PACIFIC FINANCIAL CORP
Form 10-Q
November 12, 2004

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

FORM 10Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarter ended September 30, 2004
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ____________ to ____________
Commission File Number 000-29829

PACIFIC FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

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

300 East Market Street
Aberdeen, Washington 98520-5244
(360) 533-8870
(Address, including zip code, and telephone number, including area code, of Registrant's principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:
Yes X No

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Title of Class	Outstanding at October 31, 2004
Common Stock, par value $1.00 per share	3,184,339 shares

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PART I - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

Condensed Consolidated Balance Sheets
(Dollars in thousands)

Pacific Financial Corporation
September 30, 2004 and December 31, 2003

	September 30, 2004 (Unaudited)	December 31, 2003
Assets		
Cash and due from banks	$ 9,925	$ 9,280
Interest bearing balances with banks	1,508	15,392
Federal funds sold	--	5,000
Investment securities available for sale	39,124	57,473
Investment securities held-to-maturity	8,037	7,988
Federal Home Loan Bank stock, at cost	1,850	915
Loans held for sale	1,936	--
Loans	334,081	199,738

Allowance for credit losses	4,060	2,238
Loans, net	330,021	197,500
Premises and equipment	6,786	3,967
Foreclosed real estate	84	98
Accrued interest receivable	1,977	1,275
Cash surrender value of life insurance	8,947	6,193
Goodwill	10,651	--
Intangible assets	922	--
Other assets	1,571	1,634
Total assets	$423,339	$306,715
Liabilities and Shareholders' Equity		
Deposits:		
Non-interest bearing	$ 70,637	$ 43,862
Interest bearing	277,435	216,938
Total deposits	348,072	260,800
Accrued interest payable	345	234
Short-term borrowings	5,199	--
Long-term borrowings	19,500	14,500
Other liabilities	2,788	5,531
Total liabilities	375,904	281,065
Shareholders' Equity		
Common Stock (par value $1); authorized: 25,000,000 shares; issued September 30,2004-3,184,339 shares; December 31, 2003-2,521,539 shares	3,184	2,522
Additional paid-in capital	27,108	10,005
Retained earnings	16,899	12,663
Accumulated other comprehensive income	244	460
Total shareholders' equity	47,435	25,650
Total liabilities and shareholders' equity	$423,339	$306,715

Condensed Consolidated Statements of Income
(Dollars in thousands, except per share)
(Unaudited)

	THREE MONTHS ENDED SEPTEMBER 30, 2004	THREE MONTHS ENDED SEPTEMBER 30, 2003	NINE MONTHS ENDED SEPTEMBER 30, 2004	NINE MONTHS ENDED SEPTEMBER 30, 2003
Interest Income				
Loans	$ 5,730	$ 3,345	$ 15,547	$ 9,957
Securities held to maturity:				
Taxable	23	23	75	141
Tax-exempt	64	54	182	154
Securities available for sale:				
Taxable	295	387	1,038	1,205

Tax-exempt	131	119	401	355
Deposits with banks and federal funds sold	8	54	25	83
Total interest income	6,251	3,982	17,268	11,895
Interest Expense				
Deposits	980	697	2,632	2,261
Other borrowings	170	127	474	358
Total interest expense	1,150	824	3,106	2,619
Net Interest Income	5,101	3,158	14,162	9,276
Provision for credit losses	300	--	670	--
Net interest income after provision for credit losses	4,801	3,158	13,492	9,276
Non-interest Income				
Service charges	326	235	951	763
Gain on sale of loans	330	30	719	30
Mortgage loan origination fees	2	48	12	89
Gain on sale of foreclosed real estate	--	38	51	160
Gain on sale of investments held for sale	--	--	3	4
Other operating income	234	188	630	521
Total non-interest income	892	539	2,366	1,440
Non-interest Expense				
Salaries and employee benefits	2,185	1,206	5,890	3,519
Occupancy and equipment	425	240	1,136	718
Other	1,032	557	2,821	1,607
Total non-interest expense	3,642	2,003	9,847	5,844
Income before income taxes	2,051	1,694	6,011	4,872
Provision for income taxes	616	500	1,775	1,415
Net Income	$ 1,435	$ 1,194	$ 4,236	$ 3,457
Comprehensive Income	$ 1,783	$ 791	$ 4,020	$ 3,274
Earnings per common share:				
Basic	$ .45	$ .48	$ 1.40	$ 1.38
Diluted	.44	.47	1.37	1.35
Average shares outstanding:				
Basic	3,176,457	2,512,669	3,030,292	2,512,665
Diluted	3,258,064	2,564,017	3,098,150	2,553,785

Condensed Consolidated Statements of Cash Flows
Nine months ended September 30, 2004 and 2003
(Dollars in thousands)

	2004 (UNAUDITED)	2003 (UNAUDITED)
OPERATING ACTIVITIES		

Net income	$ 4,236	$ 3,457
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	670	--
Depreciation and amortization	821	306
Deferred income tax (benefit)	(292)	--
Stock dividends received	(48)	(38)
Origination of loans held for sale	(52,572)	--
Proceeds of loans held for sale	48,046	286
Gain on sales of loans	(719)	(30)
Gain on sale of investment securities	(3)	(4)
Gain on sale of foreclosed real estate	(51)	(33)
Gain on sale of premises and equipment	--	(2)
(Increase) decrease in accrued interest receivable	(308)	31
Increase (decrease) in accrued interest payable	41	(83)
Write-down of foreclosed real estate	--	173
Other	116	(494)
Net cash provided by (used in) operating activities	(63)	3,569
INVESTING ACTIVITIES		
Net (increase) decrease in federal funds	5,000	(5,590)
(Increase) decrease in interest bearing deposits with banks	14,076	(6,940)
Purchase of securities held to maturity	(1,169)	(1,654)
Purchase of securities available for sale	(3,062)	(18,467)
Proceeds from maturities of investments held to maturity	1,088	3,126
Proceeds from sales of securities available for sale	19,060	2,994
Proceeds from maturities of securities available for sale	6,482	8,597
Net increase in loans	(14,850)	(11,007)
Proceeds from sales of loans	(5,735)	1,795
Additions to foreclosed real estate	--	(21)
Proceeds from sales of foreclosed real estate	414	642
Additions to premises and equipment	(2,138)	(167)
Proceeds from sales of premises and equipment	--	2
Purchase of bank owned life insurance	(2,500)	--
Acquisition, net of cash received	3,146	--
Net cash provided by (used in) investing activities	19,812	(26,690)
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	(818)	27,500
Net decrease in short-term borrowings	(20,134)	(1,800)
Proceeds from issuance of long-term debt	7,000	3,500
Repayments of long-term debt	(2,000)	--
Stock options exercised	378	--
Payment of dividends	(3,530)	(3,392)
Net cash provided by (used in) financing activities	(19,104)	25,808
Net increase in cash and due from banks	645	2,687
CASH AND DUE FROM BANKS		
Beginning of period	9,280	8,473
End of period	$ 9,925	$11,160
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash payments for:		

Interest	$ 2,995	$ 2,702
Income Taxes	1,174	1,728

SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING ACTIVITIES

Foreclosed real estate acquired in settlement of loans	$ (349)	$(1,127)
Financed sale of foreclosed real estate	--	154
Change in fair value of securities available for sale, net of tax	216	(183)
Common stock issued upon business combination	17,282	--

Condensed Consolidated Statements of Shareholders' Equity
Nine months ended September 30, 2004 and 2003
(Dollars in thousands) (Unaudited) ACCUMULATED

	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	OTHER COMPREHENSIVE INCOME (LOSS)	TOTAL
Balance December 31, 2002	$2,513	$ 9,839	$11,614	$717	$24,683
Other comprehensive income:					
Net income			3,457		3,457
Change in fair value of securities available for sale, net				(183)	(183)
Comprehensive income					3,274
Balance September 30, 2003	$2,513	$ 9,839	$15,071	$534	$27,957
Balance December 31, 2003	$2,522	$10,005	$12,663	$460	$25,650
Issuance of common stock	636	16,646			17,282
Stock options exercised	26	352			378
Stock option expense		30			30
Tax benefit from exercise of options		75			75
Other comprehensive income:					
Net income			4,236		4,236
Change in fair value of securities available for sale, net				(216)	(216)
Comprehensive income					4,020
Balance September 30, 2004	$3,184	$27,108	$16,899	$244	$47,435

NOTES TO FINANCIAL STATEMENTS

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared by Pacific Financial Corporation ("Pacific" or the "Company") in accordance with accounting principles generally accepted in the United States of America for interim financial information and with instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2004, are not necessarily indicative of the results anticipated for the year ending December 31, 2004. Certain information and footnote disclosures included in the Company's consolidated financial statements for the year ended December 31, 2003, have been condensed or omitted from this report. Accordingly, these statements should be read with the financial statements and notes thereto included in the Company's December 31, 2003 Annual Report on Form 10-K.

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

All dollar amounts in tables, except per share information, are stated in thousands.

2. Investment Securities

Investment securities consist principally of short and intermediate term debt instruments issued by the U.S. Treasury, other U.S. government agencies, state and local government units, and other corporations.

SECURITIES HELD TO MATURITY	AMORTIZED COST	UNREALIZED GAINS	UNREALIZED LOSSES	FAIR VALUE
September 30, 2004				
U.S. Government Securities	$ 1,899	$ 44	$ --	$ 1,943
State and Municipal Securities	6,138	73	20	6,191
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TOTAL	$8,037	$117	$20	$ 8,134

SECURITIES AVAILABLE FOR SALE	AMORTIZED COST	UNREALIZED GAINS	UNREALIZED LOSSES	FAIR VALUE
September 30, 2004				
U.S. Government Securities	$16,012	$135	$150	$15,997
State and Municipal Securities	14,656	417	44	15,029
Corporate Securities	4,102	93	2	4,193
Mutual Funds	3,986	--	81	3,905
	-------	----	----	-------
TOTAL	$38,756	$645	$277	$39,124

3. Allowance for Credit Losses

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,		TWELVE MONTHS ENDED DECEMBER 31,
	2004	2003	2004	2003	2003

Balance at beginning of period	$3,761	$2,350	$2,238	$2,473	$2,473
BNW Bancorp, Inc. acquisition	--	--	1,172	--	--
Provision for possible credit losses	300	--	670	--	--
Charge-offs	(7)	(16)	(36)	(141)	(265)
Recoveries	6	19	16	21	30
Net charge-offs	(1)	3	(20)	(120)	(235)
Balance at end of period	$4,060	$2,353	$4,060	$2,353	$2,238
Ratio of net charge-offs to average loans outstanding	.00%	.00%	.01%	.07%	.12%

4. Computation of Basic Earnings per Share:

	THREE MONTHS ENDED SEPTEMBER 30, 2004	2003	NINE MONTHS ENDED SEPTEMBER 30, 2004	2003
Net Income	$1,435,000	$1,194,000	$4,236,000	$3,457,000
Average Shares Outstanding	3,176,457	2,512,669	3,030,292	2,512,665
Basic Earnings Per Share	$ .45	$ .48	$ 1.40	$ 1.38

5. Computation of Diluted Earnings Per Share:

	THREE MONTHS ENDED SEPTEMBER 30, 2004	2003	NINE MONTHS ENDED SEPTEMBER 30, 2004	2003
Net Income	$1,435,000	$1,194,000	$4,236,000	$3,457,000
Average Shares Outstanding	3,176,457	2,512,669	3,030,292	2,512,665
Effect of dilutive securities	81,607	47,013	67,858	34,828
Average Shares Outstanding and Assumed conversion of dilutive Stock options	3,258,064	2,564,017	3,098,150	2,553,785
Diluted Earnings Per Share	$ 0.44	$ 0.47	$ 1.37	$ 1.35

6. Equity Compensation Plans

At September 30, 2004, the Company had a stock-based employee compensation plan. The Company accounts for the plan under recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. No stock-based employee compensation cost is reflected in net income, other than the $30,000 expensed in the current period for accelerated vesting on retiring director options, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share had the Company applied the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

	THREE MONTHS ENDED SEPTEMBER 30, 2004	2003	NINE MONTHS ENDED SEPTEMBER 30, 2004	2003
Net Income, as reported	$1,435,000	$1,194,000	$4,236,000	$3,457,000
Add stock compensation expensed	6,000	--	30,000	--
Less total stock-based compensation expense determined under fair value method for all qualifying awards, net of tax	39,000	22,000	118,000	66,000
Pro forma net income	1,402,000	1,172,000	4,148,000	2,391,000
Earnings per Share				
Basic:				
As reported	.45	.48	1.40	1.38
Pro forma	.44	.47	1.37	1.35
Diluted:				
As reported	.44	.47	1.37	1.35
Pro forma	.43	.46	1.34	1.33

7. Acquisition

On February 27, 2004, the Company completed the acquisition of BNW Bancorp, Inc. Each share of BNW Bancorp, Inc. was exchanged for 0.85 shares of the Company's common stock resulting in the issuance of 636,562 new shares. The acquisition was accounted for using the purchase method of accounting and, accordingly, the assets and liabilities of BNW Bancorp, Inc. were recorded at their respective fair value. Goodwill, the excess of the purchase price over the net fair value of the assets and liabilities acquired, was recorded at $10,651,000. As part of the accounting for the acquisition, the Company recorded a core deposit identifiable intangible asset of $993,000. The allocation of the purchase price will be adjusted as necessary if more current information becomes known to management.

The Company will follow the provisions of SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 provides that goodwill is no longer amortized and the value of an identifiable intangible asset is amortized over its useful life, unless the asset is determined to have an indefinite life. The Company will review the recorded value of goodwill on an annual basis for impairment. The annual test for impairment will be a two step process. The first step will be to compare the current value of BNW Bancorp, Inc. with its fair value on the purchase date. If the current value exceeds the purchase value, goodwill will not be considered to be impaired and the test is completed. If the current value is less than purchase value, the Company will perform an analysis of goodwill and appropriate impairment losses will be taken at that time.

The core deposit intangible recorded as part of the acquisition has an estimated life of seven years. Estimated amortization expense will be approximately

$118,000 for the year ended December 31, 2004 and $142,000 for the years ended December 31, 2005 through 2010 and $23,000 for the year ended December 31, 2011.

The following unaudited pro forma financials for the three and nine months ended September 30, 2004 and 2003 assume that the BNW acquisition occurred as of January of each fiscal year, after giving effect to certain adjustments. The pro forma results have been prepared for comparative purposes only and are not necessarily indicative of the results of operations which may occur in the future or that would have occurred had the BNW acquisition been consummated on the date indicated.

	Pro Forma Financial Information for the Nine Months Ended September 30, 2004	2003
	(in thousands)	
Net Interest Income	$15,053	$12,960
Non-interest Income	2,479	2,505
Non-interest Expense	11,294	9,452
Net Income	$ 3,857	$ 3,885
Earnings Per Share:		
Basic	$ 1.22	$ 1.21
Diluted	1.19	1.19

	Pro Forma Financial Information for the Three Months Ended September 30, 2004	2003
	(in thousands)	
Net Interest Income	$ 5,101	$ 4,467
Non-interest Income	892	897
Non-interest Expense	3,642	3,272
Net Income	$ 1,435	$ 1,349
Earnings Per Share:		
Basic	$ 0.45	$ 0.41
Diluted	$ 0.44	0.40

8. Commitments and Contingencies

The Company entered into a purchase and sale agreement during the third quarter for property located in Lynden, WA. The purpose of the land purchase is to construct a new full service branch facility which will provide a full range of deposit services, commercial, real estate and agriculture lending services. The Company estimates the total cost upon completion to be $815,985.00.

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

A Warning About Forward-Looking Information

This document contains forward-looking statements that are subject to risks and uncertainties. These statements are based on the 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 key employees, and/or maintain our interest margins and fee income;

2. changes in the interest rate environment that may reduce margins or decrease the value of our securities;

3. our recent acquisition of BNW Bancorp may be dilutive to earnings per share if we do not realize expected cost savings or successfully integrate BNW Bancorp into the Company without significant customer or employee disruptions or losses;

4. our growth strategy, particularly if accomplished through acquisitions, 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;

5. general economic or business conditions, either nationally or in the regions in which we do business, may be less favorable than expected, resulting in, among other things, a deterioration in credit quality or a reduced demand for credit; and

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

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

Net income. For the three months ended September 30, 2004, Pacific's net income was $1,435,000 compared to $1,194,000 for the same period in 2003. For the nine months ended September 30, 2004, net income was $4,236,000 compared to $3,457,000 for the same period in 2003. The most significant factor contributing to the increase was the acquisition of BNW Bancorp ("BNW") effective as of the close of business on February 27, 2004. We expect the BNW acquisition to continue to have a significant effect on net income for the remainder of the year 2004 due to strong loan demand in both new and historical markets served by Bank of the Pacific ("Bank"), the Company's wholly owned banking subsidiary.

Net interest income. Net interest income for the three and nine months ended September 30, 2004 increased $1,943,000, or 61.5%, and $4,886,000 or 52.7%, respectively, compared to the same periods in 2003.

This is due primarily to increased interest income from loans and the effect of the BNW acquisition at the end of February 2004. The Company acquired $109,569,000 of net loans as part of the BNW acquisition. The portfolio consisted of approximately $79,700,000 in real estate loans, $25,600,000 in commercial loans and $4,269,000 in consumer loans, the average yield on the portfolio was approximately 6.83% at September 30, 2004.

Interest income for the three and nine months ended September 30, 2004, increased $2,269,000, or 57.0%, and $5,373,000, or 45.2%, respectively, compared to the same period in 2003. Average total loans outstanding for the nine months ended September 30, 2004, and September 30, 2003, were $329,483,000, and $185,911,000, respectively, or an increase of 77.2% in 2004 over 2003.

Interest expense for the three and nine months ended September 30, 2004 increased $326,000, or 39.6%, and $487,000, or 18.6%, respectively, compared to the same period in 2003. The increase is primarily attributable to increased short term borrowings. Average interest-bearing deposit balances for the nine months ended September 30, 2004 and September 30, 2003 were $277,151,000 and $196,058,000, respectively, representing an increase of 41.4% compared to last year's period. The increase is attributable primarily to the BNW acquisition closed February 27, 2004. The Company acquired deposits valued at $88,853,000 as part of the acquisition. The deposit composition consists of approximately $15,600,000 in non-interest bearing accounts, $33,800,000 in certificates of deposit, and approximately $39,400,000 in other savings deposits with an average cost of total deposits of 1.39% at September 30, 2004.

Average short term borrowings for the nine months ended September 30, 2004 and September 30, 2003 were $8,468,000 and none, respectively, an increase of 100.0% over the 2003 period. The increase was applied primarily to funding the loan commitments outstanding for the BNW acquisition. Average long term borrowings for the nine months ended September 30, 2004 were $17,427,000 compared to $13,926,000 for the same period in 2003.

Provision and allowance 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 credit 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 at September 30, 2004.

Periodic provisions for credit 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. For additional information, please see the discussion under the heading "Critical Accounting Policy" in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2003.

During the three and nine months ended September 30, 2004, a provision of $300,000 and $670,000, respectively, was provided for possible credit losses, compared to no provision in the same periods in 2003. For the three and nine months ended September 30, 2004, net charge-offs were $1,000, and $20,000, respectively, compared to a net recovery of $3,000 and net charge-offs of $120,000, during the same periods in 2003, and compared to $235,000 in net charge-offs during the twelve months ended December 31, 2003.

At September 30, 2004, the allowance for credit losses stood at $4,060,000 compared to $2,238,000 at December 31, 2003, and $2,353,000 at September 30, 2003. Approximately $1,172,000 of this increase was attributable to the BNW acquisition and a provision of $670,000 was allocated to the allowance for credit losses as a result of continued growth in the loan portfolio. The ratio of the allowance to total loans outstanding was 1.21%, 1.12% and 1.27%, respectively, at September 30, 2004, December 31, 2003, and September 30, 2003.

Non-performing assets and foreclosed real estate owned. Non-performing assets totaled $1,052,000 at September 30, 2004. This represents .31% of total loans, compared to $563,000 or .28% at December 31, 2003, and $1,494,000 or .77% at September 30, 2003. The increase during the period ended September 30, 2004, is due primarily to a commercial loan that is guaranteed 100% by the USDA and was subsequently paid off in October 2004. Non-accrual loans at September 30, 2004 totaled $456,000. Based on current analysis, management believes losses associated with non-accrual loans will be minimal. Foreclosed real estate consists of two properties secured by real estate with no individual material balances.

ANALYSIS OF NON-PERFORMING ASSETS

(in thousands)	SEPTEMBER 30 2004	DECEMBER 31 2003	SEPTEMBER 30 2003
Accruing loans past due 90 days or more	$ 512	$ --	$ --
Non-accrual loans	456	465	596
Foreclosed real estate	84	98	898

TOTAL	$1,052	$563	$1,494

Non-interest income and expense. Non-interest income for the three and nine months ended September 30, 2004 increased $353,000, and $926,000, respectively, compared to the same period in 2003. The primary reasons for the increases were additional service charge income and

gain on sale of loans. Service charges on deposit accounts increased $91,000, and $188,000, respectively, compared to the three and nine months ended September 30, 2003. This is due in part to the implementation of the Bank's customer overdraft protection program in the branches acquired with the BNW transaction. Gain on sale of loans totaled $330,000 for the three months ended September 30, 2004, and totaled $719,000 for the nine month period in 2004. Prior to 2004, the Company did not sell loans into the secondary market. However, a real estate mortgage department was included with the BNW acquisition, resulting in revenues relating to gain on sale of loans. Commitment to sell and sale price is established at the time of origination of loans to limit any potential price risk.

Non-interest expense for the three and nine months ended September 30, 2004 increased $1,639,000, or 81.8%, and $4,003,000, or 68.5%, respectively, compared to the same periods in 2003. The BNW acquisition was the major contributing factor to increased non-interest expense due to the increase of full time equivalent employees, the addition of five branches, and expenses incurred in connection with the acquisition.

Income taxes. The federal income tax provision for the three and nine months ended September 30, 2004 was $616,000, and $1,775,000, respectively, an increase of $116,000 for the three month period, and an increase of $360,000, for the nine month period, compared to the same periods in 2003. The effective tax rate for the three and nine months ended September 30, 2004 was 30.03% and 29.53%.

Financial Condition. Total assets were $423,339,000 at September 30, 2004, an increase of $116,624,000, or 38.1%, over year-end 2003. Loans, including loans held for sale, were $336,017,000 at September 30, 2004, an increase of $136,279,000, or 68.2%, over year-end 2003. Total deposits were $348,072,000 at September 30, 2004, an increase of $87,272,000, or 33.46%, compared to December 31, 2003. Increases in assets, loans and deposit balances were primarily the result of the BNW acquisition, although the Company did see growth in each category in its historical markets.

Loans. Loan detail by category, including loans held for sale, as of September 30, 2004 and December 31, 2003 follows:

	September 30, 2004	December 31, 2003
Commercial and industrial	$ 86,475	$ 59,665
Agricultural	20,018	4,679
Real estate mortgage	172,644	117,940
Real estate construction	45,310	11,894
Installment	8,810	4,625
Credit cards and other	2,760	935
Total Loans	336,017	199,738
Allowance for credit losses	(4,060)	(2,238)
Net Loans	$331,957	$197,500

Liquidity. Adequate liquidity is available to accommodate fluctuations in deposit levels, fund operations, and provide for customer credit needs and meet obligations and commitments on a timely basis. The Company has generally been a net seller of federal funds. When necessary, liquidity can be increased by taking advances available from the Federal Home Loan Bank of Seattle.

Shareholders' equity. Total shareholders' equity was $47,435,000 at September 30, 2004, an increase of $21,785,000, or 84.9%, compared to December 31, 2003. The increase was due to net income and the acquisition of BNW Bancorp effective February 27, 2004, which was accounted for as a purchase transaction. Tangible book value per share was $11.55 at September 30, 2004 compared to $10.17 December 31, 2003. Tangible book value is calculated by dividing total equity capital minus goodwill, by total shares outstanding.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

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

It should be noted that the simulation model does not take into account future management actions that could be undertaken should actual market rates change during the year. Also, the model simulation results are not exact measures of the Company's actual interest rate risk. They are rather only indicators of rate risk exposure, based on assumptions produced in a simplified modeling environment designed to heighten sensitivity to changes in interest rates. The rate risk exposure results of the simulation model typically are greater than the Company's actual rate risk. That is due to the conservative modeling environment, which generally depicts a worst-case situation. Management has assessed the results of the simulation reports as of September 30, 2004, and believes that there has been no material change since December 31, 2003.

ITEM 4. CONTROLS AND PROCEDURES

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

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

PART II - OTHER INFORMATION

ITEM 6. EXHIBITS

See Exhibit Index immediately following signatures below.

SIGNATURES

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

PACIFIC FINANCIAL CORPORATION

DATED: November 10, 2004

By: /s/ Dennis A. Long

Dennis A. Long
President

By: /s/ John Van Dijk

John Van Dijk, Treasurer
(Principal Financial and Accounting Officer)

Exhibit Index

EXHIBIT NO.	EXHIBIT
31.1	Certification of CEO under Rule 13a - 14(a) of the Exchange Act.
31.2	Certification of CFO under Rule 13a - 14(a) of the Exchange Act.
32	Certification of CEO and CFO under 18 U.S.C. Section 1350.