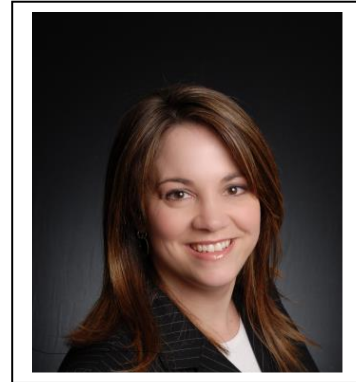
Pacific Financial Corporation

2017 Annual Report

OTCQB: **PFLC**

2017 Shareholders' Letter



Date: March 28, 2018

Dear Fellow Shareholders:

2017 was a great year for Pacific Financial, continuing our momentum of delivering strong profitability. Excluding a one-time deferred tax adjustment, non-GAAP earnings increased 23% to a record $8.1 million, or $0.76 per diluted share, compared to $6.6 million, or $0.62 per share for 2016. The sustained strength of our core earnings resulted from steady loan growth, an expanding net interest margin and strong non-interest income generation.

As displayed in the accompanying audited financial statements, net income for the year on a GAAP basis was $7.0 million, or $0.65 per diluted share. As noted above, net income was impacted by the revaluation of our deferred tax asset ("DTA"), which triggered an additional tax expense of $1.0 million in the fourth quarter of 2017, to comply with the Tax Cuts and Jobs Act enacted in December 2017.

We expect to benefit from the corporate tax reduction, and we are optimistic that the new tax law will help to reinvigorate the economy and support further growth in our markets. With an expected boost to earnings, we anticipate pursuing additional investments in our franchise, employees, customers and communities. We are embracing new technologies to help us efficiently reach more customers and deepen our ties with existing customers. In addition, the productivity initiative we adopted in 2017 is already beginning to enhance operational efficiencies, reduce expenses and augment revenues. These kinds of initiatives drive long-term growth and create value for our shareholders.

Below are investments we have made demonstrating our commitment to improving the lives of our employees and our communities:

- We boosted the minimum wage for our lower paid employees, raising the hourly rate to $14.00 per hour from $11.50 per hour. This increase takes effect on April 1, 2018.
- We have increased our matching contributions toward our employees' 401(k) retirement plan. This increase will provide strong incentives for our employees to continue to save for retirement.

We believe that increasing wages and increasing the 401(k) match is a more permanent and better way to improve the long-term earnings and savings power of our employees.

As a further demonstration of the financial success we accomplished in 2017, we raised our annual cash dividend 9% to $0.25 per share which was paid on January 8, 2018. This is the fourth consecutive year we have raised our annual cash dividend.

Of course, these successes were a direct result of the outstanding dedication and hard work of our amazing employees who live in the communities we serve. To that end, we will continue to cultivate our client relationships in Northwestern Washington and Coastal Washington and Oregon as well as expand our reach in Tacoma, Vancouver, Portland and Salem.

2017 Shareholders' Letter

Highlights from 2017:

- GAAP net income in 2017 grew 6% to $7.0 million, or $0.65 per diluted share, from $6.6 million, or $0.62 per share, in 2016. Achieved record non-GAAP earnings of $8.1 million for the year, excluding a $1.0 million DTA write-down; up 23% from 2016.
- At year-end 2017, our total assets were $895.0 million; net loans were $678.2 million; deposits equaled $777.2 million, with noninterest-bearing demand deposits accounting for 32% of total deposits.
- Our net interest margin (NIM) expanded 17 basis points to 4.28%.
- Asset quality remained stable at year end, with our adversely classified loans declining 57% to $7.5 million. Nonperforming assets were higher than a year ago at $2.2 million, primarily due to a $738,000 commercial real estate loan that we placed on nonaccrual in the third quarter of 2017.
- We remained well reserved at year end, with our allowance for loan losses at 1.32% of total loans.
- We continue to streamline our operations by expanding use of technologies, reviewing processes to improve workflows, and ascertaining other revenue enhancement while prudently managing expenses.
- All capital levels exceeded regulatory requirements for a "well-capitalized" financial institution, ending the year with a total risk-based capital ratio of 12.69%, a Tier 1 risk-based ratio at 11.46% and a leverage ratio at 9.56%.

We are proud of our proven track record and, as a vibrant local bank, we will continue to focus on lending to community-based businesses and professionals. Ultimately, we believe this will stimulate and improve economic growth in our local communities. In fact, a recent research study released by seven Federal Reserve banks, found that small businesses that apply for loans with community banks are the most successful and the most satisfied with their borrowing experience, ahead of credit unions, large banks and online lenders.

As we look forward to 2018 and beyond, we will be operating from a position of strength. We look forward to continuing to grow our franchise and will work hard to create added value for our customers and our shareholders. Please join us for our annual Shareholders' meeting on Wednesday, April 25, 2018, at 4:00 pm at 1216 Skyview Drive, Aberdeen, WA 98520.

Sincerely,

Randy Rognlin
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,				
	2017	2016	2015	2014	2013
Operations Data			(in thousands)		
Net interest income	$ 34,049	$ 31,663	$ 29,139	$ 27,033	$ 23,800
Loan loss provision (recapture)	272	998	582	300	(450)
Noninterest income	10,523	11,225	9,799	8,079	9,955
Noninterest expense	32,976	32,840	30,859	28,155	29,502
Provision for income taxes[1]	4,361	2,460	1,921	1,730	972
Net income	$ 6,963	$ 6,590	$ 5,576	$ 4,927	$ 3,731

	For the Year Ended December 31,				
	2017	2016	2015	2014	2013
Net income per share:		(dollars in thousands, except per share data)			
Basic	$ 0.67	$ 0.63	$ 0.54	$ 0.48	$ 0.37
Diluted	$ 0.65	$ 0.62	$ 0.53	$ 0.48	$ 0.37
Dividends declared	$ 2,622	$ 2,398	$ 2,287	$ 2,178	$ 2,036
Dividends declared per share	$ 0.25	$ 0.23	$ 0.22	$ 0.21	$ 0.20
Dividend payout ratio	38%	36%	41%	44%	55%
Performance Ratios					
Interest rate spread	4.14%	3.99%	3.99%	4.06%	3.87%
Net interest margin[2]	4.28%	4.11%	4.10%	4.17%	4.00%
Efficiency ratio[3]	73.98%	76.62%	79.25%	80.19%	87.40%
Return on average assets	0.79%	0.77%	0.71%	0.68%	0.55%
Return on average equity	8.19%	8.16%	7.35%	6.92%	5.48%
Balance Sheet Data					
Total assets	$ 894,953	$ 891,383	$ 824,613	$ 744,807	$ 705,039
Loans, net	678,227	648,611	617,019	554,746	496,307
Total deposits	777,225	779,731	714,499	639,054	607,347
Total borrowings	21,906	22,056	24,706	24,856	23,403
Shareholders' equity	85,031	80,005	76,285	72,483	67,137
Book value per share[4]	$ 8.10	$ 7.67	$ 7.34	$ 6.99	$ 6.59
Tangible book value per share[5]	$ 6.82	$ 6.38	$ 6.03	$ 5.68	$ 5.25
Equity to assets ratio	9.50%	8.98%	9.25%	9.73%	9.52%
Asset Quality Ratios					
Nonperforming loans to total loans	0.31%	0.19%	0.24%	1.62%	1.98%
Allowance for loan losses to total loans	1.32%	1.39%	1.33%	1.48%	1.66%
Allowance for loan losses to nonperforming loans	420.34%	747.93%	547.89%	91.54%	115.41%
Nonperforming assets to total assets	0.25%	0.20%	0.62%	1.36%	1.42%

[1] Current year results were impacted by the Tax Cuts and Jobs Act enacted December 22, 2017, which required a revaluation of our deferred tax assets and liabilities to account for the future impact of the decrease in the corporate income tax rate to 21% from 35%. Income tax expense increased $1.0 million as a result of our estimated revaluation of the net deferred tax asset.

[2] Net interest income divided by average earning assets

[3] Noninterest expense divided by the sum of net interest income and noninterest income

[4] Shareholder equity divided by shares outstanding

[5] Shareholder equity less intangibles divided by shares outstanding

Tel: 509-747-8095
Fax: 509-747-0415
www.bdo.com

601 West Riverside Ave Suite 900
Spokane, WA 99201

Independent Auditor's Report

Board of Directors
Pacific Financial Corporation
Aberdeen, Washington

We have audited the accompanying consolidated financial statements of Pacific Financial Corporation and its wholly owned subsidiary, Bank of the Pacific, which comprise the consolidated statements of financial condition as of December 31, 2017 and 2016, and the related consolidated statements of income, comprehensive income, shareholders' 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 and its subsidiary as of December 31, 2017 and 2016, and the results of their operations and their 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, 2018

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

ASSETS	December 31, 2017	December 31, 2016
Cash on hand and in banks	$ 14,667	$ 15,707
Interest bearing deposits	19,904	43,591
Cash and cash equivalents	34,571	59,298
Other interest earning deposits	994	2,231
Investment securities available for sale, at fair value	110,018	111,296
Investment securities held to maturity (fair value of $751 and $863, respectively)	749	859
Loans held for sale	10,886	6,573
Loans receivable, net	687,319	657,803
Allowance for loan losses	(9,092)	(9,192)
Total loans receivable, net	678,227	648,611
FHLB & PCBB stock, at cost	2,409	2,335
Premises and equipment, net	15,876	16,326
Other real estate owned	-	405
Cash surrender value of life insurance	19,786	19,346
Accrued interest receivable	3,061	2,885
Prepaid expenses and other assets	4,853	7,673
Goodwill	12,168	12,168
Other intangible assets	1,355	1,377
Total assets	$ 894,953	$ 891,383
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits	$ 777,225	$ 779,731
Federal Home Loan Bank advances	8,503	8,653
Junior subordinated debentures	13,403	13,403
Accrued expenses and other liabilities	10,791	9,591
Total liabilities	809,922	811,378
Shareholders' Equity:		
Preferred Stock, no par value; 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2017 and December 31, 2016	-	-
Common Stock, $1 par value; 25,000,000 shares authorized, 10,491,892 and 10,424,541 shares issued and outstanding at December 31, 2017 and 2016, respectively	10,492	10,425
Additional paid-in-capital	43,806	43,534
Retained earnings	31,078	26,737
Accumulated other comprehensive loss, net	(345)	(691)
Total shareholders' equity	85,031	80,005
Total liabilities and shareholders' equity	$ 894,953	$ 891,383

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,	
	2017	**2016**
INTEREST AND DIVIDEND INCOME		
Interest and fees on loans	$ 33,786	$ 31,828
Taxable interest on investment securities	1,184	1,122
Nontaxable interest on investment securities	1,138	922
Interest and dividends on other interest earning assets	336	263
Total interest and dividend income	36,444	34,135
INTEREST EXPENSE		
Deposits	1,814	1,928
Junior subordinated debentures	373	304
Federal Home Loan Bank advances	208	230
Other borrowings	-	10
Total interest expense	2,395	2,472
Net interest income	34,049	31,663
Provision for loan losses	272	998
Net interest income after loan loss provision	33,777	30,665
NONINTEREST INCOME		
Service charges on deposits	1,856	1,876
Gain on sale of loans, net	5,303	6,303
Gain on sale of investment securities, net	9	6
Earnings on bank owned life insurance	440	467
Other income	2,915	2,670
Total noninterest income	10,523	11,322
NONINTEREST EXPENSE		
Compensation and employee benefits	20,565	20,884
Occupancy	2,019	2,064
Equipment	1,100	1,052
Data processing	2,297	2,047
Professional services	1,270	516
Marketing	651	585
Other real estate owned, net	109	535
State and local taxes	588	459
Federal deposit insurance premium	432	456
Other expense	3,945	4,339
Total noninterest expense	32,976	32,937
Income before income taxes	11,324	9,050
Income tax expense	4,361	2,460
Net income	$ 6,963	$ 6,590
Basic earnings per common share	$ 0.67	$ 0.63
Diluted earnings per common share	$ 0.65	$ 0.62

See accompanying Notes to Consolidated Financial Statements.

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

	Twelve Months Ended December 31,	
	2017	**2016**
Net Income	$ 6,963	$ 6,590
Unrealized gain (loss) from securities:		
Change in fair value of investment securities available for sale, net of tax	424	(852)
Reclassification adjustment of net gain from sale of investment securities available for sale included in income, net of tax	(5)	(4)
Net unrealized gain (loss) from securities, net of reclassification adjustment	419	(856)
Pension plan liability adjustment:		
Unrecognized net actuarial loss during the period, net of tax	(104)	(48)
Less: amortization of unrecognized net actuarial losses included in income, net of tax	31	113
Pension plan liability adjustment, net	(73)	65
Other comprehensive income (loss), net of tax	346	(791)
Comprehensive income	$ 7,309	$ 5,799

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), net	Total Shareholders' Equity
Balance at December 31, 2015	10,394,828	$ 10,395	$ 43,245	$ 22,545	$ 100	$ 76,285
Net income	-	-	-	6,590	-	6,590
Other comprehensive loss, net of tax	-	-	-	-	(791)	(791)
Restricted stock awards issued, net of forfeitures	28,713	29	(36)	-	-	(7)
Restricted stock compensation expense	-	-	301	-	-	301
Stock option compensation expense	-	-	24	-	-	24
Exercise of stock options	1,000	1	-	-	-	1
Cash dividends declared ($0.23 per share)	-	-	-	(2,398)	-	(2,398)
Balance at December 31, 2016	10,424,541	$ 10,425	$ 43,534	$ 26,737	$ (691)	$ 80,005
Net income	-	-	-	6,963	-	6,963
Other comprehensive income, net of tax	-	-	-	-	346	346
Restricted stock awards issued, net of forfeitures	23,933	24	11	-	-	35
Restricted stock compensation expense	-	-	248	-	-	248
Stock option compensation expense	-	-	13	-	-	13
Exercise of stock options	43,418	43	-	-	-	43
Cash dividends declared ($0.25 per share)	-	-	-	(2,622)	-	(2,622)
Balance at December 31, 2017	10,491,892	$ 10,492	$ 43,806	$ 31,078	$ (345)	$ 85,031

See accompanying Notes to Consolidated Financial Statements.

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

	Twelve Months Ended December 31, 2017	2016
Cash flows from operating activities:		
Net Income	$ 6,963	$ 6,590
Adjustments to reconcile net income to net cash on hand and in banks from operating activities		
Provision for loan losses	272	998
Depreciation and amortization	2,962	2,722
Deferred income taxes	1,771	(161)
Originations of loans held for sale	(198,234)	(233,610)
Proceeds from sales of loans	207,907	245,496
Gain on sale of loans, net	(5,303)	(6,303)
Gain on sale of securities available for sale, net	(9)	(6)
Loss (gain) on sale of other real estate owned, net	51	(97)
Loss (gain) on sale of premises and equipment	3	(4)
Loss on sale of real estate owned, net	34	-
Earnings on bank owned life insurance	(440)	(467)
Increase in accrued interest receivable	(176)	(211)
Decrease in accrued interest payable	(4)	(3)
Other real estate owned write-downs	-	71
(Decrease) increase in prepaid expenses	(99)	78
Other operating activities	1,055	1,103
Net cash provided by operating activities	16,753	16,196
Cash flows from investing activities:		
Loans originated, net of principal payments	(38,179)	(31,167)
Net increase (decrease) in interest bearing balances with banks	24,924	(33,249)
Maturities of investment securities held to maturity	110	838
Maturities of investment securities available for sale	15,064	12,782
Purchase of investment securities available for sale	(30,782)	(29,156)
Purchases of FHLB Stock	(660)	(3,215)
Purchases of premises and equipment	(1,242)	(3,013)
Proceeds from sales of investment securities available for sale	16,215	2,564
Proceeds from redemption of FHLB Stock	586	3,226
Proceeds from sale of real estate owned	804	-
Proceeds from sales of other real estate owned	354	1,932
Net cash used in investing activities	(12,806)	(78,458)
Cash flows from financing activities:		
Net (decrease) increase in deposits	(2,506)	65,232
Repayments of FHLB Advances	(150)	(2,650)
Net cash from stock option exercises	147	5
Taxes paid related to net share settlement for equity awards	(80)	(11)
Cash dividends paid	(2,398)	(2,287)
Net cash (used in) provided by financing activities	(4,987)	60,289
Net decrease in cash and cash equivalents	(1,040)	(1,973)
Cash on hand and in banks at beginning of year	15,707	17,680
Cash on hand and in banks at end of year	$ 14,667	$ 15,707
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 2,400	$ 2,475
Cash paid for taxes	$ 1,522	$ 2,199
Supplemental non-cash disclosures of cash flow information:		
Other real estate owned acquired in settlement of loans	$ -	$ (219)
Transfer of loans held for sale to loans held for investment	$ 283	$ 439
Vesting of restricted stock awards, net	$ 24	$ 29
Financed sale of other real estate owned	$ -	$ 1,518
Assets transferred to assets held for sale	$ -	$ 838

See accompanying Notes to Consolidated Financial Statements.

Pacific Financial Corporation and Subsidiary
Notes to Consolidated Financial Statements
For the Years Ended December 31, 2017 and December 31, 2016

NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization – Pacific Financial Corporation (the "Company") 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 fifteen branches located in communities in Grays Harbor, Pacific, Whatcom, Clark, Skagit and Wahkiakum counties in the state of Washington and three branches 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 2017 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, 2018, 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 fair value of the debt security is below the carrying value primarily due to changes in interest rates, there has not been significant deterioration in the financial condition of the issuer, and it is not more likely than not that the Company will be required to, nor does it have the intent to sell the security before the anticipated recovery of its remaining carrying value. 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, 2017 and December 31, 2016 the stock was that of FHLB of Des Moines.

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, 2017 the Company had $13.5 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 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, 2017 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 $88,000 and $110,000 at December 31, 2017 and 2016, respectively. Amortization expense related to core deposit intangible totaled $22,000 and $27,000 during the years ended December 31, 2017 and 2016, 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.

In December 2017, the federal government enacted the Tax Cuts and Jobs Act of 2017 ("Tax Act"), which among other provisions, reduced the federal marginal corporate income tax rate from 35% to 21%. As a result of the passage of the Tax Act, the Company recorded a $1.0 million charge for the revaluation of its net deferred tax to account for the future impact of the decrease in the corporate income tax rate and other provisions of the legislation. The charge was recorded as an increase to income tax expense and reduction of the net deferred asset. The Company's financial results reflect the income tax effects of the Tax Act for which the accounting is complete and provisional amounts for those specific income tax effects of the Tax Act for which the accounting is incomplete but a reasonable estimate could be determined. As a result, these amounts could be adjusted during the measurement period, which will end in December 2018. The Company did not identify any items for which the income tax effects of the Tax Act have not been completed and a reasonable estimate could not be determined as of December 31, 2017.

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, 2017, 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, 2017. The tax years that remain subject to examination by federal and state taxing authorities are the years ended December 31, 2016, 2015 and 2014.

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 160,611 and 291,034 in 2017 and 2016, respectively.

Comprehensive income – Recognized revenue, expenses, gains and losses are included in net income. Certain changes in assets and liabilities, such as prior service costs and amortization of prior service costs related to defined benefit plans and unrealized gains and losses on securities available for sale, are reported within equity in other accumulated comprehensive loss in the consolidated balance sheet. Such items, along with net income, are components of comprehensive loss. 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, 2017 and 2016.

Recent accounting pronouncements

Financial Accounting Standards Board ("FASB") Accounting Standards update ("ASU" or "Update") ASU 2014-09, *Revenue from Contracts with Customers,* was issued in May 2014. 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 original effective date for this Update was deferred in FASB ASU 2015-14 below. The Company's primary source of revenue is interest income, which is recognized when earned and is deemed to be in compliance with this ASU. The Company is currently evaluating the impact that this Update will have on its Consolidated Financial Statements.

FASB ASU 2015-14, *Revenue from Contracts with Customers*, was issued in August 2015 and defers the effective date of the above-mentioned FASB ASU 2014-09 for certain entities. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in Update 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is now permitted, but only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company is a public business entity and did not early adopt the guidance in Update 2014-09 as permitted in this Update.

FASB ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10)*, was issued in January 2016, to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. This Update contains several provisions, including but not limited to 1) requiring equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income; 2) simplifying the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) eliminating the requirement to disclose the method(s) and significant assumptions used to estimate fair value; and 4) requiring separate presentation of financial assets and liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements. The Update also changes certain financial statement disclosure requirements, including requiring disclosures of the fair value of financial instruments be made on the basis of exit price. The Update is effective for public entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The adoption of ASU No. 2016-01 is not expected to have a material impact on the Company's future consolidated financial statements.

FASB ASU 2016-02, *Leases (Topic 842),* was issued in February 2016, to increase transparency and comparability of leases among organizations and to disclose key information about leasing arrangements. The Update sets out the principles for the recognition, measurement, presentation and disclosure of leases for both lessees and lessors. The Update requires lessees to apply a dual approach, classifying leases as either a finance or operating lease. This classification will determine whether the lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term greater than 12 months regardless of their classification. All cash payments will be classified within operating activities in the statement of cash flows. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The Update is effective for public entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Once adopted, the Company expects to report higher assets and liabilities as a result of including right-of-use assets and lease liabilities related to certain banking offices and certain equipment under non-cancelable operating lease agreements; however, based on current leases the adoption of ASU No. 2016-02 is not expected to have a material impact on the Company's future consolidated financial statements.

FASB ASU 2016-08, *Revenue from Contracts with Customers: Principal versus Agent Considerations*, was issued in March 2016 and it clarifies the implementation guidance of the above-mentioned FASB ASU 2014-09 as it relates to principal versus agent considerations. The Update addresses identifying the unit of account and nature of the goods or services as well as applying the control principle and interactions with the control principle. The amendments to the Update do not change the core principle of the guidance. The effective date and transition requirements for this Update are the same as FASB ASU 2014-09.

FASB ASU 2016-09, *Stock Compensation (Topic 718)*, issued in March 2016, is intended to simplify several aspects of the accounting for share-based payment award transactions. For public business entities, the guidance is effective for annual periods after December 15, 2016, including interim periods within those annual periods with early adoption permitted. Certain amendments will be applied using a modified retrospective transition method by means of a cumulative-effect adjustment to equity as of the beginning of the period in which the guidance is adopted. Other amendments will be applied retroactively (such as presentation of employee taxes paid on the statement of cash flows) or prospectively (such as recognition of excess tax benefits on the income statement). The Company adopted this ASU as of December 31, 2017 and the changes are reflected in the Consolidated Financial Statements.

FASB ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, was issued in April 2016 which clarifies the implementation guidance of the above-mentioned FASB ASU 2014-09 as it relates to identifying performance obligations and licensing. The effective date and transition requirements for this Update are the same as FASB ASU 2014-09. The Company is currently evaluating the impact that this Update will have on its Consolidated Financial Statements.

FASB ASU 2016-13, *Financial Instruments: Credit Losses (Topic 326): Measurement of Credit Losses on Financial*

Instruments, was issued in June 2016. Commonly referred to as the current expected credit loss model ("CECL"), this Update requires financial assets measured at amortized cost basis to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset to present the net carrying value at the amount expected to be collected on the financial asset. The measurement of expected credit losses is based on relevant information about past events including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. The amendment affects loans, debt securities, trade receivables, net investments in leases, off balance-sheet credit exposures, reinsurance receivables, and any other financial asset not excluded from the scope that have the contractual right to receive cash. The Update replaces the incurred loss impairment methodology, which generally only considered past events and current conditions, with a methodology that reflects the expected credit losses and required consideration of a broader range of reasonable and supportable information to estimate all expected credit losses. For public business entities that are not U.S. Securities and Exchange Commission filers, the Update is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years with early adoption permitted for fiscal years after December 15, 2018. An entity will apply the amendments through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. A prospective transition approach is required for debt securities. The Company is currently evaluating the impact that this Update will have on its Consolidated Financial Statements.

FASB ASU 2016-15, *Statement of Cash Flows (Topic 213): Classification of Certain Cash Receipts and Cash Payments*, was issued in August 2016. The Update addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted and must be applied using a retrospective transitional method to each period presented. The Company is currently evaluating the impact that this Update will have on its Consolidated Financial Statements.

FASB ASU 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, was issued in January 2017. The Update simplifies how an entity is required to test goodwill for impairment by eliminating a step from the goodwill impairment test. The amendments in this update provide that an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. This Update is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. As we approach the adoption date, we will consult the updated goodwill impairment test steps to determine if an impairment charge should be recognized.

FASB ASU 2017-08, *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities* was issued in March 2017 and changes the accounting for certain purchased callable debt securities held at a premium to shorten the amortization period for the premium to the earliest call date rather than to the maturity date. Accounting for purchased callable debt securities held at a discount does not change. The discount would continue to amortize to the maturity date. The updated is effective for reporting periods beginning after December 15, 2018, with early adoption permitted. The Company does not expect the Update will have a material impact on its Consolidated Financial Statements.

FASB ASU 2017-09, *Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting* was issued in May 2017 to provide clarity as to when to apply modification accounting when there is a change in the terms or conditions of a share-based payment award. According to this Update, an entity should account for the effects of a modification unless the fair value, vesting conditions and balance sheet classification of the award is the same after the modification as compared to the original award prior to the modification. The Update is effective for reporting periods beginning after December 15, 2017, with early adoption permitted. The Company does not expect the Update will have a material impact on its Condensed Consolidated Financial Statements.

FASB ASU 2018-02, *Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income* addresses the issue of stranded tax effects within accumulated other comprehensive income. The amendment allows for a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the enactment of the Tax Cuts and Jobs Act on December 22, 2017. An entity shall disclose a description of the accounting policy for reclassifying income tax effects from accumulated other comprehensive income. An entity that elects to reclassify shall disclose a statement that an election was made to reclassify from accumulated other comprehensive income to retained earnings. An entity that does not elect to reclassify shall disclosure in the period of adoption a statement that an election was not made to reclassify the income tax effects from accumulated other comprehensive income to retained earnings. The Update is effective for reporting periods beginning after December 15, 2018, with early adoption permitted. The Company does not expect the Update will have a material impact on its Condensed Consolidated Financial Statements.

NOTE 2 – RESTRICTED ASSETS

Federal Reserve Board regulations require that the Bank maintain certain minimum reserve balances in cash on hand and on deposit with the Federal Reserve Bank, based on a percentage of deposits. The required reserve balance at December 31, 2017 and 2016 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, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for Sale		(in thousands)		
Collateralized mortgage obligations: agency issued	$ 40,164	$ 46	$ 489	$ 39,721
Collateralized mortgage obligations: non-agency	257	1	2	256
Mortgage backed securities: agency issued	16,633	59	121	16,571
U.S. Government and agency securities	1,587	-	14	1,573
Municipal securities	51,448	703	332	51,819
Other securities	55	23	-	78
Total available for sale	$ 110,144	$ 832	$ 958	$ 110,018
Held to maturity				
Mortgage backed securities: agency issued	$ 36	$ 2	$ -	$ 38
Municipal securities	713	-	-	713
Total held to maturity	$ 749	$ 2	$ -	$ 751

	December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for Sale		(in thousands)		
Collateralized mortgage obligations: agency issued	$ 35,840	$ 63	$ 388	$ 35,515
Collateralized mortgage obligations: non agency	336	-	5	331
Mortgage backed securities: agency issued	15,266	48	115	15,199
U.S. Government agency securities	7,567	72	4	7,635
Municipal securities	53,047	576	1,007	52,616
Total available for sale	$ 112,056	$ 759	$ 1,519	$ 111,296
Held to maturity				
Mortgage backed securities: agency issued	$ 49	$ 4	$ -	$ 53
Municipal securities	810	-	-	810
Total held to maturity	$ 859	$ 4	$ -	$ 863

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, 2017 and December 31, 2016, were as follows:

	December 31, 2017					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available for sale	(in thousands)					
Collateralized mortgage obligations: agency issued	$ 19,268	$ 162	$ 16,169	$ 327	$ 35,437	$ 489
Collateralized mortgage obligations: non agency	-	-	111	2	111	2
Mortgage backed securities: agency issued	9,083	70	3,842	51	12,925	121
U.S. Government agency securities	1,573	14	-	-	1,573	14
Municipal securities	12,441	77	9,275	255	21,716	332
Total	$ 42,365	$ 323	$ 29,397	$ 635	$ 71,762	$ 958

	December 31, 2016					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available for sale	(in thousands)					
Collateralized mortgage obligations: agency issued	$ 23,601	$ 279	$ 5,630	$ 109	$ 29,231	$ 388
Collateralized mortgage obligations: non agency	-	-	331	5	331	5
Mortgage backed securities: agency issued	9,905	101	2,825	14	12,730	115
U.S. Government agency securities	2,586	4	-	-	2,586	4
Municipal securities	30,461	1,007	-	-	30,461	1,007
Total	$ 66,553	$ 1,391	$ 8,786	$ 128	$ 75,339	$ 1,519

At December 31, 2017, there were 105 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, 2017.

For collateralized mortgage obligations ("CMOs") 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, 2017 and 2016, no CMO was determined to be other-than-temporarily-impaired. The Company has not recorded impairments related to credit losses through earnings for the years ended December 31, 2017 and 2016.

Proceeds from sales of securities available-for-sale were $16.2 million and $2.6 million for the years ended December 31, 2017 and December 31, 2016, respectively. The following table provides the gross realized gains and losses on the sales of securities for the periods indicated:

	Twelve Months Ended December 31,	
	2017	2016
	(in thousands)	
Gross realized gain on sale of securities	$ 94	$ 8
Gross realized loss on sale of securities	85	2
Net realized gain on sale of securities	$ 9	$ 6

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 CMOs and MBS 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, 2017, by maturity were as follows:

	December 31, 2017			
	Held to Maturity		Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(in thousands)			
Due in one year or less	$ -	$ -	$ 2,050	$ 2,056
Due after one year through five years	101	103	18,817	18,748
Due after five years through ten years	544	544	31,577	31,698
Due after ten years	104	104	52,807	52,612
Declining balance securities	-		4,893	4,904
Total investment securities	$ 749	$ 751	$ 110,144	$ 110,018

At December 31, 2017 and December 31, 2016, investment securities with an estimated fair value of $72.4 million were pledged to secure public deposits, certain nonpublic deposits and borrowings.

As required of all members of the 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, 2017 and December 31, 2016, the Company held $1.4 million and $1.3 million in FHLB stock, respectively.

The Company owns $1.0 million in common stock in 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, 2017 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, 2017 and December 31, 2016, were as follows:

	December 31, 2017	December 31, 2016
	(in thousands)	
Commercial and agricultural	$ 138,629	$ 134,318
Real estate:		
Construction and development	62,980	41,983
Residential 1-4 family	88,055	91,686
Multi-family	22,333	29,747
Commercial real estate -- owner occupied	139,163	132,449
Commercial real estate -- non owner occupied	139,169	138,078
Farmland	30,196	25,588
Total real estate	481,896	459,531
Consumer	67,890	65,442
Gross loans	688,415	659,291
Deferred fees	(1,096)	(1,488)
Loans, net	$ 687,319	$ 657,803

Allowance for loan losses and credit quality

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

- The Company classifies loans into relatively homogeneous pools by loan type in accordance with regulatory guidelines for regulatory reporting purposes. The Company regularly reviews all loans within each loan category to establish risk ratings for them that include Pass, Watch, Special Mention, Substandard, Doubtful and Loss. Pursuant to ASC 310 "Accounting by Creditors for Impairment of a Loan", the impaired portion of collateral dependent loans is charged-off. Other risk-related loans not considered impaired have loss factors applied to the various loan pool balances to establish loss potential for provisioning purposes.

- Analyses are performed to establish the loss factors based on historical experience, as well as expected losses based on qualitative evaluations of such factors as the economic trends and conditions, industry conditions, levels and trends in delinquencies and impaired loans, levels and trends in charge-offs and recoveries, among others. The loss factors are applied to loan category pools segregated by risk classification to estimate the loss inherent in the Company's loan portfolio pursuant to ASC 450 "Accounting for Contingencies."

- Additionally, impaired loans are evaluated for loss potential on an individual basis in accordance with ASC 310 "Accounting by Creditors for Impairment of a Loan" and specific reserves are established based on thorough analysis of collateral values where loss potential exists. When an impaired loan is collateral dependent and a deficiency exists in the fair value of collateral securing the loan in comparison to the associated loan balance, the deficiency is charged-off at that time or a specific reserve is established. Impaired loans are reviewed no less frequently than quarterly.

- In the event that a current appraisal to support the fair value of the real estate collateral underlying an impaired loan has not yet been received, but the Company believes that the collateral value is insufficient to support the loan amount, an impairment reserve is recorded. In these instances, the receipt of a current appraisal triggers an updated review of the collateral support for the loan and any deficiency is charged-off or reserved at that time. In those instances where a

current appraisal is not available in a timely manner in relation to a financial reporting cut-off date, the Company discounts the most recent third-party appraisal depending on a number of factors including, but not limited to, property location, local price volatility, local economic conditions, and recent comparable sales. In all cases, the costs to sell the subject property are deducted in arriving at the fair value of the collateral.

Changes in the allowance for loan losses for the twelve months ended December 31, 2017 and December 31, 2016 were as follows:

	Twelve Months Ended December 31, 2017				
	Balance at Beginning of Year	**Charge-offs**	**Recoveries**	**Provision for Loan Losses**	**Balance at End of Year**
			(in thousands)		
Commercial and agricultural	$ 2,268	$ (190)	$ 46	$ (366)	$ 1,758
Real estate:					
Residential 1-4, Multi family, Const & Dev	1,260	(3)	11	24	1,292
Commercial real estate -- owner occupied	1,559	-	-	(348)	1,211
Commercial real estate -- non owner occupied	1,122	-	-	75	1,197
Farmland	596	(56)	-	96	636
Total real estate	4,537	(59)	11	(153)	4,336
Consumer	1,772	(187)	7	315	1,907
Unallocated	615	-	-	476	1,091
Total	$ 9,192	$ (436)	$ 64	$ 272	$ 9,092

	Twelve Months Ended December 31, 2016				
	Balance at Beginning of Year	**Charge-offs**	**Recoveries**	**Provision for Loan Losses**	**Balance at End of Year**
			(in thousands)		
Commercial and agricultural	$ 1,095	$ (8)	$ 7	$ 1,174	$ 2,268
Real estate:					
Residential 1-4, Multi family, Const & Dev	905	(159)	134	380	1,260
Commercial real estate -- owner occupied	2,038	-	-	(479)	1,559
Commercial real estate -- non owner occupied	1,440	-	-	(318)	1,122
Farmland	39	-	-	557	596
Total real estate	4,422	(159)	134	140	4,537
Consumer	803	(108)	11	1,066	1,772
Unallocated	1,997	-	-	(1,382)	615
Total	$ 8,317	$ (275)	$ 152	$ 998	$ 9,192

The allowance for loan losses disaggregated on the basis of the Company's impairment method as of December 31, 2017 and December 31, 2016 were as follows:

	Twelve Months Ended December 31, 2017		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Allowance for Loan Losses
		(in thousands)	
Commercial and agricultural	$ 5	$ 1,753	$ 1,758
Real estate:			
Residential 1-4, Multi family, Const & Dev	-	1,292	1,292
Commercial real estate -- owner occupied	-	1,211	1,211
Commercial real estate -- non owner occupied	-	1,197	1,197
Farmland	-	636	636
Total real estate	-	4,336	4,336
Consumer	-	1,907	1,907
Unallocated	-	1,091	1,091
Total	$ 5	$ 9,087	$ 9,092

	Twelve Months Ended December 31, 2016		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Allowance for Loan Losses
		(in thousands)	
Commercial and agricultural	$ -	$ 2,268	$ 2,268
Real estate:			
Residential 1-4, Multi family, Const & Dev	-	1,260	1,260
Commercial real estate -- owner occupied	-	1,559	1,559
Commercial real estate -- non owner occupied	-	1,122	1,122
Farmland	-	596	596
Total real estate	-	4,537	4,537
Consumer	12	1,760	1,772
Unallocated	-	615	615
Total	$ 12	$ 9,180	$ 9,192

The recorded investment of loans disaggregated on the basis of the Company's impairment method as of December 31, 2017 and December 31, 2016 were as follows:

	Twelve Months Ended December 31, 2017		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Gross Loans
		(in thousands)	
Commercial and agricultural	$ 231	$ 138,398	$ 138,629
Real estate:			
Residential 1-4, Multi family, Const & Dev	1,000	172,368	173,368
Commercial real estate -- owner occupied	738	138,425	139,163
Commercial real estate -- non owner occupied	-	139,169	139,169
Farmland	161	30,035	30,196
Total real estate	1,899	479,997	481,896
Consumer	399	67,491	67,890
Total	$ 2,529	$ 685,886	$ 688,415

	Twelve Months Ended December 31, 2016		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Gross Loans
		(in thousands)	
Commercial and agricultural	$ 287	$ 134,031	$ 134,318
Real estate:			
Residential 1-4, Multi family, Const & Dev	791	162,625	163,416
Commercial real estate -- owner occupied	-	132,449	132,449
Commercial real estate -- non owner occupied	-	138,078	138,078
Farmland	-	25,588	25,588
Total real estate	791	458,740	459,531
Consumer	538	64,904	65,442
Total	$ 1,616	$ 657,675	$ 659,291

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, 2017 and December 31, 2016 were as follows:

	December 31, 2017				
	Pass	Other Loans Especially Mentioned	Substandard	Doubtful	Total
			(in thousands)		
Commercial and agricultural	$ 126,871	$ 9,133	$ 2,625	$ -	$ 138,629
Real estate:					
Construction and development	60,329	2,101	550	-	62,980
Residential 1-4 family	85,693	1,174	1,188	-	88,055
Multi-family	21,944	-	389	-	22,333
Commercial real estate -- owner occupied	134,431	2,728	2,004	-	139,163
Commercial real estate -- non owner occupied	138,451	718	-	-	139,169
Farmland	25,081	4,954	161	-	30,196
Total real estate	465,929	11,675	4,292	-	481,896
Consumer	67,418	73	399	-	67,890
Gross Loans	660,218	20,881	7,316	-	688,415
Deferred fees	(1,096)	-	-	-	(1,096)
Loans, net	$ 659,122	$ 20,881	$ 7,316	$ -	$ 687,319

	December 31, 2016				
	Pass	Other Loans Especially Mentioned	Substandard	Doubtful	Total
			(in thousands)		
Commercial and agricultural	$ 121,841	$ 3,734	$ 8,743	$ -	$ 134,318
Real estate:					
Construction and development	38,344	-	3,639	-	41,983
Residential 1-4 family	89,672	229	1,785	-	91,686
Multi-family	29,356	-	391	-	29,747
Commercial real estate -- owner occupied	128,903	1,120	2,426	-	132,449
Commercial real estate -- non owner occupied	136,451	1,627	-	-	138,078
Farmland	24,574	778	236	-	25,588
Total real estate	447,300	3,754	8,477	-	459,531
Consumer	65,210	-	232	-	65,442
Gross Loans	634,351	7,488	17,452	-	659,291
Deferred fees	(1,488)	-	-	-	(1,488)
Loans, net	$ 632,863	$ 7,488	$ 17,452	$ -	$ 657,803

Impaired Loans

Impaired loans by type as of December 31, 2017 and 2016, and interest income recognized for the twelve months ended December 31, 2017 and 2016, were as follows:

	December 31, 2017						
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance	Average Recorded Investment	Interest Income Recognized
				(in thousands)			
Commercial and agricultural	$ -	$ 231	$ 231	$ 231	$ 5	$ 241	$ 12
Real Estate:							
Residential 1-4, Multi family, Const & Dev	1,000	-	1,000	1,622	-	1,671	9
Commercial real estate -- owner occupied	738	-	738	738	-	746	-
Commercial real estate -- non owner occupied	-	-	-	-	-	-	-
Farmland	161	-	161	217	-	221	-
Total real estate	1,899	-	1,899	2,577	-	2,638	9
Consumer	399	-	399	399	-	413	-
Total	$ 2,298	$ 231	$ 2,529	$ 3,207	$ 5	$ 3,292	$ 21

	December 31, 2016						
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance	Average Recorded Investment	Interest Income Recognized
				(in thousands)			
Commercial and agricultural	$ 287	$ -	$ 287	$ 287	$ -	$ 322	$ 5
Real Estate:							
Residential 1-4, Multi family, Const & Dev	791	-	791	1,308	-	949	86
Commercial real estate -- owner occupied	-	-	-	-	-	56	-
Commercial real estate -- non owner occupied	-	-	-	-	-	15	-
Total real estate	791	-	791	1,308	-	1,020	86
Consumer	355	183	538	538	12	431	14
Total	$ 1,433	$ 183	$ 1,616	$ 2,133	$ 12	$ 1,773	$ 105

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 2017 and 2016. Total related party loans outstanding at December 31, 2017 and 2016 to executive officers and directors were $3.5 million and $2.2 million, respectively. During 2017 and 2016, new loans of $2.1 million and $324,000, respectively, were made, and repayments totaled $790,000 and $251,000 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, 2017.

Aging Analysis

The following tables summarize the Company's loans past due, both accruing and nonaccruing, by type as of December 31, 2017 and December 31, 2016:

	December 31, 2017						
	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	$ -	$ 115	$	$ 115	$ -	$ 138,514	$ 138,629
Real estate:							
Construction and development	-	-	-	-	550	62,430	62,980
Residential 1-4 family	113	-	-	113	316	87,626	88,055
Multi-family	-	-	-	-	-	22,333	22,333
Commercial real estate -- owner occupied	-	-	-	-	738	138,425	139,163
Commercial real estate -- non owner occupied	-	-	-	-	-	139,169	139,169
Farmland	-	-	-	-	161	30,035	30,196
Total real estate	113	-	-	113	1,765	480,018	481,896
Consumer	25	-	-	25	399	67,466	67,890
Deferred fees	-	-	-	-	-	(1,096)	(1,096)
Total	$ 138	$ 115	$ -	$ 253	$ 2,164	$ 684,902	$ 687,319

	December 31, 2016						
	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	$ 176	$ -	$ -	$ 176	$ 38	$ 134,104	$ 134,318
Real estate:							
Construction and development	-	-	-	-	653	41,330	41,983
Residential 1-4 family	441	-	-	441	355	90,890	91,686
Multi-family	-	-	-	-	-	29,747	29,747
Commercial real estate -- owner occupied	-	-	-	-	-	132,449	132,449
Commercial real estate -- non owner occupied	-	-	-	-	-	138,078	138,078
Farmland	236	-	-	236	-	25,352	25,588
Total real estate	677	-	-	677	1,008	457,846	459,531
Consumer	205	219	-	424	183	64,835	65,442
Deferred fees	-	-	-	-	-	(1,488)	(1,488)
Total	$ 1,058	$ 219	$ -	$ 1,277	$ 1,229	$ 655,533	$ 657,803

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, 2017, 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, 2017.

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, 2017 and 2016, all of which were modified due to financial stress of the borrower. There were not any subsequent defaulted TDRs as of December 31, 2017 and 2016. There were no loans modified or recorded as TDRs during the years ended December 31, 2017 and 2016.

The following tables summarize the Company's TDRs by type as of December 31, 2017 and December 31, 2016:

	December 31, 2017		
	Number of Loans	Pre-TDR Outstanding Recorded Investment	Post-TDR Outstanding Recorded Investment
		(dollars in thousands)	
Commercial and agriculture	1	$ 335	$ 135
Construction and development	1	1,109	550
Residential 1-4 family	1	194	231
Farmland	1	217	161
Total TDRs (1)	4	$ 1,855	$ 1,077

	December 31, 2016		
	Number of Loans	Pre-TDR Outstanding Recorded Investment	Post-TDR Outstanding Recorded Investment
		(dollars in thousands)	
Commercial and agriculture	1	$ 335	$ 250
Construction and development	1	1,000	654
Residential 1-4 family	1	192	137
Total TDRs (1)	3	$ 1,527	$ 1,041

(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, 2017 and 2016:

	December 31, 2017		
	Accrual Status	Non-Accrual Status	Total TDRs
		(in thousands)	
Commercial and agriculture	$ 135	$ -	$ 135
Construction and development	-	550	550
Residential 1-4 family	231	-	231
Farmland	-	161	161
Total TDRs	$ 366	$ 711	$ 1,077

	December 31, 2016		
	Accrual Status	Non-Accrual Status	Total TDRs
		(in thousands)	
Commercial and agriculture	$ 250	$ -	$ 250
Construction and development	-	654	654
Residential 1-4 family	137	-	137
Total TDRs	$ 387	$ 654	$ 1,041

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, 2017 and December 31, 2016:

	Net Unrealized Gain (Loss) on Investment Securities	Defined Benefit Plans	Total
		(in thousands)	
Balance, December 31, 2016	$ (502)	$ (189)	$ (691)
Other comprehensive gain (loss) before reclassification	424	(73)	351
Amounts reclassified from AOCI for gain on sale of investment securities included in net income	(5)	-	(5)
Net current period other comprehensive income (loss)	419	(73)	346
Balance, December 31, 2017	$ (83)	$ (262)	$ (345)

	Net Unrealized Gain (Loss) on Investment Securities	Defined Benefit Plans	Total
		(in thousands)	
Balance, December 31, 2015	$ 354	$ (254)	$ 100
Other comprehensive gain before reclassifications	(852)	65	(787)
Amounts reclassified from AOCI for gain on sale of investment securities included in net income	(4)	-	(4)
Net current period other comprehensive income	(856)	65	(791)
Balance, December 31, 2016	$ (502)	$ (189)	$ (691)

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the twelve months ended December 31, 2017 and December 31, 2016:

	Twelve Months Ended December 31,	
	2017	2016
	(in thousands)	
Gain on sales of investments available for sale	$ (9)	$ (6)
Income tax expense	4	2
Unrealized gain on investment securities, net of tax	$ (5)	$ (4)

The following table presents the components of other comprehensive income for the twelve months ended December 31, 2017 and December 31, 2016:

	Twelve Months Ended December 31, 2017		
	Before Tax	Tax Effect	Net of Tax
		(in thousands)	
Net unrealized gains on investment securities:			
Net unrealized gains arising during the period	$ 642	$ 218	$ 424
Less: reclassification adjustments for net gains realized in net income	(9)	(4)	(5)
Net unrealized gains on investment securities	633	214	419
Defined benefit plans:			
Net unrecognized actuarial loss	(158)	(54)	(104)
Amortization of net actuarial gains	47	16	31
Net pension plan liability adjustment	(111)	(38)	(73)
Other comprehensive income	$ 522	$ 176	$ 346

	Twelve Months Ended December 31, 2016		
	Before Tax	Tax Effect	Net of Tax
		(in thousands)	
Net unrealized losses on investment securities:			
Net unrealized losses arising during the period	$ (1,291)	$ (439)	$ (852)
Less: reclassification adjustments for net gains realized in net income	(6)	(2)	(4)
Net unrealized losses on investment securities	(1,297)	(441)	(856)
Defined benefit plans:			
Net unrecognized actuarial loss	(73)	(25)	(48)
Amortization of unrecognized prior service costs and net actuarial gains	171	58	113
Net pension plan liability adjustment	98	33	65
Other comprehensive loss	$ (1,199)	$ (408)	$ (791)

NOTE 6 – PREMISES AND EQUIPMENT

The components of premises and equipment at December 31, 2017 and 2016 were as follows:

	December 31, 2017	December 31, 2016
	(in thousands)	
Land and premises	$ 20,742	$ 18,766
Equipment, furniture and fixtures	9,100	8,518
Construction in progress	236	2,172
	30,078	29,456
Less accumulated deprecation and amortization	(14,202)	(13,130)
Total premises and equipment	$ 15,876	$ 16,326

	December 31, 2017	December 31, 2016
	(in thousands)	
Depreciation expense	$ 1,324	$ 1,213
Rental expense	$ 661	$ 675

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):

2018	$ 596
2019	515
2020	411
2021	88
2022 - 2026	215
	$ 1,825

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

NOTE 7 – OTHER REAL ESTATE OWNED

The following table presents the activity related to OREO for the years ended December 31, 2017 and December 31, 2016:

	December 31, 2017	December 31, 2016
	(in thousands)	
Other real estate owned, beginning of period	$ 405	$ 3,610
Transfers from outstanding loans	-	219
Proceeds from sales	(354)	(3,450)
Net (loss) gain on sales	(51)	97
Impairment charges	-	(71)
Total other real estate owned, end of period	$ -	$ 405

The company had no properties classified as OREO at December 31, 2017 and one commercial real estate owner occupied property classified as OREO at December 31, 2016.

NOTE 8 – DEPOSITS

Time deposits that meet or exceed the FDIC Insurance limit of $250,000 at December 31, 2017 and 2016 were $9.9 million and $18.0 million, respectively.

The composition of deposits at December 31, 2017 and December 31, 2016 was as follows:

	December 31, 2017	December 31, 2016
	(in thousands)	
Interest-bearing demand ("NOW")	$ 190,216	$ 179,209
Money market deposits	142,491	153,570
Savings deposits	89,303	84,146
Time deposits ("CDs")	103,871	129,175
Total interest-bearing deposits	525,881	546,100
Non-interest bearing demand	251,344	233,631
Total deposits	$ 777,225	$ 779,731

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

	Maturities
2018	$ 48,157
2019	33,664
2020	11,000
2021	8,251
2022	2,799
Thereafter	-
Total	$ 103,871

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, 2017	December 31, 2016
	(dollars in thousands)	
Amount outstanding at end of period	$ -	$ -
Average balance during the year	$ 105	$ 5,091
Average interest rate during the year	1.18%	0.53%

Federal Home Loan Bank advances at December 31, 2017 and 2016 represent longer term advances from the Federal Home Loan Bank of Des Moines. Advances at December 31, 2017 bear interest from 2.23% to 2.54% with a weighted average rate of 2.41%. The advances mature in various years as follows (in thousands):

2019	$ 5,150
2020	2,650
2021	150
2022	150
2023	150
2024	253
	$ 8,503

NOTE 10 – JUNIOR SUBORDINATED DEBENTURES

At December 31, 2017, two wholly-owned subsidiary grantor trusts established by the Company had outstanding $13.4 million of Trust Preferred Securities. Trust preferred securities accrue and pay distributions periodically at specified annual rates as provided in the indentures. The trusts used the net proceeds from the offering of trust preferred securities to purchase a like amount of Junior Subordinated Debentures (the "Debentures") of the Company. The Debentures are the sole assets of the trusts. The Company's obligations under the Debentures and the related documents, taken together, constitute a full and unconditional guarantee by the Company of the obligations of the trusts. The trust preferred securities are mandatorily redeemable upon the maturity of the Debentures, or upon earlier redemption as provided in the indentures. The Company has the right to redeem the Debentures in whole or in part, at a redemption price specified in the indentures plus any accrued but unpaid interest to the redemption date.

The Debentures issued by the Company to the grantor trusts totaling $13.0 million are reflected in the consolidated balance sheet in the liabilities section under the caption "junior subordinated debentures." The Company records interest expense on the corresponding junior subordinated debentures in the consolidated statements of income. The Company recorded $403,000 in the consolidated balance sheet at December 31, 2017 and December 31, 2016, respectively, for the common capital securities issued by the issuer trusts.

As of December 31, 2017 and December 31, 2016, regular accrued interest on junior subordinated debentures totaled $63,000 and $54,000, respectively, and is included in accrued expenses and other liabilities on the balance sheet.

The terms of the junior subordinated debentures as of December 31, 2017 are:

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 (1.59% at December 13, 2017) plus 1.45% or 3.04%, 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 (1.40% at October 12, 2017) plus 1.60% or 3.0%, 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, 2017 and 2016. 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, 2017, the Company believes that it is more likely than not that it will be able to fully realize its deferred tax asset and therefore has not recorded a valuation allowance.

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. In December 2017, the federal government enacted the Tax Cuts and Jobs Act of 2017 ("Tax Act"), which among other provisions, reduced the federal marginal corporate income tax rate from 35% to 21%. As a result of the passage of the Tax Act, the Company recorded a $1.0 million charge for the revaluation of its net deferred tax asset to account for the future impact of the decrease in the corporate income tax rate and other provisions of the legislation.

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 did not have any uncertain tax positions as of December 31, 2017.

Income taxes for the years ended December 31, 2017 and December 31, 2016 was as follows:

	December 31,	
	2017	2016
	(in thousands)	
Current	$ 2,590	$ 2,621
Deferred	1,771	(161)
Total income tax expense	$ 4,361	$ 2,460

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 prepaid expenses and other assets in the consolidated financial statements at December 31, 2017 and December 31, 2016 are:

	December 31,	
	2017	2016
Deferred Tax Assets	(in thousands)	
Allowance for loan losses	$ 1,992	$ 3,170
Deferred compensation	42	77
Supplemental executive retirement plan	923	1,352
Unrealized loss on securities available for sale	28	260
OREO write-downs	-	257
Compensation expense	61	239
Other	188	245
Total deferred tax assets	$ 3,234	$ 5,600
Deferred Tax Liabilities		
Depreciation	$ 249	$ 219
Loan fees/costs	1,134	1,457
Prepaid expenses	103	137
FHLB Stock	-	20
Other	72	89
Total deferred tax liabilities	1,558	1,922
Net deferred tax assets	$ 1,676	$ 3,678

The following is a reconciliation between the statutory and effective federal income tax rate for the years ended December 31, 2017 and December 31, 2016:

	December 31,					
		2017			2016	
		Amount	Percent of Pre-tax Income		Amount	Percent of Pre-tax Income
		(dollars in thousands)				
Income tax at statutory rate	$	3,963	35.0%	$	3,167	35.0%
Adjustments resulting from:						
Tax-exempt income		(608)	-5.4%		(488)	-5.4%
Net earnings on life insurance policies		(150)	-1.3%		(195)	-2.2%
Low income housing tax credit		-	0.0%		(18)	0.2%
Deferred tax asset rate revaluation		1,032	9.1%		-	0.2%
Other		124	1.1%		(6)	0.1%
Total income tax expense	$	4,361	38.5%	$	2,460	27.2%

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 $965,000 and $958,000 in 2017 and 2016, 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. During any calendar year, eligible employees may contribute up to an amount of salary compensation as allowed by applicable IRS code. Matching contributions by the Bank are at the discretion of the Board of Directors. Contributions totaled $420,000 and $290,000 for 2017 and 2016, 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 2017 and 2016.

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 $3.9 million and $4.2 million at December 31, 2017 and 2016, respectively. In 2017 and 2016, the net benefit recorded from these plans, including the cost of the related life insurance, was $198,000 and $324,000, 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 $193,000 and $224,000 at December 31, 2017 and 2016, 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 $172,000 and $147,000 for the years ended December 31, 2017 and 2016, respectively.

Supplemental Executive Retirement Plan – Effective January 1, 2007, the Company adopted a non-qualified Supplemental Executive Retirement Plan ("SERP") that provides retirement benefits to its executive officers. The SERP is unsecured and unfunded and there are no plan assets. The post-retirement benefit provided by the SERP is designed to supplement a participating officer's retirement benefits from social security, in order to provide the officer with a certain percentage of final average income at retirement age. The benefit is generally based on average earnings, years of service and age at retirement. At the inception of the SERP, the Company recorded a prior service cost to accumulated other comprehensive income of $704,000. The Company has purchased bank owned life insurance covering all participants in the SERP. The cash surrender value of these policies totaled $6.3 million and $6.2 million at December 31, 2017 and 2016, 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, 2017 and 2016:

	December 31, 2017	December 31, 2016
Net periodic pension cost:	(dollars in thousands)	
Service cost	$ 57	$ 99
Interest cost	110	111
Amortization of prior service cost	-	91
Amortization of net loss	31	23
Net periodic pension cost	$ 198	$ 324
Weighted average assumptions:		
Discount rate	3.74%	3.91%
Rate of compensation increase	n/a	n/a

The following table sets forth the change in benefit obligation at December 31, 2017 and December 31, 2016:

	December 31, 2017	December 31, 2016
Change in benefit obligation:	(in thousands)	
Benefit obligation at the beginning of year	$ 3,049	$ 3,045
Service cost	57	99
Interest cost	110	111
Benefits paid	(150)	(254)
Actuarial loss	104	48
Benefit obligation at end of year	$ 3,170	$ 3,049

Amounts recognized in accumulated other comprehensive income at December 31, 2017 and December 31, 2016 was as follows:

	December 31, 2017	December 31, 2016
	(in thousands)	
Loss	$ 262	$ 189
Prior service cost	-	-
Total recognized in AOCI	$ 262	$ 189

The following table summarizes the projected and accumulated benefit obligations at December 31, 2017 and December 31, 2016:

	December 31, 2017	December 31, 2016
	(in thousands)	
Projected benefit obligation	$ 3,170	$ 3,049
Accumulated benefit obligation	$ 3,170	$ 3,049

Estimated future benefit payments as of December 31, 2017 were as follows (in thousands):

2018	$ 234
2019	234
2020	234
2021	234
2022	234
2023-2027	1,172
	$ 2,342

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, 2017 and December 31, 2016 is as follows:

	December 31,	
	2017	2016
	(in thousands)	
Commitments to extend credit	$ 194,206	$ 181,034
Standby letters of credit	$ 2,213	$ 2,205

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 consolidated financial statements.

At December 31, 2017, the Bank had $8.5 million in outstanding borrowings against its $178.2 million in established borrowing capacity with the FHLB, as compared to $8.7 million outstanding against a borrowing capacity of $170.3 million at December 31, 2016. 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 $49.2 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 shareholders' 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 $9.0 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, 2017	6.5 years	2.07%	23.58%	2.46%	$ 1.82
December 31, 2016	6.5 years	1.50%	22.70%	3.08%	$ 1.13

The following tables summarize the stock option activity for the years ended December 31, 2017 and 2016:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)
Outstanding at December 31, 2015	471,500	$ 7.72	
Granted	16,000	7.14	
Exercised	(1,000)	5.00	
Forfeited	(11,325)	7.07	
Expired	(40,975)	13.77	
Outstanding at December 31, 2016	434,200	$ 7.15	
Granted	17,000	9.41	
Exercised	(109,050)	6.10	
Forfeited	(12,700)	5.85	
Expired	(63,250)	13.77	
Outstanding at December 31, 2017	266,200	$ 6.22	4.63
Vested and expected to vest at December 31, 2017	266,200	$ 6.22	4.63
Exercisable at December 31, 2017	201,300	$ 6.07	3.82

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

	2017	2016
	(in thousands)	
Intrinsic value of options exercised	$ 328	$ 5
Cash received from option exercises	$ 147	$ 5

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 option compensation expense for the years ended December 31, 2017 and 2016:

	Twelve Months Ended December 31, 2017	2016
	(in thousands)	
Compensation Expense	$ 13	$ 24
Tax Effect	4	8
Compensation Expense, net	$ 9	$ 16

As of December 31, 2017, there was $39,000 of total unrecognized compensation cost related to stock options. The cost is expected to be recognized over a weighted-average period of 2.8 years.

Restricted Stock Units

The Company grants restricted stock units ("RSUs") 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 expiration.

The following table summarizes RSU activity during the twelve months ended December 31, 2017 and 2016:

	Shares	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2015	83,430	
Granted	55,825	$ 6.76
Vested	(28,712)	
Forfeited	(11,564)	
Outstanding at December 31, 2016	98,979	
Granted	10,950	$ 9.66
Vested	(30,745)	
Forfeited	(4,585)	
Outstanding at December 31, 2017	74,599	

The following table summarizes RSU compensation expense during the twelve months ended December 31, 2017 and 2016:

	Twelve Months Ended	
	2017	2016
	(in thousands)	
Compensation Expense	$ 248	$ 301
Tax Effect	84	102
Compensation Expense, net	$ 164	$ 199

As of December 31, 2017, there was $92,000 of total unrecognized compensation cost related to nonvested RSUs. The cost is expected to be recognized over a weighted-average period of 1.4 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.

Effective January 1, 2015 (with some changes transitioned into full effectiveness over two to four years), the Bank became subject to new capital adequacy requirements approved by the Federal Reserve and the FDIC that implement the revised standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of the Dodd-Frank Act. Pursuant to minimum capital requirements of the FDIC effective on January 1, 2015, all FDIC-insured financial institutions are required to maintain a minimum common equity Tier 1 risk-based capital to risk-weighted assets ratio of 4.5%, a minimum Tier 1 leverage ratio to average assets of 4.0% and minimum risk-based capital ratios of Tier 1 capital to risk-weighted assets and total capital to risk-weighted assets of 6.0% and 8.0%, respectively.

Although new capital requirements were effective on January 1, 2015, certain provisions of the new rule will be phased-in from the effective date through 2019, including, among others, a new capital conservation buffer requirement, which requires financial institutions to maintain a common equity capital ratio more than 2.5% above the required minimum levels in order to avoid limitations on capital distributions, including dividend payments, and certain discretionary bonus payments based on percentages of eligible retained income that could be utilized for such actions. The new capital conservation buffer requirement began to be phased-in on January 1, 2016 at 0.625% of risk-weighted assets, and will continue to increase by 0.625% on each subsequent January 1, until it

reaches 2.5% on January 1, 2019. At December 31, 2017, the capital conservation buffer was 5.8% and 5.5% for the Company and the Bank, respectively.

As of December 31, 2017 and 2016, 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, 2017 and 2016 are presented in the table below.

	Actual		Minimum Capital Adequacy		Minimum Capital Adequacy With Capital Buffer		To be Well Capitalized Under Prompt Correction Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(dollars in thousands)							
As of December 31, 2017								
Company								
Common equity Tier 1 capital to risk-weighted assets	$ 72,125	9.7%	$ 33,460	4.5%	$ 43,126	5.8%	N/A	N/A
Tier 1 leverage capital to average assets	85,125	9.6%	35,469	4.0%	N/A	N/A	N/A	N/A
Tier 1 capital to risk-weighted assets	85,125	11.5%	44,413	6.0%	54,036	7.3%	N/A	N/A
Total capital to risk-weighted assets	94,216	12.7%	59,349	8.0%	68,993	9.3%	N/A	N/A
Bank								
Common equity Tier 1 capital to risk-weighted assets	84,568	11.4%	31,157	4.2%	40,800	5.5%	$ 48,219	6.5%
Tier 1 leverage capital to average assets	84,568	9.5%	35,608	4.0%	N/A	N/A	44,509	5.0%
Tier 1 capital to risk-weighted assets	84,568	11.4%	44,509	6.0%	54,153	7.3%	59,346	8.0%
Total capital to risk-weighted assets	93,660	12.6%	59,467	8.0%	69,130	9.3%	74,333	10.0%
As of December 31, 2016								
Company								
Common equity Tier 1 capital to risk-weighted assets	$ 67,703	9.5%	$ 32,070	4.5%	$ 36,346	5.1%	N/A	N/A
Tier 1 leverage capital to average assets	80,703	9.3%	34,711	4.0%	N/A	N/A	N/A	N/A
Tier 1 capital to risk-weighted assets	80,703	11.3%	42,851	6.0%	47,136	6.6%	N/A	N/A
Total capital to risk-weighted assets	89,631	12.6%	56,909	8.0%	61,177	8.6%	N/A	N/A
Bank								
Common equity Tier 1 capital to risk-weighted assets	79,964	11.2%	29,987	4.2%	34,270	4.8%	$ 46,408	6.5%
Tier 1 leverage capital to average assets	79,964	9.2%	34,767	4.0%	N/A	N/A	43,459	5.0%
Tier 1 capital to risk-weighted assets	79,964	11.2%	42,838	6.0%	47,122	6.6%	57,117	8.0%
Total capital to risk-weighted assets	88,876	12.5%	56,881	8.0%	61,147	8.6%	71,101	10.0%

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, 2017 or December 31, 2016.

The following table presents the balances of assets measured at fair value on a recurring basis at December 31, 2017 and December 31, 2016.

	At December 31, 2017			
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	$ 39,721	$ -	$ 39,721	$ -
Collateralized mortgage obligations: non agency	256	-	256	-
Mortgage-backed securities: agency issued	16,571	-	16,571	-
U.S. Government agency securities	1,573	1,573	-	-
Municipal securities	51,819	-	50,078	1,741
Other securities	78	78	-	-
Total assets measured at fair value	$ 110,018	$ 1,651	$ 106,626	$ 1,741

Description	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	At December 31, 2016			
Available-for-sale securities:		(in thousands)		
Collateralized mortgage obligations: agency issued	$ 35,515	$ -	$ 35,515	$ -
Collateralized mortgage obligations: non agency	331	-	331	-
Mortgage-backed securities: agency issued	15,199	-	15,199	-
U.S. Government agency securities	7,635	-	7,635	-
State and municipal securities	52,616	-	50,741	1,875
Total assets measured at fair value	$ 111,296	$ -	$ 109,421	$ 1,875

As of December 31, 2017 and December 31, 2016, the Company had four available-for-sale 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, 2017 and 2016, 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 years ended December 31, 2017 and December 31, 2016.

	Twelve Months Ended December 31, 2017	2016
	(in thousands)	
Balance beginning of period	$ 1,875	$ 2,026
Transfers in to level 3	-	-
Change in FV (included in other comprehensive income)	(134)	(151)
Balance end of period	$ 1,741	$ 1,875

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. The following methods were used to estimate the fair value of each such class of financial instrument:

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

Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available and include consideration for variations in location, size, and income production capacity of the property. The income approach commonly utilizes a discount or cap rate to determine the present value of expected future cash flows. Additionally,

the appraisals are periodically further adjusted by the Company in consideration of charges that may be incurred in the event of foreclosure and are based on management's historical knowledge, changes in business factors and changes in market conditions. Such discounts are typically significant, and may range from 10% to 30%.

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

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

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

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

The following tables present the Company's assets that were held at the end of December 31, 2017 and December 31, 2016 that were measured at fair value on a nonrecurring basis:

	At December 31, 2017			
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)			
Loans measured for impairment, net of specific reserves	$ 231	$ -	$ -	$ 231
Total assets measured on a nonrecurring basis	$ 231	$ -	$ -	$ 231

	At December 31, 2016			
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	$ 405	$ -	$ -	$ 405
Loans measured for impairment, net of specific reserves	172	-	-	172
Total assets measured on a nonrecurring basis	$ 577	$ -	$ -	$ 577

The following table presents quantitative information about Level 3 inputs for financial instruments measured at fair value on a nonrecurring basis at December 31, 2017 (dollars in thousands):

Description	Fair Value	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)
Loans measured for impairment, net of specific reserves	$ 231	Income approach	Probability of default, discount rate	4.0%, 4.75%

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, 2017 and December 31, 2016 the stock was stock of the FHLB of Des Moines

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, 2017.

Loans receivable, 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, 2017 and December 31, 2016 was as follows:

	As of December 31, 2017				
	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	$ 34,571	$ 34,571	$ -	$ -	$ 34,571
Interest-bearing certificates of deposit (original maturities greater than 90 days)	994	994	-	-	994
Investment securities available-for-sale	110,018	-	108,277	1,741	110,018
Investment securities held-to-maturity	749	-	353	398	751
Federal Home Loan Bank stock	1,409	N/A	N/A	N/A	N/A
Pacific Coast Bankers Bank stock	1,000	-	1,000	-	1,000
Loans held-for-sale	10,886	-	10,886	-	10,886
Loans receivable, net	678,227	-	-	666,641	666,641
Financial liabilities:					
Deposits	$ 777,225	$ -	$ 778,507	$ -	$ 778,507
Long-term borrowings	8,503	-	8,648	-	8,648
Junior subordinated debentures	13,403	-	-	8,972	8,972

	As of December 31, 2016				
	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	$ 59,298	$ 59,298	$ -	$ -	$ 59,298
Interest-bearing certificates of deposit (original maturities greater than 90 days)	2,231	2,231	-	-	2,231
Investment securities available-for-sale	111,296	-	109,421	1,875	111,296
Investment securities held-to-maturity	859	-	465	398	863
Federal Home Loan Bank stock	1,335	N/A	N/A	N/A	N/A
Pacific Coast Bankers Bank stock	1,000	-	1,000	-	1,000
Loans held-for-sale	6,573	-	6,573	-	6,573
Loans receivable, net	648,611	-	-	638,726	638,726
Financial liabilities:					
Deposits	$ 779,731	$ -	$ 778,705	$ -	$ 778,705
Long-term borrowings	8,653	-	8,723	-	8,723
Junior subordinated debentures	13,403	-	-	8,521	8,521

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,	
	2017	2016
	(dollars in thousands, except per share amounts)	
Basic:		
Net income (numerator)	$ 6,963	$ 6,590
Weighted average shares outstanding (denominator)	10,452,014	10,416,162
Basic earnings per share	$ 0.67	$ 0.63
Diluted:		
Net income (numerator)	$ 6,963	$ 6,590
Weighted average shares outstanding	10,452,014	10,416,162
Effect of dilutive stock options	195,265	172,562
Weighted average shares outstanding assuming dilution (denominator)	10,647,279	10,588,724
Diluted earnings per share	$ 0.65	$ 0.62

	For the Year Ended December 31,	
	2017	2016
Shares subject to outstanding options	2,200	66,550

As of December 31, 2017 and 2016, 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 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)

	December 31, 2017	December 31, 2016
ASSETS		
Cash and cash equivalents:	$ 2,740	$ 2,645
Investment in bank	97,475	92,266
Other assets	905	1,037
Total assets	$ 101,120	$ 95,948
LIABILITIES AND SHAREHOLDERS' EQUITY		
Junior subordinated debentures	$ 13,403	$ 13,403
Dividends payable	2,623	2,398
Other liabilities	63	142
Total liabilities	16,089	15,943
Total shareholders' equity	85,031	80,005
Total liabilities and shareholders' equity	$ 101,120	$ 95,948

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

	Twelve Months Ended December 31,	
	2017	**2016**
INTEREST EXPENSE		
Junior subordinated debentures	$ 373	$ 304
Total interest expense	373	304
NONINTEREST INCOME		
Dividends from subsidiary bank	2,796	2,600
Equity in undistributed income from subsidiary bank	4,863	4,198
Other income	11	9
Total noninterest income	7,670	6,807
NONINTEREST EXPENSE		
Other expense	531	291
Total noninterest income	531	291
Income before income taxes	6,766	6,212
Income tax benefit	197	378
Net income	$ 6,963	$ 6,590

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

	Twelve Months Ended December 31,	
	2017	**2016**
Net Income	$ 6,963	$ 6,590
Change in fair value of securities available for sale	424	(852)
Reclassification adjustment of net loss (gain) from sale of investment securities available for sale included in income	(5)	(4)
Defined benefit plan	(73)	65
Other comprehensive income (loss), net of tax	346	(791)
Comprehensive income	$ 7,309	$ 5,799

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

	Twelve Months Ended December 31,	
	2017	**2016**
Cash flows from operating activities:		
Net Income	$ 6,963	$ 6,590
Adjustments to reconcile net income to cash and cash equivalents from operating activities		
Equity in undistributed income of subsidiary	(4,863)	(4,198)
Net change in other assets	144	(369)
Net change in other liabilities	(79)	(12)
Stock compensation expense	261	325
Net cash provided by operating activities	2,426	2,336
Cash flows from financing activities:		
Net cash from stock option exercises	147	5
Taxes paid related to net share settlement for equity awards	(80)	(11)
Cash dividends paid	(2,398)	(2,287)
Net cash used in financing activities	(2,331)	(2,293)
Net increase in cash and cash equivalents	95	43
Cash and cash equivalents at beginning of year	2,645	2,602
Cash and cash equivalents at end of year	$ 2,740	$ 2,645

NOTE 20 – SELECTED DATA

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

	Year Ended December 31, 2017			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
	(dollars in thousands, except per share amounts)			
Interest and dividend income	$ 8,678	$ 8,988	$ 9,283	$ 9,495
Interest expense	620	588	594	593
Net interest income	8,058	8,400	8,689	8,902
Loan loss provision	122	-	150	-
Noninterest income	2,281	2,955	2,662	2,625
Noninterest expense	8,150	8,649	8,164	8,013
Income before provision for income taxes	2,067	2,706	3,037	3,514
Provision for income taxes	476	845	884	2,156
Net income	$ 1,591	$ 1,861	$ 2,153	$ 1,358
Earnings per common share				
Basic	$ 0.15	$ 0.18	$ 0.21	$ 0.13
Diluted	$ 0.15	$ 0.17	$ 0.20	$ 0.13

	Year Ended December 31, 2016			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(dollars in thousands, except per share amounts)			
Interest and dividend income	$ 8,529	$ 8,394	$ 8,518	$ 8,694
Interest expense	607	628	616	621
Net interest income	7,922	7,766	7,902	8,073
Loan loss provision	262	276	276	184
Noninterest income	2,531	3,026	3,194	2,571
Noninterest expense	8,270	7,982	8,178	8,507
Income before provision for income taxes	1,921	2,534	2,642	1,953
Provision for income taxes	545	773	649	493
Net income	$ 1,376	$ 1,761	$ 1,993	$ 1,460
Earnings per common share				
Basic	$ 0.13	$ 0.17	$ 0.19	$ 0.14
Diluted	$ 0.12	$ 0.17	$ 0.19	$ 0.14

GENERAL CORPORATE AND SHAREHOLDER INFORMATION

Administrative Headquarters
1216 Skyview Drive
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
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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 25, 2018 at 4 p.m. at 1216 Skyview Drive, 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, 1216 Skyview Drive, Aberdeen, Washington 98520. It is also furnished upon request to customers of Bank of the Pacific pursuant to the requirements of the FDIC to provide an annual disclosure statement. This statement has not been reviewed or confirmed for accuracy or relevance by the FDIC.

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Rognlins, Inc

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

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

Randy J. Rust
Private Investor

Dan J. Tupper
Vice President & General Manager
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Susan C. Freese
Pharmacist

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

Edwin W. Ketel
Retired Owner
Oceanside Animal Clinic

Kristi Gundersen
Partner & Chief Financial Officer
Knutzen Farms, LP

John Van Dijk
Retired President & COO
Bank of the Pacific

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Pacific Financial Corporation and Bank of the Pacific

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Treasurer
Executive Vice President & CFO, Bank of the Pacific

Daniel E. Kuenzi
Executive Vice President & CCO, Bank of the Pacific

Edward T. Eng
Executive Vice President & CAO, Bank of the Pacific

Sandra P. Clark
Corporate Secretary

SUBSIDIARIES

Bank of the Pacific
1216 Skyview Drive
Aberdeen, WA 98520
360-533-8870
www.bankofthepacific.com

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Pacific Financial Corporation
1216 Skyview Drive
Aberdeen, WA 98520
360.533.8873
BankofthePacific.com

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