

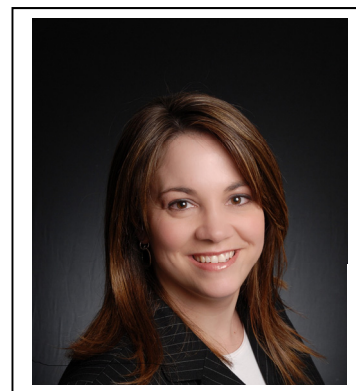


Pacific Financial Corporation

2019

Annual Report

OTCQX: PFLC



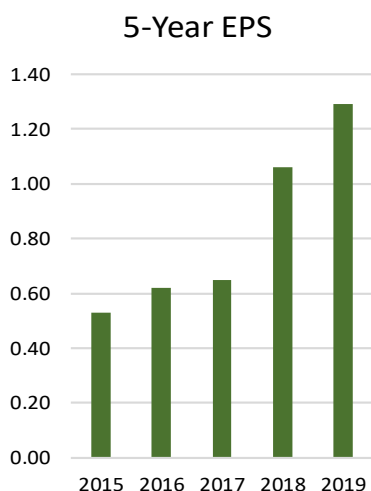
March 27, 2020

Dear Fellow Shareholders:

2019 marked Pacific Financial Corporation's most profitable year in its history, earning \$13.8 million for the year ended December 31, 2019, supported by an above industry average net interest margin of 4.58% for the year, and a 39% growth in noninterest income, which was boosted by increased mortgage lending activity. We also ended the year with total assets of \$929.4 million, a solid diversified loan portfolio of \$685.3 million and an excellent core deposit base of \$798.6 million, with 31% in non-interest bearing deposits.

We are proud of the value Pacific Financial has created for its shareholders in 2019. As we head into 2020, we will continue to drive shareholder value by remaining focused on our key strategies of growing our loan portfolio and deposit base, running a cost-efficient franchise, and enhancing our customers' overall banking experience.

In addition to delivering stellar financial results, 2019 has been an exciting year for PFLC as we continue the momentum of enhancing our visibility in the vibrant Pacific Northwest. In October 2019, we expanded our franchise with the opening of a new commercial banking center in Eugene, Oregon. We have a team of experienced lenders in place who are highly focused on commercial banking along the I-5 corridor in the greater Willamette Valley market. With our depth of talent and broad industry knowledge, rich employee culture and outstanding financial performance, our company is emerging as one of the premier community banks in the Northwest.



During 2019, we also launched the person-to-person payment platform *Zelle*, which allows our customers to send or receive money in a fast, easy and safe manner from people they know and trust with just an email address or mobile phone number within minutes. Expanding our digital capabilities and enhancing access is in line with our ongoing long-term effort to stay current with the emerging world of digital banking and meeting the rapidly changing needs of our customers. In 2020, we will explore instant issue debit cards, on-line account opening, interactive teller machines and a contact center which may allow for extended service hours.

Additionally, implementing a deposit growth strategy in our newer metro markets is a high priority for us in 2020 and beyond. To that end, we are looking to capture new business deposits, and deepen our existing relationships, which in turn will drive strong account and volume growth in our fee income lines of business.

2019 SHAREHOLDERS' LETTER

Significant Milestones and Financial Highlights from 2019:

- Earnings reached another all-time high of \$13.8 million, or \$1.29 per diluted share, for the full year of 2019, an increase of 21% from \$11.3 million, or \$1.06 per diluted share for 2018.
- Noninterest income grew 39% to \$13.9 million for the full year of 2019, compared to \$10.0 million for 2018.
- Net interest margin remained solid at 4.58% for the full year of 2019, compared to 4.52% for 2018.
- Delivered above industry peer profitability metrics with annualized return on average assets of 1.50%, and annualized return on average equity of 13.70%.
- Total assets grew by \$21.5 million to \$929.4 million at year-end 2019; gross loans were \$685.3 million; deposits totaled \$798.6 million, with noninterest-bearing deposits accounting for 31% of total deposits.
- Asset quality remained solid with nonperforming assets to total assets at 0.11% at December 31, 2019. Allowance for loan losses were 1.31% of total loans.
- All capital levels exceeded regulatory requirements for a “well-capitalized” financial institution, ending the year with a total risk-based capital ratio of 14.72%, a Tier 1 risk-based ratio at 13.54% and a leverage ratio at 11.17%.
- As a result of our growing franchise generating solid profitability, in 2019 our shareholders enjoyed a 40% increase in cash dividends on PFLC stock resulting in a premium return for our loyal shareholders. In fact, our recent dividend yield of 3.68% was well above our peer average for SNL MicroCap U. S. Banks.
- The Company transitioned to a quarterly cash dividend, with a half-year cash dividend of \$0.20 per common share paid on August 26, 2019, a third quarter dividend of \$0.11 per common share paid on November 25, 2019, and a fourth quarter dividend of \$0.11 per common share paid on February 26, 2020, for a total of \$0.42 per common share, compared to \$0.30 per share in the prior year.
- The Company authorized a stock repurchase plan of up to \$2.63 million of the outstanding common stock of the Company. We believe our stock is an attractive investment and having the ability to repurchase stock provides a means to build long-term value for our shareholders.
- The Company up-listed to the OTCQX Best Markets during 2019, improving transparency with the goal of increasing liquidity for our investors. U.S. Investors can find current financials and real-time level 2 quotes for the company on www.otcmarkets.com.

We would not have achieved our success without the commitment and dedication of our entire staff at Pacific Financial and the communities we serve. As we head into 2020, we expect some headwinds as a result of the declining interest rate environment and net interest margin pressure; however, we are optimistic about the future of our franchise and look forward to serving our customers. We will continue to execute upon our strategic initiatives that we anticipate benefitting our shareholders, customers, employees and communities. Please join us for our annual Shareholders' meeting on April 29, 2020, at 4:00 p.m. via live webcast.

Sincerely,



Randy Rognlin
Chairman of the Board
Pacific Financial Corporation



Denise Portmann
President and Chief Executive Officer
Pacific Financial Corporation

| | For the Year Ended December 31, | | | | |
|--|---|------------------|-----------------|-----------------|-----------------|
| | 2019 | 2018 | 2017 | 2016 | 2015 |
| | (dollars in thousands, except per share data) | | | | |
| Operations Data | | | | | |
| Interest and dividend income | \$ 41,570 | \$ 40,060 | \$ 36,444 | \$ 34,135 | \$ 31,340 |
| Interest expense | 2,928 | 2,590 | 2,395 | 2,472 | 2,201 |
| Net interest income | 38,642 | 37,470 | 34,049 | 31,663 | 29,139 |
| Provision for loan losses | - | - | 272 | 998 | 582 |
| Noninterest income | 13,895 | 10,031 | 10,523 | 11,225 | 9,671 |
| Noninterest expense | 35,556 | 33,793 | 32,976 | 32,840 | 30,731 |
| Income before income taxes | 16,981 | 13,708 | 11,324 | 9,050 | 7,497 |
| Income tax expense ⁽¹⁾ | 3,223 | 2,378 | 4,361 | 2,460 | 1,921 |
| Net income | \$ 13,758 | \$ 11,330 | \$ 6,963 | \$ 6,590 | \$ 5,576 |
| Net income per share: | | | | | |
| Basic | \$ 1.30 | \$ 1.07 | \$ 0.67 | \$ 0.63 | \$ 0.54 |
| Diluted | \$ 1.29 | \$ 1.06 | \$ 0.65 | \$ 0.62 | \$ 0.53 |
| Dividends declared per share ⁽²⁾ | \$ 0.31 | \$ 0.30 | \$ 0.25 | \$ 0.23 | \$ 0.22 |
| Dividends declared | \$ 3,288 | \$ 3,170 | \$ 2,622 | \$ 2,398 | \$ 2,287 |
| Dividend payout ratio | 24% | 28% | 38% | 36% | 41% |
| Performance Ratios | | | | | |
| Return on average equity | 13.70% | 12.63% | 8.19% | 8.16% | 7.35% |
| Return on average assets | 1.50% | 1.26% | 0.79% | 0.77% | 0.71% |
| Net interest margin ⁽³⁾ | 4.58% | 4.52% | 4.28% | 4.11% | 4.10% |
| Efficiency ratio ⁽⁴⁾ | 67.68% | 71.14% | 74.00% | 76.60% | 79.30% |
| Balance Sheet Data | | | | | |
| Total assets | \$ 929,415 | \$ 907,929 | \$ 894,953 | \$ 891,383 | \$ 824,613 |
| Loans, net | 675,445 | 694,054 | 678,227 | 648,611 | 617,019 |
| Total deposits | 798,638 | 783,549 | 777,225 | 779,731 | 714,499 |
| Total borrowings | 16,606 | 21,756 | 21,906 | 22,056 | 24,706 |
| Shareholders' equity | 105,293 | 92,483 | 85,031 | 80,005 | 76,285 |
| Equity to assets ratio | 11.33% | 10.19% | 9.50% | 8.98% | 9.25% |
| Book value per share ⁽⁵⁾ | \$ 9.90 | \$ 8.75 | \$ 8.10 | \$ 7.67 | \$ 7.34 |
| Tangible book value per share ⁽⁶⁾ | \$ 8.64 | \$ 7.47 | \$ 6.82 | \$ 6.38 | \$ 6.03 |
| Asset Quality Ratios | | | | | |
| Allowance for loan losses to total loans | 1.31% | 1.29% | 1.32% | 1.39% | 1.33% |
| Allowance for loan losses to nonperforming loans | 873.96% | 838.65% | 420.00% | 748.00% | 548.00% |
| Nonperforming loans to total loans | 0.15% | 0.15% | 0.31% | 0.19% | 0.24% |
| Nonperforming assets to total assets | 0.11% | 0.12% | 0.25% | 0.20% | 0.62% |

⁽¹⁾ 2017 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⁾ In 2019, the Company transitioned to a quarterly cash dividend. The fourth quarter dividend of \$0.11 per common share paid on February 26, 2020. This fourth quarter dividend is not included in the 2019 dividend declared number, as it was not declared until January 2020.

⁽³⁾ Net interest income divided by average earning assets

⁽⁴⁾ Noninterest expense divided by the sum of net interest income and noninterest income

⁽⁵⁾ Shareholder equity divided by shares outstanding

⁽⁶⁾ Shareholder equity less intangibles divided by shares outstanding



INDEPENDENT AUDITORS' REPORT

Board of Directors
Pacific Financial Corporation
Aberdeen, Washington

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Pacific Financial Corporation and its subsidiary, Bank of the Pacific, (the Company), which comprise the consolidated statement of financial condition as of December 31, 2019, and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated 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.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit 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 auditors' 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 Company'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 Company'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.

Board of Directors
Pacific Financial Corporation

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, 2019, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Other Matters

The 2018 consolidated financial statements were audited by other auditors, whose report dated March 21, 2019, expressed an unmodified opinion on those statements.

CliftonLarsonAllen LLP

CliftonLarsonAllen LLP

Bellevue, Washington
March 18, 2020

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

| | December 31, 2019 | December 31, 2018 |
|--|----------------------|----------------------|
| ASSETS | | |
| Cash on hand and in banks | \$ 12,264 | \$ 15,899 |
| Interest bearing deposits | 24,458 | 6,289 |
| Federal Funds Sold | 41,210 | - |
| Cash and cash equivalents | 77,932 | 22,188 |
| Other interest earning deposits | 3,250 | 3,250 |
| Investment securities available for sale, at fair value | 102,159 | 121,383 |
| Investment securities held to maturity (fair value of \$1,056 and \$1,227, respectively) | 1,056 | 1,227 |
| Loans held for sale | 10,108 | 6,204 |
| Loans, net of deferred fees | 684,439 | 703,103 |
| Allowance for loan losses | (8,993) | (9,049) |
| Total loans, net | 675,446 | 694,054 |
| Nonmarketable equity securities | 2,217 | 2,407 |
| Premises and equipment, net | 14,799 | 15,376 |
| Operating lease right-of-use assets | 1,294 | - |
| Cash surrender value of life insurance | 20,807 | 20,218 |
| Goodwill | 12,168 | 12,168 |
| Other intangible assets, net | 1,301 | 1,321 |
| Accrued interest receivable | 3,074 | 3,321 |
| Prepaid expenses and other assets | 3,803 | 4,812 |
| Total assets | \$ 929,414 | \$ 907,929 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits | \$ 798,638 | \$ 783,549 |
| Federal Home Loan Bank advances | 3,203 | 8,353 |
| Junior subordinated debentures | 13,403 | 13,403 |
| Operating lease liabilities | 1,301 | - |
| Accrued expenses and other liabilities | 7,576 | 10,141 |
| Total liabilities | 824,121 | 815,446 |
| Shareholders' Equity: | | |
| Preferred Stock, no par value; 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2019 and December 31, 2018 | - | - |
| Common Stock, \$1 par value; 25,000,000 shares authorized, 10,632,058 and 10,568,720 shares issued and outstanding at December 31, 2019 and 2018, respectively | 10,632 | 10,569 |
| Additional paid-in-capital | 43,735 | 43,635 |
| Retained earnings | 49,723 | 39,253 |
| Accumulated other comprehensive income (loss), net | 1,203 | (974) |
| Total shareholders' equity | 105,293 | 92,483 |
| Total liabilities and shareholders' equity | \$ 929,414 | \$ 907,929 |

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, | |
| | 2019 | 2018 |
| INTEREST AND DIVIDEND INCOME | | |
| Interest and fees on loans | \$ 37,835 | \$ 36,769 |
| Taxable interest on investment securities | 1,861 | 1,413 |
| Nontaxable interest on investment securities | 947 | 1,210 |
| Interest and dividends on other interest earning assets | 927 | 668 |
| Total interest and dividend income | 41,570 | 40,060 |
| INTEREST EXPENSE | | |
| Deposits | 2,267 | 1,873 |
| Junior subordinated debentures | 540 | 505 |
| Federal Home Loan Bank advances | 121 | 212 |
| Total interest expense | 2,928 | 2,590 |
| Net interest income | 38,642 | 37,470 |
| Provision for loan losses | - | - |
| Net interest income after loan loss provision | 38,642 | 37,470 |
| NONINTEREST INCOME | | |
| Service charges on deposits | 2,055 | 2,034 |
| Gain on sale of loans, net | 7,204 | 4,103 |
| Gain on sale of investment securities, net | 102 | - |
| Earnings on bank owned life insurance | 667 | 432 |
| Other income | 3,867 | 3,462 |
| Total noninterest income | 13,895 | 10,031 |
| NONINTEREST EXPENSE | | |
| Compensation and employee benefits | 22,553 | 21,100 |
| Occupancy | 2,125 | 2,207 |
| Equipment | 1,009 | 1,087 |
| Data processing | 2,912 | 2,862 |
| Professional services | 1,436 | 756 |
| Marketing | 690 | 662 |
| Other real estate owned, net | - | 6 |
| State and local taxes | 515 | 360 |
| Federal deposit insurance premium | 103 | 365 |
| Other expense | 4,213 | 4,388 |
| Total noninterest expense | 35,556 | 33,793 |
| Income before income taxes | 16,981 | 13,708 |
| Income tax expense | 3,223 | 2,378 |
| Net income | \$ 13,758 | \$ 11,330 |
| Basic earnings per common share | \$ 1.30 | \$ 1.07 |
| Diluted earnings per common share | \$ 1.29 | \$ 1.06 |

See accompanying Notes to Consolidated Financial Statements.

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

| | Twelve Months Ended | |
|---|----------------------------|------------------|
| | December 31, | |
| | 2019 | 2018 |
| Net Income | \$ 13,758 | \$ 11,330 |
| Other comprehensive income (loss), net of tax: | | |
| Securities available for sale, net of tax | 2,437 | (816) |
| Defined benefit plans, net of tax | <u>(260)</u> | <u>187</u> |
| Total other comprehensive income (loss), net of tax | <u>2,177</u> | <u>(629)</u> |
| Comprehensive income | <u>\$ 15,935</u> | <u>\$ 10,701</u> |

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 (Loss) Income, net | Total Shareholders' Equity |
|--|-------------------------------|-----------------|----------------------------------|----------------------|--|----------------------------------|
| Balance at December 31, 2017 | 10,491,892 | \$ 10,492 | \$ 43,806 | \$ 31,078 | \$ (345) | \$ 85,031 |
| Net income | - | - | - | 11,330 | - | 11,330 |
| Other comprehensive income (loss), net of tax | - | - | - | 15 | (629) | (614) |
| Restricted stock awards issued, net of forfeitures | 46,681 | 47 | (290) | - | - | (243) |
| Restricted stock compensation expense | - | - | 99 | - | - | 99 |
| Stock option compensation expense | - | - | 20 | - | - | 20 |
| Exercise of stock options | 30,147 | 30 | - | - | - | 30 |
| Cash dividends declared (\$0.30 per share) | - | - | - | (3,170) | - | (3,170) |
| Balance at December 31, 2018 | 10,568,720 | \$ 10,569 | \$ 43,635 | \$ 39,253 | \$ (974) | \$ 92,483 |
| Net income | - | - | - | 13,758 | - | 13,758 |
| Other comprehensive income, net of tax | - | - | - | - | 2,177 | 2,177 |
| Restricted stock awards issued, net of forfeitures | 6,312 | 6 | (25) | - | - | (19) |
| Restricted stock compensation expense | - | - | 77 | - | - | 77 |
| Stock option compensation expense | - | - | 13 | - | - | 13 |
| Exercise of stock options | 57,026 | 57 | 35 | - | - | 92 |
| Cash dividends declared (\$0.31 per share) | - | - | - | (3,288) | - | (3,288) |
| Balance at December 31, 2019 | 10,632,058 | \$ 10,632 | \$ 43,735 | \$ 49,723 | \$ 1,203 | \$ 105,293 |

See accompanying Notes to Consolidated Financial Statements.

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

| | Twelve Months Ended | |
|--|---------------------|------------------|
| | December 31, | |
| | 2019 | 2018 |
| Cash flows from operating activities: | | |
| Net Income | \$ 13,758 | \$ 11,330 |
| Adjustments to reconcile net income to net cash on hand and in banks from operating activities | | |
| Provision for loan losses | - | - |
| Depreciation and amortization | 2,075 | 2,968 |
| Deferred income taxes | 316 | 283 |
| Originations of loans held for sale | (295,983) | (164,962) |
| Proceeds from sales of loans | 298,070 | 172,683 |
| Gain on sale of loans, net | (7,204) | (4,103) |
| Gain on sale of securities available for sale, net | (102) | - |
| Loss on sale of premises and equipment | - | 30 |
| Earnings on bank owned life insurance | (667) | (432) |
| Net change in in accrued interest receivable | 247 | (260) |
| Increase in accrued interest payable | 9 | 17 |
| Net change in prepaid expenses | 61 | (147) |
| Other operating activities | 666 | (1,434) |
| Net cash provided by operating activities | 11,246 | 15,973 |
| Cash flows from investing activities: | | |
| Loans originated, net of principal payments | 19,985 | (14,811) |
| Net increase in certificates of deposits held for investment | - | (2,256) |
| Maturities of investment securities held to maturity | 171 | 402 |
| Maturities and paydowns of investment securities available for sale | 25,142 | 14,113 |
| Purchase of investment securities available for sale | (30,387) | (28,494) |
| Purchases of nonmarketable equity securities | (640) | (1,974) |
| Purchase of bank owned life insurance | (1,480) | - |
| Purchases of premises and equipment | (1,373) | (1,091) |
| Proceeds from sales of investment securities available for sale | 26,810 | - |
| Proceeds from sales of nonmarketable equity securities | 830 | 1,976 |
| Proceeds from bank owned life insurance death benefit | 1,558 | - |
| Proceeds from sales of premises and equipment | 338 | - |
| Proceeds from sales of other real estate owned | - | 150 |
| Net cash provided by (used in) investing activities | 40,954 | (31,985) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 15,089 | 6,324 |
| Repayments of FHLB Advances | (5,150) | (150) |
| Net cash from stock option exercises | 194 | 13 |
| Taxes related to net share settlement for equity awards | (131) | 64 |
| Cash dividends paid | (6,458) | (2,622) |
| Net cash provided by financing activities | 3,544 | 3,629 |
| Net increase (decrease) in cash and cash equivalents | 55,744 | (12,383) |
| Cash and cash equivalents at beginning of year | 22,188 | 34,571 |
| Cash and cash equivalents at end of year | \$ 77,932 | \$ 22,188 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for interest | \$ 2,919 | \$ 2,573 |
| Cash paid for taxes | \$ 1,780 | \$ 2,590 |
| Supplemental non-cash disclosures of cash flow information: | | |
| Other real estate owned acquired in settlement of loans | \$ - | \$ 150 |
| Initial recognition of operating lease right-of-use assets | \$ 2,013 | \$ - |
| Initial recognition of operating lease liability | \$ (2,013) | \$ - |
| Transfer of loans held for sale to loans held for investment | \$ 1,213 | \$ 1,064 |
| Transfer from securities available for sale to securities held to maturity | \$ - | \$ 880 |

See accompanying Notes to Consolidated Financial Statements.

Pacific Financial Corporation and Subsidiary
Notes to Consolidated Financial Statements
For the Years Ended December 31, 2019 and December 31, 2018

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 fourteen branches located in communities in Grays Harbor, Pacific, Whatcom, Clark, Skagit and Wahkiakum counties in the state of Washington and two branches in Clatsop County, Oregon. In addition, the Bank operates three loan production offices in Burlington, Washington and Salem and Eugene, 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 2019 presentation. These reclassifications did not change previously reported net income or stockholders’ equity.

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, the identification of impaired loans, the fair value of available for sale investment securities and the identification of deferred tax assets.

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

Subsequent events – Subsequent to year end, the World Health Organization declared the spread of Coronavirus Disease (COVID-19) a worldwide pandemic. The COVID-19 pandemic is having significant effects on global markets, supply chains, businesses, and communities. Specific to the Company, COVID-19 may impact various parts of its 2020 operations and financial results including but not limited to additional loan loss reserves, costs for emergency preparedness, or potential shortages of personnel. The Company believes it is taking appropriate actions to mitigate the negative impact. However, the full impact of COVID-19 is unknown and cannot be reasonably estimated as these events occurred subsequent to year end and are still developing.

During the period from January 1, 2020 through March 18, 2020, both domestic and international equity markets have experienced significant declines. These losses are not reflected in the financial statements as of and for the year ended December 31, 2019 as these events occurred subsequent to year end and are still developing.

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.

Nonmarketable equity securities – The Company’s investment in Federal Home Loan Bank (“FHLB”) stock is carried at cost and cash and stock dividends are recorded as income. The Company’s investment in Pacific Coast Bankers Bank (“PCBB”) stock is carried at cost, less impairment and plus or minus observable prices, if any, and cash and stock dividends are recorded as income. Nonmarketable equity securities are periodically evaluated for impairment based on ultimate recovery of par value.

The Company is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding mortgages, total assets, or FHLB advances. At December 31, 2019 and December 31, 2018 the stock was that of FHLB of Des Moines.

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.

Operating lease right-of-use assets –The Company's leases are classified as operating leases, and therefore, were previously not recognized on the Company's consolidated financial statements. With the adoption of *FASB ASU 2016-02, Leases (Topic 842)*, operating lease agreements are required to be recognized on the consolidated financial statements as a right-of-use ("ROU") asset and a corresponding lease liability. The Company elected not to include short-term leases (i.e., leases with initial terms of twelve months or less), or equipment leases (deemed immaterial) on the consolidated financial statements.

The calculated amount of the ROU assets and lease liabilities are impacted by the length of the lease term and the discount rates used to calculate the present value the minimum lease payments. For the discount rate the Company utilizes its incremental borrowing rate at lease inception over a similar term. For operating leases existing prior to January 1, 2019, the rate for the remaining lease term as of January 1, 2019 was used.

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.

Bank-owned life insurance – Bank owned life insurance is carried at the amount due upon surrender of the policy, which is also the estimated fair value. This amount was provided by the insurance companies based on the terms of the underlying insurance contract.

Off-balance-sheet credit related financial instruments – In the ordinary course of business, the Company has entered into commitments to extend credit, including commitments under credit arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded. The Company maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance-sheet commitments is included in accrued expenses and other liabilities.

Goodwill and other intangible assets – At December 31, 2019 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 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. Prior to 2019, the analysis of potential impairment of goodwill was a two-step process. The first step was a comparison of the reporting unit's fair value to its carrying value. If the reporting unit's fair value was 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. In 2019, the Company elected to early adopt *FASB ASU 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The guidance removed Step 2 of the goodwill

impairment test. Goodwill will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. All other goodwill impairment guidance remained largely unchanged.

For the years ended December 31, 2019 and December 31, 2018, the Company's goodwill impairment evaluation, based on its qualitative assessment, indicated there was no impairment. 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 \$34,000 and \$53,000 at December 31, 2019 and 2018, respectively. Amortization expense related to core deposit intangible totaled \$19,000 and \$35,000 during the years ended December 31, 2019 and 2018, respectively.

In 2006, the Bank completed a deposit transfer and assumption transaction with an Oregon-based bank for a \$1.3 million premium. In connection with completion of the transaction, the Oregon Department of Consumer and Business Services issued a Certificate of Authority to the Bank authorizing it to conduct a banking business in the State of Oregon. The premium, and the resultant right to conduct business in Oregon, is recorded as an indefinite-lived intangible asset.

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

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

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

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

As of December 31, 2019, 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, 2019. The tax years that remain subject to examination by federal and state taxing authorities are the years ended December 31, 2018, 2017 and 2016.

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 182,243 and 113,994 in 2019 and 2018, 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, 2019 and 2018.

Revenue Recognition – The Company recognizes revenue as it is earned based on contractual terms, as transactions occur, or as services are provided and collectability is reasonably assured. The principal source of revenue is interest income from loans and investments. The Company also earns non-interest income from various banking services offered to its customers. Gain on sales of loans, investment securities, earnings on bank-owned life insurance, and other income are not within the scope of ASU 606. The Company’s revenue from contracts with customers within the scope of ASU 606 is recognized in non-interest income. Certain specific policies related to those in scope with revenue streams income include the following:

Service Charges on Deposit Accounts – The Company earns fees from its deposit customers by providing contractual transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as ATM use fees, stop payment charges, statement rendering, and ACH fees, are recognized at the time the transaction is executed at the point in time the company fulfills the customer’s request for product or service. Fees, which relate primarily to deposit account maintenance, are earned over the course of a month, representing the period over which the company satisfies its performance obligation. Fees for performing that service are then assessed at the close of the statement period. Overdraft fees are recognized at the point in time that the overdraft is created by the payment of a check against a deposit account in which there are not sufficient funds to pay that item. Service charges on deposits are collected directly from the customer’s account balance per the terms of the contract with the depositor.

Interchange and Other Fees – The Company earns interchange fees from debit or credit cardholder transactions, from cards issued by the company to its customers or processed for non-customers, conducted through various card payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. Other service charges include revenue from processing wire transfers, bill pay service, cashier’s checks, and other services. The Company’s performance obligation for interchange and other service charges are largely satisfied, and related revenue recognized, when completion of the services are rendered at a point in time.

The following table presents the Company’s noninterest income by revenue stream and reportable segment for the years ended December 31, 2019 and December 31, 2018. Items outside the scope of ASC 606 are noted as such.

| | Twelve Months Ended | |
|--|----------------------------|------------------|
| | December 31, | |
| | 2019 | 2018 |
| | (in thousands) | |
| Services charges on deposits | \$ 2,055 | \$ 2,034 |
| Gain on sale of loans, net ⁽¹⁾ | 7,204 | 4,103 |
| Gain on sales of investment securities, net ⁽¹⁾ | 102 | - |
| Earnings on bank owned life insurance ⁽¹⁾ | 667 | 432 |
| Interchange and Other fees | 3,641 | 3,331 |
| Other ⁽¹⁾ | 226 | 131 |
| Total noninterest income | <u>\$ 13,895</u> | <u>\$ 10,031</u> |

⁽¹⁾ Not within the scope of ASC 606

Recent accounting pronouncements – adopted

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 overall effect of the adoption of ASU No. 2014-09 as of January 1, 2018 did not have a material impact on the Company's consolidated financial statements, as described in significant accounting policies.

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 as of January 1, 2018 did not have a material impact on the Company's 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. The Company adopted the provisions of this standard retrospectively during the year 2019, recorded a right-of-use asset and corresponding lease liability, and made relevant disclosures in Footnote 7.

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 adoption of ASU No. 2016-15 as of January 1, 2018 did not have a material impact on the Company's 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. The early adoption of ASU No. 2017-04 as of January 1, 2019 did not have a material impact on the Company's consolidated financial statements.

FASB ASU 2017-07, Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost was issued in March 2017 to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost in the income statement, and to narrow the amounts eligible for capitalization in assets. The updated is effective for reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of ASU No. 2017-07 as of January 1, 2018 did not have a material impact on the Company's consolidated financial statements.

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 adoption of ASU No. 2017-08 as of January 1, 2018 did not have a material impact on the Company's 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 adoption of ASU No. 2017-09 as of January 1, 2018 did not have a material impact on the Company's 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 adoption of ASU No. 2018-02 as of January 1, 2019 did not have a material impact on the Company's consolidated financial statements.

Recent accounting pronouncements – not yet effective

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. In October 2019, the FASB voted to approve amendments to the effective date of ASU No. 2016-13 for smaller reporting companies, as defined by the SEC, and other non-SEC reporting entities. The amendment delays the effective date for the Company until interim and annual periods beginning after December 15, 2022. 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 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement was issued in August 2018 and modifies the disclosure requirements on fair value measurements in Topic 820. The amendments in this Update are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company does not expect the Update will have a material impact on its Consolidated Financial Statements.

FASB ASU 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments, was issued in April 2019 and affects a variety of topics in the Codification and applies to all reporting entities within the scope of the affected accounting guidance. This update is not expected to have a significant impact on the Company's consolidated financial statements.

FASB ASU 2019-05, Financial Instruments – Credit Losses (Topic 326): Targeted Transition Relief, was issued in May 2019 to provide entities with an option to irrevocably elect the fair value option applied on an instrument-by-instrument basis for eligible instruments. This guidance is effective for fiscal years, and interim periods within those fiscal years beginning after December 15, 2019. This update is not expected to have a significant impact on the Company's consolidated financial statements.

FASB ASU 2019-12, Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes, was issued in December 2019, which simplifies the accounting for income taxes by removing certain exceptions to the general principles in Topic 740. The amendments also improve consistent application of and simplify GAAP for the areas of Topic 740 by clarifying and amending existing guidance. This guidance is effective for fiscal years, and interim periods within those fiscal years beginning after December 15, 2020. Early adoption of the amendments is permitted, including adoption in any interim period for which financial statements have not yet been issued. Depending on the amendment, adoption may be applied on the retrospective, modified retrospective, or prospective basis. The Company is currently reviewing the provisions of this new pronouncement, but does not expect adoption of this guidance to have a material impact on the Company's consolidated financial statements.

NOTE 2 – RESTRICTED ASSETS

Federal Reserve Board regulations require that the Bank maintain certain minimum reserve balances in cash on hand and on deposit with the Federal Reserve Bank, based on a percentage of deposits. The required reserve balance at December 31, 2019 and 2018 was met by holding cash.

NOTE 3 – INVESTMENT SECURITIES AND NONMARKETABLE INVESTMENT SECURITIES

Investment 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, 2019 | | | | |
|---------------------------------------|---------------------------|---------------------------------------|--|-----------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| (in thousands) | | | | |
| Available for Sale | | | | |
| Collateralized mortgage obligations | \$ 44,665 | \$ 628 | \$ 152 | \$ 45,141 |
| Mortgage backed securities | 18,795 | 362 | 27 | 19,130 |
| Municipal securities | 34,720 | 1,277 | 113 | 35,884 |
| Corporate debt securities | 2,003 | 2 | 1 | 2,004 |
| Total available for sale | <u>\$ 100,183</u> | <u>\$ 2,269</u> | <u>\$ 293</u> | <u>\$ 102,159</u> |
| Held to maturity | | | | |
| Mortgage backed securities | \$ 15 | \$ - | \$ - | \$ 15 |
| Municipal securities | 1,041 | - | - | 1,041 |
| Total held to maturity | <u>\$ 1,056</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 1,056</u> |
| December 31, 2018 | | | | |
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| (in thousands) | | | | |
| Available for Sale | | | | |
| Collateralized mortgage obligations | \$ 41,004 | \$ 111 | \$ 691 | \$ 40,424 |
| Mortgage backed securities | 23,169 | 95 | 259 | 22,945 |
| U.S. Government and agency securities | 3,577 | - | 28 | 3,549 |
| Municipal securities | 53,785 | 413 | 752 | 53,446 |
| Corporate debt securities | 1,000 | - | 41 | 959 |
| Total available for sale | <u>\$ 122,535</u> | <u>\$ 619</u> | <u>\$ 1,771</u> | <u>\$ 121,383</u> |
| Held to maturity | | | | |
| Mortgage backed securities | \$ 24 | \$ 1 | \$ - | \$ 25 |
| Municipal securities | 1,202 | - | - | 1,202 |
| Total held to maturity | <u>\$ 1,226</u> | <u>\$ 1</u> | <u>\$ -</u> | <u>\$ 1,227</u> |

Unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in continuous unrealized loss position, as of December 31, 2019 and December 31, 2018, were as follows:

| | December 31, 2019 | | | | | |
|-------------------------------------|----------------------------|--------------------------|--------------------------|--------------------------|-------------------|--------------------------|
| | 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 | \$ 6,598 | \$ 45 | \$ 10,466 | \$ 107 | \$ 17,064 | \$ 152 |
| Mortgage backed securities | 691 | 1 | 2,883 | 26 | 3,574 | 27 |
| Municipal securities | 6,158 | 113 | - | - | 6,158 | 113 |
| Corporate debt securities | 1,000 | 1 | - | - | 1,000 | 1 |
| Total | <u>\$ 14,447</u> | <u>\$ 160</u> | <u>\$ 13,349</u> | <u>\$ 133</u> | <u>\$ 27,796</u> | <u>\$ 293</u> |

| | December 31, 2018 | | | | | |
|-------------------------------------|----------------------------|--------------------------|--------------------------|--------------------------|-------------------|--------------------------|
| | 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 | \$ 1,650 | \$ 9 | \$ 29,035 | \$ 682 | \$ 30,685 | \$ 691 |
| Mortgage backed securities | 6,537 | 32 | 10,183 | 227 | 16,720 | 259 |
| U.S. Government agency securities | 1,985 | 2 | 1,564 | 26 | 3,549 | 28 |
| Municipal securities | 6,840 | 37 | 25,303 | 715 | 32,143 | 752 |
| Corporate debt securities | 960 | 41 | - | - | 960 | 41 |
| Total | <u>\$ 17,972</u> | <u>\$ 121</u> | <u>\$ 66,085</u> | <u>\$ 1,650</u> | <u>\$ 84,057</u> | <u>\$ 1,771</u> |

At December 31, 2019, there were 57 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, 2019.

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, 2019 and 2018, 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, 2019 and 2018.

Proceeds from sales of securities available-for-sale were \$26.8 million and \$0 for the years ended December 31, 2019 and December 31, 2018, 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, | |
| | 2019 | 2018 |
| | (in thousands) | |
| Gross realized gain on sale of securities | \$ 284 | \$ - |
| Gross realized loss on sale of securities | <u>182</u> | <u>-</u> |
| Net realized gain on sale of securities | <u>\$ 102</u> | <u>\$ -</u> |

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, 2019, by maturity were as follows:

| | December 31, 2019 | | | |
|--|--------------------------|-------------------|---------------------------|-------------------|
| | Held to Maturity | | Available for Sale | |
| | Amortized | | Amortized | |
| | Cost | Fair Value | Cost | Fair Value |
| | (in thousands) | | | |
| Due in one year or less | \$ - | \$ - | \$ 5,981 | \$ 6,014 |
| Due after one year through five years | 15 | 15 | 6,851 | 6,872 |
| Due after five years through ten years | 1,041 | 1,041 | 30,611 | 31,503 |
| Due after ten years | - | - | 51,077 | 52,086 |
| Declining balance securities | - | - | 5,663 | 5,684 |
| Total investment securities | <u>\$ 1,056</u> | <u>\$ 1,056</u> | <u>\$ 100,183</u> | <u>\$ 102,159</u> |

At December 31, 2019 and December 31, 2018, investment securities with an estimated fair value of \$75.1 million and \$67.3 million were pledged to secure public deposits, certain nonpublic deposits and borrowings, respectively.

Nonmarketable investment securities

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, 2019 and December 31, 2018, the Company held \$1.2 million and \$1.4 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. 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, 2019 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, 2019 and December 31, 2018, were as follows:

| | <u>December 31,</u> | |
|--|---------------------|-------------------|
| | <u>2019</u> | <u>2018</u> |
| | (in thousands) | |
| Commercial and agricultural | \$ 132,167 | \$ 140,167 |
| Real estate: | | |
| Construction and development | 45,227 | 47,291 |
| Residential 1-4 family | 85,711 | 89,091 |
| Multi-family | 29,865 | 30,948 |
| Commercial real estate -- owner occupied | 147,049 | 142,761 |
| Commercial real estate -- non owner occupied | 153,866 | 152,017 |
| Farmland | <u>32,370</u> | <u>28,876</u> |
| Total real estate | <u>494,088</u> | <u>490,984</u> |
| Consumer | <u>59,014</u> | <u>72,946</u> |
| Gross loans | 685,269 | 704,097 |
| Deferred fees | <u>(830)</u> | <u>(994)</u> |
| Loans, net | <u>\$ 684,439</u> | <u>\$ 703,103</u> |

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

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

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

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

The Company originates single-family residential construction loans for custom homes where the home buyer is the borrower. It has also provided financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. The Company endeavors to limit construction lending risks through adherence to specific

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

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

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, 2019 and December 31, 2018 were as follows:

| | Twelve Months Ended December 31, 2019 | | | | |
|--|--|--------------------|-------------------|--------------------------------------|-----------------------------------|
| | Balance at Beginning of Year | Charge-offs | Recoveries | Provision for Loan Losses | Balance at End of Year |
| | (in thousands) | | | | |
| Commercial and agricultural | \$ 1,847 | \$ (30) | \$ 56 | \$ (391) | \$ 1,482 |
| Real estate: | | | | | |
| Residential 1-4, Multi family, Const & Dev | 983 | - | 34 | 42 | 1,059 |
| Commercial real estate -- owner occupied | 926 | - | - | (10) | 916 |
| Commercial real estate -- non owner occupied | 1,311 | - | - | (55) | 1,256 |
| Farmland | 680 | - | - | 362 | 1,042 |
| Total real estate | 3,900 | - | 34 | 339 | 4,273 |
| Consumer | 1,986 | (139) | 23 | (149) | 1,721 |
| Unallocated | 1,316 | - | - | 201 | 1,517 |
| Total | <u>\$ 9,049</u> | <u>\$ (169)</u> | <u>\$ 113</u> | <u>\$ -</u> | <u>\$ 8,993</u> |

| | Twelve Months Ended December 31, 2018 | | | | |
|--|--|--------------------|-------------------|--------------------------------------|-----------------------------------|
| | Balance at Beginning of Year | Charge-offs | Recoveries | Provision for Loan Losses | Balance at End of Year |
| | (in thousands) | | | | |
| Commercial and agricultural | \$ 1,758 | \$ (4) | \$ 77 | \$ 16 | \$ 1,847 |
| Real estate: | | | | | |
| Residential 1-4, Multi family, Const & Dev | 1,292 | - | - | (309) | 983 |
| Commercial real estate -- owner occupied | 1,211 | - | - | (285) | 926 |
| Commercial real estate -- non owner occupied | 1,197 | - | - | 114 | 1,311 |
| Farmland | 636 | - | - | 44 | 680 |
| Total real estate | 4,336 | - | - | (436) | 3,900 |
| Consumer | 1,907 | (177) | 61 | 195 | 1,986 |
| Unallocated | 1,091 | - | - | 225 | 1,316 |
| Total | <u>\$ 9,092</u> | <u>\$ (181)</u> | <u>\$ 138</u> | <u>\$ -</u> | <u>\$ 9,049</u> |

The allowance for loan losses disaggregated on the basis of the Company's impairment method as of December 31, 2019 and December 31, 2018 were as follows:

| | Twelve Months Ended December 31, 2019 | | |
|--|--|---------------------|------------------|
| | Loans | Loans | Total |
| | Individually | Collectively | |
| | Evaluated | Evaluated | Allowance |
| | for | for | for Loan |
| | Impairment | Impairment | Losses |
| | (in thousands) | | |
| Commercial and agricultural | \$ 7 | \$ 1,475 | \$ 1,482 |
| Real estate: | | | |
| Residential 1-4, Multi family, Const & Dev | - | 1,059 | 1,059 |
| Commercial real estate -- owner occupied | - | 916 | 916 |
| Commercial real estate -- non owner occupied | - | 1,256 | 1,256 |
| Farmland | - | 1,042 | 1,042 |
| Total real estate | - | 4,273 | 4,273 |
| Consumer | - | 1,721 | 1,721 |
| Unallocated | - | 1,517 | 1,517 |
| Total | <u>\$ 7</u> | <u>\$ 8,986</u> | <u>\$ 8,993</u> |

| | Twelve Months Ended December 31, 2018 | | |
|--|--|---------------------|------------------|
| | Loans | Loans | Total |
| | Individually | Collectively | |
| | Evaluated | Evaluated | Allowance |
| | for | for | for Loan |
| | Impairment | Impairment | Losses |
| | (in thousands) | | |
| Commercial and agricultural | \$ 4 | \$ 1,843 | \$ 1,847 |
| Real estate: | | | |
| Residential 1-4, Multi family, Const & Dev | - | 983 | 983 |
| Commercial real estate -- owner occupied | - | 926 | 926 |
| Commercial real estate -- non owner occupied | - | 1,311 | 1,311 |
| Farmland | - | 680 | 680 |
| Total real estate | - | 3,900 | 3,900 |
| Consumer | - | 1,986 | 1,986 |
| Unallocated | - | 1,316 | 1,316 |
| Total | <u>\$ 4</u> | <u>\$ 9,045</u> | <u>\$ 9,049</u> |

The recorded investment of loans disaggregated on the basis of the Company's impairment method as of December 31, 2019 and December 31, 2018 were as follows:

| | Twelve Months Ended December 31, 2019 | | |
|--|--|--|--------------------|
| | Loans Individually Evaluated for Impairment | Loans Collectively Evaluated for Impairment | Gross Loans |
| | (in thousands) | | |
| Commercial and agricultural | \$ 516 | \$ 131,651 | \$ 132,167 |
| Real estate: | | | |
| Residential 1-4, Multi family, Const & Dev | 826 | 159,977 | 160,803 |
| Commercial real estate -- owner occupied | - | 147,049 | 147,049 |
| Commercial real estate -- non owner occupied | - | 153,866 | 153,866 |
| Farmland | - | 32,370 | 32,370 |
| Total real estate | <u>826</u> | <u>493,262</u> | <u>494,088</u> |
| Consumer | <u>7</u> | <u>59,007</u> | <u>59,014</u> |
| Total | <u>\$ 1,349</u> | <u>\$ 683,920</u> | <u>\$ 685,269</u> |

| | Twelve Months Ended December 31, 2018 | | |
|--|--|--|--------------------|
| | Loans Individually Evaluated for Impairment | Loans Collectively Evaluated for Impairment | Gross Loans |
| | (in thousands) | | |
| Commercial and agricultural | \$ 211 | \$ 139,956 | \$ 140,167 |
| Real estate: | | | |
| Residential 1-4, Multi family, Const & Dev | 413 | 166,917 | 167,330 |
| Commercial real estate -- owner occupied | - | 142,761 | 142,761 |
| Commercial real estate -- non owner occupied | - | 152,017 | 152,017 |
| Farmland | 21 | 28,855 | 28,876 |
| Total real estate | <u>434</u> | <u>490,550</u> | <u>490,984</u> |
| Consumer | <u>399</u> | <u>72,547</u> | <u>72,946</u> |
| Total | <u>\$ 1,044</u> | <u>\$ 703,053</u> | <u>\$ 704,097</u> |

Credit Quality Indicators

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

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

The Bank also classifies some loans as "Pass" or Other Loans Especially Mentioned ("OLEM"). Within the "Pass" classification certain loans are "Watch" rated because they have elements of risk that require more monitoring than other performing loans. "Pass" grade loans include a range of loans from very high credit quality to acceptable credit quality. These borrowers generally have strong to

acceptable capital levels and consistent earnings and debt service capacity. Loans with higher grades within the “Pass” category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Overall, loans with a “Pass” grade show no immediate loss exposure. Loans classified as OLEM continue to perform but have shown deterioration in credit quality and require close monitoring.

Credit quality indicators as of December 31, 2019 and December 31, 2018 were as follows:

| December 31, 2019 | | | | | |
|--|--------------------|---------------------------------|--------------------|-----------------|--------------|
| | Other Loans | | | | Total |
| | Pass | Especially Mentioned | Substandard | Doubtful | |
| (in thousands) | | | | | |
| Commercial and agricultural | \$ 125,052 | \$ 5,285 | \$ 1,830 | \$ - | \$ 132,167 |
| Real estate: | | | | | |
| Construction and development | 44,990 | - | 237 | - | 45,227 |
| Residential 1-4 family | 83,534 | 66 | 2,111 | - | 85,711 |
| Multi-family | 29,865 | - | - | - | 29,865 |
| Commercial real estate -- owner occupied | 144,863 | 1,012 | 1,174 | - | 147,049 |
| Commercial real estate -- non owner occupied | 151,951 | - | 1,915 | - | 153,866 |
| Farmland | 24,661 | 3,460 | 4,249 | - | 32,370 |
| Total real estate | 479,864 | 4,538 | 9,686 | - | 494,088 |
| Consumer | 58,968 | 4 | 42 | - | 59,014 |
| Gross Loans | 663,884 | 9,827 | 11,558 | - | 685,269 |
| Deferred fees | (830) | - | - | - | (830) |
| Loans, net | \$ 663,054 | \$ 9,827 | \$ 11,558 | \$ - | \$ 684,439 |

| December 31, 2018 | | | | | |
|--|--------------------|---------------------------------|--------------------|-----------------|--------------|
| | Other Loans | | | | Total |
| | Pass | Especially Mentioned | Substandard | Doubtful | |
| (in thousands) | | | | | |
| Commercial and agricultural | \$ 132,874 | \$ 5,180 | \$ 2,113 | \$ - | \$ 140,167 |
| Real estate: | | | | | |
| Construction and development | 47,291 | - | - | - | 47,291 |
| Residential 1-4 family | 87,221 | 978 | 892 | - | 89,091 |
| Multi-family | 30,560 | - | 388 | - | 30,948 |
| Commercial real estate -- owner occupied | 139,379 | 1,510 | 1,872 | - | 142,761 |
| Commercial real estate -- non owner occupied | 150,998 | 768 | 251 | - | 152,017 |
| Farmland | 25,756 | 1,479 | 1,641 | - | 28,876 |
| Total real estate | 481,205 | 4,735 | 5,044 | - | 490,984 |
| Consumer | 72,534 | 13 | 399 | - | 72,946 |
| Gross Loans | 686,613 | 9,928 | 7,556 | - | 704,097 |
| Deferred fees | (994) | - | - | - | (994) |
| Loans, net | \$ 685,619 | \$ 9,928 | \$ 7,556 | \$ - | \$ 703,103 |

Impaired Loans

Impaired loans by type as of December 31, 2019 and 2018, and interest income recognized for the twelve months ended December 31, 2019 and 2018, were as follows:

December 31, 2019

| | 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 | \$ 325 | \$ 191 | \$ 516 | \$ 516 | \$ 7 | \$ 531 | \$ - |
| Real Estate: | | | | | | | |
| Residential 1-4, Multi family, Const & Dev | 826 | - | 826 | 918 | - | 933 | - |
| Commercial real estate -- owner occupied | - | - | - | - | - | - | - |
| Commercial real estate -- non owner occupied | - | - | - | - | - | - | - |
| Farmland | - | - | - | - | - | - | - |
| Total real estate | 826 | - | 826 | 918 | - | 933 | - |
| Consumer | 7 | - | 7 | 7 | - | 7 | - |
| Total | \$ 1,158 | \$ 191 | \$ 1,349 | \$ 1,441 | \$ 7 | \$ 1,471 | \$ - |

December 31, 2018

| | 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 | \$ - | \$ 211 | \$ 211 | \$ 211 | \$ 4 | \$ 221 | \$ - |
| Real Estate: | | | | | | | |
| Residential 1-4, Multi family, Const & Dev | 413 | - | 413 | 482 | - | 491 | - |
| Commercial real estate -- owner occupied | - | - | - | - | - | - | - |
| Commercial real estate -- non owner occupied | - | - | - | - | - | - | - |
| Farmland | 21 | - | 21 | 91 | - | 188 | - |
| Total real estate | 434 | - | 434 | 573 | - | 679 | - |
| Consumer | 399 | - | 399 | 399 | - | 399 | - |
| Total | \$ 833 | \$ 211 | \$ 1,044 | \$ 1,183 | \$ 4 | \$ 1,299 | \$ - |

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 2019 and 2018. Total related party loans outstanding at December 31, 2019 and 2018 to executive officers and directors were \$2.8 million and \$4.7 million, respectively. During 2019 and 2018, new loans of \$2.0 million and \$2.0 million, respectively, were made, and repayments totaled \$3.9 million and \$940,000 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, 2019.

Aging Analysis

The following tables summarize the Company's loans past due, both accruing and nonaccruing, by type as of December 31, 2019 and December 31, 2018:

| December 31, 2019 | | | | | | | |
|--|------------------------|------------------------|----------------------------|-------------------|----------------------|-----------------------|----------------|
| | 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 Real estate: | \$ 377 | \$ - | \$ - | \$ 377 | \$ 325 | \$ 131,465 | \$ 132,167 |
| Construction and development | 122 | - | - | 122 | 237 | 44,868 | 45,227 |
| Residential 1-4 family | 58 | 238 | - | 296 | 460 | 84,955 | 85,711 |
| Multi-family | - | - | - | - | - | 29,865 | 29,865 |
| Commercial real estate -- owner occupied | - | - | - | - | - | 147,049 | 147,049 |
| Commercial real estate -- non owner occupied | 244 | - | - | 244 | - | 153,622 | 153,866 |
| Farmland | - | - | - | - | - | 32,370 | 32,370 |
| Total real estate | 424 | 238 | - | 662 | 697 | 492,729 | 494,088 |
| Consumer | 64 | 3 | - | 67 | 7 | 58,940 | 59,014 |
| Deferred fees | - | - | - | - | - | (830) | (830) |
| Total | \$ 865 | \$ 241 | \$ - | \$ 1,106 | \$ 1,029 | \$ 682,304 | \$ 684,439 |

| December 31, 2018 | | | | | | | |
|--|------------------------|------------------------|----------------------------|-------------------|----------------------|-----------------------|----------------|
| | 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 Real estate: | \$ 675 | \$ - | \$ - | \$ 675 | \$ - | \$ 139,492 | \$ 140,167 |
| Construction and development | 239 | - | - | 239 | - | 47,052 | 47,291 |
| Residential 1-4 family | 203 | 48 | - | 251 | 281 | 88,559 | 89,091 |
| Multi-family | - | - | - | - | - | 30,948 | 30,948 |
| Commercial real estate -- owner occupied | 1,099 | - | - | 1,099 | - | 141,662 | 142,761 |
| Commercial real estate -- non owner occupied | - | - | - | - | - | 152,017 | 152,017 |
| Farmland | - | - | - | - | 21 | 28,855 | 28,876 |
| Total real estate | 1,541 | 48 | - | 1,589 | 302 | 489,093 | 490,984 |
| Consumer | 146 | 88 | - | 234 | 399 | 72,313 | 72,946 |
| Deferred fees | - | - | - | - | - | (994) | (994) |
| Total | \$ 2,362 | \$ 136 | \$ - | \$ 2,498 | \$ 701 | \$ 699,904 | \$ 703,103 |

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, 2019, 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, 2019.

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, 2019 and 2018, all of which were modified due to financial stress of the borrower. There were not any subsequent defaulted TDRs as of December 31, 2019 and 2018. There were no loans modified or recorded as TDRs during the years ended December 31, 2019 and 2018.

The following tables summarize the Company's TDRs by type as of December 31, 2019 and December 31, 2018:

| | December 31, 2019 | | |
|----------------------------|----------------------------|--|---|
| | Number of Loans | Pre-TDR Outstanding Recorded Investment | Post-TDR Outstanding Recorded Investment |
| | | (dollars in thousands) | |
| | | \$ | \$ |
| Commercial and agriculture | 1 | \$ 335 | \$ 191 |
| Residential 1-4 family | 1 | 194 | 129 |
| Total TDRs ⁽¹⁾ | <u>2</u> | <u>\$ 529</u> | <u>\$ 320</u> |

| | December 31, 2018 | | |
|----------------------------|----------------------------|--|---|
| | Number of Loans | Pre-TDR Outstanding Recorded Investment | Post-TDR Outstanding Recorded Investment |
| | | (dollars in thousands) | |
| | | \$ | \$ |
| Commercial and agriculture | 1 | \$ 335 | \$ 211 |
| Residential 1-4 family | 1 | 194 | 132 |
| Farmland | 1 | 217 | 21 |
| Total TDRs ⁽¹⁾ | <u>3</u> | <u>\$ 746</u> | <u>\$ 364</u> |

⁽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, 2019 and 2018:

| December 31, 2019 | | | |
|----------------------------|---------------------------|-------------------------------|-------------------|
| | Accrual Status | Non-Accrual Status | Total TDRs |
| | (in thousands) | | |
| Commercial and agriculture | \$ 191 | \$ - | \$ 191 |
| Residential 1-4 family | 129 | - | 129 |
| Total TDRs | <u>\$ 320</u> | <u>\$ -</u> | <u>\$ 320</u> |

| December 31, 2018 | | | |
|----------------------------|---------------------------|-------------------------------|-------------------|
| | Accrual Status | Non-Accrual Status | Total TDRs |
| | (in thousands) | | |
| Commercial and agriculture | \$ 211 | \$ - | \$ 211 |
| Residential 1-4 family | 132 | - | 132 |
| Farmland | - | 21 | 21 |
| Total TDRs | <u>\$ 343</u> | <u>\$ 21</u> | <u>\$ 364</u> |

NOTE 5 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table presents the changes in each component of accumulated other comprehensive income (loss), net of tax, for the twelve months ended December 31, 2019 and December 31, 2018:

| | Investment Securities | Defined Benefit Plans | Total |
|--|----------------------------------|--------------------------------------|-----------------|
| | (in thousands) | | |
| Balance, December 31, 2018 | \$ (899) | \$ (75) | \$ (974) |
| Change in fair value of investment securities available for sale | 2,498 | - | 2,498 |
| Reclassification adjustment of net loss from sale of investment securities available for sale included in income, net of tax | (61) | - | (61) |
| Unrecognized net actuarial loss during the period, net of tax | - | (268) | (268) |
| Amortization of net actuarial gain and prior service cost included in income | - | 8 | 8 |
| Net current period other comprehensive income (loss) | <u>2,437</u> | <u>(260)</u> | <u>2,177</u> |
| Balance, December 31, 2019 | <u>\$ 1,538</u> | <u>\$ (335)</u> | <u>\$ 1,203</u> |

| | Investment Securities | Defined Benefit Plans | Total |
|--|----------------------------------|--------------------------------------|-----------------|
| | (in thousands) | | |
| Balance, December 31, 2017 | \$ (83) | \$ (262) | \$ (345) |
| Change in fair value of investment securities available for sale | (816) | - | (816) |
| Reclassification adjustment of net loss from sale of investment securities available for sale included in income, net of tax | - | - | - |
| Unrecognized net actuarial gain during the period, net of tax | - | 161 | 161 |
| Amortization of net actuarial gain and prior service cost included in income | - | 26 | 26 |
| Net current period other comprehensive (loss) income | <u>(816)</u> | <u>187</u> | <u>(629)</u> |
| Balance, December 31, 2018 | <u>\$ (899)</u> | <u>\$ (75)</u> | <u>\$ (974)</u> |

The following table presents the components of other comprehensive income for the twelve months ended December 31, 2019 and December 31, 2018:

| | Twelve Months Ended December 31, 2019 | | |
|---|--|-------------------|-------------------|
| | Before Tax | Tax Effect | Net of Tax |
| Net unrealized gains on investment securities: | | (in thousands) | |
| Net unrealized gains arising during the period | \$ 3,162 | \$ 664 | \$ 2,498 |
| Less: reclassification adjustments for net gains realized in net income | (102) | (41) | (61) |
| Net unrealized gains on investment securities | <u>3,060</u> | <u>623</u> | <u>2,437</u> |
| Defined benefit plans: | | | |
| Net unrecognized actuarial loss | (339) | (71) | (268) |
| Amortization of net actuarial gains | <u>10</u> | <u>2</u> | <u>8</u> |
| Net pension plan liability adjustment | <u>(329)</u> | <u>(69)</u> | <u>(260)</u> |
| Other comprehensive income | <u>\$ 2,731</u> | <u>\$ 554</u> | <u>\$ 2,177</u> |

| | Twelve Months Ended December 31, 2018 | | |
|--|--|-------------------|-------------------|
| | Before Tax | Tax Effect | Net of Tax |
| Net unrealized losses on investment securities: | | (in thousands) | |
| Net unrealized losses arising during the period | \$ (1,033) | \$ (217) | \$ (816) |
| Less: reclassification adjustments for net gains realized in net income | - | - | - |
| Net unrealized losses on investment securities | <u>(1,033)</u> | <u>(217)</u> | <u>(816)</u> |
| Defined benefit plans: | | | |
| Net unrecognized actuarial loss | 204 | 43 | 161 |
| Amortization of unrecognized prior service costs and net actuarial gains | <u>33</u> | <u>7</u> | <u>26</u> |
| Net pension plan liability adjustment | <u>237</u> | <u>50</u> | <u>187</u> |
| Other comprehensive loss | <u>\$ (796)</u> | <u>\$ (167)</u> | <u>\$ (629)</u> |

NOTE 6 – PREMISES AND EQUIPMENT

The components of premises and equipment at December 31, 2019 and 2018 were as follows:

| | December 31, | |
|--|---------------------|------------------|
| | 2019 | 2018 |
| | (in thousands) | |
| Land and premises | \$ 19,714 | \$ 20,679 |
| Equipment, furniture and fixtures | 9,835 | 9,304 |
| Construction in progress | <u>632</u> | <u>525</u> |
| | 30,181 | 30,508 |
| Less accumulated depreciation and amortization | <u>(15,382)</u> | <u>(15,132)</u> |
| Total premises and equipment | <u>\$ 14,799</u> | <u>\$ 15,376</u> |

Depreciation expense was \$1.1 million and \$1.3 million for the years ending December 31, 2019 and December 31, 2018, respectively.

NOTE 7 – OPERATING LEASE RIGHT-OF-USE ASSET

Future minimum payments for operating leases with initial or remaining terms of one year or more as of December 31, 2019 are as follows:

| | December 31, |
|-------------------------------------|---------------------|
| | 2019 |
| | (in thousands) |
| 2020 | \$ 637 |
| 2021 | 260 |
| 2022 | 156 |
| 2023 | 159 |
| Thereafter | 177 |
| Total future minimum lease payments | \$ 1,389 |
| Amounts representing interest | (88) |
| Total operating lease liabilities | \$ <u>1,301</u> |

At December 31, 2019 the weighted-average remaining lease term was 3.5 years and the weighted-average discount rate was 2.92%. Operating lease cost, interest on lease liabilities and amortization of ROU assets was \$799,000 for the year ending December 31, 2019.

NOTE 8 – OTHER REAL ESTATE OWNED

The following table presents the activity related to OREO for the years ended December 31, 2019 and December 31, 2018:

| | December 31, | |
|--|---------------------|-------------|
| | 2019 | 2018 |
| | (in thousands) | |
| Other real estate owned, beginning of period | \$ - | \$ - |
| Transfers from outstanding loans | - | 150 |
| Proceeds from sales | - | (150) |
| Net (loss) gain on sales | - | - |
| Impairment charges | - | - |
| Total other real estate owned, end of period | \$ <u>-</u> | \$ <u>-</u> |

The company had no properties classified as OREO at December 31, 2019 and December 31, 2018.

NOTE 9 – DEPOSITS

Time deposits that meet or exceed the FDIC Insurance limit of \$250,000 at December 31, 2019 and 2018 were \$17.1 million and \$12.4 million, respectively.

The composition of deposits at December 31, 2019 and December 31, 2018 was as follows:

| | <u>December 31,</u> | |
|---------------------------------|---------------------|-------------------|
| | <u>2019</u> | <u>2018</u> |
| | (in thousands) | |
| Interest-bearing demand ("NOW") | \$ 228,579 | \$ 191,530 |
| Money market deposits | 149,510 | 162,238 |
| Savings deposits | 104,871 | 101,408 |
| Time deposits ("CDs") | <u>70,668</u> | <u>86,188</u> |
| Total interest-bearing deposits | 553,628 | 541,364 |
| Non-interest bearing demand | <u>245,010</u> | <u>242,185</u> |
| Total deposits | <u>\$ 798,638</u> | <u>\$ 783,549</u> |

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

| | <u>Maturities</u> |
|------------|-------------------|
| 2020 | \$ 48,361 |
| 2021 | 11,101 |
| 2022 | 3,593 |
| 2023 | 3,462 |
| 2024 | 4,131 |
| Thereafter | <u>20</u> |
| Total | <u>\$ 70,668</u> |

NOTE 10 – 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:

| | <u>December 31,</u> | |
|---------------------------------------|------------------------|-------------|
| | <u>2019</u> | <u>2018</u> |
| | (dollars in thousands) | |
| Amount outstanding at end of period | \$ - | \$ - |
| Average balance during the year | \$ 115 | \$ 415 |
| Average interest rate during the year | 2.77% | 2.05% |

Federal Home Loan Bank advances at December 31, 2019 and 2018 represent longer term advances from the Federal Home Loan Bank of Des Moines. Advances at December 31, 2019 bear interest from 2.23% to 2.54% with a weighted average rate of 2.42%. The advances mature in various years as follows (in thousands):

| | <u>Maturities</u> |
|-------|-------------------|
| 2020 | \$ 2,650 |
| 2021 | 150 |
| 2022 | 150 |
| 2023 | 150 |
| 2024 | <u>103</u> |
| Total | <u>\$ 3,203</u> |

NOTE 11 – JUNIOR SUBORDINATED DEBENTURES

At December 31, 2019, 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, 2019 and December 31, 2018, respectively, for the common capital securities issued by the issuer trusts.

As of December 31, 2019 and December 31, 2018, regular accrued interest on junior subordinated debentures totaled \$78,000 and \$86,000, respectively, and is included in accrued expenses and other liabilities on the consolidated balance sheet.

The terms of the junior subordinated debentures as of December 31, 2019 and December 31, 2018 are:

| <u>Trust Name</u> | <u>Issue Date</u> | <u>Issued Amount</u> | <u>Rate</u> | <u>Maturity Date</u> |
|--|-------------------|------------------------|------------------------------|----------------------|
| | | (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 |
| | | <u>\$ 13,000</u> | | |

⁽¹⁾ Pacific Financial Corporation Statutory Trust I securities incurred interest at the fixed rate of 6.39% until mid March 2011, at which the rate changed to a variable rate of 3-month LIBOR (1.92% at December 13, 2019 and 2.78% at December 31, 2019) plus 1.45%, 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 (1.92% at December 31, 2019 and 2.78% at December 31, 2018) plus 1.60%, adjusted quarterly, through the final maturity date in July 2036.

NOTE 12 – INCOME TAXES

The Company recorded an income tax provision for the twelve months ended December 31, 2019 and 2018. 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, 2019, 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.

The Company applies the provisions of 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, 2019.

Income taxes for the years ended December 31, 2019 and December 31, 2018 was as follows:

| | December 31, | |
|--------------------------|---------------------|-----------------|
| | 2019 | 2018 |
| | (in thousands) | |
| Current | \$ 2,907 | \$ 2,095 |
| Deferred | 316 | 283 |
| Total income tax expense | <u>\$ 3,223</u> | <u>\$ 2,378</u> |

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities and net deferred tax assets are recorded in prepaid expenses and other assets in the consolidated financial statements at December 31, 2019 and December 31, 2018 are:

| | December 31, | |
|--|---------------------|-----------------|
| | 2019 | 2018 |
| | (in thousands) | |
| Deferred Tax Assets | | |
| Allowance for loan losses | \$ 1,991 | \$ 2,003 |
| Deferred compensation | 17 | 19 |
| Supplemental executive retirement plan | 887 | 874 |
| Unrealized loss on securities available for sale | - | 256 |
| Compensation expense | 26 | 27 |
| Other | 269 | 182 |
| Total deferred tax assets | <u>\$ 3,190</u> | <u>\$ 3,361</u> |
| Deferred Tax Liabilities | | |
| Depreciation | \$ 410 | \$ 231 |
| Loan fees/costs | 1,438 | 1,311 |
| Unrealized gain on securities available for sale | 367 | - |
| Prepaid expenses | 143 | 130 |
| Other | 151 | 69 |
| Total deferred tax liabilities | <u>2,509</u> | <u>1,741</u> |
| Net deferred tax assets | <u>\$ 681</u> | <u>\$ 1,620</u> |

The following is a reconciliation between the statutory and effective federal income tax rate for the years ended December 31, 2019 and December 31, 2018:

| | December 31, | | | |
|--|------------------------|---------------------------------|-----------------|---------------------------------|
| | 2019 | | 2018 | |
| | Amount | Percent of Pre-tax Income | Amount | Percent of Pre-tax Income |
| | (dollars in thousands) | | | |
| Income tax at statutory rate | \$ 3,566 | 21.0% | \$ 2,879 | 21.0% |
| Adjustments resulting from: | | | | |
| State income taxes, net of federal benefit | 120 | 0.7% | 120 | 0.9% |
| Tax-exempt income | (275) | -1.6% | (380) | -2.8% |
| Net earnings on life insurance policies | (121) | -0.7% | (90) | -0.7% |
| Other | (67) | -0.4% | (151) | -1.1% |
| Total income tax expense | <u>\$ 3,223</u> | <u>19.0%</u> | <u>\$ 2,378</u> | <u>17.3%</u> |

NOTE 13 – 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 \$1.2 million and \$1.3 million in 2019 and 2018, respectively.

401(k) Plans – The Bank has established a 401(k) 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 \$658,000 and \$537,000 for 2019 and 2018, 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 2019 and 2018.

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 \$2.9 million and \$4.0 million at December 31, 2019 and 2018, respectively. In 2019 and 2018, the net benefit recorded from these plans, including the cost of the related life insurance, was \$164,000 and \$174,000, 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 \$76,000 and \$87,000 at December 31, 2019 and 2018, 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 \$87,000 and \$96,000 for the years ended December 31, 2019 and 2018, 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 key 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 \$7.8 million at December 31, 2019 and \$6.3 million at 2018.

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, 2019 and 2018:

| | December 31, | |
|------------------------------------|------------------------|---------------|
| | 2019 | 2018 |
| Net periodic pension cost: | (dollars in thousands) | |
| Service cost | \$ 43 | \$ 46 |
| Interest cost | 112 | 102 |
| Amortization of prior service cost | - | - |
| Amortization of net loss | 8 | 26 |
| Net periodic pension cost | <u>\$ 163</u> | <u>\$ 174</u> |
| Weighted average assumptions: | | |
| Discount rate | 4.01% | 3.33% |
| Rate of compensation increase | n/a | n/a |

The following table sets forth the change in benefit obligation at December 31, 2019 and December 31, 2018:

| | December 31, | |
|---|---------------------|-----------------|
| | 2019 | 2018 |
| Change in benefit obligation: | (in thousands) | |
| Benefit obligation at the beginning of year | \$ 2,923 | \$ 3,170 |
| Service cost | 43 | 46 |
| Interest cost | 112 | 102 |
| Benefits paid | (234) | (234) |
| Actuarial loss (gain) | 268 | (161) |
| Benefit obligation at end of year | <u>\$ 3,112</u> | <u>\$ 2,923</u> |

Amounts recognized in accumulated other comprehensive income at December 31, 2019 and December 31, 2018 was as follows:

| | December 31, | |
|--------------------------|---------------------|--------------|
| | 2019 | 2018 |
| | (in thousands) | |
| Loss | \$ 335 | \$ 75 |
| Prior service cost | - | - |
| Total recognized in AOCI | <u>\$ 335</u> | <u>\$ 75</u> |

The following table summarizes the projected and accumulated benefit obligations at December 31, 2019 and December 31, 2018:

| | December 31, | |
|--------------------------------|---------------------|-------------|
| | 2019 | 2018 |
| | (in thousands) | |
| Projected benefit obligation | \$ 3,112 | \$ 2,923 |
| Accumulated benefit obligation | \$ 3,112 | \$ 2,923 |

Estimated future benefit payments as of December 31, 2019 were as follows (in thousands):

| | |
|-----------|-----------------|
| 2020 | \$ 234 |
| 2021 | 234 |
| 2022 | 234 |
| 2023 | 234 |
| 2024 | 234 |
| 2025-2029 | <u>1,360</u> |
| Total | <u>\$ 2,530</u> |

NOTE 14 – COMMITMENTS AND CONTINGENCIES

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

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, 2019 and December 31, 2018 is as follows:

| | <u>December 31,</u> | |
|------------------------------|---------------------|-------------|
| | <u>2019</u> | <u>2018</u> |
| | (in thousands) | |
| Commitments to extend credit | \$ 186,397 | \$ 186,445 |
| Standby letters of credit | \$ 1,090 | \$ 1,131 |

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, 2019, the Bank had \$3.2 million in outstanding borrowings against its \$181.0 million in established borrowing capacity with the FHLB, as compared to \$8.4 million outstanding against a borrowing capacity of \$178.2 million at December 31, 2018. 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 \$53.0 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 15 – 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 \$12.0 million.

NOTE 16 – 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, 2019 | 6.5 years | 1.81% | 12.44% | 3.10% | \$ 0.95 |
| December 31, 2018 | 6.5 years | 2.80% | 23.70% | 2.19% | \$ 2.50 |

The following tables summarize the stock option activity for the years ended December 31, 2019 and 2018:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in Years) |
|---|----------------|---------------------------------|--|
| Outstanding at December 31, 2017 | 268,700 | \$ 6.23 | |
| Granted | 17,500 | 11.42 | |
| Exercised | (30,147) | 6.56 | |
| Forfeited or canceled | (58,953) | 6.42 | |
| Expired | (1,650) | 11.27 | |
| Outstanding at December 31, 2018 | 195,450 | \$ 6.60 | |
| Granted | 140,000 | 12.58 | |
| Exercised | (101,500) | 5.87 | |
| Forfeited or canceled | (13,000) | 11.10 | |
| Expired | - | - | |
| Outstanding at December 31, 2019 | <u>220,950</u> | <u>\$ 10.49</u> | <u>7.60</u> |
| Vested and exercisable at December 31, 2019 | <u>57,600</u> | <u>\$ 5.90</u> | <u>4.04</u> |

The following table summarizes nonvested stock option activity for the years ended December 31, 2019 and 2018:

| | Shares | Weighted Average Grant Date Fair Value |
|--|-----------------|---|
| Nonvested Outstanding at December 31, 2017 | 70,400 | \$ 1.05 |
| Granted | 17,500 | 2.41 |
| Vested | (36,700) | 0.78 |
| Forfeited | <u>(2,500)</u> | <u>1.54</u> |
| Nonvested Outstanding at December 31, 2018 | 48,700 | \$ 1.85 |
| Granted | 140,000 | 0.95 |
| Vested | (13,350) | 1.32 |
| Forfeited | <u>(12,000)</u> | <u>2.39</u> |
| Nonvested Outstanding at December 31, 2019 | <u>163,350</u> | <u>\$ 1.08</u> |

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

| | <u>2019</u> | <u>2018</u> |
|--------------------------------------|----------------|-------------|
| | (in thousands) | |
| Intrinsic value of options exercised | \$ 544 | \$ 157 |
| Cash received from option exercises | \$ 194 | \$ 13 |

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, 2019 and 2018:

| | Twelve Months Ended December 31, | |
|---------------------------|---|--------------|
| | <u>2019</u> | <u>2018</u> |
| | (in thousands) | |
| Compensation Expense | \$ 13 | \$ 20 |
| Tax Effect | <u>3</u> | <u>4</u> |
| Compensation Expense, net | <u>\$ 10</u> | <u>\$ 16</u> |

As of December 31, 2019, there was \$167,000 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, 2019 and 2018:

| | <u>Shares</u> | <u>Weighted Average Grant Date Fair Value</u> |
|----------------------------------|-----------------|---|
| Outstanding at December 31, 2017 | 73,567 | |
| Granted | 13,141 | \$ 10.98 |
| Vested | (46,681) | |
| Forfeited | <u>(16,372)</u> | |
| Outstanding at December 31, 2018 | 23,655 | |
| Granted | 7,100 | \$ 11.28 |
| Vested | (8,721) | |
| Forfeited | <u>(2,500)</u> | |
| Outstanding at December 31, 2019 | <u>19,534</u> | |

The following table summarizes RSU compensation expense during the twelve months ended December 31, 2019 and 2018:

| | <u>Twelve Months Ended</u> | |
|---------------------------|----------------------------|--------------|
| | <u>2019</u> | <u>2018</u> |
| | (in thousands) | |
| Compensation Expense | \$ 77 | \$ 99 |
| Tax Effect | <u>16</u> | <u>21</u> |
| Compensation Expense, net | <u>\$ 61</u> | <u>\$ 78</u> |

As of December 31, 2019, there was \$103,000 of total unrecognized compensation cost related to nonvested RSUs. The cost is expected to be recognized over a weighted-average period of 1.5 years.

NOTE 17 – REGULATORY MATTERS

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

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 were 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 increased by 0.625% on each subsequent January 1, until it reached 2.5% on January 1, 2019.

As of December 31, 2019 and 2018, 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, 2019 and 2018 are presented in the table below.

| | <u>Actual</u> | | <u>Minimum Requirements</u> | | <u>Well-Capitalized Requirements</u> | |
|--|---------------|--------------|-----------------------------|--------------|--------------------------------------|--------------|
| | <u>Amount</u> | <u>Ratio</u> | <u>Amount</u> | <u>Ratio</u> | <u>Amount</u> | <u>Ratio</u> |
| (dollars in thousands) | | | | | | |
| As of December 31, 2019 | | | | | | |
| Company | | | | | | |
| Common equity Tier 1 capital to risk-weighted assets | \$ 90,621 | 11.8% | \$ 34,559 | 4.5% | N/A | N/A |
| Tier 1 leverage capital to average assets | 103,621 | 11.2% | 37,008 | 4.0% | N/A | N/A |
| Tier 1 capital to risk-weighted assets | 103,621 | 13.5% | 46,054 | 6.0% | N/A | N/A |
| Total capital to risk-weighted assets | 112,614 | 14.7% | 61,287 | 8.0% | N/A | N/A |
| Bank | | | | | | |
| Common equity Tier 1 capital to risk-weighted assets | 102,606 | 13.4% | 32,160 | 4.2% | \$ 49,772 | 6.5% |
| Tier 1 leverage capital to average assets | 102,606 | 11.1% | 36,975 | 4.0% | 46,219 | 5.0% |
| Tier 1 capital to risk-weighted assets | 102,606 | 13.4% | 45,943 | 6.0% | 61,257 | 8.0% |
| Total capital to risk-weighted assets | 111,782 | 14.5% | 61,673 | 8.0% | 77,091 | 10.0% |
| As of December 31, 2018 | | | | | | |
| Company | | | | | | |
| Common equity Tier 1 capital to risk-weighted assets | \$ 79,968 | 10.5% | \$ 34,272 | 4.5% | N/A | N/A |
| Tier 1 leverage capital to average assets | 92,968 | 10.2% | 36,458 | 4.0% | N/A | N/A |
| Tier 1 capital to risk-weighted assets | 92,968 | 12.2% | 45,722 | 6.0% | N/A | N/A |
| Total capital to risk-weighted assets | 102,016 | 13.4% | 60,905 | 8.0% | N/A | N/A |
| Bank | | | | | | |
| Common equity Tier 1 capital to risk-weighted assets | 92,224 | 12.1% | 32,012 | 4.2% | \$ 49,542 | 6.5% |
| Tier 1 leverage capital to average assets | 92,224 | 10.1% | 36,524 | 4.0% | 45,655 | 5.0% |
| Tier 1 capital to risk-weighted assets | 92,224 | 12.1% | 45,731 | 6.0% | 60,975 | 8.0% |
| Total capital to risk-weighted assets | 101,456 | 13.3% | 61,026 | 8.0% | 76,283 | 10.0% |

NOTE 18 – 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, 2019 or December 31, 2018.

The following table presents the balances of assets measured at fair value on a recurring basis at December 31, 2019 and December 31, 2018.

| At December 31, 2019 | | | | |
|--|-------------------|---|--|--|
| 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) | | | | |
| Available-for-sale securities: | | | | |
| Collateralized mortgage obligations | \$ 45,141 | \$ - | \$ 45,141 | \$ - |
| Mortgage-backed securities | 19,130 | - | 19,130 | - |
| Municipal securities | 35,884 | - | 35,164 | 720 |
| Corporate debt securities | 2,004 | - | 2,004 | - |
| Total assets measured at fair value | \$ 102,159 | \$ - | \$ 101,439 | \$ 720 |

| At December 31, 2018 | | | | |
|--|-------------------|---|--|--|
| 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) | | | | |
| Available-for-sale securities: | | | | |
| Collateralized mortgage obligations | \$ 40,424 | \$ - | \$ 40,424 | \$ - |
| Mortgage-backed securities | 23,005 | - | 23,005 | - |
| U.S. Government agency securities | 3,549 | 3,549 | - | - |
| Municipal securities | 53,446 | - | 52,706 | 740 |
| Corporate debt securities | 959 | 959 | - | - |
| Total assets measured at fair value | \$ 121,383 | \$ 4,508 | \$ 116,135 | \$ 740 |

As of December 31, 2019 and December 31, 2018, 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.

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, 2019 and December 31, 2018.

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, 2019 and 2018, respectively.

| | Twelve Months Ended | |
|---|----------------------------|----------------|
| | December 31, | |
| | 2019 | 2018 |
| | (in thousands) | |
| Balance beginning of period | \$ 740 | \$ 1,741 |
| Transfers in to level 3 | - | - |
| Change in FV (included in other comprehensive income) | <u>(20)</u> | <u>(1,001)</u> |
| Balance end of period | <u>\$ 720</u> | <u>\$ 740</u> |

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Certain assets and liabilities are measured at fair value on a nonrecurring basis after initial recognition such as loans measured for impairment, loans held for sale 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. 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, 2019 and December 31, 2018 that were measured at fair value on a nonrecurring basis:

| Description | At December 31, 2019 | | | |
|---|----------------------|---|--|--|
| | 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 | \$ 191 | \$ - | \$ - | \$ 191 |
| Total assets measured on a nonrecurring basis | <u>\$ 191</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 191</u> |

| Description | At December 31, 2018 | | | |
|---|----------------------|---|--|--|
| | 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 | 211 | \$ - | \$ - | \$ 211 |
| Total assets measured on a nonrecurring basis | <u>\$ 211</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 211</u> |

The following table presents quantitative information about Level 3 inputs for financial instruments measured at fair value on a nonrecurring basis at December 31, 2019 and December 31, 2018 (dollars in thousands):

| Description | Fair Value | Valuation Technique | Significant Unobservable Inputs | Range |
|---|------------|---------------------|---------------------------------------|--------------------|
| | | | | (Weighted Average) |
| At December 31, 2019 | | | | |
| Loans measured for impairment, net of specific reserves | \$ 191 | Income approach | Probability of default, discount rate | 4.0%, 4.75% |
| At December 31, 2018 | | | | |
| Loans measured for impairment, net of specific reserves | \$ 211 | Income approach | Probability of default, discount rate | 4.0%, 4.75% |

The estimated fair value of the Company's financial instruments at December 31, 2019 and December 31, 2018 was as follows:

| As of December 31, 2019 | | | |
|--|-----------------------------------|-----------------------|-----------------------------|
| | Fair Value Hierarchy Level | Carrying Value | Estimated Fair Value |
| (in thousands) | | | |
| Financial assets: | | | |
| Cash and cash equivalents | Level 1 | \$ 77,932 | \$ 77,932 |
| Other interest earning deposits | Level 1 | 3,250 | 3,250 |
| Investment securities available-for-sale | See previous table | 102,159 | 102,159 |
| Investment securities held-to-maturity | See previous table | 1,056 | 1,056 |
| Loans held-for-sale | Level 2 | 10,108 | 10,108 |
| Loans receivable, net | Level 3 | 675,446 | 679,025 |
| Accrued interest receivable | Level 1 | 3,074 | 3,074 |
| Financial liabilities: | | | |
| Deposits | Level 2 | \$ 798,638 | \$ 798,561 |
| Long-term borrowings | Level 2 | 3,203 | 3,206 |
| Junior subordinated debentures | Level 3 | 13,403 | 9,929 |
| Accrued interest payable | Level 1 | 171 | 171 |

| As of December 31, 2018 | | | |
|--|-----------------------------------|-----------------------|-----------------------------|
| | Fair Value Hierarchy Level | Carrying Value | Estimated Fair Value |
| (in thousands) | | | |
| Financial assets: | | | |
| Cash and cash equivalents | Level 1 | \$ 22,188 | \$ 22,188 |
| Other interest earning deposits | Level 1 | 3,250 | 3,250 |
| Investment securities available-for-sale | See previous table | 121,383 | 121,383 |
| Investment securities held-to-maturity | See previous table | 1,227 | 1,227 |
| Loans held-for-sale | Level 2 | 6,204 | 6,204 |
| Loans receivable, net | Level 3 | 694,054 | 694,335 |
| Accrued interest receivable | Level 1 | 3,321 | 3,321 |
| Financial liabilities: | | | |
| Deposits | Level 2 | \$ 783,549 | \$ 787,111 |
| Long-term borrowings | Level 2 | 8,353 | 8,304 |
| Junior subordinated debentures | Level 3 | 13,403 | 8,825 |
| Accrued interest payable | Level 1 | 162 | 162 |

NOTE 19 – 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 and restricted stock awards computed under the treasury stock method as if converted to common stock.

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

| | For the Year Ended December 31, | |
|---|---|--------------------|
| | <u>2019</u> | <u>2018</u> |
| | (dollars in thousands, except per share amounts) | |
| <u>Basic:</u> | | |
| Net income (numerator) | \$ 13,758 | \$ 11,330 |
| Weighted average shares outstanding (denominator) | <u>10,596,776</u> | <u>10,551,174</u> |
| Basic earnings per share | <u>\$ 1.30</u> | <u>\$ 1.07</u> |
| | | |
| <u>Diluted:</u> | | |
| Net income (numerator) | \$ 13,758 | \$ 11,330 |
| Weighted average shares outstanding | 10,596,776 | 10,551,174 |
| Effect of dilutive stock options | <u>55,021</u> | <u>122,219</u> |
| Weighted average shares outstanding assuming dilution (denominator) | <u>10,651,797</u> | <u>10,673,393</u> |
| Diluted earnings per share | <u>\$ 1.29</u> | <u>\$ 1.06</u> |
| | | |
| | For the Year Ended December 31, | |
| | <u>2019</u> | <u>2018</u> |
| Shares subject to outstanding options | - | 10,000 |

As of December 31, 2019 and 2018, 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 20 – CONDENSED FINANCIAL INFORMATION – PARENT COMPANY ONLY

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

| | December 31, 2019 | December 31, 2018 |
|---|------------------------------|------------------------------|
| ASSETS | | |
| Cash and cash equivalents: | \$ 737 | \$ 3,562 |
| Investment in bank | 117,278 | 104,739 |
| Other assets | 758 | 842 |
| Total assets | \$ 118,773 | \$ 109,143 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Junior subordinated debentures | \$ 13,403 | \$ 13,403 |
| Dividends payable | - | 3,171 |
| Other liabilities | 77 | 86 |
| Total liabilities | 13,480 | 16,660 |
| Total shareholders' equity | 105,293 | 92,483 |
| Total liabilities and shareholders' equity | \$ 118,773 | \$ 109,143 |

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

| | Twelve Months Ended December 31, | |
|---|---|-------------|
| | 2019 | 2018 |
| INTEREST EXPENSE | | |
| Junior subordinated debentures | \$ 540 | \$ 505 |
| Total interest expense | 540 | 505 |
| NONINTEREST INCOME | | |
| Dividends from subsidiary bank | 4,000 | 4,050 |
| Equity in undistributed income from subsidiary bank | 10,362 | 7,878 |
| Other income | 16 | 14 |
| Total noninterest income | 14,378 | 11,942 |
| NONINTEREST EXPENSE | | |
| Other expense | 379 | 403 |
| Total noninterest income | 379 | 403 |
| Income before income taxes | 13,459 | 11,034 |
| Income tax benefit | 299 | 296 |
| Net income | \$ 13,758 | \$ 11,330 |
| Comprehensive income | \$ 15,935 | \$ 10,701 |

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

| | Twelve Months Ended | |
|--|---------------------|-----------|
| | December 31, | |
| | 2019 | 2018 |
| Cash flows from operating activities: | | |
| Net Income | \$ 13,758 | \$ 11,330 |
| Adjustments to reconcile net income to cash and cash equivalents from operating activities | | |
| Equity in undistributed income of subsidiary | (10,362) | (7,878) |
| Net change in other assets | (24) | (227) |
| Net change in other liabilities | 108 | 23 |
| Stock compensation expense | 90 | 119 |
| Net cash provided by operating activities | 3,570 | 3,367 |
| Cash flows from financing activities: | | |
| Net cash from stock option exercises | 194 | 13 |
| Taxes paid related to net share settlement for equity awards | (131) | 64 |
| Cash dividends paid | (6,458) | (2,622) |
| Net cash used in financing activities | (6,395) | (2,545) |
| Net increase in cash and cash equivalents | (2,825) | 822 |
| Cash and cash equivalents at beginning of year | 3,562 | 2,740 |
| Cash and cash equivalents at end of year | \$ 737 | \$ 3,562 |

NOTE 21 – SELECTED DATA

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

| | Year Ended December 31, 2019 | | | |
|-----------------------------------|--|---------------------------|--------------------------|---------------------------|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| | (dollars in thousands, except per share amounts) | | | |
| Interest and dividend income | \$ 10,360 | \$ 10,460 | \$ 10,563 | \$ 10,187 |
| Interest expense | 742 | 735 | 721 | 730 |
| Net interest income | 9,618 | 9,725 | 9,842 | 9,457 |
| Provision for loan losses | - | - | - | - |
| Noninterest income | 2,398 | 3,443 | 4,167 | 3,887 |
| Noninterest expense | 8,412 | 8,692 | 9,390 | 9,062 |
| Income before income taxes | 3,604 | 4,476 | 4,619 | 4,282 |
| Income tax expense | 658 | 870 | 859 | 836 |
| Net income | \$ 2,946 | \$ 3,606 | \$ 3,760 | \$ 3,446 |
| Earnings per common share | | | | |
| Basic | \$ 0.28 | \$ 0.35 | \$ 0.35 | \$ 0.32 |
| Diluted | \$ 0.28 | \$ 0.34 | \$ 0.35 | \$ 0.32 |

| | Year Ended December 31, 2018 | | | |
|-----------------------------------|--|---------------------------|--------------------------|---------------------------|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| | (dollars in thousands, except per share amounts) | | | |
| Interest and dividend income | \$ 9,463 | \$ 9,741 | \$ 10,337 | \$ 10,519 |
| Interest expense | 580 | 624 | 686 | 700 |
| Net interest income | 8,883 | 9,117 | 9,651 | 9,819 |
| Provision for loan losses | - | - | - | - |
| Noninterest income | 2,325 | 2,649 | 2,648 | 2,409 |
| Noninterest expense | 8,557 | 8,580 | 8,392 | 8,264 |
| Income before income taxes | 2,651 | 3,186 | 3,907 | 3,964 |
| Income tax expense | 365 | 570 | 724 | 719 |
| Net income | \$ 2,286 | \$ 2,616 | \$ 3,183 | \$ 3,245 |
| Earnings per common share | | | | |
| Basic | \$ 0.21 | \$ 0.25 | \$ 0.30 | \$ 0.31 |
| Diluted | \$ 0.21 | \$ 0.25 | \$ 0.30 | \$ 0.30 |

GENERAL CORPORATE AND SHAREHOLDER INFORMATION

Administrative Headquarters

1216 Skyview Drive
Aberdeen, WA 98520
(360) 533-8870

Independent Accountants

CliftonLarsonAllen LLP
Minneapolis, Minnesota

Transfer Agent and Registrar

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

Shareholder Services

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

Change of name or address

Consolidation of accounts

Duplicate mailings

Lost stock certificates

Transfer of stock to another person

Additional administrative services

As a Pacific Financial Corporation shareholder, you are invited to take advantage of our convenient shareholder services or request more information about Pacific Financial Corporation. Access your account directly through Investor Center at www.computershare.com/investor.

Annual Meeting

The Annual Meeting of Stockholders (the "Meeting") will be a virtual meeting, conducted via live webcast only, to allow all of our Stockholders the opportunity to participate. The live webcast will be on April 29th, 2020, at 4:00 p.m. (PST). No physical meeting will be held. Stockholders of record of Common Stock at the close of business on March 10, 2020 will be able to attend the Meeting, vote and submit questions during the Meeting by logging on to www.meetingcenter.io/229365441 at the Meeting date and time using their 15-digit Control Number provided with the Notice of the Meeting. The password for this meeting is PFLC2020.

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 Lisa Dutton, 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.

Board of Directors

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

Doug Biddle
Retired CFO
Pacific Financial Corporation and Bank of the Pacific

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

Dwayne Carter
Retired President & General Manager
Brooks Manufacturing Co.

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

Edwin W. Ketel
Retired Owner
Oceanside Animal Clinic

Randy J. Rust
Private Investor

Kristi Gundersen
Partner & Chief Financial Officer
Knutzen Farms, LP

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

John Van Dijk
Retired President & COO
Pacific Financial Corporation and Bank of the Pacific

Susan C. Freese
Pharmacist

Officers

Denise J. Portmann
President and Chief Executive Officer of the Company and the Bank

Carla Tucker
Executive Vice President and Chief Financial Officer of the Company and the Bank

Daniel E. Kuenzi
Vice President of the Company and Executive Vice President and Chief Credit Officer of the Bank

Thomas Baker
Vice President of the Company and Executive Vice President and Chief Operating Officer of the Bank

Walker Evans
Vice President of the Company and Executive Vice President and Chief Lending Officer of the Bank

Lisa Dutton
Corporate Secretary

Subsidiaries

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

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★ Lynden

★ Bellingham

★ Hannegan

★ Burlington CBC/ATM

★ Anacortes

WASHINGTON

● Seattle

★ Taholah

★ Olympia CBC

★ Hoquiam

★ Montesano

★ Ocean Shores



Aberdeen

★ Raymond

★ Ocean Park

★ Naselle - ATM

★ Long Beach

★ Cathlamet

★ Warrenton - ATM

★ Astoria

★ Seaside

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