PACIFIC FINANCIAL CORP
Form 10-Q
November 14, 2003

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

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the quarter ended September 30, 2003

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from ____________ to ____________

Commission File Number 000-29829

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

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

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

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

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

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

Title of Class	Outstanding at September 30, 2003
Common Stock, par value $1.00 per share	2,512,669 shares

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PART I - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

Condensed Consolidated Balance Sheets
(Dollars in thousands)

Pacific Financial Corporation
September 30, 2003 and December 31, 2002

	September 30, 2003 (Unaudited)	December 31, 2002
Assets		
Cash and due from banks	$ 11,160	$ 8,473
Interest bearing balances with banks	7,313	373
Federal funds sold	5,590	---
Investment securities available for sale	58,591	52,230
Investment securities held-to-maturity	8,801	10,362
Federal Home Loan Bank stock, at cost	904	866
Loans held for sale	---	286
Loans	193,669	185,504
Allowance for credit losses	2,353	2,473
Loans, net	191,316	183,031

Premises and equipment	3,730	3,850
Foreclosed real estate	898	686
Accrued interest receivable	1,462	1,493
Cash surrender value of life insurance	6,120	5,898
Other assets	1,330	986
Total assets	$297,215	$268,534
Liabilities and Shareholders' Equity		
Deposits:		
Non-interest bearing	$ 42,903	$ 40,084
Interest bearing	209,851	185,170
Total deposits	252,754	225,254
Accrued interest payable	235	318
Short-term borrowings	---	1,800
Long-term borrowings	14,500	11,000
Other liabilities	1,769	5,479
Total liabilities	269,258	243,851
Shareholders' Equity		
Common Stock (par value $1); authorized: 25,000,000 shares; issued September 30, 2003-2,512,669 shares; December 31, 2002-2,512,659 shares	2,513	2,513
Additional paid-in capital	9,839	9,839
Retained earnings	15,071	11,614
Accumulated other comprehensive income	534	717
Total shareholders' equity	27,957	24,683
Total liabilities and shareholders' equity	$297,215	$268,534

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

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2003	2002	2003	2002
Interest Income				
Loans	$ 3,345	$ 3,237	$ 9,957	$ 9,867
Securities held to maturity:				
Taxable	23	54	141	54
Tax-exempt	54	100	154	226
Securities available for sale:				
Taxable	387	391	1,205	1,099
Tax-exempt	119	133	355	422
Deposits with banks and federal funds sold	54	27	83	84

Total interest income	3,982	3,930	11,895	11,752
Interest Expense				
Deposits	697	972	2,261	2,854
Other borrowings	127	74	358	144
Total interest expense	824	1,046	2,619	2,998
Net Interest Income	3,158	2,896	9,276	8,754
Provision for credit losses	---	---	---	954
Net interest income after provision for credit losses	3,158	2,896	9,276	7,800
Non-interest Income				
Service charges	235	279	763	807
Mortgage loan origination fees	48	---	89	---
Gain on sale of loans	30	---	30	---
Gain on sale of foreclosed real estate	38	19	33	160
Gain on sale of investments held for sale	---	---	4	---
Other operating income	188	179	521	668
Total non-interest income	539	480	1,440	1,635
Non-interest Expense				
Salaries and employee benefits	1,206	1,088	3,519	3,110
Occupancy and equipment	240	246	718	730
Other	557	514	1,607	1,700
Total non-interest expense	2,003	1,848	5,844	5,540
Income before income taxes	1,694	1,525	4,872	3,895
Provision for income taxes	500	452	1,415	1,168
Net Income	$ 1,194	$ 1,073	$ 3,457	$ 2,727
Earnings per common share:				
Basic	$ .48	$ .43	$ 1.38	$ 1.09
Diluted	.47	.43	1.35	1.09
Average shares outstanding:				
Basic	2,512,669	2,491,629	2,512,665	2,491,629
Diluted	2,564,017	2,509,193	2,553,785	2,511,860

Condensed Consolidated Statements of Cash Flows
Nine months ended September 30, 2003 and 2002
(Dollars in thousands)

(Unaudited)	2003	2002
OPERATING ACTIVITIES		
Net income	$ 3,457	$ 2,727
Adjustments to reconcile net income to net cash provided by operating activities:		

Provision for credit losses	---	954
Depreciation and amortization	306	324
Stock dividends received	(38)	(174)
Proceeds of loans held for sale	286	---
(Gain) on sales of loans	(30)	---
(Gain) on sale of investment securities	(4)	---
(Gain) on sale of premises and equipment	(2)	---
(Gain) on sale of foreclosed real estate	(33)	(160)
(Increase) decrease in accrued interest receivable	31	(141)
Decrease in accrued interest payable	(83)	(92)
Write-down of foreclosed real estate	173	402
Other	(494)	(1,735)
Net cash provided by operating activities	3,569	3,124
INVESTING ACTIVITIES		
Net (increase) decrease in federal funds sold	(5,590)	2,905
Increase in interest bearing deposits with banks	(6,940)	(2,353)
Purchase of securities held to maturity	(1,654)	(7,967)
Purchases of securities available for sale	(18,467)	(32,024)
Proceeds from maturities of securities held to maturity	3,126	2,819
Proceeds from maturities of securities available for sale	8,597	15,515
Proceeds from sales of securities available for sale	2,994	---
Proceeds from sales of loans	1,795	---
Net increase in loans	(11,007)	(7,209)
Proceeds from sales of foreclosed real estate	642	707
Additions to foreclosed real estate	(21)	(25)
Additions to premises and equipment	(167)	(181)
Proceeds from sales of premises and equipment	2	---
Net cash provided by (used in) investing activities	(26,690)	(26,794)
FINANCING ACTIVITIES		
Net increase in deposits	27,500	15,926
Net decrease in short-term borrowings	(1,800)	---
Proceeds from issuance of long-term debt	3,500	11,000
Payment of dividends	(3,392)	(3,289)
Net cash provided by financing activities	25,808	23,637
Net increase (decrease) in cash and due from banks	2,687	(33)
CASH AND DUE FROM BANKS		
Beginning of period	8,473	10,231
End of period	$11,160	$10,198
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash payments for:		
Interest	$ 2,702	$ 3,090
Income Taxes	1,728	1,040
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING ACTIVITIES		
Foreclosed real estate acquired in settlement of loans	$(1,127)	$ (834)
Financed sale of foreclosed real estate	154	628
Change in fair value of securities available for sale, net of tax	$ (183)	$ 277

Condensed Consolidated Statements of Shareholders' Equity
Nine months ended September 30, 2003 and 2002
(Dollars in thousands) (Unaudited)

	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	TOTAL
Balance December 31, 2001	$ 2,492	$ 9,524	$11,090	$ 408	$23,514
Other comprehensive income:					
Net income			2,727		2,727
Change in fair value of securities available for sale, net				277	277
Comprehensive income					3,004
Balance September 30, 2002	$ 2,492	$ 9,524	$13,817	$ 685	$26,518
Balance December 31, 2002	$ 2,513	$ 9,839	$11,614	$ 717	$24,683
Other comprehensive income:					
Net income			3,457		3,457
Change in fair value of securities available for sale, net				(183)	(183)
Comprehensive income					3,274
Balance September 30, 2003	$ 2,513	$ 9,839	$15,071	$ 534	$27,957

NOTES TO FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

The accompanying unaudited financial statements have been prepared by Pacific Financial Corporation ("Pacific" or the "Company") in accordance with accounting principles generally accepted in the United States of America for interim financial information and with instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2003, are not necessarily indicative of the results anticipated for the year ending December 31, 2003. Certain information and footnote disclosures included in the Company's financial statements for the year ended December 31, 2002, have been condensed or omitted from this report. Accordingly, these statements should be read with the financial statements and notes thereto included in the Company's December 31, 2002 Annual Report on Form 10-K.

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

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

2. INVESTMENT SECURITIES

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

SECURITIES HELD TO MATURITY	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED (LOSSES)	FAIR VALUE
September 30, 2003				
U.S. Government Securities	$ 3,484	$ 27	---	$ 3,511
State and Municipal Securities	5,317	65	(31)	5,351
TOTAL	$ 8,801	$ 92	$ (31)	$ 8,862

SECURITIES AVAILABLE FOR SALE	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED (LOSSES)	FAIR VALUE
September 30, 2003				
U.S. Government Securities	$19,872	$ 250	(93)	$20,029
State and Municipal Securities	13,390	623	(90)	13,923
Corporate Securities	4,079	175	---	4,254
Mutual Funds	20,441	2	(58)	20,385
TOTAL	$57,782	$ 1,050	$ (241)	$58,591

3. ALLOWANCE FOR CREDIT LOSSES

	THREE MONTHS ENDED SEPTEMBER 30, 2003	THREE MONTHS ENDED SEPTEMBER 30, 2002	NINE MONTHS ENDED SEPTEMBER 30, 2003	NINE MONTHS ENDED SEPTEMBER 30, 2002
Balance at beginning of period	$2,350	$2,559	$2,473	$2,109
Provision for possible credit losses	---	---	---	954
Charge-offs	(16)	(31)	(141)	(554)
Recoveries	19	18	21	37
Net charge-offs	3	(13)	(120)	(517)
Balance at end of period	$2,353	$2,546	$2,353	$2,546
Ratio of net charge-offs to average loans outstanding	.00%	.23%	.07%	.29%

4. COMPUTATION OF BASIC EARNINGS PER SHARE

	THREE MONTHS ENDED SEPTEMBER 30, 2003	2002	NINE MONTHS ENDED SEPTEMBER 30, 2003	2002
Net Income	$1,194,000	$1,073,000	$3,457,000	$2,727,000
Shares Outstanding, Beginning of Period	2,512,669	2,491,629	2,512,659	2,491,629
Average Shares Outstanding	2,512,669	2,491,629	2,512,665	2,491,629
Basic Earnings Per Share	$ .48	$ .43	$ 1.38	$ 1.09

5. COMPUTATION OF DILUTED EARNINGS PER SHARE

	THREE MONTHS ENDED SEPTEMBER 30, 2003	2002	NINE MONTHS ENDED SEPTEMBER 30, 2003	2002
Net Income	$1,194,000	$1,073,000	$3,457,000	$2,727,000
Average Shares Outstanding	2,512,669	2,491,629	2,512,665	2,491,629
Effect of dilutive securities	51,348	17,564	41,120	20,231
Average Shares Outstanding and Assumed conversion of dilutive Stock options	2,564,017	2,509,193	2,553,785	2,511,860
Diluted Earnings Per Share	$ .47	$ .43	$ 1.35	$ 1.09

6. EQUITY COMPENSATION PLANS

At September 30, 2003, the Company has a stock-based employee compensation plan. The Company accounts for the plan under recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share had the Company applied the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

	THREE MONTHS ENDED SEPTEMBER 30, 2003	2002	NINE MONTHS ENDED SEPTEMBER 30, 2003	2002
Net Income, as reported	$1,194,000	$1,073,000	$3,457,000	$2,727,000
Less total stock-based compensation				

expense determined under fair value method for all qualifying awards	22,000	14,000	66,000	41,000
Pro forma net income	1,172,000	1,059,000	3,391,000	2,686,000
Earnings per Share				
Basic:				
As reported	.48	.43	1.38	1.09
Pro forma	.47	.43	1.35	1.08
Diluted:				
As reported	.47	.43	1.35	1.09
Pro forma	.46	.42	1.33	1.07

7. RECENT ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities." This interpretation requires a variable interest entity to be consolidated by the primary beneficiary of that entity. The consolidation requirements of this interpretation apply immediately to variable interest entities created after January 31, 2003, and apply to existing entities for the first fiscal year or interim period beginning after June 15, 2003. Certain disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. This Statement did not have a material impact on the Company's financial condition or results of operations.

In May 2003, the FASB issued Statement No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Such instruments may have been previously classified as equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company does not anticipate that adoption of this standard will have a significant effect on its reported equity.

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

A Warning About Forward-Looking Information

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

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

1. competitive pressures among depository and other financial

institutions may impede our ability to attract and retain borrowers, depositors and other customers;

2. changes in the interest rate environment may reduce margins;

3. our recently announced acquisition of BNW Bancorp may not be completed if conditions to the merger are not satisfied; if the merger is completed, it may be dilutive to earnings per share if we do not realize expected cost savings or successfully integrate BNW Bancorp into the Company in a timely manner and without significant customer or employee disruptions or losses.

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

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

6. decreases in real estate prices may reduce the value of our securities or some loans.

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

RESULTS OF OPERATIONS

Net income. For the nine months ended September 30, 2003, Pacific's net income was $3,457,000 compared to $2,727,000 for the same period in 2002. The most significant factor contributing to the increase was a decrease in the provision for credit losses from $954,000 to zero, partially offset by an increase in the provision for income taxes. During the first quarter of 2002, management performed additional analysis on the loan portfolio upon the hiring of a new chief credit officer and received updated appraisals on some large credits that warranted additional provisions during February 2002. Management's current year analysis of the loan portfolio did not warrant an additional provision for credit losses at this time. Net income for the three months ended September 30, 2003 was $1,194,000, which compared to $1,073,000 during the same period in 2002. The increase was attributable to a decrease in interest expense, an increase in mortgage loan origination fees, gain on sale of loans and gain on sale of foreclosed real estate during the quarter ended September 30, 2003.

Net interest income. Net interest income for the three and nine months ended September 30, 2003 increased $262,000, and $522,000 respectively, compared to the same period in 2002. This is due primarily to increased interest income on loans and investment income, and decreased interest expense.

Interest income for the three months ended September 30, 2003, increased $52,000, or 1.3%, compared to the comparable period in 2002, and for the first nine months of 2003 increased $143,000, or 1.2%, from the same period in 2002. The increases are attributable primarily to increased investment securities and increased loan balances compared to the 2002 periods. Average total loans outstanding for the nine months ended September 30, 2003, and September 30, 2002, were $185,911,000, and $179,833,000, respectively, or an increase of 3.4% in 2003 over 2002.

Interest expense for the three months ended September 30, 2003 decreased $222,000, or 21.2%, compared to the same period in 2002, and decreased $379,000, or 12.6%, for the nine months ended September 30, 2003 over the comparable period in 2002. Deposits have continued to re-price downward during 2003 compared to 2002 as a result of lower market rates. Average interest-bearing deposit balances for the nine months ended September 30, 2003 and September 30, 2002 were $196,058,000 and $181,987,000, respectively, representing an increase of 7.7% compared to last year's period. The increase is very evenly spread among all of the company's deposit products. Average long term borrowings for the nine months ended September 30, 2003 were $13,926,000 compared to $5,130,000 for the same period in 2002. The Company borrowed funds from the Federal Home Loan Bank of Seattle to purchase investment securities during the third and fourth quarters of 2002.

Provision and allowance for credit losses. The allowance for credit losses reflects management's current estimate of the amount required to absorb losses on existing loans and commitments to extend credit. Loans deemed uncollectible are charged against and reduce the allowance. Periodically, a provision for credit losses is charged to current expense. This provision acts to replenish the allowance for credit losses and to maintain the allowance at a level that management deems adequate.

There is no precise method of predicting specific credit losses or amounts that ultimately may be charged off on segments of the loan portfolio. The determination that a loan may become uncollectible, in whole or in part, is a matter of judgment. Similarly, the adequacy of the allowance for credit losses can be determined only on a judgmental basis, after full review, including (a) consideration of economic conditions and the effect on particular industries and specific borrowers; (b) a review of borrowers' financial data, together with industry data, the competitive situation, the borrowers' management capabilities and other factors; (c) a continuing evaluation of the loan portfolio, including monitoring by lending officers and staff credit personnel of all loans which are identified as being of less than acceptable quality; (d) an in-depth appraisal, on a monthly basis, of all loans judged to present a possibility of loss (if, as a result of such monthly appraisals, the loan is judged to be not fully collectible, the carrying value of the loan is reduced to that portion considered collectible); and (e) an evaluation of the underlying collateral for secured lending, including the use of independent appraisals of real estate properties securing loans. A formal analysis of the adequacy of the allowance is conducted quarterly and is reviewed by the Board of Directors. Based on this analysis, management considers the allowance for credit losses to be adequate at September 30, 2003.

Periodic provisions for credit losses are made to maintain the allowance for credit losses at an appropriate level. The provisions are based on an analysis of various factors including historical loss experience based on volumes and types of loans, volumes and trends in delinquencies and non-accrual loans, trends in portfolio volume, results of internal and independent external credit reviews, and anticipated economic conditions. For additional information, please see the discussion under the heading "Critical Accounting Policy" in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2002.

During the three months ended September 30, 2003, no provision was provided for possible credit losses, and no provision was provided in the same period in 2002. For the nine months

ended September 30, 2003, no provision was provided for possible credit losses, compared to $954,000 for the comparable period in 2002. For the nine months ended September 30, 2003, net charge-offs were $120,000, compared to net charge-offs of $517,000 during the same period in 2002, and compared to $590,000 in net charge-offs during the twelve months ended December 31, 2002. The charge-offs for the period ended September 30, 2003 are primarily related to commercial loan write downs of $119,700.

At September 30, 2003, the allowance for credit losses stood at $2,353,000 compared to $2,473,000 at December 31, 2002, and $2,546,000 at September 30, 2002. The ratio of the allowance to total loans outstanding was 1.22%, 1.33% and 1.40%, respectively, at September 30, 2003, December 31, 2002, and September 30, 2002.

Non-performing assets and foreclosed real estate. Non-performing assets totaled $1,494,000 at September 30, 2003. This represents .77% of total loans, compared to $2,552,000, or 1.38%, at December 31, 2002, and $1,535,000, or .97%, at September 30, 2002. Non-accrual loans at September 30, 2003 totaled $596,000 of which $463,000 are secured by real estate. The decrease of $1,058,000 compared to December 31, 2002, is primarily due to the transfer of a motel property to foreclosed real estate that totaled $961,000. Based on current analysis, management believes losses associated with non-accrual loans will be minimal. Foreclosed real estate consists of various properties secured by real estate with no individual material balances and a motel property that totals $784,000. The Company has been successful during the recent months in selling individual properties with minimal impact to net income.

ANALYSIS OF NON-PERFORMING ASSETS

(in thousands)	SEPTEMBER 30 2003	DECEMBER 31 2002	SEPTEMBER 30 2002
Accruing loans past due 90 days or more	$ ---	$ 2	$ 1
Non-accrual loans	596	1,864	812
Foreclosed real estate	898	686	722
TOTAL	$1,494	$2,552	$1,535

Non-interest income and expense. Non-interest income for the three month and nine month periods ended September 30, 2003 increased $59,000 and decreased $195,000, respectively, compared to the same periods in 2002. Service charges on deposit accounts decreased $44,000 and $44,000 during the three and nine months ended September 30, 2003, respectively compared to the same periods in 2002. The decrease is mostly attributable to changes in pricing on commercial checking accounts. Mortgage loan origination fees increased $48,000 and $89,000 respectively for the three and nine months periods ended September 30, 2003 compared to 2002, due to increased refinancing activity as customers take advantage of low mortgage interest rates. For the three month period ended September 30, 2003 the Company recorded a gain on sale of loans totaling $30,000 and a gain on sale of foreclosed real estate of $38,000 compared to zero and $19,000 respectively for the same period in 2002. For the nine months ended September 30,

2003 gain on the sale of foreclosed real estate was $33,000 compared to a gain of $160,000 for the same period in 2002. Other operating income for the three and nine months ended September 30, 2003 increased $9,000 and decreased $147,000, respectively, compared to the same period in 2002, primarily due to a decrease in income from operations on foreclosed real estate.

Non-interest expense for the three and nine month period ended September 30, 2003 increased $155,000 and $304,000, respectively, compared to the same period in 2002. For the three-month period in 2003, salaries and benefits increased $118,000, primarily due to an increase in the number of employees and higher bonus accruals. Also, occupancy expenses decreased $6,000, while other expenses increased $43,000, compared to the same period in 2002. For the nine months ended September 30, 2003, salaries and benefits increased $409,000, occupancy expense decreased $12,000 and other expense decreased $93,000 due to a refund of business and occupation tax and decreased foreclosed real estate expenses compared to the same period in 2002.

Income taxes. The federal income tax provision for the nine months ended September 30, 2003 was $1,415,000, an increase of $247,000 compared to the same period in 2002 based upon increased income for the Company.

FINANCIAL CONDITION

Assets. Total assets were $297,215,000 at September 30, 2003, an increase of $28,681,000, or 10.7%, over year-end 2002. The majority of the increase is in the Company's cash and short term investment vehicles. Loans were $193,669,000 at September 30, 2003, an increase of $8,165,000, or 4.4%, over year-end 2002. Part of the increase is attributable to loans originated in the Gearhart loan production office that commenced operation August 1, 2003. As of September 30, 2003, the Gearhart office has originated loans totaling $5,990,000. Total deposits were $252,754,000 at September 30, 2003, an increase of $27,500,000, or 12.2%, compared to December 31, 2002. The increase in deposits over December 31, 2002 is cyclical in nature from tourist activity. Additionally, the Company sponsored a deposit campaign to attract new customers.

Loans. Loan detail by category as of September 30, 2003 and December 31, 2002 follows:

	September 30, 2003	December 31, 2002
Commercial and industrial	$ 54,978	$ 61,236
Agricultural	4,890	8,558
Real estate mortgage	118,377	101,151
Real estate construction	9,749	9,697
Installment	4,309	4,114
Credit cards and other	1,200	1,034
Total Loans	193,669	185,790
Allowance for credit losses	(2,353)	(2,473)
Net Loans	$191,316	$183,317

Liquidity. Adequate liquidity is available to accommodate fluctuations in deposit levels, fund operations, and provide for customer credit needs and meet obligations and commitments on a timely basis. The Company has no brokered deposits. It generally has been a net seller of federal funds. When necessary, liquidity can be increased by taking advances available from the Federal Home Loan Bank of Seattle.

Shareholders' equity. Total shareholders' equity was $27,957,000 at September 30, 2003, an increase of $3,274,000, or 13.3%, compared to December 31, 2002. The increase was due to net income and a decrease in the fair value of securities available for sale. Book value per share increased to $11.13 at September 30, 2003, compared to $9.82 at December 31, 2002. Book value is calculated by dividing total equity capital by total shares outstanding.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

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

It should be noted that the simulation model does not take into account future management actions that could be undertaken should actual market rates change during the year. An important point should be kept in mind; the model simulation results are not exact measures of the Company's actual interest rate risk. They are rather only indicators of rate risk exposure, based on assumptions produced in a simplified modeling environment designed to heighten sensitivity to changes in interest rates. The rate risk exposure results of the simulation model typically are greater than the Company's actual rate risk. That is due to the conservative modeling environment, which generally depicts a worst-case situation. Management has assessed the results of the simulation reports as of September 30, 2003, and believes that there has been no material change since December 31, 2002.

ITEM 4. CONTROLS AND PROCEDURES

Our chief executive officer ("CEO") and chief financial officer ("CFO"), after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")) as of the end of the period covered by this quarterly report, have concluded, based on such evaluation, that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company, including its consolidated subsidiaries, required to be included in its reports filed or submitted under the Exchange Act. No change in the Company's internal control over financial reporting occurred during our last fiscal quarter that has materially affected or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 5. OTHER INFORMATION

On October 22, 2003, the Company and BNW Bancorp, Inc. ("BNW"), the holding company for Bank NorthWest headquartered in Bellingham, Washington, signed an Agreement and Plan of Merger (the "Agreement"), under which BNW will merge into the Company. In addition, Bank NorthWest will merge into the Company's banking subsidiary, the Bank of the Pacific.

In the merger, the Company will issue 0.85 shares of the Company's common stock in exchange for each share of BNW common stock surrendered in the transaction. Consummation of the acquisition is subject to several conditions, including receipt of applicable regulatory approvals and approval by the shareholders of BNW and Pacific.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

Exhibit No.	Exhibit
2.1	Agreement and Plan of Merger between the Company and BNW Bancorp, Inc. dated as of October 22, 2003. Incorporated by reference to Exhibit 99.1 to the Company's current report on Form 8-K dated October 22, 2003.
31.1	Certification of CEO under Section 302 of the Sarbanes-Oxley Act.
31.2	Certification of CFO under Section 302 of the Sarbanes-Oxley Act.
32	Certifications of CEO and CFO under Section 906 of the Sarbanes-Oxley Act.

(b) Reports on Form 8-K:

None.

SIGNATURES

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

PACIFIC FINANCIAL CORPORATION

DATED: November 12, 2003

By: /s/ Dennis A. Long

Dennis A. Long
President

By: /s/ John Van Dijk

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