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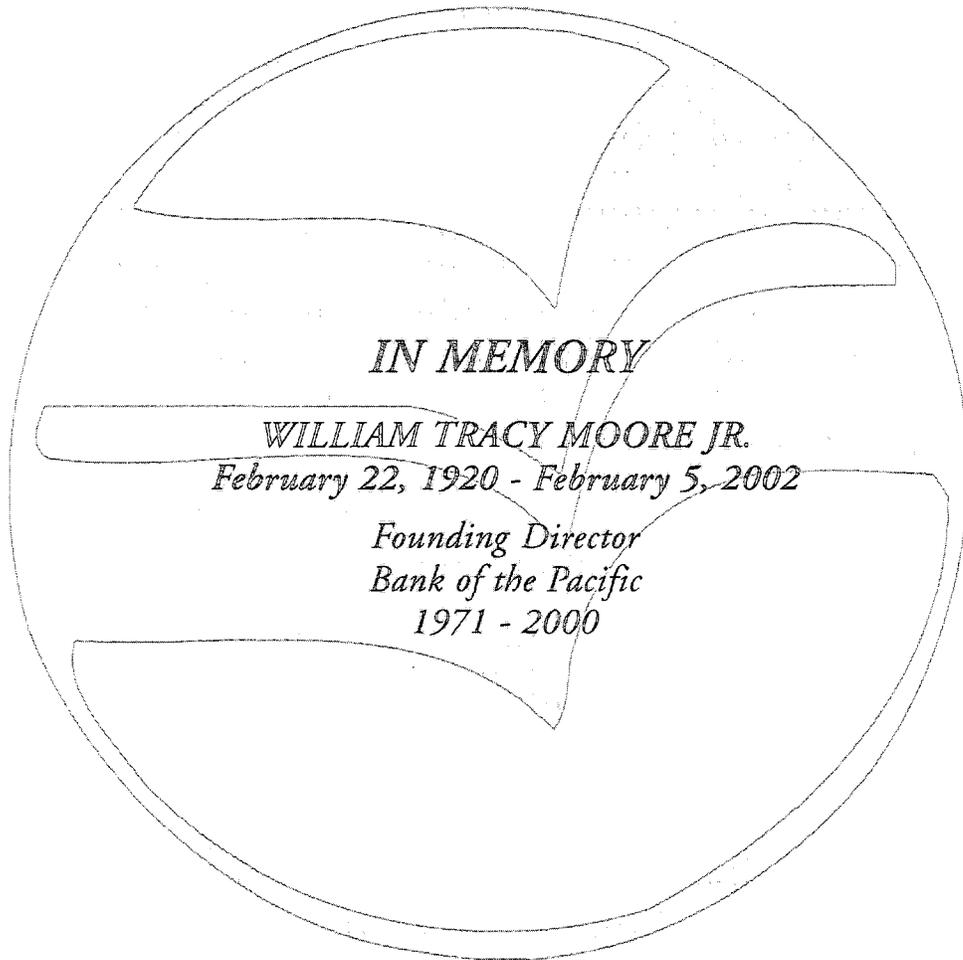
Pacific Financial Corporation

2001 ANNUAL REPORT

PROCESSED

MAR 28 2002

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FINANCIAL



IN MEMORY

WILLIAM TRACY MOORE JR.

February 22, 1920 - February 5, 2002

*Founding Director
Bank of the Pacific
1971 - 2000*

Introduction

Dear Shareholder:

Several changes occurred within our company during 2001. The most notable was the retirement of CEO, Bob Worrell, after 19 years of exemplary service. It was Bob's leadership that helped transform our Bank into a dominant financial services provider along the west coast of Washington. He continues as a valued director of our company, which has been a welcomed benefit to me as President. Other notable highlights included the addition of two new directors, Susan Freese, co-owner of Peninsula Pharmacies, and Randy Rognlin, co-owner of Rognlin, Inc. They became the youngest members of our board and serve to ensure an orderly transition of the Board, as members approach retirement age over the next two to three years.

Although rapidly declining interest rates squeezed margins, we began to realize some of the financial benefits associated with bringing the two Banks together. Net overhead, after adjusting for one time merger related expenses for 2000 and 2001, declined by nearly \$365,000 last year, and we see additional opportunities for more efficiency in 2002. Earnings for 2001 resulted in a Return on Average Assets of 1.55% and a Return on Beginning Equity of 16.8%, placing us among the top performing banks in the nation.

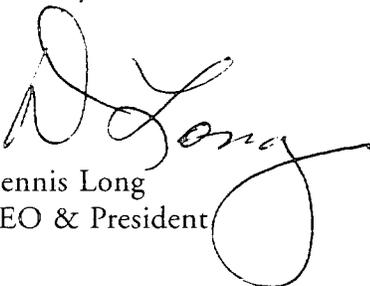
We increased the cash dividend by 4 cents per share and accomplished the name change, including new signage at all ten locations during the fourth quarter of 2001. Our newest product delivery channel, Internet Banking, was also introduced during the fourth quarter.

While net loan losses declined last year, we were not insulated from the weak economic environment that pushed us into the first recession in almost ten years. During the past two years, loan losses have been higher than our traditional levels. By banking industry standards, however, we perform at a superior level. We believe our sound underwriting practices minimized losses this past year and will serve to protect us in the years ahead.

As we look to the future, we see an economy that provides us with both challenges and opportunities. Fortunately, signs of improvement are already evident. We have knowledgeable managers and lenders who have experienced troubled economic times before. Because of our very strong capital position, coupled with diversified earnings and a quality staff, we are well positioned to successfully grow our Bank during the present decade.

I want to thank all the shareholders who have supported the merger of the two strong Banks. It went well because of great employees and the support of shareholders and customers. And to that end, it is our commitment to reward that allegiance with outstanding financial performance over the coming years.

Sincerely,



Dennis Long
CEO & President

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Independent Auditor's Report

Board of Directors
Pacific Financial Corporation
Aberdeen, Washington

We have audited the accompanying consolidated balance sheet of Pacific Financial Corporation and Subsidiary as of December 31, 2001, and the related consolidated statements of income, shareholders' equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The consolidated financial statements of Pacific Financial Corporation and Subsidiary as of and for the years ended December 31, 2000 and 1999 were audited by Knight Vale & Gregory PLLC, independent accountants, whose members became partners of McGladrey & Pullen, LLP on September 1, 2001. Knight Vale & Gregory PLLC's report, dated January 26, 2001, expressed an unqualified opinion on those statements.

We conducted our audit 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 consolidated 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 audit provides 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, 2001, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

McGladrey & Pullen, LLP

Tacoma, Washington
January 31, 2002

Consolidated Balance Sheets

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000
(Dollars in Thousands)

	<u>2001</u>	<u>2000</u>
Assets		
Cash and due from banks	\$ 10,231	\$ 8,619
Interest bearing deposits at other financial institutions	1,468	480
Federal funds sold	3,505	570
Securities available for sale	31,673	53,696
Securities held to maturity (market value \$4,942 and \$1,376)	4,945	1,376
Federal Home Loan Bank stock, at cost	3,813	3,562
Loans	176,604	177,168
Allowance for credit losses	2,109	2,026
Loans - net	174,495	175,142
Premises and equipment	4,014	4,122
Foreclosed real estate	1,040	-
Accrued interest receivable	1,405	2,302
Cash surrender value of life insurance	5,579	2,435
Other assets	<u>1,449</u>	<u>1,009</u>
Total assets	\$ 243,617	\$ 253,313
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Demand	\$ 38,437	\$ 32,510
Savings and interest-bearing demand	104,728	100,143
Time	71,479	80,858
Total deposits	214,644	213,511
Accrued interest payable	441	779
Short-term borrowings	-	11,358
Other liabilities	<u>5,018</u>	<u>4,922</u>
Total liabilities	220,103	230,570
Commitments and Contingencies	- -	- -
Shareholders' Equity		
Common stock (par value \$1); authorized: 25,000,000 shares; issued and outstanding: 2001 - 2,491,629 shares; 2000 - 2,503,130 shares	2,492	2,503
Additional paid-in capital	9,524	9,859
Retained earnings	11,090	10,572
Accumulated other comprehensive income (loss)	408	(191)
Total shareholders' equity	<u>23,514</u>	<u>22,743</u>
Total liabilities and shareholders' equity	\$ 243,617	\$ 253,313

See notes to consolidated financial statements.

Consolidated Statements of Income

Pacific Financial Corporation and Subsidiary
 Years Ended December 31, 2001, 2000 and 1999
 (Dollars in Thousands, Except Per Share Amounts)

	<u>2001</u>	<u>2000</u>	<u>1999</u>
Interest Income			
Loans	\$ 14,994	\$ 16,425	\$ 14,062
Federal funds sold and deposits in banks	410	148	570
Securities available for sale:			
Taxable	1,638	2,812	2,767
Tax exempt	545	567	675
Securities held to maturity - tax exempt	264	98	108
Federal Home Loan Bank stock dividends	<u>251</u>	<u>222</u>	<u>172</u>
Total interest income	18,102	20,272	18,354
Interest Expense			
Deposits	6,340	8,020	6,712
Short-term borrowings	<u>190</u>	<u>577</u>	<u>212</u>
Total interest expense	<u>6,530</u>	<u>8,597</u>	<u>6,924</u>
Net interest income	11,572	11,675	11,430
Provision for Credit Losses	580	635	60
Net interest income after provision for credit losses	10,992	11,040	11,370
Non-Interest Income			
Service charges on deposit accounts	828	677	745
Mortgage broker fees	32	9	36
Net gain on sales of securities available for sale	--	--	9
Other operating income	<u>669</u>	<u>531</u>	<u>465</u>
Total non-interest income	1,529	1,217	1,255
Non-Interest Expense			
Salaries and employee benefits	4,058	4,135	3,871
Occupancy	409	388	367
Equipment	554	751	646
State taxes	227	228	235
Data processing	214	229	97
Other	<u>1,731</u>	<u>1,799</u>	<u>1,795</u>
Total non-interest expense	<u>7,193</u>	<u>7,530</u>	<u>7,011</u>
Income before income taxes	5,328	4,727	5,614
Income Taxes	<u>1,521</u>	<u>1,424</u>	<u>1,692</u>
Net income	\$ 3,807	\$ 3,303	\$ 3,922
Earnings Per Share			
Basic	\$1.53	\$1.33	\$1.60
Diluted	1.52	1.31	1.59

See notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

Pacific Financial Corporation and Subsidiary
 Years Ended December 31, 2001, 2000 and 1999
 (Dollars in Thousands)

	Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance at December 31, 1998	488,969	\$ 489	\$10,972	\$ 9,656	\$ 368	\$21,485
Comprehensive income:						
Net income	--	--	--	3,922	--	3,922
Other comprehensive loss, net of tax:						
Change in fair value of securities available for sale	--	--	--	--	(1,320)	(1,320)
Comprehensive income						2,602
Stock options exercised	8,000	8	472	--	--	480
Repurchase of common stock fractional shares	(199)	--	(24)	--	--	(24)
Dividends on common stock (\$1.25 per share)	--	--	--	(3,105)	--	(3,105)
Balance at December 31, 1999	496,770	497	11,420	10,473	(952)	21,438
Comprehensive income:						
Net income	--	--	--	3,303	--	3,303
Other comprehensive income, net of tax:						
Change in fair value of securities available for sale	--	--	--	--	761	761
Comprehensive income						4,064
5-for-1 stock split	1,987,110	1,987	(1,987)	--	--	--
Stock options exercised	2,750	3	30	--	--	33
Stock purchase of branch site	16,500	16	396	--	--	412
Dividends on common stock (\$1.28 per share)	--	--	--	(3,204)	--	(3,204)
Balance at December 31, 2000	2,503,130	2,503	9,859	10,572	(191)	22,743
Comprehensive income:						
Net income	--	--	--	3,807	--	3,807
Other comprehensive income, net of tax:						
Change in fair value of securities available for sale	--	--	--	--	599	599
Comprehensive income						4,406
Stock options exercised	12,750	13	150	--	--	163
Repurchase of common stock	(24,281)	(24)	(486)	--	--	(510)
Issuance of common stock	30	--	1	--	--	1
Dividends on common stock (\$1.32 per share)	--	--	--	(3,289)	--	(3,289)
Balance at December 31, 2001	2,491,629	\$2,492	\$ 9,524	\$11,090	\$ 408	\$23,514

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Pacific Financial Corporation and Subsidiary
 Years Ended December 31, 2001, 2000 and 1999
 (Dollars in Thousands)

	<u>2001</u>	<u>2000</u>	<u>1999</u>
Cash Flows from Operating Activities			
Net income	\$ 3,807	\$ 3,303	\$ 3,922
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	423	568	496
Provision for credit losses	580	635	60
Deferred income tax (benefit)	225	(81)	(34)
Stock dividends received	(251)	(222)	(172)
Gain on sales of securities available for sale	--	--	(9)
Gain (loss) on sales of foreclosed real estate	--	(32)	2
(Increase) decrease in interest receivable	897	(298)	(140)
Increase (decrease) in interest payable	(338)	230	66
Write down of foreclosed real estate	18	--	--
Other - net	<u>(915)</u>	<u>485</u>	<u>(229)</u>
Net cash provided by operating activities	4,446	4,588	3,962
Cash Flows from Investing Activities			
Net (increase) decrease in interest bearing deposits in banks	(988)	1,264	4,645
Net increase in federal funds sold	(2,935)	(570)	12,595
Activity in securities available for sale:			
Sales	10,694	--	1,478
Maturities, prepayments and calls	36,987	12,062	27,560
Purchases	(24,828)	(2,423)	(43,322)
Activity in securities held to maturity:			
Maturities	190	239	210
Purchases	(1,123)	--	(100)
Proceeds from sales of loans	1,407	1,293	468
Increase in loans made to customers, net of principal collections	(5,165)	(26,133)	(5,921)
Purchases of premises and equipment	(509)	(764)	(310)
Proceeds from sales of premises and equipment	50	--	--
Proceeds from sales of foreclosed real estate	161	--	26
Purchase of bank owned life insurance	<u>(3,000)</u>	<u>--</u>	<u>--</u>
Net cash provided by (used in) investing activities	10,941	(15,032)	(2,671)
Cash Flows from Financing Activities			
Net increase (decrease) in deposits	1,133	7,372	(4,511)
Net increase (decrease) in short-term borrowings	(11,358)	1,683	9,589
Proceeds from issuance of long-term debt	3,000	--	--
Repayments of long-term debt	(3,000)	--	--
Common stock issued	164	33	480
Cash dividends paid	(3,204)	(3,105)	(2,379)
Repurchase of common stock and fractional shares	<u>(510)</u>	<u>--</u>	<u>(24)</u>
Net cash provided by (used in) financing activities	(13,775)	5,983	3,155
Net change in cash and due from banks	1,612	(4,461)	4,446
Cash and Due from Banks			
Beginning of year	<u>8,619</u>	<u>13,080</u>	<u>8,634</u>
End of year	\$ 10,231	\$ 8,619	\$ 13,080

(continued)

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Pacific Financial Corporation and Subsidiary
Years Ended December 31, 2001, 2000 and 1999
(Dollars in Thousands)

	<u>2001</u>	<u>2000</u>	<u>1999</u>
Supplemental Disclosures of Cash Flow Information			
Interest paid	\$ 6,868	\$ 8,367	\$ 6,858
Income taxes paid	1,375	1,247	1,750
Supplemental Disclosures of Non-Cash Investing Activities			
Fair value adjustment of securities available for sale, net of tax	\$ 599	\$ 761	\$ (1,320)
Transfer of loans to foreclosed real estate	1,733	26	74
Stock purchase of branch site	--	412	--
Financed sales of foreclosed real estate	514	235	--
Reclassification of loan receivable to securities available for sale	2,636	--	--

(concluded)

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

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. The Bank provides loan and deposit services to customers, who are predominately small- and middle-market businesses and middle-income individuals in western Washington.

Consolidated Financial Statement Presentation

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles 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 to conform to the 2001 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, and certain equity securities. 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)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

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.

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 non-accrual loans are applied to reduce the principal balance. The interest on these loans is accounted for on the cash-basis method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Credit Losses

The allowance for credit losses is maintained at a level considered adequate to provide for estimated losses on existing loans based on evaluating known and inherent risks in the loan portfolio. The allowance is reduced by loans charged off, and increased by provisions charged to earnings and recoveries on loans previously charged off. The allowance is based on management's periodic, systematic evaluation of factors underlying the quality of the loan portfolio, including changes in the size and composition of the loan portfolio, the estimated value of any underlying collateral, actual loan loss experience, current economic conditions, and detailed analysis of individual loans for which full collectibility may not be assured. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. While management uses the best information available to make its estimates, future adjustments to the allowance may be necessary if there is a significant change in economic conditions.

When available information confirms that specific loans or portions thereof are uncollectible, these amounts are charged off 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 evidenced 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.

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 1 - Summary of Significant Accounting Policies *(continued)*

Allowance for Credit Losses *(concluded)*

When management determines that it is probable that a borrower will be unable to repay all amounts due according to the terms of the loan agreement, including scheduled interest payments, the loan is considered impaired. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls are generally not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of shortfall in relation to the principal and interest owed. The amount of impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, when the primary source of repayment is provided by real estate collateral, at the fair value of the collateral less estimated selling costs.

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 for in the financial statements.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation, which is computed on a 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 are charged to income.

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.

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 1 - Summary of Significant Accounting Policies *(continued)*

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. The deferred tax provision represents the difference between the net deferred tax asset/liability at the beginning and end of the year. 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.

Stock-Based Compensation

The Company accounts for stock-based awards to employees using the intrinsic value method, in accordance with APB No. 25, *Accounting for Stock Issued to Employees*. Accordingly, no compensation expense has been recognized in the financial statements for employee stock arrangements. However, the required pro forma disclosures of the effects of all options granted on or after January 1, 1995 have been provided in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*.

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 financial statements:

Cash and Short-Term Instruments

The carrying amounts of cash and short-term instruments approximate their fair value.

Securities Available for Sale and Held to Maturity

Fair values for securities are based on quoted market prices.

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 analyses, 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.

Deposits

The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable rate, fixed term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation based on interest rates currently being offered on similar certificates.

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 1 - Summary of Significant Accounting Policies *(continued)*

Fair Values of Financial Instruments *(concluded)*

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.

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.

Cash and Cash Equivalents

The Company considers all amounts included in the balance sheets caption "Cash and due from banks" to be cash equivalents.

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 exclude dilution and are 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.

Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board adopted Financial Accounting Standards Nos. 141, *Business Combinations*, and 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires that all business combinations entered into after June 30, 2001 be accounted for under the purchase method. SFAS No. 142 addresses how goodwill and other intangible assets should be accounted for after they have been initially recorded in the financial statements. Goodwill arising from business combinations prior to the effective date of this standard will no longer be amortized, starting in 2002, but will be subject to annual tests for impairment. Other identifiable intangible assets, and certain unidentifiable intangible assets arising from certain acquisitions, will continue to be amortized using the same lives and methods. In June 2001, the FASB also issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This statement is effective for all fiscal years beginning after June 15, 2002. In August 2001 the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This statement is effective for fiscal years beginning after December 15, 2001. The Company does not anticipate that the adoption of SFAS Nos. 141, 142, 143, and 144 will have a material effect on its financial position or results of operations.

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

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. The average amounts of such balances for the years ended December 31, 2001 and 2000 were approximately \$2,878 and \$2,575, respectively.

Note 3 - Securities

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities Available for Sale				
December 31, 2001				
U.S. Treasury and Government agency securities	\$ 3,517	\$ 134	\$ --	\$ 3,651
Obligations of states and political subdivisions	11,359	355	1	11,713
Mortgage-backed securities	3,255	22	56	3,221
Corporate bonds	8,859	170	14	9,015
Mutual funds	<u>4,065</u>	<u>8</u>	<u>--</u>	<u>4,073</u>
	\$ 31,055	\$ 689	\$ 71	\$ 31,673
December 31, 2000				
U.S. Treasury and Government agency securities	\$ 28,324	\$ 18	\$ 229	\$ 28,113
Obligations of states and political subdivisions	12,110	122	54	12,178
Corporate bonds	<u>13,552</u>	<u>18</u>	<u>165</u>	<u>13,405</u>
	\$ 53,986	\$ 158	\$ 448	\$ 53,696
Securities Held to Maturity				
December 31, 2001				
State and municipal securities	\$ 4,945	\$ --	\$ 3	\$ 4,942
December 31, 2000				
State and municipal securities	\$ 1,376	\$ --	\$ --	\$ 1,376

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 3 - Securities (concluded)

The contractual maturities of investment securities held to maturity and available for sale at December 31, 2001 are as follows:

	Held to Maturity		Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 15	\$ 15	\$ 4,829	\$ 4,919
Due from one year to five years	613	610	13,357	13,745
Due from five to ten years	595	595	2,897	2,973
Due after ten years	3,722	3,722	1,135	1,147
Mortgage-backed securities	--	--	4,772	4,816
Mutual funds	--	--	4,065	4,073
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total	\$ 4,945	\$ 4,942	\$ 31,055	\$ 31,673

Gross gains realized on sales of securities was \$9 in 1999. There were no security sales in 2001 and 2000.

Securities carried at approximately \$11,618 at December 31, 2001 and \$11,401 at December 31, 2000 were pledged to secure public deposits and for other purposes required or permitted by law.

Note 4 - Loans

Loans at December 31 consist of the following:

	<u>2001</u>	<u>2000</u>
Commercial and agricultural	\$ 72,427	\$ 68,827
Real estate:		
Construction	6,554	6,118
Residential 1-4 family	31,089	31,611
Multi-family	2,040	3,495
Commercial	54,894	59,236
Farmland	3,691	1,992
Consumer	<u>5,909</u>	<u>5,889</u>
	<u>\$176,604</u>	<u>\$ 177,168</u>

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 4 - Loans (concluded)

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

	<u>2001</u>	<u>2000</u>	<u>1999</u>
Balance at beginning of year	\$ 2,026	\$ 1,930	\$ 1,864
Provision for credit losses	580	635	60
Charge-offs	(564)	(568)	(134)
Recoveries	67	29	140
Net (charge-offs) recoveries	<u>(497)</u>	<u>(539)</u>	<u>6</u>
Balance at end of year	\$ 2,109	\$ 2,026	\$ 1,930

Following is a summary of information pertaining to impaired loans:

	<u>2001</u>	<u>2000</u>	<u>1999</u>
December 31			
Impaired loans without a valuation allowance	\$ 482	\$ 2,014	\$ 175
Impaired loans with a valuation allowance	<u>1,180</u>	<u>1,114</u>	<u>--</u>
Total impaired loans	\$ 1,662	\$ 3,128	\$ 175
Valuation allowance related to impaired loans	\$ 143	\$ 412	\$ --
Years Ended December 31			
Average investment in impaired loans	\$ 1,262	\$ 3,425	\$ 59
Interest income recognized on a cash basis on impaired loans	2	31	11

At December 31, 2001, there were no commitments to lend additional funds to borrowers whose loans have been modified. Loans 90 days and over past due and still accruing interest totaled \$79 and \$292 at December 31, 2001 and 2000, respectively.

Certain related parties of the Company, principally directors and their associates, were loan customers of the Bank in the ordinary course of business during 2001 and 2000. Total loans outstanding at December 31, 2001 and 2000 to key officers and directors were \$2,390 and \$2,751, respectively. During 2001, new loans of \$1,668 were made, and repayments totaled \$2,029.

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 5 - Premises and Equipment

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

	<u>2001</u>	<u>2000</u>
Land	\$ 1,125	\$ 1,125
Premises	3,884	3,733
Equipment, furniture and fixtures	4,026	4,297
	<u>9,035</u>	<u>9,155</u>
Less accumulated depreciation and amortization	<u>5,021</u>	<u>5,033</u>
Total premises and equipment	\$ 4,014	\$ 4,122

The Company purchased the property at its Montesano Branch in 2000 for 16,500 shares of the Company's stock.

Note 6 - Deposits

The composition of deposits at December 31 is as follows:

	<u>2001</u>	<u>2000</u>
Demand deposits, non-interest bearing	\$ 38,437	\$ 32,510
NOW and money market accounts	50,799	46,047
Savings deposits	53,929	54,112
Time certificates, \$100,000 or more	26,453	30,645
Other time certificates	<u>45,026</u>	<u>50,197</u>
Total	\$214,644	\$213,511

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

2002	\$ 58,402
2003	11,219
2004	1,325
2005	230
2006	<u>303</u>
	\$ 71,479

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 7 - Short-Term Borrowings

Short-term borrowings generally mature within one to four days from the transaction date. Information concerning short-term borrowings is summarized as follows for the years ended December 31:

	<u>2001</u>	<u>2000</u>
Average balance during the year	\$ 963	\$ 9,036
Average interest rate during the year	5.68%	6.39%
Maximum month-end balance during the year	\$ 7,580	\$ 11,358
Balance outstanding at year-end	\$ - -	\$ 11,358
Average interest rate at year-end	- -%	6.39%

Note 8 - Income Taxes

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

	<u>2001</u>	<u>2000</u>	<u>1999</u>
Current	\$ 1,296	\$ 1,505	\$ 1,726
Deferred (benefit)	225	(81)	(34)
Total income taxes	\$ 1,521	\$ 1,424	\$ 1,692

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

	<u>2001</u>	<u>2000</u>
Deferred Tax Assets		
Allowance for credit losses	\$ 626	\$ 597
Deferred compensation	230	247
Unrealized loss on securities available for sale	- -	98
Other	70	164
Total deferred tax assets	926	1,106
Deferred Tax Liabilities		
Unrealized gain on securities available for sale	210	- -
Depreciation	68	37
Deferred revenue	1,045	933
Total deferred tax liabilities	1,323	970
Net deferred tax assets (liabilities)	(\$ 397)	\$ 136

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 8 - Income Taxes (concluded)

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

	2001		2000		1999	
	Amount	Percent of Pre-tax Income	Amount	Percent of Pre-tax Income	Amount	Percent Pre-tax Income
Income tax at statutory rate	\$1,865	35.0%	\$1,654	35.0%	\$1,965	35.0%
Adjustments resulting from:						
Tax-exempt income	(272)	(5.1)	(236)	(5.0)	(261)	(4.6)
Net earnings on life insurance policies	(26)	(.5)	(36)	(.7)	(35)	(.6)
Non-deductible merger costs	--	--	--	--	106	1.9
Other	(46)	(.8)	42	.9	(83)	(1.6)
Total income tax expense	\$1,521	28.6%	\$1,424	30.2%	\$1,692	30.1%

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 \$355, \$490 and \$622 in 2001, 2000 and 1999, 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 \$115, \$94 and \$95 for 2001, 2000 and 1999, respectively.

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

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 \$304, \$297 and \$327 at December 31, 2001, 2000 and 1999, 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 \$2,555 and \$2,435 at December 31, 2001 and 2000, respectively. In 2001, 2000 and 1999, the net (benefit)/cost recorded from these plans, including the cost of the related life insurance, was (\$143), \$30 and (\$3), 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, \$312 and \$33 were made in 2001, 2000 and 1999, respectively.

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 \$8, \$22 and \$19 in 2001, 2000 and 1999, respectively. Covered employees may also contribute to the plan. The plan was terminated in early 2001.

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 in the balance sheets.

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 10 - Commitments and Contingencies *(concluded)*

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:

	<u>2001</u>	<u>2000</u>
Commitments to extend credit	\$ 23,262	\$ 18,480
Standby letters of credit	1,688	1,763

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 \$11,500, none of which was used at December 31, 2001. In addition, the Bank has a credit line with the Federal Home Loan Bank of Seattle totaling 10% of assets, none of which was used at December 31, 2001. These borrowings are collateralized under blanket pledge 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, 2001 the Bank's loans to companies in the hotel/motel industry totaled \$20,956 or 11.87% 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 million.

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 12 - Stock Options

At December 31, 2001, the Company had options outstanding or available for grant under three stock-based option plans, which are described below. The Company applies APB Opinion No. 25 and related interpretations in accounting for these plans. Accordingly, no compensation cost has been recognized for the plans. Had compensation cost for the Company's stock option plans been determined based on the fair value at the grant dates for awards granted since December 31, 1994 under these plans, consistent with the method of SFAS No. 123, the Company's net income and earnings per share would have been reduced to these pro forma amounts:

	<u>2001</u>	<u>2000</u>	<u>1999</u>
Net income:			
As reported	\$ 3,807	\$ 3,303	\$ 3,922
Pro forma	3,794	3,280	3,917
Earnings per share:			
Basic:			
As reported	\$ 1.53	\$ 1.33	\$ 1.60
Pro forma	1.52	1.32	1.60
Diluted:			
As reported	1.52	1.31	1.59
Pro forma	1.51	1.30	1.58

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, (374,000 shares are available for grant at December 31, 2001). Options become exercisable ratably over five years. Under the plan adopted in 2000, the Company may grant up to 75,000 shares of its common stock to a single individual in a calendar year.

The fair value of each option granted in 2001 and 1999 was estimated on the date of grant, based on the Black-Scholes option pricing model and using the following weighted-average assumptions. There were no options granted in 2000.

	<u>2001</u>	<u>1999</u>
Dividend yield	5.76%	4.63%
Expected life	10 years	10 years
Risk-free interest rate	4.92 - 5.19%	6.6%

The weighted average fair value of options granted during 2001 and 1999 were \$0 and \$2.87, respectively.

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 12 - Stock Option (concluded)

A summary of the status of the Company's stock option plans as of December 31, 2001, 2000 and 1999, and changes during the years ending on those dates, is presented below:

	2001		2000		1999	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	74,550	\$18.21	78,550	\$18.13	93,550	\$13.14
Granted	126,000	22.22	--	--	25,000	27.00
Exercised	(12,750)	12.82	(2,750)	12.00	(40,000)	12.00
Forfeited	(3,500)	25.63	(1,250)	27.00	--	--
Outstanding at end of year	184,300	\$21.19	74,550	\$18.21	78,550	\$18.13
Exercisable at end of year	32,165	\$14.40	34,030	\$13.65	13,390	\$12.00

The following information summarizes information about stock options outstanding and exercisable at December 31, 2001:

Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Number Exercisable
\$12.00	1,000	3	1,000
13.00	9,500	4	9,500
14.40	4,000	5	4,000
15.29	23,550	5	17,665
22.22	124,500	9	--
23.25	500	9	--
27.00	21,250	8	--
	184,300		32,165

Note 13 - Stock Transactions

In July 2000, the Board of Directors effected a 5-for-1 stock split. In addition, Board of Directors approved an increase in the number of authorized common shares from 5,000,000 to 25,000,000.

Per share information for prior periods has been adjusted to reflect the effect of the stock split.

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 14 - 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 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, 2001, 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, 2001, the Company and the Bank meet all capital requirements to which they are subject.

	Actual Amount	Ratio	Capital Adequacy Purposes Amount	Ratio	To be Well Capitalized Under Prompt Corrective Action Provisions Amount	Ratio
December 31, 2001						
<i>Tier 1 capital (to average assets):</i>						
Consolidated	\$23,106	9.49%	\$9,738	4.00%	N/A	N/A
Bank	23,077	9.48	9,738	4.00	\$12,173	5.00%
<i>Tier 1 capital (to risk-weighted assets):</i>						
Consolidated	23,106	12.27	7,459	4.00	N/A	N/A
Bank	23,077	12.02	7,681	4.00	11,521	6.00
<i>Total capital (to risk-weighted assets):</i>						
Consolidated	25,215	13.39	14,918	8.00	N/A	N/A
Bank	25,186	13.12	15,362	8.00	19,202	10.00

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 14 - Regulatory Matters (concluded)

	Actual Amount	Ratio	Capital Adequacy Purposes Amount	Ratio	To be Well Capitalized Under Prompt Corrective Action Provisions Amount	Ratio
December 31, 2000						
<i>Tier 1 capital (to average assets):</i>						
Consolidated	\$22,934	9.19%	\$9,986	4.00%	N/A	N/A
Bank	22,895	9.17	9,986	4.00	\$12,482	5.00%
<i>Tier 1 capital (to risk-weighted assets):</i>						
Consolidated	22,934	12.05	7,613	4.00	N/A	N/A
Bank	22,895	12.35	7,413	4.00	11,120	6.00
<i>Total capital (to risk-weighted assets):</i>						
Consolidated	24,960	13.11	15,226	8.00	N/A	N/A
Bank	24,921	13.45	14,827	8.00	18,533	10.00

Restrictions on Retained Earnings

The Bank is restricted from paying dividends to the Company in an amount that would violate the most restrictive capital requirement shown above. At December 31, 2001, there were no regulatory dividend restrictions on the Bank's retained earnings.

Note 15 - Fair Values of Financial Instruments

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

	2001		2000	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash and due from banks, interest-bearing deposits with banks, and federal funds sold	\$ 15,204	\$ 15,204	\$ 9,669	\$ 9,669
Securities available for sale	31,673	31,673	53,696	53,696
Securities held to maturity	4,945	4,942	1,376	1,376
Federal Home Loan Bank stock	3,813	3,813	3,562	3,562
Loans receivable	174,495	177,569	175,142	175,375
Accrued interest receivable	1,405	1,405	2,302	2,302
Financial Liabilities				
Deposits	\$ 214,644	\$ 214,914	\$ 213,511	\$ 213,682
Short-term borrowings	--	--	11,358	11,358
Accrued interest payable	441	441	779	779

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

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, 2001			
Basic earnings per share:			
Net income	\$3,807	2,491,426	\$1.53
Effect of dilutive securities:			
Options	--	18,576	(.01)
Diluted earnings per share:			
Net income	\$3,807	2,510,002	\$1.52
Year Ended December 31, 2000			
Basic earnings per share:			
Net income	\$3,303	2,492,326	\$1.33
Effect of dilutive securities:			
Options	--	20,493	(.02)
Diluted earnings per share:			
Net income	\$3,303	2,512,819	\$1.31
Year Ended December 31, 1999			
Basic earnings per share:			
Net income	\$3,922	2,447,729	\$1.60
Effect of dilutive securities:			
Options	--	23,783	(.01)
Diluted earnings per share:			
Net income	\$3,922	2,471,512	\$1.59

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.

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 17 - Condensed Financial Information - Parent Company Only

Condensed Balance Sheets - December 31

	<u>2001</u>	<u>2000</u>
Assets		
Cash	\$ 3,317	\$ 66
Investment in the Bank	23,485	22,703
Due from the Bank	-	3,178
Total assets	\$ 26,802	\$ 25,947
Liabilities and Shareholders' Equity		
Dividends payable	\$ 3,288	\$ 3,204
Shareholders' equity	23,514	22,743
Total liabilities and shareholders' equity	\$ 26,802	\$ 25,947

Condensed Statements of Income - Years Ended December 31

	<u>2001</u>	<u>2000</u>	<u>1999</u>
Dividend income from the Bank	\$ 3,670	\$ 3,275	\$ 3,010
Expenses	(46)	(151)	(377)
Equity in undistributed income of the Bank	183	179	1,289
Net income	\$ 3,807	\$ 3,303	\$ 3,922

(continued)

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

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

Condensed Statements of Cash Flows - Years Ended December 31

	<u>2001</u>	<u>2000</u>	<u>1999</u>
Operating Activities			
Net income	\$ 3,807	\$ 3,303	\$ 3,922
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed income of subsidiary	(183)	(179)	(1,289)
Other - net	<u>(1)</u>	<u>57</u>	<u>20</u>
Net cash provided by operating activities	3,623	3,181	2,653
Investing Activities			
(Increase) decrease in due from the Bank	3,178	(1,794)	--
Financing Activities			
Common stock issued	164	33	480
Dividends paid	(3,204)	(3,105)	(2,379)
Repurchase of common stock and fractional shares	<u>(510)</u>	<u>--</u>	<u>(24)</u>
Net cash used in financing activities	(3,550)	(3,072)	(1,923)
Net increase (decrease) in cash	3,251	(1,685)	730
Cash			
Beginning of year	<u>66</u>	<u>1,751</u>	<u>1,021</u>
End of year	\$ 3,317	\$ 66	\$ 1,751

Notes to Consolidated Financial Statements

Pacific Financial Corporation and Subsidiary
December 31, 2001 and 2000

Note 18 - Quarterly Data (Unaudited)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Year Ended December 31, 2001				
Interest income	\$4,985	\$4,671	\$4,401	\$ 4,045
Interest expense	2,151	1,766	1,539	1,074
Net interest income	2,834	2,905	2,862	2,971
Provision for credit losses	102	98	98	282
Non-interest income	314	346	442	427
Non-interest expenses	1,808	1,759	1,761	1,866
Income before income taxes	1,238	1,394	1,445	1,250
Income taxes	361	429	399	332
Net income	\$ 877	\$ 965	\$1,046	\$ 918
Earnings per common share:				
Basic	\$ 0.35	\$ 0.39	\$ 0.42	\$ 0.37
Diluted	0.35	0.38	0.42	0.36
Year Ended December 31, 2000				
Interest income	\$4,849	\$5,099	\$5,133	\$ 5,191
Interest expense	1,915	2,096	2,224	2,362
Net interest income	2,934	3,003	2,909	2,829
Provision for credit losses	53	52	98	432
Non-interest income	356	305	304	252
Non-interest expense	1,746	1,738	1,723	2,323
Income before income taxes	1,491	1,518	1,392	326
Income taxes	467	442	444	71
Net income	\$1,024	\$1,076	\$ 948	\$ 255
Earnings per common share:				
Basic	\$ 0.41	\$ 0.43	\$ 0.38	\$ 0.11
Diluted	0.41	0.43	0.38	0.09

Management's Discussion and Analysis of Financial Condition and Results of Operations

RESULTS OF OPERATIONS

Years ended December 31, 2001, 2000, and 1999

General. The Company's net income for 2001 was \$3,807,000, a 15.3% increase compared to \$3,303,000 in 2000, and a decrease of 2.9% from \$3,922,000 in 1999. Basic earnings per share were \$1.53, \$1.33, and \$1.60 for 2001, 2000, and 1999, respectively. Return on average assets was 1.55%, 1.34%, and 1.64%, in 2001, 2000, and 1999 respectively. Return on average equity was 15.57%, 14.95%, and 17.26%, respectively, in 2001, 2000, and 1999.

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, 2001.

(Dollars in thousands)	2001	Increase (Decrease)		2000	Increase (Decrease)		1999
		Amount	%		Amount	%	
Interest income	\$18,102	\$(2,170)	(10.7)	\$20,272	\$1,918	10.4	\$18,354
Interest expense	6,530	(2,067)	(24.0)	8,597	1,673	24.2	6,924
Net interest income	11,572	(103)	(.9)	11,675	245	2.1	11,430
Provision for credit losses	580	(55)	(8.7)	635	575	958.3	60
Net interest income after provision for credit losses	10,992	(48)	(.4)	11,040	(330)	(2.9)	11,370
Other operating income	1,529	312	25.6	1,217	(38)	(3.0)	1,255
Other operating expense	7,193	(337)	(4.5)	7,530	519	7.4	7,011
Income before income taxes	5,328	601	12.7	4,727	(887)	(15.8)	5,614
Income taxes	1,521	97	6.8	1,424	(268)	(15.8)	1,692
Net income	3,807	504	15.3	3,303	(619)	(15.8)	3,922

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.

Management's Discussion and Analysis

Year Ended December 31,	Average Balance	2001 Interest Income (Expense)	Avg Rate
Assets			
Earning assets:			
Loans	\$ 170,628	\$ 15,032*	8.81%
Investment securities:			
Taxable	27,360	1,638	5.99%
Tax-exempt	15,042	1,225*	8.14%
Total investment securities	42,402	2,863	6.75%
Federal funds sold and deposits in banks	<u>11,339</u>	<u>410</u>	<u>3.61%</u>
Total earning assets/interest income	224,369	18,305	8.16%
Cash and due from banks	8,448		
Premises and equipment (net)	4,104		
Other assets	10,479		
Allowance for credit losses	<u>(1,912)</u>		
Total assets	\$ 245,488		
Liabilities and Shareholders' Equity			
Interest bearing liabilities:			
Deposits:			
Savings and interest-bearing demand	\$ 105,846	(2,395)	2.26%
Time	75,819	(3,945)	5.20%
Total deposits	181,665	(6,340)	3.49%
Other borrowings	<u>3,065</u>	<u>(190)</u>	<u>6.20%</u>
Total interest-bearing liabilities/interest expense	184,730	(6,530)	3.53%
Demand deposits	33,419		
Other liabilities	2,888		
Shareholders' equity	<u>24,451</u>		
Total liabilities and shareholders' equity	\$ 245,488		
Net interest income		\$ 11,775	
Net Interest Income as a Percentage of Average Earning Assets			
Interest income			8.16%
Interest expense			2.91%
Net interest income			5.25%

*Tax equivalent basis - 34% tax rate used

Non-accrual loans are included in "loans".

Management's Discussion and Analysis

Average Balance	2000 Interest Income (Expense)	Avg Rate	Average Balance	1999 Interest Income (Expense)	Avg Rate
\$ 165,834	\$ 16,500*	9.95%	\$ 147,689	\$ 14,129*	9.57%
45,857	2,812	6.13%	51,439	2,987	5.81%
13,187	1,077*	8.17%	14,333	1,114	7.77%
59,044	3,889	6.59%	65,772	4,101	6.24%
<u>2,258</u>	<u>148</u>	<u>6.55%</u>	<u>10,476</u>	<u>570</u>	<u>5.44%</u>
227,136	20,537	9.04%	223,937	18,800	8.40%
8,784			8,599		
3,728			3,596		
8,897			5,303		
<u>(1,997)</u>			<u>(1,922)</u>		
\$ 246,548			\$ 239,513		
\$ 109,266	(4,483)	4.10%	\$ 112,452	(3,435)	3.05%
68,516	(3,537)	5.16%	65,524	(3,277)	5.00%
177,782	(8,020)	4.51%	177,976	(6,712)	3.77%
<u>8,876</u>	<u>(577)</u>	<u>6.50%</u>	<u>4,091</u>	<u>(212)</u>	<u>5.18%</u>
186,658	(8,597)	4.61%	182,067	(6,924)	3.80%
34,343			32,921		
3,457			1,804		
<u>22,090</u>			<u>22,721</u>		
\$ 246,548			\$ 239,513		
	\$ 11,940			\$ 11,876	
		9.04%			8.40%
		3.78%			3.10%
		5.26%			5.30%

Management's Discussion and Analysis

Interest income on loans include loan fees of \$708,270, \$822,516 and \$731,508, respectively.

Net interest income decreased .9% to \$11,572,000 in 2001 compared to 2000. The decrease is primarily the result of a decreased interest rate environment. The Company's interest income decreased 10.7% to \$18,102,000 in 2001 from \$20,272,000 in 2000. This decrease, also due to decreasing interest rates, was substantially offset by a 24% decrease in interest expense from \$8,597,000 in 2000 to \$6,530,000 in 2001. Net interest margins were 5.16%, 5.14%, and 5.10% for the years ended December 31, 2001, 2000, and 1999, 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.

(dollars in thousands)	2001 compared to 2000			2000 compared to 1999		
	Volume	Rate	Net	Volume	Rate	Net
Interest earned on:						
Loans	\$ 466	\$ (1,934)	\$ (1,468)	\$ 1,788	\$ 583	\$ 2,371
Securities:						
Taxable	(1,109)	(65)	(1,174)	(336)	161	(175)
Tax-exempt	148	70	218	(88)	(19)	(107)
Total securities	(961)	5	(956)	(424)	142	(282)
Fed funds sold and interest bearing deposits in other banks	354	(93)	261	(520)	98	(422)
Total interest earning assets	(141)	(2,022)	(2,163)	844	823	1,667
Interest paid on:						
Savings and interest bearing demand deposits	(136)	(1,952)	(2,088)	(100)	1,148	1,048
Time deposits	380	28	408	152	108	260
Short term borrowings	(362)	(25)	(387)	300	65	365
Total interest bearing liabilities	(118)	(1,949)	(2,067)	352	1,321	1,673
Change in net interest income	(23)	(73)	(96)	492	(498)	(6)

Non-Interest Income. Non-interest income was \$1,529,000 for 2001, an increase of \$312,000 or 25.6% from 2000 when it totaled \$1,217,000. The 2000 amount was a decrease of \$38,000 or 3.0% compared to the 1999 total of \$1,255,000.

In 2001, service charges on deposit accounts increased \$151,000 or 22.3% to a total of \$828,000 compared to \$677,000 in 2000. The 2000 total was down \$68,000 or 9.1% compared to the 1999 total of \$745,000. During 2001, a new customer overdraft protection program was implemented which contributed to the increase in service charges on deposit accounts.

Income from sources other than service charges on deposit accounts and gains on sale of securities available for sale totaled \$669,000 in 2001, an increase of \$138,000 from 2000, or 26%. The primary reason for the increase was income from foreclosed real estate, which totaled \$139,000. During 2001, the Bank was collecting operating revenues from a motel which was brought into foreclosed real estate in July 2001. Other major components of non-interest income were credit card income and bank owned life insurance income. Income from other sources for 2000 was \$531,000, an increase of \$66,000 or 14.2% compared to 1999 primarily due to the gain on the sale of foreclosed real estate.

Management's Discussion and Analysis

The following table represents the principal categories of non-interest income for each of the years in the three-year period ended December 31, 2001.

(Dollars in thousands)	Increase (Decrease)			Increase (Decrease)			1999
	2001	Amount	%	2000	Amount	%	
Service charges on							
deposit accounts	\$ 828	\$ 151	22.3%	\$ 677	\$ (68)	(9.1%)	\$ 745
Mortgage broker fees	32	23	255.0%	9	(27)	(75.0%)	36
Net gain on sale of securities	--	--	--	--	--	--	9
Other operating income	<u>669</u>	<u>138</u>	<u>26.0%</u>	<u>531</u>	<u>66</u>	<u>14.2%</u>	<u>465</u>
Total non-interest income	\$ 1,529	\$ 312	25.6%	\$ 1,217	\$ (38)	(3.0%)	\$ 1,255

Non-Interest Expense. Total non-interest expense was \$7,193,000, a decrease of \$337,000 or 4.5% compared to \$7,530,000 in 2000. In 2000 non-interest expense increased \$519,000 or 7.4% compared to \$7,011,000 in 1999.

Salary and employee benefits decreased by \$77,000, or 1.9%, in 2001 to \$4,058,000 and increased by \$264,000, or 6.8%, in 2000. The primary reason for the decrease in 2001 was the retirement of the Company's Chief Executive Officer, Robert Worrell. The increase in 2000 was primarily due to funding a defined benefit retirement plan which was terminated on December 31, 2000.

Occupancy and equipment expense decreased \$176,000 or 15.5% in 2001 and increased \$126,000 or 12.5% in 2000. The decrease in 2001 was due to a decline in equipment maintenance expense and reduced equipment depreciation expense. The 2000 increase was the result of writing down data processing equipment no longer in service.

Other expense decreased \$84,000 or 3.7% in 2001 compared to an increase of \$129,000 or 6.0% in 2000 over 1999. The decrease in 2001 is related primarily to lower advertising expense of \$20,000, non-recurring deferred director fees of \$160,000 paid in 2000, decreased insurance expense of \$26,000 and an increase in foreclosed real estate expenses of \$127,000 primarily due to the operations of the motel. Non-recurring expenses totaled approximately \$117,000 during 2000 and is the reason for the increase compared to 1999.

The following table represents the principal categories of non-interest expense for each of the years in the three-year period ended December 31, 2001.

(Dollars in thousands)	Increase (Decrease)			Increase (Decrease)			1999
	2001	Amount	%	2000	Amount	%	
Salaries & employee benefits	\$ 4,058	\$ (77)	(1.9)%	\$ 4,135	\$ 264	6.8%	\$ 3,871
Occupancy and equipment	963	(176)	(15.5)%	1,139	126	12.5%	1,013
Other expense	<u>2,172</u>	<u>(84)</u>	<u>(3.7)%</u>	<u>2,256</u>	<u>129</u>	<u>6.0%</u>	<u>2,127</u>
Total non-interest expense	\$ 7,193	\$ (337)	(4.5)%	\$ 7,530	\$ 519	7.4%	\$ 7,011

Management's Discussion and Analysis

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.

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, 2001 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	\$ 88,042	\$ 34,490	\$ 54,072	\$ 176,604
Investment securities	12,820	14,358	9,440	36,618
Fed Funds and interest bearing balances with banks	4,973	-0-	-0-	4,973
Federal Home Loan Bank Stock	<u>-0-</u>	<u>-0-</u>	<u>3,813</u>	<u>3,813</u>
Total interest earning assets	\$ 105,835	\$ 48,848	\$ 67,325	\$ 222,008
Interest bearing liabilities				
Interest bearing demand deposits	\$ 27,120	\$ -0-	\$ -0-	\$ 27,120
Savings deposits	77,608	-0-	-0-	77,608
Time deposits	59,037	12,442	-0-	71,479
Short term borrowings	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>
Total interest bearing liabilities	\$ 163,765	\$ 12,442	\$ -0-	\$ 176,207
Net interest rate sensitivity GAP	\$ (57,930)	\$ 36,406	\$ 67,325	\$ 45,801

Management's Discussion and Analysis

The following table shows the dollar amount of interest sensitive assets and interest sensitive liabilities at December 31, 2000 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	\$ 97,464	\$ 27,174	\$ 52,530	\$ 177,168
Investment securities	15,506	26,871	12,695	55,072
Fed Funds and interest bearing balances with banks	1,050	-0-	-0-	1,050
Federal Home Loan Bank Stock	<u>-0-</u>	<u>-0-</u>	<u>3,562</u>	<u>3,562</u>
Total interest earning assets	\$ 114,020	\$ 54,045	\$ 68,787	\$ 236,852
Interest bearing liabilities				
Interest bearing demand deposits	\$ 24,125	\$ -0-	\$ -0-	\$ 24,125
Savings deposits	76,018	-0-	-0-	76,018
Time deposits	75,349	5,509	-0-	80,858
Short term borrowings	<u>11,358</u>	<u>-0-</u>	<u>-0-</u>	<u>11,358</u>
Total interest bearing liabilities	\$ 186,850	\$ 5,509	\$ -0-	\$ 192,359
Net interest rate sensitivity GAP	\$ (72,830)	\$ 48,536	\$ 68,787	\$ 44,493

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 decreased \$18,454,000, or 33.5% during 2001 to \$36,618,000 at year end from \$55,072,000 in 2000, which was a \$2,828,000 decrease over 1999. The changes in 2001 were primarily in U.S. Government agency securities due to call options being exercised by the issuers. Proceeds from the portfolio decrease were used to decrease short term borrowings during 2001.

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

(dollars in thousands)	2001	2000	1999
Treasury securities	\$ -0-	\$ 500	\$ 997
U.S. Agencies securities	6,872	27,613	27,655
Obligations of states and political subdivisions	16,658	13,554	14,291
Other securities	<u>13,088</u>	<u>13,405</u>	<u>14,957</u>
Total	\$ 36,618	\$ 55,072	\$ 57,900

Management's Discussion and Analysis

The following table presents the maturities of investment securities at December 31, 2001. Taxable equivalent values are used in calculating yields assuming a tax rate of 34%.

(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	Total
U.S. Agency securities	\$ 505	\$ 2,775	\$ 29	\$ 3,563	\$ 6,872
Weighted average yield	5.33%	6.26%	9.00%	5.62%	
Obligations of states and political subdivisions	1,505	6,712	3,568	4,873	16,658
Weighted average yield	6.72%	6.46%	6.61%	9.74%	
Other securities	6,996	6,092	-0-	-0-	13,088
Weighted average yield	5.02%	5.61%	-0-	-0-	
Total	\$ 12,721	\$ 15,174	\$ 3,519	\$ 8,399	\$ 36,618

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)	2001	2000	1999	1998	1997
Commercial	\$ 72,427	\$ 68,827	\$ 56,198	\$ 48,455	\$ 44,815
Real Estate Construction	6,554	6,118	3,325	4,929	4,258
Real Estate Mortgage	91,714	96,334	88,905	90,027	90,631
Installment	4,941	4,612	3,379	3,104	3,276
Credit cards and overdrafts	968	1,277	857	764	747
Total	\$ 176,604	\$ 177,168	\$ 152,664	\$ 147,280	\$ 143,727

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, 2001.

(dollars in thousands)	Due in one year or less	Due after one through five years	Due after five years	Total
Commercial	\$ 47,517	\$ 1,960	\$ 22,950	\$ 72,427
Real estate construction	4,265	108	2,181	6,554
Total	\$ 52,621	\$ 2,068	\$ 25,131	\$ 78,981
Total loans maturing after one year with				
Predetermined interest rates (fixed)		\$ 22,903	\$ 53,723	\$ 76,626
Floating or adjustable rates (variable)		10,868	-0-	10,868
Total		\$ 33,771	\$ 53,723	\$ 87,494

At December 31, 2001, 49.8% of the loan portfolio presented above was due in one year or less.

Management's Discussion and Analysis

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)	2001	2000	1999	1998	1997
Non-accrual loans	\$1,254	\$3,128	\$175	\$15	\$422
Accruing loans past due					
90 days or more	79	292	140	4	184
Restructured loans	0	0	0	0	0

Non-accrual loans decreased approximately \$1.9 million in 2001 from 2000 primarily due to foreclosure involving several properties. During 2001, the Company foreclosed on properties totaling \$1,733,000. 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 an agricultural property and commercial real estate. During 2001, sales of other real estate owned totaled \$674,000 net of expenses. At December 31, 2001, the balance remaining in other real estate owned totaled \$1,040,000. Non-accrual loans increased \$2,953,000 to \$3,128,000 at year-end 2000 after increasing to \$175,000 in 1999, and decreasing to \$15,000 in 1998 from \$422,000 in 1997. 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 \$75,000 for 2001, \$168,000 for 2000, \$10,000 for 1999, \$20,000 for 1998 and \$45,000 for 1997. Interest income recognized on impaired loans for 2001 was \$2,000, for 2000 was \$31,000, for 1999 was \$11,000, and was none for 1998 and 1997.

There are \$79,000 of loans which are ninety days or more past due and still accruing at year-end 2001. It is management's opinion that the loans are adequately collateralized and if foreclosure and sale of collateral is necessary, no loss will be incurred.

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, 2001 loans secured by real estate totaled \$98,268,000, which represents 55.6% of the total loan portfolio. Real estate construction loans comprised \$6,554,000 of that amount, while real estate loans secured by residential properties totaled \$33,129,000. 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%.

Management's Discussion and Analysis

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 loan losses is charged to current expense. This provision acts to replenish the allowance for loan 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 loan 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 monthly 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, 2001 are as follows:

(dollars in thousands)	2001	2000	1999	1998	1997
Balance at beginning of year	\$ 2,026	\$ 1,930	\$ 1,864	\$ 1,937	\$ 1,824
Charge-offs:					
Commercial	170	554	114	9	5
Real estate loans	366	0	0	194	0
Credit card	13	6	13	18	20
Installment	15	8	7	0	16
Total charge-offs	\$ 564	\$ 568	\$ 134	\$ 221	\$ 41
Recoveries:					
Commercial	\$ 54	\$ 15	\$ 23	\$ 34	\$ 7
Real estate loans	0	12	110	0	0
Credit card	0	0	6	3	2
Installment	13	2	1	1	3
Total recoveries	\$ 67	\$ 29	\$ 140	\$ 38	\$ 12
Net charge-offs (recoveries)	497	539	(6)	183	29
Provision for credit losses	580	635	60	110	142
Balance at end of year	\$ 2,109	\$ 2,026	\$ 1,930	\$ 1,864	\$ 1,937
Ratio of net charge-offs (recoveries)					
To average loans outstanding	.29%	.33%	--	.13%	.02%

Management's Discussion and Analysis

The allowance for credit losses was \$2,109,000 at year-end 2001, compared with \$2,026,000 at year-end 2000. The aggregate increase resulted from the provision of \$580,000 and charge-offs in 2001. The allowance for credit losses as a percentage of total loans outstanding at year-end 2001 was 1.19%, which in management's opinion is adequate and reasonable in comparison to the Company's credit risk experience.

The allowance for credit losses during 2000 increased \$96,000 compared to year-end 1999. The total allowance for credit losses was \$2,026,000 at year-end 2000 and \$1,930,000 in 1999. The aggregate increase during 2000 was the result of the provision of \$635,000 and net charge-offs. The allowance increased in 1999 from the provision of \$60,000 and recoveries of \$6,000. The allowance for credit losses as a percentage of total loans outstanding was 1.14% at year-end 2000, 1.26% at year-end 1999 and 1.27% in 1998. The allowance for credit losses at year-end 1997 was \$1,937,000. The net charge-offs were \$29,000 in 1997 and provisions for credit losses were \$142,000 in 1997. The allowance for credit losses as a percentage of total loans outstanding at year-end 1997 was 1.35%.

Charge-offs during 2001 totaled \$564,000, which was due primarily to an additional write down of \$120,000 for an agriculture cranberry farm loan, which was originally written down by \$524,000 in 2000. In addition, during 2001 a fishing vessel loan was charged-off in the amount of \$21,000, while commercial real estate loans were charged off consisting of a commercial building in the amount of \$97,000 and a medical office building in the amount of \$222,000. These charge-offs were the primary reason for the increased loan loss provisions during 2001 and 2000. Subsequent to year end 2001, management performed additional analysis and obtained appraisals for several credits due to the current economic condition in its market areas and identified weakness in the borrower's financial condition. Based on these events, further charge-offs are likely during the 2002 fiscal year, and accordingly, a significant addition to the loan loss reserve during the first quarter of 2002 is likely.

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

(dollars in thousands)	2001	2000	1999	1998	1997
Total Impaired Loans	\$1,662	\$3,218	\$175	\$15	\$422
Total Impaired Loans with Valuation Allowance	1,180	1,114	--	--	138
Valuation Allowance related to Impaired Loans	143	412	--	--	8

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.

Management's Discussion and Analysis

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)	% of									
	2001 Reserve	Total Reserve	2000 Reserve	Total Reserve	1999 Reserve	Total Reserve	1998 Reserve	Total Reserve	1997 Reserve	Total Reserve
Commercial loans	\$ 548	26%	\$ 689	34%	\$ 720	37%	\$ 710	38%	\$ 798	41%
Real estate loans	1,413	67%	1,256	62%	1,153	60%	1,091	58%	1,089	56%
Consumer loans	148	7%	81	4%	58	3%	63	4%	50	3%
Total allowance	\$ 2,109	100%	\$ 2,026	100%	\$ 1,930	100%	\$ 1,864	100%	\$ 1,937	100%

Ratio of allowance for credit losses to loans outstanding at end of year

1.19%	1.14%	1.26%	1.27%	1.35%
-------	-------	-------	-------	-------

The table indicates a decrease of \$141,000 from December 31, 2000 to December 31, 2001 in the allowance related to commercial loans, which was offset by growth of \$157,000 during the same period in the allowance for loan losses for real estate loans. This growth is due to an increase in past due balances of these loans.

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)	2001	Rate	2000	Rate	1999	Rate
Demand deposits	\$ 33,419	0.00%	\$ 34,343	0.00%	\$ 32,921	0.00%
Interest bearing demand deposits	26,949	2.09%	26,416	2.51%	31,980	2.51%
Savings deposits	78,897	2.32%	82,850	3.65%	80,472	3.67%
Time deposits	75,819	5.20%	68,516	5.16%	65,524	5.00%
Total	\$ 215,084	3.49%	\$ 212,125	3.78%	\$ 210,897	3.18%

Management's Discussion and Analysis

Maturities of time certificates of deposit as of December 31, 2001 are summarized as follows:

	<u>Under</u> <u>\$100,000</u>	<u>Over</u> <u>\$100,000</u>	<u>Total</u>
3 months or less	\$ 14,453	\$ 7,596	\$ 22,049
Over 3 through 6 months	12,386	6,478	18,864
Over 6 through 12 months	10,297	7,192	17,489
Over 12 months	<u>7,890</u>	<u>5,187</u>	<u>13,077</u>
Total	\$ 45,026	\$ 6,453	\$ 71,479

SHORT-TERM BORROWINGS

The following is information regarding the Company's short-term borrowings for the years ended December 31, 2001, 2000 and 1999.

<u>(dollars in thousands)</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
Amount outstanding at end of period	\$ 0	\$ 11,358	\$ 9,675
Weighted average interest rate thereon	0%	6.39%	5.18%
Maximum amount outstanding at any month end during period	\$7,580	\$ 11,358	\$11,375
Average amounts outstanding during the period	963	9,036	4,091
Weighted average interest rate during period	5.68%	6.39%	5.18%

KEY FINANCIAL RATIOS

<u>Year ended December 31,</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>
Return on average assets	1.55%	1.34%	1.64%	1.80%	1.99%
Return on average equity	15.57%	14.95%	17.26%	18.57%	19.70%
Average equity to average assets ratio	9.96%	8.96%	9.49%	9.69%	10.09%
Dividend payout ratio	87%	97%	79%	60%	55%

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 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's Discussion and Analysis

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 shareholder equity averaged \$24,451,000 in 2001, compared to \$22,090,000 in 2000, an increase of 10.7%, and \$22,721,000 in 1999, a decrease of 2.8% compared to 1999.

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, 2001, 2000, and 1999.

(dollars in thousands)	Actual		Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio
December 31, 2001				
Tier 1 capital (to average assets)	\$23,106	9.49%	\$ 9,738	4.00%
Tier 1 capital (to risk-weighted assets)	23,106	12.27%	7,459	4.00%
Total capital (to risk-weighted assets)	25,215	13.39%	14,918	8.00%
December 31, 2000				
Tier 1 capital (to average assets)	\$22,934	9.19%	\$ 9,986	4.00%
Tier 1 capital (to risk-weighted assets)	22,934	12.05%	7,613	4.00%
Total capital (to risk-weighted assets)	24,960	13.11%	15,226	8.00%
December 31, 1999				
Tier 1 capital (to average assets)	\$22,390	9.28%	\$ 9,646	4.00%
Tier 1 capital (to risk-weighted assets)	22,390	12.93%	6,929	4.00%
Total capital (to risk-weighted assets)	24,320	14.04%	13,857	8.00%

Management's Discussion and Analysis

Quantitative and Qualitative Disclosure 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 49% 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 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 the financial instruments including the fair value as of December 31, 2001.

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, 2001. Fair values are used in accordance with generally accepted accounting principles as disclosed in the financial statements.

Year ended December 31, 2001 (dollars in thousands)	Expected Maturity					There- after	Total	Fair Value
	2002	2003	2004	2005	2006			
Financial Assets								
Cash and cash equivalents								
Non-interest bearing	\$10,231	\$ --	\$ --	\$ --	\$ --	\$ --	\$10,231	\$10,231
Interest bearing deposits in banks	1,468	--	--	--	--	--	1,468	1,468
Weighted average interest rate	1.87%							
Federal funds sold								
Fixed rate	3,505	--	--	--	--	--	3,505	3,505
Weighted average interest rate	1.94%							
Securities available for sale								
Fixed rate	8,889	3,825	5,088	3,535	2,540	6,801	30,678	30,678
Weighted average interest rate	5.54%	6.15%	5.86%	6.47%	6.31%	6.16%		
Adjustable rate	--	995	--	--	--	--	995	995
Weighted average interest rate		2.05%						
Securities held to maturity								
Fixed rate	14	10	481	--	116	4,324	4,945	4,942
Weighted average interest rate	5.88%	5.50%	3.80%		6.11%	7.03%		
Loans receivable								
Fixed rate	11,633	4,161	6,658	6,261	6,313	53,645	88,671	91,306
Weighted average interest rate	8.09%	7.68%	8.76%	8.12%	7.58%	8.02%		
Adjustable rate	76,866	1,063	7,983	537	1,284	200	87,933	87,933
Weighted average interest rate	6.20%	7.85%	8.10%	7.77%	7.18%	6.35%		
Federal Home Loan Bank stock	3,813	--	--	--	--	--	3,813	3,813
Weighted average interest rate	7.00%							

Management's Discussion and Analysis

Year ended December 31, 2001 (dollars in thousands)	Expected Maturity					There- after	Total	Fair Value
	2002	2003	2004	2005	2006			
Financial Liabilities								
Non-interest bearing deposits	\$ 5,765	\$4,901	\$4,166	\$3,541	\$3,010	\$17,054	\$38,437	\$38,437
Interest bearing checking accounts	6,781	5,086	3,815	2,861	2,145	6,437	27,125	27,125
Weighted average interest rate	.89%	.89%	.89%	.89%	.89%	.89%		
Money Market accounts	5,918	4,439	3,329	2,497	1,873	5,619	23,675	23,675
Weighted average interest rate	1.22%	1.22%	1.22%	1.22%	1.22%	1.22%		
Savings accounts	10,786	8,628	6,902	5,522	4,418	17,672	53,928	53,928
Weighted average interest rate	1.17%	1.17%	1.17%	1.17%	1.17%	1.17%		
Certificates of deposit								
Fixed rate	55,745	10,584	1,325	230	304	--	68,188	68,458
Weighted average interest rate	3.84%	4.17%	4.39%	4.82%	4.47%			
Variable rate	3,291	--	--	--	--	--	3,291	3,291
Weighted average interest rate	3.08%							

As illustrated in the tables above, our balance sheet is currently sensitive to declining interest rates, meaning that more interest earning assets mature or re-price than interest bearing liabilities. Therefore, if our asset and liability mix were to remain unchanged, and there was an increase in market rates of interest, the Company would expect that its net income would be positively affected. In contrast, a decreasing interest rate environment would adversely 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.

Selected Financial Data

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

(\$ in thousands, except per share data)	2001	2000	1999	1998	1997
Operations Data					
Net interest income	\$ 11,572	\$ 11,675	\$ 11,430	\$ 11,100	\$ 10,692
Provision for credit losses	580	635	60	110	142
Non-interest income	1,529	1,217	1,255	1,281	1,149
Non-interest expense	7,193	7,530	7,011	6,687	6,188
Provision for income taxes	1,521	1,424	1,692	1,590	1,643
Net income	3,807	3,303	3,922	3,994	3,868
Net income per share:					
Basic	1.53	1.33	1.60 ⁽¹⁾	1.64 ⁽¹⁾	1.59 ⁽¹⁾
Diluted	1.51	1.31	1.59	1.61	1.58
(1) Restated to reflect the 5 for 1 stock split effected in July 2000.					
Dividends declared	3,289	3,204	3,105	2,379	2,118
Dividends paid ratio	86%	97%	79%	60%	55%
Performance Ratios					
Net interest margin	5.05%	5.04%	5.10%	5.37%	5.90%
Efficiency ratio	54.90%	58.41%	55.27%	54.01%	52.26%
Return on average assets	1.55%	1.34%	1.64%	1.80%	1.99%
Return on average equity	15.57%	14.95%	17.26%	18.57%	19.70%
Balance Sheet Data					
Total assets	\$ 243,617	253,313	242,189	236,364	208,551
Loans, net	174,495	175,142	150,734	145,416	141,780
Total deposits	214,644	213,511	206,139	210,650	178,726
Short-term borrowings	-0-	11,358	9,675	86	6,625
Shareholders' equity	23,514	22,743	21,438	21,485	19,657
Book value per share	9.44	9.09	8.63 ⁽¹⁾	8.79 ⁽¹⁾	8.07 ⁽¹⁾
Equity to assets ratio	9.65%	8.98%	8.85%	9.09%	9.43%
(1) Restated to reflect the 5 for 1 stock split effected in July 2000.					
Asset Quality Ratios					
Non-performing loans to total loans	.71%	1.93%	0.21%	0.01%	0.29%
Allowance for loan losses					
to total loans	1.19%	1.14%	1.26%	1.27%	1.35%
Allowance for loan losses					
to non-performing loans	168.48%	59.24%	612.69%	12,426.67%	459.00%
Non-performing assets to					
total assets	.51%	1.35%	0.13%	0.06%	0.22%

General Corporate and Stockholder's Information

Corporate
Headquarters 300 East Market Street
Aberdeen, Washington 98520
(360) 533-8870

Independent
Accountants McGladrey & Pullen, LLP
Tacoma, Washington

Transfer Agent,
Registrar and
Dividend
Disbursing
Agent Stockholder inquiries regarding transfer requirements, cash
dividends, lost certificates, consolidating records, correcting
a name or changing an address should be directed to the
transfer agent:
Pacific Financial Corporation
Attn: Marie Ross
P.O. Box 1826
Aberdeen, Washington 98520
Telephone: (360) 533-8873 ext. 233

Annual Meeting

The annual meeting of stockholders will be held on April 17, 2002, at 7 p.m. at the Aberdeen branch of The Bank of the Pacific, 300 East Market Street, Aberdeen, Washington.

Form 10-K

This report is available to stockholders of record upon written request to :

John Van Dijk, Secretary/Treasurer
Pacific Financial Corporation
P.O. Box 1826
Aberdeen, Washington 98520

Stock Information

Pacific Financial Corporation is not publicly traded. Accordingly no broker makes a market in the company's stock. The prices reported reflect only the transactions known to company management as reported by individual investors to the company as its own transfer agent. At December 31, 2001 there were approximately 957 shareholders of record. The stock prices have been restated to reflect the 5-for-1 stock split effected in July 2000. Most recent stock prices can be viewed on our website www.thebankofpacific.com.

Stock Information

<u>Quarter Ended</u>	<u>Stock Prices</u>	
	<u>High</u>	<u>Low</u>
March 31, 2000	\$29	\$26
June 30, 2000	28	25
September 30, 2000	26	24
December 31, 2000	24	21
March 31, 2001	25	23
June 30, 2001	25	21
September 30, 2001	24	21
December 31, 2001	25	23

Directors and Officers

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Private Investor

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Susan C. Freese
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Robert A. Hall
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Commission on Colleges

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John Van Dijk
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The Bank of the Pacific
300 E. Market Street
Aberdeen, WA 98520
(360) 533-8870

This annual report is furnished to shareholders and customers of The Bank of the Pacific pursuant to the requirements of the Federal Deposit Insurance Corporation (FDIC) to provide an annual disclosure statement. This statement has not been reviewed or confirmed for accuracy or relevance by the FDIC.




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