PACIFIC FINANCIAL CORP
Form 10-K
March 22, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

/X/ Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2003; or

/ / Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

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.)

300 East Market Street
Aberdeen, Washington 98520-5244
(Address of Principal Executive Offices) (Zip Code)

Registrant's telephone number, including area code:
(360) 533-8870

Securities Registered Pursuant to Section 12(b) of the Act: None

Securities Registered Pursuant to Section 12(g) of the Act:
Common Stock, par value $1.00 per share

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 periods that the Registrant was required to file such reports), and (2) has been subject to such requirements for the past 90 days. Yes__X___ No______

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the Registrant is an accelerated filer (as defined by Exchange Act Rule 12b-2). Yes [ ] No [X]

The aggregate market value of the common stock held by non-affiliates of the registrant at June 30, 2003 was $59,176,189.

The number of shares outstanding of the registrant's common stock, $1.00 par value as of February 29, 2004, was 3,159,712 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement filed in connection with its annual meeting of shareholders to be held April 28, 2004 are incorporated by reference into Part III of this Form 10-K.

PACIFIC FINANCIAL CORPORATION
ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR
ENDED DECEMBER 31, 2003

TABLE OF CONTENTS

PART I

Forward Looking Information

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

Any forward-looking statements in this document are subject to risks relating to, among other things, the following:

1. competitive pressures among depository and other financial institutions that may impede our ability to attract and retain borrowers, depositors and other customers, retain our key employees, and/or maintain our interest margins and fee income;

2. changes in the interest rate environment that may reduce margins and demand for our products and services;

3. our proposed acquisition of BNW Bancorp Inc. that may be dilutive to earnings per share if we do not realize expected cost savings or successfully integrate BNW Bancorp into the Company in a timely manner and without significant customer or employee disruptions or losses;

4. our growth strategy, particularly if accomplished through acquisitions, which may not be successful if we fail to accurately assess market opportunities, asset quality, anticipated cost savings, and transaction costs, or experience significant difficulty integrating acquired businesses or assets or opening new branches or similar offices;

5. general economic or business conditions, either nationally or in the state or regions in which we do business, that may be less favorable than expected, resulting in, among other things, a deterioration in credit quality, including as a result of lower prices in the real estate market, or a reduced demand for credit;

6. decreases in real estate prices that may reduce the value of our security for some loans; and

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

Our management believes the forward-looking statements 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.

-3-

ITEM 1. Business

Pacific Financial Corporation (the Company or Pacific) is a financial holding company headquartered in Aberdeen, Washington. The Company owns one bank, Bank of the Pacific (sometimes referred to as the Bank), which is located in Washington. The Company conducts its banking business through 10 branches located in communities throughout Grays Harbor County, Pacific County, and Wahkiakum County in Southwest Washington. The Company also operates a loan production office in Gearhart, OR. At December 31, 2003, the Company had total consolidated assets of $306.7 million, loans of $199.7 million, deposits of $260.8 million and total shareholders' equity of $25.6 million. The Company was incorporated in the State of Washington on February 12, 1997, pursuant to a holding company reorganization of the Bank. Although a reporting company with the Securities and Exchange Commission (SEC), the Company's stock is not listed on any exchange or quoted actively on any stock market.

Effective February 27, 2004, the Company completed the acquisition of BNW Bancorp, Inc. (BNW) in a merger in which each share of BNW common stock held by BNW shareholders was converted into the right to receive 0.85 shares of Pacific common stock, resulting in the issuance of 636,673 shares of Pacific stock. Simultaneous with the merger of BNW into Pacific, BNW's subsidiary Bank NorthWest was merged into Bank of the Pacific. The merger will be accounted for as a purchase transaction.

BNW, through its operating subsidiary Bank NorthWest, operated five locations in Whatcom County, Washington, including its largest city, Bellingham, Washington. At December 31, 2003, BNW had total assets of approximately $104.6 million, total loans receivable of approximately $94.1 million, total deposits of approximately $88.6 million and total shareholders' equity of approximately $7 million.

The Company does not anticipate significant changes in products and services offered to customers of Bank of the Pacific following the merger, but it will be able to offer higher lending limits to its customers, particularly those who were formerly BNW customers.

Pacific's filings with the SEC, including its annual report on Form 10-K, quarterly reports on Form 10-Q, periodic current reports on Form 8-K and amendments to these reports, are available free of charge through links from our website at http://www.thebankofpacific.com to the SEC's site at http://www.sec.gov, as soon as reasonably practicable after filing with the SEC. You may also access our filings with the SEC directly from the Edgar database found on the SEC's website. By making reference to our website above and elsewhere in this report, we do not intend to incorporate all information from our site into this report.

The Bank

Bank of the Pacific was organized in 1978 and opened for business in 1979 to meet the need for a regional community bank with local interests to serve the small to medium-sized local businesses and professionals in the coastal region of Western Washington. Services offered by the Bank include commercial loans, agriculture loans, installment loans, real estate loans, residential mortgage loans and personal and business deposit products.

The Bank originates loans primarily in its local markets. Its underwriting policies focus on assessment of each borrower's ability to service and repay the debt, and the availability of collateral that can be used to secure the loan. Depending on the nature of the borrower and the purpose and amount of the loan, the Bank's loans may be secured by a variety of collateral, including business assets, real estate, and personal assets.

The Bank's commercial and agricultural loans consist primarily of secured revolving operating lines of credit and business term loans, some of which may be partially guaranteed by the Small Business Administration or the U.S. Department of Agriculture.

Consumer installment loans and other loans represent a small percentage of total outstanding loans and include home equity loans, auto loans, boat loans, and personal lines of credit.

The Bank's primary sources of deposits are from individuals and businesses in its local markets. A concerted effort has been made to attract deposits in the local market areas through competitive pricing and delivery of quality products. These products include demand accounts, negotiable order of withdrawal accounts, money market investment accounts, savings accounts and time deposits. The Bank traditionally has not sought brokered deposits and does not intend to do so in the future.

The Bank provides 24 hour online banking to its customers with access to account balances and transaction histories, plus an electronic check register to make account management and reconciliation simple. The online banking system is compatible with budgeting software like Intuit's Quicken or Microsoft's Money. In addition, the online banking system includes the ability to transfer funds, make loan payments, reorder checks, and request statement reprints, provides loan calculators and allows for e-mail exchanges with The Bank. Also for a nominal fee, customers can request stop payments and pay an unlimited number of bills online. These services along with rate information and other information can be accessed through the Bank's website at http://www.thebankofpacific.com.

The Bank's deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to applicable legal limits under the Bank Insurance Fund. The Bank is a member of the Federal Home Loan Bank (FHLB) and is regulated by the Washington Department of Financial Institutions, Division of Banks (Division), and the FDIC.

Competition

Competition in the banking industry is significant and has intensified as the regulatory environment has grown more permissive. Banks face a growing number of competitors and greater degree of competition with respect to the provision of banking services and the attracting of deposits. The Company competes in Grays Harbor County with well-established thrifts which are headquartered in the area along with branches of large banks and with headquarters outside the area. The Company competes with well-established small community banks, branches of large banks, thrifts and credit unions in Pacific and Wahkiakum Counties in the state of Washington and Clatsop County in the state of Oregon. Other non-bank and non-depository institutions can be expected to increase competition further as they offer bank type products.

As a result of its acquisition of BNW in February 2004, the Company entered a new market in Whatcom County, Washington, including the Bellingham area. This market is very competitive and includes large regional and super-regional financial institutions that do not have a significant presence in the Company's historical market areas. The Company believes its newest territory provides opportunities for expansion, but in pursuing that expansion it expects to face greater competitive challenges than it faces in its historical market area.

The adoption of the Gramm-Leach-Bliley Act of 1999 (the Financial Services Modernization Act) eliminated many of the barriers to affiliation among providers of financial services and further opened the door to business combinations involving banks, insurance companies, securities or brokerage firms, and others. This regulatory change has led to further consolidation in the financial services industry and the creation of financial conglomerates which frequently offer multiple financial services, including deposit

services, brokerage and others. When combined with technological developments such as the Internet that have reduced barriers to entry faced by companies physically located outside the Company's market area, changes in the market have resulted in increased competition and can be expected to result in further increases in competition in the future.

Although it cannot guarantee that it will continue to do so, the Company has been able to maintain a competitive advantage in its historical markets as a result of its status as a local institution, offering products and services tailored to the needs of the community. Further, because of the extensive experience of management in its market area and the business contacts of management and the Company's directors, management believes the Company can continue to compete effectively.

According to the Market Share Report compiled by the FDIC, as of June 30, 2003, the Company held a deposit market share of 26.9% in Pacific County, 47.1% in Wahkiakum County and 17.3% in Grays Harbor County.

Employees

As of December 31, 2003, the Bank employed 95 full time equivalent employees. The Bank acquired 52 additional employees in the merger with BNW completed in February 2004. Management believes relations with its employees are good.

SUPERVISION AND REGULATION

The following is a general description of certain significant statutes and regulations affecting the banking industry. This regulation is intended primarily for the protection of depositors and not for the benefit of the Company's shareholders. The following discussion is intended to provide a brief summary and, therefore, is not complete and is qualified by the statutes and regulations referenced. Changes in applicable laws or regulations may have a material effect on the business and prospects of the Company.

The operations of the Company may also be affected by changes in the policies of banking and other government regulators. The Company cannot accurately predict the nature or extent of the effects on its business and earnings that fiscal or monetary policies, or new federal or state laws or regulations, may have in the future.

The Company

General

As a financial holding company, the Company is subject to the Bank Holding Company Act of 1956, as amended (BHCA), which places the Company under the supervision of the Board of Governors of the Federal Reserve System (the Federal Reserve). The Company must file annual reports with the Federal Reserve and must provide it with such additional information as it may require. In addition, the Federal Reserve periodically examines the Company and the Bank.

Bank Holding Company Regulation

In general, the BHCA limits a bank holding company to owning or controlling banks and engaging in other banking-related activities. Bank holding companies must obtain approval of the Federal Reserve before they: (1) acquire direct or indirect ownership or control of any voting shares of any bank that results in total ownership or control, directly or indirectly, of more than 5% of the voting shares of such bank; (2) merge or consolidate with another bank holding company; or (3) acquire substantially all of the assets of another bank or bank holding company.

Control of Nonbanks. With certain exceptions, the BHCA prohibits bank holding companies from acquiring direct or indirect ownership or control of more than 5% of the voting shares in any company that is not a bank or a bank holding company unless the Federal Reserve determines that the activities of such company are incidental or closely related to the business of banking. If a bank holding company is well-capitalized and meets certain criteria specified by the Federal Reserve, it may engage de novo in certain permissible nonbanking activities without prior Federal Reserve approval.

Control Transactions. The Change in Bank Control Act of 1978, as amended, requires a person (or group of persons acting in concert) acquiring control of a bank holding company to provide the Federal Reserve with 60 days' prior written notice of the proposed acquisition. Following receipt of this notice, the Federal Reserve has 60 days within which to issue a notice disapproving the proposed acquisition, but the Federal Reserve may extend this time period for up to another 30 days. An acquisition may be completed before expiration of the disapproval period if the Federal Reserve issues written notice of its intent not to disapprove the transaction. In addition, any company must obtain approval of the Federal Reserve before acquiring 25% (5% if the company is a bank holding company) or more of the outstanding shares or otherwise obtaining control over the Company.

Source of Strength Requirements. Under Federal Reserve policy, the Company is expected to act as a source of financial and managerial strength to the Bank. This means that the Company is required to commit, as necessary, resources to support the Bank. Any capital loans made by the Company to the Bank would be subordinate in priority to deposits and to certain other indebtedness of the Bank.

Financial Services Modernization Act

On November 12, 1999, the Financial Services Modernization Act was signed into law. The Financial Services Modernization Act repeals the two affiliation provisions of the Glass-Steagall Act: Section 20, which restricted the affiliation of Federal Reserve member banks with firms "engaged principally" in specified securities activities; and Section 32, which restricts officer, director, or employee interlocks between a member bank and any company or person "primarily engaged" in specified securities activities. In addition, the Financial Services Modernization Act contains provisions that expressly preempt any state law restricting the establishment of financial affiliations, primarily related to insurance. The general effect of the law is to establish a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms, and other financial service providers by revising and expanding the bank holding company framework to permit a holding company system to engage in a full range of financial activities through a new entity known as a financial holding company.

The Company received approval to become a financial holding company during 2000. Bank holding companies that elect to become a financial holding company may affiliate with securities firms and insurance companies and engage in other activities that are financial in nature or are incidental or complementary to activities that are financial in nature. "Financial in nature" activities include securities underwriting, dealing, and market marking, sponsoring mutual funds and investment companies, insurance underwriting and agency, merchant banking, and activities that the Federal Reserve, in consultation with the Secretary of Treasury, determines from time to time to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

The law and related regulations also:

* broadened the activities that may be conducted by national banks and by banking subsidiaries of bank holding companies, and their financial subsidiaries;

* provided an enhanced framework for protecting the privacy of consumer information; and

* modified the laws governing the implementation of the Community Reinvestment Act.

The Company does not believe that the Financial Services Modernization Act has had a material effect on its operations in the near-term. However, to the extent that the legislation permits banks, securities firms, and insurance companies to affiliate, the financial services industry may experience further consolidation. The Financial Services Modernization Act is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis. Nevertheless, this legislation may have the result of increasing the amount of competition that the Company faces from larger institutions and other types of companies with substantially greater resources than the Company and offering a wider variety of financial products than the Bank currently offers.

During 2000, the federal banking regulations adopted certain privacy and information security requirements. Adopted rules require, among other things, disclosure of privacy policies to consumers and implementation of information security programs designed to identify and assess the risks that may threaten customer information. In addition, as part of each institution's information security, it must develop a written plan to manage and control risks to consumer information, and implement, test and adjust the plan on a continuing basis. The Company believes that it is in compliance with the guidelines and that they will not adversely affect its operations.

In December 2000, pursuant to the requirements of the Financial Services Modernization Act, the federal bank and thrift regulatory agencies adopted consumer protection rules for the sale of insurance products by depository institutions. The rule was effective on April 1, 2001. The regulation requires oral and written disclosure before the completion of the sale of an insurance product that such product:

* is not a deposit or other obligation of, or guaranteed by, the depository institution or its affiliates;

* is not insured by the FDIC or any other agency of the United States, the depository institution or its affiliates; and

* involves certain investment risks, including the possible loss of value.

The depository institution may not condition an extension of credit on the consumer's purchase of an insurance product or annuity from the depository institution. The rule also addresses cross marketing and referral fees.

USA Patriot Act of 2001

On October 26, 2001, President Bush signed the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot Act) of 2001. Among other things, the USA Patriot Act (1) prohibits banks from providing correspondent accounts directly to foreign shell banks; (2) imposes due diligence requirements on banks opening or holding accounts for foreign financial institutions or wealthy foreign individuals; (3) requires financial institutions to establish an anti-money-laundering compliance program, and (4) eliminates civil liability for persons who file suspicious activity reports. The USA Patriot Act also increases governmental powers to investigate terrorism, including expanded government access to account records. The Department of the Treasury is empowered to administer and make rules to implement the act. We do not believe that compliance with the USA Patriot Act has had a material effect on our business and operations.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 was adopted in response to public concerns regarding corporate accountability in connection with the recent accounting scandals at various large publicly traded companies. The stated goals of the act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies, and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The Sarbanes-Oxley Act generally applies to all companies such as the Company that file periodic reports with the SEC under the Securities Exchange Act of 1934, as amended (Exchange Act).

The Sarbanes-Oxley Act includes additional disclosure requirements and new corporate governance rules, and has resulted in significant rulemaking by the SEC and the securities exchanges relating to corporate governance, independence of board members, internal control over financial reporting, disclosure controls, and other matters. Most rulemaking initiatives were completed by the close of 2003. Sarbanes-Oxley represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees.

The Sarbanes-Oxley Act addresses, among other matters, (1) board audit committees; (2) certification of Exchange Act reports by the chief executive officer and the chief financial officer; (3) the forfeiture of bonuses or other incentive-based compensation and securities trading profits by directors and executive officers in the twelve-month period following initial publication of any financial statements that later require restatement; (4) disclosure of off-balance sheet transactions; (5) expedited reporting of stock transactions by insiders; (6) disclosure of whether an issuer has a code of ethics, and changes or waivers of such code; (7) the formation of a Public Company Accounting Oversight Board; (8) auditor independence; and (9) increased criminal penalties for violations of securities laws.

We believe the Sarbanes-Oxley Act has resulted in increases in our reporting expenses and audit and audit related costs; nonetheless, we do not believe that the Act has had or will have a material adverse effect on our business and operations.

Transactions With Affiliates

The Company and the Bank are deemed affiliates within the meaning of the Federal Reserve Act, and transactions between affiliates are subject to certain restrictions. Accordingly, the Company and the Bank must comply with Sections 23A and 23B of the Federal Reserve Act. Generally, Sections 23A and 23B (1) limit the extent to which a financial institution or its subsidiaries may engage in covered transactions with an affiliate, as defined, to an amount equal to 10% of such institution's capital and surplus and an aggregate limit on all such transactions with all affiliates to an amount equal to 20% of such capital and surplus, and (2) require all transactions with an affiliate to be on terms substantially the same, or at least as favorable to the institution or subsidiary, as those provided to a non-affiliate. Regulation W, which collected many existing interpretations of provisions of the Federal Reserve Act, became effective in April 2003. The regulation restricts loans, asset purchases and other transactions between a depository institution and its affiliated entities.

Regulation of Management

Federal law (1) sets forth the circumstances under which officers or directors of a financial institution may be removed by the institution's federal supervisory agency; (2) places restraints on lending by an institution to its executive officers, directors, principal shareholders, and their related interests; and (3) prohibits management personnel from serving as a director or in other management positions with another financial

institution which has assets exceeding a specified amount or which has an office within a specified geographic area.

Tie-In Arrangements

The Company and the Bank cannot engage in certain tie-in arrangements in connection with any extension of credit, sale or lease of property or furnishing of services. For example, with certain exceptions, neither the Company nor the Bank may condition an extension of credit to a customer on either (1) a requirement that the customer obtain additional services provided by it or (2) an agreement by the customer to refrain from obtaining other services from a competitor.

State Law Restrictions

As a Washington business corporation, the Company may be subject to certain limitations and restrictions as provided under applicable Washington corporate law. In addition, Washington banking law restricts and governs certain activities of the Bank.

The Bank

General

The Bank, as an FDIC insured state-chartered bank, is subject to regulation and examination by the FDIC and the Department of Financial Institutions of the State of Washington. The federal laws that apply to the Bank regulate, among other things, the scope of its business, its investments, its reserves against deposits, the timing of the availability of deposited funds and the nature and amount of and collateral for loans.

CRA. The Community Reinvestment Act (the CRA) requires that, in connection with examinations of financial institutions within their jurisdiction, the FDIC evaluate the record of the financial institutions in meeting the credit needs of their local communities, including low and moderate income neighborhoods, consistent with the safe and sound operation of those banks. These factors are also considered in evaluating mergers, acquisitions, and applications to open a branch or facility. In connection with the FDIC's assessment of the record of financial institutions under the CRA, it assigns a rating of either, "outstanding," "satisfactory," "needs to improve," or "substantial noncompliance" following an examination. The Bank received a CRA rating of "outstanding" during its most recent examination.

Insider Credit Transactions. Banks are also subject to certain restrictions imposed by the Federal Reserve Act on extensions of credit to executive officers, directors, principal shareholders, or any related interests of such persons. Extensions of credit (i) must be made on substantially the same terms, including interest rates and collateral, and follow credit underwriting procedures that are not less stringent than those prevailing at the time for comparable transactions with persons not covered above and who are not employees and (ii) must not involve more than the normal risk of repayment or present other unfavorable features. Banks are also subject to certain lending limits and restrictions on overdrafts to such persons. A violation of these restrictions may result in the assessment of substantial civil monetary penalties on the affected bank or any officer, director, employee, agent, or other person participating in the conduct of the affairs of that bank, the imposition of a cease and desist order, and other regulatory sanctions.

FDICIA. Under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), each federal banking agency has prescribed, by regulation, noncapital safety and soundness standards for institutions under its authority. These standards cover internal controls, information systems, and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, such other operational and managerial standards as the agency determines to be appropriate, and standards for asset quality, earnings and stock valuation. An institution

which fails to meet these standards must develop a plan acceptable to the agency, specifying the steps that the institution will take to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. Management believes that the Bank meets all such standards and, therefore, does not believe that these regulatory standards will materially affect the Company's business or operations.

Interstate Banking and Branching

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Act) permits nationwide interstate banking and branching under certain circumstances. This legislation generally authorizes interstate branching and relaxes federal law restrictions on interstate banking. Currently, bank holding companies may purchase banks in any state, and states may not prohibit such purchases. Additionally, banks are permitted to merge with banks in other states as long as the home state of neither merging bank has opted out. The Interstate Act requires regulators to consult with community organizations before permitting an interstate institution to close a branch in a low-income area.

With regard to interstate bank mergers, Washington has opted in to the Interstate Act and allows in-state banks to merge with out-of-state banks subject to certain aging requirements. Washington law generally authorizes the acquisition of an in-state bank by an out-of-state bank through merger with a

Washington financial institution that has been in existence for at least 5 years prior to the acquisition. With regard to interstate bank branching, out-of-state banks that do not already operate a branch in Washington may not establish de novo branches in Washington or establish and operate a branch by acquiring a branch in Washington. Under FDIC regulations, banks are prohibited from using their interstate branches primarily for deposit production. The FDIC has accordingly implemented a loan-to-deposit ratio screen to ensure compliance with this prohibition.

Deposit Insurance

The deposits of the Bank are currently insured to a maximum of $100,000 per depositor through the Bank Insurance Fund administered by the FDIC. All insured banks are required to pay semi-annual deposit insurance premium assessments to the FDIC.

FDICIA included provisions to reform the Federal deposit insurance system, including the implementation of risk-based deposit insurance premiums. FDICIA also permits the FDIC to make special assessments on insured depository institutions in amounts determined by the FDIC to be necessary to give it adequate assessment income to repay amounts borrowed from the U.S. Treasury and other sources, or for any other purpose the FDIC deems necessary. The FDIC has implemented a risk-based insurance premium system under which banks are assessed insurance premiums based on how much risk they present to the insurance fund. Banks with higher levels of capital and a low degree of supervisory concern are assessed lower premiums than banks with lower levels of capital or a higher degree of supervisory concern. The Bank presently qualifies for the lowest premium level.

Dividends

The principal source of the Company's cash revenues is dividends received from the Bank. The payment of dividends is subject to government regulation, in that regulatory authorities may prohibit banks and bank holding companies from paying dividends in a manner that would constitute an unsafe or unsound banking practice. In addition, a bank may not pay cash dividends if that payment could reduce the amount of its capital below that necessary to meet minimum applicable regulatory capital requirements. Other than the laws and regulations noted above, which apply to all banks and bank holding companies, neither the Company nor the Bank are currently subject to any regulatory restrictions on their dividends.

Under applicable restrictions, as of December 31, 2003, the Bank could declare dividends totaling $4,579,000 without obtaining prior regulatory approval.

Capital Adequacy

Federal bank regulatory agencies use capital adequacy guidelines in the examination and regulation of bank holding companies and banks. If capital falls below minimum guideline levels, the holding company or bank may be denied approval to acquire or establish additional banks or non-bank businesses or to open new facilities.

The FDIC and Federal Reserve use risk-based capital guidelines for banks and bank holding companies. These are designed to make such capital requirements more sensitive to differences in risk profiles among banks and bank holding companies, to account for off-balance sheet exposure and to minimize disincentives for holding liquid assets. Assets and off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items. The guidelines are minimums, and the Federal Reserve has noted that bank holding companies contemplating significant expansion programs should not allow expansion to diminish their capital ratios and should maintain ratios well in excess of the minimum. The current guidelines require all bank holding companies and federally-regulated banks to maintain a minimum risk-based total capital ratio equal to 8%, of which at least 4% must be Tier I capital. Tier I capital for bank holding companies includes common shareholders' equity, certain qualifying perpetual preferred stock and minority interests in equity accounts of consolidated subsidiaries, less intangibles except as described above and accumulated other comprehensive income (loss).

The Federal Reserve also employs a leverage ratio, which is Tier I capital as a percentage of total assets less intangibles, to be used as a supplement to risk-based guidelines. The principal objective of the leverage ratio is to constrain the maximum degree to which a bank holding company may leverage its equity capital base. The Federal Reserve requires a minimum leverage ratio of 3%. However, for all but the most highly rated bank holding companies and for bank holding companies seeking to expand, the Federal Reserve expects an additional cushion of at least 1% to 2%.

FDICIA created a statutory framework of supervisory actions indexed to the capital level of the individual institution. Under regulations adopted by the FDIC, an institution is assigned to one of five capital categories depending on its total risk-based capital ratio, Tier I risk-based capital ratio, and leverage ratio, together with certain subjective factors. Institutions which are deemed to be undercapitalized depending on the category to which they are assigned are subject to certain mandatory supervisory corrective actions. The Company does not believe that these regulations had a material effect on its operations.

Effects of Government Monetary Policy

The earnings and growth of the Company are affected not only by general economic conditions, but also by the fiscal and monetary policies of the federal government, particularly the Federal Reserve. The Federal Reserve can and does implement national monetary policy for such purposes as curbing inflation and combating recession, but its open market operations in U.S. government securities, control of the discount rate applicable to borrowings from the Federal Reserve, and establishment of reserve requirements against certain deposits, influence the growth of bank loans, investments and deposits, and also affect interest rates charged on loans or paid on deposits. The nature and impact of future changes in monetary policies and their impact on the Company and the Bank cannot be predicted with certainty.

ITEM 2. Properties

The Company's administrative offices are located in Aberdeen, Washington. The building located at 300 East Market Street is owned by the Bank and houses the main branch and the administrative and operations offices of the Bank and the Company. The Bank completed construction and occupied the building in December of 1979.

Pacific owns the land and buildings occupied by its nine branches in Grays Harbor, Pacific and Wahkiakum Counties, as well as its data processing operations in Long Beach, Washington. Four of the five branches acquired in the merger with BNW operate in leased facilities, and the Everson, WA branch land and building is owned.

In addition to the land and buildings owned by Pacific, it also owns all of its furniture, fixtures and equipment, including data processing equipment, at December 31, 2003. The net book value of the Company's premises and equipment was $3.9 million at that date.

ITEM 3. Legal Proceedings

The Company and the Bank from time to time are party to various legal proceedings arising in the ordinary course of business. Management believes that there are no threatened or pending proceedings against the Company or the Bank which, if determined adversely, would have a material effect on its business or financial condition.

In addition, a lawsuit was filed in Wahkiakum County Superior Court against the Bank, which seeks damages for soil contamination. The subject property was sold by the Bank to the plaintiff several years ago. Plaintiff now alleges that the property was contaminated by petroleum products that seeped from an adjacent parcel owned by the Bank. The adjacent parcel had been a service station and garage for many years prior to its acquisition by the Bank. The Bank has completed remediation of the contaminated soil. The levels of contamination of the property were minimal. Based on information known to management at this time, the Company does not believe that this litigation will result in a material adverse effect on the Company's results of operations or financial condition.

ITEM 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders in the fourth quarter of 2003.

PART II

ITEM 5. Market for Registrant's Common Equity and Related Stockholder Matters

The Company's common stock is not listed on any exchange or traded on the over-the-counter market, and as of January 1, 2004, no broker made a market in the stock. Trading in our stock has been very limited, and the trades that have occurred cannot be characterized as amounting to an established public trading market. The Company's common stock is traded by individuals on a personal basis and the prices reported reflect only the transactions known to Company management. Because only limited information is available, the following data may not accurately reflect the actual market value of the Company's common stock. The following data includes trades between individual investors, as reported to the Company as its own transfer agent.

		2003			2002	
	Shares Traded	High	Low	Shares Traded	High	Low
First Quarter	5,887	$ 27.00	$ 24.75	7,399	$ 25.00	$ 23.50

Second Quarter	21,945	$ 30.00	$ 28.00	9,265	$ 23.75	$ 22.50
Third Quarter	4,110	$ 31.00	$ 30.00	36,554	$ 24.50	$ 21.50
Fourth Quarter	1,865	$ 33.50	$ 31.00	10,106	$ 25.00	$ 23.75

As of December 31, 2003, there were approximately 920 shareholders of record of the Company's common stock.

The Company's Board of Directors declared dividends on its common stock in December 2003 and 2002 in the amounts per share of $1.40 and $1.35, respectively. The Board of Directors has adopted a dividend policy which is reviewed annually. There can be no assurance the Company will continue to increase its dividend or declare and pay dividends at historical rates.

Payment of dividends is subject to regulatory limitations. Under federal banking law, the payment of dividends by the Company and the Bank is subject to capital adequacy requirements established by the Federal Reserve and the FDIC. Under Washington general corporate law as it applies to the Company, no cash dividend may be declared or paid if, after giving effect to the dividend, the Company is insolvent or its liabilities exceed its assets. Payment of dividends on the Common Stock is also affected by statutory limitations, which restrict the ability of the Bank to pay upstream dividends to the Company. Under Washington banking law as it applies to the Bank, no dividend may be declared or paid in an amount greater than net profits then available, and after a portion of such net profits have been added to the surplus funds of the Bank. Under applicable restrictions, as of December 31, 2003, the Bank could declare dividends totaling $4,579,000 without obtaining prior regulatory approval.

-14-

ITEM 6. Selected Financial Data

The following table sets forth certain selected consolidated financial data of the Company at and for the years ended December 31:

	2003	2002	2001	2000	1999
	($ in thousands, except per share data)				
Operations Data					
Net interest income	$ 12,541	$ 11,788	$ 11,572	$ 11,675	$ 11,430
Provision for credit losses	--	954	580	635	60
Noninterest income	1,846	2,059	1,529	1,217	1,255
Noninterest expense	7,945	7,414	7,193	7,530	7,011
Provision for income taxes	1,863	1,563	1,521	1,424	1,692
Net income	4,579	3,916	3,807	3,303	3,922
Net income per share:					
Basic	1.82	1.57	1.53	1.33	1.60(1)
Diluted	1.79	1.56	1.52	1.31	1.59(1)
Dividends declared	3,530	3,392	3,289	3,204	3,105
Dividends declared per share	1.40	1.35	1.32	1.28	1.25(1)
Dividends paid ratio	77%	87%	86%	97%	79%

(1) Restated to reflect the 5 for 1 stock split effected in July 2000.

Performance Ratios					
Net interest margin	4.75%	5.05%	5.16%	5.14%	5.10%
Efficiency ratio	55.22%	53.54%	54.90%	58.41%	55.27%
Return on average assets	1.61%	1.54%	1.55%	1.34%	1.64%
Return on average equity	17.10%	15.81%	15.57%	14.95%	17.26%
Balance Sheet Data					
Total assets	$ 306,715	268,534	243,617	253,313	242,189
Loans, net	197,500	183,031	174,495	175,142	150,734
Total deposits	260,800	225,254	214,644	213,511	206,139
Other borrowings	14,500	12,800	--	11,358	9,675
Shareholders' equity	25,650	24,683	23,514	22,743	21,438
Book value per share	10.17	9.82	9.44	9.09	8.63(1)
Equity to assets ratio	8.36%	9.19%	9.65%	8.98%	8.85%

(1) Restated to reflect the 5 for 1 stock split effected in July 2000.

Asset Quality Ratios					
Nonperforming loans to total loans	.27%	1.00%	.71%	1.93%	.21%
Allowance for loan losses to total loans	1.12%	1.33%	1.19%	1.14%	1.26%
Allowance for loan losses to nonperforming loans	411.40%	132.67%	168.18%	59.24%	612.69%
Nonperforming assets to total assets	.18%	.69%	.51%	1.35%	.13%

-15-

ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with Pacific's audited consolidated financial statements and related notes appearing elsewhere in this report. In addition, please refer to Pacific's forward-looking statement disclosure included on the first page of this report.

RESULTS OF OPERATIONS

Years ended December 31, 2003, 2002, and 2001

General. The Company's net income for 2003 was $4,579,000, a 16.9% increase compared to $3,916,000 in 2002, and an increase of 20.3% from $3,807,000 in 2001. Basic earnings per share were $1.82, $1.57, and $1.53 for 2003, 2002, and 2001, respectively. Return on average assets was 1.61%, 1.54%, and 1.55% in 2003, 2002, and 2001, respectively. Return on average equity was 17.10%, 15.81%, and 15.57%, respectively, in 2003, 2002, and 2001. The increased earnings for the current year are primarily a result of the absence of a provision for credit losses due to improvement in nonperforming loans, coupled with increased interest income and a decrease in interest expense.

The following table presents condensed consolidated statements of income for the Company for each of the years in the three-year period ended December 31, 2003.

(Dollars in thousands)	2003	Increase (Decrease) Amount	%	2002	Increase (Decrease) Amount	%	2001
Interest income	$15,949	$170	1.1	$15,779	$(2,323)	(12.8)	$18,102
Interest expense	3,408	(583)	(14.6)	3,991	(2,539)	(38.9)	6,530
Net interest income	12,541	753	6.4	11,788	216	1.9	11,572
Provision for credit losses	--	(954)	(100.0)	954	374	64.5	580
Net interest income after provision for credit losses	12,541	1,707	15.8	10,834	(158)	(1.4)	10,992
Other operating income	1,846	(213)	(10.3)	2,059	530	34.7	1,529
Other operating expense	7,945	531	7.2	7,414	221	3.1	7,193
Income before income taxes	6,442	963	17.6	5,479	151	2.8	5,328
Income taxes	1,863	300	19.2	1,563	42	2.8	1,521
Net income	4,579	663	16.9	3,916	109	2.9	3,807

Net Interest Income. The Company derives the majority of its earnings from net interest income, which is the difference between interest income earned on interest earning assets and interest expense incurred on interest bearing liabilities. The following table sets forth information with regard to average balances of the interest earning assets and interest bearing liabilities and the resultant yields or cost, net interest income, and the net interest margin.

	Year Ended December 31, 2003			2002		
	Average Balance	Interest Income (Expense)	Avg Rate	Average Balance	Interest Income (Expense)	Avg Rate
Assets (dollars in thousands)						
Earning assets:						
Loans	$188,267	$ 13,381*	7.11%	$178,765	$ 13,212*	7.39%
Investment Securities:						
Taxable	48,206	1,738	3.61%	32,991	1,541	4.67%
Tax-Exempt	14,721	1,050*	7.13%	14,510	1,165*	8.03%
Total investment securities	62,927	2,788	4.43%	47,501	2,706	5.70%
Federal Home Loan Bank Stock	887	49	5.52%	3,102	186	6.01%
Federal funds sold and deposits in banks	11,855	118	1.00%	5,644	107	1.90%
Total earning assets/interest income	$263,936	$ 16,336	6.18%	$235,013	$ 16,211	6.90%
Cash and due from banks	7,930			8,331		
Bank premises and equipment (net)	3,780			3,930		
Other assets	10,448			9,552		
Allowance for credit losses	(2,357)			(2,515)		
Total assets	$283,737			$254,310		
	========			========		

Liabilities and Shareholders' Equity						
Interest bearing liabilities:						
Deposits:						
Savings and interest-bearing demand	$112,129	$ (827)	.74%	$104,111	$ (1,080)	1.04%
Time	86,634	(2,096)	2.42%	79,664	(2,667)	3.35%
Total deposits	$198,763	(2,923)	1.47%	183,775	(3,747)	2.04%
Short-term borrowings	--	--	--	174	(4)	2.48%
Long-term borrowings	14,071	(485)	3.45%	6,548	(240)	3.67%
Total interest-bearing liabilities/ Interest expense	$212,834	$ (3,408)	1.60%	$190,497	$ (3,991)	2.10%
Demand deposits	42,864			36,180		
Other liabilities	1,253			2,867		
Shareholders' equity	26,786			24,766		
Total liabilities and shareholders' equity	$283,737			$254,310		
Net interest income		$ 12,928*			$ 12,220*	
Net interest income as a percentage of average earning assets						
Interest income			6.18%			6.90%
Interest expense			1.29%			1.72%
Net interest income			4.89%			5.18%

* Tax equivalent basis - 34% tax rate used

Nonaccrual loans are included in "loans."

Interest income on loans include loan fees of $1,003,182, $778,605, and $708,270 in 2003, 2002, and 2001, respectively.

For purposes of computing the average yield, the Company used historical cost balances which do not give effect to changes in fair value that are reflected as a component of shareholders' equity.

Net interest income increased 6.4% to $12,541,000 in 2003 compared to 2002. The increase is primarily the result of no provision for credit losses during the year reflecting an improvement in the quality of the credit portfolio. The Company's interest income increased 1.1% to $15,949,000 in 2003 from $15,779,000 in 2002. This increase is due to the increased balances in interest bearing deposits in banks, fed funds sold, securities and loans. Although average earning assets balances increased, the continued overall decline in market interest rates resulted in a reduction in average interest rates for all interest earning categories. However, lower interest rates also led to a 14.6% decrease in interest expense to $3,408,000 in 2003, compared to $3,991,000 in 2002. Net interest income decreased 1.4% to $10,834,000 in 2002 compared to 2001. The decrease is primarily the result of a decreased interest rate environment in addition to an increase of $374,000 in the provision for credit losses during 2002. The Company's interest income decreased 12.8% to $15,779,000 in 2002 from $18,102,000 in 2001. The decrease was substantially offset by a 38.9% decrease in interest expense from $6,530,000 in 2001 to $3,991,000 in 2002.

The Company's average loan portfolio increased $9,502,000, or 5.3%, from yearend 2002 to yearend 2003, and increased $8,137,000, or 4.8%, from 2001 to 2002. The growth in 2003 is primarily due to the opening of a loan production office on August 1, 2003 in Gearhart, Oregon. A large portion of the Company's loan portfolio rates are tied to variable rate indexes. Given the unprecedented drop in rates experienced in both years 2001 and 2002 and the continued low interest rate environment, the decrease in rates overshadowed the growth in the portfolio, causing a further decline in the average interest rates earned.

The Company's average investment portfolio increased $15,426,000 or 32.5% from 2002. These investments were invested in various long-term investment products, resulting in an increase in earnings on the investment portfolio due to the change in yield earned on long-term products versus short-term products. The Company's average investment portfolio increased $5,099,000, or 12%, during 2002 from 2001. The changes in 2002 were primarily during the third quarter of 2002 and were in U.S. Government mortgage backed securities.

The Company's average deposits increased $14,988,000 or 8.2% from 2002, and increased $2,110,000 or 1.2% in 2002 from 2001. The primary reason for the increase in 2003 is due to an increase of $16,357,000 in the Company's N.O.W. checking accounts and an increase of $10,177,000 in money market accounts. Management attributes the deposit growth to its targeted marketing program and to consumer uncertainty regarding alternative investment options. Along with the increase in average deposits, the Company was able to reprice its deposit offerings to current market rates, yielding a decrease in interest expense.

The Company increased its average borrowings during 2003 by $7,523,000 or 114.9%. These borrowings consist of advances from the Federal Home Loan Bank of Seattle. The proceeds were used to fund loan growth and for investment purposes. The Company increased its average borrowings during 2002 by $6,548,000 or 100%.

Net interest margins were 4.75%, 5.05%, and 5.16% for the years ended December 31, 2003, 2002, and 2001, respectively.

The following table presents changes in net interest income attributable to changes in volume or rate. Changes not solely due to volume or rate are allocated to volume and rate based on the absolute values of each.

	2003 compared to 2002			2002 compared to 2001		
	Increase (decrease) due to			Increase (decrease) due to		
(dollars in thousands)	Volume	Rate	Net	Volume	Rate	Net
Interest earned on:						
Loans	$687	$(518)	$169	$690	$(2,510)	$(1,820)
Securities:						
Taxable	602	(405)	197	301	(398)	(97)
Tax-exempt	17	(132)	(115)	(43)	(17)	(60)
Total securities	619	(537)	82	258	(415)	(157)
Federal Home Loan Bank Stock	(123)	(14)	(137)	(35)	(30)	(65)
Fed funds sold and interest bearing deposits						

in other banks	79	(68)	11	(156)	(147)	(303)
Total interest earning assets	1,262	(1,137)	125	757	(3,102)	(2,345)
Interest paid on:						
Savings and interest bearing demand deposits	(78)	331	253	39	1,276	1,315
Time deposits	(218)	789	571	(191)	1,469	1,278
Other borrowings	(254)	13	(241)	(157)	103	(54)
Total interest bearing liabilities	(550)	1,133	583	(309)	2,848	2,539
Change in net interest income	712	(4)	708	448	(254)	(194)

Non-Interest Income. Non-interest income was $1,846,000 for 2003, a decrease of $213,000 or 10.3% from 2002 when it totaled $2,059,000. The 2002 amount was an increase of $530,000 or 34.7% compared to the 2001 total of $1,529,000.

In 2003, service charges on deposit accounts decreased $42,000 or 3.9% to a total of $1,027,000 compared to $1,069,000 in 2002. The 2002 total was up $241,000 or 29.1% compared to the 2001 total of $828,000. During the second half of 2001, a new customer overdraft protection program was implemented which contributed to the increase in service charges on deposit accounts during both 2001 and 2002. The decrease in 2003 was attributed to system changes related to commercial deposit relationships in which one month's charges were not assessed.

Income from sources other than service charges on deposit accounts totaled $819,000 in 2003, a decrease of $171,000 from 2002, or 17.3%. The primary reason for the decrease was income and gains on sale from foreclosed real estate, which decreased $266,000. The Company sold several foreclosed real estate properties in 2002 that recognized gains. Other major components of non-interest income were mortgage broker fees, gain on sale of loans and bank owned life insurance income. Income from other sources for 2002 was $990,000, an increase of $289,000 or 41.2% compared to 2001, primarily due to collecting operating revenues from a motel that was brought into foreclosed real estate and earnings from bank owned life insurance.

The following table represents the principal categories of non-interest income for each of the years in the three-year period ended December 31, 2003.

		Increase (Decrease)			Increase (Decrease)	
(Dollars in thousands)	2003	Amount	%	2002	Amount	%
Service charges on deposit accounts	$1,027	$(42)	(3.9%)	$1,069	$241	29.1%
Mortgage broker fees	101	98	326.7%	3	(29)	(90.6%
Income from and gains on sale of foreclosed real estate	26	(266)	(91.1%)	292	153	110.1%
Net gains from sales of loans	34	34	100.0%	--	--	--
Net gain on sale of securities	4	4	100.0%	--	--	--
Earnings on bank owned life insurance	328	(22)	(6.3%)	350	183	109.6%
Other operating income	326	(19)	(5.5%)	345	(18)	(4.9%

Total non-interest income	1,846	(213)	(10.3%)	2,059	530	34.7%

Non-Interest Expense. Total non-interest expense in 2003 was $7,945,000, an increase of $531,000 or 7.2% compared to $7,414,000 in 2002. In 2002 non-interest expense increased $221,000 or 3.1% compared to $7,193,000 in 2001.

Salary and employee benefits increased by $568,000, or 13.5%, in 2003 to $4,764,000 and increased by $138,000, or 3.4%, in 2002 compared to 2001. Salary and benefits increased primarily due to a larger employee base in 2003, as the Company opened a loan production office during the year and increased staffing levels in other areas, in addition to normal merit increases.

Occupancy and equipment expense decreased $19,000 or 1.9% in 2003 and increased $21,000 or 2.2% in 2002. The decrease in 2003 was due to reduced equipment depreciation expenses. The 2002 increase was the result of costs associated with maintenance of buildings and equipment.

State taxes paid in 2003 totaled $69,000, a decrease of $137,000 or 66.5% compared to 2002. This was the result of a tax refund pertaining to an application filed by the Company with the Washington State Department of Revenue for overpayment of business and occupation tax. State taxes decreased $21,000 in 2002 or 9.3% compared to 2001.

Data processing expense increased $37,000 or 13.8% compared to 2002, and increased $54,000 or 25.2% in 2002 compared to 2001. The increases are primarily due to costs associated with the opening of the loan production office and costs related to continued enhancement of the Company's technology and security systems.

Other expense increased $82,000 or 4.7% in 2003 compared to an increase of $29,000 or 1.7% in 2002 over 2001. The increase in 2003 is due primarily to increased advertising and marketing expenses, as the Company embarked on a direct marketing program and implemented a community oriented advertising program. The increase in 2002 is related primarily to an increase in advertising expense of $30,000, professional fees of $35,000 and data processing costs of $47,000, which offset decreases in legal expense of $33,000, travel expenses of $10,000 and loan collection expense of $22,000.

The following table represents the principal categories of non-interest expense for each of the years in the three-year period ended December 31, 2003.

		Increase (Decrease)			Increase (Decrease)	
(Dollars in thousands)	2003	Amount	%	2002	Amount	%
Salaries and employee benefits	$4,764	$ 568	13.5%	$4,196	$ 138	3.4%
Occupancy and equipment	965	(19)	(1.9%)	984	21	2.2%
State taxes	69	(137)	(66.5%)	206	(21)	(9.3%
Data processing	305	37	13.8%	268	54	25.2%

Other expense	1,842	82	4.7%	1,760	29	1.7%
Total non-interest expense	$7,945	$ 531	7.2%	$7,414	$ 221	3.1%

CRITICAL ACCOUNTING POLICY

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. The financial information contained within these statements is, to a significant extent, financial information that is based on approximate measures of the financial effects of transactions and events that have already occurred. Based on its evaluation of accounting policies that involve the most complex and subjective decisions and assessments, management has identified its most critical accounting policy as related to the allowance for credit losses. The Company's allowance for credit loss methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for credit losses that management believes is appropriate at each reporting date. Quantitative factors include the Company's historical loss experience, delinquency and charge-off trends, collateral values, changes in nonperforming loans, and other factors. Quantitative factors also incorporate known information about individual loans, including borrowers' sensitivity to interest rate movements. Qualitative factors include the general economic environment in the Company's markets, including economic conditions and, in particular, the state of certain industries. Size and complexity of individual credits in relation to loan structure, existing loan policies and pace of portfolio growth are other qualitative factors that are considered in the methodology. As the Company adds new products and increases the complexity of its loan portfolio, it intends to enhance its methodology accordingly. A materially different amount could be reported for the provision for credit losses in the statement of operations to change the allowance for credit losses if management's assessment of the above factors were different. This discussion and analysis should be read in conjunction with the Company's financial statements and the accompanying notes presented elsewhere herein, as well as the portion of this Management's Discussion and Analysis section entitled "Lending - Allowance and Provision for Credit Losses". Although management believes the levels of the allowance as of both December 31, 2003 and 2002 were adequate to absorb losses inherent in the loan portfolio, a decline in local economic conditions, or other factors, could result in increasing losses that cannot reasonably be predicted at this time.

ASSET AND LIABILITY MANAGEMENT

The largest component of the Company's earnings is net interest income. Interest income and interest expense are affected by general economic conditions, competition in the market place, market interest rates and repricing and maturity characteristics of the Company's assets and liabilities. Exposure to interest rate risk is primarily a function of differences between the maturity and repricing schedules of assets (principally loans and investment securities) and liabilities (principally deposits). Assets and liabilities are described as interest sensitive for a given period of time when they mature or can reprice within that period. The difference between the amount of interest sensitive assets and interest sensitive liabilities is referred to as the interest sensitive "GAP" for any given period. The "GAP" may be either positive or negative. If positive, more assets reprice than liabilities. If negative, the reverse is true.

-21-

Certain shortcomings are inherent in the interest sensitivity "GAP" method of analysis. Complexities such as prepayment risk and customer responses to interest rate changes are not taken into account in the "GAP" analysis. Accordingly, management also utilizes a net interest income simulation model to measure interest rate sensitivity. Simulation modeling gives a broader view of net interest income variability, by providing various rate shock exposure estimates. Management regularly reviews the interest rate risk position and provides measurement reports to the Board of Directors.

The following table shows the dollar amount of interest sensitive assets and interest sensitive liabilities at December 31, 2003 and differences between them for the maturity or repricing periods indicated.

(dollars in thousands)	Due in one year or less	Due after one through five years	Due after five years	Total
Interest earning assets				
Loans	$ 78,261	$ 43,407	$ 78,070	$199,738
Investment securities	27,136	21,652	16,673	65,461
Fed Funds and interest bearing balances with banks	20,392	--	--	20,392
Federal Home Loan Bank Stock	--	--	915	915
Total interest earning assets	$125,789	$ 65,059	$ 95,658	$286,506
Interest bearing liabilities				
Interest bearing demand deposits	$ 47,388	$ --	$ --	$ 47,388
Savings deposits	84,105	--	--	84,105
Time deposits	59,040	26,405	--	85,445
Long term borrowings	2,000	6,500	6,000	14,500
Total interest bearing liabilities	$192,533	$ 32,905	$ 6,000	$231,438
Net interest rate sensitivity GAP	$(66,744)	$ 32,154	$ 89,658	$ 55,068
Cumulative interest rate sensitivity GAP		$(34,590)	$ 55,068	$ 55,068
Cumulative interest rate sensitivity GAP as a % of earning assets		(12.1%)	19.2%	19.2%

The following table shows the dollar amount of interest sensitive assets and interest sensitive liabilities at December 31, 2002 and difference between them for the maturity or repricing periods indicated.

(dollars in thousands)	Due in one year or less	Due after one through five years	Due after five years	Total
Interest earning assets				
Loans	$ 70,081	$ 45,383	$ 70,326	$185,790

Investment securities	23,856	18,445	20,291	62,592
Fed Funds and interest bearing balances with banks	373	--	--	373
Federal Home Loan Bank Stock	--	--	866	866
Total interest earning assets	$ 94,310	$ 63,828	$ 91,483	$249,621
Interest bearing liabilities				
Interest bearing demand deposits	$ 31,030	$ --	$ --	$ 31,030
Savings deposits	72,163	--	--	72,163
Time deposits	71,441	10,536	--	81,977
Short term borrowings	1,800	0	--	1,800
Long term borrowings	--	5,000	6,000	11,000
Total interest bearing liabilities	$176,434	$ 15,536	$ 6,000	$197,970
Net interest rate sensitivity GAP	$(82,124)	$ 48,292	$ 85,483	$ 51,651
Cumulative interest rate sensitivity GAP		$ 33,832)	$ 51,651	51,651
Cumulative interest rate sensitivity GAP as a % of earning assets		(13.6%)	20.7%	20.7%

Effects of Changing Prices. The results of operations and financial conditions presented in this report are based on historical cost information, and are unadjusted for the effects of inflation. Since the assets and liabilities of financial institutions are primarily monetary in nature, the performance of the Company is affected more by changes in interest rates than by inflation. Interest rates generally increase as the rate of inflation increases, but the magnitude of the change in rates may not be the same.

The effects of inflation on financial institutions is normally not as significant as its influence on businesses which have investments in plants and inventories. During periods of high inflation there are normally corresponding increases in the money supply, and financial institutions will normally experience above-average growth in assets, loans and deposits. Inflation does increase the price of goods and services, and therefore operating expenses increase during inflationary periods.

INVESTMENT PORTFOLIO

The Company's investment securities portfolio increased $2,869,000, or 4.6% during 2003 to $65,461,000 at year end from $62,592,000 in 2002, which was a $25,974,000 increase over 2001. The changes in 2003 were primarily in U.S. Government agency mortgaged backed securities. Based on the low interest rate environment during 2002, the Bank borrowed long term funds from the Federal Home Loan Bank of Seattle totaling $7,000,000 and purchased U.S. Government agency mortgage backed securities. The transaction resulted in a yield spread of 195 basis points.

The carrying values of investment securities at December 31 in each of the last three years are as follows:

HELD TO MATURITY

(dollars in thousands)	2003	2002	2001

U.S. Agencies securities	$ 2,944	$ 6,611	$ -0-
Obligations of states and political subdivisions	5,044	3,751	4,945
Total	$ 7,988	$10,362	$ 4,945
AVAILABLE FOR SALE			
U.S. Agencies securities	18,030	19,164	6,872
Obligations of states and political subdivisions	14,751	12,098	11,713
Other securities	24,692	20,968	13,088
Total	$57,473	$52,230	$31,673

The following table presents the maturities of investment securities at December 31, 2003. Taxable equivalent values are used in calculating yields assuming a tax rate of 34%.

HELD TO MATURITY

(dollars in thousands)	Due in one year or less	Due after one through five years	Due after five through ten years	Due after ten years
U.S. Agency securities	$ --	$ --	$ --	$ 2,944
Weighted average yield	--	--	--	4.05%
Obligations of states and political subdivisions	$ 449	$ 1,598	$ 964	$ 2,033
Weighted average yield	4.01%	4.15%	7.14%	7.06%
Total	$ 449	$ 1,598	$ 964	$ 4,977
AVAILABLE FOR SALE				
U.S. Agency securities	$ 1,620	$ 498	$ 3,220	$12,692
Weighted average yield	5.63%	2.62%	3.56%	3.97%
Obligations of states and political subdivisions	$ 2,226	$ 7,663	$ 3,126	$ 1,736
Weighted average yield	7.23%	6.61%	6.53%	6.60%
Other securities	$20,459	$ 3,134	$ 1,099	0
Weighted average yield	2.35%	5.83%	4.06%	0
Total	$24,305	$11,295	$ 7,445	$14,428

LENDING

General. The Company's policy is to originate loans primarily in its local markets. Depending on the purpose of the loan, the loans may be secured by a variety of collateral, including business assets, real estate, and personal assets.

The following table sets forth the composition of the Company's loan portfolio at December 31 in each of the past five years.

(dollars in thousands)	2003	2002	2001	2000	1999
Commercial	$ 64,344	$ 69,794	$ 72,427	$ 68,827	$ 56,198
Real Estate Construction	11,894	9,697	6,554	6,118	3,325
Real Estate Mortgage	117,940	101,151	91,714	96,334	88,905
Installment	4,625	4,114	4,941	4,612	3,379
Credit cards and overdrafts	935	1,034	968	1,277	857
Total	$199,738	$185,790	$176,604	$177,168	$152,664

Loan Maturities and Sensitivity in Interest Rates. The following table presents information related to maturity distribution and interest rate sensitivity of commercial and real estate construction loans outstanding, based on scheduled repayments at December 31, 2003.

(dollars in thousands)	Due in one year or less	Due after one through five years	Due after five year	Total
Commercial	$ 38,964	$ 13,648	$ 11,732	$ 64,344
Real estate construction	7,967	726	3,201	11,894
Total	$ 46,931	$ 14,374	$ 14,933	$ 76,238
Total loans maturing after one year with				
Predetermined interest rates (fixed)		$ 27,484	$115,665	$143,149
Floating or adjustable rates (variable)		13,323	2,358	15,681
Total		$ 40,807	$118,023	$158,830

At December 31, 2003, 39.2% of the total loan portfolio presented above was due in one year or less.

Risk Elements. Risk elements include accruing loans past due ninety days or more, non-accrual loans, and loans which have been restructured to provide reduction or deferral of interest or principal for reasons related to the debtor's financial difficulties. The Company's policy for placing loans on non-accrual status is based upon management's evaluation of the ability of the borrower to meet both principal and interest payments as they become due. Generally, loans with interest or principal payments which are ninety or more days past due are placed on non-accrual, unless they are well-secured and in the process of collection, and the interest accrual is reversed against income.

The following table presents information related to the Company's non-accrual loans and other non-performing assets at December 31 in each of the last five years.

(dollars in thousands)	2003	2002	2001	2000	1999
Non-accrual loans	$ 465	$1,864	$1,254	$3,128	$ 175
Accruing loans past due 90 days or more	--	2	79	292	140
Restructured loans	--	--	--	--	0
Foreclosed real estate owned	98	686	1,040	--	177

Non-accrual loans decreased approximately $1,399,000 to $465,000 in 2003 from 2002. The total is net of charge-offs based on management's estimate of fair market value or the result of appraisals. The properties consist of real estate and commercial real estate properties. During 2003, sales of foreclosed real estate owned totaled $1,363,000. At December 31, 2003, the balance remaining in foreclosed real estate owned totaled $98,000. Non-accrual loans decreased $1,874,000 to $1,254,000 at year-end 2001 after increasing to $3,128,000 in 2000 from $175,000 in 1999. The increase in non-accrual loans experienced in 2000 was attributable to the decline in the regional and national economies and the local agriculture economy. Interest income on non-accrual loans that would have been recorded had those loans performed in accordance with their initial terms, as of December 31, was $37,000 for 2003, $118,000 for 2002, $75,000 for 2001, $168,000 for 2000 and $10,000 for 1999. Interest income recognized on impaired loans for 2003 was $19,000, for 2002 was $13,000, for 2001 was $2,000, for 2000 was $31,000, and for 1999 was $11,000.

Loan Concentrations. The Company has credit risk exposure related to real estate loans. The Company makes real estate loans for construction and loans for other purposes which are secured by real estate. At December 31, 2003, loans secured by real estate totaled $129,834,000, which represents 65% of the total loan portfolio. Real estate construction loans comprised $11,894,000 of that amount, while real estate loans secured by residential properties totaled $26,615,000. As a result of these concentrations of loans, the loan portfolio is susceptible to changes in economic and market conditions in the Company's market areas. The Company generally requires collateral on all real estate exposures and typically maintains loan-to-value ratios of no greater than 80%.

Allowance and Provision for Credit Losses. The allowance for credit losses reflects management's current estimate of the amount required to absorb losses on existing loans and commitments to extend credit. Loans deemed uncollectible are charged against and reduce the allowance. Periodically, a provision for credit losses is charged to current expense. This provision acts to replenish the allowance for credit losses and to maintain the allowance at a level that management deems adequate. There is no precise method of predicting specific loan losses or amounts that ultimately may be charged off on segments of the loan portfolio. The determination that a loan may become uncollectible, in whole or in part, is a matter of judgment. Similarly, the adequacy of the allowance for credit losses can be determined only on a judgmental basis, after full review, including (a) consideration of 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 appraisal, on a monthly basis, of all loans judged to present a possibility of loss (if, as a result of such monthly appraisals, 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. A formal analysis of the adequacy of the allowance is conducted quarterly and is reviewed by the Board of Directors. Based on this analysis, management considers the allowance for credit losses to be adequate.

Periodic provisions for loan losses are made to maintain the allowance for credit losses at an appropriate level. The provisions are 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.

Transactions in the allowance for credit losses for the five years ended December 31, 2003 are as follows:

(dollars in thousands)	2003	2002	2001	2000	1999
Balance at beginning of year	$2,473	$2,109	$2,026	$1,930	$1,864
Charge-offs:					
Commercial	17	131	170	554	114
Real estate loans	239	461	366	--	--
Credit card	6	16	13	6	13
Installment	3	24	15	8	7
Total charge-of	$ 265	$ 632	$ 564	$ 568	$ 134
Recoveries:					
Commercial	$ 5	$ 11	$ 54	$ 15	$ 23
Real estate loans	23	28	12	110	
Credit card	1	2	--	--	6
Installment	1	1	13	2	1
Total recoveries	$ 30	$ 42	$ 67	$ 29	$ 140
Net charge-offs (recoveries)	235	590	497	539	(6)
Provision for credit losses	0	954	580	635	60
Balance at end of year	$2,238	$2,473	$2,109	$ 2,026	$1,930
Ratio of net charge-offs (recoveries) to average loans outstanding	.12%	.33%	.29%	.33%	--

The allowance for credit losses was $2,238,000 at year-end 2003, compared with $2,473,000 at year-end 2002, a decrease of $235,000 or 9.5%. The aggregate decrease resulted from the net charge-offs totaling $235,000 in 2003. The decreased level of allowance for credit losses was primarily due to improvement in the quality of the loan portfolio and decreased loss factors utilized in the allowance for loan loss analysis. Changes in the composition of the loan portfolio included a 7.8% decrease in commercial loans, while real estate construction and real estate mortgage loans increased 39.3%. Estimated loss factors used in the allowance for credit loss analysis are established based in part on historic charge-off data by loan category and economic conditions. Based on the trends in historical charge-offs analysis, the loss factors used in the allowance for credit loss analysis for commercial loans and real estate loans were increased during the year ended December 31, 2003.

Based on the methodology used for credit loss analysis, management deemed the allowance for credit losses of $2,238,000 at December 31, 2003 (1.12% of total loans outstanding and 411.40% of non-performing loans) adequate to provide for estimated losses based on an evaluation of known and inherent risks in the loan portfolio at that date.

In May 1993, the Financial Accounting Standards Board (FASB) issued SFAS No. 114, "Accounting by Creditors for Impairment of a Loan" and in October 1996, issued SFAS No. 118, "Accounting by Creditors for Impairment of a Loan--Income Recognition Disclosures, an amendment to SFAS No. 114". The Company measures impaired loans based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair market value of the collateral if the loan is collateral dependent. The Company excludes loans that are currently measured at fair value or at the lower of cost or fair value, and certain large groups of smaller balance homogeneous loans that are collectively measured for impairment. The Company's Board of Directors approved a change in definition of impaired loans during 2003. Impaired loans now include all loans in non-accrual status over $5,000 and loans in excess of $1,000,000 that meet at least watch status risk characteristics.

-26-

The following table summarizes the Bank's impaired loans at December 31:

(dollars in thousands)	2003	2002	2001	2000	1999
Total Impaired Loans	$11,147	$ 2,314	$ 1,662	$ 3,128	$ 175
Total Impaired Loans with Valuation Allowance	123	18	1,180	1,114	--
Valuation Allowance related to Impaired Loans	23	2	143	412	--

No allocation of the allowance for credit losses was considered necessary for the remaining impaired loans. The balance of the allowance for credit losses in excess of these specific reserves is available to absorb losses from all loans.

It is the Company's policy to charge-off any loan or portion of a loan that is deemed uncollectible in the ordinary course of business. The entire allowance for credit losses is available to absorb such charge- offs. The Company allocates its allowance for credit losses primarily on the basis of historical data. Based on certain characteristics of the portfolio, losses can be anticipated for major loan categories.

The following table presents the allocation of the allowance for credit losses among the major loan categories based primarily on their historical net charge-off experience and other business considerations at December 31 in each of the last five years.

(Dollars in thousands)	2003 Reserve	% of Total Loans	2002 Reserve	% of Total Loans	2001 Reserve	% of Total Loans	2000 Reserve
Commercial loans	$ 764	32%	967	37%	$ 548	41%	$ 689
Real estate loans	1,399	65%	$1,406	60%	1,413	56%	1,256
Consumer loans	75	3%	100	3%	148	3%	81
Total allowance	$2,238	100%	$2,473	100%	$2,109	100%	$2,026
Ratio of allowance for credit losses to loans outstanding at end of year	1.12%		1.33%		1.19%		1.14%

The table indicates a decrease of $203,000 in the allowance related to commercial loans from December 31, 2002 to December 31, 2003, a decrease of $7,000 relating to real estate loans, and a decrease of $25,000 related to consumer loans. There was an increase of $419,000 from December 31, 2001 to December 31, 2002 in the allowance related to commercial loans, which was offset by decreases of $7,000 in real estate loans and $48,000 in consumer loans during the same period.

-27-

DEPOSITS

The Company's primary source of funds has historically been customer deposits. A variety of deposit products are offered to attract customer deposits. The products include non-interest bearing demand accounts, negotiable order of withdrawal (NOW) accounts, savings accounts, and time deposits. Interest-bearing accounts earn interest at rates established by management, based on competitive market factors and the need to increase or decrease certain types of maturities of deposits. The Company has succeeded in growing its deposit base over the last three years despite increasing competition for deposits in our markets. The Company believes that it has benefited from its local identity and superior customer service. Attracting deposits remains integral to the Company's business as it is the primary source of funds for loans and a major decline in deposits or failure to attract deposits in the future could have an adverse effect on operations.

The following table sets forth the average balances for each major category of deposits and the weighted average interest rate paid for deposits for the periods indicated.

(dollars in thousands)	2003	RATE	2002	RATE	2001	RATE
Demand deposits	$ 42,864	0.00%	$ 36,180	0.00%	$ 33,419	0.00%
Interest bearing demand deposits	33,251	.42%	29,137	.76%	26,949	2.09%
Savings deposits	78,878	.87%	74,974	1.15%	78,897	2.32%
Time deposits	86,634	2.42%	79,664	3.35%	75,819	5.20%
Total	$241,627	1.20%	$219,955	1.70%	$215,084	3.49%

Maturities of time certificates of deposit as of December 31, 2003 are summarized as follows:

(dollars in thousands)	Under $100,000	Over $100,000	Total
3 months or less	$ 9,030	$11,866	$20,895
Over 3 through 6 months	7,453	8,201	15,654
Over 6 through 12 months	11,788	10,702	22,490
Over 12 months	13,566	12,839	26,405
Total	41,837	43,608	85,445

SHORT-TERM BORROWINGS

The following is information regarding the Company's short-term borrowings for the years ended December 31, 2003, 2002 and 2001.

(dollars in thousands)	2003	2002	2001
Amount outstanding at end of period	$--	$1,800	$ --
Weighted average interest rate thereon	0%	1.35%	0%
Maximum amount outstanding at any month end during period	$--	$2,790	$7,580
Average amounts outstanding during the period	--	174	963
Weighted average interest rate during period	0%	2.48%	5.68%

CONTRACTUAL OBLIGATIONS

The following is information regarding the Company's long-term obligations, which consists of borrowings from the Federal Home Loan Bank, for the year ended December 31, 2003.

		Payments due by Period			
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Contractual obligations					
Other Long-term Liabilities	$14,500	2,000	3,000	9,500	0

KEY FINANCIAL RATIOS

Year ended December 31,	2003	2002	2001	2000	1999
Return on average assets	1.61%	1.54%	1.55%	1.34%	1.64%
Return on average equity	17.10%	15.81%	15.57%	14.95%	17.26%
Average equity to average assets ratio	9.44%	9.74%	9.96%	8.96%	9.49%
Dividend payout ratio	77%	87%	86%	97%	79%

LIQUIDITY AND CAPITAL RESOURCES

Liquidity. The primary concern of depositors, creditors and regulators is the Company's ability to have sufficient funds readily available to repay liabilities as they mature. In order to ensure adequate funds are available at all times, the Company monitors and projects the amount of funds required on a daily basis. Through the Bank, the Company obtains funds from its customer base, which provides a stable source of "core" demand and consumer deposits.

Other sources are available with borrowings from the Federal Home Loan Bank of Seattle and correspondent banks. Liquidity requirements can also be met through disposition of short-term assets. In management's opinion, the Company maintains an adequate level of liquid assets, consisting of cash and due from banks, interest bearing deposits with banks, and federal funds sold to support the daily cash flow requirements.

Management expects to continue to rely on customer deposits as the primary source of liquidity, but may also obtain liquidity from maturity of its investment securities, sale of securities currently available for sale, net income, and other borrowings. Although deposit balances have shown historical growth, deposit habits of customers may be influenced by changes in the financial services industry, interest rates available on other investments, general economic conditions, consumer confidence, and competition. 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 issues. Therefore, reductions in deposits could adversely affect the Company's results of operations.

Capital. The Company endeavors to maintain equity capital at an adequate level to support and promote investor confidence. The Company conducts its business through the Bank. Thus, the Company needs to be able to provide capital and financing to the Bank should the need arise. The primary sources for obtaining capital are additional stock sales and retained earnings. Total shareholders' equity averaged $26,786,000 in 2003, compared to $24,766,000 in 2002, an increase of 8.2%, and $24,451,000 in 2001, an increase of 10.7% compared to 2000.

-29-

The Company's Board of Directors considers financial results, growth plans, and anticipated capital needs in formulating its dividend policy. The payment of dividends is subject to adequate financial results of the Bank, and limitations imposed by law and governmental regulations.

The Federal Reserve has established guidelines that mandate risk-based capital requirements for bank holding companies. Under the guidelines, one of four risk weights is applied to balance sheet assets, each with different capital requirements based on the credit risk of the asset. The Company's capital ratios include the assets of the Bank on a consolidated basis in accordance with the requirements of the Federal Reserve. The Company's capital ratios have exceeded the minimum required to be classified "well capitalized" for each of the past three years.

The following table sets forth the minimum required capital ratios and actual ratios for December 31, 2003 and 2002.

(dollars in thousands)	Actual Amount	Ratio	Capital Adequacy Purposes Amount	Ratio
December 31, 2003				
Tier 1 capital (to average assets)	$25,093	8.46%	$11,864	4.00%
Tier 1 capital (to risk-weighted assets)	25,093	11.56%	8,686	4.00%
Total capital (to risk-weighted assets)	27,331	12.59%	17,372	8.00%
December 31, 2002				
Tier 1 capital (to average assets)	$23,966	8.92%	$10,753	4.00%
Tier 1 capital (to risk-weighted assets)	23,966	11.73%	8,172	4.00%
Total capital (to risk-weighted	26,457	12.95%	16,344	8.00%

assets)

OTHER EVENTS

On October 22, 2003, the Company announced the signing of a definitive agreement for the acquisition of BNW Bancorp, Inc. ("BNW") by merger. Upon completion of the transaction on Februaruy 27, 2004, each share of BNW common stock was converted into the right to receive 0.85 shares of the Company's common stock, resulting in the issuance of approximately 636,673 of the Company's common stock. Simultaneous with the merger of BNW into Pacific, BNW's subsidiary Bank NorthWest was merged into Bank of the Pacific.

As a result of the merger of BNW into Pacific, the Company had assets of approximately $407 million, deposits of approximately $339 million, and shareholders equity of approximately $44 million, at February 29, 2004. BNW had net interest income of $4,822,622, noninterest income of $1,259,821, and noninterest expense of $5,078,774 for fiscal year 2003. There is no assurance that the five branches acquired from BNW in the merger will achieve similar results in 2004, or future years.

ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk

The Company's results of operations are largely dependent upon its ability to manage interest rate risk. Management considers interest rate risk to be a significant market risk that could have a material effect on the Company's financial condition and results of operations. The Company does not currently use derivatives to manage market and interest rate risks. All of the Company's transactions are denominated in U.S. dollars. Approximately 30% of the Company's loans have interest rates that float with the Company's reference rate. Fixed rate loans generally are made with a term of five years or less.

In the Asset and Liability section of the Management's Discussion and Analysis in Item 7 is a table presenting estimated maturity or pricing information indicating the Company's exposure to interest rate changes. The assumptions and description of the process used to manage interest rate risk is further discussed in the Asset and Liability Management section. The following table discloses the balances of financial instruments held by the Company, including the fair value as of December 31, 2003.

The expected maturities are disclosed based on contractual schedules. Principal repayments are not considered. The expected maturities for financial liabilities with no stated maturity reflect estimated future roll-off rates. The roll-off rates for non-interest bearing deposits, interest bearing demand deposits, money market accounts, and savings deposits are 15%, 25%, 25% and 20%, respectively. The interest rates disclosed are based on rates in effect at December 31, 2003. Fair values are estimated in accordance with generally accepted accounting principles as disclosed in the financial statements.

	Expected Maturity				
Year ended December 31, 2003 (dollars in thousands)	2004	2005	2006	2007	2008
Financial Assets					
Cash and cash equivalents					

Non-interest bearing	$ 9,280	--	--	--	--	
Interest bearing deposits in banks	$15,392	--	--	--	--	
Weighted average interest rate	1.24%					
Federal funds sold						
Fixed rate	$ 5,000	--	--	--	--	
Weighted average interest rate	.90%					
Securities available for sale						
Fixed rate	$ 3,846	$ 4,156	$ 3,188	$ 984	$ 1,151	$2
Weighted average interest rate	6.33%	6.03%	4.27%	3.92%	4.28%	
Adjustable rate	$20,459	--	--	--	--	$
Weighted average interest rate	2.35%				2.19%	
Securities held to maturity						
Fixed rate	$ 449	--	$ 56	$ 854	$ 688	$
Weighted average interest rate	3.02%		4.50%	2.50%	2.90%	
Loans receivable						
Fixed rate	$35,250	$ 5,484	$ 9,120	$8,528	$ 6,769	$7
Weighted average interest rate	6.49%	7.78%	6.94%	7.20%	7.04%	
Adjustable rate	$43,207	$ 399	$ 5,686	$ 1,744	$ 5,894	$
Weighted average interest rate	5.27%	3.53%	5.97%	7.08%	5.23%	
Federal Home Loan Bank stock	$ 915	--	--	--	--	
Weighted average interest rate	5.52%					

Year ended December 31, 2002 (dollars in thousands)	Expected Maturity 2004	2005	2006	2007	2008	
Financial Liabilities						
Non-interest bearing deposits	$ 6,579	$ 9,321	$ 6,990	$ 4,194	$ 3,355	$1
Interest bearing checking accounts	$ 7,108	$10,070	$ 7,552	$ 5,664	$ 3,399	$1
Weighted average interest rate	.54%	.54%	.54%	.54%	.54%	
Money Market accounts	$ 4,770	$ 6,756	$ 5,067	$ 3,801	$ 2,280	$
Weighted average interest rate	.86%	.86%	.86%	.86%	.86%	
Savings accounts	$ 7,846	$11,115	$ 8,336	$ 5,002	$ 4,002	$1
Weighted average interest rate	.80%	.80%	.80%	.80%	.80%	
Certificates of deposit						
Fixed rate	$56,274	$ 8,319	$ 2,007	$ 3,318	$ 5,584	
Weighted average interest rate	1.61%	2.13%	2.97%	4.66%	3.91%	
Variable rate	$ 9,943	--	--	--	--	
Weighted average interest rate	3.31%					
Borrowings						
Fixed rate	$ 2,000	$ 2,000	$ 1,000	--	$ 3,500	$
Weighted average interest rate	3.20%	4.41%	3.48%		2.94%	

As illustrated in the tables above, our balance sheet is currently sensitive to decreasing interest rates, meaning that more interest bearing assets mature or re-price than interest earning liabilities. Therefore, if our asset and liability mix were to remain unchanged, and there was a decrease in market rates of interest, the Company would expect that its net income would be adversely affected. In contrast, an increasing interest rate environment would positively affect such income. While the table presented above provides information about the Company's interest sensitivity, it does not predict the trends of future earnings. For this reason, financial modeling is used to forecast earnings under varying interest rate projections. While this process assists in managing interest rate risk, it does require significant assumptions for the projection of loan prepayments, loan origination volumes and liability funding sources that may prove to be inaccurate.

ITEM 8. Financial Statements and Supplementary Data

Information required for this item is included in Item 15 of this report.

ITEM 9. Changes in and disagreements with accountants on accounting and financial disclosure

Not applicable.

ITEM 9A. Controls and Procedures

Pacific's disclosure controls and procedures are designed to ensure that information the Company must disclose in its reports filed or submitted under the 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 Pacific'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 III

ITEM 10. Directors and Executive Officers of the Registrant

Information concerning directors and executive officers requested by this item is contained in the registrant's 2004 Proxy Statement for its annual meeting of shareholders to be held on April 28, 2004 ("2004 Proxy Statement"), in the sections entitled "MANAGEMENT-Certain Executive Officers," "Proposal No. 1 - Election of Directors," and "Compliance with Section 16(a) of the Exchange Act" and is incorporated into this report by reference.

The Board of Directors adopted a Code of Ethics for the Company's executive officers that requires the Company's officers to maintain the highest standards of professional conduct. A copy of the Code of Ethics is available on the Company's Web site www.thebankofpacific.com under the link called Stockholder Information and President's Letter.

The Company has a separately designated Audit Committee established in accordance with Section 3(a)(58)(A) of the Exchange Act. The committee is composed of Directors Duane E. Hagstrom, Gary C. Forcum, Robert Hall, Ed Ketel, Randy Rognlin, Walter Westling and David Woodland, each of whom is independent as that term is used in Item 7(d)(3)(iv) of Schedule 14A under the Exchange Act. In determining independence of board members, the Company's board of directors has applied the definition of independence found in the Nasdaq listing standards.

The Company's Board of Directors has determined that Duane E. Hagstrom and Gary Forcum are audit committee financial experts as defined in Item 401(h) of the SEC's Regulation S-K. Directors Hagstrom and Forcum are independent as that term is used in Item 7(d)(3)(iv) of Schedule 14A.

ITEM 11. Executive Compensation

Information concerning executive compensation requested by this item is contained in the registrant's 2004 Proxy Statement in the sections entitled "DIRECTOR COMPENSATION" and "EXECUTIVE COMPENSATION" (not including "Audit Committee Report," "Report of the Compensation Committee" and "Stock Performance Graph"), and is incorporated into this report by reference.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information concerning security ownership of certain beneficial owners and management requested by this item is contained in the registrant's 2004 Proxy Statement in the section entitled "MANAGEMENT - Security Ownership of Certain Beneficial Owners and Management," and is incorporated into this report by reference.

Equity Compensation Plan Information. The following table summarizes share and exercise price information about the Company's equity compensation plans as of December 31, 2003.

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	Number availabl issuanc compen (exclud reflected
Equity compensation plans approved by security holders:	232,950	$23.25	2
Equity compensation plans not approved by security holders:	--	--	
Total	232,950	$23.25	2

ITEM 13. Certain Relationships and Related Transactions

Information concerning certain relationships and related transactions requested by this item is contained in the registrant's 2004 Proxy Statement in the section entitled "Compensation Committee Interlocks and Insider Participation" and is incorporated into this report by reference.

ITEM 14. Principal Accountant Fees and Services

Information concerning fees paid to our accountants required by this item is included under the heading "AUDITORS - Fees Paid to Auditors" in the registrant's 2004 Proxy Statement and is incorporated into this report by reference.

Part IV

ITEM 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) (1) The following financial statements are filed below:
- Independent Auditor's Report
- Consolidated Balance Sheets
- Consolidated Statements of Income
- Consolidated Statements of Shareholders' Equity
- Consolidated Statements of Cash Flows

McGladrey & Pullen, LLP is a member firm of RSM International - an affiliation of separate and independent legal entities.

Independent Auditor's Report

Board of Directors
Pacific Financial Corporation
Aberdeen, Washington

We have audited the accompanying consolidated balance sheets of Pacific Financial Corporation and Subsidiary as of December 31, 2003 and 2002, and the related consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pacific Financial Corporation and Subsidiary as of December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

/s/ McGladrey & Pullen, LLP
Tacoma, Washington
January 30, 2004

Consolidated Balance Sheets

(Dollars in Thousands)

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

	2003	2002
Assets		
Cash and due from banks	$ 9,280	$ 8,473
Interest bearing deposits in banks	15,392	373
Federal funds sold	5,000	--
Securities available for sale	57,473	52,230
Securities held to maturity (market value $8,097 and $10,414)	7,988	10,362
Federal Home Loan Bank stock, at cost	915	866
Loans held for sale	--	286
Loans	199,738	185,504
Allowance for credit losses	2,238	2,473
Loans - net	197,500	183,031
Premises and equipment	3,967	3,850
Foreclosed real estate	98	686
Accrued interest receivable	1,275	1,493
Cash surrender value of life insurance	6,193	5,898
Other assets	1,634	986
Total assets	$306,715	$268,534
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Demand, non-interest bearing	43,862	$ 40,084
Savings and interest-bearing demand	131,493	103,193
Time, interest-bearing	85,445	81,977
Total deposits	260,800	225,254
Accrued interest payable	234	318
Short-term borrowings	--	1,800
Long-term borrowings	14,500	11,000
Other liabilities	5,531	5,479
Total liabilities	281,065	243,851
Commitments and Contingencies	--	--

Shareholders' Equity		
Common stock (par value $1); authorized: 25,000,000 shares; issued and outstanding: 2003 - 2,521,539 shares; 2002 - 2,512,659 shares	2,522	2,513
Additional paid-in capital	10,005	9,839
Retained earnings	12,663	11,614
Accumulated other comprehensive income	460	717
Total shareholders' equity	25,650	24,683
Total liabilities and shareholders' equity	$306,715	$268,534

See notes to consolidated financial statements.

Consolidated Statements of Income

(Dollars in Thousands, Except Per Share Amounts)

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2003, 2002 and 2001

	2003	2002	2001
Interest Income			
Loans	$13,350	$13,175	$14,994
Federal funds sold and deposits in banks	118	107	410
Securities available for sale:			
Taxable	1,570	1,401	1,638
Tax-exempt	484	501	545
Securities held to maturity:			
Taxable	168	139	--
Tax-exempt	210	270	264
Federal Home Loan Bank stock dividends	49	186	251
Total interest income	15,949	15,779	18,102
Interest Expense			
Deposits	2,923	3,747	6,340
Short-term borrowings	--	4	190
Long-term borrowings	485	240	--
Total interest expense	3,408	3,991	6,530
Net interest income	12,541	11,788	11,572
Provision for Credit Losses	--	954	580
Net interest income after provision for credit losses	12,541	10,834	10,992
Non-Interest Income			
Service charges on deposit accounts	1,027	1,069	828
Mortgage broker fees	101	3	32
Income from and gains on sale of foreclosed real estate	26	292	139

Net gains from sales of loans	34	--	--
Net gains on sales of securities available for sale	4	--	--
Earnings on bank owned life insurance	328	350	167
Other operating income	326	345	363
Total non-interest income	1,846	2,059	1,529
	======	======	======
Non-Interest Expense			
Salaries and employee benefits	4,764	4,196	4,058
Occupancy	433	419	409
Equipment	532	565	554
State taxes	69	206	227
Data processing	305	268	214
Other	1,842	1,760	1,731
Total non-interest expense	7,945	7,414	7,193
	======	======	======
Income before income taxes	6,442	5,479	5,328
	======	======	======
Income Taxes	1,863	1,563	1,521
Net income	$ 4,579	$ 3,916	$ 3,807
	======	======	======
Earnings Per Share			
Basic	$ 1.82	$ 1.57	$ 1.53
Diluted	1.79	1.56	1.52

See notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

(Dollars in Thousands)

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2003, 2002 and 2001

	Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Earnings
Balance at December 31, 2000	2,503,130	$ 2,503	$ 9,859	$10,572
Comprehensive income:				
Net income	--	--	--	3,807
Other comprehensive income, net of tax:				
Change in fair value of				

securities available for sale	--	--	--	--
Comprehensive income				
Stock options exercised	12,750	13	150	--
Repurchase of common stock	(24,281)	(24)	(486)	--
Issuance of common stock	30	--	1	--
Cash dividends declared ($1.32 per share)	--	--	--	(3,289)
Balance at December 31, 2001	2,491,629	2,492	9,524	11,090
	=========	======	======	======
Comprehensive income:				
Net income	--	--	--	3,916
Other comprehensive income, net of tax:				
Change in fair value of securities available for sale	--	--	--	--
Comprehensive income				
Stock options exercised	21,000	21	275	--
Issuance of common stock	30	---	1	--
Cash dividends declared ($1.35 per share)	--	--	---	(3,392)
Tax benefit from exercise of stock options	--	--	39	--
Balance at December 31, 2002	2,512,659	2,513	9,839	11,614
	=========	======	======	======
Comprehensive income:				
Net income	--	--	--	4,579
Other comprehensive income, net of tax:				
Change in fair value of securities available for sale	--	--	--	--
Comprehensive income				
Stock options exercised	8,850	9	165	--
Issuance of common stock	30	--	1	--
Cash dividends declared ($1.40 per share)	--	--	--	(3,530)
Balance at December 31, 2003	2,521,539	$ 2,522	$10,005	$12,663
	=========	======	======	======

See notes to consolidated financial statements.

-38-

Consolidated Statements of Cash Flows

(Dollars in Thousands)

Pacific Financial Corporation and Subsidiary

Years Ended December 31, 2003, 2002 and 2001

	2003	2002	
Cash Flows from Operating Activities			
Net income	$ 4,579	$ 3,916	$
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	404	433	
Provision for credit losses	--	954	
Deferred income tax (benefit)	(144)	(82)	
Originations of loans held for sale	--	(548)	
Proceeds from sales of loans held for sale	286	262	
Stock dividends received	(49)	(186)	
Gain on sales of loans	(34)	--	
Gain on sale of securities available for sale	(4)	--	
Gain on sales of foreclosed real estate	(10)	(178)	
Loss on sale of premises and equipment	11	--	
Earnings on bank owned life insurance	(328)	(350)	
(Increase) decrease in interest receivable	218	(88)	
Decrease in interest payable	(84)	(123)	
Write-down of foreclosed real estate	173	420	
Other - net	(49)	929	
Net cash provided by operating activities	4,969	5,359	
	======	======	=
Cash Flows from Investing Activities			
Net (increase) decrease in interest bearing deposits in banks	(15,019)	1,095	
Net (increase) decrease in federal funds sold	(5,000)	3,505	(
Activity in securities available for sale:			
Sales	2,994	--	1
Maturities, prepayments and calls	12,343	14,109	3
Purchases	(21,275)	(34,338)	(2
Activity in securities held to maturity:			
Maturities	3,919	3,481	
Purchases	(1,654)	(8,920)	(
Federal Home Loan Bank stock redemption	--	3,133	
Proceeds from sales of SBA loan pools	2,006	--	
Increase in loans made to customers, net of principal collections	(16,709)	(10,046)	(
Purchases of premises and equipment	(511)	(261)	
Proceeds from sales of premises and equipment	2	--	
Additions to foreclosed real estate	(21)	--	
Proceeds from sales of foreclosed real estate	734	707	
Purchase of bank owned life insurance	--	--	(
Net cash provided by (used in) investing activities	(38,191)	(27,535)	1
	======	======	=

(continued)

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(concluded) (Dollars in Thousands)

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2003, 2002 and 2001

	2003	2002	
Cash Flows from Financing Activities			
Net increase in deposits	$35,546	$10,610	$
Net increase (decrease) in short-term borrowings	(1,800)	1,800	(1
Proceeds from issuance of long-term debt	3,500	11,000	
Repayments of long-term debt	--	--	(
Common stock issued	175	297	
Cash dividends paid	(3,392)	(3,289)	(
Repurchase of common stock and fractional shares	--	--	
Net cash provided by (used in) financing activities	34,029	20,418	(1
Net change in cash and due from banks	807	(1,758)	
Cash and Due from Banks			
Beginning of year	8,473	10,231	
End of year	$ 9,280	$ 8,473	$1
Supplemental Disclosures of Cash Flow Information			
Interest paid	$ 3,492	$ 4,114	$
Income taxes paid	2,087	1,260	
Supplemental Disclosures of Non-Cash Investing Activities			
Fair value adjustment of securities available for sale, net of tax	$ 257	$ 309	$
Transfer of loans to foreclosed real estate	1,127	1,198	
Financed sales of foreclosed real estate	839	629	
Reclassification of loan receivable to securities available for sale	--	--	

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

Note 1 - Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of Pacific Financial Corporation (the Company) and its wholly owned subsidiary, The Bank of the Pacific (the Bank). All significant intercompany transactions and balances have been eliminated.

Nature of Operations

The Company is a holding company which operates primarily through its subsidiary bank. The Bank operates ten branches located in Grays Harbor, Pacific and Wahkiakum Counties in western Washington and one loan production office in Clatsop County Oregon. The Bank provides loan and deposit services to customers, who are predominately small- and middle-market businesses and middle-income individuals in western Washington and Oregon.

Consolidated Financial Statement Presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and practices within the banking industry. The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities, as of the date of the balance sheet, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for credit losses and the valuation of foreclosed real estate and deferred tax assets.

Certain prior year amounts have been reclassified, with no change to net income or shareholders' equity, to conform to the 2003 presentation. All dollar amounts, except per share information, are stated in thousands.

Securities Available for Sale

Securities available for sale consist of debt securities, marketable equity securities and mutual funds that the Bank intends to hold for an indefinite period, but not necessarily to maturity. Such securities may be sold to implement the Bank's asset/liability management strategies and in response to changes in interest rates and similar factors. Securities available for sale are reported at fair value. Unrealized gains and losses, net of the related deferred tax effect, are reported as a net amount in a separate component of shareholders' equity entitled "accumulated other comprehensive income (loss)." Realized gains and losses on securities available for sale, determined using the specific identification method, are included in earnings. Amortization of premiums and accretion of discounts are recognized in interest income over the period to maturity.

(continued)

Note 1 - Summary of Significant Accounting Policies (continued)

Securities Held to Maturity

Debt securities for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized in interest income over the period to maturity.

Declines in the fair value of individual securities held to maturity and available for sale below their cost that are other than temporary result in write-downs of the individual securities to their fair value. Such write-downs are included in earnings as realized losses.

Federal Home Loan Bank Stock

The Company, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in capital stock of the FHLB in an amount equal to the greater of 1% of its outstanding home loans or 5% of advances from the FHLB. The recorded amount of FHLB stock equals its fair value because the shares can only be redeemed by the FHLB at the $100 per share par value.

Loans Held for Sale

Mortgage loans originated for sale in the foreseeable future in the secondary market are carried at the lower of aggregate cost or estimated market value. Gains and losses on sales of loans are recognized at settlement date and are determined by the difference between the sales proceeds and the carrying value of the loans. All sales are made without recourse. Net unrealized losses are recognized through a valuation allowance established by charges to income.

Loans

Loans are stated at the amount of unpaid principal, reduced by an allowance for credit losses. Interest on loans is accrued daily based on the principal amount outstanding.

Generally, the accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due or when they are past due 90 days as to either principal or interest, unless they are well secured and in the process of collection. When interest accrual is discontinued, all unpaid accrued interest is reversed against current income. If management determines that the ultimate collectibility of principal is in doubt, cash receipts on nonaccrual loans are applied to reduce the principal balance on a cash-basis method, until the loans qualify for return to accrual status. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. The interest on these loans is accounted for on the cash-basis method, until qualifying for return to accrual.

(continued)

December 31, 2003 and 2002

Note 1 - Summary of Significant Accounting Policies (continued)

Allowance for Credit Losses

The allowance for credit losses is maintained at a level sufficient to provide for probable credit losses based on evaluating known and inherent risks in the loan portfolio. The allowance is provided based upon management's continuing analysis of the pertinent factors underlying the quality of the loan portfolio. These factors include changes in the size and composition of the loan portfolio, delinquency levels, actual loan loss experience, current economic conditions, and detailed analysis of individual loans for which full collectibility may not be assured. The detailed analysis includes techniques to estimate the fair value of loan collateral and the existence of potential alternative sources of repayment. The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. The appropriateness of the allowance for losses on loans is estimated based upon these factors and trends identified by management at the time consolidated financial statements are prepared.

When available information confirms that specific loans or portions thereof are uncollectible, identified amounts are charged against the allowance for credit losses. The existence of some or all of the following criteria will generally confirm that a loss has been incurred: the loan is significantly delinquent and the borrower has not demonstrated the ability or intent to bring the loan current; the Bank has no recourse to the borrower, or if it does, the borrower has insufficient assets to pay the debt; the estimated fair value of the loan collateral is significantly below the current loan balance, and there is little or no near-term prospect for improvement.

In accordance with SFAS No. 114, Accounting by Creditors for Impairment of a Loan, and SFAS No. 118, an amendment of SFAS No. 114, a loan is considered impaired when it is probable that a creditor will be unable to collect all amounts (principal and interest) due according to the contractual terms of the loan agreement. Smaller balance homogenous loans, such as residential mortgage loans and consumer loans, are collectively evaluated for potential loss. When a loan has been identified as being impaired, the amount of the impairment is measured by using discounted cash flows, except when, as a practical expedient, the current fair value of the collateral, reduced by costs to sell, is used. When the measurement of the impaired loan is less than the recorded investment in the loan including accrued interest, an impairment is recognized by creating or adjusting an allocation of the allowance for loan losses.

A provision for credit losses is charged against income and is added to the allowance for credit losses based on quarterly assessments of the loan portfolio. The allowance for credit losses is allocated to certain loan categories based on the relative risk characteristics, asset classifications and actual loss experience of the loan portfolio. While management has allocated the allowance for credit losses to various loan portfolio segments, the allowance is general in nature and is available for the loan portfolio in its entirety.

The ultimate recovery of all loans is susceptible to future market factors beyond the Bank's control. These factors may result in losses or recoveries differing significantly from those provided in the consolidated financial statements. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for credit losses, and may require the Bank to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

(continued)

Note 1 - Summary of Significant Accounting Policies (continued)

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation, which is computed on the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is less. Gains or losses on dispositions are reflected in earnings.

Foreclosed Real Estate

Real estate properties acquired through, or in lieu of, foreclosure are to be sold and are initially recorded at the lower of cost or fair value of the properties less estimated costs of disposal. Any write-down to fair value at the time of transfer to other real estate owned is charged to the allowance for credit losses. Properties are evaluated regularly to ensure that the recorded amounts are supported by their current fair values, and that valuation allowances to reduce the carrying amounts to fair value less estimated costs to dispose are recorded as necessary. Any subsequent reductions in carrying values, and revenue and expense from the operations of properties, are charged to operations.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Income Taxes

Deferred tax assets and liabilities result from differences between the financial statement carrying amounts and the tax bases of assets and liabilities, and are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The Bank provides for income taxes separately and remits to the Company amounts currently due.

(continued)

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

Note 1 - Summary of Significant Accounting Policies (continued)

Stock-Based Compensation

At December 31, 2003, the Company has three stock-based employee compensation plans, which are described more fully in Note 14. The Company accounts for those plans under the recognition and measurement principles of APB No. 25, Accounting for Stock Issued to Employees, and related interpretations. Accordingly, no stock-based compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, to stock-based compensation awards for the effects of all options granted on or after January 1, 1995 for the years ended December 31:

	2003	2002	2001
Net income, as reported	$4,579	$3,916	$3,807
Less total stock-based compensation expense determined under fair value method for all qualifying awards, net of tax	86	93	10
Pro forma net income	$4,493	$3,823	$3,797
Earnings Per Share			
Basic:			
As reported	$ 1.82	$ 1.57	$ 1.53
Pro forma	1.79	1.54	1.52
Diluted:			
As reported	1.79	1.56	1.52
Pro forma	1.76	1.53	1.50

Fair Values of Financial Instruments

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

Cash, Interest Bearing Deposits at Other Financial Institutions, and Federal Funds Sold
The carrying amounts of cash, interest bearing deposits at other financial institutions, and federal funds sold approximate their fair value.

Securities Available for Sale and Held to Maturity
Fair values for securities are based on quoted market prices.

(continued)

Note 1 - Summary of Significant Accounting Policies (continued)

Fair Values of Financial Instruments (concluded)

Federal Home Loan Bank Stock
The carrying value of Federal Home Loan Bank stock approximates its fair value.

Loans
For variable rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values of loans held for sale are based on their estimated market prices. Fair values for impaired loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Deposit Liabilities
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 carrying amounts of federal funds purchased and other short-term borrowings maturing within 90 days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

Long-Term Borrowings

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

Accrued Interest
The carrying amounts of accrued interest approximate their fair values.

Off-Balance-Sheet Instruments
The fair value of commitments to extend credit and standby letters of credit was estimated using the fees 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 Bank's off-balance-sheet instruments consist of non-fee producing, variable-rate commitments, the Bank has determined they do not have a distinguishable fair value.

(continued)

Note 1 - Summary of Significant Accounting Policies (concluded)

Cash Equivalents and Cash Flows

The Company considers all amounts included in the balance sheet caption "Cash and due from banks" to be cash equivalents. Cash flows from loans, interest bearing deposits in banks, federal funds sold, short-term borrowings, and deposits are reported net.

The Company maintains balances in depository institution accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

Earnings Per Share

Basic earnings per share excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding. Diluted earnings per share reflect the potential dilution that could occur if common shares were issued pursuant to the exercise of options under the Company's stock option plans.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on securities available for sale, are reported as a separate component of the equity section of the consolidated balance sheets, such items, along with net income, are components of comprehensive income. Gains and losses on securities available for sale are reclassified to net income as the gains or losses are realized upon sale of the securities. Other-than-temporary impairment charges are reclassified to net income at the time of the charge.

Recent Accounting Pronouncements

The Financial Accounting Standards Board has issued Statement No. 149, Amendments of Statement No. 133 on Derivative Instruments and Hedging. This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under Statement No. 133. The Statement was effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. Implementation of the Statement on July 1, 2003 did not have a significant impact on the consolidated financial statements.

The Financial Accounting Standards Board has issued Statement No.150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity, and requires that certain freestanding financial instruments be reported as liabilities on the consolidated balance sheets. For the Company, the Statement is effective for the fiscal year beginning January 1, 2005 and implementation is not expected to have a significant impact on the consolidated financial statements.

Note 2 - Restricted Assets

Federal Reserve Board regulations require that the Bank maintains certain minimum reserve balances in cash and on deposit with the Federal Reserve Bank, based on a percentage of deposits. The average amount of such balances for the years ended December 31, 2003 and 2002 were approximately $650.

Note 3 - Securities

Investment securities have been classified according to management's intent. The carrying amounts of securities and their approximate fair values are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities Available for Sale				
December 31, 2003				
U.S. Treasury and Government agency securities	$ 1,738	$ 81	$ --	$ 1,819
Obligations of states and political subdivisions	14,239	600	88	14,751
Mortgage-backed securities	16,121	181	91	16,211
Corporate bonds	4,122	122	11	4,233

Mutual funds	20,556	---	97	20,459
	$56,776	$ 984	$287	$57,473
	======	=====	===	======
December 31, 2002				
U.S. Treasury and Government agency securities	$ 2,165	$ 142	$ --	$ 2,307
Obligations of states and political subdivisions	11,502	609	13	12,098
Mortgage-backed securities	16,669	215	27	16,857
Corporate bonds	5,979	127	7	6,099
Mutual funds	14,828	47	6	14,869
	$51,143	$1,140	$ 53	$52,230
	======	=====	===	======
Securities Held to Maturity				
December 31, 2003				
State and municipal securities	$ 5,044	$ 75	$ 20	$ 5,099
Mortgage-backed securities	2,944	54	--	2,998
	======	=====	===	======
December 31, 2002				
State and municipal securities	$ 3,751	$ 39	$ 28	$ 3,762
Mortgage-backed securities	6,611	41	--	6,652
	$10,362	$ 80	$ 28	$10,414
	======	=====	===	======

(continued)

Note 3 - Securities (concluded)

Unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in continuous unrealized loss position, as of December 31, 2003 are summarized as follows:

	Less than Fair Value	12 Months Unrealized Loss	More than Fair Value	12 Months Unrealized Loss	Total Fair Value
Available for Sale					
Obligations of states and political subdivisions	$1,546	$ 88	$ --	$ --	$ 1,546

Mortgage-backed securities	3,375	67	2,942	24	6,317
Corporate bonds	1,094	11	---	---	1,094
Mutual funds	3,855	44	16,604	53	20,459
Total	$9,870	$210	$19,546	$ 77	$29,416
	=====	===	======	===	======
Held to Maturity					
State and municipal securities	$ 374	$ 16	$ 912	$ 4	$ 1,286
	=====	===	======	===	======

For all the above investment securities, the unrealized losses are generally due to changes in interest rates and, as such, are considered to be temporary by the Company.

The contractual maturities of investment securities held to maturity and available for sale at December 31, 2003 are as follows:

	Held to Maturity		Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 449	$ 456	$ 2,659	$ 2,733
Due from one year to five years	1,598	1,614	9,032	9,478
Due from five to ten years	964	1,011	5,263	5,437
Due after ten years	2,033	2,018	3,145	3,155
Mortgage-backed securities	2,944	2,998	16,121	16,211
Mutual funds	--	--	20,556	20,459
Total	$7,988	$8,097	$56,776	$57,473
	=====	=====	======	======

Gross gains realized on sales of securities were $9 and gross losses realized were $5 in 2003. There were no sales of securities in 2002 and 2001.

Securities carried at approximately $18,691 at December 31, 2003 and $25,622 at December 31, 2002 were pledged to secure public deposits, borrowings at the Federal Home Loan Bank of Seattle, for other purposes required or permitted by law.

-49-

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

Note 4 - Loans

Loans at December 31 consist of the following:

	2003	2002
Commercial and agricultural	$ 64,344	$ 69,794
Real estate:		
Construction	11,894	9,697
Residential 1-4 family	24,418	28,085
Multi-family	2,197	1,574
Commercial	85,933	65,336
Farmland	5,268	5,870
Consumer	5,684	5,148
	$199,738	$185,504
	=======	=======

Changes in the allowance for credit losses for the years ended December 31 are as follows:

	2003	2002	2001
Balance at beginning of year	$2,473	$2,109	$2,026
Provision for credit losses	--	954	580
Charge-offs	(265)	(632)	(564)
Recoveries	30	42	67
Net charge-offs	(235)	(590)	(497)
Balance at end of year	$2,238	$2,473	$2,109
	=====	=====	=====

Following is a summary of information pertaining to impaired loans:

	2003	2002	2001
December 31			
Impaired loans without a valuation allowance	$ 342	$2,296	$ 482
Impaired loans with a valuation allowance	123	18	1,180
Total impaired loans	$ 465	$2,314	$1,662
	=====	=====	=====
Valuation allowance related to impaired loans	$ 23	$ 2	$ 143
	=====	=====	=====
Years Ended December 31			
Average investment in impaired loans	$1,412	$2,390	$1,262
Interest income recognized on a cash basis on impaired loans	12	13	2

(continued)

December 31, 2003 and 2002

Note 4 - Loans (concluded)

At December 31, 2003, there were no commitments to lend additional funds to borrowers whose loans have been modified. There were no loans 90 days and over past due and still accruing interest at December 31, 2003 and 2002.

Certain related parties of the Company, principally directors and their associates, were loan customers of the Bank in the ordinary course of business during 2003 and 2002. Total loans outstanding at December 31, 2003 and 2002 to key officers and directors were $6,483 and $5,698, respectively. During 2003, new loans of $7,646 were made, and repayments totaled $6,861. In management's opinion, these loans and transactions were on the same terms as those for comparable loans and transactions with non-related parties. No loans to related parties were on non-accrual, past due or restructured at December 31, 2003.

Note 5 - Premises and Equipment

The components of premises and equipment at December 31 are as follows:

	2003	2002
Land	$ 1,125	$ 1,125
Premises	4,309	3,992
Equipment, furniture and fixtures	4,122	4,074
	9,556	9,191
Less accumulated depreciation and amortization	5,589	5,341
Total premises and equipment	$ 3,967	$ 3,850

Note 6 - Deposits

The composition of deposits at December 31 is as follows:

	2003	2002
Demand deposits, non-interest bearing	$ 43,862	$ 40,084
NOW and money market accounts	79,185	52,651
Savings deposits	52,308	50,542
Time certificates, $100,000 or more	43,608	35,086
Other time certificates	41,837	46,891
Total	$260,800	$225,254

(continued)

Note 6 - Deposits (concluded)

Scheduled maturities of time certificates of deposit are as follows for future years ending December 31:

2004	$59,040
2005	15,463
2006	2,041
2007	3,318
2008	5,583
	$85,445

Note 7 - Long-Term Borrowings

Long-term borrowings at December 31, 2003 represent advances from the Federal Home Loan Bank bearing interest at 2.78% to 4.41% and maturing in various years as follows: 2004 - $2,000; 2005 - $2,000; 2006 - $1,000; 2008 - $3,500; and 2009 - $6,000. The Bank has pledged $29,727 of securities and loans as collateral for these borrowings and short-term borrowings at December 31, 2003.

Note 8 - Income Taxes

Income taxes are comprised of the following for the years ended December 31:

	2003	2002	2001
Current	$1,719	$1,645	$1,296
Deferred (benefit)	144	(82)	225
Total income taxes	$1,863	$1,563	$1,521
	=====	=====	=====

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities at December 31 are:

	2003	2002
Deferred Tax Assets		
Allowance for credit losses	$ 634	$ 730
Deferred compensation	159	161
Other	12	8
Total deferred tax assets	805	899
	===	===

(continued)

Note 8 - Income Taxes (concluded)

	2003	2002
Deferred Tax liabilities		
Unrealized gain on securities available for sale	$ 237	$ 369
Depreciation	167	119
Deferred revenue	886	884
Total deferred tax liabilities	1,290	1,372
	=====	=====
Net deferred tax liabilities	($ 485)	($ 473)
	=====	=====

Net deferred tax liabilities are included in other liabilities on the consolidated balance sheets.

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

	2003		2002		2001	
	Amount	Percent of Pre-tax Income	Amount	Percent of Pre-tax Income	Amount	Perce of Pre Inco
Income tax at statutory rate	$2,255	35.0%	$1,918	35.0%	$1,865	35
Adjustments resulting from:						
Tax-exempt income	(232)	(3.6)	(276)	(5.0)	(272)	(5
Net earnings on life insurance policies	(103)	(1.6)	(111)	(2.0)	(26)	(
Other	(57)	(.9)	32	.5	(46)	(
Total income tax expense	$1,863	28.9%	$1,563	28.5%	$1,521	28
	=====	====	=====	====	=====	==

Note 9 - Employee Benefits

Incentive Compensation Plan

The Bank has a plan that provides incentive compensation to key employees if the Bank meets certain performance criteria established by the Board of Directors. The cost of this plan was $602, $435 and $355 in 2003, 2002 and 2001, respectively.

401(k) Plans

The Bank has established a 401(k) profit sharing plan for those employees who meet the eligibility requirements set forth in the plan. Eligible employees may contribute up to 15% of their compensation. Matching contributions by the Bank are at the discretion of the Board of Directors. Contributions totaled $129, $126 and $115 for 2003, 2002 and 2001, respectively.

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

Note 9 - Employee Benefits (concluded)

Director and Employee Deferred Compensation Plans

The Company has director and employee deferred compensation plans. Under the terms of the plans, a director or employee may participate upon approval by the Board. The participant may then elect to defer a portion of his or her earnings (directors' fees or salary) as designated at the beginning of each plan year. Payments begin upon retirement, termination, death or permanent disability, sale of the Company, the ten-year anniversary of the participant's participation date, or at the discretion of the Company. There are currently two participants in the plans. Total deferrals plus earnings were $105, $110 and $304 at December 31, 2003, 2002 and 2001, respectively. There is no expense to the Company for this plan.

The directors of a bank acquired by the Company in 1999 adopted two deferred compensation plans for directors - one plan providing retirement income benefits for all directors and the other, a deferred compensation plan, covering only those directors who have chosen to participate in the plan. At the time of adopting these plans, the Bank purchased life insurance policies on directors participating in both plans which may be used to fund payments to them under these plans. Cash surrender values on these policies were $2,819 and $2,700 at December 31, 2003 and 2002, respectively. In 2003, 2002 and 2001, the net (benefit)/cost recorded from these plans, including the cost of the related life insurance, was ($271), ($315) and ($104), respectively. Both of these plans were fully funded and frozen as of September 30, 2000. Plan participants were given the option to either remain in the plan until reaching the age of 70 or to receive a lump-sum distribution. Participants electing to remain in the plan will receive annual payments over a ten-year period upon reaching 70 years of age.

Qualified Non-Contributory Defined Benefit Plan

The Company maintained a non-contributory defined benefit plan covering substantially all employees of the former Bank of the Pacific, which was frozen and terminated on December 31, 2000. The Bank made annual contributions to the plan equal to the amount accrued for pension expenses, which were invested in shares of registered investment companies. Final funding of the plan did not occur until 2001 upon receipt of plan administrator distribution totals. Contributions of $149 were made in 2001.

Non-Qualified Deferred Compensation Plan

The Company has a non-qualified deferred compensation plan to cover selected employees. Its annual contributions to the plan totaled $6, $6 and $8 in 2003, 2002 and 2001, respectively. Covered employees may also contribute to the plan.

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

Note 10 - Commitments and Contingencies

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of their 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 commitments at December 31 is as follows:

	2003	2002
Commitments to extend credit	$44,044	$23,638
Standby letters of credit	2,715	2,326

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. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank's experience has been that approximately 67% of loan commitments is drawn upon by customers. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above, and is required in instances where the Bank deems necessary.

Certain executive officers have entered into employment contracts with the Bank which provide for contingent payments subject to future events.

The Bank has agreements with commercial banks for lines of credit totaling $17,200, none of which was used at December 31, 2003. In addition, the Bank has a credit line with the Federal Home Loan Bank of Seattle totaling 20% of assets, $14,500 of which was used at December 31, 2003. These borrowings are collateralized under blanket pledge and custody agreements.

Because of the nature of its activities, the Company is subject to various pending and threatened legal actions which arise 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 financial position of the Company.

Note 11 - Significant Concentrations of Credit Risk

Most of the Bank's business activity is with customers and governmental entities located in the state of Washington, including investments in state and municipal securities. Loans are generally limited by state banking regulations to 20% of the Bank's shareholder's equity, excluding accumulated other comprehensive income (loss). As of December 31, 2003 the Bank's loans to companies in the hotel\motel industry totaled $33,323 or 16% of total loans. Standby letters of credit were granted primarily to commercial borrowers. The Bank, as a matter of practice, generally does not extend credit to any single borrower or group of borrowers in excess of $4.25 million.

Note 12 - Stock Options

The Company's three stock incentive plans provide for granting incentive stock options, as defined under current tax laws, to key personnel and under the plan adopted in 2000, options not qualified for favorable tax treatment and other types of stock based awards. Under the first plan, options are exercisable 90 days from the date of grant. These options terminate if not exercised within ten years from the date of grant. If after six years from the date of grant fewer than 20% of the options have been exercised, they will expire at a rate of 20% annually. Under the second plan, the options are exercisable one year from the date of grant, at a rate of 10% annually. Options terminate if not exercised when they become available, and no additional grants will be made under these two plans. The plan adopted in 2000, authorizes the issuance of up to a total of 500,000 shares, (296,500 shares are available for grant at December 31, 2003). Under the 2000 plan, options either become exercisable ratably over five years or vest fully five years from the date of grant. Under the 2000 plan, the Company may grant up to 75,000 options for its common stock to a single individual in a calendar year.

The fair value of each option grant is estimated on the date of grant, based on the Black-Scholes option pricing model and using the following weighted-average assumptions:

	2003	2002	2001
Dividend yield	5.31%	5.67%	5.76%
Expected life	10 years	10 years	10 years
Risk-free interest rate	4.38%	5.49%	4.93%
Expected volatility	17.73%	18.99%	19.13%

The weighted average fair value of options granted during 2003 and 2002 was $2.86 and $3.03, respectively.

The Black-Scholes model used by the Company to calculate option values, as well as other currently accepted option valuation models, were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. These models also require highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the calculated values. Accordingly, management believes that this model does not necessarily provide a reliable single measure of the fair value of the Company's option awards.

(continued)

Note 12 - Stock Options (concluded)

A summary of the status of the Company's stock option plans as of December 31, 2003, 2002 and 2001, and changes during the years ending on those dates, is presented below:

	2003		2002		2001	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weight Averag Exerci Price
Outstanding at beginning of year	179,796	$22.26	184,300	$21.19	74,550	$18.21
Granted	62,004	25.61	23,996	23.34	126,000	22.22
Exercised	(8,850)	19.65	(21,000)	14.09	(12,750)	12.82
Forfeited	--	--	(7,500)	22.22	(3,500)	25.63
Outstanding at end of year	232,950	$23.25	179,796	$22.26	184,300	$21.19
Exercisable at end of year	76,999	$22.06	53,300	$21.08	32,165	$14.40

The following information summarizes information about stock options outstanding and exercisable at December 31, 2003:

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price

$15.29	13,550	3	$15.29	13,550	$15.29
22.22 - 24.00	153,650	7	22.55	47,449	22.33
25.00	35,500	9	25.00	--	25.00
27.00	20,250	6	27.00	16,000	27.00
31.00	10,000	9	31.00	--	31.00
	232,950			76,999	
	=======			======	

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

Note 13 - Regulatory Matters

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 and total capital (as defined) to risk-weighted assets (as defined).

As of December 31, 2003, the most recent notification from the Bank's regulator categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Company and the Bank's actual capital amounts and ratios are also presented in the table. Management believes, as of December 31, 2003, the Company and the Bank meet all capital requirements to which they are subject.

	Actual Amount	Ratio	Capital Purposes Amount	Ratio	To be Well Capita Under Prompt Corrective Adequacy Action Provisions Amount
December 31, 2003					
Tier 1 capital (to average assets):					
Consolidated	$25,190	8.49%	$11,864	4.00%	N/A
Bank	24,651	8.31	11,864	4.00	$14,830
Tier 1 capital (to risk-weighted assets):					
Consolidated	25,190	11.62	8,675	4.00	N/A
Bank	24,651	11.37	8,675	4.00	13,012
Total capital (to risk-weighted assets):					
Consolidated	27,428	12.65	17,350	8.00	N/A
Bank	26,889	12.40	17,350	8.00	21,687

(continued)

Note 13 - Regulatory Matters (concluded)

	Actual Amount	Ratio	Capital Purposes Amount	Ratio	To be Well Capita Under Prompt Corrective Adequacy Action Provisions Amount
December 31, 2002					
Tier 1 capital (to average assets):					
Consolidated	$23,966	8.92%	$10,753	4.00%	N/A
Bank	23,832	8.87	10,753	4.00	$13,441
Tier 1 capital (to risk-weighted assets):					
Consolidated	23,966	11.73	8,172	4.00	N/A
Bank	23,832	11.67	8,171	4.00	12,257
Total capital (to risk-weighted assets):					
Consolidated	26,457	12.95	16,344	8.00	N/A

Bank	26,323	12.89	16,342	8.00	20,428

Note 14 - Comprehensive Income

Net unrealized gains and losses include, net of tax, $254 of unrealized losses arising during 2003, $309 of unrealized gains arising during 2003 and $599 of unrealized gains arising during 2002, less reclassification adjustments of $3, $0 and $0 for gains included in net income in 2003, 2002 and 2001, respectively, as follows:

	Before-Tax Amount	Tax Benefit (Expense)	Net-of-T Amount
2003			
Unrealized holding losses arising during the year	($384)	$130	($254)
Reclassification adjustments for gains realized in net income	(4)	1	(3)
Net unrealized losses	($388)	$131	($257)
	===	===	===
2002			
Unrealized holding losses arising during the year	$467	($158)	$309
Reclassification adjustments for gains realized in net income	--	--	--
Net unrealized gains	$467	($158)	$309
	===	===	===
2001			
Unrealized holding losses arising during the year	$908	($309)	$599
Reclassification adjustments for gains realized in net income	--	--	--
Net unrealized gains	$908	($309)	$599
	===	===	===

-59-

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

Note 15 - Fair Values of Financial Instruments

The estimated fair values of the Company's financial instruments at December 31 are as follows:

	2003 Carrying Amount	Fair Value	2002 Carrying Amount	Fair Value
Financial Assets				
Cash and due from banks, interest-bearing deposits with banks, and federal funds sold	$ 29,672	$ 29,672	$ 8,846	$ 8,846
Securities available for sale	57,473	57,473	52,230	52,230
Securities held to maturity	7,988	8,097	10,362	10,414
Federal Home Loan Bank stock	915	915	866	866
Loans receivable, net	197,500	200,449	183,031	188,247
Loans held for sale	--	--	286	286
Accrued interest receivable	1,275	1,275	1,493	1,493
Financial Liabilities				
Deposits	$260,800	$261,516	$225,254	$226,146
Short-term borrowings	--	--	1,800	1,800
Long-term borrowings	14,500	14,319	11,000	11,105
Accrued interest payable	234	234	318	318

The Bank assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Bank's financial instruments will change when interest rate levels change and that change may either be favorable or unfavorable to the Bank. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities, and attempts to minimize interest rate risk by adjusting terms of new loans, and deposits and by investing in securities with terms that mitigate the Bank's overall interest rate risk.

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

Note 16 - Earnings Per Share Disclosures

Following is information regarding the calculation of basic and diluted earnings per share for the years indicated.

	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
Year Ended December 31, 2003			
Basic earnings per share:			
Net income	$4,579	2,512,844	$1.82
Effect of dilutive securities:			
Options	--	47,003	(.03)
Diluted earnings per share:			
Net income	$4,579	2,559,847	$1.79
Year Ended December 31, 2002			
Basic earnings per share:			
Net income	$3,916	2,492,526	$1.57
Effect of dilutive securities:			
Options	--	17,869	(.01)
Diluted earnings per share:			
Net income	$3,916	2,510,395	$1.56
Year Ended December 31, 2001			
Basic earnings per share:			
Net income	$3,807	2,491,426	$1.53
Effect of dilutive securities:			
Options	--	19,736	(.01)
Diluted earnings per share:			
Net income	$3,807	2,511,162	$1.52

The number of shares shown for "options" is the number of incremental shares that would result from the exercise of options and use of the proceeds to repurchase shares at the average market price during the year.

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

Note 17 - Condensed Financial Information - Parent Company Only

Condensed Balance Sheets - December 31

	2003	2002
Assets		

Cash	$ 3,699	$ 3,467
Investment in the Bank	25,208	24,549
Due from the Bank	89	59
Other assets	184	--
Total assets	$29,180	$28,075
	======	======
Liabilities and Shareholders' Equity		
Dividends payable	$ 3,530	$ 3,392
Shareholders' equity	25,650	24,683
Total liabilities and shareholders' equity	$29,180	$28,075
	======	======

Condensed Statements of Income - Years Ended December 31

	2003	2002	2001
Dividend Income from the Bank	$ 3,729	$ 3,200	$ 3,670
Expenses	(96)	(59)	(69)
Income before income tax benefit	3,633	3,141	3,601
	======	======	======
Income Tax Benefit	30	20	23
Income before equity in undistributed income of the Bank	3,663	3,161	3,624
	======	======	======
Equity in Undistributed Income of the Bank	916	755	183
Net income	$ 4,579	$ 3,916	$ 3,807
	======	======	======

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

Note 17 - Condensed Financial Information - Parent Company Only (concluded)

Condensed Statements of Cash Flows - Years Ended December 31

	2003	2002	2001
Operating Activities			
Net income	$ 4,579	$ 3,916	$ 3,807
Adjustments to reconcile net income to net cash provided by operating activities:			

Equity in undistributed income of subsidiary	(916)	(755)	(183)
Other - net	(214)	(19)	(1)
Net cash provided by operating activities	3,449	3,142	3,623
Investing Activities			
Increase in amounts due from the Bank	--	--	3,178
Financing Activities			
Common stock issued	175	297	164
Dividends paid	(3,392)	(3,289)	(3,204)
Repurchase of common stock and fractional shares	--	--	(510)
Net cash used in financing activities	(3,217)	(2,992)	(3,550)
Net increase in cash	232	150	3,251
Cash			
Beginning of year	3,467	3,317	66
End of year	$ 3,699	$ 3,467	$ 3,317

Note 18 - Subsequent Event

On October 22, 2003, the Company announced the signing of a definitive agreement for the acquisition of BNW Bancorp, Inc. by merger. Upon completion of the transaction, each share of BNW Bancorp, Inc. common stock will be converted into the right to receive 0.85 shares of the Company's common stock. The Company will issue approximately 610,240 shares of its own stock to acquire all of BNW Bancorp, Inc.'s outstanding shares at an exchange ratio of 0.85 of the Company's shares. The merger, which has been unanimously approved by the directors of both companies, is subject to certain conditions, including approval of the shareholders of BNW Bancorp, Inc. and shareholders of the Company and the receipt of regulatory approval. The merger is expected to be completed in the first quarter of 2004. BNW Bancorp, Inc. will merge into Pacific Financial

Corporation, immediately followed by the merger of Bank Northwest, a subsidiary of BNW Bancorp, Inc., into Bank of the Pacific. After the merger the combined organization will have assets of approximately $407 million, deposits of approximately $339 million, and shareholders' equity of approximately $44 million.

Note 19 - Quarterly Data (Unaudited)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Year Ended December 31, 2003				
Interest income	$3,922	$3,991	$3,982	$4,054
Interest expense	899	896	824	789
Net interest income	3,023	3,095	3,158	3,265
Provision for credit losses	--	--	--	--
Non-interest income	444	457	539	406
Non-interest expenses	1,910	1,931	2,003	2,101
Income before income taxes	1,557	1,621	1,694	1,570
Income taxes	445	470	500	448
Net income	$1,112	$1,151	$1,194	$1,122
Earnings per common share:				
Basic	$ .44	$ .46	$ .48	$ .44
Diluted	.44	.45	.47	.43

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2003 and 2002

Note 19 - Quarterly Data (Unaudited) (concluded)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Year Ended December 31, 2002				
Interest income	$3,880	$3,930	$3,942	$4,027
Interest expense	971	981	1,046	993
Net interest income	2,909	2,949	2,896	3,034

Provision for credit losses	954	--	--	--
Non-interest income	454	704	477	424
Non-interest expenses	1,819	1,873	1,848	1,874
Income before income taxes	590	1,780	1,525	1,584
	=====	=====	=====	=====
Income taxes	182	534	452	395
Net income	$ 408	$1,246	$1,073	$1,189
	=====	=====	=====	=====
Earnings per common share:				
Basic	$ .16	$ .50	$ .43	$ .48
Diluted	.16	.50	.43	.47

Notes to Consolidated Financial Statements

(a) (2) Schedules: None

(a) (3) Exhibits: See Exhibit Index immediately following the signature page.

(b) Reports on Form 8-K: During the three months ended December 31, 2003, Pacific filed the following current reports on Form 8-K:

* Report on Form 8-K dated October 22, 2003, reporting that the Company had entered into an Agreement and Plan of Merger dated October 22, 2003, governing the terms and conditions under which BNW Bancorp, Inc., would be merged into Pacific and Bank NorthWest, BNW Bancorp's banking subsidiary, would be merged into the Bank of the Pacific; and

* Report on Form 8-K dated December 19, 2003, reporting that Pacific's board of directors had declared a cash dividend of $1.40 per share payable to shareholders of record as of December 31, 2003.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, on the 19th day of March, 2004.

PACIFIC FINANCIAL CORPORATION
(Registrant)

/s/ Dennis A. Long	/s/ John Van Dijk
Dennis A. Long, President and CEO	John Van Dijk, Executive Vice President, Treasurer (CFO) and Secretary

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated, on the 19th day of March, 2004.

Principal Executive Officer and Director	Principal Financial and Accounting Officer
/s/ Dennis A. Long	/s/ John Van Dijk
Dennis A. Long, President and CEO and Director Principal Executive Officer	John Van Dijk, Treasurer (CFO) Principal Financial and Accounting Officer

Remaining Directors

/s/ Joseph A. Malik	/s/ Sidney R. Snyder
Joseph A. Malik (Chairman of the Board)	Sidney R. Snyder
/s/ Gary C. Forcum	/s/ Duane E. Hagstrom
Gary C. Forcum	Duane E. Hagstrom
/s/ Walter L. Westling	/s/ Robert A. Hall
Walter L. Westling	Robert A. Hall
/s/ David L. Woodland	/s/ Robert J. Worrell
David L. Woodland	Robert J. Worrell
/s/ Susan C. Freese	/s/ Randy W. Rognlin
Susan C. Freese	Randy W. Rognlin
/s/ Randy Rust	/s/ Edwin Ketel
Randy Rust	Edwin Ketel
/s/ Douglas M. Schermer	
Douglas M. Schermer	John R. Ferlin
	/s/ Stewart L. Thomas
G. Dennis Archer	Stewart L. Thomas

Exhibit Index

EXHIBIT NO. EXHIBIT

2.1	Agreement and Plan of Merger between the Company and BNW Bancorp, Inc. dated as of October 22, 2003(1)
3.1	Restated Articles of Incorporation (2)
3.2	Bylaws (3)
10	Executive Compensation Plans and Arrangements and Other Management Contracts
10.1	Employment Agreement with Dennis A. Long dated January 27, 2004
10.2	Employment Agreement with John Van Dijk dated January 2, 2003 (4)
10.3	Employment Agreement with Bruce D. MacNaughton dated January 2, 2003 (4)
10.4	Bank of the Pacific Incentive Stock Option Plan (5)
10.5	The Bank of Grays Harbor Incentive Stock Option Plan (5)
10.6	2000 Stock Incentive Compensation Plan (6)
10.7	Bonus Program for Officers (6)
10.8	The Bank of Grays Harbor Employee Deferred Compensation Plan (7)
21	Subsidiaries of Registrant - Bank of the Pacific, organized under Washington law
23	Consent of McGladrey & Pullen, LLP, Independent Auditors
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)
32	Certification Pursuant to 18 U.S.C. 1350
99	Description of common stock of the Company (8)

(1) Incorporated by reference to Exhibit 99.1 to the Company's current report on Form 8-K dated October 22, 2003.

(2) Incorporated by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2000.

(3) Incorporated by reference to Exhibit 2b to Form 8-A filed by the Company and declared effective on March 7, 2000 (Registration No. 000-29329)

(4) Incorporated by reference to Exhibits 10.2 and 10.3 to the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

(5) Incorporated by reference to Exhibits 10.7 and 10.8 to the Company's Annual Report on Form 10-K for the year ended December 31, 1999.

(6) Incorporated by reference to Exhibits 10.1 and 10.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2000.

(7) Incorporated by reference to Exhibit 10.10 to the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

(8) Incorporated by reference to Exhibit 99 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000.