PACIFIC FINANCIAL CORP
Form 10-Q
May 15, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2014

.. **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)	(I.R.S. Employer Identification No.)

1101 S. Boone Street

Aberdeen, Washington 98520-5244

(Address of principal executive offices) (Zip Code)

(360) 533-8870

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

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

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

The number of shares outstanding of Registrant's common stock as of April 30, 2014 was 10,182,083.

Form 10-Q

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PACIFIC FINANCIAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in Thousands, except per share data)
(UNAUDITED)

ASSETS

	March 31, 2014	December 31, 2013
Cash and cash equivalents:		
Cash and due from banks	$15,747	$12,214
Interest-bearing deposits in banks	19,872	23,734
Total cash and cash equivalents	35,619	35,948
Interest-bearing certificates of deposit (original maturities greater than 90 days)	2,727	2,727
Federal Home Loan Bank stock, at cost	2,985	3,013
Investment securities:		
Investment securities available-for-sale, at fair market value	95,129	96,144
Investment securities held-to-maturity, at amortized cost		
(fair value of $2,128 and $2,158)	2,110	2,132
Total investment securities	97,239	98,276
Loans held-for-sale	7,997	7,765
Loans, net of deferred loan fees	518,552	504,666
Allowance for loan losses	(8,288)	(8,359)
Loans, net	510,264	496,307
Premises and equipment, net of accumulated depreciation and amortization	16,706	16,790
Other real estate owned and foreclosed assets	2,386	2,771
Accrued interest receivable	2,423	2,307
Cash surrender value of life insurance	18,349	18,237
Goodwill	12,168	12,168
Other intangible assets	1,471	1,481
Other assets	7,106	7,249
TOTAL ASSETS	$717,440	$705,039

LIABILITIES AND SHAREHOLDERS' EQUITY
LIABILITIES

Deposits:		
Demand	$152,916	$145,028
Interest-bearing demand and savings	342,008	336,260
Time deposits	125,532	126,059
Total deposits	620,456	607,347
Accrued interest payable	166	167
Long-term borrowings	10,000	10,000
Junior subordinated debentures	13,403	13,403
Other liabilities	4,820	6,985
Total liabilities	648,845	637,902
COMMITMENTS AND CONTINGENCIES (Note 7)		
SHAREHOLDERS' EQUITY		
Common Stock, par value $1		
25,000,000 shares authorized, 10,182,083 shares issued and outstanding		
at 03/31/2014 and 12/31/2013	10,182	10,182
Additional paid-in-capital	41,852	41,817
Retained earnings	17,535	16,507
Accumulated other comprehensive income/(loss)	(974)	(1,369)
Total shareholders' equity	68,595	67,137
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$717,440	$705,039

See accompanying notes.

PACIFIC FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(Dollars in Thousands, Except per Share Data)
(UNAUDITED)

	For the Three Months Ended	
	March 31, 2014	March 31, 2013
INTEREST AND DIVIDEND INCOME		
Loans	$6,495	$5,873
Deposits in banks and federal funds sold	21	28
Investment securities:		
Taxable	339	104
Tax-exempt	229	266
FHLB dividends	1	0
Total interest and dividend income	7,085	6,271
INTEREST EXPENSE		
Deposits:		
Interest-bearing demand and savings	141	199
Time	276	367
Long-term borrowings	60	61
Junior subordinated debentures	53	62
Total interest expense	530	689
Net interest income	6,555	5,582
LOAN LOSS PROVISION	-	-
Net interest income after loan loss provision	6,555	5,582
NON-INTEREST INCOME		
Service charges on deposit accounts	435	410
Net gains (loss) on sale of other real estate owned	(36)	(20)
Net gains from sales of loans	627	1,509
Net gains on sales of securities available for sale	52	58
Net other-than-temporary impairment (net of $15 and $10, respectively recognized other comprehensive income before taxes)	(45)	-
Earnings on bank owned life insurance	111	121
Other operating income	464	548
Total non-interest income	1,608	2,626
NON-INTEREST EXPENSE		

Salaries and employee benefits	4,055	4,386
Occupancy	506	413
Equipment	252	191
Data processing	433	430
Professional services	185	262
Other real estate owned write-downs	12	352
Other real estate owned operating costs	61	84
State taxes	97	117
FDIC and state assessments	134	136
Other non-interest expense	1,095	1,048
Total non-interest expense	6,830	7,419
INCOME BEFORE PROVISION FOR INCOME TAXES	1,333	789
PROVISION FOR INCOME TAXES	305	88
NET INCOME APPLICABLE TO COMMON SHAREHOLDERS	$1,028	$701
EARNINGS PER COMMON SHARE:		
BASIC	$0.10	$0.07
DILUTED	$0.10	$0.07
WEIGHTED AVERAGE SHARES OUTANDING:		
BASIC	10,182,083	10,121,853
DILUTED	10,272,341	10,162,075

See accompanying notes.

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PACIFIC FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in Thousands)
(UNAUDITED)

	March 31, 2014	March 31, 2013
NET INCOME	$1,028	$701
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX:		
Change in fair value of securities available-for-sale	366	(129)
Defined benefit plan	29	28
Total other comprehensive income (loss), net of tax	395	(101)
COMPREHENSIVE INCOME	$1,423	$600

See accompanying notes.

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PACIFIC FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Dollars in Thousands, Except Share Amounts)
(UNAUDITED)

	Common Stock				Accumulated Other	Total
	Shares	Amount	Additional Paid-in Capital	Retained Earnings	Comprehensive Income/(Loss)	Shareholders' Equity
BALANCE - December 31, 2012	10,121,853	$ 10,122	$ 41,366	$ 14,812	$ 421	$ 66,721
Net income	-	-		701	-	701
Other comprehensive income, net of tax						
Unrealized holding loss on securities less reclassification adjustments for net gains included in net income	-	-	-	-	(129)	(129)
Amortization of unrecognized prior service costs and net gains/(losses)	-	-	-	-	28	- 28
Stock-based compensation expense	-	-	17	-	-	17
BALANCE - March 31, 2013	10,121,853	$ 10,122	$ 41,383	$ 15,513	$ 320	$ 67,338
BALANCE - December 31, 2013	10,182,083	$ 10,182	$ 41,817	$ 16,507	$ (1,369)	$ 67,137
Net income	-	-		1,028	-	1,028
Other comprehensive income, net of tax						
Unrealized holding gain on securities less reclassification adjustments for net gains included in net income	-	-	-	-	366	366
Amortization of unrecognized prior service costs and net gains/(losses)	-	-	-	-	29	- 29
Stock-based compensation expense	-	-	35	-	-	35
BALANCE - March 31, 2014	10,182,083	$ 10,182	$ 41,852	$ 17,535	$ (974)	$ 68,595

See accompanying notes.

PACIFIC FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)
(UNAUDITED)

	March 31, 2014	March 31, 2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income	$1,028	$701
Adjustments to reconcile net income to net cash from operating activities		
Depreciation and amortization	467	516
Originations of loans held for sale	(27,065)	(85,244)
Proceeds from sales of loans held for sale	27,460	87,702
Net gains on sales of loans	(627)	(1,509)
Net gain on sales of securities available for sale	(52)	(58)
Net OTTI recognized in earnings	45	-
(Gain) loss on sales of other real estate owned	36	20
(Gain) loss on sale of premises and equipment	(11)	-
Earnings on bank owned life insurance	(111)	(121)
(Increase) decrease in accrued interest receivable	(116)	(279)
Increase (decrease) in accrued interest payable	(1)	(8)
Other real estate owned write-downs	12	352
(Increase) decrease in prepaid expenses	(159)	97
Other -- net	(39)	(37)
Net cash provided by operating activities	867	2,132
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (increase) decrease in interest bearing balances with banks	3,862	6,867
Purchase of certificates of deposits held for investment, net	-	750
Activity in securities available for sale:		
Sales	4,849	1,171
Maturities, prepayments and calls	2,237	2,923
Purchases	(5,741)	(13,681)
Activity in securities held to maturity:		
Maturities	22	18
Purchases	-	-
(Increase) decrease in loans made to customers, net of principal collections	(13,959)	(23,288)
Purchases of premises and equipment	(81)	(792)
Proceeds from sales of other real estate owned	396	368
Proceeds from sales of premises and equipment	8	-
Net cash provided by (used in) investing activities	(8,407)	(25,664)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	13,109	20,952

Net decrease in short-term borrowings	-	(3,000)
Proceeds from issuance of long-term debt	-	2,500
Cash dividends paid	(2,036)	-
Net cash provided by financing activities	11,073	20,452
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	3,533	(3,080)
CASH AND DUE FROM BANKS - BEGINNING OF THE PERIOD	12,214	14,168
CASH AND DUE FROM BANKS - END OF THE PERIOD	$15,747	$11,088
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid for interest	$531	$697
Cash paid for taxes	$330	$80
SUPPLEMENTAL SCHEDULE OF NON CASH INVESTING AND FINANCING ACTIVITIES		
Change in fair value of securities available-for-sale, net of tax	$366	$(129)
Transfer of loans held for sale to loans held for investment	$-	$64
Other real estate owned acquired in settlement of loans	$(111)	$(209)
Financed sale of other real estate owned	$52	$-

See accompanying notes.

PACIFIC FINANCIAL CORPORATION

Notes to Condensed Consolidated Financial Statements

As of and for the 3 months ended March 31, 2014

(Unaudited)

(Dollars in thousands, except per share amounts)

NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization – Pacific Financial Corporation (the "Company" or "Pacific") is a bank holding company headquartered in Aberdeen, Washington. The Company owns one bank, Bank of the Pacific (the "Bank"), which is also located in Washington. The Company was incorporated in the State of Washington in February, 1997, pursuant to a holding company reorganization of the Bank.

The Company conducts its banking business through the Bank, which operates 16 branches located in communities in Grays Harbor, Pacific, Whatcom, Skagit and Wahkiakum counties in the state of Washington and three in Clatsop County, Oregon. In addition, the Bank operates three loan production offices in Burlington, Dupont and Vancouver, Washington and has a residential real estate mortgage department. During second quarter 2013, the Bank completed the acquisition of three branches from Sterling Savings Bank. Total deposits assumed were $37,634,000 and loans acquired totaled $3,989,000. Of the three branches purchased, two were consolidated into existing Pacific branches to maximize branch efficiencies resulting in one new branch in Astoria, Oregon. Separately, the Company opened a full-service branch in Warrenton, Oregon in October 2013 that further expands operations on the northern Oregon coast.

The accompanying unaudited condensed consolidated financial statements have been prepared by Pacific Financial Corporation ("Pacific" or the "Company") in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with instructions to Form 10-Q. Accordingly, these financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of Management, adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2014, are not necessarily indicative of the results anticipated for the year ending December 31, 2014. Certain information and footnote disclosures included in the Company's consolidated financial statements for the year ended December 31, 2013, have been condensed or omitted from this report. Accordingly, these statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 (the "2013 Annual Report").

Basis of presentation – The consolidated financial statements include the accounts of Bank of the Pacific and its wholly-owned subsidiary. All intercompany accounts and transactions have been eliminated in consolidation.

The interim consolidated financial statements are not audited, but include all adjustments that Management considers necessary for a fair presentation of consolidated financial condition and results of operations for the interim periods presented.

Method of accounting and use of estimates – The Company prepares its consolidated financial statements in conformity with accounting principles generally accepted in the United States of America and prevailing practices within the banking industry. This requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of income and expenses during the reporting periods. Actual results could differ from those estimates. Significant estimates made by Management involve the calculation of the allowance for loan losses, impaired loans, the fair value of available-for-sale investment securities, deferred tax assets, and the value of other real estate owned and foreclosed assets.

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

In preparing these financial statements, the Company has evaluated events and transactions subsequent to March 31, 2014, for potential recognition or disclosure in the financial statements. In Management's opinion, all accounting adjustments necessary to accurately reflect the financial position and results of operations on the accompanying financial statements have been made. These adjustments include normal and recurring accruals considered necessary for a fair and accurate presentation.

Cash dividends – No cash dividends were declared in the quarter ended March 31, 2014.

NOTE 2 – EARNINGS PER SHARE

The Company's basic earnings per common share is computed by dividing net income available to common shareholders (net income less dividends declared by the weighted average number of common shares outstanding during the period). The Company's diluted earnings per common share is computed similar to basic earnings per common share except that the numerator is equal to net income (available to common shareholders) and the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. Included in the denominator are the dilutive effects of stock options computed under the treasury stock method and outstanding warrants as if converted to common stock.

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

	Three Months Ended March 31,	
	2014	2013
Basic:		
Net income	$1,028	$701
Weight average shares outstanding	10,182,083	10,121,853
Basic earnings per share	$0.10	$0.07
Diluted:		
Net income	$1,028	$701
Weight average shares outstanding	10,182,083	10,121,853
Effect of dilutive stock options	90,258	40,222
Weighted average shares outstanding assuming dilution	10,272,341	10,162,075
Diluted earnings per share	$0.10	$0.07

	March 31, 2014	March 31, 2013
Shares subject to outstanding options	395,895	470,140
Shares subject to outstanding warrants	638,920	699,642

As of March 31, 2014 and 2013, the shares subject to outstanding options and the shares subject to outstanding warrants had exercise prices in excess of the current market value. All of these shares are not included in the table above, as exercise of these options and warrants would not be dilutive to shareholders.

NOTE 3 – INVESTMENT SECURITIES

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

Investment securities at March 31, 2014 and December 31, 2013 consisted of the following:
(Dollars in Thousands)

	March 31, 2014			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Available-for-sale:				
Collateralized mortgage obligations: agency issued	$38,417	$ 202	$ 1,052	$37,567
Collateralized mortgage obligations: non-agency	2,158	-	184	1,974
Mortgage-backed securities: agency issued	13,284	24	276	13,032
U.S. Government and agency securities	9,843	52	67	9,828
State and municipal securities	32,264	911	447	32,728
Corporate bonds	-	-	-	-
Total available-for-sale	$95,966	$ 1,189	$ 2,026	$95,129
Held-to-maturity:				
Mortgage-backed securities: agency issued	$150	$ 13	$ -	$163
State and municipal securities	1,960	5	-	1,965
Total held-to-maturity	$2,110	$ 18	$ -	$2,128

	December 31, 2013			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Available-for-sale:				
Collateralized mortgage obligations: agency issued	$39,791	$ 246	$ 1,246	$38,791
Collateralized mortgage obligations: non agency	2,251	3	243	2,011
Mortgage-backed securities: agency issued	13,671	21	303	13,389
U.S. Government agency securities	8,859	34	82	8,811
State and municipal securities	31,973	774	587	32,160
Corporate bonds	991	-	9	982

Total available-for-sale	$97,536	$ 1,078	$ 2,470	$96,144
Held-to-maturity:				
Mortgage-backed securities: agency issued	$159	$ 13	$ -	$172
State and municipal securities	1,973	13	-	1,986
Total held-to-maturity	$2,132	$ 26	$ -	$2,158

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 March 31, 2014, and December 31, 2013, are summarized as follows:

(Dollars in Thousands)

	Less than 12 months		12 months or more		Total	
At March 31, 2014	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-sale:						
Collateralized mortgage obligations: agency issued	$21,280	$ 599	$8,128	$ 453	$29,408	$ 1,052
Collateralized mortgage obligations: non agency	392	16	1,583	168	1,975	184
Mortgage-backed securities: agency issued	7,301	212	3,076	64	10,377	276
U.S. Government agency securities	5,617	67	-	-	5,617	67
State and municipal securities	9,332	315	2,558	132	11,890	447
Corporate bonds	-	-	-	-	-	-
Total	$43,922	$ 1,209	$15,345	$ 817	$59,267	$ 2,026

	Less than 12 months		12 months or more		Total	
At December 31, 2013	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-sale:						
Collateralized mortgage obligations: agency issued	$21,043	$ 778	$6,265	$ 468	$27,308	$ 1,246
Collateralized mortgage obligations: non agency	389	27	1,619	216	2,008	243
Mortgage-backed securities: agency issued	7,752	218	2,643	85	10,395	303
U.S. Government agency securities	5,550	82	-	-	5,550	82
State and municipal securities	11,551	485	1,821	102	13,372	587
Corporate bonds	982	9	-	-	982	9
Total	$47,267	$ 1,599	$12,348	$ 871	$59,615	$ 2,470

At March 31, 2014, there were 76 investment securities in an unrealized loss position, of which 22 were in a continuous loss position for 12 months or more. The unrealized losses on these securities were caused by changes in interest rates, widening pricing spreads and market illiquidity, leading to a decline in the fair value subsequent to their purchase. The Company has evaluated the securities shown above and anticipates full recovery of amortized cost with respect to these securities at maturity or sooner in the event of a more favorable market environment. Based on management’s evaluation, and because the Company does not have the intent to sell these securities and it is not more likely than not that it will have to sell the securities before recovery of cost basis, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2014, except as described below with respect to one non-agency MBS.

For non-agency MBS the Company estimates expected future cash flows of the underlying collateral, together with any credit enhancements. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which considers current delinquencies, future expected default rates and collateral value by vintage) and prepayments. The expected cash flows of the security are then discounted to arrive at a present value amount. For the three months ended March 31, 2014 and 2013, one non-agency MBS was determined to be other-than-temporarily-impaired resulting in the Company recording $45 and $0, respectively, in impairments related to credit losses through earnings.

The following table presents the cash proceeds from the sales of securities and their associated gross realized gains and gross realized losses that are included in earnings for the three months ended March 31, 2014 and 2013:

Investment securities gross gains and losses

(Dollars in Thousands)

	For the Three Months Ended	
	March 31, 2014	March 31, 2013
Gross realized gain on sale of securities	$62	$58
Gross realized loss on sale of securities	(10)	-
Net realized gain on sale of securities	$52	$58
Proceeds from sale of securities	$4,849	$1,171

The Company did not engage in originating subprime mortgage loans, and it does not believe that it has material exposure to subprime mortgage loans or subprime mortgage backed securities. Additionally, the Company does not own any sovereign debt of Eurozone nations or structured financial products, such as collateralized debt obligations or structured investment vehicles, which are known by the Company to have elevated risk characteristics.

The amortized cost and estimated fair value of investment securities at March 31, 2014, by maturity are shown below. The amortized cost and fair value of collateralized mortgage obligations and mortgage-backed securities are presented by expected average life, rather than contractual maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to prepay underlying loans without prepayment penalties.

At March 31, 2014
(Dollars in Thousands)

	Held-to-maturity		Available-for-sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$190	$191	$1,090	$1,091
Due after one year through five years	-	-	9,684	9,648
Due after five years through ten years	907	910	10,533	10,630
Due after ten years	863	863	20,798	21,187
Mortgage-backed securities	150	164	53,861	52,573
Total investment securities	$2,110	$2,128	$95,966	$95,129

At March 31, 2014, investment securities with an estimated fair value of $58.6 million were pledged to secure public deposits, certain nonpublic deposits and borrowings.

As required of all members of the Federal Home Loan Bank ("FHLB") system, the Company maintains an investment in the capital stock of the FHLB in an amount equal to the greater of $500 or 0.5% of home mortgage loans and pass-through securities plus 5.0% of the outstanding balance of mortgage home loans sold to FHLB under the Mortgage Purchase Program. The FHLB system, the largest government sponsored entity in the United States, is made up of 12 regional banks, including the FHLB of Seattle. Participating banks record the value of FHLB stock equal to its par value at $100 per share. At March 31, 2014, the Company held approximately $3.0 million in FHLB stock.

The Company is required to hold FHLB's stock in order to receive advances and views this investment as long-term. Thus, when evaluating it for impairment, the value is determined based on the recovery of the par value through redemption by the FHLB or from the sale to another member, rather than by recognizing temporary declines in value. The FHLB of Seattle disclosed that it reported net income for the twelve month period ended December 31, 2013. On November 22, 2013, the FHLB of Seattle entered into an amended Stipulation and Consent to the Issuance of a Consent Order with the Federal Housing Finance Agency ("Finance Agency"), modifying the previous order issued on October 25, 2010. The Finance Agency now deems the FHLB of Seattle to be "adequately capitalized", under the Finance Agency's Prompt Corrective Action rule. The Company has concluded that its investment in FHLB is not impaired as of March 31, 2014, and believes that it will ultimately recover the par value of its investment in this stock.

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NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY

Loans

Loans held in the portfolio at March 31, 2014 and December 31, 2013, are as follows:

(Dollars in Thousands)	March 31, 2014	December 31, 2013
Commercial and agricultural	$101,971	$104,111
Real estate:		
Construction and development	30,765	29,096
Residential 1-4 family	89,244	87,762
Multi-family	18,982	17,520
Commercial real estate -- owner occupied	112,771	105,594
Commercial real estate -- non owner occupied	119,803	117,294
Farmland	22,940	23,698
Consumer/Finance	23,156	20,728
Gross loans	519,632	505,803
Less: deferred fees	(1,080)	(1,137)
Portfolio Loans	$518,552	$504,666

Allowance for losses and credit quality

The allowance for loan losses represents the Company's estimate as to the probable credit losses inherent in its loan portfolio. The allowance for loan losses is increased through periodic charges to earnings through provision for loan losses and represents the aggregate amount, net of loans charged-off and recoveries on previously charged-off loans, that is needed to establish an appropriate reserve for credit losses. The allowance is estimated based on a variety of factors and using a methodology as described below:

- The Company classifies loans into relatively homogeneous pools by loan type in accordance with regulatory guidelines for regulatory reporting purposes. The Company regularly reviews all loans within each loan category to establish risk ratings for them that include Pass, Watch, Special Mention, Substandard, Doubtful and Loss. Pursuant to "Accounting by Creditors for Impairment of a Loan", the impaired portion of collateral dependent loans is charged-off. Other risk-related loans not considered impaired have loss factors applied to the various loan pool balances to establish loss potential for provisioning purposes.

- Analyses are performed to establish the loss factors based on historical experience, as well as expected losses based on qualitative evaluations of such factors as the economic trends and conditions, industry conditions, levels and trends in delinquencies and impaired loans, levels and trends in charge-offs and recoveries, among others. The loss factors are applied to loan category pools segregated by risk classification to estimate the loss inherent in the Company's loan portfolio pursuant to "Accounting for Contingencies."

- Additionally, impaired loans are evaluated for loss potential on an individual basis in accordance with "Accounting by Creditors for Impairment of a Loan," and specific reserves are established based on thorough analysis of collateral values where loss potential exists. When an impaired loan is collateral dependent and a deficiency exists in the fair value of collateral securing the loan in comparison to the associated loan balance, the deficiency is charged-off at that time or a specific reserve is established. Impaired loans are reviewed no less frequently than quarterly.

- In the event that a current appraisal to support the fair value of the real estate collateral underlying an impaired loan has not yet been received, but the Company believes that the collateral value is insufficient to support the loan amount, an impairment reserve is recorded. In these instances, the receipt of a current appraisal triggers an updated review of the collateral support for the loan and any deficiency is charged-off or reserved at that time. In those instances where a current appraisal is not available in a timely manner in relation to a financial reporting cut-off date, the Company discounts the most recent third-party appraisal depending on a number of factors including, but not limited to, property location, local price volatility, local economic conditions, and recent comparable sales. In all cases, the costs to sell the subject property are deducted in arriving at the fair value of the collateral.

Changes in the allowance for credit losses for the three months ended March 31, 2014 and 2013 were as follows:

Allowance for Credit Losses and Recorded Investment in Financing Receivables

Dollars in Thousands	Commercial	Commercial Real Estate ("CRE")	Residential Real Estate	Consumer	Unallocated	Total
For the three months ended March 31, 2014						
Allowance for credit losses:						
Beginning balance	$ 775	$ 3,506	$ 675	$ 744	$ 2,659	$ 8,359
Charge-offs and concessions	(17)	(7)	(40)	(18)	-	(82)
Recoveries	1	5	4	1	-	11
Provision / (recapture)	(15)	(99)	(35)	(47)	196	-
Ending balance	$ 774	$ 3,603	$ 674	$ 774	$ 2,463	$ 8,288
Ending balance: individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -
Ending balance: collectively evaluated for impairment	$ 774	$ 3,603	$ 674	$ 774	$ 2,463	$ 8,288
Loans:						
Ending balance	$ 101,971	$ 286,279	$ 108,226	$ 23,156	$ -	$ 519,632
Ending balance: individually evaluated for impairment	$ 418	$ 8,710	$ 771	$ 53	$ -	$ 9,952
Ending balance: collectively evaluated for impairment	$ 101,553	$ 277,569	$ 107,455	$ 23,103	$ -	$ 509,680
Less deferred fees						$ (1,080)
Ending balance total loans						$ 518,552

Allowance for Credit Losses and Recorded Investment in Financing Receivables

Residential

Dollars in Thousands	Commercial	Commercial Real Estate ("CRE")	Real Estate	Consumer	Unallocated	Total
For the three months ended March 31, 2013						
Allowance for credit losses:						
Beginning balance	$ 923	$ 4,098	$ 829	$ 531	$ 2,977	$ 9,358
Charge-offs and concessions	-	(5)	(10)	(11)	-	(26)
Recoveries	10	5	-	1	-	16
Provision / (recapture)	(222)	(355)	(32)	21	588	-
Ending balance	$ 711	$ 3,743	$ 787	$ 542	$ 3,565	$ 9,348
Ending balance: individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -
Ending balance: collectively evaluated for impairment	$ 711	$ 3,743	$ 787	$ 542	$ 3,565	$ 9,348
Loans:						
Ending balance	$ 96,642	$ 275,600	$ 87,921	$ 12,023	$ -	$ 472,186
Ending balance: individually evaluated for impairment	$ 1,574	$ 12,137	$ 1,265	$ -	$ -	$ 14,976
Ending balance: collectively evaluated for impairment	$ 95,068	$ 263,463	$ 86,656	$ 12,023	$ -	$ 457,210
Less deferred fees						$ (1,015)
Ending balance total loans						$ 471,171

Credit Quality Indicators

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

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

The Bank also classifies some loans as “Pass” or Other Loans Especially Mentioned (“OLEM”). Within the Pass classification certain loans are “Watch” rated because they have elements of risk that require more monitoring than other performing loans. Pass grade loans include a range of loans from very high credit quality to acceptable credit quality. These borrowers generally have strong to acceptable capital levels and consistent earnings and debt service capacity. Loans with higher grades within the Pass category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Overall, loans with a Pass grade show no immediate loss exposure. Loans classified as OLEM continue to perform but have shown deterioration in credit quality and require close monitoring.

(Dollars in Thousands)
Credit quality indicators as of March 31, 2014 and December 31, 2013 were as follows:

March 31, 2014	Pass	Other Loans Especially Mentioned	Substandard	Doubtful	Total
Commercial and agricultural	$94,808	$ 6,316	$ 847	$ -	$101,971
Real estate:					
Construction and development	29,437	50	1,278	-	30,765
Residential 1-4 family	85,739	728	2,777	-	89,244
Multi-family	18,709	273	-	-	18,982
Commercial real estate -- owner occupied	107,823	844	4,104	-	112,771
Commercial real estate -- non owner occupied	99,830	13,275	6,698	-	119,803
Farmland	19,493	2,442	1,005	-	22,940
Total real estate	361,031	17,612	15,862	-	394,505
Consumer/Finance	23,006	65	85	-	23,156
Less deferred fees	-	-	-	-	(1,080)
Total loans	$478,845	$ 23,993	$ 16,794	$ -	$518,552

December 31, 2013	Pass	Other Loans Especially Mentioned	Substandard	Doubtful	Total
Commercial and agricultural	$100,262	$ 2,858	$ 991	$ -	$104,111
Real estate:					
Construction and development	26,587	1,101	1,408	-	29,096
Residential 1-4 family	84,407	554	2,801	-	87,762
Multi-family	17,520	0	0	-	17,520
Commercial real estate -- owner occupied	100,612	1,019	3,963	-	105,594
Commercial real estate -- non owner occupied	98,044	16,752	2,498	-	117,294
Farmland	20,228	2,464	1,006	-	23,698
Total real estate	347,398	21,890	11,676	-	380,964
Consumer/Finance	20,570	62	96	-	20,728
Less deferred fees	-	-	-	-	(1,137)
Total loans	$468,230	$ 24,810	$ 12,763	$ -	$504,666

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Impaired Loans

Impaired loans by type as of March 31, 2014, and interest income recognized for the three months ended March 31, 2014, were as follows:

(Dollars in Thousands)	Unpaid Principal Balance	Recorded Investment	Related Allowance	3 Month Average Recorded Investment	3 Month Interest Income Recognized
March 31, 2014					
With no Related Allowance:					
Commercial	$ 457	$ 418	$ -	$ 503	$ 7
Consumer	53	53	-	53	-
Residential real estate	1,077	771	-	698	11
Commercial real estate:					
CRE -- owner occupied	1,917	1,915	-	1,814	-
CRE -- non owner occupied	6,759	4,562	-	4,571	8
Farmland	955	955	-	955	110
Construction and development	3,562	1,278	-	1,343	15
Total	$ 14,780	$ 9,952	$ -	$ 9,937	$ 151
With a Related Allowance:					
Consumer/Finance	$ -	$ -	$ -	$ -	$ -
Residential real estate	-	-	-	-	-
Total	$ -	$ -	$ -	$ -	$ -
Total Impaired Loans:					
Commercial	$ 457	$ 418	$ -	$ 503	$ 7
Consumer	53	53	-	53	-
Residential real estate	1,077	771	-	698	11
Commercial real estate:					
CRE -- owner occupied	1,917	1,915	-	1,814	-
CRE -- non owner occupied	6,759	4,562	-	4,571	8
Farmland	955	955	-	955	110
Construction and development	3,562	1,278	-	1,343	15
Total Impaired Loans	$ 14,780	$ 9,952	$ -	$ 9,937	$ 151

Impaired loans by type as of March 31, 2013, and interest income recognized for the three months ended March 31, 2013, were as follows:

(Dollars in Thousands)	Unpaid Principal Balance	Recorded Investment	Related Allowance	3 Month Average Recorded Investment	3 Month Interest Income Recognized
March 31, 2013					
With no Related Allowance:					
Commercial	$ 1,574	$ 1,574	$ -	$ 1,897	$ 2
Consumer	-	-	-	-	-
Residential real estate	1,572	1,265	-	1,067	4
Commercial real estate:					
CRE -- owner occupied	2,909	2,909	-	3,022	12
CRE -- non owner occupied	7,038	6,433	-	6,114	17
Farmland	4,107	1,840	-	1,816	20
Construction and development	955	955	-	966	-
Total	$ 18,155	$ 14,976	$ -	$ 14,882	$ 55
With a Related Allowance:					
Consumer	$ -	$ -	$ -	$ -	$ -
Residential real estate	-	-	-	-	-
Total	$ -	$ -	$ -	$	$ -
Total Impaired Loans:					
Commercial	$ 1,574	$ 1,574	$ -	$ 1,897	$ 2
Consumer	-	-	-	-	-
Residential real estate	1,572	1,265	-	1,067	4
Commercial real estate:					
CRE -- owner occupied	2,909	2,909	-	3,022	12
CRE -- non owner occupied	7,038	6,433	-	6,114	17
Farmland	4,107	1,840	-	1,816	20
Construction and development	955	955	-	966	-
Total Impaired Loans	$ 18,155	$ 14,976	$ -	$ 14,882	$ 55

Aging Analysis

The following tables summarize the Company's loans past due, both accruing and nonaccruing, by type as of March 31, 2014 and December 31, 2013:

(Dollars in Thousands)

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Non-accrual Loans	Current	Total Loans
March 31, 2014:							
Commercial and agricultural	$32	$ -	$ -	$32	$ 121	$101,818	$101,971
Real estate:							
Construction and development	-	-	-	-	1,277	29,488	30,765
Residential 1-4 family	150	30	-	180	547	88,517	89,244
Multi-family	-	-	-		-	18,982	18,982
Commercial real estate -- owner occupied	309	-	-	309	1,861	110,601	112,771
Commercial real estate -- non owner occupied	251	-	-	251	2,482	117,070	119,803
Farmland	-	-	-		955	21,985	22,940
Total real estate	710	30	-	740	7,122	386,643	394,505
Consumer/Finance	-	8	-	8	53	23,095	23,156
Less deferred fees	-	-	-	-	-	(1,080)	(1,080)
Total	$742	$ 38	$ -	$780	$ 7,296	$510,476	$518,552
December 31, 2013:							
Commercial and agricultural	$14	$ -	$ -	$14	$ 286	$103,811	$104,111
Real estate:							
Construction and development	-	-	-	-	1,408	27,688	29,096
Residential 1-4 family	333	-	-	333	400	87,029	87,762
Multi-family	-	-	-	-	-	17,520	17,520
Commercial real estate -- owner occupied	-	-	-	-	1,659	103,935	105,594
Commercial real estate -- non owner occupied	-	-	-	-	2,482	114,812	117,294
Farmland	875	-	-	875	955	21,868	23,698
Total real estate	1,208	-	-	1,208	6,904	372,852	380,964
Consumer/Finance	165	3	-	168	53	20,507	20,728
Less deferred fees	-	-	-	-	-	(1,137)	(1,137)

Total	$1,387	$ 3	$ -	$1,390	$ 7,243	$496,033	$504,666

Modifications

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

Loans modified in a TDR are typically already on non-accrual status and partial charge-offs have in some cases already been taken against the outstanding loan balance. Loans modified in a TDR for the Company may have the financial effect of increasing the specific allowance associated with the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the estimated fair value of the collateral, less any selling costs, if the loan is collateral dependent. The Company's practice is to re-appraise collateral dependent loans every six to nine months. During the three months ended March 31, 2014, there was no impact on the allowance from TDRs during the period, as the loans classified as TDRs during the period did not have a specific reserve and were already considered impaired loans at the time of modification and no further impairment was required upon modification.

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

The following table presents TDRs for the three months ended March 31, 2014 and 2013, all of which were modified due to financial stress of the borrower.

Restructured loans by type current and subsequently defaulted

(Dollars in Thousands)

	March 31, 2014					
	Current Restructured Loans			Subsequently Defaulted Restructured Loans		
	Number of Loans	Pre-TDR Outstanding Recorded Investment	Post-TDR Outstanding Recorded Investment	Number of Loans	Pre-TDR Outstanding Recorded Investment	Post-TDR Outstanding Recorded Investment
Commercial and agriculture	1	$ 335	$ 297	-	$ -	$ -
Construction and development	3					