PACIFIC FINANCIAL CORP
Form 10-Q
November 14, 2012

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

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2012

OR

.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____________ to ____________

Commission File Number 000-29829

PACIFIC FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	**91-1815009** (IRS Employer Identification No.)

1101 S. Boone Street
Aberdeen, Washington 98520-5244
(360) 533-8870
(Address, including zip code, and telephone number,
including area code, of Registrant's principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. (See the definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act).

¨ Large Accelerated Filer ¨ Accelerated Filer ¨ Non-accelerated Filer x Smaller Reporting Company

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

The number of shares of the issuer's common stock, par value $1.00 per share, outstanding as of October 31, 2012, was 10,121,853 shares.

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PART I – FINANCIAL INFORMATION

ITEM 1 – FINANCIAL STATEMENTS

PACIFIC FINANCIAL CORPORATION

Condensed Consolidated Balance Sheets

September 30, 2012 and December 31, 2011

(Dollars in thousands) (Unaudited)

	September 30, 2012	December 31, 2011
Assets		
Cash and due from banks	$ 14,752	$ 12,607
Interest bearing deposits in banks	28,222	28,525
Investment securities available-for-sale (amortized cost of $50,267 and $47,015)	51,704	47,652
Investment securities held-to-maturity (fair value of $6,897 and $7,118)	6,848	7,025
Federal Home Loan Bank stock, at cost	3,154	3,182
Loans held for sale	21,948	14,541
Loans	465,970	474,893
Allowance for credit losses	11,157	11,127
Loans, net	454,813	463,766
Premises and equipment	14,646	14,884
Other real estate owned	5,803	7,725
Accrued interest receivable	2,395	2,156
Cash surrender value of life insurance	17,663	17,275
Goodwill	11,282	11,282
Other intangible assets	1,268	1,268
Other assets	9,565	9,366
Total assets	$ 644,063	$ 641,254
Liabilities and Shareholders' Equity		
Deposits:		
Demand, non-interest bearing	$ 123,289	$ 108,899
Savings and interest-bearing demand	285,303	286,642
Time, interest-bearing	139,590	152,509
Total deposits	548,182	548,050

Accrued interest payable	235	1,490
Secured borrowings	219	741
Short-term borrowings	3,000	—
Long-term borrowings	7,500	10,500
Junior subordinated debentures	13,403	13,403
Other liabilities	4,510	3,800
Total liabilities	**577,049**	**577,984**
Commitments and Contingencies (Note 6)	—	—
Shareholders' Equity		
Common Stock (par value $1); 25,000,000 shares authorized; 10,121,853 shares issued and outstanding at September 30, 2012 and December 31, 2011	10,122	10,122
Additional paid-in capital	41,360	41,342
Retained earnings	15,157	12,051
Accumulated other comprehensive income (loss)	375	(245)
Total shareholders' equity	**67,014**	**63,270**
Total liabilities and shareholders' equity	$ 644,063	$ 641,254

See notes to condensed consolidated financial statements.

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PACIFIC FINANCIAL CORPORATION

Condensed Consolidated Statements of Income

Three and nine months ended September 30, 2012 and 2011

(Dollars in thousands, except per share data) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest and dividend income				
Loans	$6,292	$6,861	$19,390	$20,459
Investment securities	440	516	1,378	1,548
Deposits with banks and federal funds sold	19	29	55	77
Total interest and dividend income	6,751	7,406	20,823	22,084
Interest Expense				
Deposits	686	1,112	2,259	3,731
Other borrowings	143	224	462	833
Total interest expense	829	1,336	2,721	4,564
Net Interest Income	5,922	6,070	18,102	17,520
Provision for credit losses	—	1,050	400	1,550
Net interest income after provision for credit losses	5,922	5,020	17,702	15,970
Non-interest Income				
Service charges on deposits	406	470	1,256	1,350
Net gain (loss) on sales of other real estate owned	(18)	17	293	(126)
Gain on sales of loans	1,501	1,084	3,501	2,183
Gain on sales of investments available-for-sale, net	65	352	164	536
Net other-than-temporary impairment losses (net of $20, $29, $50 and $338, respectively, recognized in other comprehensive income before taxes)	(160)	—	(265)	(243)
Earnings on bank owned life insurance	130	135	388	398
Other operating income	519	397	1,363	1,061
Total non-interest income	2,443	2,455	6,700	5,159
Non-interest Expense				
Salaries and employee benefits	4,101	3,363	11,823	10,188
Occupancy and equipment	614	623	1,865	1,908
Other real estate owned write-downs	364	62	698	599
Other real estate owned operating costs	101	89	401	293
Professional services	178	174	514	574
FDIC and State assessments	135	215	468	711

Data processing	355	336	1,048	920
Other	1,222	1,198	3,762	3,600
Total non-interest expense	7,070	6,060	20,579	18,793
Income before income taxes	1,295	1,415	3,823	2,336
Income taxes	280	211	717	97
Net Income	$1,015	$1,204	$3,106	$2,239
Earnings per common share:				
Basic	$0.10	$0.12	$0.31	$0.22
Diluted	0.10	0.12	0.31	0.22
Weighted Average shares outstanding:				
Basic	10,121,853	10,121,853	10,121,853	10,121,853
Diluted	10,122,224	10,121,919	10,122,145	10,121,875

See notes to condensed consolidated financial statements.

PACIFIC FINANCIAL CORPORATION

Condensed Consolidated Statements of Comprehensive Income

Three and nine months ended September 30, 2012 and 2011

(Dollars in thousands) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net Income	$ 1,015	$ 1,204	$ 3,106	$ 2,239
Other comprehensive income, net of tax:				
Net unrealized gains on investment securities (net of tax of $258, $257, $274 and $488, respectively)	500	499	532	948
Defined benefit plans (net of tax of $10, $8, $30 and $24, respectively)	29	24	88	70
Other Comprehensive Income	529	523	620	1,018
Comprehensive Income	$ 1,544	$ 1,727	$ 3,726	$ 3,257

See notes to condensed consolidated financial statements.

PACIFIC FINANCIAL CORPORATION

Condensed Consolidated Statements of Cash Flows

Nine months ended September 30, 2012 and 2011

(Dollars in thousands)

(Unaudited)

	2012	2011
OPERATING ACTIVITIES		
Net income	$3,106	$2,239
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for credit losses	400	1,550
Depreciation and amortization	1,094	1,191
Origination of loans held for sale	(184,171)	(104,807)
Proceeds of loans held for sale	180,265	104,771
Gain on sales of loans	(3,501)	(2,183)
Gain on sale of investments available-for-sale	(164)	(536)
Net OTTI losses recognized in earnings	265	243
Net (gain) loss on sale of other real estate owned	(293)	126
Net (gain) loss on sale of premises and equipment	(5)	1
Increase in accrued interest receivable	(239)	(111)
Increase (decrease) in accrued interest payable	(1,255)	83
Other real estate owned write-downs	698	599
Other, net	(130)	2,425
Net cash provided by (used in) operating activities	(3,930)	5,591
INVESTING ACTIVITIES		
Net decrease in interest bearing balances with banks	303	14,981
Purchase of securities held-to-maturity	—	(828)
Purchase of securities available-for-sale	(15,806)	(24,425)
Proceeds from maturities of investments held-to-maturity	176	151
Proceeds from sales of securities available-for-sale	6,334	12,881
Proceeds from maturities of securities available-for-sale	6,010	4,309
Proceeds from sales of government loan pools	1,215	5,514
Net (increase) decrease in loans	5,675	(18,749)
Proceeds from sales of other real estate owned	3,402	1,061
Purchase of premises and equipment, and additions to other real estate owned	(844)	(636)
Net cash provided by (used in) investing activities	6,465	(5,741)
FINANCING ACTIVITIES		
Net increase in deposits	132	15,983
Net decrease in short-term borrowings	—	(10,500)
Proceeds from issuance of long-term borrowings	2,500	7,500

Repayment of long-term borrowings	(2,500)	(7,500)
Net decrease in secured borrowings	(522)	(170)
Net cash provided by (used in) financing activities	(390)	5,313
Net increase in cash and due from banks	2,145	5,163
Cash and due from banks		
Beginning of period	12,607	7,428
End of period	$ **14,752**	$ 12,591
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash payments for:		
Interest	$ 3,976	$ 4,481
Income taxes	1,411	55
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Change in fair value of securities available-for-sale, net of tax	$ 532	$ 948
Transfer of loans held for sale to loans held for investment	—	300
Other real estate owned acquired in settlement of loans	(2,485)	(4,437)
Financed sale of other real estate owned	783	750
Reclass of long-term borrowings to short-term borrowings	3,000	—

See notes to condensed consolidated financial statements.

PACIFIC FINANCIAL CORPORATION

Condensed Consolidated Statements of Shareholders' Equity

Nine months ended September 30, 2012 and 2011

(Dollars in thousands)

(Unaudited)

	Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance January 1, 2011	10,121,853	$ 10,122	$ 41,316	$ 9,233	$ (902)	$ 59,769
Other comprehensive income:						
Net income				2,239		2,239
Unrealized holding gain on securities less reclassification adjustment for net gains included in net income					948	948
Amortization of unrecognized prior service costs and net (gains)/losses					70	70
Comprehensive income						3,257
Stock compensation expense			19			19
Balance September 30, 2011	10,121,853	$ 10,122	$ 41,335	$ 11,472	$ 116	$ 63,045
Balance January 1, 2012	10,121,853	$ 10,122	$ 41,342	$ 12,051	$ (245)	$ 63,270
Other comprehensive income:						
Net income				3,106		3,106
Unrealized holding gain on securities less reclassification adjustment for net gains included in net income					532	532
Amortization of unrecognized prior service costs and net (gains)/losses					88	88
Comprehensive income						3,726
Stock compensation expense			18			18
Balance September 30, 2012	10,121,853	$ 10,122	$ 41,360	$ 15,157	$ 375	$ 67,014

See notes to condensed consolidated financial statements.

PACIFIC FINANCIAL CORPORATION

Notes to Condensed Consolidated Financial Statements

(Unaudited)

(Dollars in thousands, except per share amounts)

Note 1 – Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by Pacific Financial Corporation ("Pacific" or the "Company") in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with instructions to Form 10-Q. Accordingly, these financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2012, are not necessarily indicative of the results anticipated for the year ending December 31, 2012. Certain information and footnote disclosures included in the Company's consolidated financial statements for the year ended December 31, 2011, have been condensed or omitted from this report. Accordingly, these statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Note 2 – Earnings per Share

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Basic:				
Net income	$1,015	$1,204	$3,106	$2,239

Weighted average shares outstanding	10,121,853	10,121,853	10,121,853	10,121,853
Basic earnings per share	$0.10	$0.12	$0.31	$0.22
Diluted:				
Net income	$1,015	$1,204	$3,106	$2,239
Weighted average shares outstanding	10,121,853	10,121,853	10,121,853	10,121,853
Effect of dilutive stock options	371	66	292	22
Weighted average shares outstanding assuming dilution	10,122,224	10,121,919	10,122,145	10,121,875
Diluted earnings per share	$0.10	$0.12	$0.31	$0.22

As of September 30, 2012 and 2011, there were 532,107 and 585,048 shares, respectively, subject to outstanding options and 699,642 and 699,642 shares, respectively, subject to outstanding warrants with exercise prices in excess of the current market value. All of these shares are not included in the table above, as exercise of these options and warrants would not be dilutive to shareholders.

Note 3 – 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 government units, and other corporations, and mortgage backed securities ("MBS").

Securities Held-to-Maturity	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2012				
State and municipal securities	$ 6,610	$ 28	$ —	$6,638
Agency MBS	238	21	—	259
Total	$ 6,848	$ 49	$ —	$6,897
December 31, 2011				
State and municipal securities	$ 6,732	$ 68	$ —	$6,800
Agency MBS	293	25	—	318
Total	$ 7,025	$ 93	$ —	$7,118

Securities Available-for-Sale	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2012				
U.S. Government securities	$ 1,196	$ 14	$ —	$1,210
State and municipal securities	23,595	1,546	2	25,139
Agency MBS	16,241	323	73	16,491
Non-agency MBS	5,361	34	391	5,004
Corporate bonds	3,874	39	53	3,860
Total	$ 50,267	$ 1,956	$ 519	$51,704
December 31, 2011				
U.S. Government securities	$ 73	$ 11	$ —	$84
State and municipal securities	21,398	1,462	1	22,859
Agency MBS	16,709	255	49	16,915
Non-agency MBS	6,825	25	968	5,882
Corporate bonds	2,010	—	98	1,912
Total	$ 47,015	$ 1,753	$ 1,116	$47,652

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 September 30, 2012 and December 31, 2011 are summarized as follows:

	Less than 12 Months		12 months or More		Total	
Available-for-Sale	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
September 30, 2012						
State and municipal securities	$ 78	$ 2	$ —	$ —	$78	$ 2
Agency MBS	4,858	67	470	6	5,328	73
Non-agency MBS	—	—	3,644	391	3,644	391
Corporate bonds	1,533	53	—	—	1,533	53
Total	$ 6,469	$ 122	$ 4,114	$ 397	$10,583	$ 519
December 31, 2011						
State and municipal securities	$ 77	$ 1	$ —	$ —	$77	$ 1
Agency MBS	4,985	49	—	—	4,985	49
Non-agency MBS	590	90	4,223	878	4,813	968
Corporate bonds	1,912	98	—	—	1,912	98
Total	$ 7,564	$ 238	$ 4,223	$ 878	$11,787	$ 1,116

At September 30, 2012, there were 18 investment securities in an unrealized loss position, of which seven were in a continuous loss position for 12 months or more. The unrealized losses on these securities were caused by changes in interest rates, widening pricing spreads and market illiquidity, leading to a decline in the fair value subsequent to their purchase. The Company has evaluated the securities shown above and anticipates full recovery of amortized cost with respect to these securities at maturity or sooner in the event of a more favorable market environment. Based on management’s evaluation, and because the Company does not have the intent to sell these securities and it is not more likely than not that it will have to sell the securities before recovery of cost basis, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2012, except as described below with respect to one non-agency MBS.

For non-agency MBS the Company estimates expected future cash flows of the underlying collateral, together with any credit enhancements. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which considers current delinquencies, future expected default rates and collateral value by vintage) and prepayments. The expected cash flows of the security are then discounted to arrive at a present value amount. For the nine months ended September 30, 2012, one non-agency MBS was determined to be other-than-temporarily-impaired resulting in the Company recording $50 in impairments not related to credit losses through other comprehensive income and $265 in impairments related to credit losses through earnings.

Gross gains realized on sales of securities were $170 and $557 and gross losses realized were $6 and $21 during the nine months ended September 30, 2012 and 2011, respectively.

The Company did not engage in originating subprime mortgage loans and it does not believe that it has material exposure to subprime mortgage loans or subprime mortgage backed securities. Additionally, the Company does not have any investment in, or exposure to, collateralized debt obligations, structured investment vehicles or Euro zone sovereign debt.

Note 4 – Loans

Loans and Leases

Loans (including loans held for sale) at September 30, 2012 and December 31, 2011 are as follows:

	September 30, 2012	December 31, 2011
Commercial	$ 98,002	$ 90,731
Residential real estate:		
Residential 1-4 family	97,987	90,552
Multi-family	7,914	7,682
Commercial real estate:		
Construction and land development	38,760	47,156
Commercial real estate – owner occupied	112,051	118,469
Commercial real estate – non owner occupied	100,995	103,005
Farmland	25,371	23,752
Consumer	7,641	8,928
Less unearned income	(803)	(841)
Total Loans	$ 487,918	$ 489,434

Allowance for Credit Losses

Changes in the allowance for credit losses for the three and nine months ended September 30, 2012 and 2011, and the year ended December 31, 2011 are as follows:

Allowance for Credit Losses	Commercial	Commercial Real Estate (“CRE”)	Residential Real Estate	Consumer	Unallocated	Total
Three months ended September 30, 2012						
Beginning balance	$ 1,105	$ 6,858	$ 819	$ 600	$ 1,682	$ 11,064
Charge-offs	(10)	—	(275)	(161)	—	(446)
Recoveries	—	535	—	4	—	539

Provision for (recapture of) credit losses	102	(756)	254	71	329	—
Ending balance	$ 1,197	$ 6,637	$ 798	$ 514	$ 2,011	$11,157
Nine months ended September 30, 2012						
Beginning balance	$ 1,012	$ 6,803	$ 1,046	$ 642	$ 1,624	$11,127
Charge-offs	(67)	(694)	(395)	(294)	—	(1,450)
Recoveries	23	888	162	7	—	1,080
Provision for (recapture of) credit losses	229	(360)	(15)	159	387	400
Ending balance	$ 1,197	$ 6,637	$ 798	$ 514	$ 2,011	$11,157

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	Commercial	Commercial Real Estate ("CRE")	Residential Real Estate	Consumer	Unallocated	Total
Three months ended September 30, 2011						
Beginning balance	$ 829	$ 6,410	$ 1,598	$ 403	$ 1,726	$10,966
Charge-offs	(36)	(916)	(271)	(30)	—	(1,253)
Recoveries	—	126	32	2	—	160
Provision for (recapture of) credit losses	334	390	(112)	31	407	1,050
Ending balance	$ 1,127	$ 6,010	$ 1,247	$ 406	$ 2,133	$10,923
Nine months ended September 30, 2011						
Beginning balance	$ 816	$ 5,385	$ 1,754	$ 690	$ 1,972	$10,617
Charge-offs	(134)	(1,466)	(361)	(55)	—	(2,016)
Recoveries	68	640	57	7	—	722
Provision for (recapture of) credit losses	377	1,451	(203)	(236)	161	1,550
Ending balance	$ 1,127	$ 6,010	$ 1,247	$ 406	$ 2,133	$10,923
Twelve months ended December 31, 2011						
Beginning balance	$ 816	$ 5,385	$ 1,754	$ 690	$ 1,972	$10,617
Charge-offs	(161)	(2,005)	(665)	(93)	—	(2,924)
Recoveries	69	750	107	8	—	934
Provision for (recapture of) credit losses	288	2,673	(150)	37	(348)	2,500
Ending balance	$ 1,012	$ 6,803	$ 1,046	$ 642	$ 1,624	$11,127

Recorded investment in loans as of September 30, 2012 and December 31, 2011 are as follows:

September 30, 2012	Commercial	Commercial Real Estate ("CRE")	Residential Real Estate	Consumer	Unallocated	Total
Allowance for credit losses:						
Ending balance: individually evaluated for impairment	$ —	$ 1,781	$ —	$ —	$ —	$ 1,781
Ending balance: collectively evaluated for impairment	1,197	4,856	798	514	2,011	9,376
Loans:						
Ending balance: individually evaluated for impairment	$ 776	$ 9,472	$ 768	$ —	$ —	$ 11,016
Ending balance: collectively evaluated for impairment	97,226	267,705	83,185	7,641	—	455,757
Loans held for sale	—	—	21,948	—	—	21,948
Ending balance	$ 98,002	$ 277,177	$ 105,901	$ 7,641	$ —	$ 488,721
Less unearned income						(803)
Ending balance total loans						$ 487,918
December 31, 2011						
Allowance for credit losses:						
Ending balance: individually evaluated for impairment	$ —	$ 1,987	$ 45	$ —	$ —	$ 2,032
Ending balance: collectively evaluated for impairment	1,012	4,816	1,001	642	1,624	9,095
Loans:						
Ending balance: individually evaluated for impairment	$ 529	$ 13,076	$ 827	$ —	$ —	$ 14,432
Ending balance: collectively evaluated for impairment	90,202	279,306	82,866	8,928	—	461,302
Loans held for sale	—	—	14,541	—	—	14,541

Ending balance	$ 90,731	$ 292,382	$ 98,234	$ 8,928	$ —	$ 490,275
Less unearned income						(841)
Ending balance total loans						$ 489,434

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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 credit 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.

Loans by credit quality risk rating at September 30, 2012 are as follows:

	Pass	Other Loans Especially Mentioned	Substandard	Doubtful	Total
Commercial	$92,647	$ 1,911	$ 3,397	$ 47	$98,002
Real estate:					
Construction and development	30,568	622	7,570	—	38,760

Residential 1-4 family	92,808	707	4,445	27	97,987
Multi-family	7,914	—	—	—	7,914
CRE – owner occupied	105,759	1,862	4,430	—	112,051
CRE – non owner occupied	74,533	17,831	8,631	—	100,995
Farmland	24,227	110	1,034	—	25,371
Total real estate	335,809	21,132	26,110	27	383,078
Consumer	7,567	—	74	—	7,641
Subtotal	$436,023	$ 23,043	$ 29,581	$ 74	$488,721
Less unearned income					(803)
Total loans					$487,918

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Loans by credit quality risk rating at December 31, 2011 are as follows:

	Pass	Other Loans Especially Mentioned	Substandard	Doubtful	Total
Commercial	$83,920	$ 2,232	$ 4,579	$ —	$90,731
Real estate:					
Construction and development	37,804	1,394	7,958	—	47,156
Residential 1-4 family	86,239	741	3,572	—	90,552
Multi-family	7,682	—	—	—	7,682
CRE – owner occupied	111,028	1,856	5,585	—	118,469
CRE – non owner occupied	77,414	13,877	11,714	—	103,005
Farmland	22,543	110	1,099	—	23,752
Total real estate	342,710	17,978	29,928	—	390,616
Consumer	8,804	53	63	8	8,928
Subtotal	$435,434	$ 20,263	$ 34,570	$ 8	$490,275
Less unearned income					(841)
Total loans					$489,434

Impaired Loans

Following is a summary of information pertaining to impaired loans at September 30, 2012:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	3 Month Average Recorded Investment	9 Month Average Recorded Investment	3 Months Interest Income Recognized	9 Months Interest Income Recognized
With no related allowance recorded:							
Commercial	$ 776	$ 786	$ —	$ 692	$ 653	$ 9	$ 24
Consumer	—	—	—	113	56	—	—
Residential real estate	768	983	—	734	728	4	13
Commercial real estate:							
CRE – owner occupied	2,086	2,086	—	1,110	791	—	2
CRE – non-owner occupied	2,326	2,419	—	2,365	2,641	32	54
Construction and development	1,576	3,855	—	1,640	2,936	18	53

With an allowance recorded:							
Residential real estate	—	—	—	—	121	—	—
Commercial real estate:							
CRE – non-owner occupied	3,485	3,997	1,781	3,485	3,556	—	—
Construction and development	—	—	—	92	189	—	12
Total:							
Commercial	776	786	—	692	653	9	24
Consumer	—	—	—	113	56	—	—
Residential real estate	768	983	—	734	849	4	13
Commercial real estate:							
CRE – owner occupied	2,086	2,086	—	1,110	791	—	2
CRE – non-owner occupied	5,811	6,416	1,781	5,850	6,197	32	54
Construction and development	1,576	3,855	—	1,732	3,125	18	65

Following is a summary of information pertaining to impaired loans at September 30, 2011:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	3 Month Average Recorded Investment	9 Month Average Recorded Investment	3 Months Interest Income Recognized	9 Months Interest Income Recognized
With no related allowance recorded:							
Commercial	$ 180	$ 194	$ —	$ 187	$ 312	$ 2	$ 13
Residential real estate	406	521	—	551	1,510	4	15
Commercial real estate:							
CRE – owner occupied	430	481	—	997	1,057	3	5
CRE – non-owner occupied	5,981	6,351	—	5,057	3,248	—	21
Construction and development	5,250	7,401	—	5,054	6,001	18	90
With an allowance recorded:							
Commercial	—	—	—	—	253	—	5
Residential real estate	—	—	—	36	18	—	—
Construction and development	1,162	1,162	357	1,503	752	—	52
Total:							
Commercial	180	194	—	187	565	2	18
Residential real estate	406	521	—	587	1,528	4	15
Commercial real estate:							
CRE – owner occupied	430	481	—	997	1,057	3	5
CRE – non-owner occupied	5,981	6,351	—	5,057	3,248	—	21
Construction and development	6,412	8,563	357	6,557	6,753	18	142

Following is a summary of information pertaining to impaired loans as of and for the year ended December 31, 2011:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$ 530	$ 556	$ —	$ 355	$ 15
Residential real estate	528	620	—	1,314	16
Commercial real estate:					
CRE – owner occupied	629	719	—	971	7
CRE – non-owner occupied	2,912	2,912	—	3,181	21
Construction and development	5,335	7,501	—	5,868	188
With an allowance recorded:					

Commercial	—	—	—	202	5
Residential real estate	298	298	45	74	—
Commercial real estate:					
CRE - non-owner occupied	3,627	3,997	1,782	725	—
Construction and development	573	573	205	716	3
Total:					
Commercial	530	556	—	557	20
Residential real estate	826	918	45	1,388	16
Commercial real estate:					
CRE – owner occupied	629	719	—	971	7
CRE – non-owner occupied	6,539	6,909	1,782	3,906	21
Construction and development	5,908	8,074	205	6,584	191

Aging Analysis

The following table provides an age analysis of past due loans at September 30, 2012.

	Current	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due and Still Accruing	Total Past Due	Non-accrual Loans	Total Loans
Commercial	$96,155	$ 1,070	$ —	$ —	$1,070	$ 777	$98,002
Real estate:							
Construction & development	37,179	5	—	—	5	1,576	38,760
Residential 1-4 family	96,242	659	318	—	977	768	97,987
Multi-family	7,914	—	—	—	—	—	7,914
CRE owner occupied (1)	108,714	481	—	770	1,251	2,086	112,051
CRE non-owner occupied	95,184	—	—	—	—	5,811	100,995
Farmland	25,371	—	—	—	—	—	25,371
Total real estate	370,604	1,145	318	770	2,233	10,241	383,078
Consumer	7,634	7	—	—	7	—	7,641
Less unearned income	(803)	—	—	—	—	—	(803)
Total	$473,590	$ 2,222	$ 318	$ 770	$3,310	$ 11,018	$487,918

(1) Loans totaling $770,000 past due 90 days or more and still accruing interest are made up entirely of loans guaranteed by the United Stated Department of Agriculture (USDA) or Small Business Administration.

The following table provides an age analysis of past due loans at December 31, 2011.

	Current	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due and Still Accruing	Total Past Due	Non-accrual Loans	Total Loans

Commercial	$89,981	$ 220	$ —	$ —	$220	$ 530	$90,731
Real estate:							
Construction & development	41,570	76	—	—	76	5,510	47,156
Residential 1-4 family	88,661	880	184	299	1,363	528	90,552
Multi-family	7,682	—	—	—	—	—	7,682
CRE owner occupied	116,979	508	353	—	861	629	118,469
CRE non-owner occupied	96,332	134	—	—	134	6,539	103,005
Farmland	23,752	—	—	—	—	—	23,752
Total real estate	374,976	1,598	537	299	2,434	13,206	390,616
Consumer	8,869	59	—	—	59	—	8,928
Less unearned income	(841)	—	—	—	—	—	(841)
Total	$472,985	$ 1,877	$ 537	$ 299	$2,713	$ 13,736	$489,434

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Modifications

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

Loans modified in a TDR are typically already on non-accrual status and partial charge-offs have in some cases already been taken against the outstanding loan balance. As a result, loans modified in a TDR for the Company may have the financial effect of increasing the specific allowance associated with the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the estimated fair value of the collateral, less any selling costs, if the loan is collateral dependent. The Company's practice is to re-appraise collateral dependent loans semi-annually. During the nine months ended September 30, 2012, 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.

The Company closely monitors the performance of modified loans for delinquency, as delinquency is considered an early indicator of possible future default. The allowance may be increased, adjustments may be made in the allocation of the allowance, or partial charge-offs may be taken to further write-down the carrying value of the loan.

The following tables present TDRs for the three and nine months ended September 30, 2012, all of which were modified due to financial stress of the borrower.

	Current TDRs			Subsequently Defaulted TDRs		
Nine months ended September 30, 2012	Number of Contracts	Pre-TDR Outstanding Recorded	Post-TDR Outstanding Recorded	Number of Contracts	Pre-TDR Outstanding Recorded	Post-TDR Outstanding Recorded

		Investment	Investment		Investment	Investment
Commercial	1	$ 335	$ 323			
Residential real estate	3	342	300	—	$ —	$ —
CRE owner occupied	1	59	58	—	—	—
CRE non-owner occupied	1	2,180	2,165	—	—	—
Construction & development	3	2,972	1,552	2	2,561	2,465
Ending balance (1)	9	$ 5,888	$ 4,398	2	$ 2,561	$ 2,465

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	Current TDRs			Subsequently Defaulted TDRs		
Three months ended September 30, 2012	Number of Contracts	Pre-TDR Outstanding Recorded Investment	Post-TDR Outstanding Recorded Investment	Number of Contracts	Pre-TDR Outstanding Recorded Investment	Post-TDR Outstanding Recorded Investment
Residential real estate	—	$ —	$ —	—	$ —	$ —
Ending balance (1)	—	$ —	$ —	—	$ —	$ —

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

The construction and development loan TDRs that subsequently defaulted were modified by extending the maturity date. Both loans were on non-accrual status prior to and after the TDR. The subsequent defaults reported above occurred during the last twelve months and the loans were subsequently transferred to other real estate owned during the three months ended March 31, 2012. There were no other loans modified as a TDR within the previous 12 months that subsequently defaulted during the three and nine months ended September 30, 2012.

Loans classified as TDRs are considered impaired loans. The Company had no commitments to lend additional funds for loans classified as troubled debt restructured at September 30, 2012.

Note 5 – Stock Based Compensation

Stock Options

The Company's 2000 Stock Incentive Plan provided for incentive and non-qualified stock options and other types of stock based awards to key personnel. Under the plan, the Company was authorized to issue up to 1,100,000 shares; however the plan expired January 1, 2011. On April 27, 2011, the shareholders of the Company approved the 2011 Equity Incentive Plan, pursuant to which the Company is authorized to issue up to 900,000 shares of common stock in connection with awards under the plan.

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

Grant period ended	Expected Life	Risk Free Interest Rate	Expected Volatility	Dividend Yield	Average Fair Value
September 30, 2012	6.5 years	1.34 %	22.43 %	—%	$ 0.77
September 30, 2011	6.5 years	1.50 %	22.51 %	—%	$ 1.05

A summary of stock option activity under the stock option plans as of September 30, 2012 and 2011, and changes during the nine months then ended are presented below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
September 30, 2012				
Outstanding beginning of period	586,448	$ 11.32		
Granted	10,500	5.00		
Exercised	—	—		
Forfeited	(12,550)	10.44		
Expired	(47,291)	10.57		
Outstanding end of period	537,107	$ 11.28	4.3	$ —
Exercisable end of period	368,727	$ 13.26	2.9	$ —
September 30, 2011				
Outstanding beginning of period	818,612	$ 11.07		
Granted	5,000	3.95		
Exercised	—	—		
Forfeited	(55,125)	11.16		
Expired	(178,439)	10.10		
Outstanding end of period	590,048	$ 11.30	4.8	$ —
Exercisable end of period	411,768	$ 12.88	3.4	$ —

A summary of the status of the Company’s non-vested options as of September 30, 2012 and 2011 and changes during the nine months then ended are presented below:

	2012		2011	
	Shares	Weighted Average Fair Value	Shares	Weighted Average Fair Value
Non-vested beginning of period	174,740	$ 0.37	218,885	$ 0.51
Granted	10,500	0.77	5,000	1.05
Vested	(10,950)	1.69	(19,305)	1.71

Forfeited	(5,910)		0.27	(26,300)		0.50
Non-vested end of period	168,380	$	0.32	178,280	$	0.39

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The Company accounts for stock based compensation in accordance with GAAP, which requires measurement of compensation cost for all stock-based awards based on grant date fair value and recognition of compensation cost over the service period of each award. Stock-based compensation expense during the nine months ended September 30, 2012 and 2011 was $13 and $19 ($9 and $13 net of tax), respectively. Future compensation expense for unvested awards outstanding as of September 30, 2012 is estimated to be $27 recognized over a weighted average period of 1.7 years. There were no options exercised during the nine months ended September 30, 2012 and 2011.

Restricted Stock Units

In March 2012, the Company granted restricted stock units ("RSU") to certain employees receiving awards under the Company's Annual Incentive Compensation Plan. Recipients of RSUs will be issued a specified number of shares of the Company's common stock upon the lapse of their applicable restrictions. Restrictions require the employee to continue in employment for a period of three years from the date the RSU is awarded.

The following table summarizes RSU activity during 2012. There was no RSU activity prior to 2012.

	Shares	Weighted average grant price	Weighted average remaining contractual terms (in years)
Outstanding, January 1, 2012	—	$ —	—
Granted	7,274	4.15	2.5
Forfeited	(545)		
Outstanding, September 30, 2012	6,729	$ 4.15	2.5

For the nine months ended September 30, 2012, the Company recognized compensation expense related to RSUs of $5 ($3 net of tax). As of September 30, 2012, there was $23 of total unrecognized compensation expense related to non-vested RSUs.

Note 6 – 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 September 30, 2012 and December 31, 2011 is as follows:

	September 30, 2012	December 31, 2011
Commitments to extend credit	$ 78,336	$ 91,596
Standby letters of credit	2,065	1,310

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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.

In connection with certain loans held for sale, the Bank typically makes representations and warranties that the underlying loans conform to specified guidelines. If the underlying loans do not conform to the specifications, the Bank may have an obligation to repurchase the loans or indemnify the purchaser against loss. The Bank believes that the potential for loss under these arrangements is remote. Accordingly, no contingent liability is recorded in the condensed consolidated financial statements.

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 7 – Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2011-04, *"Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*." This ASU is the result of joint efforts by the FASB and International Accounting Standards Board to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and International Financial Reporting Standards. The amendments are effective for interim and annual periods beginning after December 15, 2011 with prospective application required. The Company adopted the provisions of ASU No. 2011-04 effective January 1, 2012. The fair value measurement provisions had no impact on the Company's consolidated financial statements. See Note 8 for the enhanced disclosures required by ASU No. 2011-04.

In June 2011, FASB issued ASU No. 2011-05, "*Comprehensive Income (Topic 220): Presentation of Comprehensive Income*". This ASU will require companies to present the components of net income and other comprehensive income either as one continuous statement or as two consecutive statements. It eliminates the option to present components of other comprehensive income as part of the statement of changes in shareholders' equity. The standard does not change the items which must be reported in other comprehensive income, how such items are measured or when they must be reclassified to net income. This standard is effective for interim and annual periods beginning after December 15, 2011. The FASB subsequently deferred the effective date of certain provisions of this standard pertaining to the reclassification of items out of accumulated other comprehensive income. A Consolidated Statement of Comprehensive Income has been included as part of the Company's unaudited financial statements, for the nine months ended September 30, 2012 and 2011. The adoption of ASU No. 2011-05 had no impact on the Company's financial condition, results of operations or cash flows.

Note 8 – 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 observable market data. Standard inputs include benchmark yields, reported trades, broker/dealer quotes, credit ratings, bids and offers, relative credit information and reference data from market research publications. Investment securities that are deemed to have been trading in illiquid or inactive markets may require the use of significant unobservable inputs.

The pricing service provides quoted market prices when available. Quoted prices are not always available due to bond market inactivity. For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows. Discounted cash flows are calculated using spread to swap and LIBOR curves that are updated to incorporate loss severities, volatility, credit spread and optionality. Additionally, the pricing service may obtain a broker quote when sufficient information is not available to produce a valuation. Valuations and broker quotes are non-binding and do not represent quotes on which one may execute the disposition of the assets.

The Company generally obtains one value from its primary external third-party pricing service. The Company’s third-party pricing service has established processes for us to submit inquiries regarding quoted prices. The Company’s third-party pricing service will review the inputs to the evaluation in light of any new market data presented by us. The Company’s third-party pricing service may then affirm the original quoted price or may update the evaluation on a going forward basis.

On a quarterly basis, management reviews the pricing information received from the third party-pricing service through a combination of procedures that include an evaluation of methodologies used by the pricing service, analytical reviews and performance analysis of the prices against statistics and trends and maintenance of an investment watch list. Based on this review, management determines whether the current placement of the security in the fair value hierarchy is appropriate or whether transfers may be warranted. As necessary, the Company compares prices received from the pricing service to discounted cash flow models or through performing independent valuations of inputs and assumptions similar to those used by the pricing service in order to ensure prices represent a reasonable estimate of fair value. Although the Company does identify differences from time to time as a result of these validation procedures, the Company did not make any significant adjustments as of September 30, 2012 or December 31, 2011.

The following table presents the balances of assets measured at fair value on a recurring basis at September 30, 2012 and December 31, 2011.

September 30, 2012	Readily Available Market Inputs Level 1	Observable Market Inputs Level 2	Significant Unobservable Inputs Level 3	Total
Securities available-for-sale				
U.S. Government securities	$ —	$ 1,210	$ —	$1,210
State and municipal securities	—	24,068	1,071	25,139
Agency MBS	—	16,491	—	16,491
Non-agency MBS	—	5,004	—	5,004
Corporate bonds	2,272	1,588	—	3,860
Total	$ 2,272	$ 48,361	$ 1,071	$51,704

December 31, 2011	Readily Available Market Inputs Level 1	Observable Market Inputs Level 2	Significant Unobservable Inputs Level 3	Total
Securities available-for-sale				
U.S. Government securities	$ —	$ 84	$ —	$84
State and municipal securities	—	21,719	1,140	22,859
Agency MBS	—	16,915	—	16,915
Non-agency MBS	—	5,882	—	5,882
Corporate bonds	918	994	—	1,912
Total	$ 918	$ 45,594	$ 1,140	$47,652

As of September 30, 2012 and December 31, 2011, the Company had two investments classified as Level 3 investments which consist of local non-rated municipal bonds for which the Company is the sole owner of the entire bond issue. The valuation of these securities is supported by analysis prepared by an independent third party. Their approach to determining fair value involves using recently executed transactions and market quotations for similar securities. As these securities are not rated by the rating agencies and there is no trading volume, management determined that these securities should be classified as Level 3 within the fair value hierarchy. Additionally, these securities are considered sensitive to changes in credit given the unobserved assumed credit ratings.

The following table presents a reconciliation of assets that are measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the nine months ended September 30, 2012 and 2011, respectively. There were no transfers of assets into or out of Level 1, 2 or 3 for the nine months ended September 30, 2012.

	Three months ended September 30,		Nine months Ended September 30,	
	2012	2011	2012	2011
Balance beginning of period	$ 1,069	$ 1,135	$ 1,140	$ 1,157
Included in other comprehensive income (loss)	2	31	(69)	9
Balance end of period	$ 1,071	$ 1,166	$ 1,071	$ 1,166

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Certain assets and liabilities are measured at fair value on a nonrecurring basis after initial recognition such as loans measured for impairment and other real estate owned (“OREO”). The following methods were used to estimate the fair value of each such class of financial instrument:

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

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 lower of the carrying amount of the loan or fair value of the property less estimated costs to sell. This amount becomes the property's new basis. Management considers third party appraisals in determining the fair value of particular properties. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach.

Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available and include consideration for variations in location, size, and income production capacity of the property. Additionally, the appraisals are periodically further adjusted by the Company based on management's historical knowledge, changes in business factors and changes in market conditions. Such discounts are typically significant, and may range from 10% to 25% resulting in a Level 3 classification.

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

The following table presents the Company's assets that were held at the end of each period that were accounted for at fair value on a nonrecurring basis at September 30, 2012 and December 31, 2011.

	Readily Available Market Inputs Level 1	Observable Market Inputs Level 2	Significant Unobservable Inputs Level 3	Total
September 30, 2012				
Impaired loans	$ —	$ —	$ 4,791	$4,791
OREO	$ —	$ —	$ 2,995	$2,995
December 31, 2011				
Impaired loans	$ —	$ —	$ 7,183	$7,183
OREO	$ —	$ —	$ 6,455	$6,455

Other real estate owned with a pre-foreclosure loan balance of $2,637 was acquired during the nine months ended September 30, 2012. Upon foreclosure, certain of these assets were written down a total of $152 to their fair value, less estimated costs to sell, which was charged to the allowance for credit losses during the period.

The following table presents quantitative information about Level 3 inputs for financial instruments measured at fair value on a nonrecurring basis at September 30, 2012:

	Fair Value	Valuation Technique	Significant Unobservable	Range (Weighted Average)

			Inputs		
Impaired loans	$1,306	Appraised value - Sales comparison approach	Adjustment for market conditions	0-15% (1	)%
	$3,485	Income approach	Discount rate	10.5	%
OREO	$2,995	Appraised value - Sales comparison approach	Adjustment for market conditions	0-10% (5	)%

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Fair Value of Financial Instruments

The following methods and assumptions were used by the Company in estimating the fair values of financial instruments disclosed in these consolidated financial statements:

Cash and due from banks, and Interest bearing deposits in banks

The carrying amounts of cash and interest bearing deposits at other financial institutions approximate their fair value.

Investment Securities Available-for-Sale and Held-to-Maturity

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

Federal Home Loan Bank stock

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

Loans, net and Loans held for sale

The fair value of loans is estimated based on comparable market statistics for loans with similar credit ratings. An additional liquidity discount is also incorporated to more closely align the fair value with observed market prices. Fair values of loans held for sale are based on a discounted cash flow calculation using interest rates currently available on similar loans. The fair value was determined on an aggregate loan basis.

Deposits

The fair value of deposits with no stated maturity date is included at the amount payable on demand. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation based on interest rates currently offered on similar certificates.

Short-term borrowings

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

Long-term borrowings

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

Secured borrowings

For variable rate secured borrowings that reprice frequently and have no significant change in credit risk, fair values are based on carrying values.

Junior subordinated debentures

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

Off-Balance-Sheet Instruments

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

The estimated fair values of the Company's financial instruments at September 30, 2012 and December 31, 2011 are as follows:

September 30, 2012	Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets					
Cash and cash equivalents	$42,974	$42,974	$—	$—	$ 42,974
Securities available-for sale	51,704	2,272	48,361	1,071	51,704
Securities held-to-maturity	6,848	—	6,897	—	6,897
Federal Home Loan Bank stock	3,154	—	3,154	—	3,154
Loans held for sale	21,948	—	22,491	—	22,491
Loans, net	454,813	—	—	411,250	411,250
Financial Liabilities					
Deposits	$548,182	$—	$549,561	$—	$ 549,561
Short-term borrowings	3,000	—	3,050	—	3,050
Long-term borrowings	7,500	—	7,779	—	7,779
Secured borrowings	219	—	219	—	219
Junior subordinated debentures	13,403	—	—	7,057	7,057

December 31, 2011	Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets					
Cash and cash equivalents	$41,132	$41,132	$—	$—	$ 41,132
Securities available-for sale	47,652	918	45,594	1,140	47,652
Securities held-to-maturity	7,025	—	7,118	—	7,118
Loans held for sale	14,541	—	14,808	—	14,808
Loans, net	463,766	—	—	419,059	419,059
Financial Liabilities					
Deposits	$548,050	$—	$549,472	$—	$ 549,472
Short-term borrowings	—	—	—	—	—
Long-term borrowings	10,500	—	10,867	—	10,867
Secured borrowings	741	—	741	—	741
Junior subordinated debentures	13,403	—	—	6,691	6,691

Note 9 – Subsequent Event

On November 2, 2012, the Company received a final determination in favor of the Bank in its appeal of a USDA decision to revoke a guaranty on a loan to one of the Bank's borrowers. As a result of the decision, the guaranty is reinstated, and can only be revoked should the USDA appeal and the decision is reversed. Absent an appeal, the reinstatement of the guarantee during the fourth quarter of 2012 would result in the elimination of a $1.7 million specific reserve for the loan that was included in the Company's allowance for credit losses at September 30, 2012. The Company expects the reversal to have a favorable, but not necessarily equivalent, impact on provision for credit losses during the fourth quarter of this year.

ITEM 2 – MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

A Warning About Forward-Looking Information

This document contains forward-looking statements that are subject to risks and uncertainties. These statements are based on the present beliefs and assumptions of our management, and on information currently available to them. Forward-looking statements include the information concerning our possible future results of operations set forth under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and statements preceded by, followed by or that include the words "believes," "expects," "anticipates," "intends," "plans," "estimates" or similar expressions.

Any forward-looking statements in this document are subject to the risks of our business, including risk factors described in our Annual Report on Form 10-K for the year ended December 31, 2011 (the "2011 10-K"), as well as risks relating to, among other things, the following:

1. changing laws, regulations, standards, and government programs that may limit our revenue sources, significantly increase our costs, including compliance and insurance costs, limit our opportunities to generate noninterest income, and place additional burdens on our limited management resources;

2. economic and business conditions, nationally and in the regions in which we do business, that have resulted in, and may continue to result in, among other things, restrained demand for credit and other banking services and/or reduced credit quality , and additional workout and other real estate owned ("OREO") expenses;

3. decreases in real estate and other asset prices, whether or not due to economic conditions, that may reduce the value of the assets that serve as collateral for many of our loans;

4 competitive pressures among depository and other financial institutions that may impede our ability to attract and retain depositors, borrowers and other customers, maintain and improve our net interest income and margin and non-interest income, such as fee income, and/or retain our key employees; and

5. a lack of liquidity in the market for our common stock that may make it difficult or impossible for you to liquidate your investment in our stock or lead to distortions in the market price of our stock.

Our management believes the forward-looking statements in this report are reasonable; however, you should not place undue reliance on them. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions. Many of the factors that will determine our future results and share value are beyond our ability to control or predict. We undertake no obligation to update forward-looking statements.

Overview

The Company is a bank holding company headquartered in Aberdeen, Washington. The Company's wholly-owned subsidiary, The Bank of the Pacific (the “Bank”), is a state chartered bank, also located in Washington. The Company has two wholly-owned subsidiary trusts known as PFC Statutory Trust I and II (the “Trusts”) that were formed December 2005 and May 2006, respectively, in connection with the issuance of trust preferred securities. The Company was incorporated in the state of Washington on February 12, 1997, pursuant to a holding company reorganization of the Bank.

The Company conducts its banking business through the Bank, which operates 16 branches located in communities in Grays Harbor, Pacific, Whatcom, Skagit and Wahkiakum counties in the state of Washington and one in Clatsop County, Oregon. During 2012, the Company opened a loan production office in Burlington, Washington. Additionally, the Company is currently in the process of establishing a full service branch in Warrenton, Oregon, with an estimated opening date in 2013.

The Bank provides loan and deposit services to customers who are predominantly small and middle-market businesses and middle-income individuals.

Critical Accounting Policies

Critical accounting policies are discussed in the 2011 10-K under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operation – Critical Accounting Policies.” There have been no material changes in our critical accounting policies from the 2011 10-K.

Recent Accounting Pronouncements

Please see Note 7 of the Company's Notes to Condensed Consolidated Financial Statements above for a discussion of recent accounting pronouncements and the likely effect on the Company.

Financial Summary

The following are significant trends reflected in the Company's results of operations for the three and nine months ended September 30, 2012, and financial condition as of that date:

- Net income for the three months ended September 30, 2012 was $1,015,000, a decrease of $189,000, or 15.7%, compared to the same period of the prior year. The decrease in net income for the three month period was primarily related to increases in other real estate owned write-downs (OREO), other than temporary impairment losses and salaries, which were partially offset by a decrease in provision for credit losses. Net income for the nine months ended September 30, 2012 was $3,106,000, an increase of $867,000, or 38.7%, compared to net income of $2,239,000 for the same period in 2011, which was mostly due to increases in net interest income and gains on sales of loans and OREO, coupled with the positive effects of a decrease in provision for credit losses, which were only partially offset by increased salary and benefit expenses.

- Return on average assets and return on average equity were 0.65% and 6.35%, respectively, for the nine months ended September 30, 2012, compared to 0.46% and 4.87%, respectively, for the same period in 2011.

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- Net interest income of $5,922,000 for the three months ended September 30, 2012 decreased $148,000 compared to the same period of the prior year due to continued downward pressure on interest rates. Net interest income of $18,102,000 for the nine months ended September 30, 2012 increased $582,000 compared to the same period of the prior year. The increase is primarily the result of decreased average funding costs, which dropped from 1.25% for the nine months ended September 30, 2011, to 0.79% in the current period. Net interest margin improved to 4.14% and 4.23% for the three and nine months ended September 30, 2012, compared to 4.11% and 4.02%, respectively, in the same periods one year ago.

- The Bank's tier 1 leverage ratio was 10.78% and total risk-based capital ratio was 16.04% at September 30, 2012, an increase from 10.35% and 15.05%, respectively, at year-end. During the second quarter of 2012, the Bank paid a $1,400,000 dividend to the Company to allow it to pay accrued interest on outstanding junior subordinated debentures. Approximately $835,000 was paid during June 2012, with another $569,000 paid in the current quarter, bringing all interest payments on the junior subordinated debentures current. The Company had previously elected to exercise the right to defer interest payments as allowed in the debenture agreement. Additionally, during the current quarter, the Company announced a stock repurchase plan authorizing the Company to purchase up to 250,000 shares of its common stock.

- Total assets were $644,063,000 at September 30, 2012, an increase of $2,809,000, or 0.44%, over year-end 2011. Increases in investments and loans held for sale were the primary contributors to overall asset decline, which were partially offset by a decrease in loans and OREO. Total loans, including loans held for sale, of $487,918,000 at September 30, 2012, decreased $1,516,000, or 0.31%, compared to year-end 2011.

- Non-performing assets ("NPAs") totaled $17,591,000 at September 30, 2012, which represents 2.73% of total assets, and is a decrease from $21,760,000 at December 31, 2011. The decrease is largely due to a decline in non-performing loans from $14,035,000 at year-end 2011 to $11,788,000 as of September 30, 2012. The largest reduction was in the construction and land development non-performing loan category which decreased by $3,934,000, or 71.40%, due to pay-offs.

- Provision for credit losses were zero and $400,000 for the three and nine months ended September 30, 2012 compared to $1,050,000 and $1,550,000 for the same periods one year ago. The decrease in the 2012 third quarter over the prior year is due partly to net recoveries of $93,000 for the three months ended September 30, 2012 compared to net charge-offs of $1,093,000 one year ago. Provision expense for the first nine months of 2012 is down from the prior year due to improving credit quality as evidenced by decreases in non-performing loans. The allowance for credit losses was relatively flat at 2.29% of total loans (including loans held for sale) compared to 2.27% at year-end 2011.

- Total deposits of $548,182,000 at September 30, 2012 were flat compared to $548,050,000 at December 31, 2011. However, non-interest bearing demand accounts increased by $14,390,000, or 13.21%, during the current nine-month period, which increase was offset by a similar decrease in higher cost certificates of deposit. Funding costs for interest-bearing deposits decreased to 0.69% for the current quarter, compared to 1.09% for the same period a year ago.

- The Company's liquidity ratio of approximately 43% at September 30, 2012 remains strong and translates into over $278 million in available funding to meet loan and deposit needs.

Results of Operations

Net income. For the three and nine months ended September 30, 2012, net income was $1,015,000 and $3,106,000, respectively, compared to $1,204,000 and $2,239,000 for the same periods in 2011. The decrease in net income for the three month period was primarily related to increases in commissions paid in loans sold, OREO write-downs and other than temporary impairment losses (OTTI), which were partially offset by a decrease in provision for credit losses. The increase in net income for the nine month periods was primarily related to increases in net interest income and gain on sale of loans and OREO, coupled with a decrease in FDIC assessments, which were partially offset by an increase in salaries and benefits, OREO costs, and data processing expenses.

Net interest income. Net interest income for the three months ended September 30, 2012 decreased $148,000, or 2.44%, compared to the same period in 2011. Net interest income for the nine months ended September 30, 2012 increased $582,000, or 3.32%, compared to the same period in 2011. See the table below and the accompanying discussion for further information on interest income and expense. The net interest margin (net interest income divided by average earning assets and adjusted for tax on tax-exempt securities and loans) increased to 4.14% for the three months ended September 30, 2012 from 4.11% for the same period of the prior year. Net interest margin increased to 4.23% for the nine months ended September 30, 2012 from 4.02% for the same period last year. The increase in the current three and nine month periods is due to an improvement in the average cost of funds to 0.79% for the nine months ended September 30, 2012 from 1.25% one year ago, that was only partially offset by a decline in the Company’s average yield earned on assets from 5.20% to 5.01%. While net interest margin increased during the current nine month period, it has contracted since June 30, 2012 when net interest margin was 4.27%. Management believes the net interest margin may continue to decline slightly through the remainder of 2012 as market interest rates remain at historically low levels.

The following tables set forth information with regard to average balances of interest earning assets and interest bearing liabilities and the resultant yields or cost, net interest income, and the net interest margin on a tax equivalent basis. Loans held for sale and non-accrual loans are included in total loans.

Three Months Ended September 30,

(dollars in thousands)	2012 Average Balance	2012 Interest Income (Expense)		2012 Avg Rate	**2011** Average Balance	2011 Interest Income (Expense)		2011 Avg Rate
Interest Earning Assets								
Loans (1)	$482,172	$ 6,374	*	5.29%	$483,482	$ 6,932	*	5.74%
Taxable securities	29,626	186		2.51	30,473	260		3.41
Tax-exempt securities	27,897	385	*	5.52	25,083	388	*	6.19
Federal Home Loan Bank Stock	3,181	—		—	3,183	—		—
Interest earning balances with banks	29,838	19		0.25	48,627	29		0.24
Total interest earning assets	$572,714	$ 6,964		4.86%	$590,848	$ 7,609		5.15%
Cash and due from banks	10,948				10,700			
Bank premises and equipment (net)	14,726				14,977			
Other real estate owned	6,286				7,857			
Other assets	42,680				41,980			
Allowance for credit losses	(11,030)				(11,098)			
Total assets	$636,324				$655,264			
Interest Bearing Liabilities								
Savings and interest bearing demand	$286,210	$ (253	)	0.35%	$282,974	$ (394	)	0.56%
Time deposits	142,661	(433	)	1.21	174,513	(718	)	1.65
Total deposits	428,871	(686	)	0.64	457,487	(1,112	)	0.97
Short-term borrowings	3,000	(22	)	2.93	7,728	(69	)	3.57
Long-term borrowings	7,500	(51	)	2.72	10,500	(79	)	3.01
Secured borrowings	220	(1	)	1.82	762	(9	)	4.72
Junior subordinated debentures	13,403	(69	)	2.06	13,403	(67	)	2.00
Total borrowings	24,123	(143	)	2.37	32,393	(224	)	2.77
Total interest-bearing liabilities	$452,994	$ (829	)	0.73%	$489,880	$ (1,336	)	1.09%
Demand deposits	112,364				98,471			
Other liabilities	4,512				4,273			
Shareholders' equity	66,454				62,640			

Total liabilities and shareholders' equity	$636,324			$655,264		
Net interest income		$ 6,135	*		$ 6,273	*
Net interest spread			4.28%			4.25%
Net interest margin			4.14%			4.11%
Tax equivalent adjustment		$ 213	*		$ 230	*

*** Tax equivalent basis – 34% tax rate used**

(1) Interest income on loans includes loan fees of $113 and $138 in 2012 and 2011, respectively.

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Nine Months Ended September 30,

(dollars in thousands)	2012 Average Balance	2012 Interest Income (Expense)		2012 Avg Rate	2011 Average Balance	2011 Interest Income (Expense)		2011 Avg Rate
Interest Earning Assets								
Loans (1)	$480,367	$ 19,625	*	5.45 %	$481,470	$ 20,681	*	5.73%
Taxable securities	30,336	633		2.78	29,990	810		3.60
Tax-exempt securities	26,895	1,129	*	5.60	23,950	1,118	*	6.22
Federal Home Loan Bank Stock	3,182	—		—	3,183	—		—
Interest earning balances with banks	30,270	55		0.24	42,716	77		0.24
Total interest earning assets	$571,050	$ 21,442		5.01 %	$581,309	$ 22,686		5.20%
Cash and due from banks	10,264				10,126			
Bank premises and equipment (net)	14,798				15,090			
Other real estate owned	7,340				7,287			
Other assets	41,284				41,842			
Allowance for credit losses	(11,011)				(11,022)			
Total assets	$634,725				$644,632			
Interest Bearing Liabilities								
Savings and interest bearing demand	$289,776	$ (856)		0.39 %	$271,496	$ (1,261)		0.62%
Time deposits	146,931	(1,403)		1.27	183,117	(2,470)		1.80
Total deposits	436,707	(2,259)		0.69	454,613	(3,731)		1.09
Short-term borrowings	2,595	(57)		2.93	9,205	(265)		3.84
Long-term borrowings	7,905	(166)		2.80	10,500	(256)		3.25
Secured borrowings	551	(18)		4.36	802	(32)		5.32
Junior subordinated debentures	13,403	(221)		2.20	13,403	(280)		2.79
Total borrowings	24,454	(462)		2.52	33,910	(833)		3.28
Total interest-bearing liabilities	$461,161	$ (2,721)		0.79 %	$488,523	$ (4,564)		1.25%
Demand deposits	103,308				90,163			
Other liabilities	5,014				4,608			
Shareholders' equity	65,242				61,338			
Total liabilities and shareholders' equity	$634,725				$644,632			
Net interest income		$ 18,721	*			$ 18,122	*	
Net interest spread				4.37 %				4.16%
Net interest margin				4.23 %				4.02%
Tax equivalent adjustment		$ 619	*			$ 602	*	

*** Tax equivalent basis – 34% tax rate used**

(1) Interest income on loans includes loan fees of $416 and $378 in 2012 and 2011, respectively.

Interest and dividend income on a tax equivalent basis for the three and nine months ended September 30, 2012 decreased $645,000 and $1,244,000, or 8.48% and 5.48%, respectively, compared to the same periods in 2011. The decrease was primarily due to the decline in income earned on our loan and investment portfolio as a result of the low interest rate environment. Loans averaged $480,367,000 with an average yield of 5.45% for the nine months ended September 30, 2012, compared to average loans of $481,470,000 with an average yield of 5.73% for the same period in 2011. Interest and dividend income on investment securities on a tax equivalent basis for the three and nine months ended September 30, 2012 decreased $77,000 and $166,000, or 11.88% and 8.61%, respectively, compared to the same periods in 2011. The decrease was attributable to the reduction in yield from accelerated prepayments on mortgage-backed securities and the maturity and sale of higher yielding securities that cannot be replaced in the current low rate environment.

Average interest earning balances with banks for the three and nine months ended September 30, 2012 were $29,838,000 and $30,270,000, respectively, compared to $48,627,000 and $42,716,000 for the same periods in 2011. The average yield in all periods was 0.24 – 0.25% and is comparable to the federal funds target rate of 0.25% set by the Federal Open Market Committee.

Interest expense for the three and nine months ended September 30, 2012 decreased $507,000 and $1,843,000, or 37.95% and 40.38%, respectively, compared to the same periods in 2011. The decrease is primarily attributable to a decrease in rates paid on deposits, coupled with lower average balances outstanding on time deposits. The Company continued to reduce interest rates on certain deposit products in response to the continued low interest rate environment. The average balance of time deposits declined $36,186,000 compared to the first nine months of 2011, as fewer retail customers have been willing to lock in low interest rates for an extended period of time. In total, average interest-bearing deposit balances for the nine months ended September 30, 2012 and 2011 were $436,707,000 and $454,613,000, respectively, with an average cost of 0.69% and 1.09%, respectively.

Average borrowings for the nine months ended September 30, 2012 were $24,454,000 with an average cost of 2.52% compared to $33,910,000 with an average cost of 3.28% for the same period in 2011. The decrease in average borrowing balances outstanding is primarily due to the maturity of $10,500,000 in FHLB advances in the latter part of 2011. The pay down in borrowings was funded by growth in lower cost demand, money market and savings deposits, further improving net interest margin.

Provision and allowance for credit losses. The allowance for credit losses reflects management's current estimate of the amount required to absorb probable losses on loans in its loan portfolio based on factors present as of the end of the period. Loans deemed uncollectible are charged against and reduce the allowance.

Periodic provisions for credit losses are charged to current expense to replenish the allowance for credit losses in order to maintain the allowance at a level management considers adequate. The amount of provision is based on an analysis of various factors including historical loss experience based on volumes and types of loans, volumes and trends in delinquencies and non-accrual loans, trends in portfolio volume, results of internal and independent external credit reviews, and anticipated economic conditions. Estimated loss factors used in the allowance for credit loss analysis are established based in part on historic charge-off data by loan category and economic conditions. During the three months ended September 30, 2012, based upon charge-off experience and other factors considered by management, the loss factors used in the allowance for credit losses were updated specifically on pass rated commercial loans from 0.55% to 0.50%, on non-owner occupied commercial real estate loans from 0.65% to 0.50%, on land and land development loans from 5.50% to 5.00% and on speculative residential construction loans from 1.75% to 1.25%, resulting in a decrease in the estimate for the allowance for credit losses. For additional information, please see the discussion under the heading “Critical Accounting Policies” in Item 7 of our 2011 10-K.

During the three and nine months ended September 30, 2012, provision for credit losses totaled zero and $400,000 compared to $1,050,000 and $1,550,000 for the same periods in 2011. The decrease in provision for credit losses in the current nine-month period is due to improving credit quality as evidenced by decreases in non-performing loans and loans classified substandard, coupled with a decrease in net charge-offs. Non-performing loans decreased from $14,035,000 at December 31, 2011, to $11,788,000 at September 30, 2012. Loans classified as substandard decreased $4,989,000 from year-end 2011 to $29,581,000 at the close of the third quarter.

For the three and nine months ended September 30, 2012, net charge-offs (recoveries) were ($93,000) and $370,000 compared to $1,093,000 and $1,294,000 for the same periods in 2011. Net charge-offs for the twelve months ended December 31, 2011 were $1,990,000. The ratio of net charge-offs to average loans outstanding for the nine months ended September 30, 2012 and 2011 was 0.08% and 0.27%, respectively.

At September 30, 2012, the allowance for credit losses was $11,157,000 compared to $11,127,000 at December 31, 2011, and $10,923,000 at September 30, 2011. The slight increase compared to year-end 2011 is due to net recoveries recognized during the current quarter. The ratio of the allowance for credit losses to total loans outstanding (including loans held for sale) was 2.29%, 2.34% and 2.25%, at September 30, 2012, December 31, 2011 and September 30, 2011, respectively. The allowance for credit losses as a percentage of total loans remains elevated compared to historical standards and is reflective of management’s review since year-end 2011 of qualitative factors including the continued uncertainty in the economy, pervasive high unemployment rates in our geographic markets, and deterioration in real estate values, albeit at a slower pace than in the last three years.

The Company’s loan portfolio includes a significant portion of government guaranteed loans which are fully guaranteed by the United States Government. Government guaranteed loans were $50,710,000, $52,928,000, and $56,774,000 at September 30, 2012, December 31, 2011 and September 30, 2011, respectively. The ratio of allowance for credit losses to total loans outstanding excluding the government guaranteed loans was 2.55%, 2.64%, and 2.54%, respectively.

There is no precise method of predicting specific credit losses or amounts that ultimately may be charged off. The determination that a loan may become uncollectible, in whole or in part, is a matter of significant management judgment. Similarly, the adequacy of the allowance for credit losses is a matter of judgment that requires consideration of many factors, including (a) economic conditions and the effect on particular industries and specific borrowers; (b) a review of borrowers' financial data, together with industry data, the competitive situation, the borrowers' management capabilities and other factors; (c) a continuing evaluation of the loan portfolio, including monitoring by lending officers and staff credit personnel of all loans which are identified as being of less than acceptable quality; (d) an in-depth review, at a minimum quarterly or more frequently as considered necessary, of all loans judged to present a possibility of loss (if, as a result of such quarterly analysis, the loan is judged to be not fully collectible, the carrying value of the loan is reduced to that portion considered collectible); and (e) an evaluation of the underlying collateral for secured lending, including the use of independent appraisals of real estate properties securing loans. An analysis of the adequacy of the allowance is conducted by management quarterly and is reviewed by the board of directors. Based on this analysis and applicable accounting standards, management considers the allowance for credit losses to be adequate at September 30, 2012.

On November 2, 2012, the Company received a final determination in favor of the Bank in its appeal of a USDA decision to revoke a guaranty on a loan to one of the Bank’s borrowers. As a result of the decision, the guaranty is reinstated, and can only be revoked should the USDA appeal and the decision is reversed. Absent an appeal, the reinstatement of the guarantee during the fourth quarter of 2012 would result in the elimination of a $1.7 million specific reserve for the loan that was included in the Company’s allowance for credit losses at September 30, 2012.

The Company expects the reversal to have a favorable, but not necessarily equivalent, impact on provision for credit losses during the fourth quarter of this year.

Non-performing assets and other real estate owned. Non-performing assets totaled $17,591,000 at September 30, 2012. This represents 2.73% of total assets, compared to $21,760,000, or 3.39%, at December 31, 2011, and $20,589, or 3.15%, at September 30, 2011. Commercial real estate loans are the primary components of non-performing assets, representing $7,897,000, or 44.89%, of non-performing assets.

The following table presents information related to the Company’s non-performing assets:

SUMMARY OF NON-PERFORMING ASSETS (dollars in thousands)	September 30, 2012		December 31, 2011		September 30, 2011	
Accruing loans past due 90 days or more	$ 770		$ 299		$ —	
Non-accrual loans:						
Construction, land development and other land loans	1,576		5,510		4,852	
Residential real estate 1-4 family	768		528		429	
Commercial real estate	7,897		7,168		6,419	
Consumer	—		—		—	
Commercial	777		530		180	
Total non-accrual loans (1)	11,018		13,736		11,880	
Total non-performing loans	11,788		14,035		11,880	
OREO	5,803		7,725		8,709	
Total Non-Performing Assets (2)	$ 17,591		$ 21,760		$ 20,589	
Troubled debt restructured loans on accrual status	$ 126		$ 398		$ 398	
Allowance for credit losses	$ 11,157		$ 11,127		$ 10,923	
Allowance for credit losses to non-performing loans	94.65	%	79.28	%	91.94	%
Allowance for credit losses to non-performing assets	63.42	%	51.14	%	53.05	%
Non-performing loans to total loans (3)	2.53	%	2.96	%	2.50	%
Non-performing assets to total assets	2.73	%	3.39	%	3.15	%

(1) Includes $4,272,000, $7,734,000 and $4,942,000 in non-accrual troubled debt restructured loans (“TDRs”) as of September 30, 2012, December 31, 2011 and September 30, 2011, respectively, which are also considered impaired loans.

(2) Does not include TDRs on accrual status.

(3) Excludes loans held for sale.

Non-performing loans decreased $2,247,000, or 16.01%, from the balance at December 31, 2011 due mostly to a decrease in non-accrual construction, land development and other land loans. The level of non-performing assets is still considered elevated by historical standards and reflects the continued weakness in the real estate market and economy in our region. In addition to the decrease in non-performing loans, OREO decreased by $1,922,000, or 24.88%, from the balance at December 31, 2011 due mostly to the sale of a 13-lot subdivision with a book value of $1,079,000 during the second quarter.

Currently, it is our practice to obtain new appraisals on non-performing collateral dependent loans and/or OREO semi-annually. Based upon the appraisal review for non-performing loans, the Company will record the loan at the lower of carrying value or fair value of collateral (less estimated costs to sell) by recording a charge-off to the allowance for credit losses or by designating a specific reserve. Generally, the Company will record the charge-off rather than designate a specific reserve. During the nine months ended September 30, 2012 and 2011, as a result of these appraisals and other factors, the Company recorded OREO write-downs of $698,000 and $599,000, respectively, and net charge-offs of $370,000 and $1,294,000, respectively.

OREO at September 30, 2012 totaled $5,803,000 and consists of properties as follows: twelve land or land development properties totaling $2,096,000, three residential construction properties totaling $798,000, nine commercial real estate properties totaling $2,526,000, and three single family residences collectively valued at $383,000. The balances are recorded at the lower of the original carrying amount of the loan or estimated net realizable value of the real estate less selling costs.

A troubled debt restructuring ("TDR") is a loan for which the terms have been modified in order to grant a concession to a borrower that is experiencing financial difficulty. Troubled debt restructurings are considered impaired loans and reported as such. For more information regarding TDRs, see Note 4-"Loans" of the condensed consolidated financial statements. The Company had troubled debt restructures totaling $4,398,000 and $8,132,000 at September 30, 2012 and December 31, 2011, respectively. The decrease in the current period is largely due to the transfer of $2,465,000 in previously restructured construction and land loans to OREO.

Non-interest income and expense. Non-interest income of $2,443,000 was relatively flat for the three months ended September 30, 2012, compared to $2,455,000 for the same period in 2011. An increase in gain on sales of loans was equally offset by a decrease in gain on sale of investments and an increase in OTTI. Non-interest income for the nine months ended September 30, 2012 increased by $1,541,000, or 29.87%, compared to the same period in 2011. The increase for the nine month period was the result of an increase in gain on sale of loans of $1,318,000 due to increased mortgage refinancing activity driven by the low rate environment. Additionally, gain on sale of OREO increased $419,000, as the Company continues to have success in liquidating properties.

Gain on sales of loans, the largest component of non-interest income, totaled $1,501,000 and $3,501,000 for the three and nine months ended September 30, 2012 compared to $1,084,000 and $2,183,000 for the same periods in 2011. Originations of loans held for sale were $184,171,000 for the nine months ended September 30, 2012, compared to $104,807,000 for the same period in 2011. Also contributing to the growth in volume was the addition of origination staff during the second and third quarter. The Company plans to continue to expand its mortgage origination staff to capitalize on the opportunities in its local markets. Management expects gain on sale of loans to continue at a robust pace for the remainder of 2012.

Service charges on deposits for the three and nine months ended September 30, 2012 decreased $64,000 and $94,000, or 13.62% and 6.96%, respectively. The decrease is due to declining overdraft revenue.

The Bank recorded net gains on sale of securities available-for-sale of $65,000 and $164,000 during the three and nine months ended September 30, 2012, compared to $352,000 and $536,000 for the same periods in the prior year. For the three and nine months ended September 30, 2012, one non-agency mortgage-backed security was determined to be other-than-temporarily-impaired resulting in the Company recording $160,000 and $265,000 in impairment charges related to credit losses, resulting in a reduction in earnings, compared to zero and $243,000 for the same periods a year ago. As of September 30, 2012, an additional $50,000 in impairments, not related to credit losses, have been recorded through other comprehensive income.

Total non-interest expense for the three and nine months ended September 30, 2012 increased $1,010,000 and $1,786,000, or 16.67% and 9.50%, respectively, compared to the same periods in 2011. The increases are attributable to increases in salaries and employee benefits related to annual performance and merit increases, coupled with higher commissions paid on the sale of loans held for sale and increased OREO and data processing expenses. These expense increases were partially offset by reductions in FDIC assessments and occupancy expenses. Salaries and employee benefits for the three and nine months ended September 30, 2012 and 2011, increased $738,000 and $1,635,000, or 21.94% and 16.05%, respectively. Full time equivalent employees at September 30, 2012 were 233 compared to 212 at September 30, 2011.

Income taxes. The federal income tax expense for the three and nine months ended September 30, 2012 was $280,000 and $717,000, respectively, as compared to $211,000 and $97,000, respectively, for the three and nine months ended September 30, 2011. The effective tax rate for the nine months ended September 30, 2012 was 18.75%. The effective tax rate differs from the statutory rate of 34.40% due to tax exempt income representing an increasing share of income as investments in municipal securities and loans, income earned on BOLI, and tax credits received on investments in low income housing partnerships remained at historical levels, while other earnings declined.

Financial Condition

Assets. Total assets were $644,063,000 at September 30, 2012, a slight increase of $2,809,000, or 0.44%, over year-end 2011. Increases in investments and loans held for sale were the primary contributors to overall asset growth, which were partially offset by a decrease in loans and OREO.

Investments. The investment portfolio provides the Company with an income alternative to loans. The Company's investment portfolio at September 30, 2012 was $58,552,000 compared to $54,677,000 at the end of 2011, an increase of $3,875,000, or 7.09%, due to investments in municipal and corporate bond securities as an alternative to cash. For additional information on investments, see Note 3 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

Loans. Total loans, including loans held for sale, decreased $1,516,000, or 0.31%, to $487,918,000 at September 30, 2012, compared to $489,434,000 at December 31, 2011. The decrease in loans was primarily due to a decline of $8,396,000 in construction and land development loans and $8,428,000 in commercial real estate loans which were largely a result of continued loan payoffs prior to maturity, which the Company believes are reflective of the current low interest rate environment and economic conditions. These declines were mostly offset by a modest increase in commercial and industrial loans and residential real estate loans. Loan detail by category, including loans held for sale, as of September 30, 2012 and December 31, 2011, follows (in thousands):

	September 30, 2012	December 31, 2011
Commercial	$ 98,002	$ 90,731
Residential real estate:		
Residential 1-4 family	97,987	90,552
Multi-family	7,914	7,682
Commercial real estate:		
Construction and land development	38,760	47,156
Commercial real estate – owner occupied	112,051	118,469
Commercial real estate – non owner occupied	100,995	103,005

Farmland	25,371	23,752
Consumer	7,641	8,928
Less unearned income	(803)	(841)
Total Loans	487,918	489,434
Allowance for credit losses	(11,157)	(11,127)
Net Loans	$ 476,761	$ 478,307

While total loans declined during the first nine months of 2012, total loans outstanding increased $8,432,000 since June 30, 2012. Management believes the loan portfolio will continue to grow, although at a rather subdued rate. While the Company would like to see stronger loan growth, the uncertainty surrounding various aspects of the economy is causing many customers to wait for more clarity before borrowing additional funds to expand their businesses or purchase assets.

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Interest and fees earned on our loan portfolio is our primary source of revenue. Gross loans represented 75.8% of total assets as of September 30, 2012, compared to 76.3% at December 31, 2011. The majority of the Company's loan portfolio is comprised of commercial and industrial loans and real estate loans. The commercial and industrial loans are a diverse group of loans to small, medium, and larger businesses for purposes ranging from working capital needs to term financing of equipment.

The commercial real estate loan category constitutes 44% of our loan portfolio and generally consists of a wide cross-section of retail, small office, warehouse, and industrial type properties. Loan to value ratios for the Company's commercial real estate loans at origination generally do not exceed 75% and debt service ratios are generally 125% or better. While we have significant balances within this lending category, we believe that our lending policies and underwriting standards are sufficient to reduce risk even in a downturn in the commercial real estate market. Additionally, this is a sector in which we have significant long-term management experience. It is our strategic plan to seek growth in commercial and small business loans where available and owner occupied commercial real estate loans.

We remain conservative in underwriting while active in managing our existing construction loan and land development portfolios. While these segments have historically played a significant role in our loan portfolio, balances have declined over the last three years. Construction and land development loans represented 7.9% and 9.6% of our loan portfolio at September 30, 2012 and December 31, 2011, respectively. We believe this segment will remain challenged through 2012, although to a lesser extent than the previous three years.

It is the Company's strategic objective to keep concentrations in land and residential construction and total commercial real estate below the regulatory guidelines of 100% and 300% of risk based capital, respectively. As of September 30, 2012, concentration in land and residential construction as a percentage of risk-based capital was 37% and concentration in commercial real estate as a percentage of risk based capital stood at 204%.

Deposits. Total deposits were $548,182,000 at September 30, 2012, a slight increase of $132,000, or 0.02%, compared to December 31, 2011. Deposit detail by category as of September 30, 2012 and December 31, 2011 follows (in thousands):

	September 30, 2012	December 31, 2011
Demand, non-interest bearing	$ 123,289	$ 108,899
Interest bearing demand	122,804	122,160
Money market	99,630	99,031
Savings	62,869	65,451
Time, interest bearing	139,590	152,509

Total deposits	$ 548,182	$ 548,050

An increase in non-interest bearing demand deposits of $14,390,000, or 13.21%, was offset by a similar decrease in time deposits. The increase in demand accounts is consistent with the cyclical pattern of our deposits for our tourist heavy locations in which balances typically reach their highest point in the third quarter of the year, in addition to new business relationships that accompany the increase in commercial loans.

Time deposits decreased $12,919,000, or 8.47%, due to our commitment to maintain a disciplined pricing strategy, focusing on enhancing long-term customer relationships rather than on rate sensitive customers. Management believes that certificates of deposit are not considered an attractive investment option for some segments of our customer base in the current low interest rate environment. As a result, the percentage of time certificates of deposit to total deposits decreased to 25.5% at September 30, 2012, from 27.8% at December 31, 2011, which favorably impacted net interest margin.

It is our strategic goal to grow core deposits through the quality and breadth of our branch network, increased brand awareness, superior sales practices and competitive rates. In the long-term we anticipate continued growth in our core deposits through both the addition of new customers and our current client base. In addition, management's strategy for funding asset growth as opportunities arise may include use of brokered and other wholesale deposits on an as-needed basis.

Liquidity. We believe adequate liquidity continues to be available to accommodate fluctuations in deposit levels, fund operations, provide for customer credit needs, and meet obligations and commitments on a timely basis. The Bank's primary sources of funds are customer deposits, maturities of investment securities, loan sales, loan repayments, net income, and other borrowings which are used to make loans, acquire investment securities and other assets, and fund continuing operations. While maturities and scheduled amortization of loans are a predictable source of funds, deposit flows and prepayments are greatly influenced by the level of interest rates, economic conditions, and competition. In addition to customer deposits, when necessary, liquidity can be increased by taking advances from credit available to the Bank.

The Bank's liquidity position at September 30, 2012, includes $43.0 million in cash and interest bearing deposits with banks and $51.7 million in investments classified as available-for-sale. We generally maintain sufficient cash and short-term investments to meet short-term liquidity needs. In addition, the Bank maintains credit facilities with correspondent banks totaling $16,000,000, of which none was used as of September 30, 2012. The Bank also has a credit line with the Federal Home Loan Bank ("FHLB") of Seattle for up to 20% of assets, of which $10,500,000 was used at September 30, 2012. Based on current pledged collateral, the Bank had $111.0 million of available borrowing capacity on its line at the FHLB, although each advance is subject to prior consent. The Bank also has a borrowing facility of $46.9 million at the Federal Reserve Bank subject to pledged collateral, of which none was used at September 30, 2012. Borrowings may be used on a short-term basis to compensate for reductions in deposits, but are generally not considered a long-term solution to liquidity needs.

The holding company relies on dividends from the Bank and proceeds from the exercise of stock options, which are used for various corporate purposes. Dividends from the Bank are the holding company's most important source of funds, and are subject to regulatory restrictions and the capital needs of the Bank, which are always primary. Sales of trust preferred securities ("TRUPs") historically were a source of liquidity for the holding company and capital for both the holding company and the Bank; however, we have not issued TRUPs since 2006 and do not anticipate TRUPs will be a source of liquidity in 2012 or beyond.

At September 30, 2012, two wholly-owned subsidiary grantor trusts established by the Company had issued and outstanding $13,403,000 of TRUPs. During the nine months ended September 30, 2012, the Company paid all accrued interest, including deferred interest on PFC Trust I and II, which had accrued since the Company elected, in 2009, to exercise its right to defer interest on its trust preferred debentures, as permitted by the terms thereof. As of September 30, 2012, regular interest on TRUPs totaled $43,000 and is included in accrued interest payable on the balance sheet.

For additional information regarding trust preferred securities, see the 2011 10-K under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity".

Capital. The Federal Reserve and the FDIC have established minimum guidelines that mandate risk-based capital requirements for bank holding companies and member banks. Under the guidelines, risk percentages are assigned to various categories of assets and off-balance sheet items to calculate a risk-adjusted capital ratio. Regulatory minimum risk-based capital guidelines under the Federal Reserve require Tier 1 capital to risk-weighted assets of 4% and total capital to risk-weighted assets of 8% to be considered adequately capitalized. To qualify as well capitalized under the FDIC guidelines, banks must have a Tier 1 leverage ratio of 5%, a Tier 1 risk-based capital ratio of 6%, and a Total risk-based capital ratio of 10%. Failure to qualify as well capitalized can negatively impact a bank's ability to expand and to engage in certain activities.

The capital ratios for the Company and the Bank at September 30, 2012 and December 31, 2011, were as follows:

	Company		Bank		Requirements	
	September 30, 2012	December 31, 2011	September 30, 2012	December 31, 2011	**Adequately Capitalized**	**Well Capitalized**
Tier 1 leverage ratio	10.77%	10.18 %	10.78%	10.35 %	4 %	5 %
Tier 1 risk-based capital ratio	14.76%	13.56 %	14.77%	13.79 %	4 %	6 %
Total risk-based capital ratio	16.02%	14.82 %	16.04%	15.05 %	8 %	10 %

Total shareholders' equity was $67,014,000 at September 30, 2012, an increase of $3,744,000, or 5.92%, compared to December 31, 2011.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest rate, credit, and operations risks are the most significant market risks that affect the Company's performance. The Company relies on loan review, prudent loan underwriting standards, and an adequate allowance for possible credit losses to mitigate credit risk.

An asset/liability management simulation model is used to measure interest rate risk. The model produces regulatory oriented measurements of interest rate risk exposure. The model quantifies interest rate risk by simulating forecasted net interest income over a 12-month time period under various interest rate scenarios, as well as monitoring the change in the present value of equity under the same rate scenarios. The present value of equity is defined as the difference between the market value of assets less current liabilities. By measuring the change in the present value of equity under various rate scenarios, management is able to identify interest rate risk that may not be evident from changes in forecasted net interest income.

The Company is currently asset sensitive, meaning that interest earning assets mature or re-price more quickly than interest-bearing liabilities in a given period. Therefore, a significant increase in market rates of interest could improve net interest income. Conversely, a decreasing rate environment may adversely affect net interest income.

It should be noted that the simulation model does not take into account future management actions that could be undertaken should actual market rates change during the year. Also, the simulation model results are not exact measures of the Company's actual interest rate risk. They are only indicators of rate risk exposure based on assumptions produced in a simplified modeling environment designed to heighten sensitivity to changes in interest rates. The rate risk exposure results of the simulation model typically are greater than the Company's actual rate risk. That is due to the modeling environment, which generally depicts a worst-case situation. Management has assessed the results of the simulation reports as of September 30, 2012 and believes that there has been no material change since December 31, 2011.

ITEM 4. CONTROLS AND PROCEDURES

The Company's disclosure controls and procedures are designed to ensure that information the Company must disclose in its reports filed or submitted under the Securities Exchange Act of 1934 ("Exchange Act") is recorded, processed, summarized, and reported on a timely basis. Our management has evaluated, with the participation and under the supervision of our chief executive officer (“CEO”) and chief financial officer (“CFO”), the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act) as of the end of the period covered by this report. Based on this evaluation, our CEO and CFO have concluded that, as of such date, the Company's disclosure controls and procedures are effective in ensuring that information relating to the Company, including its consolidated subsidiaries, required to be disclosed in reports that it files under the Exchange Act is (1) recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and (2) accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosures.

No change in the Company's internal control over financial reporting occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 1A. RISK FACTORS

There has been no material change from the risk factors previously reported in the 2011 10-K.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In September 2012, the Company's board of directors approved a share repurchase program authorizing the purchase of up to 250,000 shares of its common stock. There were no purchases of common stock by the Company during the quarter ended September 30, 2012.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

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None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

See Exhibit Index immediately following signatures below.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	PACIFIC FINANCIAL CORPORATION
DATED: November 14, 2012	By: /s/ Dennis A. Long Dennis A. Long Chief Executive Officer
	By: /s/ Denise Portmann Denise Portmann Chief Financial Officer

EXHIBIT INDEX

EXHIBIT NO.	EXHIBIT
31.1	Certification of CEO under Rule 13a – 14(a) of the Exchange Act.
31.2	Certification of CFO under Rule 13a – 14(a) of the Exchange Act.
32	Certification of CEO and CFO under 18 U.S.C. Section 1350.
101.	INS XBRL Instance Document *
101.	SCH XBRL Taxonomy Extension Schema Document *
101.	CAL XBRL Taxonomy Extension Calculation Linkbase Document *
101.	DEF XBRL Taxonomy Extension Definition Linkbase Document *
101.	LAB XBRL Taxonomy Extension Label Linkbase Document *
101.	PRE XBRL Taxonomy Extension Presentation Linkbase Document *

* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended and otherwise are not subject to liability under those sections.