PACIFIC FINANCIAL CORP
Form 10-Q
November 14, 2013

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, 2013
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	**91-1815009**
(State or other jurisdiction of incorporation or organization)	(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, 2013, was 10,121,853 shares.

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

PACIFIC FINANCIAL CORPORATION
Condensed Consolidated Balance Sheets
September 30, 2013 and December 31, 2012
(Dollars in thousands) (Unaudited)

	September 30, 2013	December 31, 2012
Assets		
Cash and due from banks	$ 15,494	$ 14,168
Interest bearing deposits in banks	54,163	42,687
Certificates of deposits held for investment	1,735	2,985
Investment securities available-for-sale (amortized cost of $92,557 and $59,658)	91,742	61,106
Investment securities held-to-maturity (fair value of $2,409 and $6,985)	2,387	6,937
Federal Home Loan Bank stock, at cost	3,041	3,126
Loans held for sale	7,266	12,950
Loans	486,700	448,196
Allowance for credit losses	(8,806)	(9,358)
Loans, net	477,894	438,838
Premises and equipment	16,398	14,593
Other real estate owned	4,334	4,679
Accrued interest receivable	2,320	2,079
Cash surrender value of life insurance	18,126	17,784
Goodwill	12,168	11,282
Other intangible assets	1,494	1,268
Other assets	7,186	9,112
Total assets	$ 715,748	$ 643,594
Liabilities and Shareholders' Equity		
Deposits:		
Demand, non-interest bearing	$ 156,164	$ 115,138
Savings and interest-bearing demand	326,775	295,100
Time, interest-bearing	135,979	138,005
Total deposits	618,918	548,243
Accrued interest payable	182	213
Short-term borrowings		3,000
Long-term borrowings	10,000	7,500
Junior subordinated debentures	13,403	13,403
Other liabilities	4,909	4,514
Total liabilities	647,412	576,873

Commitments and Contingencies (Note 7)

Shareholders' Equity				
Common Stock (par value $1); 25,000,000 shares authorized;				
10,121,853 shares issued and outstanding at September 30, 2013 and December 31, 2012		10,122		10,122
Additional paid-in capital		41,449		41,366
Retained earnings		17,754		14,812
Accumulated other comprehensive income (loss)		(989)		421
Total shareholders' equity		68,336		66,721
Total liabilities and shareholders' equity	$	715,748	$	643,594

See notes to condensed consolidated financial statements.

3

PACIFIC FINANCIAL CORPORATION
Condensed Consolidated Statements of Income
Three and nine months ended September 30, 2013 and 2012
(Dollars in thousands, except per share data) (Unaudited)

	Three Months Ended September 30, 2013	2012	Nine Months Ended September 30, 2013	2012
Interest and dividend income				
Loans	$ 6,116	$ 6,292	$ 18,158	$ 19,390
Investment securities and FHLB dividends	455	440	1,233	1,378
Deposits with banks and federal funds sold	34	19	85	55
Total interest and dividend income	6,605	6,751	19,476	20,823
Interest Expense				
Deposits	474	686	1,573	2,259
Other borrowings	116	143	354	462
Total interest expense	590	829	1,927	2,721
Net Interest Income	6,015	5,922	17,549	18,102
Provision for (recapture of) credit losses			(450)	400
Net interest income after provision for credit losses	6,015	5,922	17,999	17,702
Non-interest Income				
Service charges on deposits	440	406	1,281	1,256
Net gain (loss) on sales of other real estate owned	18	(18)	43	293
Gain on sales of loans	1,128	1,501	4,306	3,501
Gain on sales of investments available-for-sale, net	14	65	401	164
Net other-than-temporary impairment losses (net of $7, $20, $2 and $50 respectively, recognized in other comprehensive income before taxes)	(4)	(160)	(38)	(265)
Earnings on bank owned life insurance	105	130	342	388
Other operating income	531	519	1,698	1,363
Total non-interest income	2,232	2,443	8,033	6,700
Non-interest Expense				
Salaries and employee benefits	4,098	4,101	12,983	11,823
Occupancy and equipment	706	614	1,957	1,865
Other real estate owned write-downs	176	364	636	698
Other real estate owned operating costs	67	101	276	401
Professional services	198	178	696	514
FDIC and State assessments	129	135	395	468
Data processing	449	355	1,688	1,048

Other	1,266	1,222	3,749	3,762
Total non-interest expense	7,089	7,070	22,380	20,579
Income before income taxes	1,158	1,295	3,652	3,823
Income taxes	249	280	710	717
Net Income	$ 909	$ 1,015	$ 2,942	$ 3,106
Earnings per common share:				
Basic	$ 0.09	$ 0.10	$ 0.29	$ 0.31
Diluted	$ 0.09	$ 0.10	$ 0.29	$ 0.31
Weighted Average shares outstanding:				
Basic	10,121,853	10,121,853	10,121,853	10,121,853
Diluted	10,194,826	10,122,224	10,179,928	10,122,145

See notes to condensed consolidated financial statements.

PACIFIC FINANCIAL CORPORATION
Condensed Consolidated Statements of Comprehensive Income
Three and nine months ended September 30, 2013 and 2012
(Dollars in thousands, except per share data) (Unaudited)

	Three Months Ended September 30, 2013	2012	Nine Months Ended September 30, 2013	2012
Net income	$ 909	$ 1,015	$ 2,942	$ 3,106
Other comprehensive income (loss), net of tax:				
Net unrealized gain (losses) on investment securities	509	500	(1,494)	532
Defined benefit plans	28	29	84	88
Other Comprehensive Income (Loss)	537	529	(1,410)	620
Comprehensive Income	$ 1,446	$ 1,544	$ 1,532	$ 3,726

See notes to condensed consolidated financial statements.

PACIFIC FINANCIAL CORPORATION

Condensed Consolidated Statements of Cash Flows

Nine months ended September 30, 2013 and 2012
(Dollars in thousands)
(Unaudited)

	2013	2012
OPERATING ACTIVITIES		
Net income	$ 2,942	$ 3,106
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for (recapture of) credit losses	(450)	400
Depreciation and amortization	1,710	1,094
Origination of loans held for sale	(201,278)	(184,171)
Proceeds of loans held for sale	211,204	180,265
Gain on sales of loans	(4,306)	(3,501)
Gain on sale of investments available-for-sale	(401)	(164)
Net OTTI losses recognized in earnings	38	265
Net gain on sale of other real estate owned	(43)	(293)
Net (gain) loss on sale of premises and equipment	18	(5)
Increase in accrued interest receivable	(241)	(239)
Decrease in accrued interest payable	(33)	(1,255)
Other real estate owned write-downs	636	698
Other, net	2,977	(130)
Net cash provided by (used in) operating activities	12,773	(3,930)
INVESTING ACTIVITIES		
Net (increase)/decrease in interest bearing balances with banks	(11,476)	303
Net decrease in certificates of deposits held for investment	1,250	
Purchase of securities available-for-sale	(48,892)	(15,806)
Proceeds from maturities of investments held-to-maturity	4,549	176
Proceeds from sales of securities available-for-sale	7,237	6,334
Proceeds from maturities of securities available-for-sale	8,467	6,010
Proceeds from sales of government loan pools		1,215
Net (increase) decrease in loans made to customers, net of principal collections	(36,395)	5,675
Proceeds from sales of other real estate owned	1,343	3,402
Purchase of premises and equipment, and additions to other real estate owned	(2,012)	(844)
Cash received in acquisition, net of cash paid	31,941	
Net cash provided by (used in) investing activities	(43,988)	6,465
FINANCING ACTIVITIES		
Net increase in deposits	33,041	132
Repayment of short-term borrowings	(3,000)	
Proceeds from issuance of long-term debt	2,500	2,500
Repayment of long-term borrowings		(2,500)
Net decrease in secured borrowings		(522)
Net cash provided by (used in) financing activities	32,541	(390)

Net increase in cash and due from banks		1,326		2,145
Cash and due from Banks				
Beginning of period		14,168		12,607
End of period	$	15,494	$	14,752
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION				
Cash payments for:				
Interest	$	1,958	$	3,976
Income taxes		440		1,411
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES				
Change in fair value of securities available-for-sale, net of tax	$	(1,494)	$	532
Transfer of loans held for sale to loans held for investment		64		
Other real estate owned acquired in settlement of loans		(1,591)		(2,485)
Financed sale of other real estate owned				783
Reclass of long-term borrowings to short-term borrowings				3,000

See notes to condensed consolidated financial statements.

6

PACIFIC FINANCIAL CORPORATION
Condensed Consolidated Statements of Shareholders' Equity
Nine months ended September 30, 2013 and 2012
(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, 2012	10,121,853	$10,122	$41,342	$12,051	$(245)	$63,270
Net income				3,106		3,106
Other comprehensive income					620	620
Stock compensation expense			18			18
Balance September 30, 2012	10,121,853	$10,122	$41,360	$15,157	$375	$67,014
Balance January 1, 2013	10,121,853	$10,122	$41,366	$14,812	$421	$66,721
Net income				2,942		2,942
Other comprehensive loss					(1,410)	(1,410)
Stock compensation expense			83			83
Balance September 30, 2013	10,121,853	$10,122	$41,449	$17,754	$(989)	$68,336

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, 2013, are not necessarily indicative of the results anticipated for the year ending December 31, 2013. Certain information and footnote disclosures included in the Company's consolidated financial statements for the year ended December 31, 2012, 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, 2012.

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.

Certain prior year disclosures have been reclassified to conform to the 2013 presentation with no change to net income or shareholders’ equity as previously reported. Loans held for sale have been excluded from the loan and credit quality tables in Note 4- Loans.

Note 2 Earnings per Share

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

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Basic:				
Net income	$ 909	$ 1,015	$ 2,942	$ 3,106
Weighted average shares outstanding	10,121,853	10,121,853	10,121,853	10,121,853
Basic earnings per share	$ 0.09	$ 0.10	$ 0.29	$ 0.31
Diluted:				
Net income	$ 909	$ 1,015	$ 2,942	$ 3,106
Weighted average shares outstanding	10,121,853	10,121,853	10,121,853	10,121,853
Effect of dilutive stock options	72,973	371	58,075	292
Weighted average shares outstanding assuming dilution	10,194,826	10,122,224	10,179,928	10,122,145
Diluted earnings per share	$ 0.09	$ 0.10	$ 0.29	$ 0.31

8

As of September 30, 2013 and 2012, there were 433,995 and 532,107 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, 2013				
State and municipal securities	$2,217	$9	$	$2,226
Agency MBS	170	13		183
Total	$2,387	$22	$	$2,409
December 31, 2012				
State and municipal securities	$6,716	$32	$	$6,748
Agency MBS	221	16		237
Total	$6,937	$48	$	$6,985

Securities Available-for-Sale	Amortized Cost		Unrealized Gains		Unrealized Losses		Fair Value	
September 30, 2013								
U.S. Government securities	$	8,889	$	49	$	79	$	8,859
State and municipal securities		32,417		896		488		32,825
Agency MBS		48,311		291		1,318		47,284
Non-agency MBS		2,349		5		175		2,179
Corporate bonds		591		4				595
Total	$	92,557	$	1,245	$	2,060	$	91,742
December 31, 2012								
U.S. Government securities	$	5,922	$	36	$	6	$	5,952

State and municipal securities		25,254		1,691		39		26,906
Agency MBS		22,113		249		203		22,159
Non-agency MBS		2,804		12		272		2,544
Corporate bonds		3,565				20		3,545
Total	$	59,658	$	1,988	$	540	$	61,106

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, 2013 and December 31, 2012 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, 2013						
U.S. Government securities	$4,608	$ 79	$	$	$ 4,608	$ 79
State and municipal securities	12,848	488			12,848	488
Agency MBS	32,262	1,285	1,512	33	33,774	1,318
Non-agency MBS	437	4	1,737	171	2,174	175
Total	$50,155	$ 1,856	$ 3,249	$ 204	$ 53,404	$ 2,060
December 31, 2012						
U.S. Government securities	$2,688	$ 6	$	$	$ 2,688	$ 6
State and municipal securities	1,896	39			1,896	39
Agency MBS	11,890	198	370	5	12,260	203
Non-agency MBS			1,909	272	1,909	272
Corporate bonds	1,957	20			1,957	20
Total	$18,431	$ 263	$ 2,279	$ 277	$ 20,710	$ 540

At September 30, 2013, there were 72 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

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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, 2013, 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, 2013 and 2012, one non-agency MBS was determined to be other-than-temporarily-impaired resulting in the Company recording $38 and $265, respectively, in impairments related to credit losses through earnings.

Gross gains realized on sales of securities were $445 and $170 and gross losses realized were $44 and $6 during the nine months ended September 30, 2013 and 2012, 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 own any sovereign debt of Eurozone nations or structured financial products, such as collateralized debt obligations or structured investment vehicles, that are known by the Company to have elevated risk characteristics.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Note 4 Loans

Loans

Loans held in the portfolio at September 30, 2013 and December 31, 2012 are as follows:

	September 30, 2013	December 31, 2012
Commercial	$ 94,471	$ 87,278
Residential real estate:		
Residential 1-4 family	85,625	77,497
Multi-family	13,846	7,744
Commercial real estate:		
Construction and land development	29,538	31,411
Commercial real estate owner occupied	106,670	109,783
Commercial real estate non owner occupied	115,290	103,014
Farmland	24,002	24,544
Consumer	18,366	7,782
Less unearned income	(1,108)	(857)
Total Loans	$ 486,700	$ 448,196

Allowance for Credit Losses

Changes in the allowance for credit losses for the three and nine months ended September 30, 2013 and 2012, and the year ended December 31, 2012 are as follows:

Allowance for Credit Losses	Commercial	Commercial Real Estate (“CRE”)	Residential Real Estate	Consumer	Unallocated	Total
Three months ended September 30, 2013						
Beginning balance	$809	$3414	$813	$638	$3,288	$8,962
Charge-offs	(40)	(37)	(29)	(79)		(185)
Recoveries	20	5	3	1		29
Provision for (recapture of) credit losses	45	164	(16)	149	(342)	
Ending balance	$834	$3,546	$771	$709	$2,946	$8,806
Nine months ended September 30, 2013						
Beginning balance	$923	$4,098	$829	$531	$2,977	$9,358
Charge-offs	(40)	(83)	(95)	(145)		(363)
Recoveries	35	220	4	2		261
	(84)	(689)	33	321	(31)	(450)

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Provision for (recapture of) credit losses						
Ending balance	$834	$3,546	$771	$709	$2,946	$8,806

11

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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
Twelve months ended December 31, 2012						
Beginning balance	$ 1,012	$ 6,803	$ 1,046	$ 642	$ 1,624	$ 11,127
Charge-offs	(67)	(827)	(576)	(309)		(1,779)
Recoveries	23	917	162	8		1,110
Provision for (recapture of) credit losses	(45)	(2,795)	197	190	1,353	(1,100)
Ending balance	$ 923	$ 4,098	$ 829	$ 531	$ 2,977	$ 9,358

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Recorded investment in loans as of September 30, 2013 and December 31, 2012 are as follows:

September 30, 2013	Commercial	Commercial Real Estate (“CRE”)	Residential Real Estate	Consumer	Unallocated	Total
Allowance for Credit Losses:						
Ending balance: individually evaluated for impairment	$	$	$	$	$	$
Ending balance: collectively evaluated for impairment	834	3,546	771	709	2,946	8,806
Loans:						
Ending balance: individually evaluated for impairment	$766	$6,378	$871	$2,368	$	$10,383
Ending balance: collectively evaluated for impairment	93,705	269,122	98,600	15,998		477,425
Ending balance	$94,471	$275,500	$99,471	$18,366	$	$487,808
Less unearned income						(1,108)
Ending balance total loans						$486,700
December 31, 2012						
Allowance for Credit Losses:						
Ending balance: individually evaluated for impairment	$	$	$	$	$	$
Ending balance: collectively evaluated for impairment	923	4,098	829	531	2,977	9,358
Loans:						
Ending balance: individually evaluated for impairment	$2,219	$11,697	$868	$	$	$14,784
Ending balance: collectively evaluated for impairment	85,059	257,055	84,373	7,782		434,269
Ending balance	$87,278	$268,752	$85,241	$7,782	$	$449,053
Less unearned income						(857)
Ending balance total loans						$448,196

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, 2013 are as follows:

	Pass	Other Loans Especially Mentioned	Substandard	Doubtful	Total
Commercial	$ 89,893	$ 3,257	$ 1,311	$ 10	$ 94,471
Real estate:					
Construction and development	27,075	957	1,506		29,538
Residential 1-4 family	81,675	616	3,334		85,625
Multi-family	13,846				13,846
CRE owner occupied	101,197	1,445	4,028		106,670
CRE non owner occupied	96,851	15,935	2,504		115,290
Farmland	22,425	569	1,008		24,002
Total real estate	343,069	19,522	12,380		374,971
Consumer	18,306	14	46		18,366
Subtotal	$ 451,268	$ 22,793	$ 13,737	$ 10	$ 487,808
Less unearned income					(1,108)
Total loans					$ 486,700

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Loans by credit quality risk rating at December 31, 2012 are as follows:

	Pass	Other Loans Especially Mentioned	Substandard	Doubtful	Total
Commercial	$ 82,899	$ 979	$ 3,368	$ 32	$ 87,278
Real estate:					
Construction and development	27,209	603	3,355	244	31,411
Residential 1-4 family	72,414	2,016	3,067		77,497
Multi-family	7,744				7,744
CRE owner occupied	103,444	1,844	4,495		109,783
CRE non owner occupied	84,610	12,346	6,058		103,014
Farmland	23,511		1,033		24,544
Total real estate	318,932	16,809	18,008	244	353,993
Consumer	7,740		42		7,782
Subtotal	$ 409,571	$ 17,788	$ 21,418	$ 276	$ 449,053
Less unearned income					(857)
Total loans					$ 448,196

Impaired Loans

Following is a summary of information pertaining to impaired loans at September 30, 2013:

	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	$ 766	$ 766	$	$ 984	$ 1,440	$ 1	$ 6
Residential real estate	871	1,102		1,233	1,150	9	19
Commercial real estate:							
CRE owner occupied	1,787	1,787		2,327	2,674		24
CRE non-owner occupied	4,591	6,791		4,584	5,349	9	32
Construction and development	1,413	3,685		1,435	1,626	20	60
Farmland	955	955		955	960		
With an allowance recorded:							
Consumer				5	2		
Residential real estate				100	50		1
Total:							

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Commercial	766	766		984	1,440	1	6
Consumer				5	2		1
Residential real estate	871	1,102		1,333	1,200	9	19
Commercial real estate:							
CRE owner occupied	1,787	1,787		2,327	2,674		24
CRE non-owner occupied	4,591	6,791		4,584	5,349	9	32
Construction and development	1,413	3,685		1,435	1,626	20	60
Farmland	955	955		955	960		
Total	$ 10,383	$ 15,086	$	$ 11,623	$ 13,251	$ 39	$ 142

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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
Total	$ 11,017	$ 14,126	$ 1,781	$ 10,231	$ 11,671	$ 63	$ 158

Following is a summary of information pertaining to impaired loans at December 31, 2012:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$ 2,219	$ 2,219	$	$ 966	$ 30
Consumer				45	
Residential real estate	868	1,100		756	17

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Commercial real estate:					
CRE owner occupied	3,134	3,166		1,259	2
CRE non-owner occupied	5,795	6,401		3,272	84
Construction and development	1,792	4,053		2,707	81
Farmland	976	976		195	
With an allowance recorded:					
Residential real estate				97	
Commercial real estate:					
CRE - non-owner occupied				2,845	
Construction and development				189	12
Total:					
Commercial	2,219	2,219		966	30
Consumer				45	
Residential real estate	868	1,100		853	17
Commercial real estate:					
CRE owner occupied	3,134	3,166		1,259	2
CRE non-owner occupied	5,795	6,401		6,117	84
Construction and development	1,792	4,053		2,896	93
Farmland	976	976		195	
Total	$ 14,784	$ 17,915	$	$ 12,331	$ 226

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Aging Analysis

The following table provides an age analysis of past due loans at September 30, 2013.

	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	$ 93,905	$ 52	$	$ 54	$ 106	$ 460	$ 94,471
Real estate:							
Construction & development	28,125					1,413	29,538
Residential 1-4 family	84,078	387	203	167	757	790	85,625
Multi-family	13,846						13,846
CRE owner occupied	104,852	87			87	1,731	106,670
CRE non-owner occupied	112,810					2,480	115,290
Farmland	23,010	37			37	955	24,002
Total real estate	366,721	511	203	167	881	7,369	374,971
Consumer	18,361	5			5		18,366
Less unearned income	(1,108)						(1,108)
Total	$ 477,879	$ 568	$ 203	$ 221	$ 992	$ 7,829	$ 486,700

The following table provides an age analysis of past due loans at December 31, 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	$ 85,243	$ 107	$ 27	$	$ 134	$ 1,901	$ 87,278
Real estate:							
Construction & development	29,619					1,792	31,411
Residential 1-4 family	75,102	1,505	90		1,595	800	77,497
Multi-family	7,744						7,744
CRE owner occupied	105,936					3,847	109,783
CRE non-owner occupied	96,567	652			652	5,795	103,014
Farmland	23,435	133			133	976	24,544
Total real estate	338,403	2,290	90		2,380	13,210	353,993

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Consumer	7,773	8			8	1	7,782
Less unearned income	(857)						(857)
Total	$ 430,562	$ 2,405	$ 117	$	$ 2,522	$ 15,112	$ 448,196

17

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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. Loans modified in a TDR for the Company may have the financial effect of increasing the specific allowance associated with the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the estimated fair value of the collateral, less any selling costs, if the loan is collateral dependent. The Company's practice is to re-appraise collateral dependent loans every six to nine months. During the nine months ended September 30, 2013, there was no impact on the allowance from TDRs during the period, as the loans classified as TDRs during the period did not have a specific reserve and were already considered impaired loans at the time of modification and no further impairment was required upon modification.

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

The following table presents TDRs for the nine months ended September 30, 2013, all of which were modified due to financial stress of the borrower.

Nine months ended September 30, 2013	Current TDRs			Subsequently Defaulted TDRs		
	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
Commercial	1	$ 335	$ 306		$	$
Residential real estate	2	272	227			
CRE owner occupied	1	59	56			
CRE non-owner occupied	1	2,180	2,110			
Construction & development	3	2,972	1,413			
Ending balance (1)	8	$ 5,818	$ 4,112		$	$

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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

There were no loans modified as a TDR within the previous 12 months that subsequently defaulted during the three and nine months ended September 30, 2013. Loans classified as TDRs are considered impaired loans. The Company had no commitments to lend additional funds for loans classified as TDRs at September 30, 2013.

Note 5 Accumulated Other Comprehensive Loss

The following table presents the changes in each component of accumulated other comprehensive income, net of tax, for the nine months ended September 30, 2013 and 2012:

	Net Unrealized Gains and Losses on Investment Securities		Defined Benefit Plans		Total	
Balance, January 1, 2013	$	956	$	(535)	$	421
Other comprehensive loss before reclassifications		(1,254)		84		(1,170)
Amounts reclassified from AOCI		(240)				(240)
Net current period other comprehensive income (loss)		(1,494)		84		(1,410)
Balance, September 30, 2013	$	(538)	$	(451)	$	(989)
Balance, January 1, 2012	$	420	$	(665)	$	(245)
Other comprehensive loss before reclassifications		465		88		553
Amounts reclassified from AOCI		67				67
Net current period other comprehensive income (loss)		532		88		620
Balance, September 30, 2012	$	952	$	(577)	$	375

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income ("AOCI") for the three and nine months ended September 30, 2013:

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from AOCI				Affected Line Item in the Statement Where Net Income is Presented
	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013		
Net Unrealized Gains and Losses on Investment Securities	$	(14)	$	(401)	Gain on sales of investments available for sale
		4		38	Net OTTI losses
		3		123	Income tax expense
	$	(7)	$	(240)	Net of tax

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

19

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

The following table presents the components of other comprehensive income (loss) for the three and nine months ended September 30, 2013 and 2012.

Three Months Ended September 30, 2013	Before Tax		Tax Effect		Net of Tax	
Net unrealized losses on investment securities:						
Net unrealized losses arising during the period	$	781	$	265	$	516
Less: reclassification adjustment for net gains including OTTI losses realized in net income		(10)		(3)		(7)
Net unrealized losses on investment securities		771		262		509
Defined Benefit Plans:						
Amortization of unrecognized prior service costs and net actuarial gains/losses		43		15		28
Other Comprehensive Loss	$	814	$	277	$	537
Nine Months Ended September 30, 2013						
Net unrealized losses on investment securities:						
Net unrealized losses arising during the period	$	(1,901)	$	(647)	$	(1,254)
Less: reclassification adjustment for net gains including OTTI losses realized in net income		(363)		(123)		(240)
Net unrealized losses on investment securities		(2,264)		(770)		(1,494)
Defined Benefit Plans:						
Amortization of unrecognized prior service costs and net actuarial gains/losses		128		44		84
Other Comprehensive Loss	$	(2,136)	$	(726)	$	(1,410)
Three Months Ended September 30, 2012						
Net unrealized gains on investment securities:						
Net unrealized gains arising during the period	$	663	$	226	$	437
Less: reclassification adjustment for net gains including OTTI losses realized in net income		95		32		63
Net unrealized gains on investment securities		758		258		500
Defined Benefit Plans:						
Amortization of unrecognized prior service costs and net actuarial gains/losses		44		15		29
Other Comprehensive Income	$	802	$	273	$	529
Nine Months Ended September 30, 2012						
Net unrealized gains on investment securities:						
Net unrealized gains arising during the period	$	907	$	308	$	599
Less: reclassification adjustment for net gains realized in net income		101		34		67
Net unrealized gains on investment securities		806		274		532
Defined Benefit Plans:						

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Amortization of unrecognized prior service costs and net actuarial gains/losses	133	45	88
Other Comprehensive Income	$ 939	$ 319	$ 620

20

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Note 6 Stock Based Compensation

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

Stock Options

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

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

Grant period ended	Expected Life	Risk Free Interest Rate		Expected Volatility		Dividend Yield		Average Fair Value	
September 30, 2013	6.5 years	1.35	%	23.04	%	4.14	%	$	0.57
September 30, 2012	6.5 years	1.34	%	22.43	%		%	$	0.77

A summary of stock option activity as of September 30, 2013 and 2012, 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, 2013						
Outstanding beginning of period	537,107	$	11.28			
Granted	183,500		5.03			
Exercised						
Forfeited	(33,275)		9.25			
Expired	(64,337)		11.36			
Outstanding end of period	622,995	$	9.54	5.4	$	114
Exercisable end of period	313,245	$	13.25	2.7	$	4

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

September 30, 2012	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
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	$

A summary of the status of the Company's non-vested options as of September 30, 2013 and 2012 and changes during the nine months then ended, are presented below:

	2013		2012	
	Shares	Weighted Average Fair Value	Shares	Weighted Average Fair Value
Non-vested beginning of period	147,280	$ 0.31	174,740	$ 0.37
Granted	183,500	0.57	10,500	0.77
Vested	(2,275)	0.65	(10,950)	1.69
Forfeited	(18,755)	0.40	(5,910)	0.27
Non-vested end of period	309,750	$ 0.45	168,380	$ 0.32

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, 2013 and 2012 was $38 and $13 ($25 and $9 net of tax), respectively. Future compensation expense for unvested awards outstanding as of September 30, 2013, is estimated to be $90 recognized over a weighted average period of 1.8 years. There were no options exercised during the nine months ended September 30, 2013 and 2012.

Restricted Stock Units

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

The following table summarizes RSU activity during the nine months ended September 30, 2013 and 2012.

	Shares	Weighted average grant price	Weighted average remaining contractual terms (in years)
Outstanding, January 1, 2013	16,059		
Granted	35,476	$ 4.93	
Forfeited	(1,511)		
Outstanding, September 30, 2013	50,024		2.2
Outstanding, January 1, 2012			
Granted	7,274	$ 4.15	
Forfeited	(545)		
Outstanding, September 30, 2012	6,729		2.5

For the nine months ended September 30, 2013 and 2012, the Company recognized compensation expense related to RSUs of $46 and $5 ($30 and $3 net of tax), respectively. As of September 30, 2013, there was $193 of total unrecognized compensation expense related to non-vested RSUs.

Note 7 Commitments and Contingencies

The Company’s wholly owned subsidiary, the Bank of the Pacific (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, 2013 and December 31, 2012 is as follows:

	September 30, 2013	December 31, 2012
Commitments to extend credit	$ 100,403	$ 84,493
Standby letters of credit	1,738	1,975

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.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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 8 Recent Accounting Pronouncements

In December 2011, FASB issued ASU No. 2011-11, “*Disclosures about Offsetting Assets and Liabilities*”. This ASU will require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of ASU No. 2011-11 did not have a significant impact on the Company’s Consolidated Financial Statements at the date of adoption.

In February 2013, FASB issued ASU No. 2013-02, *“Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income”*. This ASU requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component and to present either on the face of the statement where net income is presented, or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2012. The disclosures required from adoption of this ASU have been included in these financial statements.

In July 2013, FASB issued ASU No. 2013-11, "*Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists.*" The provisions of ASU No. 2013-11 require an entity to present an unrecognized tax benefit, or portion thereof, in the statement of financial position as a reduction to a deferred tax asset for a net operating loss carryforward or a tax credit carryforward, with certain exceptions related to availability. ASU No. 2013-11 is effective for interim and annual reporting periods beginning after December 15, 2013. The adoption of ASU No. 2013-11 is not expected to have a material impact on the Company's Consolidated Financial Statements.

Note 9 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:

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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

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

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

Investment Securities Available-for-Sale

The Company uses an independent pricing service to assist management in determining fair values of investment securities available-for-sale. This service provides pricing information by utilizing evaluated pricing models supported with market based information. Standard inputs include benchmark yields, reported trades, broker/dealer quotes, credit ratings, bids and offers, relative credit information and reference data from market research publications. Investment securities that are deemed to have been trading in illiquid or inactive markets may require the use of significant unobservable inputs.

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

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

On a quarterly basis, management reviews the pricing information received from the third party-pricing service through a combination of procedures that include an evaluation of methodologies used by the pricing service, analytical reviews and performance analyses of the prices against statistics and trends and maintenance of an investment watch list. Based on this review, management determines whether the current placement of the security in the fair value hierarchy is appropriate or whether transfers may be warranted. As necessary, the Company compares prices received from the pricing service to discounted cash flow models or through performing independent valuations of inputs and assumptions similar to those used by the pricing service in order to ensure prices represent a reasonable estimate of fair value. Although the Company does identify differences from time to time as a result of these validation procedures, the Company did not make any significant adjustments as of September 30, 2013 or December 31, 2012.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

The following table presents the balances of assets measured at fair value on a recurring basis at September 30, 2013 and December 31, 2012.

September 30, 2013	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	$	$ 8,859	$	$ 8,859
State and municipal securities		31,862	963	32,825
Agency MBS		47,284		47,284
Non-agency MBS		2,179		2,179
Corporate bonds		595		595
Total	$	$ 90,779	$ 963	$ 91,742
December 31, 2012				
Securities available-for-sale				
U.S. Government securities	$	$ 5,952	$	$ 5,952
State and municipal securities		25,807	1,099	26,906
Agency MBS		22,159		22,159
Non-agency MBS		2,544		2,544
Corporate bonds	1,957	1,588		3,545
Total	$ 1,957	$ 58,050	$ 1,099	$ 61,106

As of September 30, 2013 and December 31, 2012, 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 three and nine months ended September 30, 2013 and 2012, respectively. There were no transfers of assets in to or out of Level 3 for the three and nine months ended September 30, 2013. There were no transfers of assets into or out of Level 1, 2 or 3 for the three months ended September 30, 2013. There was one transfer of a corporate bond totaling $994 transferred from Level 2 to Level 1 during the nine months ended September 30, 2013.

	Three months ended September 30, 2013	2012	Nine months ended September 30, 2013	2012
Balance beginning of period	$ 977	$ 1,069	$ 1,099	$ 1,140
Principal payments	(10)		(10)	
Included in other comprehensive income (loss)	(4)	2	(126)	(69)
Balance end of period	$ 963	$ 1,071	$ 963	$ 1,071

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

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

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

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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 measured at fair value on a nonrecurring basis during the nine months ended September 30, 2013 and year ended December 31, 2012.

	Readily Available Market Inputs Level 1	Observable Market Inputs Level 2	Significant Unobservable Inputs Level 3	Total
September 30, 2013				
Impaired loans	$	$	$ 61	$ 61
OREO	$	$	$ 1,856	$ 1,856
December 31, 2012				
Impaired loans	$	$	$ 5,053	$ 5,053
OREO	$	$	$ 4,807	$ 4,807

Other real estate owned with a pre-foreclosure loan balance of $1,651 was acquired during the nine months ended September 30, 2013. Upon foreclosure, these assets were written down $60 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, 2013:

	Fair Value	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)
Impaired Loans	$ 61	Appraised value Sales comparison approach	Adjustment for market conditions	0-10% (3%)
OREO	$ 1,856	Appraised value - Sales comparison approach	Adjustment for market conditions	0-10% (3%)

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:

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Cash and due from banks, Interest bearing deposits in banks, and Certificates held for investment
The carrying amounts of cash, interest bearing deposits at other financial institutions approximate their fair value.

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

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

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

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

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 is estimated using discounted cash flow analysis based on the Company’s incremental borrowing rates for similar types of borrowing arrangements.

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

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

The estimated fair value of the Company’s financial instruments at September 30, 2013 and December 31, 2012 is as follows:

September 30, 2013	Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets					
Cash and cash equivalents	$ 69,657	$ 69,657	$	$	$ 69,657
Certificates of deposits held for investment	1,735		1,735		1,735
Securities available-for sale	91,742		90,779	963	91,742
Securities held-to-maturity	2,387		2,409		2,409
Federal Home Loan Bank Stock	3,041		3,041		3,041
Loans held for sale	7,266		7,258		7,258
Loans, net	477,894			442,329	442,329
Financial Liabilities					
Deposits	$ 618,918	$ 482,836	$ 137,025	$	$ 619,861
Long-term borrowings	10,000		10,206		10,206
Junior subordinated debentures	13,403			7,769	7,769

December 31, 2012	Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets					
Cash and cash equivalents	$ 56,855	$ 56,855	$	$	$ 56,855
Certificates of deposits held for investment	2,985	2,985			2,985
Securities available-for sale	61,106	1,957	58,050	1,099	61,106
Securities held-to-maturity	6,937		6,985		6,985
Federal Home Loan Bank Stock	3,126		3,126		3,126
Loans held for sale	12,950		12,977		12,977
Loans, net	438,838			401,224	401,224
Financial Liabilities					
Deposits	$ 548,243	$	$ 549,504	$	$ 549,504
Short-term borrowings	3,000		3,042		3,042
Long-term borrowings	7,500		7,765		7,765
Junior subordinated debentures	13,403			8,318	8,318

Note 10 Business Combination

On January 28, 2013, the Bank and Sterling Savings Bank, a Washington state-chartered bank (“Sterling”), entered into a Purchase and Assumption Agreement (the “Agreement”) pursuant to which the Bank agreed to purchase from Sterling three branches located in Aberdeen, Washington; Astoria, Oregon; and Seaside, Oregon, including certain deposit liabilities, loans and other assets and liabilities associated with such branch locations. The actual amount of loans and deposits, the value of other assets and liabilities transferred to the Bank and the actual price paid were determined at the time of the closing of the transaction on June 1, 2013, in accordance with the terms of the Agreement. The purchase price was $976 and exceeded the estimated fair value of tangible net assets acquired by approximately $1,127, which was recorded as goodwill and intangible assets.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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Cash flow information relative to the asset purchase agreement is as follows (in thousands):

Fair value of net assets acquired	$37,533
Cash paid for deposit premium	(976)
Liabilities assumed	(37,684)
Goodwill and intangible assets recorded	$(1,127)

The primary purpose of the acquisition is to expand the Company's market share in the northern Oregon coast, to provide existing customers with added convenience and service, and to provide our new customers with the opportunity to enjoy the outstanding personalized service and commitment of our community-based bank.

Fair value adjustments and related goodwill were recorded in the statement of financial condition of the Company. The following is a condensed balance sheet disclosing the estimated fair value amounts of the acquired branches of Sterling assigned to the major consolidated asset and liability captions at the acquisition date (in thousands):

Cash and cash equivalents	$31,941
Loans receivable	3,989
Premises and equipment	604
Goodwill and intangible assets	1,127
Other assets	23
Total assets	$37,684
Deposits and accrued interest payable	$37,636
Deferred tax liability	47
Other liabilities	1
Equity	
Total liabilities and shareholders' equity	$37,684

The core deposit intangible asset that was recognized as part of the business combination was $242 and will be amortized over its estimated useful life of approximately ten years utilizing an accelerated method. The goodwill of $885 will not be amortized for financial statement purposes; instead, it will be reviewed annually for impairment.

The fair value of savings and transaction deposit accounts acquired from Sterling was assumed to approximate the carrying value as these accounts have no stated maturity and are payable on demand. Certificates of deposit were valued by comparing the contractual cost of the portfolio to an identical portfolio bearing current market rates. The projected cash flows from maturing certificates were calculated based on contractual rates. The fair value of certificates of deposit was calculated by discounting their contractual cash flows at a market rate for a certificate of deposit with a corresponding maturity.

Direct costs related to the Sterling acquisition will be expensed as incurred in the year ended December 31, 2013. These acquisition and integration expenses will include salaries and benefits, technology and communications, occupancy and equipment, professional services and other noninterest expenses. For the nine months ended September 30, 2013, the Company incurred $615,000 of expenses related to acquisition costs.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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," “will”, "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, 2012 (the “2012 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. stagnant economic or business conditions, nationally and in the regions in which we do business that have resulted in, and may continue to result in, among other things, reduced demand for credit and other banking services, lower 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;

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

6. integration of three bank branches and related assets acquired from Sterling that may cost more or be less beneficial to us than expected.

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.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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 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 two in Clatsop County, Oregon. In addition, the Bank operates three loan production offices in Burlington, Dupont and Vancouver, Washington and has a residential real estate mortgage department. During second quarter 2013, the Bank completed the acquisition of three branches from Sterling Savings Bank. Total deposits assumed were $37,634,000 and loans acquired totaled $3,989,000. Of the three branches purchased, two were consolidated into existing Pacific branches to maximize branch efficiencies resulting in one new branch in Astoria, Oregon. Separately, the Company opened a full-service branch in Warrenton, Oregon in October 2013 that further expands operations on the northern Oregon coast.

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 2012 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 2012 10-K.

Recent Accounting Pronouncements

Please see Note 8 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, 2013, and financial condition as of that date:

- Net income for the three months ended September 30, 2013 was $909,000, a decrease of $106,000 compared to the same period of the prior year. The decrease in net income for the current quarter primarily relates to a decrease in gain on sales of loans, which was partially offset by an increase in net interest income. Net income for the nine months ended September 30, 2013 was $2,942,000, a decrease of $164,000 compared to net income of $3,106,000 for the first three quarters of 2012.

- Return on average assets (“ROAA”) and return on average equity (“ROAE”) were 0.59% and 5.79%, respectively, for the nine months ended September 30, 2013, compared to 0.65% and 6.35%, respectively, for the same periods in 2012. The reductions in ROAA and ROAE were primarily driven by a decrease in net interest income and an increase in non-interest expense.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

· Net interest income of $6,015,000 and $17,549,000 for the three and nine months ended September 30, 2013, increased $93,000 and decreased ($553,000), respectively, compared to the same periods of the prior year. The increase in the current three month period is due to reductions in interest expense on deposits. The decrease for the nine-month period is primarily the result of lower yields in the loan portfolio, as well as reinvestment of principal payments in the investment portfolio at near historically low interest rates. Net interest margin declined to 3.80% and 3.87% for the three and nine months ended September 30, 2013, compared to 4.14% and 4.23%, respectively, in the same periods one year ago.

· The Bank's tier 1 leverage ratio was 10.04% and total risk-based capital ratio was 14.85% at September 30, 2013.

· Total assets were $715,748,000 at September 30, 2013, an increase of $72,154,000, or 11.21%, over year-end 2012. Increases in investments and loans were the primary contributors to overall asset growth. Total loans of $486,700,000 at September 30, 2013, increased $38,504,000, or 8.59%, compared to year-end 2012.

· Non-performing assets ("NPAs") totaled $12,384,000 at September 30, 2013, which represents 1.73% of total assets, and is a decrease from $19,791,000 at December 31, 2012. The decrease is largely due to a decline in non-performing loans from $15,112,000 at year-end 2012 to $8,050,000 as of September 30, 2013, of which $1,800,000 is guaranteed by the United States Department of Agriculture ("USDA"). NPAs are concentrated in commercial real estate loans, which represented $4,211,000, or 34.00%, of NPAs.

· Provision for (recapture of) credit losses was $0 and ($450,000) for the three and nine months ended September 30, 2013, compared to $0 and $400,000 for the same periods one year ago. The recapture of prior provision in the current year is due to improving credit quality and lower levels of NPAs.

· Total deposits of $618,918,000 at September 30, 2013 increased $70,675,000, or 12.89%, for the nine months ended September 30, 2013, compared to December 31, 2012, driven by the Sterling branch acquisition, in addition to organic deposit growth. Core deposits (excluding certificates of deposits) represent 78.03% and 74.83% of total deposits at September 30, 2013 and December 31, 2012, respectively.

Results of Operations

Net income. For the three and nine months ended September 30, 2013, net income was $909,000 and $2,942,000, respectively, compared to $1,015,000 and $3,106,000 for the same periods in 2012. The decrease in net income in the current quarter primarily relates to a decrease in gain on sale of loans resulting from declining mortgage volume, which was partially offset by an increase in net interest income, coupled with decreases in OTTI losses and OREO writedowns. The decrease in the nine month comparison period was mostly attributable to a decline in net interest income and an increase in expenses relating to mortgage commissions, coupled with professional fees and data processing costs related to the branch acquisition.

Net interest income. Net interest income for the three and nine months ended September 30, 2013 increased $93,000 or 1.57% and decreased $553,000 or 3.05%, respectively, compared to the same periods in 2012. 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) decreased to 3.80% for the three months ended September 30, 2013, from 4.14% for the same period of the prior year due primarily to a decrease in loan yield to 5.04% for the three months ended September 30, 2013, from 5.29% for the same period last year. However, net interest income in dollars increased from the prior three month period due to growth in average interest earning balances outstanding of $60,460,000, or 10.56%, which was driven by investment and loan growth. Net interest margin decreased to 3.87% for the nine months ended September 30, 2013, from 4.23% for the same period last year. The decrease in the nine month period is due to a decrease in the Company's average yield earned on assets from 5.01% for the nine months ended September 30, 2012 to 4.41% at September 30, 2013, which was only partially offset by a decline in the average cost of funds to 0.54% at September 30, 2013, from 0.79% one year ago.

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,

	2013			2012		
(dollars in thousands)	Average Balance	Interest Income (Expense)	Avg Rate	Average Balance	Interest Income (Expense)	Avg Rate
Interest Earning Assets						
Loans (1)	$ 489,056	$ 6,162*	5.04 %	$ 482,172	$ 6,374*	5.29 %
Taxable securities	60,221	221	1.47	29,626	186	2.51
Tax-exempt securities	32,302	355*	4.40	27,897	385*	5.52
Federal Home Loan Bank Stock	3,065	1	0.13	3,181		
Interest earning balances with banks	48,530	33	0.27	29,838	19	0.25
Total interest earning assets	$ 633,174	$ 6,772	4.28 %	$ 572,714	$ 6,964	4.86 %
Cash and due from banks	12,362			10,948		
Bank premises and equipment (net)	16,167			14,726		
Other real estate owned	4,070			6,286		
Other assets	39,350			42,680		
Allowance for credit losses	(8,917)			(11,030)		
Total assets	$ 696,206			$ 636,324		
Interest Bearing Liabilities						
Savings and interest bearing demand	$ 322,605	$ (166)	0.21 %	$ 286,210	$ (253)	0.35 %
Time deposits	138,762	(307)	0.88	142,661	(433)	1.21
Total deposits	461,367	(473)	0.41	428,871	(686)	0.64
Short-term borrowings				3,000	(22)	2.93
Long-term borrowings	10,000	(54)	2.16	7,500	(51)	2.72
Secured borrowings				220	(1)	1.82
Junior subordinated debentures	13,403	(62)	1.85	13,403	(69)	2.06

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Total borrowings	23,403	(116)	1.98	24,123	(143)	2.37
Total interest-bearing liabilities	$ 484,770	$ (589)	0.49 %	$ 452,994	$ (829)	0.73 %
Demand deposits	138,875			112,364		
Other liabilities	4,958			4,512		
Shareholders’ equity	67,603			66,454		
Total liabilities and shareholders’ equity	$ 696,206			$ 636,324		
Net interest income		$ 6,183*			$ 6,135*	
Net interest spread			3.91 %			4.28 %
Net interest margin			3.80 %			4.14 %
Tax equivalent adjustment		$ 168*			$ 213*	

* Tax equivalent basis 34% tax rate used

(1) Interest income on loans includes loan fees of $169 and $113 in 2013 and 2012, respectively.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Nine Months Ended September 30,

	2013			2012		
(dollars in thousands)	Average Balance	Interest Income (Expense)	Avg Rate	Average Balance	Interest Income (Expense)	Avg Rate
Interest Earning Assets						
Loans (1)	$ 480,404	$ 18,323*	5.09 %	$ 480,367	$ 19,625*	5.45 %
Taxable securities	49,411	471	1.27	30,336	633	2.78
Tax-exempt securities	32,634	1,153*	4.71	26,895	1,129*	5.60
Federal Home Loan Bank Stock	3,094	1	0.04	3,182		
Interest earning balances with banks	39,671	85	0.29	30,270	55	0.24
Total interest earning assets	$ 605,214	$ 20,033	4.41 %	$ 571,050	$ 21,442	5.01 %
Cash and due from banks	11,478			10,264		
Bank premises and equipment (net)	15,547			14,798		
Other real estate owned	4,086			7,340		
Other assets	41,203			41,284		
Allowance for credit losses	(9,218)			(11,011)		
Total assets	$ 668,310			$ 634,725		
Interest Bearing Liabilities						
Savings and interest bearing demand	$ 311,792	$ (547)	0.23 %	$ 289,776	$ (856)	0.39 %
Time deposits	136,863	(1,026)	1.00	146,931	(1,403)	1.27
Total deposits	448,655	(1,573)	0.47	436,707	(2,259)	0.69
Short-term borrowings	406	(9)	2.96	2,595	(57)	2.93
Long-term borrowings	9,660	(159)	2.19	7,905	(166)	2.80
Secured borrowings				551	(18)	4.36
Junior subordinated debentures	13,403	(186)	1.85	13,403	(221)	2.20
Total borrowings	23,469	(354)	2.01	24,454	(462)	2.52
Total interest-bearing liabilities	$ 472,124	$ (1,927)	0.54 %	$ 461,161	$ (2,721)	0.79 %
Demand deposits	123,868			103,308		
Other liabilities	4,596			5,014		
Shareholders' equity	67,722			65,242		
Total liabilities and shareholders' equity	$ 668,310			$ 634,725		
Net interest income		$ 18,106*			$ 18,721*	
Net interest spread			3.99 %			4.37 %
Net interest margin			3.87 %			4.23 %
Tax equivalent adjustment		$ 557*			$ 619*	

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

* Tax equivalent basis 34% tax rate used

(1) Interest income on loans includes loan fees of $396 and $416 in 2013 and 2012, respectively.

Interest and dividend income on a tax equivalent basis for the three and nine months ended September 30, 2013 decreased $192,000 and $1,409,000, or 2.76% and 6.57%, respectively, compared to the same periods in 2012. The decrease was primarily due to the decline in income earned on our loan and investment portfolio as a result of the continued low interest rate environment. Loans averaged $480,404,000 with an average yield of 5.09% for the nine months ended September 30, 2013, compared to average loans of $480,367,000 with an average yield of 5.45% for the same period in 2012. Loans averaged $489,056,000 with an average yield of 5.04% for the three months ended September 30, 2013, compared to average loans of $482,172,000 with an average yield of 5.29% for the same period in 2012.

Interest and dividend income on investment securities on a tax equivalent basis for the three and nine months ended September 30, 2013 increased $5,000, or 0.87%, and decreased $138,000, or 7.83%, respectively, compared to the same periods in 2012. The increase in the current three-month period is due to growth in average balances outstanding in the investment portfolio of $35,000,000, or 60.85%. The decrease in the nine-month period was attributable to the reduction in yield from accelerated prepayments on mortgage-backed securities and the maturity of higher yielding securities that cannot be replaced at similar rates in the current low rate environment. Additionally, new securities purchased during 2013 are at substantially lower yields than existing bonds in the portfolio.

Average interest earning balances with banks for the three and nine months ended September 30, 2013 were $48,530,000 and $39,671,000 with an average yield of 0.27% and 0.29%, respectively, compared to $29,838,000 and $30,270,000 with an average yield of 0.25% and 0.24%, respectively, for the same periods in 2012. The average yield in all periods is comparable to the federal funds target rate of 0.25% set by the Federal Open Market Committee of the Federal Reserve.

Interest expense for the three and nine months ended September 30, 2013 decreased $239,000 and $794,000, or 28.83% and 29.18%, respectively, compared to the same periods in 2012. The decrease is primarily attributable to a decrease in rates paid on deposits, coupled with lower average balances outstanding on time deposits. The average balance of time deposits as of September 30, 2013 declined $10,068,000, or 6.85%, compared to the September 30, 2012, as fewer retail customers have been willing to lock in low interest rates for an extended period of time. Additionally, the opportunity for continued downward repricing of maturing certificates of deposits has diminished. We believe that rates currently paid on non-maturity deposits are effectively near the floor. In total, average interest-bearing liabilities for the nine months ended September 30, 2013 and 2012, were $472,124,000 and $461,161,000, respectively, with an average cost of 0.54% and 0.79%, respectively.

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 the Bank’s 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, portfolio migration analysis, economic conditions and other qualitative factors. During the three months ended September 30, 2013, loss factors used in the allowance for credit losses for credit cards were increased from 2.45% to 5.00% based upon charge-off experience and other factors considered by management. There were no other changes to loss factors during the period. For additional information, please see the discussion under the heading “Critical Accounting Policies” in Item 7 of our 2012 10-K.

During the three and nine months ended September 30, 2013, provision for (recapture of) credit losses totaled $0 and ($450,000), respectively, compared to $0 and $400,000 for the same periods in 2012. The decrease in provision for credit losses in the nine month period is due to improving credit quality as evidenced by decreases in non-performing loans and assets, loans classified substandard, and net charge-offs. Non-performing loans decreased from $15,112,000 at December 31, 2012, to $8,050,000 at September 30, 2013. Loans classified as substandard decreased $7,681,000 from year-end 2012 to $13,737,000 at the close of the quarter. Key credit metrics continue to significantly improve over the quarter and from year ago levels.

For the three and nine months ended September 30, 2013, net charge-offs (recoveries) were $156,000 and $102,000 compared to ($93,000) and $370,000 for the same periods in 2012. Net charge-offs for the twelve months ended December 31, 2012 were $669,000. The ratio of net charge-offs (recoveries) to average loans outstanding for the nine months ended September 30, 2013 and 2012 was less than 0.02% and 0.08%, respectively.

At September 30, 2013, the allowance for credit losses was $8,806,000 compared to $9,358,000 at December 31, 2012, and $11,157,000 at September 30, 2012. The ratio of the allowance for credit losses to total loans outstanding was 1.81%, 2.09% and 2.39%, at September 30, 2013, December 31, 2012 and September 30, 2012, respectively, and is directionally consistent with improving credit quality trends.

We continue to maintain a substantial unallocated allowance for credit losses that is reflective of management's assessment of qualitative factors, including the continued uncertainty in the economy and financial industry, pervasive high unemployment rates in our geographic markets, and continued pressure on real estate values in many of the Company's markets. Additionally, there continues to be a significant number of distressed sellers in the market. Aside from housing-related construction and development loans, non-performing loans often reflect unique operating difficulties for the individual borrower; however, the weak pace of general economic activity and pressure on commercial real estate values have been significant contributing factors to delinquencies and defaults in other non-housing-related segments of the portfolio. Lastly, there remains uncertainty with specific credits within our impaired loans that present a higher risk profile.

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 $38,397,000, $49,966,000, and $50,710,000 at September 30, 2013, December 31, 2012 and September 30, 2012, respectively. The ratio of allowance for credit losses to total loans outstanding excluding the government guaranteed loans was 1.96%, 2.35%, and 2.55%, 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 of quarterly or more frequently as considered necessary, of all loans judged to present a possibility of loss (if, as a result of such quarterly 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, 2013.

Non-performing assets and other real estate owned. Non-performing assets totaled $12,384,000 at September 30, 2013, representing 1.73% of total assets, compared to $19,791,000, or 3.08%, at December 31, 2012, and $17,591,000, or 2.73%, at September 30, 2012. Non-performing commercial real estate loans of $4,211,000 represent 53.79% of non-performing loans.

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

SUMMARY OF NON-PERFORMING ASSETS (in thousands)	September 30, 2013	December 31, 2012	September 30, 2012
Accruing loans past due 90 days or more	$ 221	$	$ 770
Non-accrual loans:			
Construction, land development and other land loans	1,413	1,792	1,576
Residential real estate 1-4 family	790	800	768
Commercial real estate	4,211	9,642	7,897
Farmland	955	976	
Commercial and industrial	460	1,901	777
Installment		1	
Total non-accrual loans (1)	7,829	15,112	11,018
Total non-performing loans	8,050	15,112	11,788
OREO	4,334	4,679	5,803
Total Non-Performing Assets (2)	$ 12,384	$ 19,791	$ 17,591
Troubled debt restructured loans on accrual status	$ 2,699	$ 444	$ 126
Allowance for credit losses	$ 8,806	$ 9,358	$ 11,157
Allowance for credit losses to non-performing loans	109.39 %	61.92 %	94.65 %
Allowance for credit losses to non-performing assets	71.11 %	47.28 %	63.42 %
Non-performing loans to total loans (3)	1.65 %	3.37 %	2.53 %
Non-performing assets to total assets	1.73 %	3.08 %	2.73 %

(1) Includes $1,413,000, $3,930,00 0 and $4,272,000 in non-accrual troubled debt restructured loans ("TDRs") as of September 30, 2013, December 31, 2012 and September 30, 2012, 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 $7,062,000, or 46.73%, from the balance at December 31, 2012 due to a decrease in non-accrual commercial and commercial real estate loans from principal payments received under a USDA guarantee coupled with credit risk upgrades. Additionally, of the $7,829,000 in non-accrual loans at September 30, 2013, $1,800,000 remains guaranteed by the USDA. In addition to the decrease in non-performing loans, OREO decreased by $345,000, or 7.37%, from the balance at December 31, 2012, due to a combination of OREO sales and write-downs.

Currently, it is our practice to obtain new appraisals on non-performing collateral dependent loans and/or OREO semi-annually on land and every nine months on improved properties. Based upon 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, 2013 and 2012, as a result of these appraisals and other factors, the Company recorded OREO write-downs of $636,000 and $698,000, respectively.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

OREO at September 30, 2013 totaled $4,334,000 and consists of properties as follows: eight land or land development properties totaling $903,000, one residential construction property totaling $104,000, nine commercial real estate properties totaling $2,679,000, and three single family residences collectively valued at $648,000. 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.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

The Company had troubled debt restructures totaling $4,112,000 and $4,374,000 at September 30, 2013 and December 31, 2012, respectively. For more information regarding TDRs, see Note 4-"Loans" of the condensed consolidated financial statements.

Non-interest income and expense. Non-interest income for the three and nine months ended September 30, 2013 decreased $211,000, or 8.64%, and increased $1,333,000, or 19.90%, respectively, compared to the same periods in 2012. The decrease in the current three-month period is due to tapering mortgage refinance volume driven by rising mortgage rates. The increase in the nine-month period was largely the result of an increase in gain on sale of loans to $4,306,000 due to increased mortgage refinancing activity driven by the low rate environment and recovering housing market during the first half of the year. Originations of loans held for sale were $201,278,000 for the nine months ended September 30, 2013, compared to $184,171,000 for the same period in 2012. Management expects refinance activity to slow for the remainder of 2013, and is making adjustments to operations in anticipation.

Service charges on deposits for the three and nine months ended September 30, 2013, were relatively unchanged at $440,000 and $1,281,000, compared to $406,000 and $1,256,000 for the same periods in 2012. Additionally, gain on sale of OREO increased $36,000 and decreased $250,000 during the three and nine months ended September 30, 2013, compared to the same periods in 2012.

The Bank recorded net gains on sale of securities available-for-sale of $14,000 and $401,000 during the three and nine months ended September 30, 2013, compared to $65,000 and $164,000 for the same periods in the prior year. One non-agency mortgage-backed security was determined to be other-than-temporarily-impaired resulting in the Company recording $4,000 and $160,000, respectively, in impairment charges related to credit losses through earnings for the three months ended September 30, 2013 and 2012, and $38,000 and $265,000 for the nine months ended September 30, 2013 and 2012, respectively. There were no additional OTTI securities at September 30, 2013 or December 31, 2012.

Total non-interest expense for the three and nine months ended September 30, 2013 increased $19,000 and $1,801,000, or 0.27% and 8.75%, respectively, compared to the same periods in 2012. The increase in the current three-month period is mostly related to increases in occupancy and data processing costs related to the additional accounts and locations from the branch acquisition. These were partially offset by a decrease in OREO write-downs during the current quarter. The increase in the nine-month period was mostly related to increases in salary and employee benefit costs, although increases in professional services and data processing expenses also contributed and were only partially offset by reductions in FDIC assessments and OREO costs. Salaries and employee benefits for the nine months ended September 30, 2013 and 2012, were $12,983,000 and $11,823,000, respectively. The increase is mostly related to an increase in commissions paid on the sale of loans held for sale as part of the increased residential mortgage production during the first part of the year. Additionally, annual performance and merit increases, as well as an increase in health insurance premiums, contributed to the increase in salaries and benefits for 2013. Employees hired for the loan production offices and acquired branches were more than offset by reductions in other positions throughout the Company. Full time equivalent employees at September 30, 2013 were 231, a decrease from 237 at December 31, 2012, and 233 at September 30, 2012. The increase in professional service fees during the nine-month period is due to the legal costs associated with the Bank's acquisition of three branches from Sterling, which closed in second quarter 2013. Additionally, the increase in data processing includes $395,000 in one-time conversion expenses from the branch acquisition. Overall, total non-interest expense was impacted by approximately $615,000 in acquisition costs which were expensed as incurred, mostly in second quarter 2013.

Income taxes. The federal income tax expense for the three and nine months ended September 30, 2013, was $249,000 and $710,000 as compared to $280,000 and $717,000, respectively, for the three and nine months ended September 30, 2012. The effective tax rate for the three and nine months ended September 30, 2013 was 21.5% and 19.4%, respectively. The effective tax rate differs from the statutory rate of 34.4% due to tax exempt income representing an increasing share of income as investments in municipal securities and loans, income earned on bank owned life insurance, 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 $715,748,000 at September 30, 2013, an increase of $72,154,000, or 11.21%, over year-end 2012. Increases in loans and investments were the primary contributors to overall asset growth, which were partially offset by a decrease in loans held for sale.

Investments. The investment portfolio provides the Company with an income alternative to loans. The Company's investment portfolio at September 30, 2013 was $94,129,000 compared to $68,043,000 at the end of 2012, an increase of $26,086,000, or 38.34%, due to investments in municipal, government agency and mortgage-backed securities from proceeds received from the Sterling branch acquisition. 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 held in the portfolio increased $38,504,000, or 8.59%, to $486,700,000 at September 30, 2013, compared to $448,196,000 at December 31, 2012. The increase in loans was primarily due to increases of $7,193,000 in commercial loans, $6,102,000 in multi-family loans, $12,276,000 in non-owner occupied commercial real estate loans and $10,584,000 in installment loans throughout the Company's footprint. Loan demand, particularly among business owners, is on the rise compared to recent years due to a recovering economy. We also believe increased loan production resulted from the Bank's sustained marketing efforts and two loan production offices opened during 2013. Additionally, acquired loans of $3,989,000 contributed to the consumer loan increase.

Loan detail by category as of September 30, 2013 and December 31, 2012, follows (in thousands):

	September 30, 2013	December 31, 2012
Commercial	$ 94,471	$ 87,278
Residential real estate:		
Residential 1-4 family	85,625	77,497
Multi-family	13,846	7,744
Commercial real estate:		
Construction and land development	29,538	31,411
Commercial real estate owner occupied	106,670	109,783
Commercial real estate non owner occupied	115,290	103,014
Farmland	24,002	24,544
Consumer	18,366	7,782
Less unearned income	(1,108)	(857)
Total Loans	486,700	448,196
Allowance for credit losses	(8,806)	(9,358)
Net Loans	$ 477,894	$ 438,838

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

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Interest and fees earned on our loan portfolio is our primary source of revenue. Gross loans represented 68% of total assets as of September 30, 2013, compared to 72% at December 31, 2012. 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 consists of a wide cross-section of retail, small office, warehouse, and industrial 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 construction and land development loans. While these segments have historically played a significant role in our loan portfolio, balances have declined in recent years due to lower originations and active management of problem loans within our existing portfolio. Construction and land development loans represented 6.1% and 7.0% of our loan portfolio at September 30, 2013 and at December 31, 2012, respectively.

It is the Company's strategic objective to maintain concentrations in land and residential construction and total commercial real estate loans below the regulatory guidelines of 100% and 300% of risk based capital, respectively. As of September 30, 2013, concentration in land and residential construction as a percentage of risk-based capital was 29% and total concentration in non-owner occupied commercial real estate plus land and residential construction as a percentage of risk based capital stood at 203%.

Deposits. Total deposits were $618,918,000 at September 30, 2013, an increase of $70,675,000, or 12.89%, compared to December 31, 2012 due to a combination of acquired deposits representing $37,634,000 and organic deposit growth of $33,041,000. Deposit detail by category as of September 30, 2013 and December 31, 2012 follows (in thousands):

	September 30, 2013	December 31, 2012
Demand, non-interest bearing	$ 156,164	$ 115,138
Interest bearing demand	135,808	125,758
Money market	118,087	106,849
Savings	72,880	62,493
Time, interest bearing	135,979	138,005
Total deposits	$ 618,918	$ 548,243

The increase in non-maturity deposits, excluding acquired deposits, is consistent with the cyclical pattern of our deposits for the tourist heavy locations in which balances typically reach their highest point in the third quarter of the year. Additionally, the increase in demand accounts is partially attributable to growth in commercial accounts as a result of new commercial lending relationships. The ratio of non-interest bearing deposits to total deposits was 25.23% and 21.00% at September 30, 2013 and December 31, 2012, respectively.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

42

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

Time deposits decreased $2,026,000, or 1.47%, due to our commitment to maintain a disciplined pricing strategy. The Bank prices time deposits competitively to retain existing relationship-based customers, but not to retain time deposit only customers or to attract new time deposit customers. Additionally, management believes that time deposits are not considered an attractive investment option for some segments of our customer base in the current low interest rate environment.

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 new customers and our current client base. In addition, management's strategy for funding asset growth 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, 2013, includes $71,392,000 in cash, interest bearing deposits with banks, and certificates of deposits held for investment and $91,742,000 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, 2013. The Bank also has a credit line with the Federal Home Loan Bank ("FHLB") of Seattle for up to 20% of assets, of which $10,000,000 was used at September 30, 2013. Based on current pledged collateral, the Bank had $99,603,000 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 $50,207,000 at the Federal Reserve Bank subject to pledged collateral, of which none was used at September 30, 2013. 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 for liquidity, which is 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.

At September 30, 2013, two wholly-owned subsidiary grantor trusts established by the Company had issued and outstanding $13,403,000 of trust preferred securities. For additional information regarding trust preferred securities, see the 2012 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. The Federal Reserve's regulatory minimum risk-based capital guidelines 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.

At September 30, 2013, there were 72 investment securities in an unrealized loss position, of which seven were in a

In early July 2013, the Federal Reserve Board and the FDIC issued final rules implementing the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The rules revise minimum capital requirements and adjust prompt corrective action thresholds. The interim final rule revises the regulatory capital elements, adds a new common equity Tier I capital ratio, and increases the minimum Tier I capital ratio requirement. The revisions also permit banking organizations to retain, through a one-time election, the existing treatment for accumulated other comprehensive income and implement a new capital conservation buffer. The final rule will become effective January 1, 2015, subject to a transition period. The complex final rule will require careful review and analysis, but management believes the Company and the Bank will continue to exceed the well capitalized requirements.

The capital ratios for the Company and the Bank at September 30, 2013 and December 31, 2012, were as follows:

	Company September 30, 2013	December 31, 2012	Bank September 30, 2013	December 31, 2012	Requirements Adequately Capitalized	Well Capitalized
Tier 1 leverage ratio	10.04 %	10.69 %	10.04 %	10.69 %	4 %	5 %
Tier 1 risk-based capital ratio	13.59 %	14.95 %	13.59 %	14.96 %	4 %	6 %
Total risk-based capital ratio	14.84 %	16.21 %	14.85 %	16.22 %	8 %	10 %

Total shareholders' equity was $68,336,000 at September 30, 2013, an increase of $1,615,000, or 2.42%, compared to December 31, 2012.

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, 2013 and believes that there has been no material change since December 31, 2012.

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

Not applicable.

ITEM 1A. RISK FACTORS

There has been no material change from the risk factors previously reported in the 2012 10-K.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

None.

45

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, 2013	By:	/s/ Dennis A. Long Dennis A. Long Chief Executive Officer
	By:	/s/ Denise Portmann Denise Portmann Chief Financial Officer

46

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.

47