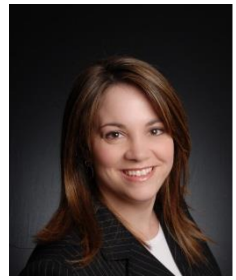
# Pacific Financial Corporation

# Annual Report 2015

OTCQB: PFLC



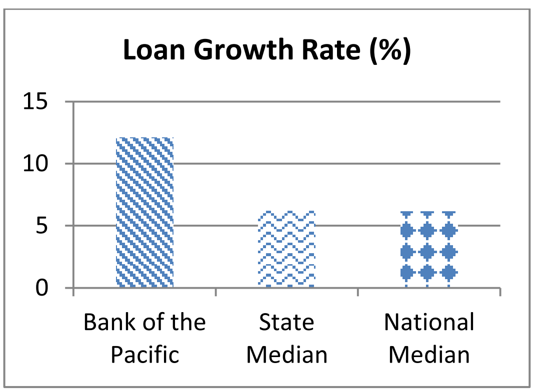
March 23, 2016

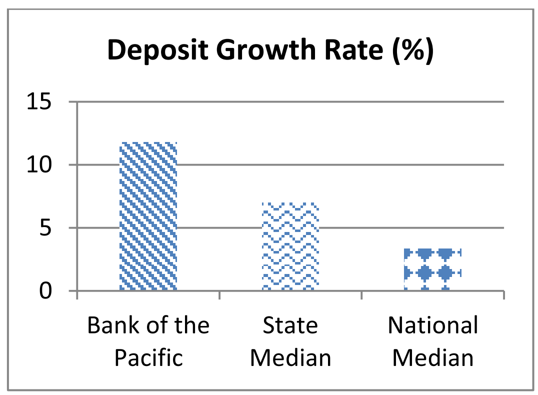
Denise Portmann
President & CEO

Dear Fellow Shareholders:

We are very proud of the exceptional financial performance Pacific Financial has delivered to its shareholders in 2015. We grew earnings by 13% to $5.6 million for the year, or $0.54 per share, and achieved our sixth consecutive year of profitability. In addition, for the second consecutive year we raised our annual cash dividend by 5% to $0.22 per share for 2015, equating to a yield of approximately 3.3% at current market levels.

Our company is emerging as an outstanding franchise, as we continue to make progress in executing on our growth strategies, strengthening our balance sheet, and prudently managing our operations. The loan portfolio increased 11% during the year, while total deposits increased 12%, substantially outpacing the median state and national averages, as displayed below.




Source: SNL Financial, LC

Core deposits remained strong at 93% of total deposits. Our capital ratios continue to exceed regulatory requirements with total risk-based capital at 12.78%. Credit quality metrics continue to improve, now at levels we have not seen since 2007. Nonperforming loans were 0.62% of total assets at year end, less than half the level of a year ago. Our net interest margin also remains above average at 4.10% for the full year.

We expect to sustain our loan and deposit growth momentum into 2016, as we continue to focus on our customer’s financial needs to deliver real value and real solutions. With our strong capital and liquidity, we are well positioned to build upon our performance in 2016. The accompanying Selected Financial Data demonstrates our improvement in financial performance in 2015. Some of those highlights are displayed as follows:

- Earnings grew to $5.6 million, or $0.54 per share, an increase of 13%;

- Non-interest bearing deposits increased 12%;
- Gross loans grew 11%;
- Net interest income increased 8% to $29.1 million;
- Net overhead ratio improved to 2.67% from 2.77%;
- Tangible book value per share grew to $6.03 at December 31, 2015, an increase of 6%.

In addition, we accomplished the following initiatives to improve operating performance and efficiency:

- Completed SEC deregistration of common stock, reducing expenses by approximately $200,000;
- Renegotiated our core processing contract to achieve 10% savings;
- Closed two underperforming branches in WA, while enhancing electronic banking channels in the first quarter of 2016.

Additionally, in early 2015 we expanded our presence in the high-growth market of Salem, OR by adding a seasoned commercial lending team. These high-quality banking professionals have focused on commercial lending, generated solid core deposits and built deep relationships with the business owners in that community. This initiative has proven to be a perfect fit for our strategic direction. As we go forward, we expect our 2016 plans to further enhance our franchise and will include:

- Creating a small business banking specialty unit to nurture deposit and loan relationships in this segment, while adding technology-assisted underwriting to improve delivery of credit products.
- Expanding our treasury management team with enhanced treasury management products set to capture additional deposits and fee income from the commercial banking segment.
- Creating a Small Business Administration (SBA) lending unit to generate and sell government-guaranteed loans to boost non-interest income.
- Pursuing in-market or adjacent market branch acquisitions to improve market share and enhance branch operational economies of scale.

Community banks such as ours are critical to our communities, and we are deeply embedded in our communities making a positive impact. We have intimate knowledge of our local economies and local small businesses which allow us to effectively serve our clients providing them with many products and services tailored to meet their needs.

We have an outstanding board of directors with an exceptional management team and a strong culture of loyal employees. We thank you for your continued support and confidence. As always, we will continue to search for ways to improve efficiencies while maintaining strong open communications with our shareholders. Please join us for our annual shareholders' meeting on Wednesday, April 27, 2016, at 4:00 p.m. at 1101 S. Boone Street, Aberdeen, WA 98520.

Sincerely,

Gary. C. Forcum
Chairman of the Board
Pacific Financial Corporation

Denise Portmann
President and Chief Executive Officer
Pacific Financial Corporation

**Pacific Financial Corporation**
**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.

| | For the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2015 | 2014 | 2013 | 2012 | 2011 |
| **Operations Data** | | | (in thousands) | | |
| Net interest income | $ 29,139 | $ 27,033 | $ 23,800 | $ 24,011 | $ 23,685 |
| Loan loss provision (recapture) | 582 | 300 | (450) | (1,100) | 2,500 |
| Noninterest income | 9,799 | 8,079 | 9,955 | 9,391 | 7,614 |
| Noninterest expense | 30,859 | 28,155 | 29,502 | 28,417 | 25,648 |
| Provision for income taxes | 1,921 | 1,730 | 972 | 1,300 | 333 |
| **Net income** | $ 5,576 | $ 4,927 | $ 3,731 | $ 4,785 | $ 2,818 |

| | For the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2015 | 2014 | 2013 | 2012 | 2011 |
| Net income per share: | (dollars in thousands, except per share data) | | | | |
| Basic | $ 0.54 | $ 0.48 | $ 0.37 | $ 0.47 | $ 0.28 |
| Diluted | 0.53 | 0.48 | 0.37 | 0.47 | 0.28 |
| | | | | | |
| Dividends declared | $ 2,287 | $ 2,178 | $ 2,036 | $ 2,024 | $ - |
| Dividends declared per share | $ 0.22 | $ 0.21 | $ 0.20 | $ 0.20 | $ - |
| Dividends payout ratio | 41% | 44% | 55% | 42% | - |
| | | | | | |
| **Performance Ratios** | | | | | |
| Interest rate spread | 3.99% | 4.06% | 3.87% | 4.20% | 4.03% |
| Net interest margin (1) | 4.10% | 4.17% | 4.00% | 4.34% | 4.22% |
| Efficiency ratio (2) | 79.25% | 80.19% | 87.40% | 85.08% | 81.95% |
| Return on average assets | 0.71% | 0.68% | 0.55% | 0.75% | 0.44% |
| Return on average equity | 7.35% | 6.92% | 5.48% | 7.28% | 4.55% |
| | | | | | |
| **Balance Sheet Data** | | | | | |
| Total assets | $ 824,613 | $ 744,807 | $ 705,039 | $ 643,594 | $ 641,254 |
| Loans, net | 617,019 | 554,746 | 496,307 | 438,838 | 463,766 |
| Total deposits | 714,499 | 639,054 | 607,347 | 548,243 | 548,050 |
| Total borrowings | 24,706 | 24,856 | 23,403 | 23,903 | 24,644 |
| Shareholders' equity | 76,285 | 72,483 | 67,137 | 66,721 | 63,270 |
| Book value per share (3) | $ 7.34 | $ 6.99 | $ 6.59 | $ 6.59 | $ 6.25 |
| Tangible book value per share (4) | $ 6.03 | $ 5.68 | $ 5.25 | $ 5.35 | $ 5.01 |
| Equity to assets ratio | 9.25% | 9.73% | 9.52% | 10.37% | 9.87% |
| | | | | | |
| **Asset Quality Ratios** | | | | | |
| Nonperforming loans to total loans | 0.24% | 1.62% | 1.98% | 3.37% | 2.96% |
| Allowance for loan losses to total loans | 1.33% | 1.48% | 1.66% | 2.09% | 2.34% |
| Allowance for loan losses to nonperforming loans | 547.89% | 91.54% | 115.41% | 61.92% | 79.28% |
| Nonperforming assets to total assets | 0.62% | 1.36% | 1.42% | 3.08% | 3.39% |

(1) Net interest income divided by average earning assets
(2) Noninterest expense divided by the sum of net interest income and noninterest income
(3) Shareholder equity divided by shares outstanding
(4) Shareholder equity less intangibles divided by shares outstanding

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# Independent Auditor's Report

Board of Directors and Shareholders
Pacific Financial Corporation
Aberdeen, Washington

We have audited the accompanying consolidated financial statements of Pacific Financial Corporation, which comprise the consolidated balance sheets as of December 31, 2015 and 2014, and the related consolidated statements of income and comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Opinion*

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pacific Financial Corporation as of December 31, 2015 and 2014, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

BDO USA, LLP

Spokane, Washington
March 23, 2016

**Pacific Financial Corporation**
**Consolidated Statements of Financial Condition**
(Dollars in thousands, except per share data)

**ASSETS**

| | December 31, 2015 | December 31, 2014 |
|---|---|---|
| Cash on hand and in banks | $ 17,680 | $ 14,782 |
| Interest bearing deposits | 9,846 | 16,255 |
| Cash and cash equivalents | 27,526 | 31,037 |
| Other interest earning deposits | 2,727 | 2,727 |
| Investment securities available for sale, at fair value | 100,024 | 87,440 |
| Investment securities held to maturity (fair value of $1,713 and $1,852, respectively) | 1,697 | 1,829 |
| Loans held for sale | 12,333 | 5,786 |
| Loans, net of deferred loan fees | 625,336 | 563,099 |
| Allowance for loan losses | (8,317) | (8,353) |
| Total Loans, net | 617,019 | 554,746 |
| Federal Home Loan Bank stock, at cost | 1,346 | 2,896 |
| Pacific Coast Bankers' Bank stock, at cost | 1,000 | 1,000 |
| Premises and equipment, net of accumulated depreciation and amortization | 15,749 | 16,303 |
| Other real estate owned and foreclosed assets | 3,610 | 999 |
| Accrued interest receivable | 2,674 | 2,348 |
| Cash surrender value of life insurance | 19,231 | 18,742 |
| Goodwill | 12,168 | 12,168 |
| Other intangible assets | 1,404 | 1,439 |
| Other assets | 6,105 | 5,347 |
| **TOTAL ASSETS** | $ 824,613 | $ 744,807 |

**LIABILITIES AND SHAREHOLDERS' EQUITY**

| | December 31, 2015 | December 31, 2014 |
|---|---|---|
| **LIABILITIES** | | |
| Deposits | | |
| Demand | $ 185,001 | $ 165,760 |
| Interest bearing demand and savings | 389,723 | 354,611 |
| Time deposits | 139,775 | 118,683 |
| Total deposits | 714,499 | 639,054 |
| Federal Home Loan Bank Advances | 11,303 | 11,453 |
| Junior subordinated debentures | 13,403 | 13,403 |
| Accrued interest payable and other liabilities | 9,123 | 8,414 |
| Total liabilities | 748,328 | 672,324 |
| **SHAREHOLDERS' EQUITY** | | |
| Preferred Stock, no par value; 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2015 and December 31, 2014 | - | - |
| Common Stock, $1 par value; 25,000,000 shares authorized, 10,394,828 and 10,371,460 shares issued and outstanding at December 31, 2015 and 2014, respectively | 10,395 | 10,371 |
| Additional paid-in-capital | 43,245 | 42,991 |
| Retained earnings | 22,545 | 19,256 |
| Accumulated other comprehensive income (loss), net | 100 | (135) |
| Total shareholders' equity | 76,285 | 72,483 |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | $ 824,613 | $ 744,807 |

**See accompanying Notes to Consolidated Financial Statements.**

# Pacific Financial Corporation
## Consolidated Statements of Income
(Dollars in thousands, except per share data)

| | Twelve Months Ended December 31, 2015 | Twelve Months Ended December 31, 2014 |
|---|---|---|
| **INTEREST AND DIVIDEND INCOME** | | |
| Loans, including fees | $ 29,294 | $ 26,937 |
| Deposits in banks and federal funds sold | 92 | 89 |
| Taxable interest on investment securities | 1,094 | 1,269 |
| Tax-exempt interest on investment securities | 792 | 830 |
| FHLB & PCBB dividends | 68 | 33 |
| Total interest and dividend income | 31,340 | 29,158 |
| **INTEREST EXPENSE** | | |
| Deposits | 1,715 | 1,668 |
| Federal Funds Purchased | 2 | 1 |
| Federal Home Loan Bank Advances | 236 | 215 |
| Junior subordinated debentures | 248 | 241 |
| Total interest expense | 2,201 | 2,125 |
| Net interest income | 29,139 | 27,033 |
| **LOAN LOSS PROVISION** | 582 | 300 |
| Net interest income after loan loss provision | 28,557 | 26,733 |
| **NONINTEREST INCOME** | | |
| Service charges on deposits | 1,764 | 1,809 |
| Net gain (loss) on sale of other real estate owned | 128 | (207) |
| Gains on sales of loans, net | 4,961 | 3,686 |
| Gain on sales of securities available for sale, net | 53 | 88 |
| Other-than-temporary impairment, net | - | (48) |
| Earnings on bank owned life insurance | 490 | 505 |
| Other noninterest income | 2,403 | 2,246 |
| Total noninterest income | 9,799 | 8,079 |
| **NONINTEREST EXPENSE** | | |
| Salaries and employee benefits | 19,070 | 17,118 |
| Occupancy | 1,965 | 2,006 |
| Equipment | 1,061 | 1,050 |
| Data processing | 1,872 | 2,009 |
| Professional services | 599 | 745 |
| Other real estate owned write-downs | 104 | 67 |
| Other real estate owned operating costs | 184 | 238 |
| State and local taxes | 465 | 417 |
| FDIC and state assessments | 535 | 491 |
| Other noninterest expense | 5,004 | 4,014 |
| Total noninterest expense | 30,859 | 28,155 |
| **INCOME BEFORE INCOME TAXES** | 7,497 | 6,657 |
| **INCOME TAX EXPENSE** | 1,921 | 1,730 |
| **NET INCOME APPLICABLE TO COMMON SHAREHOLDERS** | $ 5,576 | $ 4,927 |
| **EARNINGS PER COMMON SHARE:** | | |
| **BASIC** | $ 0.54 | $ 0.48 |
| **DILUTED** | $ 0.53 | $ 0.48 |
| **WEIGHTED AVERAGE SHARES OUTSTANDING:** | | |
| **BASIC** | 10,382,499 | 10,256,242 |
| **DILUTED** | 10,524,303 | 10,347,338 |

**See accompanying Notes to Consolidated Financial Statements.**

# Pacific Financial Corporation
## Consolidated Statements of Comprehensive Income
(Dollars in thousands)

| | Twelve Months Ended December 31, | |
|---|---|---|
| | **2015** | **2014** |
| **NET INCOME** | $ 5,576 | $ 4,927 |
| Change in fair value of securities available for sale | 4 | 1,269 |
| Defined benefit pension plan | 231 | (35) |
| Other comprehensive income, net of tax | 235 | 1,234 |
| **COMPREHENSIVE INCOME** | $ 5,811 | $ 6,161 |

**See accompanying Notes to Consolidated Financial Statements.**

**Pacific Financial Corporation**
**Consolidated Statements of Shareholders' Equity**
(Dollars in thousands, except share amounts)

| | Number of Common Shares | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
|---|---|---|---|---|---|---|
| **Balance at December 31, 2013** | 10,182,083 | $ 10,182 | $ 41,817 | $ 16,507 | $ (1,369) | $ 67,137 |
| Net income | - | - | - | 4,927 | - | 4,927 |
| Other comprehensive income, net of tax | | | | | | |
| Unrealized holding loss 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 |
| Cash dividends declared ($0.21 per share) | - | - | - | (2,178) | - | (2,178) |
| Stock-based compensation expense | - | - | 139 | - | - | 139 |
| **Balance at December 31, 2014** | 10,371,460 | $ 10,371 | $ 42,991 | $ 19,256 | $ (135) | $ 72,483 |
| Net income | - | - | - | 5,576 | - | 5,576 |
| Other comprehensive income, net of tax | | | | | | |
| Unrealized holding gain on securities less reclassification adjustments for net gains included in net income | - | - | - | - | 4 | 4 |
| Amortization of unrecognized prior service costs and net gains | - | - | - | - | 231 | 231 |
| Issuance of common stock | 23,368 | 24 | 41 | - | - | 65 |
| Cash dividends declared ($0.22 per share) | - | - | - | (2,287) | - | (2,287) |
| Stock-based compensation expense | - | - | 213 | - | - | 213 |
| **Balance at December 31, 2015** | 10,394,828 | $ 10,395 | $ 43,245 | $ 22,545 | $ 100 | $ 76,285 |

**See accompanying Notes to Consolidated Financial Statements.**

# Pacific Financial Corporation
## Consolidated Statements of Cash Flow
(Dollars in thousands)

| | Twelve Months Ended December 31, 2015 | Twelve Months Ended December 31, 2014 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net Income | $ 5,576 | $ 4,927 |
| Adjustments to reconcile net income to net cash from operating activities | | |
| Provision for loan losses | 582 | 300 |
| Depreciation and amortization | 2,861 | 2,538 |
| Deferred income taxes | 29 | 727 |
| Originations of loans held for sale | (206,986) | (150,899) |
| Proceeds from sales of loans held for sale | 205,400 | 155,846 |
| Gain on sales of loans, net | (4,961) | (3,546) |
| Gain on sales of securities available for sale, net | (53) | (88) |
| Other-than-temporary impairment recognized in earnings | - | 48 |
| (Gain) loss on sales of other real estate owned | (128) | 207 |
| Gain on sale of premises and equipment | (30) | (2) |
| Earnings on bank owned life insurance | (490) | (505) |
| Increase in accrued interest receivable | (326) | (41) |
| Increase (decrease) in accrued interest payable | 7 | (22) |
| Other real estate owned write-downs | 104 | 67 |
| (Increase) decrease in prepaid expenses | (376) | 12 |
| Other operating activities | 644 | 1,791 |
| Net cash provided by operating activities | 1,853 | 11,360 |
| **Cash flows from investing activities** | | |
| Loans originated, net of principal payments | (66,952) | (60,809) |
| Net decrease in interest bearing balances with banks | 6,409 | 7,479 |
| Maturities of investment securities held to maturity | 131 | 303 |
| Maturities of investment securities available for sale | 10,262 | 8,623 |
| Purchase of investment securities available for sale | (29,240) | (17,711) |
| Purchases of premises and equipment | (844) | (848) |
| Proceeds from sales of investment securities available for sale | 6,808 | 17,755 |
| Proceeds from sales of government loan pools | - | 2,541 |
| Proceeds from sales of other real estate owned | 1,289 | 1,527 |
| Net cash used in investing activities | (72,137) | (41,140) |
| **Cash flows from financing activities** | | |
| Net increase in deposits | 75,445 | 31,707 |
| Proceeds from FHLB Advances | - | 1,500 |
| Repayments of FHLB Advances | (150) | (47) |
| Issuance of common stock | 65 | 1,224 |
| Cash dividends paid | (2,178) | (2,036) |
| Net cash provided by financing activities | 73,182 | 32,348 |
| Net increase in cash and cash equivalents | 2,898 | 2,568 |
| **Cash and cash equivalents at beginning of year** | 14,782 | 12,214 |
| **Cash and cash equivalents at end of year** | $ 17,680 | $ 14,782 |
| **Supplemental disclosures of cash flow information:** | | |
| Cash paid for interest | $ 2,194 | $ 2,147 |
| Cash paid for taxes | $ 2,306 | $ 643 |
| **Supplemental non-cash disclosures of cash flow information:** | | |
| Transfer of loans held for sale to loans held for investment | $ - | $ 578 |
| Other real estate owned acquired in settlement of loans | $ (3,876) | $ (842) |
| Financed sale of other real estate owned | $ 448 | $ 813 |
| check | 17,680 | 14,782 |

**See accompanying Notes to Consolidated Financial Statements.**

## 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 Aberdeen, 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 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 three loan production offices in Burlington and DuPont, Washington and Salem Oregon and has a residential real estate mortgage department.

**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.

Certain prior year amounts have been reclassified to conform with the 2015 presentation. None of these reclassifications have an effect on net income or net cash flows.

**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.

**Subsequent events** –The Company performed an evaluation of subsequent events through March 23, 2016, the date these financial statements were available to be issued. There were no significant subsequent events identified.

**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 noninterest 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.

At December 31, 2015 the stock was that of FHLB of Des Moines and at December 31, 2014 the stock was that of FHLB of Seattle. The FHLB of Seattle merger with and into the FHLB of Des Moines was effective in the second quarter of 2015.

**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 payoff 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. TDRs 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, 2015 the Company had $13.6 million 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, 2015 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 noninterest expenses using an accelerated method over ten years. Net unamortized core deposit intangible totaled $134,000 and $171,000 at December 31, 2015 and 2014, respectively. Amortization expense related to core deposit intangible totaled $34,000 and $43,000 during the years ended December 31, 2015 and 2014, respectively.

In 2006, the Bank completed a deposit transfer and assumption transaction with an Oregon-based bank for a $1.3 million 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 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, 2015, 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, 2015. The tax years that remain subject to examination by federal and state taxing authorities are the years ended December 31, 2014, 2013 and 2012.

**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 260,350 and 361,545 in 2015 and 2014, respectively. There were no outstanding warrants for the years ended 2015 and 2014.

**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, 2015 and 2014.

**Recent accounting pronouncements** – In January 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (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's adoption of this standard did not 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, 2017, including interim periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. 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's adoption of this standard did not have a material effect on its financial statements.

In January 2016, FASB issued ASU 2016-01, "'*Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*". The amendments in ASU 2016-01:

- Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income.

-Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.

-Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables).

-Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost.

ASU 2016-01 is effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact that this Update will have on its consolidated financial position, results of operations or cash flows.

**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 required reserve balance at December 31, 2015 and 2014 was met by holding cash.

**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 were as follows:

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | | (in thousands) | | |
| **Available for Sale** | | | | |
| Collateralized mortgage obligations: agency issued | $ 39,445 | $ 129 | $ 529 | $ 39,045 |
| Collateralized mortgage obligations: non-agency | 434 | - | 12 | 422 |
| Mortgage backed securities: agency issued | 12,256 | 50 | 128 | 12,178 |
| U.S. Government and agency securities | 8,588 | 81 | 23 | 8,646 |
| State and municipal securities | 38,765 | 999 | 31 | 39,733 |
| Total available for sale | $ 99,488 | $ 1,259 | $ 723 | $ 100,024 |
| **Held to maturity** | | | | |
| Mortgage backed securities: agency issued | $ 65 | $ 5 | $ - | $ 70 |
| State and municipal securities | 1,632 | 11 | - | 1,643 |
| Total held to maturity | $ 1,697 | $ 16 | $ - | $ 1,713 |

| | December 31, 2014 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | | (in thousands) | | |
| **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 agency securities | 7,977 | 111 | 32 | 8,056 |
| State and municipal securities | 27,121 | 850 | 80 | 27,891 |
| Total available for sale | $ 86,907 | $ 1,236 | $ 703 | $ 87,440 |
| **Held to maturity** | | | | |
| Mortgage backed securities: agency issued | $ 123 | $ 12 | $ - | $ 135 |
| State and municipal securities | 1,706 | 11 | - | 1,717 |
| Total held to maturity | $ 1,829 | $ 23 | $ - | $ 1,852 |

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, 2015 and December 31, 2014, were as follows:

| | December 31, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Less Than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | | | (in thousands) | | | |
| **Available for sale** | | | | | | |
| Collateralized mortgage obligations: agency issued | $ 25,029 | $ 325 | $ 7,987 | $ 204 | $ 33,016 | $ 529 |
| Collateralized mortgage obligations: non agency | - | - | 422 | 12 | 422 | 12 |
| Mortgage backed securities: agency issued | 6,240 | 64 | 3,273 | 64 | 9,513 | 128 |
| U.S. Government agency securities | 5,595 | 23 | - | - | 5,595 | 23 |
| State and municipal securities | 5,133 | 31 | - | - | 5,133 | 31 |
| Total | $ 41,997 | $ 443 | $ 11,682 | $ 280 | $ 53,679 | $ 723 |

| | December 31, 2014 | | | | | |
|---|---|---|---|---|---|---|
| | Less Than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | | | (in thousands) | | | |
| **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 | $ 14,177 | $ 150 | $ 31,195 | $ 553 | $ 45,372 | $ 703 |

At December 31, 2015, there were 68 investment securities in an unrealized loss position. 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, 2015.

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 years ended December 31, 2015 and 2014, no CMO was determined to be other-than-temporarily-impaired. The Company recorded $0 and $48,000 in impairments related to credit losses through earnings for the years ended December 31, 2015 and 2014, respectively.

The following table presents the cash proceeds from the sales of securities and their associated gross realized gains and gross realized losses that were included in earnings for the twelve months ended December 31, 2015 and 2014:

| | Twelve Months Ended December 31, 2015 | Twelve Months Ended December 31, 2014 |
|---|---|---|
| | (in thousands) | |
| Gross realized gain on sale of securities | $ 108 | $ 315 |
| Gross realized loss on sale of securities | (55) | (227) |
| Net realized gain on sale of securities | $ 53 | $ 88 |
| Proceeds from sale of securities | $ 6,845 | $ 17,755 |

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 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.

The amortized cost and estimated fair value of investment securities at December 31, 2015, by maturity were as follows:

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Held to Maturity | | Available for Sale | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| | (in thousands) | | | |
| Due in one year or less | $ - | $ - | $ 2,594 | $ 2,602 |
| Due after one year through five years | 175 | 178 | 14,885 | 14,982 |
| Due after five years through ten years | 1,168 | 1,176 | 23,929 | 24,633 |
| Due after ten years | 289 | 289 | 5,945 | 6,162 |
| Declining Balance Securities | 65 | 70 | 52,135 | 51,645 |
| Total investment securities | $ 1,697 | $ 1,713 | $ 99,488 | $ 100,024 |

At December 31, 2015 and 2014, investment securities with an estimated fair value of $84.4 million and $84.1 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. Participating banks record the value of FHLB stock equal to its par value at $100 per share. At December 31, 2015 and 2014, the Company held approximately $1.3 million and $2.9 million, respectively, in FHLB stock. The $1.6 million decrease was due to the repurchase of stock by the FHLB of Seattle as a result of the FHLB of Seattle merger with FHLB of Des Moines which was effective during the second quarter of 2015. Based on the FHLB of Des Moines structure, the amount of stock to be held by participating banks is substantially less than that of the former FHLB of Seattle.

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, 2015 and maintains capital ratios that exceed "well capitalized" standards for regulatory purposes.

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

Loans held in the portfolio at December 31, 2015 and December 31, 2014, were as follows:

| | December 31, 2015 | December 31, 2014 |
|---|---|---|
| | (in thousands) | |
| Commercial and agricultural | $ 131,734 | $ 120,517 |
| Real estate: | | |
| Construction and development | 33,170 | 26,711 |
| Residential 1-4 family | 94,217 | 92,965 |
| Multi-family | 26,828 | 18,541 |
| Commercial real estate -- owner occupied | 134,366 | 125,632 |
| Commercial real estate -- non owner occupied | 134,612 | 117,137 |
| Farmland | 20,492 | 22,245 |
| Consumer | 51,352 | 40,565 |
| Gross loans | 626,771 | 564,313 |
| Less: deferred fees | (1,435) | (1,214) |
| Portfolio Loans | $ 625,336 | $ 563,099 |

### 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 that time or a specific reserve is established. Impaired loans are reviewed no less frequently than quarterly.

fair value of collateral securing the loan in comparison to the associated loan balance, the deficiency is charged-off at

- 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 31, 2015 and December 31, 2014 were as follows:

| | Twelve Months Ended December 31, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Commercial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
| | | | (in thousands) | | | |
| Beginning balance | $ 1,022 | $ 3,419 | $ 701 | $ 979 | $ 2,232 | $ 8,353 |
| Charge-offs and concessions | - | (806) | (86) | (143) | - | (1,035) |
| Recoveries | 49 | 263 | 86 | 19 | - | 417 |
| Provision (recapture) | 24 | 645 | 202 | (54) | (235) | 582 |
| Ending balance | $ 1,095 | $ 3,521 | $ 903 | $ 801 | $ 1,997 | $ 8,317 |

| | Twelve Months Ended December 31, 2014 | | | | | |
|---|---|---|---|---|---|---|
| | Commercial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
| | | | (in thousands) | | | |
| 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 | $ 1,022 | $ 3,419 | $ 701 | $ 979 | $ 2,232 | $ 8,353 |

The recorded investment in loans as of December 31, 2015 and December 31, 2014 were as follows:

| December 31, 2015 | Commercial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| | | | (in thousands) | | | |
| **Allowance for Loan Losses** | | | | | | |
| Ending balance: individually evaluated for impairment | $ - | $ - | $ - | $ - | $ - | $ - |
| Ending balance: collectively evaluated for impairment | 1,095 | 3,521 | 903 | 801 | 1,997 | 8,317 |
| Total allowance for loan losses | $ 1,095 | $ 3,521 | $ 903 | $ 801 | $ 1,997 | $ 8,317 |
| **Loans** | | | | | | |
| Ending balance: individually evaluated for impairment | $ 430 | $ 1,210 | $ 284 | $ 57 | $ N/A | $ 1,981 |
| Ending balance: collectively evaluated for impairment | 131,304 | 321,430 | 120,761 | 51,295 | N/A | 624,790 |
| Total | $ 131,734 | $ 322,640 | $ 121,045 | $ 51,352 | $ N/A | 626,771 |
| Less deferred fees | | | | | | (1,435) |
| Total loans | | | | | | $ 625,336 |

| December 31, 2014 | Commercial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| | | | (in thousands) | | | |
| **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 | $ 1,022 | $ 3,419 | $ 701 | $ 979 | $ 2,232 | $ 8,353 |
| **Loans** | | | | | | |
| Ending balance: individually evaluated for impairment | $ 380 | $ 9,864 | $ 1,067 | $ - | $ N/A | $ 11,311 |
| Ending balance: collectively evaluated for impairment | 120,137 | 281,861 | 110,439 | 40,565 | N/A | 553,002 |
| Total | $ 120,517 | $ 291,725 | $ 111,506 | $ 40,565 | $ N/A | 564,313 |
| Less deferred fees | | | | | | (1,214) |
| Total loans | | | | | | $ 563,099 |

## 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, 2015 and December 31, 2014 were as follows:

| | December 31, 2015 | | | | |
|---|---|---|---|---|---|
| | Pass | Other Loans Especially Mentioned | Substandard | Doubtful | Total |
| | | | (in thousands) | | |
| Commercial and agricultural | $ 123,098 | $ 5,690 | $ 2,946 | $ - | $ 131,734 |
| Real estate: | | | | | |
| Construction and development | 32,375 | - | 796 | - | 33,171 |
| Residential 1-4 family | 91,315 | 1,332 | 1,569 | - | 94,216 |
| Multi-family | 26,828 | - | - | - | 26,828 |
| Commercial real estate -- owner occupied | 126,894 | 5,552 | 1,920 | - | 134,366 |
| Commercial real estate -- non owner occupied | 123,236 | 2,707 | 8,669 | - | 134,612 |
| Farmland | 20,251 | 241 | - | - | 20,492 |
| Total real estate | 420,899 | 9,832 | 12,954 | - | 443,685 |
| Consumer | 51,161 | 19 | 172 | - | 51,352 |
| Less deferred fees | (1,435) | - | - | - | (1,435) |
| Total loans | $ 593,723 | $ 15,541 | $ 16,072 | $ - | $ 625,336 |

| | December 31, 2014 | | | | |
|---|---|---|---|---|---|
| | Pass | Other Loans Especially Mentioned | Substandard | Doubtful | Total |
| | | | (in thousands) | | |
| 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 | 364,795 | 22,167 | 16,020 | 249 | 403,231 |
| Consumer | 40,436 | 82 | 47 | - | 40,565 |
| Less deferred fees | - | - | - | - | (1,214) |
| Total loans | $ 517,031 | $ 28,603 | $ 18,430 | $ 249 | $ 563,099 |

## Impaired Loans

Impaired loans by type as of December 31, 2015 and 2014, and interest income recognized for the twelve months ended December 31, 2015 and 2014, were as follows:

| | December 31, 2015 | | | | |
|---|---|---|---|---|---|
| | **Unpaid Principal Balance** | **Recorded Investment** | **Related Allowance** | **Average Recorded Investment** | **Interest Income Recognized** |
| With no Related Allowance: | | | (in thousands) | | |
| Commercial | $ 430 | $ 430 | $ - | $ 375 | $ 10 |
| Consumer | 57 | 57 | - | 35 | 3 |
| Residential real estate | 700 | 425 | - | 750 | 94 |
| Commercial real estate: | | | | | |
| CRE -- owner occupied | 56 | 56 | - | 779 | 2 |
| CRE -- non owner occupied | 217 | 217 | - | 2,883 | 70 |
| Farmland | - | - | - | 41 | - |
| Construction and development | 1,109 | 796 | - | 843 | - |
| Total | $ 2,569 | $ 1,981 | $ - | $ 5,706 | $ 179 |
| With a Related Allowance: | | | | | |
| CRE -- non owner occupied | $ - | $ - | $ - | $ - | $ - |
| Total | $ - | $ - | $ - | $ - | $ - |
| Total Impaired Loans: | | | | | |
| Commercial | $ 430 | $ 430 | $ - | $ 375 | $ 10 |
| Consumer | 57 | 57 | - | 35 | 3 |
| Residential real estate | 700 | 425 | - | 750 | 94 |
| Commercial real estate: | | | | | |
| CRE -- owner occupied | 56 | 56 | - | 779 | 2 |
| CRE -- non owner occupied | 217 | 217 | - | 2,883 | 70 |
| Farmland | - | - | - | 41 | - |
| Construction and development | 1,109 | 796 | - | 843 | - |
| Total Impaired Loans | $ 2,569 | $ 1,981 | $ - | $ 5,706 | $ 179 |

| | December 31, 2014 | | | | |
|---|---|---|---|---|---|
| | Unpaid Principal Balance | Recorded Investment | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| With no Related Allowance: | | | (in thousands) | | |
| 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 | $ 13,823 | $ 11,062 | $ - | $ 9,642 | $ 404 |
| | | | | | |
| With a Related Allowance: | | | | | |
| CRE -- non owner occupied | 249 | 249 | 249 | 83 | - |
| Total | $ 249 | $ 249 | $ 249 | $ 83 | $ - |
| | | | | | |
| 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 | $ 14,072 | $ 11,311 | $ 249 | $ 9,725 | $ 404 |

**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 2015 and 2014. Total related party loans outstanding at December 31, 2015 and 2014 to executive officers and directors were $2.1 million and $2.4 million, respectively. During 2015 and 2014, new loans of $401,000 and $3.8 million, respectively, were made, and repayments totaled $679,000 and $1.4 million 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, 2015.

**Aging Analysis**

The following tables summarize the Company’s loans past due, both accruing and nonaccruing, by type as of December 31, 2015 and December 31, 2014:

| | December 31, 2015 | | | | | | |
|---|---|---|---|---|---|---|---|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Non-accrual Loans | Loans Not Past Due | Total Loans |
| | | | | (in thousands) | | | |
| Commercial and agricultural | $ 76 | $ - | $ - | $ 76 | $ 164 | $ 131,494 | $ 131,734 |
| Real estate: | | | | | | | |
| Construction and development | 14 | - | - | 14 | 796 | 32,360 | 33,170 |
| Residential 1-4 family | 100 | - | - | 100 | 284 | 93,833 | 94,217 |
| Multi-family | - | - | - | - | - | 26,828 | 26,828 |
| Commercial real estate -- owner occupied | - | 857 | - | 857 | - | 133,509 | 134,366 |
| Commercial real estate -- non owner occupied | - | 66 | - | 66 | 217 | 134,329 | 134,612 |
| Farmland | - | - | - | - | - | 20,492 | 20,492 |
| Total real estate | 114 | 923 | - | 1,037 | 1,297 | 441,351 | 443,685 |
| Consumer | 114 | - | - | 114 | 57 | 51,181 | 51,352 |
| Less deferred fees | - | - | - | - | - | (1,435) | (1,435) |
| Total | $ 304 | $ 923 | $ - | $ 1,227 | $ 1,518 | $ 622,591 | $ 625,336 |

| | December 31, 2014 | | | | | | |
|---|---|---|---|---|---|---|---|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Non-accrual Loans | Loans Not Past Due | Total Loans |
| | | | | (in thousands) | | | |
| 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 |

## Troubled Debt Restructured Loans

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, 2015, 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, 2015.

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, 2015 and 2014, all of which were modified due to financial stress of the borrower. There were not any subsequent defaulted TDRs as of December 31, 2015 and 2014. There were no loans modified or recorded as TDRs during the years ended December 31, 2015 and 2014.

The following tables summarize the Company's TDRs by type as of December 31, 2015 and December 31, 2014:

| | December 31, 2015 | | |
|---|---|---|---|
| | Number of Loans | Pre-TDR Outstanding Recorded Investment | Post-TDR Outstanding Recorded Investment |
| | | (dollars in thousands) | |
| Commercial and agriculture | 1 | $ 335 | $ 266 |
| Construction and development | 1 | 1,000 | 796 |
| Residential real estate | 1 | 192 | 141 |
| CRE -- owner occupied | 1 | 59 | 56 |
| Total TDRs (1) | 4 | $ 1,586 | $ 1,259 |

| | December 31, 2014 | | |
|---|---|---|---|
| | Number of Loans | Pre-TDR Outstanding Recorded Investment | Post-TDR Outstanding Recorded Investment |
| | | (dollars in thousands) | |
| 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 TDRs (1) | 7 | $ 5,610 | $ 3,560 |

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

The following tables present troubled debt restructurings by accrual or nonaccrual status as of December 31, 2015 and 2014:

| | December 31, 2015 | | |
|---|---|---|---|
| | Accrual Status | Non-Accrual Status | Total TDRs |
| | | (in thousands) | |
| Commercial and agriculture | $ 266 | $ - | $ 266 |
| Construction and development | - | 796 | 796 |
| Residential real estate | 141 | - | 141 |
| CRE -- owner occupied | 56 | - | 56 |
| Total TDRs | $ 463 | $ 796 | $ 1,259 |

| | December 31, 2014 | | |
|---|---|---|---|
| | Accrual Status | Non-Accrual Status | Total TDRs |
| | | (in thousands) | |
| 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 TDRs | $ 2,595 | $ 965 | $ 3,560 |

## 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, 2015 and December 31, 2014:

| | Net Unrealized Gain (Loss) on Investment Securities | Defined Benefit Plans | Total |
|---|---|---|---|
| | | (in thousands) | |
| Balance, January 1, 2015 | $ 350 | $ (485) | $ (135) |
| Other comprehensive gain before reclassifications | 39 | 231 | 270 |
| Amounts reclassified from AOCI | (35) | - | (35) |
| Net current period other comprehensive income | 4 | 231 | 235 |
| Balance, December 31, 2015 | $ 354 | $ (254) | $ 100 |

| | Net Unrealized Gain (Loss) on Investment Securities | Defined Benefit Plans | Total |
|---|---|---|---|
| | | (in thousands) | |
| 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 | $ 350 | $ (485) | $ (135) |

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the twelve months ended December 31, 2015 and December 31, 2014:

| | Twelve Months Ended December 31, 2015 | 2014 |
|---|---|---|
| | (in thousands) | |
| Gain on sales of investments available for sale | $ (53) | $ (88) |
| Other-than-temporary impairment, net | - | 48 |
| Income tax expense | 18 | 14 |
| Unrealized gain on investment securities, net of tax | $ (35) | $ (26) |

The following table presents the components of other comprehensive income (loss) for the twelve months ended December 31, 2015 and December 31, 2014:

| | Twelve Months Ended December 31, 2015 | | |
|---|---|---|---|
| | Before Tax | Tax Effect | Net of Tax |
| Net unrealized gains on investment securities: | | (in thousands) | |
| Net unrealized gains arising during the period | $ 59 | $ 20 | $ 39 |
| Less: reclassification adjustments for net gains realized in net income | (53) | (18) | (35) |
| Net unrealized gains on investment securities | 6 | 2 | 4 |
| Defined benefit plans: | | | |
| Amortization of unrecognized prior service costs and net actuarial gains | 350 | 119 | 231 |
| Other Comprehensive Income | $ 356 | $ 121 | $ 235 |

| | Twelve Months Ended December 31, 2014 | | |
|---|---|---|---|
| | Before Tax | Tax Effect | Net of Tax |
| | | (in thousands) | |
| Net unrealized gains 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 gains on investment securities | 1,922 | 653 | 1,269 |
| Defined benefit plans: | | | |
| Amortization of unrecognized prior service costs and net actuarial losses | (53) | (18) | (35) |
| Other Comprehensive Income | $ 1,869 | $ 635 | $ 1,234 |

## NOTE 6 – PREMISES AND EQUIPMENT

The components of premises and equipment at December 31, 2015 and 2014 were as follows:

| | December 31, 2015 | 2014 |
|---|---|---|
| | (in thousands) | |
| Land and premises | $ 19,600 | $ 19,875 |
| Equipment, furniture and fixtures | 7,993 | 7,698 |
| Construction in progress | 431 | 84 |
| | 28,024 | 27,657 |
| Less accumulated deprecation and amortization | (12,275) | (11,354) |
| Total premises and equipment | $ 15,749 | $ 16,303 |

| | December 31, 2015 | 2014 |
|---|---|---|
| | (in thousands) | |
| Depreciation expense | $ 1,235 | $ 1,242 |
| Rental expense | $ 567 | $ 574 |

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 were as follows (in thousands):

| | | |
|---|---|---|
| 2016 | $ | 534 |
| 2017 | | 424 |
| 2018 | | 395 |
| 2019 | | 348 |
| 2020 | | 256 |
| | $ | 1,957 |

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 Other Real Estate Owned (OREO) for the years ended December 31, 2015 and December 31, 2014:

| | December 31, | |
|---|---|---|
| | **2015** | **2014** |
| | (in thousands) | |
| Other real estate owned, beginning of period | $ 999 | $ 2,771 |
| Transfers from outstanding loans | 3,876 | 842 |
| Proceeds from sales | (1,289) | (2,340) |
| Net gain (loss) on sales | 128 | (207) |
| Impairment charges | (104) | (67) |
| Total other real estate owned | $ 3,610 | $ 999 |

OREO property types were as follows for the years ended December 31, 2015 and December 31, 2014:

| | December 31, | | | |
|---|---|---|---|---|
| | **2015** | | **2014** | |
| | **Amount** | **Number of Properties** | **Amount** | **Number of Properties** |
| | (dollars in thousands) | | | |
| Construction, Land Dev & Other Land | $ - | - | $ 35 | 1 |
| Nonfarm Nonresidential Properties | 3,610 | 4 | 964 | 3 |
| Total OREO | $ 3,610 | 4 | $ 999 | 4 |

**NOTE 8 – DEPOSITS**

Time deposits that meet or exceed the FDIC Insurance limit of $250,000 at December 31, 2015 and 2014 were $71.4 million and $37.0 million, respectively.

The composition of deposits at December 31, 2015 and December 31, 2014 was as follows:

| | December 31, 2015 | December 31, 2014 |
|---|---|---|
| | (in thousands) | |
| Interest-bearing demand (NOW) | $ 165,544 | $ 151,130 |
| Money market deposits | 133,799 | 123,484 |
| Savings deposits | 90,380 | 79,997 |
| Time deposits (CDs) | 139,775 | 118,683 |
| Total interest-bearing deposits | 529,498 | 473,294 |
| Non-interest bearing demand | 185,001 | 165,760 |
| Total deposits | $ 714,499 | $ 639,054 |

Scheduled maturities of CDs were as follows for future years ending December 31 (in thousands):

| | Maturities |
|---|---|
| 2016 | $ 65,764 |
| 2017 | 23,665 |
| 2018 | 18,099 |
| 2019 | 24,060 |
| 2020 | 8,071 |
| Thereafter | 116 |
| Total | $ 139,775 |

**NOTE 9 – BORROWINGS**

Federal funds purchased and short-term advances from the Federal Home Loan Bank generally mature within one to four days from the transaction date. The following is a summary of these borrowings:

| | December 31, 2015 | December 31, 2014 |
|---|---|---|
| | (dollars in thousands) | |
| Amount outstanding at end of period | $ - | $ - |
| Average balance during the year | $ 3,519 | $ 153 |
| Average interest rate during the year | 0.29% | 0.28% |

Federal Home Loan Bank advances at December 31, 2015 and 2014 represent longer term advances from the Federal Home Loan Bank of Des Moines (FHLB). Advances at December 31, 2015 bear interest from 0.47% to 2.54% with a weighted average rate of 1.98%. The advances mature in various years as follows (in thousands):

| | |
|---|---|
| 2016 | $ 2,500 |
| 2019 | $ 5,000 |
| 2020 | $ 2,500 |
| 2024 | $ 1,303 |

**NOTE 10 – JUNIOR SUBORDINATED DEBENTURES**

At December 31, 2015, two wholly-owned subsidiary grantor trusts established by the Company had outstanding $13.4 million of Trust Preferred Securities (TPS). 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, 2015 and 2014, respectively, for the common capital securities issued by the issuer trusts.

As of December 31, 2015 and 2014, 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, 2015.

| Trust Name | Issue Date | Issued Amount | Rate | Maturity Date |
|---|---|---|---|---|
| | | (dollars in thousands) | | |
| 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 |
| | | $ 13,000 | | |

[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 (0.51% at December 11, 2015) plus 1.45% or 1.96%, 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 (0.32% at October 13, 2015) plus 1.60% or 1.92%, 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, 2015 and 2014. 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, 2015, the Company maintained a deferred tax asset balance of $3.1 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, 2015.

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

| | December 31, 2015 | December 31, 2014 |
|---|---|---|
| | (in thousands) | |
| Current | $ 1,866 | $ 1,003 |
| Deferred | 55 | 727 |
| Total income tax provision | $ 1,921 | $ 1,730 |

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:

| | December 31, 2015 | December 31, 2014 |
|---|---|---|
| | (in thousands) | |
| **Deferred Tax Assets** | | |
| Allowance for loan losses | $ 2,855 | $ 2,863 |
| Deferred compensation | 92 | 102 |
| Supplemental executive retirement plan | 1,286 | 1,151 |
| Loan fees/costs | 493 | 416 |
| OREO write-downs | 118 | 11 |
| Compensation expense | 196 | - |
| Non-accrual loan interest | - | 73 |
| Other | 239 | 445 |
| Total deferred tax assets | $ 5,279 | $ 5,061 |
| **Deferred Tax Liabilities** | | |
| Depreciation | $ 115 | $ 100 |
| Loan fees/costs | 1,658 | 1,290 |
| Unrealized gain on securities available for sale | 183 | 181 |
| Prepaid expenses | 144 | 128 |
| FHLB dividends | 20 | 130 |
| Other | 70 | 67 |
| Total deferred tax liabilities | 2,190 | 1,896 |
| **Net deferred tax assets** | $ 3,089 | $ 3,165 |

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

| | December 31, 2015 Amount | 2015 Percent of Pre-tax Income | 2014 Amount | 2014 Percent of Pre-tax Income |
|---|---|---|---|---|
| | (dollars in thousands) | | | |
| Income tax at statutory rate | $ 2,624 | 35.0% | $ 2,330 | 35.0% |
| Adjustments resulting from: | | | | |
| Tax-exempt income | (395) | -5.3% | (412) | -6.2% |
| Net earnings on life insurance policies | (167) | -2.2% | (169) | -2.5% |
| Low income housing tax credit | (66) | 0.9% | (82) | -1.2% |
| Other | (75) | -1.0% | 63 | 1.0% |
| Total income tax expense | $ 1,921 | 25.6% | $ 1,730 | 25.9% |

As of December 31, 2015, 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 $671,000 and $609,000 in 2015 and 2014, 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 $205,000 and $180,000 for 2015 and 2014, 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 2015 and 2014.

The directors of a bank acquired by the Company in 1999 adopted two deferred compensation plans for directors. One plan provides retirement income benefits for all directors and the other, a deferred compensation plan, covers 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 $4.1 million and $4.0 million at December 31, 2015 and 2014, respectively. In 2015 and 2014, the net benefit recorded from these plans, including the cost of the related life insurance, was $378,000 and $380,000, 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 $268,000 and $311,000 at December 31, 2015 and 2014, 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 $136,000 and $137,000 in 2015 and 2014, 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 $704,000. The Company has purchased bank owned life insurance covering all participants in the SERP. The cash surrender value of these policies totaled $6.1 million and $5.9 million at December 31, 2015 and 2014, 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, 2015 and 2014:

| | December 31, | |
|---|---|---|
| | **2015** | **2014** |
| Net periodic pension cost: | (dollars in thousands) | |
| Service cost | $ 134 | $ 153 |
| Interest cost | 103 | 111 |
| Amortization of prior service cost | 90 | 90 |
| Amortization of net loss | 51 | 26 |
| Net periodic pension cost | $ 378 | $ 380 |
| Weighted average assumptions: | | |
| Discount rate | 3.57% | 4.37% |
| Rate of compensation increase | n/a | n/a |

The following table sets forth the change in benefit obligation at December 31, 2015 and December 31, 2014:

| | December 31, | |
|---|---|---|
| | **2015** | **2014** |
| Change in benefit obligation: | (in thousands) | |
| Benefit obligation at the beginning of year | $ 2,944 | $ 2,573 |
| Service cost | 134 | 153 |
| Interest cost | 103 | 111 |
| Benefits paid | (45) | (45) |
| Actuarial (gain) loss | (91) | 152 |
| Benefit obligation at end of year | $ 3,045 | $ 2,944 |

Amounts recognized in accumulated other comprehensive income at December 31 were as follows:

| | December 31, | |
|---|---|---|
| | 2015 | 2014 |
| | (in thousands) | |
| Loss | $ 164 | $ 334 |
| Prior service cost | 90 | 152 |
| Total recognized in AOCI | $ 254 | $ 486 |

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

| | December 31, | |
|---|---|---|
| | 2015 | 2014 |
| | (in thousands) | |
| Projected benefit obligation | $ 3,045 | $ 2,944 |
| Accumulated benefit obligation | 3,045 | 2,944 |

Estimated future benefit payments as of December 31, 2015 were as follows (in thousands):

| | |
|---|---|
| 2016 | $ 254 |
| 2017 | $ 150 |
| 2018 | $ 242 |
| 2019 | $ 242 |
| 2020 | $ 242 |
| 2021-2025 | $ 1,211 |

## 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, 2015 and December 31, 2014 is as follows:

| | December 31, | |
|---|---|---|
| | 2015 | 2014 |
| | (in thousands) | |
| Commitments to extend credit | $ 159,911 | $ 109,545 |
| Standby letters of credit | $ 1,756 | $ 1,351 |

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, 2015, the Bank had $11.3 million in outstanding borrowings against its $294.2 million in established borrowing capacity with the FHLB, as compared to $11.5 million outstanding against a borrowing capacity of $149.7 million at December 31, 2014. 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 $65.4 million, subject to collateral requirements, and $16.0 million 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 $8.5 million.

## 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 Stock Price Volatility | Dividend Yield | Weighted Average Fair value of Options Granted |
|---|---|---|---|---|---|
| December 31, 2015 | 6.5 years | 1.85% | 22.82% | 3.20% | $ 1.05 |
| December 31, 2014 | 6.5 years | 2.11% | 23.23% | 3.27% | $ 1.02 |

The following tables summarize the stock option activity for the years ended December 31, 2015 and 2014:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in Years) |
|---|---|---|---|
| Outstanding at December 31, 2013 | 625,495 | 9.53 | |
| Granted | 23,500 | 6.13 | |
| Exercised | (4,000) | 5.00 | |
| Forfeited | (7,650) | 6.89 | |
| Expired | (70,400) | 15.17 | |
| Outstanding at December 31, 2014 | 566,945 | 8.75 | |
| Granted | 7,500 | 6.60 | |
| Exercised | (4,000) | 5.00 | |
| Forfeited | (22,550) | 8.98 | |
| Expired | (78,045) | 14.77 | |
| Outstanding at December 31, 2015 | 469,850 | $ 7.74 | 1.60 |
| Vested and expected to vest at December 31, 2015 | 469,850 | $ 7.74 | 1.60 |
| Exercisable at December 31, 2015 | 330,700 | $ 8.79 | 1.60 |

Information related to the stock option plan during each year follows:

| | 2015 | 2014 |
|---|---|---|
| | (in thousands) | |
| Intrinsic value of options exercised | $ 8 | $ 6 |
| Cash received from option exercises | $ 20 | $ 20 |

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.

The following information summarizes information about stock expense for the years ended December 31, 2015 and 2014:

| | Twelve Months Ended December 31, | |
|---|---|---|
| | 2015 | 2014 |
| | (in thousands) | |
| Compensation Expense | $ 31 | $ 67 |
| Tax Effect | 11 | 23 |
| Compensation Expense, net | $ 20 | $ 44 |

As of December 31, 2015, there was $35,000 of total unrecognized compensation cost related to nonvested stock options. The cost is expected to be recognized over a weighted-average period of 1.6 years.

*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, 2015 and 2014:

| | Shares | Weighted Average Grant Date Fair Value |
|---|---|---|
| Outstanding at December 31, 2013 | 50,024 | |
| Granted | 13,624 | $ 5.43 |
| Vested | (476) | |
| Forfeited | (1,939) | |
| Outstanding at December 31, 2014 | 61,233 | |
| Granted | 44,966 | $ 6.75 |
| Vested | (19,368) | |
| Forfeited | (3,127) | |
| Outstanding at December 31, 2015 | 83,704 | |

The following table summarizes RSU compensation expense during the twelve months ended December 31, 2015 and 2014:

| | December 31, 2015 | December 31, 2014 |
|---|---|---|
| | (in thousands) | |
| Compensation Expense | $ 213 | $ 148 |
| Tax Effect | 72 | 50 |
| Compensation Expense, net | $ 141 | $ 98 |

As of December 31, 2015, there was $245,000 of total unrecognized compensation cost related to nonvested RSUs. The cost is expected to be recognized over a weighted-average period of 1.5 years.

**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, 2015 and 2014, 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, 2015 and 2014 are presented in the table below.

| | Actual | | Required for Capital Adequacy Purposes | | To be Well Capitalized Under Prompt Correction Action Regulations* | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | | | (dollars in thousands) | | | |
| **As of December 31, 2015** | | | | | | |
| Company | | | | | | |
| Common equity Tier 1 capital to risk-weighted assets | $ 63,456 | 9.57% | 29,838 | 4.50% | N/A | N/A |
| Tier 1 leverage capital to average assets | 76,456 | 9.44% | 32,397 | 4.00% | N/A | N/A |
| Tier 1 capital to risk-weighted assets | 76,456 | 11.53% | 39,786 | 6.00% | N/A | N/A |
| Total capital to risk-weighted assets | 84,742 | 12.78% | 53,047 | 8.00% | N/A | N/A |
| Bank | | | | | | |
| Common equity Tier 1 capital to risk-weighted assets | 75,725 | 11.44% | 27,801 | 4.20% | 43,026 | 6.50% |
| Tier 1 leverage capital to average assets | 75,725 | 9.35% | 32,396 | 4.00% | 40,495 | 5.00% |
| Tier 1 capital to risk-weighted assets | 75,725 | 11.44% | 39,716 | 6.00% | 52,955 | 8.00% |
| Total capital to risk-weighted assets | 84,001 | 12.69% | 52,956 | 8.00% | 66,195 | 10.00% |
| **As of December 31, 2014** | | | | | | |
| Company | | | | | | |
| Tier 1 leverage capital to average assets | $ 72,011 | 9.80% | 27,604 | 4.00% | N/A | N/A |
| Tier 1 capital to risk-weighted assets | 72,011 | 12.36% | 23,308 | 4.00% | N/A | N/A |
| Total capital to risk-weighted assets | 79,308 | 13.61% | 46,616 | 8.00% | N/A | N/A |
| Bank | | | | | | |
| Tier 1 leverage capital to average assets | 71,392 | 9.73% | 27,591 | 4.00% | 34,489 | 5.00% |
| Tier 1 capital to risk-weighted assets | 71,392 | 12.27% | 23,282 | 4.00% | 34,922 | 6.00% |
| Total capital to risk-weighted assets | 78,681 | 13.52% | 46,563 | 8.00% | 58,204 | 10.00% |

*includes Basel III Capital Conservation Buffer

## 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, 2015 or December 31, 2014.

The following table presents the balances of assets measured at fair value on a recurring basis at December 31, 2015 and December 31, 2014.

| | At December 31, 2015 | | | |
|---|---|---|---|---|
| **Description** | **Fair Value** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| Available-for-sale securities: | | (in thousands) | | |
| Collateralized mortgage obligations: agency issued | $ 39,045 | $ - | $ 39,045 | $ - |
| Collateralized mortgage obligations: non agency | 422 | - | 422 | - |
| Mortgage-backed securities: agency issued | 12,178 | - | 12,178 | - |
| U.S. Government agency securities | 8,646 | - | 8,646 | - |
| State and municipal securities | 39,733 | - | 37,707 | 2,026 |
| Total assets measured at fair value | $ 100,024 | $ - | $ 97,998 | $ 2,026 |

| | At December 31, 2014 | | | |
|---|---|---|---|---|
| **Description** | **Fair Value** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| Available-for-sale securities: | | (in thousands) | | |
| 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 |

As of December 31, 2015 and December 31, 2014, the Company had four securities 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, 2015 and 2014, 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. There were no transfers in or out of Level 3 during the year ended December 31, 2015. Transfers in and out of Level 3 at December 31, 2014 are as follows:

| | Twelve Months Ended December 31, 2015 | 2014 |
|---|---|---|
| | (in thousands) | |
| Balance beginning of period | $ 2,150 | $ 1,419 |
| Transfers in to level 3 | - | 810 |
| Change in FV (included in other comprehensive income) | (124) | (79) |
| Balance end of period | $ 2,026 | $ 2,150 |

*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.

There were no assets held at the end of December 31, 2015 that were measured at fair value on a nonrecurring basis. Other real estate owned with a pre-foreclosure loan balance of $2.6 million was acquired during the twelve months ended December 31, 2015. Upon foreclosure, write downs totaling $684,000 were applied to the allowance for loan losses during the period related to these assets.

The following table presents the Company's assets that were held at the end of December 31, 2014 that were measured at fair value on a nonrecurring basis:

| | At December 31, 2014 | | | |
|---|---|---|---|---|
| **Description** | **Fair Value** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| | (in thousands) | | | |
| Other real estate owned and foreclosed assets | $ 139 | $ - | $ - | $ 139 |
| Loans measured for impairment, net of specific reserves | 231 | - | - | 231 |
| Total assets measured on a nonrecurring basis | $ 370 | $ - | $ - | $ 370 |

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 | 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 not publically traded; thus, it is not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability. At December 31, 2015 the stock was stock of the FHLB of Des Moines and at December 31, 2014 was stock of the FHLB of Seattle. The FHLB of Seattle merged with and into the FHLB of Des Moines effective in the second calendar quarter of 2015.

**Pacific Coast Bankers' Bank stock**
PCBB stock is carried at cost which approximates fair value and equals its par value based on a third-party valuation opinion as of December 31, 2015.

**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, 2015 and December 31, 2014 is as follows:

| | As of December 31, 2015 | | | | |
|---|---|---|---|---|---|
| | 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 |
| | | | (in thousands) | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | $ 27,526 | $ 27,526 | $ - | $ - | $ 27,526 |
| Interest-bearing certificates of deposit (original maturities greater than 90 days) | 2,727 | 2,727 | - | - | 2,727 |
| Investment securities available-for-sale | 100,024 | - | 97,998 | 2,026 | 100,024 |
| Investment securities held-to-maturity | 1,697 | - | 1,285 | 428 | 1,713 |
| Federal Home Loan Bank stock | 1,346 | N/A | N/A | N/A | N/A |
| Pacific Coast Bankers Bank stock | 1,000 | - | 1,000 | - | 1,000 |
| Loans held-for-sale | 12,333 | - | 12,333 | - | 12,333 |
| Loans | 617,019 | - | - | 584,432 | 584,432 |
| Financial liabilities: | | | | | |
| Deposits | $ 714,499 | $ - | $ 715,235 | $ - | $ 715,235 |
| Long-term borrowings | 11,303 | - | 11,379 | - | 11,379 |
| Junior subordinated debentures | 13,403 | - | - | 7,990 | 7,990 |

| | 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 |
| | | | (in thousands) | | |
| 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 | N/A | N/A | N/A | N/A |
| 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 |

## 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, 2015 | 2014 |
|---|---|---|
| | (dollars in thousands, except per share amounts) | |
| *Basic:* | | |
| Net income (numerator) | $ 5,576 | $ 4,927 |
| Weighted average shares outstanding (denominator) | 10,382,499 | 10,256,242 |
| Basic earnings per share | $ 0.54 | $ 0.48 |
| | | |
| *Diluted:* | | |
| Net income (numerator) | $ 5,576 | $ 4,927 |
| Weighted average shares outstanding | 10,382,499 | 10,256,242 |
| Effect of dilutive stock options | 141,804 | 91,096 |
| Weighted average shares outstanding assuming dilution (denominator) | 10,524,303 | 10,347,338 |
| Diluted earnings per share | $ 0.53 | $ 0.48 |

| | For the Year Ended December 31, 2015 | 2014 |
|---|---|---|
| Shares subject to outstanding options | 260,350 | 361,545 |
| Shares subject to outstanding warrants | N/A | N/A |

As of December 31, 2015 and 2014, the shares subject to outstanding options 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 – CONDENSED FINANCIAL INFORMATION – PARENT COMPANY ONLY

**Pacific Financial Corporation – Parent Company Only**
**Consolidated Statements of Financial Condition**
(in thousands)

**ASSETS**

| | December 31, 2015 | December 31, 2014 |
|---|---|---|
| Cash and cash equivalents: | $ 2,602 | $ 2,585 |
| Investment in bank | 88,458 | 84,864 |
| Other assets | 957 | 655 |
| **TOTAL ASSETS** | $ 92,017 | $ 88,104 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **LIABILITIES** | | |
| Junior subordinated debentures | $ 13,403 | $ 13,403 |
| Dividends payable | 2,287 | 2,178 |
| Other liabilities | 42 | 40 |
| Total liabilities | 15,732 | 15,621 |
| **SHAREHOLDERS' EQUITY** | | |
| Shareholders' equity | 76,285 | 72,483 |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | $ 92,017 | $ 88,104 |

## Pacific Financial Corporation – Parent Company Only
## Consolidated Statements of Income
(in thousands)

| | Twelve Months Ended December 31, 2015 | Twelve Months Ended December 31, 2014 |
|---|---|---|
| **INCOME** | | |
| Dividend income from the bank | $ 2,786 | $ 1,678 |
| Other income | 7 | 7 |
| Total interest and dividend income | **2,793** | **1,685** |
| **EXPENSES** | 834 | 902 |
| **INCOME BEFORE PROVISION FOR INCOME TAXES** | **1,959** | **783** |
| **INCOME TAX BENEFIT** | 162 | 215 |
| **INCOME BEFORE EQUITY IN UNDISTRIBUTED INCOME OF THE BANK** | **2,121** | **998** |
| **EQUITY IN UNDISTRIBUTED INCOME OF THE BANK** | 3,455 | 3,929 |
| **NET INCOME** | **$ 5,576** | **$ 4,927** |

## Pacific Financial Corporation – Parent Company Only
## Consolidated Statements of Comprehensive Income
(Dollars in thousands)

| | Twelve Months Ended December 31, 2015 | Twelve Months Ended December 31, 2014 |
|---|---|---|
| **NET INCOME** | $ 5,576 | $ 4,927 |
| Change in fair value of securities available for sale | 4 | 1,269 |
| Defined benefit plan | 231 | (35) |
| Other comprehensive income, net of tax | 235 | 1,234 |
| **COMPREHENSIVE INCOME** | $ 5,811 | $ 6,161 |

## Pacific Financial Corporation – Parent Company Only
## Consolidated Statements of Cash Flows
(Dollars in thousands)

| | Twelve Months Ended December 31, 2015 | Twelve Months Ended December 31, 2014 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net Income | $ 5,576 | $ 4,927 |
| Adjustments to reconcile net income to net cash from operating activities | | |
| Equity in undistributed income of subsidiary | (3,455) | (3,929) |
| Net change in other assets | (162) | (362) |
| Net change in other liabilities | 2 | - |
| Stock compensation expense | 213 | 139 |
| Net cash provided by operating activities | 2,174 | 775 |
| **Cash flows from financing activities** | | |
| Common stock issued | 21 | 1,224 |
| Warrants exercised | - | 142 |
| Repurchase of restricted stock units | - | (3) |
| Cash dividends paid | (2,178) | (2,036) |
| Net cash used in financing activities | (2,157) | (673) |
| Net increase in cash and cash equivalents | 17 | 102 |
| **Cash and cash equivalents at beginning of year** | 2,585 | 2,483 |
| **Cash and cash equivalents at end of year** | $ 2,602 | $ 2,585 |

## NOTE 20 – SELECTED DATA

Results of operations on a quarterly basis were as follows (unaudited):

| | Year Ended December 31, 2015 | | | |
|---|---|---|---|---|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| | (dollars in thousands, except per share amounts) | | | |
| Interest and dividend income | $ 7,432 | $ 7,817 | $ 7,946 | $ 8,145 |
| Interest expense | 509 | 528 | 561 | 603 |
| **Net interest income** | **6,923** | **7,289** | **7,385** | **7,542** |
| Loan loss provision | 30 | 187 | 165 | 200 |
| Noninterest income | 1,973 | 2,823 | 2,686 | 2,317 |
| Noninterest expense | 7,484 | 7,732 | 7,709 | 7,934 |
| **Income before provision for income taxes** | **1,382** | **2,193** | **2,197** | **1,725** |
| Provision for income taxes | 286 | 611 | 596 | 428 |
| **Net income** | $ **1,096** | $ **1,582** | $ **1,601** | $ **1,297** |
| **Earnings per common share** | | | | |
| Basic | $ 0.11 | $ 0.15 | $ 0.15 | $ 0.12 |
| Diluted | $ 0.10 | $ 0.15 | $ 0.15 | $ 0.12 |

| | Year Ended December 31, 2014 | | | |
|---|---|---|---|---|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| | (dollars in thousands, except per share amounts) | | | |
| Interest and dividend 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** |
| Loan loss provision | - | 100 | 100 | 100 |
| Noninterest income | 1,608 | 2,176 | 2,274 | 2,021 |
| Noninterest expense | 6,830 | 7,066 | 7,133 | 7,127 |
| **Income before provision for income taxes** | **1,333** | **1,806** | **1,923** | **1,594** |
| Provision for 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 |

# 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 U.S: 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* | *Lost stock certificates* |
| *Consolidation of accounts* | *Transfer of stock to another person* |
| *Duplicate mailings* | *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 27, 2016 at 4 p.m. at 1101 S. Boone Street, Aberdeen, WA 98520.

**Annual Report**
This annual report, including accompanying financial statements and schedules, is available without charge to shareholders or beneficial owners of our common stock upon written request to Sandra Clark, Corporate Secretary, Pacific Financial Corporation, P.O. Box 1826, Aberdeen, Washington 98520. It is also 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.

## ***BOARD OF DIRECTORS***

Gary C. Forcum, Chairman
Private Investor

Douglas M. Schermer
Owner and President
Schermer Construction Inc.
& Wishkah Rock Products

Denise Portmann
President & CEO
Pacific Financial Corporation and
Bank of the Pacific

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

Randy J. Rust
Private Investor

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

Susan C. Freese
Pharmacist

Dwayne M. Carter
President & General Manager
Brooks Manufacturing Co.

Edwin W. Ketel
Owner
Oceanside Animal Clinic

Kristi Gundersen
Partner & Chief Financial Officer
Knutzen Farms, LP

John Van Dijk
Retired President & COO
Bank of the Pacific

## ***OFFICERS***

Denise J. Portmann
President & CEO
Pacific Financial Corporation and Bank of the Pacific

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

Douglas N. Biddle
Treasurer
Executive Vice President & CFO, Bank of the Pacific

Sandra P. Clark
Corporate Secretary

## ***SUBSIDIARIES***

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