thousands) | | | | | | | | | |
| ASSETS: | | | | | | | | | |
| Interest bearing certificate of deposit | \$ 2,727 | \$ 42 | 1.54% | \$ 2,309 | \$ 29 | 1.26% | \$ 2,985 | \$ 12 | 0.40% |
| Interest bearing deposits in banks | 20,326 | 47 | 0.23% | 36,539 | 85 | 0.23% | 29,104 | 72 | 0.25% |
| Investments - taxable | 63,312 | 1,269 | 2.00% | 53,505 | 778 | 1.45% | 29,993 | 770 | 2.57% |
| Investments - nontaxable | 29,514 | 1,258 | 4.26% | 32,650 | 1,508 | 4.62% | 27,590 | 1,525 | 5.53% |
| Federal home loan bank stock | 2,962 | 3 | 0.10% | 3,078 | 2 | 0.06% | 3,173 | - | 0.00% |
| Pacific coast bankers bank stock | 266 | 30 | 11.28% | - | - | 0.00% | - | - | 0.00% |
| Gross loans (1) | 536,971 | 26,871 | 5.00% | 477,356 | 24,302 | 5.09% | 466,943 | 25,461 | 5.45% |
| Loans held for sale | 7,026 | 255 | 3.63% | 9,302 | 312 | 3.35% | 12,950 | 492 | 3.80% |
| Deferred fees | (1,123) | - | 0.00% | (1,034) | - | 0.00% | (857) | - | 0.00% |
| Total interest earning assets | 661,981 | 29,775 | 4.50% | 613,705 | 27,016 | 4.40% | 571,881 | 28,332 | 4.95% |
| Cash and due from banks | 13,201 | | | 11,637 | | | 10,751 | | |
| Bank premises and equipment (net) | 16,633 | | | 15,831 | | | 14,753 | | |
| Other real estate owned | 1,658 | | | 4,030 | | | 6,880 | | |
| Allowance for loan losses | (8,327) | | | (9,065) | | | (11,022) | | |
| Other assets | 40,679 | | | 40,908 | | | 42,427 | | |
| Total assets | \$ 725,825 | | | \$ 677,046 | | | \$ 635,670 | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY: | | | | | | | | | |
| Interest-bearing deposits | \$ 344,084 | \$ 581 | 0.17% | \$ 316,184 | \$ 699 | 0.22% | \$ 288,984 | 1,084 | 0.38% |
| Time deposits | 122,002 | 1,087 | 0.89% | 135,447 | 1,321 | 0.98% | 144,486 | 1,798 | 1.24% |
| Long term borrowings | 10,591 | 215 | 2.03% | 9,745 | 214 | 2.20% | 7,803 | 217 | 2.78% |
| Short term borrowings | 150 | 1 | 0.67% | 304 | 9 | 0.00% | 2,697 | 79 | 2.93% |
| Secured borrowings | - | - | 0.00% | - | - | 0.00% | 448 | 20 | 4.46% |
| Junior subordinated debentures | 13,403 | 241 | 1.80% | 13,403 | 247 | 1.84% | 13,403 | 286 | 2.13% |
| Total interest bearing liabilities | 490,230 | 2,125 | 0.43% | 475,083 | 2,490 | 0.52% | 457,821 | 3,484 | 0.76% |
| Non-interest-bearing deposits | 158,697 | | | 129,218 | | | 107,048 | | |
| Other liabilities | 5,710 | | | 4,688 | | | 5,058 | | |
| Equity | 71,188 | | | 68,057 | | | 65,743 | | |
| Total liabilities and shareholders' equity | \$ 725,825 | | | \$ 677,046 | | | \$ 635,670 | | |
| Net interest income (3) | | \$ 27,650 | | | \$ 24,526 | | | \$ 24,848 | |
| Net interest spread | | | 4.07% | | | 3.88% | | | 4.19% |
| Average yield on investments | | | 2.72% | | | 2.65% | | | 3.99% |
| Average yield on earning assets (2) (3) | | | 4.50% | | | 4.40% | | | 4.95% |
| Interest expense to earning assets | | | 0.33% | | | 0.42% | | | 0.61% |
| Net interest income to earning assets (2) (3) | | | 4.18% | | | 4.00% | | | 4.34% |
| Reconciliation of Non-GAAP measure: | | | | | | | | | |
| Tax Equivalent Net Interest Income | | | | | | | | | |
| Net interest income | | \$ 27,033 | | | \$ 23,800 | | | \$ 24,011 | |
| Tax equivalent adjustment for municipal loan interest | | 189 | | | 213 | | | 318 | |
| Tax equivalent adjustment for municipal bond interest | | 428 | | | 513 | | | 519 | |
| Tax equivalent net interest income | | \$ 27,650 | | | \$ 24,526 | | | \$ 24,848 | |

Non-GAAP financial measures have inherent limitations, are not required to be uniformly applied, and are not audited.

Management believes that presentation of this non-GAAP measure provides useful information frequently used by shareholders in the evaluation of a company.

Non-GAAP financial measures have limitations as analytical tools and should not be considered in isolation or as a substitute for analyses of results as reported under GAAP.

(1) Non-accrual loans of approximately \$8.7 million at 12/31/14, \$7.2 million for 12/31/13, and \$15.1 million for 12/31/2012 are included in the average loan balances.

(2) Loan interest income includes loan fee income of \$679,000, \$547,000, and \$569,000 for the twelve months ended 12/31/2014, 12/31/2013, and 12/31/12, respectively.

(3) Tax-exempt income has been adjusted to a tax equivalent basis at a 34% effective rate. The amount of such adjustment was an addition to recorded pre-tax income of \$617,000, \$726,000, \$837,000 for the twelve months ended December 31, 2014, 2013, and 2012, respectively.

Net interest income for the twelve months ended December 31, 2014 increased from the twelve months ended December 31, 2013. This increase was primarily due to the growth in earning assets, along with changes in the balance sheet mix. Loan balances increased due to the production generated predominately in our Washington and Oregon markets. Investment securities and interest bearing deposits in banks decreased as a proportion of the balance sheet, due to the strong loan demand during the current year. Funding costs have declined over the year due to the shift in mix toward non-interest bearing demand and lower-cost deposits, and continued historically low interest rates.

As a result, net interest margin improved for the year ended December 31, 2014 as compared to the prior year, primarily due to the improvement in the yield on earning assets and a decline in the cost of liabilities. This was because higher-yielding loans increased as a proportion of earning assets during 2014. The improvement in yields on investment securities also enhanced net interest margin for the

twelve months ending December 31, 2014 as compared to the same period in 2013. This was primarily the result of redeploying lower yielding cash-equivalents into higher-yielding federal government guaranteed mortgage-backed securities.

In addition, a decline in the rate paid for interest-bearing liabilities and an increase of the proportion of funding coming from non-interest bearing deposits contributed to a decline in the cost of liabilities, thus resulting in an improvement of net interest margin in 2014 as compared to 2013.

Net interest income for the twelve months ended December 31, 2013 decreased from the twelve months ended December 31, 2012. 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 during the 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.

As a result, net interest margin declined for the year ended December 31, 2013 as compared to the prior year, primarily due to the decrease in the yield on earning assets, despite the decline in the cost of liabilities. This was because lower-yielding investment securities increased as a proportion of earning assets during 2013. The additional deposits obtained via the purchase of three branches from Sterling Savings Bank in June 2013 were deployed directly into investment securities initially and then used to fund loan growth over time.

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) | For the Twelve Months Ended December 31, 2014 vs. December 31, 2013 Increase (Decrease) Due To | | | For the Twelve Months Ended December 31, 2013 vs. December 31, 2012 Increase (Decrease) Due To | | |
|--|--|----------|---------------|--|------------|---------------|
| | Volume | Rate | Net Change | Volume | Rate | Net Change |
| ASSETS: | | | | | | |
| Interest bearing certificate of deposit | \$ 5 | \$ 8 | \$ 13 | \$ (3) | \$ 20 | \$ 17 |
| Interest bearing deposits in banks | (37) | (1) | (38) | 19 | (6) | 13 |
| Investments - taxable | 142 | 349 | 491 | 604 | (596) | 8 |
| Investments - nontaxable | (145) | (105) | (250) | 280 | (297) | (17) |
| Federal home loan bank stock | - | 1 | 1 | - | - | - |
| Pacific coast bankers bank stock | - | 30 | 30 | - | - | - |
| Gross loans (1) | 3,034 | (465) | 2,569 | 568 | (1,727) | (1,159) |
| Loans held for sale | (76) | 19 | (57) | (139) | (41) | (180) |
| Deferred fees | - | - | - | - | - | - |
| Total interest earning assets | \$ 2,923 | \$ (164) | \$ 2,759 | \$ 1,329 | \$ (2,647) | \$ (1,318) |
| LIABILITIES AND SHAREHOLDERS' EQUITY: | | | | | | |
| Interest-bearing deposits | \$ 61 | \$ (179) | \$ (118) | \$ 103 | \$ (488) | \$ (385) |
| Time deposits | (132) | (102) | (234) | (112) | (365) | (477) |
| Long term borrowings | 19 | (18) | 1 | 54 | (57) | (3) |
| Short term borrowings | - | (8) | (8) | (70) | - | (70) |
| Secured borrowings | - | - | - | (20) | - | (20) |
| Junior subordinated debentures | - | (6) | (6) | - | (39) | (39) |
| Total interest bearing liabilities (increase) decrease | (52) | (313) | (365) | (45) | (949) | (994) |
| Net increase (decrease) in net interest income | \$ 2,975 | \$ 149 | \$ 3,124 | \$ 1,374 | \$ (1,698) | \$ (324) |

Non-Interest Income. Noninterest income for 2014 was down from 2013, reflecting the declines in gains on sale of residential mortgage loans due to the reduction in refinancing activity beginning in the latter half of 2013, declines in gains on sale of securities and higher losses on sale of OREO due to a more aggressive approach to reducing these assets. This was partially offset by an increase in annuity commission fee income.

Non-interest income was up in 2013 as compared to 2012. Categories contributing to this were increases in service charges on deposits and ATM/debit card fee income due to growth in core deposits, primarily from the acquisition of the Sterling Savings Bank branches. Also contributing were growth in annuity commission fee income as more employees became licensed to offer these products and a reduction in OTTI losses due to a reduction in the securities incurring such write-downs. This was partially offset by a decrease in gain on sale of OREO as a result of a declining volume of such properties.

The following table represents the principal categories of non-interest income for each of the years in the three-year period ended December 31, 2014.

| For The Twelve Months Ended | | | 2014 to 2013 | | | | 2013 to 2012 | |
|---|-----------------|-----------------|-------------------|-------------|-----------------|---------------|--------------|--|
| | December | December | | | December | | | |
| | 31, 2014 | 31, 2013 | \$ Change | % Change | 31, 2012 | \$ Change | % Change | |
| Service charges on deposit accounts | \$ 1,809 | \$ 1,731 | \$ 78 | 5% | \$ 1,686 | \$ 45 | 3% | |
| Net gain (loss) on sale of other real estate owned | (207) | 40 | (247) | -618% | 331 | (291) | -88% | |
| Net gains from sales of loans | 3,686 | 5,171 | (1,485) | -29% | 5,058 | 113 | 2% | |
| Net gains on sales of securities available for sale | 88 | 405 | (317) | -78% | 303 | 102 | 34% | |
| Net other-than-temporary impairment | (48) | (37) | (11) | 30% | (333) | 296 | -89% | |
| Earnings on bank owned life insurance | 505 | 452 | 53 | 12% | 510 | (58) | -11% | |
| Other operating income | | | | | | | | |
| Fee income | 1,709 | 1,811 | (102) | -6% | 1,673 | 138 | 8% | |
| Annuity sales income | 464 | 320 | 144 | 45% | 17 | 303 | 1782% | |
| Other non-interest income | 73 | 62 | 11 | 18% | 146 | (84) | -58% | |
| Total non-interest income | \$ 8,079 | \$ 9,955 | \$ (1,876) | -19% | \$ 9,391 | \$ 564 | 6% | |

Non-Interest Expense. Noninterest expense for 2014 was down as compared to 2013. Increases in personnel expense related to the addition of loan production personnel and branch staff for a new branch that opened in the fourth quarter of 2013 were partially offset by \$471,000 savings generated from reduction in mortgage lending staff initiated in first quarter 2014 prompted by the decline in residential mortgage loan refinance activity. Total costs associated with OREO and related third-party loan expenses decreased due to the decline in OREO balances and stabilization of collateral valuations. Also, data processing and other conversion expenses totaling \$615,000 related to the acquisition of three branches from Sterling in 2013 did not recur in 2014.

Total non-interest expense in 2013 was up compared to 2012. Contributing to this increase were costs associated with acquisition and operation of the three branches acquired from Sterling, as previously noted. The increase in salary and benefits costs 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. The effect of these increases was partially mitigated by decreases in FDIC insurance assessments, expenses related to OREO and other related costs.

The following table shows the principal categories of non-interest expense for each of the years in the three-year period ended December 31, 2014.

For The Twelve Months Ended

| | December | | 2014 to 2013 | | December | | 2013 to 2012 | |
|---|------------------|------------------|-------------------|------------|------------------|-----------------|--------------|--|
| | 31, 2014 | 31, 2013 | \$ Change | % Change | 31, 2012 | \$ Change | % Change | |
| Salaries and employee benefits | \$ 17,118 | \$ 17,013 | \$ 105 | 1% | \$ 16,215 | \$ 798 | 5% | |
| Occupancy | 2,006 | 1,839 | 167 | 9% | 1,673 | 166 | 10% | |
| Equipment | 1,050 | 860 | 190 | 22% | 801 | 59 | 7% | |
| Data processing | 2,009 | 2,268 | (259) | -11% | 1,607 | 661 | 41% | |
| Professional services | 745 | 935 | (190) | -20% | 750 | 185 | 25% | |
| Other real estate owned write-downs | 67 | 946 | (879) | -93% | 1,314 | (368) | -28% | |
| Other real estate owned operating costs | 238 | 408 | (170) | -42% | 550 | (142) | -26% | |
| State taxes | 417 | 458 | (41) | -9% | 518 | (60) | -12% | |
| FDIC and state assessments | 491 | 535 | (44) | -8% | 610 | (75) | -12% | |
| Other non-interest expense: | | | | | | | | |
| Director fees | 287 | 224 | 63 | 28% | 236 | (12) | -5% | |
| Communication | 209 | 172 | 37 | 22% | 170 | 2 | 1% | |
| Advertising | 331 | 316 | 15 | 5% | 366 | (50) | -14% | |
| Professional liability insurance | 85 | 90 | (5) | -6% | 113 | (23) | -20% | |
| Amortization | 385 | 415 | (30) | -7% | 381 | 34 | 9% | |
| Other non-interest expense | 2,717 | 3,023 | (306) | -10% | 3,113 | (90) | -3% | |
| Total non-interest expense | \$ 28,155 | \$ 29,502 | \$ (1,347) | -5% | \$ 28,417 | \$ 1,085 | 4% | |

Income Taxes. For the years ended December 31, 2014, 2013 and 2012 income taxes totaled \$1.7 million, \$972,000 and \$1.3 million, respectively, representing effective tax rates of 26.0%, 20.7% and 21.4%, 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, 2014 and 2013, the Company had a net deferred tax asset of \$3.2 million and \$4.5 million, respectively.

See “Critical Accounting Policies” in this section above.

FINANCIAL CONDITION

At December 31, 2014 and 2013

Cash and Cash Equivalents

Total cash and cash equivalents, including interest bearing deposits in banks, decreased to \$33,764,000 at December 31, 2014, from \$38,675,000 at December 31, 2013, due to increased lending through new loan production offices.

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 decreased \$9,007,000, or 9.2%, during 2014 to \$89,269,000 as funds were redeployed to support loan growth during the period. 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.

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, 2014, the Company owned 38 securities in a continuous unrealized loss position for

twelve months or longer, with an amortized cost of \$31,748,000 and fair value of \$31,195,000. These securities that have been in a continuous unrealized loss position for twelve months or longer at December 31, 2014, 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, 2014. For more information regarding our investment securities and analysis of the value of securities in our investment portfolio, see Note 3 - "Securities" and Note 17 - "Fair Value Measurements" to the Company's audited consolidated financial statements included in Item 15 of this report. See also "Critical Accounting Policies" in this section above.

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

| (Dollars in Thousands) | | 2014 | 2013 | 2012 |
|--|----|---------------|------------------|------------------|
| Available-for-sale: | | | | |
| Collateralized mortgage obligations: agency issued | \$ | 38,767 | \$ 38,791 | \$ 17,066 |
| Collateralized mortgage obligations: non agency | | 527 | 2,011 | 2,544 |
| Mortgage-backed securities: agency issued | | 12,199 | 13,389 | 5,093 |
| U.S. Government agency securities | | 8,056 | 8,811 | 5,952 |
| State and municipal securities | | 27,891 | 32,160 | 26,906 |
| Corporate bonds | | - | 982 | 3,545 |
| Total available-for-sale | \$ | <u>87,440</u> | <u>\$ 96,144</u> | <u>\$ 61,106</u> |
| Held-to-maturity: | | | | |
| Mortgage-backed securities: agency issued | \$ | 123 | \$ 159 | \$ 221 |
| State and municipal securities | | 1,706 | 1,973 | 6,716 |
| Total held-to-maturity | \$ | <u>1,829</u> | <u>\$ 2,132</u> | <u>\$ 6,937</u> |
| Total investments | \$ | <u>89,269</u> | <u>\$ 98,276</u> | <u>\$ 68,043</u> |

The following table presents the maturities of investment securities at December 31, 2014.

At December 31, 2014
(Dollars in Thousands)

| | Held-to-maturity | | Available-for-sale | |
|--|------------------|-----------------|--------------------|------------------|
| | Amortized | | Amortized | |
| | Cost | Fair Value | Cost | Fair Value |
| Due in one year or less | \$ - | \$ - | \$ 325 | \$ 329 |
| Due after one year through five years | - | - | 8,636 | 8,662 |
| Due after five years through ten years | 889 | 899 | 12,903 | 13,160 |
| Due after ten years | 817 | 818 | 13,234 | 13,796 |
| Declining Balance Securities | 123 | 135 | 51,809 | 51,493 |
| Total investment securities | \$ <u>1,829</u> | \$ <u>1,852</u> | \$ <u>86,907</u> | \$ <u>87,440</u> |

Loan Portfolio

General. Total loans at December 31, 2014 were up as compared to December 31, 2013 and 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 consumer 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 2015, 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 at December 31 in each of the past five years.

Loans as of December 31, 2014, 2013, 2012, 2011 and 2010 consisted of the following:

| (Dollars in Thousands) | December 31, 2014 | December 31, 2013 | December 31, 2012 | December 31, 2011 | December 31, 2010 |
|--|----------------------|----------------------|----------------------|----------------------|----------------------|
| Commercial and agricultural | \$ 120,517 | \$ 104,111 | \$ 87,278 | \$ 90,731 | \$ 84,575 |
| Real estate: | | | | | |
| Construction and development | 26,711 | 29,096 | 31,411 | 47,156 | 46,256 |
| Residential 1-4 family | 92,965 | 87,762 | 77,497 | 76,011 | 79,068 |
| Multi-family | 18,541 | 17,520 | 7,744 | 7,682 | 9,113 |
| Commercial real estate -- owner occupied | 125,632 | 105,594 | 109,783 | 118,469 | 109,936 |
| Commercial real estate -- non owner occupied | 117,137 | 117,294 | 103,014 | 103,005 | 106,079 |
| Farmland | 22,245 | 23,698 | 24,544 | 23,752 | 22,354 |
| Consumer | 40,565 | 20,728 | 7,782 | 8,928 | 9,128 |
| Gross loans | <u>564,313</u> | <u>505,803</u> | <u>449,053</u> | <u>475,734</u> | <u>466,509</u> |
| Less: deferred fees | <u>(1,214)</u> | <u>(1,137)</u> | <u>(857)</u> | <u>(841)</u> | <u>(828)</u> |
| Portfolio Loans | <u>\$ 563,099</u> | <u>\$ 504,666</u> | <u>\$ 448,196</u> | <u>\$ 474,893</u> | <u>\$ 465,681</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. 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. In addition, the loan portfolio contains \$30.8 million and \$11.2 million, as of December 31, 2014 and 2013, respectively, in indirect consumer loans to individuals to finance luxury and classic cars as a part of a strategy begun in 2013 to diversify the loan portfolio.

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 in owner occupied commercial real estate loans.

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, 2014, loans secured by real estate totaled \$403.2 million, which represents 71.4% of the total loan portfolio. 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. See "Risk Factors" under Item 1A of this report.

We remain active in managing our existing construction loan and land development portfolios, the balances of which have declined over the last three years. Construction and land development loans represented 4.8% and 5.7% of total loans outstanding at December 31, 2014 and 2013, respectively. We believe this segment will remain challenged into 2015, 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, 2014, concentration in land and residential construction as a percentage of risk based capital was 36.0% and total concentration in non-owner occupied commercial real estate plus land and residential construction as a percentage of risk-based capital stood at 216.4%. In addition, the Company manages new loan origination volume using concentration limits that establish maximum exposure levels by designated industry segment, real estate product types, geography, and single borrower limits.

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, 2014.

| (dollars in thousands) | Due in one year or less | Due after one through five years | Due after five years | Total |
|--|----------------------------|--|-------------------------|-------------------|
| Commercial | \$ 68,734 | \$ 27,140 | \$ 5,583 | \$ 101,457 |
| Construction, land development, other land loans | 13,364 | 19,071 | 40 | 32,475 |
| Residential real estate 1-4 family | 45,924 | 51,090 | 5,686 | 102,700 |
| Multi-family | - | 6,163 | 12,378 | 18,541 |
| Farmland | 9,336 | 8,492 | 551 | 18,379 |
| Commercial real estate | 74,892 | 173,455 | 2,948 | 251,295 |
| Consumer | 4,313 | 15,106 | 17,527 | 36,946 |
| Credit cards and overdrafts | 2,520 | - | - | 2,520 |
| Total | \$ 219,083 | \$ 300,517 | \$ 44,713 | \$ 564,313 |
| Less unearned income | | | | (1,214) |
| Total loans | | | | 563,099 |
| Total loans maturing after one year with | | | | |
| Predetermined interest rates (fixed) | | \$ 78,793 | \$ 30,032 | \$ 108,825 |
| Floating or adjustable rates (variable) | | 221,724 | 14,681 | 236,405 |
| Total | | \$ 300,517 | \$ 44,713 | \$ 345,230 |

At December 31, 2014, 81% of the total loan portfolio was either due in one year or less or maturing after one year, but with a variable rate. This compares to 82% as of December 31, 2013. Management seeks to maintain a significant proportion of its loan portfolio subject to near term changes in interest rates to mitigate interest rate risk.

Asset Quality. The Company continues to aggressively identify and monitor adversely classified assets and take action based upon available information. Levels of adversely classified assets increased primarily due to a \$4.6 million commercial loan relationship and a \$2.0 million commercial real estate loan. Delinquencies continue to be well-managed and no significant adverse trends have been identified.

Adversely classified loans and securities

(Dollars in Thousands)

| | December 31, 2014 | December 31, 2013 | 2014 to 2013 | | December 31, 2012 | 2013 to 2012 | |
|---|----------------------|----------------------|-------------------|-------------|----------------------|-------------------|-------------|
| | | | \$ Change | % Change | | \$ Change | % Change |
| Rated substandard or worse, but not impaired | \$ 7,368 | \$ 2,842 | \$ 4,526 | 159% | \$ 6,909 | \$ (4,067) | -59% |
| Impaired | 11,311 | 9,922 | 1,389 | 14% | 14,784 | (4,862) | -33% |
| Total adversely classified loans ¹ | <u>\$ 18,679</u> | <u>\$ 12,764</u> | <u>\$ 5,915</u> | 46% | <u>\$ 21,693</u> | <u>\$ (8,929)</u> | -41% |
| Total investment securities ² | <u>\$ 199</u> | <u>\$ 1,834</u> | <u>\$ (1,635)</u> | -89% | <u>\$ 2,245</u> | <u>\$ (411)</u> | -18% |
| Gross loans (excluding deferred loan fees) | \$ 564,313 | \$ 505,803 | \$ 58,510 | 12% | \$ 449,053 | \$ 56,750 | 13% |
| Adversely classified loans to gross loans | 3.31% | 2.52% | | | 4.83% | | |
| Allowance for loan losses | \$ 8,353 | \$ 8,359 | \$ (6) | 0% | \$ 9,358 | \$ (999) | -11% |
| Allowance for loan losses as a percentage of adversely classified loans | 44.72% | 65.49% | | | 43.14% | | |
| Allowance for loan losses to total impaired loans | 73.85% | 84.25% | | | 63.30% | | |
| Adversely classified loans and securities to total assets | 2.53% | 2.07% | | | 3.72% | | |

¹Adversely classified loans are defined as loans having a well-defined weakness or weaknesses related to the borrower's financial capacity or to pledged collateral that may jeopardize the repayment of the debt. They are characterized by the possibility that the Bank may sustain some loss if the deficiencies giving rise to the substandard classification are not corrected. Note that any loans internally rated worse than substandard are included in the impaired loan totals.

²Adversely classified investment securities consist of one private label collateralized mortgage obligation (CMO) as of 12/31/2014 and four private label CMOs as of 12/31/2013 and 12/31/2012.

The following table presents information related to the Company's delinquent loans, not on non-accrual status, as of December 31 in each of the last three years.

30-89 Days Past Due by type

(Dollars in Thousands)

| | December 31, 2014 | % of Category | December 31, 2013 | % of Category | 2014 to 2013 | | December 31, 2012 | % of Category | 2013 to 2012 | |
|---|----------------------|------------------|----------------------|------------------|--------------|----------|----------------------|------------------|--------------|----------|
| | | | | | \$ Change | % Change | | | \$ Change | % Change |
| Commercial and agricultural | \$ - | 0.0% | \$ 14 | 1.0% | \$ (14) | -100% | \$ 134 | 5.3% | \$ (120) | -90% |
| Real estate: | | | | | | | | | | |
| Construction and development | 18 | 2.1% | - | 0.0% | 18 | 100% | - | 0.0% | - | 0% |
| Residential 1-4 family | 605 | 71.9% | 333 | 24.0% | 272 | 82% | 1,595 | 63.2% | (1,262) | -79% |
| Multi-family | - | 0.0% | - | 0.0% | - | 0% | - | 0.0% | - | 0% |
| Commercial real estate -- owner occupied | - | 0.0% | - | 0.0% | - | 0% | - | 0.0% | - | 0% |
| Commercial real estate -- non owner occupied | - | 0.0% | - | 0.0% | - | 0% | 652 | 25.9% | (652) | -100% |
| Farmland | 46 | 5.5% | 875 | 62.9% | (829) | -95% | 133 | 5.3% | 742 | 558% |
| Total real estate | \$ 669 | | \$ 1,208 | | \$ (539) | -45% | \$ 2,380 | | \$ -1,172 | |
| Consumer | 172 | 20.5% | 168 | 12.1% | 4 | 2% | 8 | 0.3% | 160 | 2000% |
| Total loans 30-89 days past due, not in nonaccrual status | \$ 841 | 100.0% | \$ 1,390 | 100.0% | \$ (549) | -39% | \$ 2,522 | 100.0% | \$ (1,132) | -45% |
| Delinquent loans to total loans, not in nonaccrual status | 0.23% | | 0.28% | | | | 0.57% | | | |

Non-performing Assets. Non-performing 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.

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.

Non-performing assets

| (Dollars in Thousands) | December 31, 2014 | December 31, 2013 | December 31, 2012 | December 31, 2011 | December 31, 2010 |
|---|----------------------|----------------------|----------------------|----------------------|----------------------|
| Loans on nonaccrual status | | | | | |
| Commercial and agricultural | \$ 96 | \$ 286 | \$ 1,901 | \$ 530 | \$ 1,251 |
| Real estate: | | | | | |
| Construction and development | 965 | 1,408 | 1,792 | 5,510 | 5,529 |
| Residential 1-4 family | 848 | 400 | 800 | 528 | 2,246 |
| Commercial real estate -- owner occupied ⁽⁴⁾ | 1,325 | 1,659 | 3,847 | 629 | 470 |
| Commercial real estate -- non owner occupied | 5,482 | 2,482 | 5,795 | 6,539 | 333 |
| Farmland | - | 955 | 976 | - | 170 |
| Total real estate | 8,620 | 6,904 | 13,210 | 13,206 | 8,748 |
| Consumer | - | 53 | 1 | - | - |
| Total loans on non accrual status ⁽¹⁾ | 8,716 | 7,243 | 15,112 | 13,736 | 9,999 |
| Loans past due greater than 90 days but not on nonaccrual status | 409 | - | - | 299 | - |
| Total non-performing loans | 9,125 | 7,243 | 15,112 | 14,035 | 9,999 |
| Other real estate owned | | | | | |
| Construction, Land Dev & Other Land | 35 | 237 | 1,860 | 4,150 | 4,043 |
| 1-4 Family Residential Properties | - | 672 | 507 | 1,427 | 540 |
| Nonfarm Nonresidential Properties | 964 | 1,862 | 2,312 | 2,148 | 1,997 |
| | 999 | 2,771 | 4,679 | 7,725 | 6,580 |
| Total nonperforming assets ⁽²⁾ | \$ 10,124 | \$ 10,014 | \$ 19,791 | \$ 21,760 | \$ 16,579 |
| Troubled debt restructured loans on accrual status | 2,595 | 2,680 | 444 | 398 | - |
| Allowance for loan losses | 8,353 | 8,359 | 9,358 | 11,127 | 10,617 |
| Allowance to non-performing loans | 91.54% | 115.41% | 61.92% | 79.28% | 106.18% |
| Allowance to non-performing assets | 82.51% | 83.47% | 47.28% | 51.14% | 64.04% |
| Non-performing loans to total loans ⁽³⁾ | 1.62% | 1.44% | 3.37% | 2.96% | 2.15% |
| Non-performing assets to total assets | 1.36% | 1.42% | 3.08% | 3.39% | 2.57% |

⁽¹⁾ Includes \$965,000, \$1,408,000, \$3,930,000, \$7,734,000, and \$932,000 in non-accrual troubled debt restructured loans ("TDRs") as of December 31, 2014, 2013, 2012, 2011, and 2010, respectively, which are also considered impaired loans.

⁽²⁾ Does not include TDR's 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.

At December 31, 2014, total non-performing assets remained virtually unchanged in dollars from the prior year-end, with an increase in non-performing loans being offset by a similar decrease in OREO. Approximately one-half, or \$4.3 million, is represented by two commercial real estate loan relationships. The collateral value supporting these loans is considered sufficient to mitigate any potential losses, for which specific reserves have already been established. One of these relationships, a \$1.7 million loan secured by income-producing commercial real estate, is now paid current as to principal and interest.

Non-performing loans decreased at December 31, 2013, from the balance at December 31, 2012, due to decreases in all non-accrual loan categories except consumer loans. The decline in non-accrual commercial real estate is primarily the result of partial or full payoffs

totaling \$3.4 million from six borrowing relationships. The decrease in non-accrual commercial loans is made up primarily of a partial payoff of one relationship totaling \$1.4 million.

The Company continues to aggressively identify and monitor non-performing assets and take action based upon available information. Troubled debt restructures ("TDRs") declined as of December 31, 2014, as compared to December 31, 2013. TDRs are loans for which the terms have been modified in order to grant a concession to a borrower that is experiencing financial difficulty. TDRs 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 \$679,000, \$1,130,000 and \$1,213,000 for 2014, 2013 and 2012, respectively. Interest income recognized on impaired loans was \$404,000, \$177,000 and \$226,000 for 2014, 2013 and 2012, 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 its review of the appraisal, 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 loan losses or by designating a specific reserve. Generally, the Company will record the charge-off rather than designate a specific reserve.

OREO at December 31, 2014 was down from the previous year-end primarily due to a decline in transfers into OREO from outstanding loans during the current year. In addition, impairment charges declined due to improvement in real estate prices and reduced levels of these assets. Management continues to market its OREO properties through an orderly liquidation process rather than engaging in immediate liquidation that it believes may result in discounts greater than the projected carrying costs. Most of the properties held as OREO are commercial real estate.

(Unaudited)
(Dollars in Thousands)

| For the Twelve Months Ended | December | % of | December | % of | 2014 to 2013 | | December | % of | 2013 to 2012 | |
|--|----------|----------|----------|----------|--------------|----------|----------|----------|--------------|----------|
| | 31, 2014 | Category | 31, 2013 | Category | \$ Change | % Change | 31, 2012 | Category | \$ Change | % Change |
| Other real estate owned, beginning of period | \$ 2,771 | 277% | \$ 4,679 | 169% | \$ (1,908) | -41% | \$ 7,725 | 165% | \$ (3,046) | -39% |
| Transfers from outstanding loans | 842 | 84% | 1,756 | 63% | (914) | -52% | 3,082 | 66% | (1,326) | -43% |
| Proceeds from sales | (2,340) | -234% | (2,758) | -100% | 418 | -15% | (5,145) | -110% | 2,387 | -46% |
| Net gain (loss) on sales | (207) | -21% | 40 | 1% | (247) | -618% | 331 | 7% | (291) | -88% |
| Impairment charges | (67) | -6% | (946) | -34% | 879 | -93% | (1,314) | -28% | 368 | -28% |
| Total other real estate owned | \$ 999 | 100% | \$ 2,771 | 100% | \$ (1,772) | -64% | \$ 4,679 | 100% | \$ (1,908) | -41% |

Other real estate owned and foreclosed assets by type

(Unaudited)

(Dollars in Thousands)

| | December | # of | December | # of | 2014 to 2013 | | December | # of | 2013 to 2012 | |
|-------------------------------------|----------|------------|----------|------------|--------------|----------|----------|------------|--------------|----------|
| | 31, 2014 | Properties | 31, 2013 | Properties | \$ Change | % Change | 31, 2012 | Properties | \$ Change | % Change |
| Construction, Land Dev & Other Land | \$ 35 | 1 | \$ 237 | 5 | \$ (202) | -85% | \$ 1,860 | 13 | \$ (1,623) | -87% |
| 1-4 Family Residential Properties | - | - | 672 | 4 | (672) | -100% | 507 | 4 | 165 | 33% |
| Nonfarm Nonresidential Properties | 964 | 3 | 1,862 | 8 | (898) | -48% | 2,312 | 9 | (450) | -19% |
| Total OREO by type | \$ 999 | 4 | \$ 2,771 | 17 | \$ (1,772) | -64% | \$ 4,679 | 26 | \$ (1,908) | -41% |

Allowance and Provision for Credit Losses. The allowance for loan 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 loan 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 loan 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, 2014, based upon charge-off experience and other factors considered by management, the loss factors used in the allowance for loan losses were updated from 0.40% to 0.30% on pass rated commercial loans, from 0.40% to 0.35% on non owner-occupied commercial real estate loans, from 0.55% to 0.35% on owner-occupied commercial real estate and from 0.65% to 0.60% on residential real estate. Loss factors for land and land development loans, speculative residential construction, personal lines of credit and other consumer loans remained unchanged. As a result, the estimate for

the allowance for loan losses decreased. See “Critical Accounting Policies” in this section above, as well as “Risk Factors” under Item 1A. above.

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

Allowance for Loan Losses

(Dollars in Thousands)

| For the Twelve Months Ended | December 31, 2014 | December 31, 2013 | December 31, 2012 | December 31, 2011 | December 31, 2010 |
|---|----------------------|----------------------|----------------------|----------------------|----------------------|
| Gross loans outstanding at end of period | \$ 564,313 | \$ 505,803 | \$ 449,053 | \$ 475,734 | \$ 466,509 |
| Average loans outstanding, gross | \$ 536,971 | \$ 477,356 | \$ 466,086 | \$ 483,974 | \$ 485,872 |
| Allowance for loan losses, beginning of period | \$ 8,359 | \$ 9,358 | \$ 11,127 | \$ 10,617 | \$ 11,092 |
| Charge-offs | | | | | |
| Commercial | (26) | (131) | (67) | (161) | (469) |
| Commercial Real Estate | (533) | (90) | (827) | (2,005) | (2,055) |
| Residential Real Estate | (129) | (453) | (576) | (665) | (1,518) |
| Consumer | (79) | (154) | (309) | (93) | (119) |
| Total charge-offs | (767) | (828) | (1,779) | (2,924) | (4,161) |
| Recoveries | | | | | |
| Commercial | 11 | 36 | 23 | 69 | 13 |
| Commercial Real Estate | 425 | 226 | 917 | 750 | 19 |
| Residential Real Estate | 22 | 14 | 162 | 107 | 48 |
| Consumer | 3 | 3 | 8 | 8 | 6 |
| Total recoveries | 461 | 279 | 1,110 | 934 | 86 |
| Net charge-offs | (306) | (549) | (669) | (1,990) | (4,075) |
| Provision for (recapture of) loan losses | 300 | (450) | (1,100) | 2,500 | 3,600 |
| Allowance for loan losses, end of period | \$ 8,353 | \$ 8,359 | \$ 9,358 | \$ 11,127 | \$ 10,617 |
| Ratio of net loans charged-off to average gross loans outstanding, annualized | 0.06% | 0.12% | 0.14% | 0.41% | 0.84% |
| Ratio of allowance for loan losses to gross loans outstanding | 1.48% | 1.65% | 2.08% | 2.34% | 2.28% |

The allowance for loan losses continues to decline in relation to total loans in concert with the general trend of improvement in charge offs and delinquencies after incorporating loss potential of adversely classified loans. As such, loss factors used in estimates to establish reserve levels have declined. A provision was made to the allowance for loan losses in the current year, corresponding to recent growth in the loan portfolio.

The recapture of provision in the prior year was 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.

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 \$32.8 million and \$37.8 million at December 31, 2014 and 2013, respectively. The ratio of the allowance for loan losses to total loans outstanding excluding the government guaranteed loans was 1.56% and 1.76%, 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 loan 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 loan losses to be adequate at December 31, 2014.

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)

| | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|-----------|----------|-----------|-----------|-----------|
| Total impaired loans | \$ 11,311 | \$ 9,922 | \$ 14,784 | \$ 14,432 | \$ 14,673 |
| Total impaired loans with valuation allowance | 249 | - | - | 4,498 | 508 |
| Valuation allowance related to impaired loans | - | - | - | 2,032 | 142 |

No valuation allowance was considered necessary for the remaining impaired loans. The balance of the allowance for loan 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 loan losses is available to absorb such charge-offs.

The Company allocates its allowance for loan 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 loan 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)

| For the Twelve Months Ended | December 31, 2014 | % of total loans* | December 31, 2013 | % of total loans* | December 31, 2012 | % of total loans* | December 31, 2011 | % of total loans* | December 31, 2010 | % of total loans* |
|---|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Commercial loans | \$ 1,022 | 20% | \$ 775 | 19% | \$ 923 | 19% | \$ 1,012 | 18% | \$ 816 | 19% |
| Real estate loans | 4,120 | 74% | 4,181 | 79% | 4,927 | 79% | 7,849 | 80% | 7,139 | 79% |
| Consumer loans | 979 | 6% | 744 | 2% | 531 | 2% | 642 | 2% | 690 | 2% |
| Unallocated | 2,232 | 0% | 2,659 | 0% | 2,977 | 0% | 1,624 | 0% | 1,972 | 0% |
| Total allowance | \$ <u>8,353</u> | 100% | \$ <u>8,359</u> | 100% | \$ <u>9,358</u> | 100% | \$ <u>11,127</u> | 100% | \$ <u>10,617</u> | 100% |
| Ratio of allowance for loan losses to gross loans outstanding | <u>1.48%</u> | | <u>1.66%</u> | | <u>2.09%</u> | | <u>2.34%</u> | | <u>2.28%</u> | |

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

The table indicates decreases during 2014 in the portion of the allowance related to real estate loans, respectively, which were partially offset by an increase in the portion related to commercial and consumer loans. The significant decline in 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 commercial and consumer loans resulted from an increase in classified loans in this sector, as previously noted. The increase in the allowance related to consumer loans resulted from growth in this sector. The unallocated portion of the allowance declined due to a reduction in qualitative risk factors corresponding to improving trends in economic conditions.

The table indicates decreases 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

Total deposits were up at December 31, 2014, compared to the previous two years. Non-interest bearing demand and interest-bearing demand deposits increased due to recent success in acquiring business deposit relationships in conjunction with the growth in lending achieved over the past year. The combination of our efforts to reduce higher-cost time deposits through lowering interest rates paid and offering non-insured deposit products continued to impact the balances of these types of deposits. 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. Growth in all categories in 2013 was also the result of the acquisition of three Sterling branches in second quarter 2013, representing \$37.6 million in deposits.

Total brokered deposits were \$22.4 million at December 31, 2014, which included \$2.3 million via reciprocal deposit arrangements. This compares to \$21.6 million at December 31, 2013, which included \$3.9 million via reciprocal deposit arrangements. Brokered deposits have been acquired over the past several years at historically low rates for extended maturities to help insulate the Bank in a rising rate environment. The weighted average term of these brokered deposits is 50 months. Longer term CDs are generally not available in the retail market as customers generally desire to keep funds more liquid and accessible. The Company views the prudent use of brokered deposits and borrowings to be an appropriate funding tool to support interest rate risk mitigation strategies.

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, 2014, 2013 and 2012, respectively, follows:

| Deposits | | | |
|---------------------------------|----------------------|----------------------|----------------------|
| (Dollars in Thousands) | December 31, 2014 | December 31, 2013 | December 31, 2012 |
| Interest-bearing demand (NOW) | \$ 151,130 | \$ 144,221 | \$ 125,758 |
| Money market deposits | 123,484 | 118,627 | 106,849 |
| Savings deposits | 79,997 | 73,412 | 62,493 |
| Time, interest deposits (CD's) | 118,683 | 126,059 | 138,005 |
| Total interest-bearing deposits | 473,294 | 462,319 | 433,105 |
| Non-interest bearing demand | 165,760 | 145,028 | 115,138 |
| Total deposits | \$ 639,054 | \$ 607,347 | \$ 548,243 |

The ratio of non-interest bearing deposits to total deposits is displayed in the table below.

| Deposits (Unaudited) | December 31, | | December 31, | | 2014 to 2013 | | December | | 2013 to 2012 | |
|--|------------------------|---------------------|-------------------|---------------------|------------------|----------|-------------------|---------------------|------------------|----------|
| | 2014 | Percent of Total | 2013 | Percent of Total | \$ Change | % Change | 31, 2012 | Percent of Total | \$ Change | % Change |
| | (Dollars in Thousands) | | | | | | | | | |
| Interest-bearing demand and money market | \$ 274,614 | 42% | \$ 262,848 | 43% | \$ 11,766 | 4% | \$ 232,607 | 43% | \$ 30,241 | 13% |
| Savings | 79,997 | 13% | 73,412 | 12% | 6,585 | 9% | 62,493 | 11% | 10,919 | 17% |
| Time deposits | 118,683 | 19% | 126,059 | 21% | (7,376) | -6% | 138,005 | 25% | (11,946) | -9% |
| Total interest-bearing deposits | <u>473,294</u> | 74% | <u>462,319</u> | 76% | <u>10,975</u> | 2% | <u>433,105</u> | 79% | <u>29,214</u> | 7% |
| Non-interest bearing demand | 165,760 | 26% | 145,028 | 24% | 20,732 | 14% | 115,138 | 21% | 29,890 | 26% |
| Total deposits | <u>\$ 639,054</u> | 100% | <u>\$ 607,347</u> | 100% | <u>\$ 31,707</u> | 5% | <u>\$ 548,243</u> | 100% | <u>\$ 59,104</u> | 11% |

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.

| Deposits (Dollars in Thousands) | December 31, | | December 31, | | December 31, | |
|------------------------------------|-------------------|-------|-------------------|-------|-------------------|-------|
| | 2014 | Rate | 2013 | Rate | 2012 | Rate |
| Interest-bearing demand (NOW) | \$ 147,225 | 0.23% | \$ 131,179 | 0.30% | \$ 120,472 | 0.48% |
| Money market and savings deposits | 196,859 | 0.12% | 185,005 | 0.27% | 168,512 | 0.30% |
| Time, interest deposits (CD's) | <u>122,002</u> | 0.89% | <u>135,447</u> | 0.98% | <u>144,486</u> | 1.24% |
| Total interest-bearing deposits | 466,086 | | 451,631 | | 433,470 | |
| Non-interest bearing demand | <u>158,697</u> | 0.00% | <u>129,218</u> | 0.00% | <u>107,048</u> | 0.00% |
| Total deposits | <u>\$ 624,783</u> | 0.27% | <u>\$ 580,849</u> | 0.35% | <u>\$ 540,518</u> | 0.53% |

Maturities of time certificates of deposit as of December 31, 2014 are summarized as follows:

| (Dollars in Thousands) | Under | | Over | | Total |
|--------------------------|------------------|----|---------------|----|----------------|
| | \$100,000 | | \$100,000 | | |
| 3 months or less | \$ 9,636 | \$ | 20,202 | \$ | 29,838 |
| Over 3 through 6 months | 7,939 | | 4,683 | | 12,622 |
| Over 6 through 12 months | 10,662 | | 14,516 | | 25,178 |
| Over 12 months | <u>14,798</u> | | <u>36,247</u> | | <u>51,045</u> |
| Total time certificates | <u>\$ 43,035</u> | \$ | <u>75,648</u> | \$ | <u>118,683</u> |

Short-Term Borrowings

The following is information regarding the Company's short-term borrowings for the years ended December 31, 2014, 2013 and 2012.

| | 2014 | 2013 | 2012 |
|--|--------|----------|----------|
| Amount outstanding at end of period | \$ - | \$ - | \$ 3,000 |
| Weighted average interest rate thereon | 0.28% | - | 2.94% |
| Maximum month-end balance during year | \$ - | \$ 3,000 | \$ 3,000 |
| Average balance during the year | \$ 153 | \$ 303 | \$ 2,697 |
| Average interest rate during the year | 0.28% | 2.94% | 2.94% |

CONTRACTUAL OBLIGATIONS

The Company is party to many contractual financial obligations at December 31, 2014, 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 for such obligations are due.

| | Less than 1 year | 1-2 years | 3-5 years | More than 5 years | Total |
|-----------------------------------|---------------------|--------------|--------------|----------------------|---------|
| Operating leases | \$ 491 | \$ 567 | \$ 462 | \$ 412 | 1,932 |
| Total deposits | 422,249 | 40,104 | 10,879 | 62 | 473,294 |
| Federal home loan bank borrowings | - | 5,000 | 5,000 | 1,453 | 11,453 |
| Junior subordinated debentures | - | - | - | 13,403 | 13,403 |

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:

(Dollars in Thousands)

| | December 31, 2014 | December 31, 2013 |
|------------------------------|----------------------|----------------------|
| Commitments to extend credit | \$ 109,545 | \$ 106,017 |
| Standby letters of credit | \$ 1,351 | \$ 1,733 |

KEY FINANCIAL RATIOS

FINANCIAL PERFORMANCE OVERVIEW

For The Twelve Months Ended

| | December 31, 2014 | December 31, 2013 | December 31, 2012 | December 31, 2011 | December 31, 2010 |
|--------------------------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| Selective performance ratios | | | | | |
| Return on average assets, annualized | 0.68% | 0.55% | 0.75% | 0.44% | 0.25% |
| Return on average equity, annualized | 6.92% | 5.48% | 7.28% | 4.45% | 2.77% |
| Dividend payout ratio | 44% | 55% | 42% | 0% | 0% |

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, 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.

At December 31, 2014, the Bank had \$11.5 million in outstanding borrowings against its \$149.7 million in established borrowing capacity with the FHLB, as compared to \$10.0 million outstanding against a borrowing capacity of \$143.1 million at December 31, 2013. The Bank's borrowing facility with the FHLB is subject to collateral and stock ownership requirements. The Bank also had an available discount window primary credit line with the Federal Reserve Bank of San Francisco of approximately \$52.9 million, subject to collateral requirements, and \$16.0 million from correspondent banks with no balance outstanding on any of these facilities.

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. In addition, the exercise of outstanding warrants during 2013 provided a nonrecurring source of additional funds during that year. 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.

At December 31, 2014, two wholly-owned subsidiary grantor trusts established by the Company had issued and outstanding \$13.4 million of trust preferred securities ("TRUPs"). As of December 31, 2014 and 2013, interest payable on TRUPs totaled \$40,000 and \$40,000 in each year, and is included in accrued interest payable on the balance sheet. For more information regarding the Company's issuance of TRUPs, 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. 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 Company and its Bank subsidiary continue to satisfy the requirements to qualify as "well-capitalized" under regulatory guidelines. Capital growth is provided primarily through earnings retention. Also, \$1.2 million of additional capital was supplied in the current year via the exercise at a price of \$6.50 per share of warrants to purchase 185,000 shares of common stock originally issued in conjunction with a private capital raise conducted in 2009. In general, capital ratios declined from December 31, 2013 due to the successful execution of the Company's growth strategy and shift in the balance sheet mix to higher risk-weighted loan assets.

The Board of Governors of the Federal Reserve System ("Federal Reserve") and the FDIC have established minimum requirements for capital adequacy for bank holding companies and state non-member banks. For more information on these topics, see the discussions under the subheading "Capital Adequacy" in the section "Business" included in Item 1 of this Form 10-K for the year ended December 31, 2014.

The total risk based capital ratios of the Company include \$13.4 million of junior subordinated debentures, all of which qualified as Tier 1 capital at December 31, 2014 and 2013, under guidance issued by the Federal Reserve. The Company expects to continue to rely on these junior subordinated debentures as part of its regulatory capital.

The following table sets forth the minimum required capital ratios and actual ratios for December 31, 2014 and 2013.

| (Dollars in Thousands) | December 31, 2014 | December 31, 2013 | Change | Regulatory Minimum to be "Well Capitalized" greater than or equal to |
|---|----------------------|----------------------|--------|--|
| <u>Pacific Financial Corporation</u> | | | | |
| Actual amount | | | | |
| Total risk-based capital ratio | 13.61% | 14.11% | (0.50) | 10% |
| Tier 1 risk-based capital ratio | 12.36% | 12.85% | (0.49) | 6% |
| Leverage ratio | 9.80% | 9.83% | (0.03) | 5% |
| Tangible common equity ratio | 8.05% | 7.74% | 0.31 | n/a |
| <u>Bank of the Pacific</u> | | | | |
| Total risk-based capital ratio | 13.52% | 14.03% | (0.51) | 10% |
| Tier 1 risk-based capital ratio | 12.27% | 12.78% | (0.51) | 6% |
| Leverage ratio | 9.73% | 9.77% | (0.04) | 5% |

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, 2014, 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 12.0%. 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 net income growth rate that approximated 23%; an asset growth of 4.4% in years one through five; net interest margin ranging from 4.02% in the base year to 4.24% in year five; and a return on assets that ranged from 0.62% to 1.24%.

In applying the market approach method, the Company considered all banks that announced a sale between January 1, 2013 and June 30, 2014, with total assets under \$5 billion and a return on assets greater than zero. This resulted in selecting 24 institutions which fit these criteria. After selecting these 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 \$8.50 per share, or \$86.6 million, after giving similar consideration to the values derived from 1) the market approach of \$8.20 per share weighted at 80%, and 2) the income approach of \$9.67 per share million weighted at 20%. This estimate compares to a carrying value of its reporting unit of \$70.9 million. Accordingly, following step one of the Company's 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, a future impairment charge may be necessary if our stock price declines, market values of others in the financial industry decrease, the Bank's revenue falls, or there are significant adverse changes in the operating environment for the financial industry.

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.

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, 2014 and differences between them for the maturity or repricing periods indicated.

At December 31, 2014
(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 | \$ 223,655 | \$ 300,517 | \$ 44,713 | \$ 568,885 |
| Investments and bank owned life insurance | 30,477 | 42,039 | 34,961 | 107,477 |
| Fed funds sold and interest bearing balances with bank and interest bearing cd's | 18,982 | - | - | 18,982 |
| Federal home loan bank stock | - | - | 2,896 | 2,896 |
| Pacific coast bankers bank stock | - | - | 1,000 | 1,000 |
| Total interest earnings assets | \$ 273,114 | \$ 342,556 | \$ 83,570 | \$ 699,240 |
| Interest bearing liabilities | | | | |
| Interest bearing demand deposits | \$ 151,131 | \$ - | \$ - | \$ 151,131 |
| Savings and money market deposits | 203,480 | - | - | 203,480 |
| Time deposits | 67,638 | 50,983 | 62 | 118,683 |
| Borrowings | - | 10,000 | 1,453 | 11,453 |
| Junior subordinated debentures | - | - | 13,403 | 13,403 |
| Total interest bearing liabilities | \$ 422,249 | \$ 60,983 | \$ 14,918 | \$ 498,150 |
| Net interest rate sensitivity GAP | \$ (149,135) | \$ 281,573 | \$ 68,652 | \$ 201,090 |
| Cumulative interest rate sensitivity GAP | | 132,438 | 201,090 | |
| Cumulative interest rate sensitivity GAP as a % of earnings assets | | 21.51% | 28.76% | |

Effects of Changing Prices. The results of operations and financial condition presented in this report are based on historical cost information, and are not adjusted 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, 2014. 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, 2014, 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, 2014 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 2015 annual meeting of shareholders to be held on April 29, 2015 ("2015 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, Dan J. Tupper, Randy Rust, and Dwayne Carter. Messrs. Forcum, Tupper, Rust and Carter are independent applying the definition of independence for audit committee members found in the Nasdaq listing standards. Director John Van Dijk is considered independent per the Exchange Act rules, but as a former executive, 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 2015 Proxy Statement in the sections entitled "DIRECTOR COMPENSATION FOR 2014" 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 2015 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 2015 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 2014, are Douglas Schermer (Chair), John Van Dijk, Gary Forcum and Randy Rognlin.

Information concerning director independence requested by this item is contained in the registrant's 2015 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 2015 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 – BDO USA LLP
 - Report of Independent Registered Public Accounting Firm – Deloitte & Touche LLP
 - Consolidated Balance Sheets
 - Consolidated Statements of Income
 - Consolidated Statements of Comprehensive Income
 - Consolidated Statements of Shareholders' Equity
 - Consolidated Statements of Changes in Cash Flows
 - Notes to Consolidated Financial Statements

- (a) (2) Schedules: None

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

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
Pacific Financial Corporation
Aberdeen, Washington

We have audited the accompanying consolidated balance sheet of Pacific Financial Corporation as of December 31, 2014 and the related consolidated statements of income and comprehensive income, shareholders' equity, and cash flows for the period ended December 31, 2014. 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 audit.

We conducted our audit 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 audit 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 presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pacific Financial Corporation at December 31, 2014, and the results of its operations and its cash flows for the period ended December 31, 2014, in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO USA LLP

Spokane, Washington
March 26, 2015

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 sheet of Pacific Financial Corporation and subsidiary (the "Company") as of December 31, 2013, and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for each of the two 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 the results of their operations and their cash flows for each of the two 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
CONSOLIDATED BALANCE SHEETS
(Dollars in Thousands, except per share data)

ASSETS

| | December 31, 2014 | December 31, 2013 |
|---|----------------------|----------------------|
| Cash and cash equivalents: | | |
| Cash and due from banks | \$ 14,782 | \$ 12,214 |
| Interest-bearing deposits in banks | 16,255 | 23,734 |
| Total cash and cash equivalents | 31,037 | 35,948 |
| Interest-bearing certificates of deposit (original maturities greater than 90 days) | 2,727 | 2,727 |
| Federal Home Loan Bank stock, at cost | 2,896 | 3,013 |
| Pacific Coast Bankers' Bank stock, at cost | 1,000 | - |
| Investment securities: | | |
| Investment securities available-for-sale, at fair market value (amortized cost of \$86,907 and \$97,536) | 87,440 | 96,144 |
| Investment securities held-to-maturity, at amortized cost (fair value of \$1,852 and \$2,158) | 1,829 | 2,132 |
| Total investment securities | 89,269 | 98,276 |
| Loans held-for-sale | 5,786 | 7,765 |
| Loans, net of deferred loan fees | 563,099 | 504,666 |
| Allowance for loan losses | (8,353) | (8,359) |
| Loans, net | 554,746 | 496,307 |
| Premises and equipment, net of accumulated depreciation and amortization | 16,303 | 16,790 |
| Other real estate owned and foreclosed assets | 999 | 2,771 |
| Accrued interest receivable | 2,348 | 2,307 |
| Cash surrender value of life insurance | 18,742 | 18,237 |
| Goodwill | 12,168 | 12,168 |
| Other intangible assets | 1,439 | 1,481 |
| Other assets | 5,347 | 7,249 |
| TOTAL ASSETS | \$ 744,807 | \$ 705,039 |

LIABILITIES AND SHAREHOLDERS' EQUITY

LIABILITIES

| | | |
|--|-------------------|-------------------|
| Deposits: | | |
| Demand | \$ 165,760 | \$ 145,028 |
| Interest-bearing demand and savings | 354,611 | 336,260 |
| Time deposits | 118,683 | 126,059 |
| Total deposits | 639,054 | 607,347 |
| Accrued interest payable | 145 | 167 |
| Short-term borrowings | - | - |
| Long-term borrowings | 11,453 | 10,000 |
| Junior subordinated debentures | 13,403 | 13,403 |
| Other liabilities | 8,269 | 6,985 |
| Total liabilities | 672,324 | 637,902 |
| Preferred Stock, par value none | | |
| 5,000,000 shares authorized, none outstanding | - | - |
| Common Stock, par value \$1 | | |
| 25,000,000 shares authorized, 10,371,460 shares issued and outstanding at 12/31/2014 and 10,182,083 at 12/31/2013 | 10,371 | 10,182 |
| Additional paid-in-capital | 42,991 | 41,817 |
| Retained earnings | 19,256 | 16,507 |
| Accumulated other comprehensive loss | (135) | (1,369) |
| Total shareholders' equity | 72,483 | 67,137 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 744,807 | \$ 705,039 |

See accompanying notes.

PACIFIC FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(Dollars in Thousands, Except per Share Data)

| | For the Year Ended | | |
|---|--------------------|-----------------|-----------------|
| | December 31, | December 31, | December 31, |
| | <u>2014</u> | <u>2013</u> | <u>2012</u> |
| INTEREST AND DIVIDEND INCOME | | | |
| Loans | \$ 26,937 | \$ 24,401 | \$ 25,635 |
| Deposits in banks and federal funds sold | 89 | 114 | 84 |
| Securities available for sale: | | | |
| Taxable | 1,261 | 769 | 756 |
| Tax-exempt | 749 | 798 | 711 |
| Securities held to maturity: | | | |
| Taxable | 8 | 10 | 14 |
| Tax-exempt | 81 | 198 | 295 |
| FHLB & PCBB dividends | 33 | - | - |
| | <u>29,158</u> | <u>26,290</u> | <u>27,495</u> |
| INTEREST EXPENSE | | | |
| Deposits: | | | |
| Interest-bearing demand and savings | 581 | 700 | 1,084 |
| Time | 1,087 | 1,320 | 1,798 |
| Short-term borrowings | 1 | 9 | 79 |
| Long-term borrowings | 215 | 214 | 217 |
| Secured borrowings | - | - | 20 |
| Junior subordinated debentures | 241 | 247 | 286 |
| | <u>2,125</u> | <u>2,490</u> | <u>3,484</u> |
| Total interest expense | 2,125 | 2,490 | 3,484 |
| Net interest income | 27,033 | 23,800 | 24,011 |
| LOAN LOSS PROVISION (RECAPTURE) | | | |
| | 300 | (450) | (1,100) |
| Net interest income after loan loss provision (recapture) | <u>26,733</u> | <u>24,250</u> | <u>25,111</u> |
| NON-INTEREST INCOME | | | |
| Service charges on deposit accounts | 1,809 | 1,731 | 1,686 |
| Net (loss) gain on sale of other real estate owned | (207) | 40 | 331 |
| Net gains from sales of loans | 3,686 | 5,171 | 5,058 |
| Net gains on sales of securities available for sale | 88 | 405 | 303 |
| Net other-than-temporary impairment | (48) | (37) | (333) |
| Earnings on bank owned life insurance | 505 | 452 | 510 |
| Other operating income | 2,246 | 2,193 | 1,836 |
| | <u>8,079</u> | <u>9,955</u> | <u>9,391</u> |
| Total non-interest income | 8,079 | 9,955 | 9,391 |
| NON-INTEREST EXPENSE | | | |
| Salaries and employee benefits | 17,118 | 17,013 | 16,215 |
| Occupancy | 2,006 | 1,839 | 1,673 |
| Equipment | 1,050 | 860 | 801 |
| Data processing | 2,009 | 2,268 | 1,607 |
| Professional services | 745 | 935 | 750 |
| Other real estate owned write-downs | 67 | 946 | 1,314 |
| Other real estate owned operating costs | 238 | 408 | 550 |
| State taxes | 417 | 458 | 518 |
| FDIC and state assessments | 491 | 535 | 610 |
| Other non-interest expense | 4,014 | 4,240 | 4,379 |
| | <u>28,155</u> | <u>29,502</u> | <u>28,417</u> |
| Total non-interest expense | 28,155 | 29,502 | 28,417 |
| INCOME BEFORE PROVISION FOR INCOME TAXES | | | |
| | 6,657 | 4,703 | 6,085 |
| PROVISION FOR INCOME TAXES | | | |
| | 1,730 | 972 | 1,300 |
| Effective Tax Rate | 25.99% | 20.67% | 21.36% |
| NET INCOME APPLICABLE TO COMMON SHAREHOLDERS | | | |
| | <u>\$ 4,927</u> | <u>\$ 3,731</u> | <u>\$ 4,785</u> |
| EARNINGS PER COMMON SHARE: | | | |
| BASIC | \$ 0.48 | \$ 0.37 | \$ 0.47 |
| DILUTED | \$ 0.48 | \$ 0.37 | \$ 0.47 |
| WEIGHTED AVERAGE SHARES OUTSTANDING: | | | |
| BASIC | 10,256,242 | 10,121,738 | 10,121,853 |
| DILUTED | 10,347,338 | 10,189,888 | 10,126,244 |

See accompanying notes.

PACIFIC FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in Thousands)

| | For the Year Ended | | |
|---|----------------------|----------------------|----------------------|
| | December 31, 2014 | December 31, 2013 | December 31, 2012 |
| NET INCOME | \$ 4,927 | \$ 3,731 | \$ 4,785 |
| OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX: | | | |
| Change in fair value of securities available-for-sale | 1,269 | (1,875) | 536 |
| Defined benefit plan | (35) | 85 | 130 |
| Total other comprehensive income (loss), net of tax | 1,234 | (1,790) | 666 |
| COMPREHENSIVE INCOME | \$ 6,161 | \$ 1,941 | \$ 5,451 |

See accompanying notes.

PACIFIC FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Dollars in Thousands, Except Share Amounts)

| | Common Stock | | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income/(Loss) | Total Shareholders' Equity |
|---|-------------------|------------------|-------------------------------|----------------------|--|----------------------------------|
| | Shares | Amount | | | \$ | |
| BALANCE - December 31, 2011 | 10,121,853 | \$ 10,122 | \$ 41,342 | \$ 12,051 | \$ (245) | \$ 63,270 |
| Net income | - | - | - | 4,785 | - | 4,785 |
| Other comprehensive income, net of tax | | | | | | |
| Unrealized holding gain on securities less reclassification adjustments for net gains included in net income | - | - | - | - | 536 | 536 |
| Amortization of unrecognized prior service costs and net gains | - | - | - | - | 130 | 130 |
| Dividend paid (\$0.20 per share) | - | - | - | (2,024) | - | (2,024) |
| Stock-based compensation expense | - | - | 24 | - | - | 24 |
| BALANCE - December 31, 2012 | <u>10,121,853</u> | <u>\$ 10,122</u> | <u>\$ 41,366</u> | <u>\$ 14,812</u> | <u>\$ 421</u> | <u>\$ 66,721</u> |
| Net income | - | - | - | 3,731 | - | 3,731 |
| Other comprehensive income, net of tax | | | | | | |
| Unrealized holding loss on securities less reclassification adjustments for net gains included in net income | - | - | - | - | (1,875) | (1,875) |
| Amortization of unrecognized prior service costs and net gains | - | - | - | - | 85 | 85 |
| Issuance of common stock | 60,230 | 60 | 334 | - | - | 394 |
| Dividend declared (\$0.20 per share) | - | - | - | (2,036) | - | (2,036) |
| Stock-based compensation expense | - | - | 117 | - | - | 117 |
| BALANCE - December 31, 2013 | <u>10,182,083</u> | <u>\$ 10,182</u> | <u>\$ 41,817</u> | <u>\$ 16,507</u> | <u>\$ (1,369)</u> | <u>\$ 67,137</u> |
| Net income | - | - | - | 4,927 | - | 4,927 |
| Other comprehensive income, net of tax | | | | | | |
| Unrealized holding gain on securities less reclassification adjustments for net gains included in net income | - | - | - | - | 1,269 | 1,269 |
| Amortization of unrecognized prior service costs and net gains | - | - | - | - | (35) | (35) |
| Issuance of common stock | 189,377 | 189 | 1,035 | - | - | 1,224 |
| Dividend declared (\$0.21 per share) | - | - | - | (2,178) | - | (2,178) |
| Stock-based compensation expense | - | - | 139 | - | - | 139 |
| BALANCE - December 31, 2014 | <u>10,371,460</u> | <u>\$ 10,371</u> | <u>\$ 42,991</u> | <u>\$ 19,256</u> | <u>\$ (135)</u> | <u>\$ 72,483</u> |

See accompanying notes.

PACIFIC FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)

| | For the Year Ended | | |
|--|----------------------|----------------------|----------------------|
| | December 31, 2014 | December 31, 2013 | December 31, 2012 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Net Income | \$ 4,927 | \$ 3,731 | \$ 4,785 |
| Adjustments to reconcile net income to net cash from operating activities | | | |
| Provision for (recapture of) credit losses | 300 | (450) | (1,100) |
| Depreciation and amortization | 2,538 | 2,328 | 1,491 |
| Deferred income taxes | 727 | 386 | 63 |
| Originations of loans held for sale | (150,899) | (225,068) | (251,435) |
| Proceeds from sales of loans held for sale | 155,846 | 234,194 | 256,720 |
| Net gain on sales of loans | (3,546) | (5,171) | (5,058) |
| Net gain on sales of securities available for sale | (88) | (405) | (303) |
| Net OTTI recognized in earnings | 48 | 37 | 333 |
| Loss (gain) on sales of other real estate owned | 207 | (40) | (331) |
| (Gain) loss on sale of premises and equipment | (2) | 36 | (6) |
| Earnings on bank owned life insurance | (505) | (452) | (510) |
| (Increase) decrease in accrued interest receivable | (41) | (228) | 77 |
| Decrease in accrued interest payable | (22) | (48) | (1,277) |
| Other real estate owned write-downs | 67 | 946 | 1,314 |
| Additions to other real estate owned | - | - | (185) |
| Decrease in prepaid expenses | 12 | 2,157 | 374 |
| Other operating activities | 1,791 | 1,003 | 288 |
| | <u>11,360</u> | <u>12,956</u> | <u>5,240</u> |
| Net cash provided by operating activities | | | |
| | <u>11,360</u> | <u>12,956</u> | <u>5,240</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES | | | |
| Net decrease (increase) in interest bearing balances with banks | 7,479 | 18,953 | (14,162) |
| Net decrease (increase) in certificates of deposits held for investment | - | 258 | (2,985) |
| Activity in securities available for sale: | | | |
| Sales | 17,755 | 7,832 | 10,917 |
| Maturities, prepayments and calls | 8,623 | 11,265 | 10,451 |
| Purchases | (17,711) | (57,521) | (34,194) |
| Activity in securities held to maturity: | | | |
| Maturities, prepayments and calls | 303 | 4,804 | 286 |
| Purchases | - | - | (200) |
| Proceeds from sales of government loan pools | 2,541 | 6,266 | 1,296 |
| (Increase) decrease in loans made to customers, net of principal collections | (60,809) | (60,004) | 24,105 |
| Purchases of premises and equipment | (848) | (2,728) | (844) |
| Proceeds from sales of other real estate owned | 1,527 | 2,660 | 4,223 |
| Cash received in acquisition, net of cash paid | - | 31,941 | - |
| | <u>(41,140)</u> | <u>(36,274)</u> | <u>(1,107)</u> |
| Net cash used in investing activities | | | |
| | <u>(41,140)</u> | <u>(36,274)</u> | <u>(1,107)</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES | | | |
| Net increase in deposits | 31,707 | 21,470 | 193 |
| Net decrease in short-term borrowings | - | (3,000) | - |
| Decrease in secured borrowings | - | - | (741) |
| Proceeds from issuance of long-term debt | 1,500 | 2,500 | 2,500 |
| Repayments of long-term debt | (47) | - | (2,500) |
| Issuance of common stock | 1,224 | 394 | - |
| Cash dividends paid | (2,036) | - | (2,024) |
| | <u>32,348</u> | <u>21,364</u> | <u>(2,572)</u> |
| Net cash provided by (used in) financing activities | | | |
| | <u>32,348</u> | <u>21,364</u> | <u>(2,572)</u> |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | 2,568 | (1,954) | 1,561 |
| CASH AND DUE FROM BANKS - BEGINNING OF THE PERIOD | 12,214 | 14,168 | 12,607 |
| CASH AND DUE FROM BANKS - END OF THE PERIOD | <u>\$ 14,782</u> | <u>\$ 12,214</u> | <u>\$ 14,168</u> |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION | | | |
| Cash paid for interest | \$ 2,147 | \$ 2,536 | \$ 4,761 |
| Cash paid for taxes | \$ 643 | \$ 690 | \$ 1,998 |
| SUPPLEMENTAL SCHEDULE OF NON CASH INVESTING AND FINANCING ACTIVITIES | | | |
| Change in fair value of securities available-for-sale, net of tax | \$ 920 | \$ (1,875) | \$ 536 |
| Transfer of loans held for sale to loans held for investment | \$ 578 | \$ 986 | \$ 1,295 |
| Other real estate owned acquired in settlement of loans | \$ (842) | \$ (1,756) | \$ (2,897) |
| Reclass of current portion of long-term borrowings to short-term borrowings | \$ - | \$ - | \$ 3,000 |
| Financed sale of other real estate owned | \$ 813 | \$ 98 | \$ 922 |

See accompanying notes.

Pacific Financial Corporation and Subsidiary
December 31, 2014 and 2013 and for the three years ended December 31, 2014, 2013 and 2012
Notes to Consolidated Financial Statements, Dollars in Thousands Except Per Share Amounts

NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization – Pacific Financial Corporation (the “Company” or “Pacific”) is a bank holding company headquartered in Aberdeen, Washington. The Company owns one banking subsidiary, Bank of the Pacific (the “Bank”), which is also headquartered 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 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.

The Company conducts its banking business through the Bank, which operates 17 branches located in communities in Grays Harbor, Pacific, Whatcom, Clark, Skagit and Wahkiakum counties in the state of Washington and three in Clatsop County, Oregon. In addition, the Bank operates two loan production offices in Burlington and Dupont, 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 \$37.6 million and loans acquired totaled \$4.0 million. 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.

Basis of presentation – The consolidated financial statements include the accounts of Pacific Financial Corporation and its wholly-owned subsidiary. All intercompany accounts and transactions have been eliminated in consolidation.

The interim consolidated financial statements are not audited, but include all adjustments that Management considers necessary for a fair presentation of consolidated financial condition and results of operations for the interim periods presented.

Method of accounting and use of estimates – The Company prepares its consolidated financial statements in conformity with accounting principles generally accepted in the United States of America and prevailing practices within the banking industry. This requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of income and expenses during the reporting periods. Actual results could differ from those estimates. Significant estimates made by Management involve the calculation of the allowance for loan losses, impaired loans, the fair value of available-for-sale investment securities, deferred tax assets, and the value of other real estate owned and foreclosed assets.

The Company utilizes the accrual method of accounting, which recognizes income when earned and expenses when incurred.

In preparing these financial statements, the Company has evaluated events and transactions subsequent to December 31, 2014, for potential recognition or disclosure in the financial statements. In Management’s opinion, all accounting adjustments necessary to accurately reflect the financial position and results of operations on the accompanying financial statements have been made. These adjustments include normal and recurring accruals considered necessary for a fair and accurate presentation.

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 income (loss).” Realized gains and losses on securities available for sale, determined using the specific identification method, are included in earnings. Amortization of premiums and accretion of discounts are recognized in interest income over the period to maturity. For mortgage-backed securities, actual maturity may differ from contractual maturity due to principal payments and amortization of premiums and accretion of discounts may vary due to prepayment speed assumptions.

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

Declines in the fair value of individual securities held to maturity and available for sale that are deemed to be other than temporary are reflected in earnings when identified. Management evaluates individual securities for other than temporary impairment (“OTTI”) on a quarterly basis. OTTI is separated into a credit and noncredit component. Noncredit component losses are recorded in other comprehensive 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, 2014, future deterioration of the FHLB's financial condition may result in future impairment losses.

Pacific Coast Bankers Bank Stock -- The Company's investment in Pacific Coast Bankers Bank ("PCBB") stock is carried at cost.

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 loan losses, any deferred fees or costs on originated loans, and unamortized premiums or discounts on purchased loans. Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment of yield over the contractual life of the related loans using the effective interest method.

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

Allowance for loan losses -- The allowance for loan 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 loan 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 loan 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.

For all portfolio segments, a restructuring of a debt constitutes a troubled debt restructuring ("TDR") if the Company grants a concession to the borrower for economic or legal reasons related to the borrower's financial difficulties that it would not otherwise consider. Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the

original contractual terms. Loans or leases that are reported as TDRs are considered impaired and measured for impairment as described above.

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 loan losses. Properties are evaluated regularly to ensure that the recorded amounts are supported by their current fair values, and that write-downs to reduce the carrying amounts to fair value less estimated costs to dispose are recorded as necessary. Any subsequent reductions in carrying values, and revenue and expense from the operations of properties, are charged to operations.

Goodwill and other intangible assets -- At December 31, 2014 the Company had \$13,607 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, 2014 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 \$171 and \$213 at December 31, 2014 and 2013, respectively. Amortization expense related to core deposit intangible totaled \$43 and \$28 during the years ended December 31, 2014 and 2013, respectively.

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.

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, 2014, 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, 2014. The tax years that remain subject to examination by federal and state taxing authorities are the years ended December 31, 2013, 2012 and 2011.

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

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

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

Earnings Per Share -- Basic earnings per share excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding. Diluted earnings per share reflect the potential dilution that could occur if common shares were issued pursuant to the exercise of options under the Company's stock option plans. Stock options excluded from the calculation of diluted earnings per share because they are antidilutive, were 361,545, 436,495, and 532,106 in 2014, 2013 and 2012, respectively. Outstanding warrants also excluded were 0, 638,920, and 699,642 for the years ended 2014, 2013, and 2012, respectively.

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

Business Segment -- The Company operates a single business segment. The financial information that is used by the chief operating decision maker in allocating resources and assessing performance is only provided for one reportable segment as of December 31, 2014, 2013 and 2012.

Recent Accounting Pronouncements -- 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 disclosures required from adoption of this ASU have been included in these financial statements.

In January 2014, FASB issued ASU 2014-04, "*Receivables – Troubled Debt Restructurings by Creditors – Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*". ASU 2014-04 clarifies when banks and similar institutions (creditors) should reclassify mortgage loans collateralized by residential real estate properties from the loan portfolio to other real estate owned (OREO). The ASU also requires certain interim and annual disclosures. ASU 2014-04 is effective for interim and annual periods beginning after December 15, 2014. The Company does not anticipate that the adoption of this standard will have a material effect on its financial statements.

In May 2014, FASB issued ASU 2014-09, "*Revenue from Contracts with Customers*". Under this Update, FASB created a new Topic 606 which is in response to a joint initiative of FASB and the International Accounting Standards Board to clarify the principles for

recognizing revenue and to develop a common revenue standard for U.S. GAAP and international financial reporting standards that would:

1. Remove inconsistencies and weaknesses in revenue requirements.
2. Provide a more robust framework for addressing revenue issues.
3. Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
4. Provide more useful information to users of financial statements through improved disclosure requirements.
5. Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

The amendments in this Update are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. The Company is currently evaluating the impact that this Update will have on its consolidated financial position, results of operations or cash flows.

In August 2014, FASB issued ASU 2014-14, "*Receivables- Troubled Debt Restructurings by Creditors; Classification of Certain Government-Guaranteed Mortgage Loans Upon Foreclosure*". This ASU will require creditors to derecognize certain foreclosed government-guaranteed mortgage loans and to recognize a separate other receivable that is measured at the amount the creditor expects to recover from the guarantor, and to treat the guarantee and the receivable as a single unit of account. ASU 2014-14 is effective for interim and annual periods beginning after December 15, 2014. The Company does not anticipate that the adoption of this standard will have a material effect on its 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, 2014 and 2013 was approximately \$1,031 and \$953, respectively.

NOTE 3 - SECURITIES

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

Investment securities at December 31, 2014 and December 31, 2013 consisted of the following:

(Dollars in Thousands)

| | December 31, 2014 | | | |
|--|-------------------|------------------------------|-------------------------------|------------------|
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| Available-for-sale: | | | | |
| Collateralized mortgage obligations: agency issued | \$ 38,949 | \$ 236 | \$ 418 | \$ 38,767 |
| Collateralized mortgage obligations: non-agency | 535 | - | 8 | 527 |
| Mortgage-backed securities: agency issued | 12,325 | 39 | 165 | 12,199 |
| U.S. Government and agency securities | 7,977 | 111 | 32 | 8,056 |
| State and municipal securities | 27,121 | 850 | 80 | 27,891 |
| Total available-for-sale | <u>\$ 86,907</u> | <u>\$ 1,236</u> | <u>\$ 703</u> | <u>\$ 87,440</u> |
| Held-to-maturity: | | | | |
| Mortgage-backed securities: agency issued | \$ 123 | \$ 12 | \$ - | \$ 135 |
| State and municipal securities | 1,706 | 11 | - | 1,717 |
| Total held-to-maturity | <u>\$ 1,829</u> | <u>\$ 23</u> | <u>\$ -</u> | <u>\$ 1,852</u> |
| | December 31, 2013 | | | |
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| Available-for-sale: | | | | |
| Collateralized mortgage obligations: agency issued | \$ 39,791 | \$ 246 | \$ 1,246 | \$ 38,791 |
| Collateralized mortgage obligations: non agency | 2,251 | 3 | 243 | 2,011 |
| Mortgage-backed securities: agency issued | 13,671 | 21 | 303 | 13,389 |
| U.S. Government agency securities | 8,859 | 34 | 82 | 8,811 |
| State and municipal securities | 31,973 | 774 | 587 | 32,160 |
| Corporate bonds | 991 | - | 9 | 982 |
| Total available-for-sale | <u>\$ 97,536</u> | <u>\$ 1,078</u> | <u>\$ 2,470</u> | <u>\$ 96,144</u> |
| Held-to-maturity: | | | | |
| Mortgage-backed securities: agency issued | \$ 159 | \$ 13 | \$ - | \$ 172 |
| State and municipal securities | 1,973 | 13 | - | 1,986 |
| Total held-to-maturity | <u>\$ 2,132</u> | <u>\$ 26</u> | <u>\$ -</u> | <u>\$ 2,158</u> |

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, 2014, and December 31, 2013, are summarized as follows:

(Dollars in Thousands)

| | Less than 12 months | | 12 months or more | | Total | |
|--|---------------------|-----------------|-------------------|---------------|------------------|-----------------|
| | Fair Value | Unrealized | Fair Value | Unrealized | Fair Value | Unrealized |
| | | Losses | | Losses | | Losses |
| At December 31, 2014 | | | | | | |
| Available-for-sale: | | | | | | |
| Collateralized mortgage obligations: agency issued | \$ 5,836 | \$ 27 | \$ 17,446 | \$ 391 | \$ 23,282 | \$ 418 |
| Collateralized mortgage obligations: non agency | 335 | 2 | 192 | 6 | 527 | 8 |
| Mortgage-backed securities: agency issued | 2,883 | 80 | 6,888 | 85 | 9,771 | 165 |
| U.S. Government agency securities | - | - | 3,615 | 32 | 3,615 | 32 |
| State and municipal securities | 5,123 | 41 | 3,054 | 39 | 8,177 | 80 |
| Total | <u>\$ 14,177</u> | <u>\$ 150</u> | <u>\$ 31,195</u> | <u>\$ 553</u> | <u>\$ 45,372</u> | <u>\$ 703</u> |
| | | | | | | |
| | Less than 12 months | | 12 months or more | | Total | |
| | Fair Value | Unrealized | Fair Value | Unrealized | Fair Value | Unrealized |
| | | Losses | | Losses | | Losses |
| At December 31, 2013 | | | | | | |
| Available-for-sale: | | | | | | |
| Collateralized mortgage obligations: agency issued | \$ 21,043 | \$ 778 | \$ 6,265 | \$ 468 | \$ 27,308 | \$ 1,246 |
| Collateralized mortgage obligations: non agency | 389 | 27 | 1,619 | 216 | 2,008 | 243 |
| Mortgage-backed securities: agency issued | 7,752 | 218 | 2,643 | 85 | 10,395 | 303 |
| U.S. Government agency securities | 5,550 | 82 | - | - | 5,550 | 82 |
| State and municipal securities | 11,551 | 485 | 1,821 | 102 | 13,372 | 587 |
| 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> |

At December 31, 2014, there were 56 investment securities in an unrealized loss position, of which 38 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, leading to 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, 2014.

For collateralized mortgage obligations ("CMO") 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 twelve months ended December 31, 2014, no CMO was determined to be other-than-temporarily-impaired. For the twelve months ended December 31, 2013, one CMO was determined to be other-than-temporarily-impaired. This security was sold in second quarter 2014, incurring a loss of \$69,000. The Company recorded \$48,000, \$37,000, and \$333,000 in impairments related to credit losses through earnings for the twelve months ended December 31, 2014, 2013, and 2012 respectively.

The following table presents the cash proceeds from the sales of securities and their associated gross realized gains and gross realized losses that are included in earnings for the twelve months ended December 31, 2014, 2013, and 2012:

Investment securities gross gains and losses

(Dollars in Thousands)

| | For the Year Ended | | |
|---|--------------------|---------------|---------------|
| | December 31, | December 31, | December 31, |
| | 2014 | 2013 | 2012 |
| Gross realized gain on sale of securities | \$ 315 | \$ 448 | \$ 332 |
| Gross realized loss on sale of securities | (227) | (43) | (29) |
| Net realized gain on sale of securities | <u>\$ 88</u> | <u>\$ 405</u> | <u>\$ 303</u> |
| Proceeds from sale of securities | \$ 17,755 | \$ 7,832 | \$ 10,917 |

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 own any sovereign debt of Eurozone nations or structured financial products, such as collateralized debt obligations or structured investment vehicles, which are known by the Company to have elevated risk characteristics.

The amortized cost and estimated fair value of investment securities at December 31, 2014, by maturity are shown below. The amortized cost and fair value of collateralized mortgage obligations and mortgage-backed securities are presented by expected average life, rather than contractual maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to prepay underlying loans without prepayment penalties.

At December 31, 2014

(Dollars in Thousands)

| | Held-to-maturity | | Available-for-sale | |
|--|------------------|-----------------|--------------------|------------------|
| | Amortized | | Amortized | |
| | Cost | Fair Value | Cost | Fair Value |
| Due in one year or less | \$ - | \$ - | \$ 325 | \$ 329 |
| Due after one year through five years | - | - | 8,636 | 8,662 |
| Due after five years through ten years | 889 | 899 | 12,903 | 13,160 |
| Due after ten years | 817 | 818 | 13,234 | 13,796 |
| Declining Balance Securities | 123 | 135 | 51,809 | 51,493 |
| Total investment securities | \$ <u>1,829</u> | \$ <u>1,852</u> | \$ <u>86,907</u> | \$ <u>87,440</u> |

At December 31, 2014 and 2013, investment securities with an estimated fair value of \$84.1 million and \$57.4 million, respectively, were pledged to secure public deposits, certain nonpublic deposits and borrowings.

As required of all members of the Federal Home Loan Bank (“FHLB”) system, the Company maintains an investment in the capital stock of the FHLB in an amount equal to the greater of \$500,000 or 0.5% of home mortgage loans and pass-through securities plus 5.0% of the outstanding balance of mortgage home loans sold to FHLB under the Mortgage Purchase Program. The FHLB system, the largest government sponsored entity in the United States, is made up of 12 regional banks, including the FHLB of Seattle. Participating banks record the value of FHLB stock equal to its par value at \$100 per share. At December 31, 2014 and 2013, the Company held approximately \$2.9 million and 3.0 million, respectively, in FHLB stock.

The Company is required to hold FHLB’s stock in order to receive advances and views this investment as long-term. Thus, when evaluating it for impairment, the value is determined based on the recovery of the par value through redemption by the FHLB or from the sale to another member, rather than by recognizing temporary declines in value. The FHLB of Seattle disclosed that it reported net income for the twelve month period ended December 31, 2014, at which time it declared a cash dividend. On November 22, 2013, the FHLB of Seattle entered into an amended Stipulation and Consent to the Issuance of a Consent Order with the Federal Housing Finance Agency (“Finance Agency”), modifying the previous order issued on October 25, 2010. The Finance Agency now deems the FHLB of Seattle to be “adequately capitalized” under the Finance Agency’s Prompt Corrective Action rule. The Company has concluded that its investment in FHLB is not impaired as of December 31, 2014, and believes that it will ultimately recover the par value of its investment in this stock.

The Company owns \$1.0 million in common stock in Pacific Coast Bankers’ Bancshares (PCBB), from which the Company receives a variety of corresponding banking services through its banking subsidiary Pacific Coast Bankers Bank. An investment by the Company in such an entity is permissible under 12 CFR 362.3(a)(2)(iv). When evaluating this investment for impairment, the value is determined based on the recovery of the par value through any redemption by PCBB or from the sale to another eligible purchaser, rather than by recognizing temporary declines in value. PCBB disclosed that it reported net income for the twelve month period ended December 31, 2014 and maintains capital ratios that exceed “well capitalized” standards for regulatory purposes.

NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY

Loans

Loans held in the portfolio at December 31, 2014 and December 31, 2013, are as follows:

| (Dollars in Thousands) | December 31, 2014 | December 31, 2013 |
|--|----------------------|----------------------|
| Commercial and agricultural | \$ 120,517 | \$ 104,111 |
| Real estate: | | |
| Construction and development | 26,711 | 29,096 |
| Residential 1-4 family | 92,965 | 87,762 |
| Multi-family | 18,541 | 17,520 |
| Commercial real estate -- owner occupied | 125,632 | 105,594 |
| Commercial real estate -- non owner occupied | 117,137 | 117,294 |
| Farmland | 22,245 | 23,698 |
| Consumer | 40,565 | 20,728 |
| Gross loans | 564,313 | 505,803 |
| Less: deferred fees | (1,214) | (1,137) |
| Portfolio Loans | \$ <u>563,099</u> | \$ <u>504,666</u> |

Allowance for loan losses and credit quality

The allowance for loan losses represents the Company's estimate as to the probable credit losses inherent in its loan portfolio. The allowance for loan losses is increased through periodic charges to earnings through provision for loan losses and represents the aggregate amount, net of loans charged-off and recoveries on previously charged-off loans, that is needed to establish an appropriate reserve for credit losses. The allowance is estimated based on a variety of factors and using a methodology as described below:

- The Company classifies loans into relatively homogeneous pools by loan type in accordance with regulatory guidelines for regulatory reporting purposes. The Company regularly reviews all loans within each loan category to establish risk ratings for them that include Pass, Watch, Special Mention, Substandard, Doubtful and Loss. Pursuant to ASC 310 "Accounting by Creditors for Impairment of a Loan", the impaired portion of collateral dependent loans is charged-off. Other risk-related loans not considered impaired have loss factors applied to the various loan pool balances to establish loss potential for provisioning purposes.
- Analyses are performed to establish the loss factors based on historical experience, as well as expected losses based on qualitative evaluations of such factors as the economic trends and conditions, industry conditions, levels and trends in delinquencies and impaired loans, levels and trends in charge-offs and recoveries, among others. The loss factors are applied to loan category pools segregated by risk classification to estimate the loss inherent in the Company's loan portfolio pursuant to ASC 450 "Accounting for Contingencies."
- Additionally, impaired loans are evaluated for loss potential on an individual basis in accordance with ASC 310 "Accounting by Creditors for Impairment of a Loan," and specific reserves are established based on thorough analysis of collateral values where loss potential exists. When an impaired loan is collateral dependent and a deficiency exists in the fair value of collateral securing the loan in comparison to the associated loan balance, the deficiency is charged-off at that time or a specific reserve is established. Impaired loans are reviewed no less frequently than quarterly.
- In the event that a current appraisal to support the fair value of the real estate collateral underlying an impaired loan has not yet been received, but the Company believes that the collateral value is insufficient to support the loan amount, an impairment reserve is recorded. In these instances, the receipt of a current appraisal triggers an updated review of the collateral support for the loan and any deficiency is charged-off or reserved at that time. In those instances where a current appraisal is not available in a timely manner in relation to a financial reporting cut-off date, the Company discounts the most recent third-party appraisal depending on a number of factors including, but not limited to, property location, local price volatility, local economic conditions, and recent comparable sales. In all cases, the costs to sell the subject property are deducted in arriving at the fair value of the collateral.

Changes in the allowance for loan losses for the twelve months ended December, 2014 and 2013 were as follows:

Allowance for Loan Losses

| Dollars in Thousands | Commercial Real | | Residential | Consumer | Unallocated | Total |
|--|-----------------|-----------------|---------------|---------------|-----------------|-----------------|
| | Commercial | Estate ("CRE") | Real Estate | | | |
| For the twelve months ended December 31, 2014 | | | | | | |
| Beginning balance | \$ 775 | \$ 3,506 | \$ 675 | \$ 744 | \$ 2,659 | \$ 8,359 |
| Charge-offs and concessions | (26) | (533) | (129) | (79) | - | (767) |
| Recoveries | 11 | 425 | 22 | 3 | - | 461 |
| Provision / (recapture) | 262 | 21 | 133 | 311 | (427) | 300 |
| Ending balance | \$ <u>1,022</u> | \$ <u>3,419</u> | \$ <u>701</u> | \$ <u>979</u> | \$ <u>2,232</u> | \$ <u>8,353</u> |

Allowance for Loan Losses

| Dollars in Thousands | Commercial Real | | Residential | Consumer | Unallocated | Total |
|--|-----------------|-----------------|---------------|---------------|-----------------|-----------------|
| | Commercial | Estate ("CRE") | Real Estate | | | |
| For the twelve months ended December 31, 2013 | | | | | | |
| Beginning balance | \$ 923 | \$ 4,098 | \$ 829 | \$ 531 | \$ 2,977 | \$ 9,358 |
| Charge-offs and concessions | (131) | (90) | (453) | (154) | - | (828) |
| Recoveries | 36 | 226 | 14 | 3 | - | 279 |
| Provision / (recapture) | (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> |

Recorded investment in loans as of December 31, 2014 and 2013 are as follows:

Schedule of Loan Losses Related to Financing Receivables Current and Noncurrent

| Dollars in Thousands | Commercial Real | | Residential | Consumer | Unallocated | Total |
|---|-------------------|-------------------|-------------------|------------------|-----------------|-------------------|
| | Commercial | Estate ("CRE") | Real Estate | | | |
| As of December 31, 2014 | | | | | | |
| Allowance for Loan Losses: | | | | | | |
| Ending balance: individually evaluated for impairment | \$ - | \$ 249 | \$ - | \$ - | \$ - | \$ 249 |
| Ending balance: collectively evaluated for impairment | 1,022 | 3,170 | 701 | 979 | 2,232 | 8,104 |
| Total allowance for loan losses | \$ <u>1,022</u> | \$ <u>3,419</u> | \$ <u>701</u> | \$ <u>979</u> | \$ <u>2,232</u> | \$ <u>8,353</u> |
| Loans: | | | | | | |
| Ending balance: individually evaluated for impairment | \$ 380 | \$ 9,864 | \$ 1,067 | \$ - | \$ - | \$ 11,311 |
| Ending balance: collectively evaluated for impairment | 120,137 | 281,861 | 110,439 | 40,565 | - | 553,002 |
| Ending balance | \$ <u>120,517</u> | \$ <u>291,725</u> | \$ <u>111,506</u> | \$ <u>40,565</u> | \$ <u>-</u> | \$ <u>564,313</u> |
| Less deferred fees | | | | | | \$ (1,214) |
| Ending balance total loans | | | | | | \$ <u>563,099</u> |

Schedule of Loan Losses Related to Financing Receivables Current and Noncurrent

Dollars in Thousands

| | <u>Commercial</u> | <u>Commercial Real Estate ("CRE")</u> | <u>Residential Real Estate</u> | <u>Consumer</u> | <u>Unallocated</u> | <u>Total</u> |
|--|-------------------|---|------------------------------------|------------------|--------------------|-------------------|
| As of December 31, 2013 | | | | | | |
| Allowance for Loan Losses: | | | | | | |
| Ending balance: individually evaluated for impairment | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
| Ending balance: collectively evaluated for impairment | \$ 775 | \$ 3,506 | \$ 675 | \$ 744 | \$ 2,659 | \$ 8,359 |
| Total allowance for loan losses | <u>\$ 775</u> | <u>\$ 3,506</u> | <u>\$ 675</u> | <u>\$ 744</u> | <u>\$ 2,659</u> | <u>\$ 8,359</u> |
| 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 deferred fees | | | | | | <u>\$ (1,137)</u> |
| Ending balance total loans | | | | | | <u>\$ 504,666</u> |

Credit Quality Indicators

Federal regulations require that the Bank periodically evaluate the risks inherent in its loan portfolios. In addition, the Washington Division of Banks and the Federal Deposit Insurance Corporation ("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 loan losses, thereby reducing that 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.

Credit quality indicators as of December 31, 2014 and December 31, 2013 were as follows:

(Dollars in Thousands)

December 31, 2014

| | Pass | Other Loans Especially Mentioned | Substandard | Doubtful | Total |
|--|-------------------|--|------------------|---------------|-------------------|
| Commercial and agricultural | \$ 111,800 | \$ 6,354 | \$ 2,363 | \$ - | \$ 120,517 |
| Real estate: | | | | | |
| Construction and development | 25,696 | 50 | 965 | - | 26,711 |
| Residential 1-4 family | 89,183 | 684 | 3,098 | - | 92,965 |
| Multi-family | 18,274 | 267 | - | - | 18,541 |
| Commercial real estate -- owner occupied | 117,444 | 1,717 | 6,471 | - | 125,632 |
| Commercial real estate -- non owner occupied | 94,068 | 17,587 | 5,233 | 249 | 117,137 |
| Farmland | 20,130 | 1,862 | 253 | - | 22,245 |
| Total real estate | <u>364,795</u> | <u>22,167</u> | <u>16,020</u> | <u>249</u> | <u>403,231</u> |
| Consumer | 40,436 | 82 | 47 | - | 40,565 |
| Less deferred fees | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>(1,214)</u> |
| Total loans | <u>\$ 517,031</u> | <u>\$ 28,603</u> | <u>\$ 18,430</u> | <u>\$ 249</u> | <u>\$ 563,099</u> |

December 31, 2013

| | Pass | Other Loans Especially Mentioned | Substandard | Doubtful | Total |
|--|-------------------|--|------------------|-------------|-------------------|
| Commercial and agricultural | \$ 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 |
| Commercial real estate -- owner occupied | 100,612 | 1,019 | 3,963 | - | 105,594 |
| Commercial real estate -- 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 |
| Less deferred fees | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>(1,137)</u> |
| Total loans | <u>\$ 468,230</u> | <u>\$ 24,810</u> | <u>\$ 12,763</u> | <u>\$ -</u> | <u>\$ 504,666</u> |

Impaired Loans

Impaired loans by type as of December 31, 2014, and interest income recognized for the twelve months ended December 31, 2014, were as follows:

(Dollars in Thousands)

| | Unpaid Principal Balance | Recorded Investment | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|------------------------------|--------------------------------|-------------------------|----------------------|-----------------------------------|----------------------------------|
| December 31, 2014 | | | | | |
| With no Related Allowance: | | | | | |
| Commercial | \$ 418 | \$ 380 | \$ - | \$ 439 | \$ 19 |
| Consumer | - | - | - | 53 | - |
| Residential real estate | 1,359 | 1,067 | - | 866 | 58 |
| Commercial real estate: | | | | | |
| CRE -- owner occupied | 1,381 | 1,379 | - | 1,662 | - |
| CRE -- non owner occupied | 7,642 | 7,271 | - | 4,705 | 45 |
| Farmland | - | - | - | 716 | 225 |
| Construction and development | 3,023 | 965 | - | 1,201 | 57 |
| Total | <u>\$ 13,823</u> | <u>\$ 11,062</u> | <u>\$ -</u> | <u>\$ 9,642</u> | <u>\$ 404</u> |
| With a Related Allowance: | | | | | |
| Consumer | \$ - | \$ - | \$ - | \$ - | - |
| Residential real estate | - | - | - | - | - |
| CRE -- non owner occupied | 249 | 249 | 249 | 83 | - |
| Total | <u>\$ 249</u> | <u>\$ 249</u> | <u>\$ 249</u> | <u>\$ 83</u> | <u>-</u> |
| Total Impaired Loans: | | | | | |
| Commercial | \$ 418 | \$ 380 | \$ - | \$ 439 | \$ 19 |
| Consumer | - | - | - | 53 | - |
| Residential real estate | 1,359 | 1,067 | 249 | 866 | 58 |
| Commercial real estate: | | | | | |
| CRE -- owner occupied | 1,381 | 1,379 | - | 1,662 | - |
| CRE -- non owner occupied | 7,891 | 7,520 | - | 4,788 | 45 |
| Farmland | - | - | - | 716 | 225 |
| Construction and development | 3,023 | 965 | - | 1,201 | 57 |
| Total Impaired Loans | <u><u>\$ 14,072</u></u> | <u><u>\$ 11,311</u></u> | <u><u>\$ 249</u></u> | <u><u>\$ 9,725</u></u> | <u><u>\$ 404</u></u> |

Impaired loans by type as of December 31, 2013, and interest income recognized for the twelve months ended December 31, 2013, were as follows:

| (Dollars in Thousands) | Unpaid Principal Balance | Recorded Investment | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|------------------------------|--------------------------------|------------------------|----------------------|-----------------------------------|----------------------------------|
| December 31, 2013 | | | | | |
| With no Related Allowance: | | | | | |
| Commercial | \$ 608 | \$ 587 | - | \$ 1,270 | \$ 9 |
| Consumer | 53 | 53 | - | 11 | 1 |
| Residential real estate | 815 | 626 | - | 1,045 | 25 |
| Commercial real estate: | | | | | |
| CRE -- owner occupied | 1,714 | 1,714 | - | 2,482 | 24 |
| CRE -- non owner occupied | 6,776 | 4,579 | - | 5,195 | 40 |
| Farmland | 955 | 955 | - | 959 | - |
| Construction and development | 3,685 | 1,408 | - | 1,582 | 78 |
| Total | <u>\$ 14,606</u> | <u>\$ 9,922</u> | <u>\$ -</u> | <u>\$ 12,544</u> | <u>\$ 177</u> |
| With a Related Allowance: | | | | | |
| Consumer | \$ - | \$ - | - | \$ 2 | - |
| Residential real estate | - | - | - | 40 | - |
| CRE -- non owner occupied | - | - | - | - | - |
| Total | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 42</u> | <u>\$ -</u> |
| Total Impaired Loans: | | | | | |
| Commercial | \$ 608 | \$ 587 | - | \$ 1,270 | \$ 9 |
| Consumer | 53 | 53 | - | 13 | 1 |
| Residential real estate | 815 | 626 | - | 1,085 | 25 |
| Commercial real estate: | | | | | |
| CRE -- owner occupied | 1,714 | 1,714 | - | 2,482 | 24 |
| CRE -- non owner occupied | 6,776 | 4,579 | - | 5,195 | 40 |
| Farmland | 955 | 955 | - | 959 | - |
| Construction and development | 3,685 | 1,408 | - | 1,582 | 78 |
| Total Impaired Loans | <u>\$ 14,606</u> | <u>\$ 9,922</u> | <u>\$ -</u> | <u>\$ 12,586</u> | <u>\$ 177</u> |

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 2014 and 2013. Total related party loans outstanding at December 31, 2014 and 2013 to executive officers and directors were \$2,374 and \$66, respectively. During 2014 and 2013, new loans of \$3,758 and \$5, respectively, were made, and repayments totaled \$1,450 and \$324, 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, 2014.

Aging Analysis

The following tables summarize the Company's loans past due, both accruing and nonaccruing, by type as of December 31, 2014 and December 31, 2013:

(Dollars in Thousands)

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Non-accrual Loans | Current | Total Loans |
|--|------------------------|------------------------|----------------------------|-------------------|----------------------|------------|----------------|
| December 31, 2014: | | | | | | | |
| Commercial and agricultural | \$ - | \$ - | \$ - | \$ - | \$ 96 | \$ 120,421 | \$ 120,517 |
| Real estate: | | | | | | | |
| Construction and development | 18 | - | - | 18 | 965 | 25,728 | 26,711 |
| Residential 1-4 family | 537 | 68 | - | 605 | 848 | 91,512 | 92,965 |
| Multi-family | - | - | - | - | - | 18,541 | 18,541 |
| Commercial real estate -- owner occupied | - | - | 409 | 409 | 1,325 | 123,898 | 125,632 |
| Commercial real estate -- non owner occupied | - | - | - | - | 5,482 | 111,655 | 117,137 |
| Farmland | 46 | - | - | 46 | - | 22,199 | 22,245 |
| Total real estate | 601 | 68 | 409 | 1,078 | 8,620 | 393,533 | 403,231 |
| Consumer | 170 | 2 | - | 172 | - | 40,393 | 40,565 |
| Less deferred fees | - | - | - | - | - | (1,214) | (1,214) |
| Total | \$ 771 | \$ 70 | \$ 409 | \$ 1,250 | \$ 8,716 | \$ 553,133 | \$ 563,099 |
| December 31, 2013: | | | | | | | |
| Commercial and agricultural | \$ 14 | \$ - | \$ - | \$ 14 | \$ 286 | \$ 103,811 | \$ 104,111 |
| Real estate: | | | | | | | |
| Construction and development | - | - | - | - | 1,408 | 27,688 | 29,096 |
| Residential 1-4 family | 333 | - | - | 333 | 400 | 87,029 | 87,762 |
| Multi-family | - | - | - | - | - | 17,520 | 17,520 |
| Commercial real estate -- owner occupied | - | - | - | - | 1,659 | 103,935 | 105,594 |
| Commercial real estate -- non owner occupied | - | - | - | - | 2,482 | 114,812 | 117,294 |
| Farmland | 875 | - | - | 875 | 955 | 21,868 | 23,698 |
| Total real estate | 1,208 | - | - | 1,208 | 6,904 | 372,852 | 380,964 |
| Consumer | 165 | 3 | - | 168 | 53 | 20,507 | 20,728 |
| Less deferred fees | - | - | - | - | - | (1,137) | (1,137) |
| Total | \$ 1,387 | \$ 3 | \$ - | \$ 1,390 | \$ 7,243 | \$ 496,033 | \$ 504,666 |

Interest income on non-accrual loans that would have been recorded had those loans performed in accordance with their initial terms was \$679, \$1,130, and \$1,213 for 2014, 2013, and 2012, respectively.

Modifications

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

Loans modified in a TDR are considered impaired loans and typically already on non-accrual status. Partial charge-offs have in some cases already been taken against the outstanding loan balance. 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 every six to nine months. During the twelve months ended December 31, 2014, there was no impact on the allowance from TDRs during the period, as the loans classified as TDRs during the period did not have a specific

reserve and were already considered impaired loans at the time of modification and no further impairment was required upon modification. The Company had no commitments to lend additional funds for loans classified as TDRs at December 31, 2014.

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 table presents TDRs as of December 31, 2014 and 2013, all of which were modified due to financial stress of the borrower. There were not any subsequent defaulted TDRs as of December 31, 2014 and 2013. There were no loans modified or recorded as TDRs during the years ended December 31, 2014 and 2013.

Restructured loans by type current and subsequently defaulted
(Dollars in Thousands)

| | | December 31, 2014 | | |
|------------------------------|-----------------|----------------------------|-------------|--|
| | | Current Restructured Loans | | |
| | | Pre-TDR | Post-TDR | |
| | | Outstanding | Outstanding | |
| | | Recorded | Recorded | |
| | Number of Loans | Investment | Investment | |
| Commercial and agriculture | 1 | \$ 335 | \$ 284 | |
| Construction and development | 2 | 2,764 | 965 | |
| Residential real estate | 2 | 272 | 219 | |
| CRE -- owner occupied | 1 | 59 | 54 | |
| CRE -- non owner occupied | 1 | 2,180 | 2,038 | |
| Total restructured loans (1) | 7 | \$ 5,610 | \$ 3,560 | |

| | | December 31, 2013 | | |
|------------------------------|-----------------|----------------------------|-------------|--|
| | | Current Restructured Loans | | |
| | | Pre-TDR | Post-TDR | |
| | | Outstanding | Outstanding | |
| | | Recorded | Recorded | |
| | Number of Loans | Investment | Investment | |
| Commercial and agriculture | 1 | \$ 335 | \$ 302 | |
| Construction and 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 | |
| Total restructured loans (1) | 8 | \$ 5,818 | \$ 4,088 | |

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

The following table summarizes the Company's troubled debt restructured loans by type and geographic region as of December 31, 2014:

Restructured loans by type and geographic region
(Dollars in Thousands)

| | December 31, 2014 | | | | | Number of Loans |
|------------------------------|----------------------------|-------------------------|---------------------|--------|----------|-----------------|
| | Restructured Loans | | | | | |
| | Central Western Washington | Southwestern Washington | Northern Washington | Oregon | Totals | |
| Commercial and agriculture | \$ - | \$ - | \$ 284 | \$ - | \$ 284 | 1 |
| Construction and development | - | - | 841 | 124 | 965 | 2 |
| Residential real estate | - | - | - | 219 | 219 | 2 |
| CRE -- owner occupied | 54 | - | - | - | 54 | 1 |
| CRE -- non owner occupied | - | - | 2,038 | - | 2,038 | 1 |
| Total restructured loans | \$ 54 | \$ - | \$ 3,163 | \$ 343 | \$ 3,560 | 7 |

The following table presents troubled debt restructurings by accrual or nonaccrual status as of December 31, 2014 and 2013:

Restructured loans by accrual or nonaccrual status
(Dollars in Thousands)

| | December 31, 2014 | | |
|------------------------------|--------------------|--------------------|---------------------|
| | Restructured loans | | |
| | Accrual Status | Non-accrual Status | Total Modifications |
| Commercial and agriculture | \$ 284 | \$ - | \$ 284 |
| Construction and development | - | 965 | 965 |
| Residential real estate | 219 | - | 219 |
| CRE -- owner occupied | 54 | - | 54 |
| CRE -- non owner occupied | 2,038 | - | 2,038 |
| Total restructured loans | <u>\$ 2,595</u> | <u>\$ 965</u> | <u>\$ 3,560</u> |

| | December 31, 2013 | | |
|------------------------------|--------------------|--------------------|---------------------|
| | Restructured loans | | |
| | Accrual Status | Non-accrual Status | Total Modifications |
| Commercial and agriculture | \$ 302 | \$ - | \$ 302 |
| Construction and development | - | 1,408 | 1,408 |
| Residential real estate | 227 | - | 227 |
| CRE -- owner occupied | 55 | - | 55 |
| CRE -- non owner occupied | 2,096 | - | 2,096 |
| Total restructured loans | <u>\$ 2,680</u> | <u>\$ 1,408</u> | <u>\$ 4,088</u> |

NOTE 5 – ACCUMULATED OTHER COMPREHENSIVE INCOME/(LOSS)

The following table presents the changes in each component of accumulated other comprehensive income/(loss), net of tax, for the twelve months ended December 31, 2014 and 2013:

(Dollars in Thousands)

| | Net Unrealized Gains and Losses | | |
|--|---------------------------------|-----------------------|-------------------|
| | On Investment Securities | Defined Benefit Plans | Total |
| Balance, January 1, 2014 | \$ (919) | \$ (450) | \$ (1,369) |
| Other comprehensive gain (loss) before reclassifications | 1,295 | (35) | 1,260 |
| Amounts reclassified from AOCI | (26) | - | (26) |
| Net Current period other comprehensive income (loss) | 1,269 | (35) | 1,234 |
| Balance, December 31, 2014 | <u>\$ 350</u> | <u>\$ (485)</u> | <u>\$ (135)</u> |
| | | | |
| | Net Unrealized Gains and Losses | | |
| | On Investment Securities | Defined Benefit Plans | Total |
| Balance, January 1, 2013 | \$ 956 | \$ (535) | \$ 421 |
| Other comprehensive gain (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> |

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (“AOCI”) for the twelve months ended December 31, 2014 and 2013:

(Dollars in Thousands)

| Details about Accumulated Other Comprehensive Income Components | For the Year Ended December 31, 2014 | Affected Line Item in the Statement Where Net Income is Presented |
|---|--------------------------------------|---|
| Net Unrealized Gains and Losses on Investment Securities | \$ (88) | (Gain) on sales of investments available for sale |
| | 48 | Net OTTI losses |
| | 14 | Income tax expense |
| | <u>\$ (26)</u> | Unrealized gain on investment securities net of tax |

(Dollars in Thousands)

| Details about Accumulated Other Comprehensive Income Components | For the Year 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> | Unrealized gain on investment securities net of tax |

The following table presents the components of other comprehensive income (loss) for the twelve months ended December 31, 2014 and 2013:

(Dollars in Thousands)

| | <u>Before Tax</u> | <u>Tax Effect</u> | <u>Net of Tax</u> |
|---|------------------------|----------------------|------------------------|
| Twelve months ended December 31, 2014 | | | |
| Net unrealized losses on investment securities: | | | |
| Net unrealized gains arising during the period | \$ 1,962 | \$ 667 | \$ 1,295 |
| Less: reclassification adjustments for net gains realized in net income | (40) | (14) | (26) |
| Net unrealized losses on investment securities | <u>\$ 1,922</u> | <u>\$ 653</u> | <u>\$ 1,269</u> |
| Defined benefit plans: | | | |
| Amortization of unrecognized prior service costs and net actuarial gains/losses | <u>\$ (53)</u> | <u>\$ (18)</u> | <u>\$ (35)</u> |
| Other Comprehensive Income | <u><u>\$ 1,869</u></u> | <u><u>\$ 635</u></u> | <u><u>\$ 1,234</u></u> |

(Dollars in Thousands)

| | <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 adjustments for net gains realized in net income | (368) | (125) | (243) |
| Net unrealized losses on investment securities | <u>\$ (2,841)</u> | <u>\$ (966)</u> | <u>\$ (1,875)</u> |
| Defined benefit plans: | | | |
| Amortization of unrecognized prior service costs and net actuarial gains/losses | <u>\$ 129</u> | <u>\$ 44</u> | <u>\$ 85</u> |
| Other Comprehensive Loss | <u><u>\$ (2,712)</u></u> | <u><u>\$ (922)</u></u> | <u><u>\$ (1,790)</u></u> |

NOTE 6 – PREMISES AND EQUIPMENT

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

| <u>Premises and equipment</u> | <u>2014</u> | <u>2013</u> |
|--|-------------------------|-------------------------|
| Land and premises | \$ 19,875 | \$ 19,859 |
| Equipment, furniture and fixtures | 7,698 | 8,142 |
| Construction in progress | 84 | 167 |
| | <u>27,657</u> | <u>28,168</u> |
| Less accumulated depreciation and amortization | <u>(11,354)</u> | <u>(11,378)</u> |
| Total premises and equipment | <u><u>\$ 16,303</u></u> | <u><u>\$ 16,790</u></u> |

| | <u>2014</u> | <u>2013</u> | <u>2012</u> |
|----------------------|-----------------|-----------------|---------------|
| Depreciation expense | <u>\$ 1,242</u> | <u>\$ 1,013</u> | <u>\$ 989</u> |
| Rental expense | <u>\$ 574</u> | <u>\$ 544</u> | <u>\$ 442</u> |

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:

| | | |
|------|----|---------------------|
| 2015 | \$ | 491 |
| 2016 | | 331 |
| 2017 | | 236 |
| 2018 | | 233 |
| 2019 | | <u>229</u> |
| | \$ | <u><u>1,520</u></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:

| For the Twelve Months Ended | December 31, 2014 | December 31, 2013 | \$ Change |
|--|----------------------|----------------------|-------------------|
| Other real estate owned, beginning of period | \$ 2,771 | \$ 4,679 | \$ (1,908) |
| Transfers from outstanding loans | 842 | 1,756 | (914) |
| Proceeds from sales | (2,340) | (2,758) | 418 |
| Net gain (loss) on sales | (207) | 40 | (247) |
| Impairment charges | <u>(67)</u> | <u>(946)</u> | <u>879</u> |
| Total other real estate owned | <u>\$ 999</u> | <u>\$ 2,771</u> | <u>\$ (1,772)</u> |

At December 31, 2014 and 2013, OREO consisted of properties as follows:

Other real estate owned and foreclosed assets by type

(Unaudited)

(Dollars in Thousands)

| | December 31, 2014 | # of Properties | December 31, 2013 | # of Properties |
|-------------------------------------|----------------------|--------------------|----------------------|--------------------|
| Construction, Land Dev & Other Land | \$ 35 | 1 | 237 | 5 |
| 1-4 Family Residential Properties | - | - | 672 | 4 |
| Nonfarm Nonresidential Properties | <u>964</u> | <u>3</u> | <u>1,862</u> | <u>8</u> |
| Total OREO by type | <u>\$ 999</u> | <u>4</u> | <u>2,771</u> | <u>17</u> |

Net (loss) gain on sales of OREO totaled \$(207), \$40 and \$331 for the years ended December 31, 2014, 2013 and 2012, respectively.

NOTE 8 – DEPOSITS

The composition of deposits at December 31 is as follows:

| Deposits | | December 31, | December 31, |
|--------------------------------------|----|----------------|-------------------|
| (Dollars in Thousands) | | 2014 | 2013 |
| NOW and money market accounts | \$ | 274,614 | \$ 262,848 |
| Savings deposits | | 79,997 | 73,412 |
| Time certificates, \$100,000 or more | | 75,648 | 76,628 |
| Other time certificates | | 43,035 | 49,431 |
| Total interest-bearing deposits | | 473,294 | 462,319 |
| Non-interest bearing demand | | 165,760 | 145,028 |
| Total deposits | \$ | <u>639,054</u> | <u>\$ 607,347</u> |

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

At December 31, 2014
(Dollars in Thousands)

| | | <u>Maturities</u> |
|--------------|-----------|-----------------------|
| 2015 | \$ | 67,642 |
| 2016 | | 25,656 |
| 2017 | | 14,342 |
| 2018 | | 5,724 |
| 2019 | | 5,160 |
| Thereafter | | 159 |
| Total | \$ | <u>118,683</u> |

NOTE 9 – BORROWINGS

Long-term borrowings at December 31, 2014 and 2013 represent advances from the Federal Home Loan Bank of Seattle (“FHLB”). Advances at December 31, 2014 bear interest at 0.47% to 2.54% and mature in various years as follows: 2016 - \$5,000, 2019 - \$5,000 and \$1,453 in 2024. The Bank has pledged \$140,773 in loans as collateral for these borrowings at December 31, 2014.

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, 2014, and 2013. The following is a summary of short-term borrowings for the years ended:

(Dollars in Thousands)

| | 2014 | 2013 |
|--|--------|----------|
| Amount outstanding at end of period | \$ - | \$ - |
| Weighted average interest rate thereon | 0.28% | - |
| Maximum month-end balance during year | \$ - | \$ 3,000 |
| Average balance during the year | \$ 153 | \$ 303 |
| Average interest rate during the year | 0.28% | 2.94% |

NOTE 10 – JUNIOR SUBORDINATED DEBENTURES

At December 31, 2014, two wholly-owned subsidiary grantor trusts established by the Company had outstanding \$13.0 million 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.

The Debentures issued by the Company to the grantor trusts totaling \$13.0 million 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 \$403,000 in the consolidated balance sheet at December 31, 2014 and 2013, respectively, for the common capital securities issued by the issuer trusts.

As of December 31, 2014 and 2013, regular accrued interest on junior subordinated debentures totaled \$40,000 for both years and is included in accrued interest payable on the balance sheet. Following are the terms of the junior subordinated debentures as of December 31, 2014.

(Dollars in Thousands)

| Trust Name | Issue Date | Issued Amount | Rate | Maturity Date |
|--|---------------|------------------|------------------------------|---------------|
| Pacific Financial Corporation Statutory Trust I | December 2005 | \$ 5,000 | LIBOR + 1.45% ⁽¹⁾ | March 2036 |
| Pacific Financial Corporation Statutory Trust II | June 2006 | 8,000 | LIBOR + 1.60% ⁽²⁾ | July 2036 |
| | | <u>\$ 13,000</u> | | |

⁽¹⁾ Pacific Financial Corporation Statutory Trust I securities incurred interest at the fixed rate of 6.39% until mid March 2011, at which the rate changed to a variable rate of 3-month LIBOR (0.24% at December 15, 2014) plus 1.45% or 1.69%, adjusted quarterly, through the final maturity date in March 2036.

⁽²⁾ Pacific Financial Corporation Statutory Trust II securities incur interest at a variable rate of 3-month LIBOR (0.253% at January 1, 2015) plus 1.60% or 1.85%, adjusted quarterly, through the final maturity date in July 2036.

NOTE 11 – INCOME TAXES

The Company recorded an income tax provision for the twelve months ended December 31, 2014, 2013, and 2012. The amount of the provision for each period was commensurate with the estimated tax liability associated with the net income earned during the period. As of December 31, 2014, the Company maintained a deferred tax asset balance of \$3.2 million. The Company believes it will be fully utilized in the normal course of business, thus no valuation allowance is maintained against this asset.

The Company's provision for income taxes includes both federal and state income taxes and reflects the application of federal and state statutory rates to the Company's income before taxes. The principal difference between statutory tax rates and the Company's effective tax rate is the benefit derived from investing in tax-exempt securities and bank owned life insurance.

Income taxes are accounted for using the asset and liability method. Under this method a deferred tax asset or liability is determined based on the enacted tax rates which will be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in the Company’s income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are established to reduce the net carrying amount of deferred tax assets if it is determined to be more likely than not, that all or some portion of the potential deferred tax asset will not be realized.

The Company applies the provisions of FASB ASC 740, Income Taxes, relating to the accounting for uncertainty in income taxes. The Company periodically reviews its income tax positions based on tax laws and regulations, and financial reporting considerations, and records adjustments as appropriate. This review takes into consideration the status of current taxing authorities’ examinations of the Company’s tax returns, recent positions taken by the taxing authorities on similar transactions, if any, and the overall tax environment. The Company’s uncertain tax positions were nominal in amount as of December 31, 2014.

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

| | 2014 | 2013 | 2012 |
|---------------------------------|------------------------|----------------------|------------------------|
| Current | \$ 1,003 | \$ 586 | \$ 1,237 |
| Deferred | <u>727</u> | <u>386</u> | <u>63</u> |
| Total income tax benefit | \$ <u>1,730</u> | \$ <u>972</u> | \$ <u>1,300</u> |

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities and net deferred tax assets are recorded in other assets in the consolidated financial statements at December 31 are:

| | 2014 | 2013 |
|--|------------------------|------------------------|
| Deferred Tax Assets | | |
| Allowance for loan losses | \$ 2,863 | \$ 2,892 |
| Deferred compensation | 102 | 111 |
| Supplemental executive retirement plan | 1,151 | 1,039 |
| Unrealized loss on securities available for sale | - | 473 |
| Loan fees/costs | 416 | 393 |
| OREO write-downs | 11 | 305 |
| OREO operating expenses | - | 174 |
| Tax credit carry-forwards | - | 534 |
| Non-accrual loan interest | 73 | 108 |
| Other | <u>445</u> | <u>170</u> |
| Total deferred tax assets | \$ <u>5,061</u> | \$ <u>6,199</u> |
| Deferred Tax Liabilities | | |
| Depreciation | \$ 100 | \$ 172 |
| Loan fees/costs | 1,290 | 1,185 |
| Unrealized gain on securities available for sale | 181 | - |
| Prepaid expenses | 128 | 108 |
| FHLB dividends | 130 | 137 |
| Other | <u>67</u> | <u>51</u> |
| Total deferred tax liabilities | <u>1,896</u> | <u>1,653</u> |
| Net deferred tax assets | \$ <u>3,165</u> | \$ <u>4,546</u> |

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

| | 2014 | Percent | 2013 | Percent | 2012 | Percent |
|---|------------------------|--------------|----------------------|--------------|------------------------|--------------|
| | Amount | of Pre-tax | Amount | of Pre-tax | Amount | of Pre-tax |
| | | Income | | Income | | Income |
| Income tax at statutory rate | \$ 2,330 | 35.0% | \$ 1,646 | 35.0% | \$ 2,130 | 35.0% |
| Adjustments resulting from: | | | | | | |
| Tax-exempt income | (412) | -6.2% | (483) | -10.3% | (542) | -8.9% |
| Net earnings on life insurance policies | (169) | -2.5% | (152) | -3.2% | (178) | -2.9% |
| Low income housing tax credit | (82) | -1.2% | (101) | -2.1% | (109) | -1.8% |
| Other | <u>63</u> | 1.0% | <u>62</u> | 1.3% | <u>(1)</u> | 0.0% |
| Total income tax expense | \$ <u>1,730</u> | 25.9% | \$ <u>972</u> | 20.7% | \$ <u>1,300</u> | 21.4% |

As of December 31, 2014, the Company believes that it is more likely than not that it will be able to fully realize its deferred tax asset ("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 \$609, \$272, and \$400 in 2014, 2013 and 2012, 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 \$180, \$161 and \$152 for 2014, 2013 and 2012, 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. There were no deferrals or ongoing expense to the Company for these plans in 2014, 2013, and 2012.

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 \$4,020 and \$3,911 at December 31, 2014 and 2013, respectively. In 2014, 2013 and 2012, the net benefit recorded from these plans, including the cost of the related life insurance, was \$380, \$354 and \$396, 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 \$311 and \$322 at December 31, 2014 and 2013, 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 \$137, \$107 and \$95 in 2014, 2013 and 2012, 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 accumulate 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 \$5,945 and \$5,817 at December 31, 2014 and 2013, 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:

(Dollars in Thousands)

| | 2014 | 2013 | 2012 |
|------------------------------------|---------------|---------------|---------------|
| Net periodic pension cost: | | | |
| Service cost | \$ 153 | \$ 145 | \$ 167 |
| Interest cost | 111 | 104 | 106 |
| Amortization of prior service cost | 90 | 90 | 90 |
| Amortization of net (gain)/loss | <u>26</u> | <u>22</u> | <u>27</u> |
| Net periodic pension cost | <u>\$ 380</u> | <u>\$ 361</u> | <u>\$ 390</u> |
| Weighted average assumptions: | | | |
| Discount rate | 3.57% | 4.37% | 4.47% |
| Rate of compensation increase | n/a | n/a | n/a |

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

| (Dollars in Thousands) | | 2014 | 2013 |
|---|----|--------------|-----------------|
| Change in benefit obligation: | | | |
| Benefit obligation at the beginning of year | \$ | 2,573 | \$ 2,342 |
| Service cost | | 153 | 145 |
| Interest cost | | 111 | 104 |
| Benefits paid | | (45) | (45) |
| Actuarial gain/(loss) | | <u>152</u> | <u>27</u> |
| Benefit obligation at end of year | \$ | <u>2,944</u> | \$ <u>2,573</u> |

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

| (Dollars in Thousands) | | 2014 | 2013 |
|--------------------------|----|------------|---------------|
| Loss | \$ | 334 | \$ 179 |
| Prior service cost | | <u>152</u> | <u>271</u> |
| Total recognized in AOCI | \$ | <u>486</u> | \$ <u>450</u> |

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

| (Dollars in Thousands) | | 2014 | 2013 |
|--------------------------------|----|-------|----------|
| Projected benefit obligation | \$ | 2,944 | \$ 2,573 |
| Accumulated benefit obligation | | 2,944 | 2,573 |

Estimated future benefit payments as of December 31, 2014 are as follows:

| (Dollars in Thousands) | |
|------------------------|------------|
| 2015 | \$ 149,743 |
| 2016 | 149,743 |
| 2017 | 149,743 |
| 2018 | 242,175 |
| 2019 | 242,175 |
| 2020-2024 | 1,210,875 |

NOTE 13 – COMMITMENTS AND CONTINGENCIES

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

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as they do for on-balance-sheet instruments. A summary of the Bank's off-balance sheet commitments at December 31, 2014 and December 31, 2013 is as follows:

| (Dollars in Thousands) | | December 31, 2014 | December 31, 2013 |
|------------------------------|----|----------------------|----------------------|
| Commitments to extend credit | \$ | 109,545 | \$ 106,017 |
| Standby letters of credit | \$ | 1,351 | \$ 1,733 |

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. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

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 condensed consolidated financial statements.

At December 31, 2014, the Bank had \$11,500 in outstanding borrowings against its \$149,700 in established borrowing capacity with the FHLB, as compared to \$10,000 outstanding against a borrowing capacity of \$143,100 at December 31, 2013. The Bank's borrowing facility with the FHLB is subject to collateral and stock ownership requirements. The Bank also had an available discount window primary credit line with the Federal Reserve Bank of San Francisco of approximately \$52,900, subject to collateral requirements, and \$16,000 from correspondent banks with no balance outstanding on any of these facilities.

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 results of operations or financial condition of the Company.

NOTE 14 – SIGNIFICANT CONCENTRATION 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 \$8,500.

NOTE 15 – STOCK BASED COMPENSATION

The Company's 2011 Equity Incentive Plan, as amended (the "2011 Plan"), provides for the issuance of up to 900,000 shares in connection with incentive and nonqualified stock options, restricted stock, restricted stock units and other equity-based awards. Prior to adoption of the 2011 Plan, the Company made equity-based awards under the Company's 2000 Stock Incentive Plan, which expired January 1, 2011.

Stock Options

The 2011 Plan authorizes the issuance of incentive and non-qualified stock options, as defined under current tax laws, to key personnel. Options granted under the 2011 Plan either become exercisable ratably over five years or in a single installment five years from the date of grant.

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

| Grant period ended | Expected Life | Risk Free Interest Rate | Expected Volatility | Dividend Yield | Average Fair Value |
|--------------------|------------------|----------------------------|------------------------|-------------------|-----------------------|
| December 31, 2014 | 6.5 years | 2.11% | 23.23% | 3.27% | \$ 1.02 |
| December 31, 2013 | 6.5 years | 1.36% | 23.05% | 4.13% | \$ 0.58 |
| December 31, 2012 | 6.5 years | 1.34% | 22.43% | 0.00% | \$ 0.77 |

A summary of stock option activity as of December 31, 2014, 2013 and 2012, and changes during the twelve months then ended are presented below:

| | December 31, 2014 | | December 31, 2013 | | December 31, 2012 | |
|----------------------------------|-------------------|---------------------------------|-------------------|---------------------------------|-------------------|---------------------------------|
| | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price |
| Outstanding beginning of period | 625,495 | \$ 9.53 | 537,107 | \$ 11.28 | 586,448 | \$ 11.32 |
| Granted | 23,500 | 6.13 | 186,000 | 5.05 | 10,500 | 5.00 |
| Exercised | (4,000) | 5.00 | - | - | - | - |
| Forfeited | (7,650) | 6.89 | (64,337) | 11.36 | (12,550) | 10.44 |
| Expired | (70,400) | 15.17 | (33,275) | 9.25 | (47,291) | 10.57 |
| Outstanding end of period | 566,945 | \$ 8.75 | 625,495 | \$ 9.53 | 537,107 | \$ 11.28 |
| Exercisable end of period | 388,345 | \$ 10.39 | 328,845 | \$ 12.95 | 389,827 | \$ 12.98 |

A summary of the status of the Company's non-vested options as of December 31, 2014 and 2013 and changes during the twelve months then ended, are presented below:

| | December 31, 2014 | | December 31, 2013 | |
|---------------------------------|-------------------|-----------------------------|-------------------|-----------------------------|
| | Shares | Weighted Average Fair Value | Shares | Weighted Average Fair Value |
| Non-vested beginning of period | 296,650 | \$ 0.47 | 147,280 | \$ 0.31 |
| Granted | 23,500 | 1.02 | 186,000 | 0.57 |
| Vested | (136,650) | 0.34 | (17,875) | 0.32 |
| Forfeited | (4,900) | 0.34 | (18,755) | 0.40 |
| Non-vested end of period | 178,600 | \$ 0.65 | 296,650 | \$ 0.47 |

The following information summarizes information about stock options outstanding and exercisable at December 31, 2014:

| Range of exercise prices | Options Outstanding | | | Options Exercisable | | |
|--------------------------|---------------------|---|---------------------------------|---------------------|---|---------------------------------|
| | Number | Weighted Average Remaining Contractual Term (Years) | Weighted Average Exercise Price | Number | Weighted Average Remaining Contractual Term (Years) | Weighted Average Exercise Price |
| 0.00 - 5.00 | 175,900 | 7.95 | \$ 4.97 | 32,800 | 7.94 | \$ 4.95 |
| 5.01 - 10.00 | 197,500 | 5.54 | 6.83 | 162,000 | 4.85 | 6.98 |
| 10.01 - 14.74 | 111,650 | 2.16 | 13.69 | 111,650 | 2.17 | 13.69 |
| 14.75 - 16.00 | 81,895 | 0.28 | 14.80 | 81,895 | 0.27 | 14.80 |
| | 566,945 | 4.86 | \$ 8.74 | 388,345 | 3.37 | \$ 10.39 |

| | December 31, 2014 | December 31, 2013 |
|--|----------------------|----------------------|
| Aggregate intrinsic value outstanding end of period | \$ 306,710 | \$ 303,450 |
| Aggregate intrinsic value exercisable end of period | \$ 55,390 | \$ - |

The Company accounts for stock based compensation in accordance with GAAP, which requires measurement of compensation cost for all stock-based awards based on grant date fair value and recognition of compensation cost over the service period of each award.

Stock-based compensation expense

(Unaudited)

(Dollars in Thousands)

| Twelve months ended December 31, 2014 | <u>Before Tax</u> | <u>Tax Effect</u> | <u>Net of Tax</u> |
|--|------------------------------|------------------------------|-------------------|
| Recognized compensation expense | \$ <u>67</u> | \$ <u>23</u> | \$ <u>44</u> |
| Twelve months ended December 31, 2013 | <u>Before Tax</u> | <u>Tax Effect</u> | <u>Net of Tax</u> |
| Recognized compensation expense | \$ <u>50</u> | \$ <u>17</u> | \$ <u>33</u> |
| | <u>December 31, 2014</u> | <u>December 31, 2013</u> | |
| Future compensation expense (1) | \$ <u>60</u> | \$ <u>80</u> | |
| Weighted Average Remaining Contractual Term (Years) | <u>1.8</u> | <u>1.8</u> | |

(1) related to non-vested stock options

Restricted Stock Units

The Company grants restricted stock units ("RSU") to employees qualifying for awards under the Company's Annual Incentive Compensation Plan. Recipients of RSUs will be issued a specified number of shares of common stock under the 2011 Plan upon the lapse of applicable restrictions. Outstanding RSUs are subject to forfeiture if the recipient's employment terminates prior to the expiration of three years from the date of grant.

The following table summarizes RSU activity during the twelve months ended December 31, 2014 and 2013:

| | <u>December 31, 2014</u> | | | <u>December 31, 2013</u> | | |
|----------------------------------|--------------------------|---|--|--------------------------|---|---|
| | <u>Shares</u> | <u>Weighted Average Grant Price</u> | <u>Weighted Average Remaining Contractual terms (in years)</u> | <u>Shares</u> | <u>Weighted Average Grant Price</u> | <u>Weighted Average Remaining Contractual terms (in</u> |
| Outstanding, January 1, 2014 | 50,024 | | | 16,059 | | |
| Granted | 13,624 | \$ 5.43 | | 35,476 | \$ 4.93 | |
| Converted | (476) | | | - | | |
| Forfeited | <u>(1,939)</u> | | | <u>(1,511)</u> | | |
| Outstanding end of period | <u>61,233</u> | | <u>1.3</u> | <u>50,024</u> | | <u>2.0</u> |

The following table summarizes RSU compensation expense during the twelve months ended December 31, 2014 and 2013:

RSU compensation expense

(Unaudited)

(Dollars in Thousands)

| Twelve months ended December 31, 2014 | <u>Before Tax</u> | <u>Tax Effect</u> | <u>Net of Tax</u> |
|---------------------------------------|------------------------------|------------------------------|-------------------|
| RSU recognized compensation expense | \$ 148 | \$ 50 | \$ 98 |
| | | | |
| Twelve months ended December 31, 2013 | <u>Before Tax</u> | <u>Tax Effect</u> | <u>Net of Tax</u> |
| RSU recognized compensation expense | \$ 66 | \$ 22 | \$ 44 |
| | | | |
| | <u>December 31, 2014</u> | <u>December 31, 2013</u> | |
| Future compensation expense (1) | \$ 150 | \$ 172 | |

(1) related to non-vested RSU's

NOTE 16 – REGULATORY MATTERS

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

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

As of December 31, 2014 and 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.

Actual capital amounts and ratios for December 31, 2014 and 2013 are presented in the table below.

| (Dollars in Thousands) | Actual Amount | Ratio | Capital Adequacy Purposes Amount | Ratio | To be well capitalized under prompt corrective action provisions amount | Ratio |
|---------------------------------|------------------|--------|---|-------|---|-------|
| December 31, 2014 | | | | | | |
| Total risk-based capital ratio | | | | | | |
| Company | \$ 79,308 | 13.61% | \$ 46,616 | 8.00% | n/a | n/a |
| Bank | 78,681 | 13.52% | 46,563 | 8.00% | 58,204 | 10% |
| Tier 1 risk-based capital ratio | | | | | | |
| Company | 72,011 | 12.36% | 23,308 | 4.00% | n/a | n/a |
| Bank | 71,392 | 12.27% | 23,282 | 4.00% | 34,922 | 6% |
| Tier 1 leverage capital ratio | | | | | | |
| Company | 72,011 | 9.80% | 27,604 | 4.00% | n/a | n/a |
| Bank | 71,392 | 9.73% | 27,591 | 4.00% | 34,489 | 5% |

| (Dollars in Thousands) | Actual Amount | Ratio | Capital Adequacy Purposes Amount | Ratio | To be well capitalized under prompt corrective action provisions amount | Ratio |
|---------------------------------|------------------|--------|---|-------|---|-------|
| December 31, 2013 | | | | | | |
| Total risk-based capital ratio | | | | | | |
| Company | \$ 74,477 | 14.11% | \$ 42,237 | 8.00% | n/a | n/a |
| Bank | 74,036 | 14.03% | 42,202 | 8.00% | 52,753 | 10% |
| Tier 1 risk-based capital ratio | | | | | | |
| Company | 67,856 | 12.85% | 21,119 | 4.00% | n/a | n/a |
| Bank | 67,420 | 12.78% | 21,101 | 4.00% | 31,652 | 6% |
| Tier 1 leverage capital ratio | | | | | | |
| Company | 67,856 | 9.83% | 27,604 | 4.00% | n/a | n/a |
| Bank | 67,420 | 9.77% | 27,591 | 4.00% | 34,489 | 5% |

NOTE 17 – FAIR VALUE MEASUREMENTS

Fair Value Hierarchy

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

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

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

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

Investment Securities Available-for-Sale

The Company uses an independent pricing service to assist management in determining fair values of investment securities available-for-sale. This service provides pricing information by utilizing evaluated pricing models supported with market based information. 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 analyses 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, 2014 or December 31, 2013.

The following table presents the balances of assets measured at fair value on a recurring basis at December 31, 2014 and December 31, 2013.

(Dollars in Thousands)

| Description | Fair Value Measurements | | | |
|--|--------------------------|--|--------------------------------------|---|
| | At December 31, 2014 | | | |
| | Fair Value 12/31/2014 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Available-for-sale securities: | | | | |
| Collateralized mortgage obligations: agency issued | \$ 38,767 | \$ - | \$ 38,767 | \$ - |
| Collateralized mortgage obligations: non agency | 527 | - | 527 | - |
| Mortgage-backed securities: agency issued | 12,199 | - | 12,199 | - |
| U.S. Government agency securities | 8,056 | - | 8,056 | - |
| State and municipal securities | 27,891 | - | 25,741 | 2,150 |
| Total assets measured at fair value | \$ 87,440 | \$ - | \$ 85,290 | \$ 2,150 |

| Description | Fair Value Measurements | | | |
|--|--------------------------|--|--------------------------------------|---|
| | At December 31, 2013 | | | |
| | Fair Value 12/31/2013 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Available-for-sale securities: | | | | |
| Collateralized mortgage obligations: agency issued | \$ 38,791 | \$ - | \$ 38,791 | \$ - |
| Collateralized mortgage obligations: non agency | 2,011 | - | 2,011 | - |
| Mortgage-backed securities: agency issued | 13,389 | - | 13,389 | - |
| U.S. Government agency securities | 8,811 | - | 8,811 | - |
| State and municipal securities | 32,160 | - | 30,741 | 1,419 |
| Corporate bonds | 982 | - | 982 | - |
| Total assets measured at fair value | \$ 96,144 | \$ - | \$ 94,725 | \$ 1,419 |

As of December 31, 2014 and December 31, 2013, the Company had four and two investments, respectively, classified as Level 3 investments which consist of 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, management determined that these securities should be classified as Level 3 within the fair value hierarchy.

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 twelve months ended December 31, 2014 and 2013, respectively. Transfers between level categorizations may occur due to changes in the availability of market observable inputs, which generally are caused by changes in market conditions such as liquidity, trading volume or bid-ask spreads. Transfers between level categorizations may also occur due to changes in the valuation source. For example, in situations where a fair value quote is not provided by the Company's independent third-party valuation service provider and as a result the price is stale, the security is transferred into Level 3. Transfers in and out of level categorizations are reported as having occurred at December 31, 2014 and 2013.

| (Dollars in Thousands) | Twelve months ended December 31, | |
|---|----------------------------------|-----------------|
| | 2014 | 2013 |
| Balance beginning of period | \$ 1,419 | \$ 1,099 |
| Transfers in to level 3 | 810 | 464 |
| Change in FV (included in other comprehensive income) | (79) | (144) |
| Balance end of period | <u>\$ 2,150</u> | <u>\$ 1,419</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 consider third party appraisals by qualified licensed appraisers, less estimated costs to sell. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach.

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

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

Other real estate owned – OREO is initially recorded at the 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 adjustments are typically downward, 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 loan losses. Management periodically reviews OREO to ensure the property is carried at the lower of its new basis or fair value, net of estimated costs to sell. Any additional write-downs based on re-evaluation of the property fair value are charged to non-interest expense. Because of the high degree of judgment required in estimating the fair value of OREO and because of the relationship between fair value and general economic conditions, we consider the fair value of OREO to be highly sensitive to changes in market conditions.

The following table presents the Company's assets that were held at the end of each period that were measured at fair value on a nonrecurring basis during the twelve months ended December 31, 2014 and year ended December 31, 2013:

(Dollars in Thousands)

| Description | Fair Value Measurements As of December 31, 2014 | | | |
|--|--|---|--------------------------------------|---|
| | Fair Value 12/31/2014 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Other real estate owned and foreclosed assets | \$ 139 | \$ - | \$ - | \$ 139 |
| Loans measured for impairment, net of specific reserves | 231 | - | - | 231 |
| Total impaired assets measured at fair value | \$ 370 | \$ - | \$ - | \$ 370 |

| Description | Fair Value Measurements As of December 31, 2013 | | | |
|--|--|---|--------------------------------------|---|
| | Fair Value 12/31/2013 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Other real estate owned and foreclosed assets | \$ 1,960 | \$ - | \$ - | \$ 1,960 |
| Loans measured for impairment, net of specific reserves | 162 | - | - | 162 |
| Total impaired assets measured at fair value | \$ 2,122 | \$ - | \$ - | \$ 2,122 |

Other real estate owned with a pre-foreclosure loan balance of \$969 was acquired during the twelve months ended December 31, 2014. Upon foreclosure, write downs totaling \$127 were applied to the allowance for loan losses during the period related to these assets.

The following table presents quantitative information about Level 3 inputs for financial instruments measured at fair value on a nonrecurring basis at December 31, 2014:

(Dollars in Thousands)

| Description | Fair Value 12/31/2014 | Valuation Technique | Significant Unobservable Inputs | Range (Weighted Average) |
|--|--------------------------|------------------------|---------------------------------------|--------------------------------|
| Other real estate owned and foreclosed assets | \$ 139 | Appraised value | Adjustment for market conditions | 0-9% (2.5%) |
| Loans measured for impairment, net of specific reserves | \$ 231 | Appraised value | Adjustment for market conditions | 0-20% (2.2%) |

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, interest bearing deposits at other financial institutions approximate their fair value.

Investment securities available-for-sale and held-to-maturity

The fair value of all investment securities are based upon the assumptions market participants would use in pricing the security. Such assumptions include observable and unobservable inputs such as quoted market prices, dealer quotes and analysis of

discounted cash flows.

Federal Home Loan Bank Stock

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

Pacific Coast Bankers' Bancshares Stock

PCBB stock is carried at cost which approximates fair value and equals its par value based on the price per share paid at the capital offering concluded during the current quarter.

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 based 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.

Borrowings

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

Junior subordinated debentures

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

Off-Balance-Sheet Instruments

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

The estimated fair value of the Company's financial instruments at December 31, 2014 and December 31, 2013 is as follows:

(Dollars in Thousands)

| | | As of December 31, 2014 | | | | |
|--|----|-------------------------|---|---|---|---------------------|
| | | Carrying Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value |
| Financial assets: | | | | | | |
| Cash and cash equivalents | \$ | 31,037 | \$ 31,037 | \$ - | \$ - | \$ 31,037 |
| Interest-bearing certificates of deposit (original maturities greater than 90 days) | | 2,727 | 2,727 | - | - | 2,727 |
| Investment securities available-for-sale | | 87,440 | - | 85,290 | 2,150 | 87,440 |
| Investment securities held-to-maturity | | 1,829 | - | 1,852 | - | 1,852 |
| Federal Home Loan Bank stock | | 2,896 | - | 2,896 | - | 2,896 |
| Pacific Coast Bankers Bank stock | | 1,000 | - | 1,000 | - | 1,000 |
| Loans held-for-sale | | 5,786 | - | 5,786 | - | 5,786 |
| Loans | | 554,746 | - | - | 527,510 | 527,510 |
| Financial liabilities: | | | | | | |
| Deposits | \$ | 639,054 | \$ - | \$ 639,537 | \$ - | \$ 639,537 |
| Long-term borrowings | | 11,453 | - | 11,583 | - | 11,583 |
| Junior subordinated debentures | | 13,403 | - | - | 7,644 | 7,644 |
| | | As of December 31, 2013 | | | | |
| | | Carrying Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value |
| Financial assets: | | | | | | |
| Cash and cash equivalents | \$ | 35,948 | \$ 35,948 | \$ - | \$ - | \$ 35,948 |
| Interest-bearing certificates of deposit (original maturities greater than 90 days) | | 2,727 | 2,727 | - | - | 2,727 |
| Investment securities available-for-sale | | 96,144 | - | 94,725 | 1,419 | 96,144 |
| Investment 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 | | 496,307 | - | - | 473,224 | 473,224 |
| Financial liabilities: | | | | | | |
| Deposits | \$ | 607,347 | \$ - | \$ 606,654 | \$ - | \$ 606,654 |
| Long-term borrowings | | 10,000 | - | 10,195 | - | 10,195 |
| Junior subordinated debentures | | 13,403 | - | - | 7,646 | 7,646 |

NOTE 18 – EARNINGS PER SHARE

The Company's basic earnings per common share is computed by dividing net income available to common shareholders (net income less dividends declared by the weighted average number of common shares outstanding during the period). The Company's diluted earnings per common share is computed similar to basic earnings per common share except that the numerator is equal to net income available to common shareholders and the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. Included in the denominator are the dilutive effects of stock options computed under the treasury stock method and outstanding warrants as if converted to common stock.

The following table illustrates the computation of basic and diluted earnings per share.

| | For the Year Ended | | |
|---|--------------------|----------------|----------------|
| | December 31, | | |
| | <u>2014</u> | <u>2013</u> | <u>2012</u> |
| <i>Basic:</i> | | | |
| Net income (numerator) | \$ 4,927 | \$ 3,731 | \$ 4,785 |
| Weighted average shares outstanding (denominator) | 10,256,242 | 10,121,738 | 10,121,853 |
| Basic earnings per share | \$ 0.48 | \$ 0.37 | \$ 0.47 |
| <i>Diluted:</i> | | | |
| Net income (numerator) | \$ 4,927 | \$ 3,731 | \$ 4,785 |
| Weighted average shares outstanding | 10,256,242 | 10,121,738 | 10,121,853 |
| Effect of dilutive stock options | <u>91,096</u> | <u>66,150</u> | <u>4,391</u> |
| Weighted average shares outstanding assuming dilution (denominator) | 10,347,338 | 10,187,888 | 10,126,244 |
| Diluted earnings per share | \$ 0.48 | \$ 0.37 | \$ 0.47 |
| | December 31, | December 31, | December 31, |
| | <u>2014</u> | <u>2013</u> | <u>2012</u> |
| Shares subject to outstanding options | 361,545 | 436,495 | 532,106 |
| Shares subject to outstanding warrants | - | 638,920 | 699,642 |

As of December 31, 2014 and 2013, the shares subject to outstanding options and for December 31, 2013, the shares subject to outstanding warrants, included some options that had exercise prices in excess of the current market value. Those specific shares are not included in the table above, as exercise of these options and warrants would not be dilutive to shareholders.

NOTE 19 – 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 agreement is as follows (in thousands):

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

The primary purposes of the acquisition are 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.

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 | <u>23</u> |
| Total assets | <u>\$37,684</u> |
| Deposits and accrued interest payable | \$37,636 |
| Deferred tax liability | 47 |
| Other liabilities | <u>1</u> |
| 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 were expensed as incurred in the year ended December 31, 2013. These acquisition and integration expenses included 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 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.

| | |
|--|------------------|
| 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 | <u>36,803</u> |
| Total assets | <u>\$681,278</u> |
| Deposits and accrued interest payable | \$586,092 |
| Borrowings | 23,903 |
| Other liabilities | 4,562 |
| Equity | <u>66,721</u> |
| Total liabilities and shareholders' equity | <u>\$681,278</u> |

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.

| | |
|-------------------------------------|----------------|
| 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, 2014 or 2013 for both the balance sheet and income statement.

NOTE 20 – CONDENSED FINANCIAL INFORMATION-PARENT COMPANY ONLY

PACIFIC FINANCIAL CORPORATION-PARENT COMPANY ONLY
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Dollars in Thousands)

ASSETS

| | December 31, 2014 | December 31, 2013 |
|----------------------------|----------------------|----------------------|
| Cash and cash equivalents: | \$ 2,585 | \$ 2,483 |
| Investment in bank | 84,864 | 79,701 |
| Other assets | 655 | 432 |
| TOTAL ASSETS | \$ 88,104 | \$ 82,616 |

LIABILITIES AND SHAREHOLDERS' EQUITY**LIABILITIES**

| | | |
|--------------------------------|---------------|---------------|
| Junior subordinated debentures | \$ 13,403 | \$ 13,403 |
| Dividends payable | 2,178 | 2,036 |
| Other liabilities | 40 | 40 |
| Total liabilities | <u>15,621</u> | <u>15,479</u> |

SHAREHOLDERS' EQUITY

| | | |
|---|------------------|------------------|
| Shareholders' equity | <u>72,483</u> | <u>67,137</u> |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 88,104 | \$ 82,616 |

PACIFIC FINANCIAL CORPORATION-PARENT COMPANY ONLY
 CONSOLIDATED STATEMENTS OF INCOME
 (Dollars in Thousands)

| | For the Year Ended | | |
|---|----------------------|----------------------|----------------------|
| | December 31, 2014 | December 31, 2013 | December 31, 2012 |
| INCOME | | | |
| Dividend income from the bank | \$ 1,678 | \$ 2,400 | \$ 3,500 |
| Other income | 7 | 7 | 10 |
| Total interest and dividend income | <u>1,685</u> | <u>2,407</u> | <u>3,510</u> |
| EXPENSES | <u>902</u> | <u>608</u> | <u>517</u> |
| INCOME BEFORE PROVISION FOR INCOME TAXES | 783 | 1,799 | 2,993 |
| INCOME TAX BENEFIT | <u>215</u> | <u>124</u> | <u>101</u> |
| INCOME BEFORE EQUITY IN UNDISTRIBUTED INCOME OF THE BANK | 998 | 1,923 | 3,094 |
| EQUITY IN UNDISTRIBUTED INCOME OF THE BANK | <u>3,929</u> | <u>1,808</u> | <u>1,691</u> |
| NET INCOME | \$ 4,927 | \$ 3,731 | \$ 4,785 |

PACIFIC FINANCIAL CORPORATION-PARENT COMPANY ONLY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in Thousands)

| | For the Year Ended | | |
|---|----------------------|----------------------|----------------------|
| | December 31, 2014 | December 31, 2013 | December 31, 2012 |
| NET INCOME | \$ 4,927 | \$ 3,731 | \$ 4,785 |
| OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX: | | | |
| Change in fair value of securities available-for-sale | 1,269 | (1,875) | 536 |
| Defined benefit plan | (35) | 85 | 130 |
| Total other comprehensive income (loss), net of tax | <u>1,234</u> | <u>(1,790)</u> | <u>666</u> |
| COMPREHENSIVE INCOME | <u>\$ 6,161</u> | <u>\$ 1,941</u> | <u>\$ 5,451</u> |

PACIFIC FINANCIAL CORPORATION AND SUBSIDIARY-PARENT COMPANY ONLY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)

| | For the Year Ended | | |
|---|----------------------|----------------------|----------------------|
| | December 31, 2014 | December 31, 2013 | December 31, 2012 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Net Income | \$ 4,927 | \$ 3,731 | \$ 4,785 |
| Adjustments to reconcile net income to net cash from operating activities | | | |
| Equity in undistributed income of subsidiary | (3,929) | (1,808) | (1,691) |
| Net change in other assets | (223) | (29) | 35 |
| Net change in other liabilities | - | (96) | (1,312) |
| Other -- net | - | 117 | 24 |
| Net cash provided by operating activities | <u>775</u> | <u>1,915</u> | <u>1,841</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES | | | |
| Common stock issued | - | 394 | - |
| Warrants exercised | 1,366 | - | - |
| Repurchase of stock (RSU) | (3) | - | - |
| Dividends paid | (2,036) | - | (2,024) |
| Net cash provided by (used in) financing activities | <u>(673)</u> | <u>394</u> | <u>(2,024)</u> |
| NET (DECREASE) INCREASE IN CASH | 102 | 2,309 | (183) |
| CASH - BEGINNING OF THE PERIOD | <u>2,483</u> | <u>173</u> | <u>356</u> |
| CASH - END OF THE PERIOD | <u>\$ 2,585</u> | <u>\$ 2,483</u> | <u>\$ 173</u> |

QUARTERLY DATA (UNAUDITED)
(Dollars in Thousands, Except per Share Data)

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|--|-----------------|-----------------|-----------------|-----------------|
| Year Ended December 31, 2014 | | | | |
| Interest income | \$ 7,085 | \$ 7,337 | \$ 7,400 | \$ 7,336 |
| Interest expense | 530 | 541 | 518 | 536 |
| Net interest income | 6,555 | 6,796 | 6,882 | 6,800 |
| Provision for credit losses | - | 100 | 100 | 100 |
| Non-interest income | 1,608 | 2,176 | 2,274 | 2,021 |
| Non-interest expense | 6,830 | 7,066 | 7,133 | 7,127 |
| Income before income taxes | 1,333 | 1,806 | 1,923 | 1,594 |
| Income taxes | 305 | 403 | 549 | 473 |
| Net income | \$ 1,028 | \$ 1,403 | \$ 1,374 | \$ 1,121 |
| Earnings per common share | | | | |
| Basic | \$ 0.10 | \$ 0.14 | \$ 0.13 | \$ 0.11 |
| Diluted | \$ 0.10 | \$ 0.14 | \$ 0.13 | \$ 0.11 |
| Year Ended December 31, 2013 | | | | |
| 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 |
| Recapture of credit losses | - | (450) | - | - |
| Non-interest income | 2,626 | 3,175 | 2,232 | 1,922 |
| Non-interest expense | 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 | \$ 701 | \$ 1,332 | \$ 909 | \$ 789 |
| Earnings per common share | | | | |
| Basic | \$ 0.07 | \$ 0.13 | \$ 0.09 | \$ 0.08 |
| Diluted | \$ 0.07 | \$ 0.13 | \$ 0.09 | \$ 0.08 |
| 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 expense | 6,599 | 6,910 | 7,070 | 7,838 |
| Income before income taxes | 1,199 | 1,329 | 1,295 | 2,262 |
| Income taxes | 181 | 256 | 280 | 583 |
| Net income | \$ 1,018 | \$ 1,073 | \$ 1,015 | \$ 1,679 |
| Earnings per common share | | | | |
| Basic | \$ 0.10 | \$ 0.11 | \$ 0.10 | \$ 0.16 |
| Diluted | \$ 0.10 | \$ 0.11 | \$ 0.10 | \$ 0.16 |

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 26th day of March, 2015.

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 26th day of March, 2015.

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, Chief Financial Officer

Remaining Directors

/s/ Gary C. Forcum

Gary C. Forcum (Chairman of the Board)

/s/ John Van Dijk

John Van Dijk

/s/ Randy W. Rognlin

Randy W. Rognlin

/s/ Edwin Ketel

Edwin Ketel

/s/ Randy Rust

Randy Rust

/s/ Dwayne Carter

Dwayne Carter

/s/ Douglas M. Schermer

Douglas M. Schermer

/s/ Susan C. Freese

Susan C. Freese

/s/ Denise Portmann

Denise Portmann, Secretary

/s/ Dan J. Tupper

Dan J. Tupper

/s/ Kristi Gundersen

Kristi Gundersen

| <u>EXHIBIT NO.</u> | <u>EXHIBIT</u> |
|--------------------|--|
| 3.1 | Restated Articles of Incorporation. Incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K dated April 23, 2014 (the "April 2014 8-K"). |
| 3.2 | Amended and Restated Bylaws. Incorporated by reference to Exhibit 3.3 to the April 2014 8-K. |
| 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 | 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).* |
| 10.9 | 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.* |
| 10.10 | 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.* |
| 10.11 | 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.* |
| 10.12 | 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.* |
| 10.13 | 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.* |
| 10.14 | 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 |
| 10.15 | Forms of nonqualified option, incentive option and restricted unit award statements for use under the 2011 Plan. Incorporated by reference to Exhibit 10.17 of the Company's Annual Report on Form 10-K for the year ended December 31, 2013.* |
| 21 | Subsidiaries of the Registrant |
| 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.

SCHEDULE OF SUBSIDIARIES

The following is a list of registrant's subsidiaries at March 26, 2015.

| <u>Name of Organization</u> | <u>State of Incorporation or Organization</u> |
|-----------------------------|---|
| 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 |

**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 designed 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 26, 2015 /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;
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 26, 2015

/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 26, 2015

/s/ Douglas N. Biddle

Douglas N. Biddle,
Executive Vice President and
Chief Financial Officer
March 26, 2015

GENERAL CORPORATE AND SHAREHOLDER INFORMATION

Administrative Headquarters

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

Independent Accountants

BDO USA, LLP
Spokane, Washington

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 account directly through Investor Center at www.computershare.com/investor.

Annual Meeting

The annual meeting of shareholders will be held on April 29, 2015 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

Kristi Gundersen
Partner & CFO
Knutzen Farms, LP

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
Chief Financial Officer
Executive Vice President & CFO, Bank of the Pacific

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

Dan Tupper
Vice President & General Manager
Crown Distributing Co. of Aberdeen, Inc.

SUBSIDIARIES

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

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

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Pacific Financial Corporation

1101 S. Boone Street
Aberdeen, WA 98520

360.533.8873

BankofthePacific.com

Member
FDIC



Cover photo of
Mt. Hood in Oregon