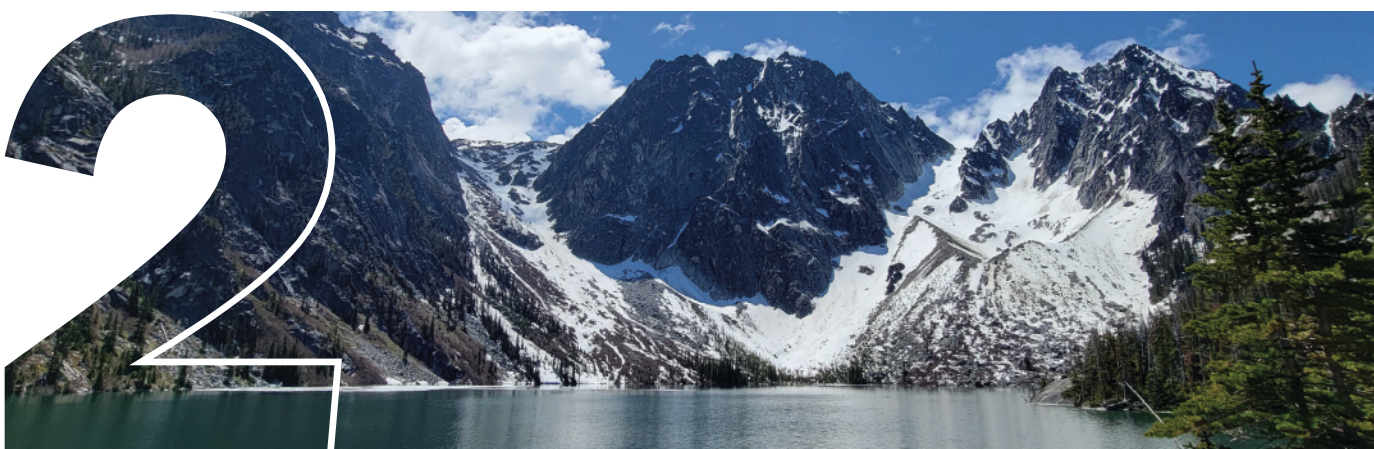


ANNUAL
REPORT




**Pacific Financial
Corporation**

OTCQX: PFLC



Dear Fellow Shareholders:

We began 2022 in a historically low interest rate environment. As inflation continued to heat up, the Federal Reserve began increasing interest rates in March 2022 and then in an effort to restore price stability, continued to raise rates at the fastest pace in over 40 years. With these increases in the federal funds rate, the Company's net interest income improved substantially in the second half of the year, benefiting from an asset-sensitive balance sheet, an exceptional core deposit franchise and a strong liquidity position. Net income for 2022 was \$10.9 million, or \$1.04 per diluted share, resulting in a return on average assets (ROAA) of 0.82% and return on average equity (ROAE) of 10.24%.

Commercial loan production in the third and fourth quarter ramped up with total originations of over \$150 million in new loan commitments, the highest since 2016 and loan payoffs slowed to a more normalized pace, both contributing to a strong finish for the year. As a result of the increase in loan production and an improved net interest margin, the Company recognized record quarterly profits in the fourth quarter with net income of \$4.7 million, ROAA of 1.41%, ROAE of 18.70%, and an Efficiency Ratio of 59.67%, all of which exceeded our strategic goals. This strong performance allowed us to return \$5.4 million in capital to our shareholders in 2022 through a quarterly cash dividend. This represented a dividend yield of 4.34% for our shareholders.

During 2022, we also celebrated 50 years of serving our customers and shareholders. Thank you to our customers for continuing to do business with us and valuing our relationship. Thank you to our prospects for meeting with us and considering our solutions. Thank you to our shareholders for your support and loyalty. Thank you to our Board of Directors for your direction and oversight, Ed Ketel in particular as he retires after 20 years of service. And thank you to our dedicated and amazing employees for living out our mission and holding steadfast to our values, enabling us to grow our Company and reinvest in our local communities.

Looking ahead, we are well positioned for the current rate environment and expect to continue the momentum of strong financial performance into 2023. Although we do anticipate some headwinds as deposit costs increase, mortgage banking activity slows, and inflation pressures persist, we have prudently managed our balance sheet, asset quality, and capital levels to help withstand these challenges. We are proud of our proven track record and, as a vibrant Pacific Northwest Bank, we plan to continue to build an outstanding franchise.

Please join us for our annual Shareholders' meeting on Wednesday, April 26, 2023, at 4:00 pm. You may access the meeting virtually via the internet at www.virtualshareholdermeeting.com/PFLC2023. As a shareholder, you will be required to enter your control number found on your proxy card.

The Board and management team are excited about the opportunities we see in our markets and aim to generate fiscally responsible growth capable of delivering long-term value for our shareholders.

Sincerely,

A handwritten signature in black ink that reads "Denise Portmann".

Denise Portmann
President and Chief Executive Officer
Pacific Financial Corporation

	For the Year Ended December 31,				
	2022	2021	2020	2019	2018
	(dollars in thousands, except per share data) (unaudited)				
Operations Data					
Interest and dividend income	\$ 42,152	\$ 37,159	\$ 39,574	\$ 41,570	\$ 40,060
Interest expense	1,206	1,254	2,380	2,928	2,590
Net interest income	40,946	35,905	37,194	38,642	37,470
Provision (benefit) for loan losses	-	(3,650)	3,500	-	-
Noninterest income	7,227	16,729	20,146	13,895	10,031
Noninterest expense	34,974	40,702	39,594	35,556	33,793
Income before income taxes	13,199	15,582	14,246	16,981	13,708
Income tax expense	2,311	2,885	2,862	3,223	2,378
Net income	\$ 10,888	\$ 12,697	\$ 11,384	\$ 13,758	\$ 11,330
Net income per share:					
Basic	\$ 1.05	\$ 1.22	\$ 1.08	\$ 1.30	\$ 1.07
Diluted	\$ 1.04	\$ 1.22	\$ 1.07	\$ 1.29	\$ 1.06
Dividends declared per share ⁽¹⁾	\$ 0.52	\$ 0.52	\$ 0.38	\$ 0.31	\$ 0.30
Dividends declared	\$ 5,407	\$ 5,418	\$ 4,023	\$ 3,288	\$ 3,170
Dividend payout ratio	50%	43%	35%	24%	28%
Performance Ratios					
Return on average equity	10.24%	10.85%	10.33%	13.70%	12.63%
Return on average assets	0.82%	1.00%	1.07%	1.50%	1.26%
Net interest margin	3.29%	3.00%	3.73%	4.58%	4.52%
Efficiency ratio	72.60%	77.33%	69.05%	67.68%	71.14%
Balance Sheet Data					
Total assets	\$ 1,306,203	\$ 1,319,966	\$ 1,167,293	\$ 929,415	\$ 907,929
Loans, net	631,722	620,036	717,330	675,445	694,054
Total deposits	1,180,362	1,178,940	1,028,424	798,638	783,549
Total borrowings	13,403	13,806	13,956	16,606	21,756
Shareholders' equity	103,162	117,642	114,186	105,293	92,483
Equity to assets ratio	7.90%	8.91%	9.78%	11.33%	10.19%
Book value per share	\$ 9.91	\$ 11.32	\$ 10.94	\$ 9.90	\$ 8.75
Tangible book value per share	\$ 8.62	\$ 10.03	\$ 9.65	\$ 8.64	\$ 7.47
Asset Quality Ratios					
Allowance for loan losses to total loans	1.29%	1.32%	1.65%	1.31%	1.29%
Allowance for loan losses to nonperforming loans	947.76%	679.52%	504.52%	873.96%	838.65%
Nonperforming loans to total loans	0.14%	0.19%	0.33%	0.15%	0.15%
Nonperforming assets to total assets	0.07%	0.11%	0.20%	0.11%	0.12%

⁽¹⁾ In 2019, the Company transitioned to a quarterly cash dividend. The fourth quarter dividend of \$0.11 per common share paid on February 26, 2020. This fourth quarter dividend is not included in the 2019 dividend declared number, as it was not declared until January 2020.



INDEPENDENT AUDITORS' REPORT

Board of Directors
Pacific Financial Corporation
Aberdeen, Washington

Report on the Audit of the Consolidated Financial Statements

Opinion

We have audited the accompanying consolidated financial statements of Pacific Financial Corporation and its subsidiary, Bank of the Pacific, (the Company), which comprise the consolidated statements of financial condition as of December 31, 2022 and 2021, and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pacific Financial Corporation and its subsidiary as of December 31, 2022 and 2021, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

We have also audited in accordance with auditing standards generally accepted in the United States of America, Pacific Financial Corporation and its subsidiary's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income (call report instructions), as of December 31, 2022, based on criteria established in *Internal Control – Integrated Framework (2013)*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 16, 2023, expressed an unqualified opinion.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditors' Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are required to be independent of Pacific Financial Corporation and its subsidiary and to meet our other ethical responsibilities in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about Pacific Financial Corporation and its subsidiary's ability to continue as a going concern for one year after the date the consolidated financial statements are available to be issued.

Auditors' Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the consolidated financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the consolidated financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about Pacific Financial Corporation and its subsidiary's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control related matters that we identified during the audit.

Other Information Included in the Annual Report

Management is responsible for the other information included in the annual report. The other information comprises the letter to the shareholders, financial information, and nonfinancial information but does not include the consolidated financial statements and our auditors' report thereon. Our opinion on the consolidated financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the consolidated financial statements, or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.

CliftonLarsonAllen LLP

CliftonLarsonAllen LLP

Bellevue, Washington
March 16, 2023

Pacific Financial Corporation
Consolidated Statements of Financial Condition
(Dollars in thousands, except per share data)

	December 31,	December 31,
ASSETS	2022	2021
Cash on hand and in banks	\$ 18,673	\$ 15,859
Interest bearing deposits	295,563	319,626
Federal Funds Sold	-	50,881
Cash and cash equivalents	<u>314,236</u>	<u>386,366</u>
Other interest earning deposits	4,250	3,250
Investment securities available for sale, at fair value	226,784	232,947
Investment securities held to maturity (fair value of \$56,513 and \$788, respectively)	59,513	788
Loans held for sale	-	6,104
Loans, net of deferred fees	639,958	628,333
Allowance for loan losses	<u>(8,236)</u>	<u>(8,297)</u>
Total loans, net	<u>631,722</u>	<u>620,036</u>
Nonmarketable equity securities	2,583	2,416
Premises and equipment, net	12,871	13,004
Operating lease right-of-use assets	1,077	1,462
Cash surrender value of life insurance	26,776	26,072
Goodwill	12,168	12,168
Other intangible assets, net	1,268	1,276
Accrued interest receivable	4,044	3,357
Prepaid expenses and other assets	8,911	10,720
Total assets	<u>\$ 1,306,203</u>	<u>\$ 1,319,966</u>
 LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits	\$ 1,180,362	\$ 1,178,940
Federal Home Loan Bank advances	-	403
Junior subordinated debentures	13,403	13,403
Operating lease liabilities	1,149	1,482
Accrued expenses and other liabilities	<u>8,127</u>	<u>8,096</u>
Total liabilities	<u>1,203,041</u>	<u>1,202,324</u>
Shareholders' Equity:		
Preferred Stock, no par value; 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2022 and December 31, 2021	-	-
Common Stock, \$1 par value; 25,000,000 shares authorized, 10,414,276 and 10,388,267 shares issued and outstanding at December 31, 2022 and 2021, respectively	10,414	10,388
Additional paid-in-capital	42,065	41,884
Retained earnings	69,844	64,363
Accumulated other comprehensive income (loss), net	<u>(19,161)</u>	<u>1,007</u>
Total shareholders' equity	<u>103,162</u>	<u>117,642</u>
Total liabilities and shareholders' equity	<u>\$ 1,306,203</u>	<u>\$ 1,319,966</u>

See accompanying Notes to Consolidated Financial Statements.

Pacific Financial Corporation
Consolidated Statements of Income
(Dollars in thousands, except per share data)

	Twelve Months Ended December 31,	
	2022	2021
INTEREST AND DIVIDEND INCOME		
Interest and fees on loans	\$ 30,079	\$ 33,563
Taxable interest on investment securities	4,418	2,061
Nontaxable interest on investment securities	1,048	1,002
Interest and dividends on other interest earning assets	6,607	533
Total interest and dividend income	42,152	37,159
INTEREST EXPENSE		
Deposits	742	1,011
Junior subordinated debentures	460	232
Federal Home Loan Bank advances	4	11
Total interest expense	1,206	1,254
Net interest income	40,946	35,905
Benefit for loan losses	-	(3,650)
Net interest income after loan loss benefit	40,946	39,555
NONINTEREST INCOME		
Service charges on deposits	1,621	1,446
Gain on sale of loans, net	1,406	9,448
Earnings on bank owned life insurance	682	1,384
Other income	3,518	4,451
Total noninterest income	7,227	16,729
NONINTEREST EXPENSE		
Compensation and employee benefits	22,401	27,114
Occupancy	2,023	1,978
Equipment	1,184	1,244
Data processing	3,506	3,288
Professional services	709	943
Marketing	400	300
State and local taxes	693	858
Federal deposit insurance premium	357	422
Other expense	3,701	4,555
Total noninterest expense	34,974	40,702
Income before income taxes	13,199	15,582
Income tax expense	2,311	2,885
Net income	\$ 10,888	\$ 12,697
Basic earnings per common share	\$ 1.05	\$ 1.22
Diluted earnings per common share	\$ 1.04	\$ 1.22

See accompanying Notes to Consolidated Financial Statements.

Pacific Financial Corporation
Consolidated Statements of Comprehensive Income
(Dollars in thousands)

	Twelve Months Ended	
	December 31,	
	2022	2021
Net Income	\$ 10,888	\$ 12,697
Other comprehensive income (loss), net of tax:		
Securities available for sale, net of tax	(20,707)	(3,430)
Defined benefit plans, net of tax	539	195
Total other comprehensive income (loss), net of tax	(20,168)	(3,235)
Comprehensive income (loss)	\$ (9,280)	\$ 9,462

See accompanying Notes to Consolidated Financial Statements.

Pacific Financial Corporation
Consolidated Statements of Shareholders' Equity
(Dollars in thousands, except share amounts)

	Number of Common Shares	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss) , net	Total Shareholders' Equity
Balance at December 31, 2020	10,434,533	\$ 10,435	\$ 42,425	\$ 57,084	\$ 4,242	\$ 114,186
Net income	-	-	-	12,697	-	12,697
Other comprehensive loss, net of tax	-	-	-	-	(3,235)	(3,235)
Stock option exercises/stock unit vested	11,326	11	(8)	-	-	3
Stock based compensation expense	-	-	126	-	-	126
Stock repurchase and cancelation of shares	(57,592)	(58)	(659)	-	-	(717)
Cash dividends declared (\$0.52 per share)	-	-	-	(5,418)	-	(5,418)
Balance at December 31, 2021	10,388,267	\$ 10,388	\$ 41,884	\$ 64,363	\$ 1,007	\$ 117,642
Net income	-	-	-	10,888	-	10,888
Other comprehensive loss, net of tax	-	-	-	-	(20,168)	(20,168)
Stock option exercises/stock unit vested	26,009	26	31	-	-	57
Stock based compensation expense	-	-	150	-	-	150
Cash dividends declared (\$0.52 per share)	-	-	-	(5,407)	-	(5,407)
Balance at December 31, 2022	10,414,276	\$ 10,414	\$ 42,065	\$ 69,844	\$ (19,161)	\$ 103,162

See accompanying Notes to Consolidated Financial Statements.

Pacific Financial Corporation
Consolidated Statements of Cash Flows
(Dollars in thousands)

	Twelve Months Ended	
	December 31,	
	2022	2021
Cash flows from operating activities:		
Net Income	\$ 10,888	\$ 12,697
Adjustments to reconcile net income to net cash on hand and in banks from operating activities		
Benefit for loan losses	-	(3,650)
Depreciation and amortization	3,357	3,055
Deferred income taxes	59	1,443
Originations of loans held for sale	(65,030)	(425,575)
Proceeds from sales of loans	71,690	470,461
Gain on sale of loans, net	(1,406)	(9,448)
(Gain) loss on sale of premises and equipment	13	(12)
Earnings on bank owned life insurance	(682)	(1,384)
Net change in accrued interest receivable	(687)	1,324
Net change in accrued interest payable	73	(30)
Net change in prepaid expenses	(184)	(332)
Other operating activities	7,283	(9,897)
Net cash provided by operating activities	25,374	38,652
Cash flows from investing activities:		
Net change in loans	(10,150)	96,451
Maturities of investment securities held to maturity	3,470	135
Maturities and paydowns of investment securities available for sale	18,047	19,000
Purchase of investment securities available for sale	(40,309)	(133,538)
Purchase of investment securities held to maturity	(61,839)	-
Purchases of nonmarketable equity securities	(184)	(286)
Increase in other interest earning deposits	(1,000)	-
Purchase of bank owned life insurance	(36)	(6,036)
Purchases of premises and equipment	(1,174)	(597)
Proceeds from sales of nonmarketable equity securities	17	7
Proceeds from bank owned life insurance death benefit	14	2,689
Proceeds from sales of premises and equipment	-	24
Net cash used in investing activities	(93,144)	(22,151)
Cash flows from financing activities:		
Net increase in deposits	1,422	150,516
Repayments of FHLB Advances	(403)	(150)
Net cash from stock option exercises	52	64
Repurchase of common stock	-	(717)
Taxes related to net share settlement for equity awards	(24)	(53)
Cash dividends paid	(5,407)	(5,418)
Net cash provided by (used in) financing activities	(4,360)	144,242
Net increase (decrease) in cash and cash equivalents	(72,130)	160,743
Cash and cash equivalents at beginning of year	386,366	225,623
Cash and cash equivalents at end of year	\$ 314,236	\$ 386,366
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$ 1,133	\$ 1,284
Cash paid for taxes	\$ 115	\$ 2,275
Supplemental non-cash disclosures of cash flow information:		
Transfer of loans held for sale to loans held for investment	\$ 850	\$ 6,636

See accompanying Notes to Consolidated Financial Statements.

Pacific Financial Corporation and Subsidiary
Notes to Consolidated Financial Statements
For the Years Ended December 31, 2022 and December 31, 2021

NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization – Pacific Financial Corporation (the “Company”) is a bank holding company headquartered in Aberdeen, Washington. The Company owns one banking subsidiary, Bank of the Pacific (the “Bank”), which is also headquartered in Aberdeen, Washington. The Company was incorporated in the State of Washington in February, 1997, pursuant to a holding company reorganization of the Bank. The Company has two wholly owned subsidiaries, PFC Statutory Trust I and II (the “Trusts”), which do not meet the criteria for consolidation, and therefore, are not consolidated in the Company’s financial statements.

The Company conducts its banking business through the Bank, which operates fourteen branches located in communities in Grays Harbor, Pacific, Whatcom, Clark, Skagit and Wahkiakum counties in the state of Washington and two branches in Clatsop County, Oregon. In addition, the Bank operates two loan production offices in Burlington, Washington; and Salem, Oregon; and a residential real estate mortgage department.

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

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

Certain prior year amounts have been reclassified to conform with the 2022 presentation. These reclassifications did not change previously reported net income or shareholders’ equity.

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

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

Subsequent events – The Company performed an evaluation of subsequent events through March 15, 2023, the date these financial statements were available to be issued.

Securities available for sale – Securities available for sale consist of debt securities that the Company intends to hold for an indefinite period, but not necessarily to maturity. Securities available for sale are reported at fair value. Unrealized gains and losses, net of the related deferred tax effect, are reported net as a separate component of shareholders’ equity entitled “accumulated other comprehensive income.” 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. For mortgage backed securities, actual maturity may differ from contractual maturity due to principal payments and amortization of premiums and accretion of discounts may vary due to prepayment speed assumptions. For callable securities amortization of premiums are recognized over the period to first call date.

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. Amortization of premiums and accretion of discounts are recognized in interest income over the period to maturity. For mortgage backed securities, actual maturity may differ from contractual maturity due to principal payments and amortization of premiums and accretion of discounts may vary due to prepayment speed assumptions. For callable securities amortization of premiums are recognized over the period to first call date.

Other than temporary impairment (OTTI) – Declines in the fair value of individual securities held to maturity and available for sale that are deemed to be other than temporary are reflected in earnings when identified. Management evaluates individual securities for other than temporary impairment (“OTTI”) on a quarterly basis. OTTI is separated into a credit and noncredit component. Noncredit component losses are recorded in other comprehensive income (loss) when the fair value of the debt security is below the carrying value primarily due to changes in interest rates, there has not been significant deterioration in the financial condition of the issuer, and it is not more likely than not that the Company will be required to, nor does it have the intent to sell the security before the anticipated recovery of its remaining carrying value. Credit component losses are reported in noninterest income.

Nonmarketable equity securities – The Company’s investment in Federal Home Loan Bank (“FHLB”) stock is carried at cost and cash and stock dividends are recorded as income. The Company’s investment in Pacific Coast Bankers Bank (“PCBB”) stock is carried at cost, less impairment and plus or minus observable prices, if any, and cash and stock dividends are recorded as income. Nonmarketable equity securities are periodically evaluated for impairment based on ultimate recovery of par value.

The Company is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding mortgages, total assets, or FHLB advances. At December 31, 2022 and 2021 the stock was that of FHLB of Des Moines.

Loans held for sale – Mortgage loans originated for sale in the foreseeable future in the secondary market are carried at the lower of aggregate cost or estimated fair value. Gains and losses on sales of loans are recognized at settlement date and are determined by the difference between the sales proceeds and the carrying value of the loans. Net unrealized losses are recognized through a valuation allowance established by charges to income. Loans held for sale that are unable to be sold in the secondary market are transferred to loans receivable when identified.

Loans receivable – Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding principal balances adjusted for any charge-offs, the allowance for loan losses, any deferred fees or costs on originated loans, and unamortized premiums or discounts on purchased loans. Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment of yield over the contractual life of the related loans using the effective interest method.

Interest income on loans is accrued over the term of the loans based upon the principal outstanding. The accrual of interest on loans is discontinued when, in management’s opinion, the borrower may be unable to meet payments as they come due. When interest accrual is discontinued, all unpaid accrued interest is reversed against interest income. Interest income is subsequently recognized only to the extent that cash payments are received until, in management’s judgment, the borrower has the ability to make contractual interest and principal payments, in which case the loan is returned to accrual status.

The Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”) – In response to the Coronavirus Disease 2019 (“COVID-19”) pandemic, the CARES Act was signed into law on March 27, 2020 to provide national emergency economic relief measures. Many of the CARES Act’s programs are dependent upon the direct involvement of U.S. financial institutions and have been implemented through rules and guidance adopted by federal departments and agencies, including the U.S. Department of Treasury, the Federal Reserve and other federal banking agencies, including those with direct supervisory jurisdiction over the Company and the Bank.

Small Business Administration (“SBA”) Paycheck Protection Program (“PPP”) – The CARES Act amended the SBA’s loan program, in which the Bank participated, to create a guaranteed, unsecured loan program, the PPP, to fund operational costs of eligible businesses, organizations and self-employed persons during COVID-19.

The Consolidated Appropriations Act of 2021 (“CA Act”) was signed into law on December 27, 2020 and provided COVID-19 emergency response and relief, including renewing and extending the SBA PPP. During 2021, the Company participated in the CARES Act by offering PPP loans to clients affected by the COVID-19 pandemic.

Troubled Debt Restructuring (“TDR”) and Loan Modifications for Affected Borrowers – The CARES Act permits banks to suspend requirements under GAAP for loan modifications to borrowers affected by COVID-19 that would otherwise be characterized as TDRs and suspend any determination related thereto if loans met certain criteria and was not more than 30 days past due at December 31, 2019. The CA Act also extended relief offered under the CARES Act related to TDRs as a result of COVID-19 through January 1, 2022 or 60 days after the end of the national emergency declared by the President, whichever is earlier. The Company modified loans due to the effects of the COVID-19 pandemic that were not classified as TDRs in 2021.

Allowance for loan losses – The allowance for loan losses is established through a provision that is charged to earnings as probable losses are incurred. Losses are charged against the allowance when management believes the collectability of a loan balance is unlikely. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management’s periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower’s ability to repay, estimated value of underlying collateral and prevailing economic conditions. The evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available. The Company’s methodology for assessing the appropriateness of the allowance consists of several key elements, which includes a general formulaic allowance and a specific allowance on impaired loans. The formulaic portion of the general credit loss allowance is established by applying a loss percentage factor to the different loan types based on historical loss experience adjusted for qualitative factors.

A loan is considered impaired when, based on current information and events, it is probable the Company will be unable to collect principal and interest when due according to the contractual terms of the original loan agreement. 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 borrowers, including the length of the delay, the reasons for the delay, the borrower’s prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial, construction and real estate loans by either the present value of the expected future cash flows discounted at the loan’s effective interest rate, or the fair value of the collateral less estimated selling costs if the loan is collateral dependent. When the net realizable value of an impaired loan is less than the book value of the loan, impairment is recognized by adjusting the allowance for loan losses. Uncollected accrued interest is reversed against interest income. If ultimate collection of principal is in doubt, all subsequent cash receipts including interest payments on impaired loans are applied to reduce the principal balance.

A restructuring of a debt constitutes a troubled debt restructuring (“TDR”) if the Company grants a concession to the borrower for economic or legal reasons related to the borrower’s financial difficulties that it would not otherwise consider. TDRs typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans or leases that are reported as TDRs are considered impaired and measured for impairment as described above.

Premises and equipment – Premises and equipment are stated at cost less accumulated depreciation, which is computed on the straight-line method over the estimated useful lives of the assets. Asset lives range from 3 to 39 years. 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.

Right of Use Lease Asset & Lease Liability –The Company leases retail space, office space and equipment under operating leases. For operating leases greater than 12 months, an operating right of use (ROU) asset and an operating lease liability (lease liability) is recorded on the consolidated financial statements. The Company elected not to include short-term leases (i.e., leases with initial terms of twelve months or less), or equipment leases (deemed immaterial) on the consolidated financial statements.

The calculated amount of the ROU assets and lease liabilities are impacted by the length of the lease term and the discount rates used to calculate the present value the minimum lease payments. For the discount rate the Company utilizes its incremental borrowing rate at lease inception over a similar term. For operating leases existing prior to January 1, 2019, the rate for the remaining lease term as of January 1, 2019 was used.

Other real estate owned – Real estate properties acquired through, or in lieu of, foreclosure are to be sold and are initially recorded at the 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 (“OREO”) is charged to the allowance for loan losses. Properties are evaluated regularly to ensure that the recorded amounts are supported by their current fair values, and that write-downs to reduce the carrying amounts to fair value less estimated costs to dispose are recorded as necessary. Any subsequent reductions in carrying values, and revenue and expense from the operations of properties, are charged to operations.

Bank-owned life insurance – Bank owned life insurance is carried at the amount due upon surrender of the policy, which is also the estimated fair value. This amount was provided by the insurance companies based on the terms of the underlying insurance contract.

Off-balance-sheet credit related financial instruments – In the ordinary course of business, the Company has entered into commitments to extend credit, including commitments under credit arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded. The Company maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance-sheet commitments is included in accrued expenses and other liabilities.

Goodwill and other intangible assets – At December 31, 2022 the Company had \$13.4 million in goodwill and other intangible assets. Goodwill is initially recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired. Goodwill is reviewed for potential impairment on an annual basis or more frequently if events or circumstances indicate a potential impairment, at the reporting unit level. The Company has one reporting unit, the Bank, for purposes of computing goodwill. An assessment of qualitative factors is completed to determine if it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If the qualitative analysis concludes that further analysis is required, then a quantitative impairment test would be completed. The quantitative goodwill impairment test is used to identify the existence of impairment and the amount of impairment loss and compares the reporting unit's estimated fair value, including goodwill, to its carrying amount. If the fair value exceeds the carrying amount then goodwill is not considered impaired. If the carrying amount exceeds its fair value, an impairment loss would be recognized equal to the amount of excess, limited to the amount of total goodwill allocated to that reporting unit. The impairment loss would be recognized as a charge to earnings.

For the years ended December 31, 2022 and 2021, the Company's goodwill impairment evaluation, based on its qualitative assessment, indicated there was no impairment. No assurance can be given that the Company will not record an impairment loss on goodwill in the future.

Core deposit intangibles are amortized to noninterest expenses using an accelerated method over ten years. Net unamortized core deposit intangible was \$0 and \$8,000 at December 31, 2022 and 2021, respectively. Amortization expense related to core deposit intangible totaled \$8,000 and \$11,000 during the years ended December 31, 2022 and 2021, respectively.

In 2006, the Bank completed a deposit transfer and assumption transaction with an Oregon-based bank for a \$1.3 million premium. In connection with completion of the transaction, the Oregon Department of Consumer and Business Services issued a Certificate of Authority to the Bank authorizing it to conduct a banking business in the State of Oregon. The premium, and the resultant right to conduct business in Oregon, is recorded as an indefinite-lived intangible asset.

Impairment of long-lived assets – Management periodically reviews the carrying value of its long-lived assets to determine if impairment has occurred or whether changes in circumstances have occurred that would require a revision to the remaining useful life, of which there have been none. In making such determination, management evaluates the performance, on an undiscounted basis, of the underlying operations or assets which give rise to such amount.

Transfers of financial assets – Transfers of financial assets, including cash, investment securities, loans and loans held for sale, 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 Company, (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 Company does not maintain effective control over the transferred assets through either an agreement to repurchase them before their maturity, or the ability to cause the buyer to return specific assets.

Advertising – Advertising costs are expensed as incurred.

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. Deferred tax assets are reduced by a valuation allowance when management determines that it is more likely than not that some portion or all of the deferred tax assets will not be realized. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The Company files a consolidated federal income tax return. The Bank provides for income taxes separately and remits to the Company amounts currently due in accordance with a tax allocation agreement between the Company and the Bank.

As of December 31, 2022, the Company had no unrecognized tax benefits. The Company's policy is to recognize interest and penalties on unrecognized tax benefits in "Income Taxes" in the consolidated statements of income. The amount of interest and penalties accrued as of December 31, 2022 and December 31, 2021 and recognized during the years ended December 31, 2022, and 2021 were

immaterial. The tax years that remain subject to examination by federal and state taxing authorities are the years ended December 31, 2021, 2020 and 2019.

Stock-based compensation – Accounting guidance requires measurement of compensation cost for all stock based awards based on the grant date fair value and recognition of compensation cost over the service period of stock based awards. The fair value of stock options is determined using the Black-Scholes valuation model. The Company’s stock compensation plans are described more fully in Note 16.

Cash equivalents and cash flows – The Company considers all amounts included in the balance sheet caption “Cash and due from banks” to be cash equivalents. Cash and cash equivalents have a maturity of 90 days or less at the time of purchase. Cash flows from loans, interest bearing deposits in banks, federal funds sold, short-term borrowings, secured borrowings and deposits are reported net. The Company maintains balances in depository institution accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

Certificates of deposit held for investment – Certificates of deposit held for investments include amounts invested with financial institutions for a stated interest rate and maturity date and are included in the balance sheet caption “Other interest earning deposits”. Early withdraw penalties apply, however the Company plans to hold these investments to maturity.

Earnings per share – Basic earnings per share excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding. Diluted earnings per share reflect the potential dilution that could occur if common shares were exercised or issued under the Company’s stock compensation plans. Stock options and restricted stock units excluded from the calculation of diluted earnings per share because they are antidilutive, were 122,000 and 121,000 in 2022 and 2021, respectively.

Comprehensive income – Recognized revenue, expenses, gains and losses are included in net income. Certain changes in assets and liabilities, such as prior service costs and amortization of prior service costs related to defined benefit plans and unrealized gains and losses on securities available for sale, are reported within equity in other accumulated comprehensive loss in the consolidated balance sheet. Such items, along with net income, are components of comprehensive loss. Gains and losses on securities available for sale are reclassified to net income as the gains or losses are realized upon sale of the securities. Other-than-temporary impairment charges are reclassified to net income at the time of the charge.

Business segment – The Company operates a single business segment. The financial information that is used by the chief operating decision maker in allocating resources and assessing performance is only provided for one reportable segment as of December 31, 2022 and 2021.

Revenue Recognition – The Company recognizes revenue as it is earned based on contractual terms, as transactions occur, or as services are provided and collectability is reasonably assured. The principal source of revenue is interest income from loans and investments, which is out of scope of ASC 606 Revenue Recognition. The Company also earns non-interest income from various banking services offered to its customers. Gain on sales of loans, investment securities, earnings on bank-owned life insurance, and other income are not within the scope of ASC 606. The Company’s revenue from contracts with customers within the scope of ASC 606 is recognized in non-interest income. Certain specific policies related to those in scope with revenue streams income include the following:

Service Charges on Deposit Accounts – The Company earns fees from its deposit customers by providing contractual transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as ATM use fees, stop payment charges, statement rendering, and ACH fees, are recognized at the time the transaction is executed at the point in time the Company fulfills the customer’s request for product or service. Fees, which relate primarily to deposit account maintenance, are earned over the course of a month, representing the period over which the Company satisfies its performance obligation. Fees for performing that service are then assessed at the close of the statement period. Overdraft fees are recognized at the point in time that the overdraft is created by the payment of a check against a deposit account in which there are not sufficient funds to pay that item. Service charges on deposits are collected directly from the customer’s account balance per the terms of the contract with the depositor.

Interchange and Other Fees – The Company earns interchange fees from debit or credit cardholder transactions, from cards issued by the Company to its customers or processed for non-customers, conducted through various card payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. Other service charges include revenue from processing wire

transfers, bill pay service, cashier's checks, and other services. The Company's performance obligation for interchange and other service charges are largely satisfied, and related revenue recognized, when completion of the services are rendered at a point in time.

The following table presents the Company's noninterest income by revenue stream and reportable segment for the years ended December 31, 2022 and 2021. Items outside the scope of ASC 606 are noted as such.

	Twelve Months Ended	
	December 31,	
	2022	2021
	(in thousands)	
Service charges on deposits	\$ 1,621	\$ 1,446
Gain on sale of loans, net ⁽¹⁾	1,406	9,448
Earnings on bank owned life insurance ⁽¹⁾	682	1,384
Interchange and other fees	3,519	4,383
Other ⁽¹⁾	(1)	68
Total noninterest income	<u>\$ 7,227</u>	<u>\$ 16,729</u>

⁽¹⁾ Not within the scope of ASC 606

Recent accounting pronouncements – not yet effective

FASB ASU 2016-13, Financial Instruments: Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, was issued in June 2016. Commonly referred to as the current expected credit loss model ("CECL"), this Update requires financial assets measured at amortized cost basis to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset to present the net carrying value at the amount expected to be collected on the financial asset. The measurement of expected credit losses is based on relevant information about past events including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. The amendment affects loans, debt securities, trade receivables, net investments in leases, off balance-sheet credit exposures, reinsurance receivables, and any other financial asset not excluded from the scope that have the contractual right to receive cash. The Update replaces the incurred loss impairment methodology, which generally only considered past events and current conditions, with a methodology that reflects the expected credit losses and required consideration of a broader range of reasonable and supportable information to estimate all expected credit losses. In October 2019, the FASB voted to approve amendments to the effective date of ASU No. 2016-13 for smaller reporting companies, as defined by the SEC, and other non-SEC reporting entities. The amendment delays the effective date for the Company until interim and annual periods beginning after December 15, 2022. An entity will apply the amendments through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. A prospective transition approach is required for debt securities. The Company is finalizing the allowance for credit losses under CECL and related methodology, and is not expecting the adoption of ASU 2016-13 to have a material impact on the Consolidated Financial Statements.

FASB ASU 2020-04, Reference Rate Reform (Topic 848), as amended by ASU 2021-01, was issued in March 2020 and provides optional expedients and exceptions for applying GAAP to loan and lease agreements, derivative contracts, and other transactions affected by the anticipated transition away from LIBOR toward new interest rate benchmarks. For transactions that are modified because of reference rate reform and that meet certain scope guidance (i) modifications of loan agreements should be accounted for by prospectively adjusting the effective interest rate and the modification will be considered "minor" so that any existing unamortized origination fees/costs would carry forward and continue to be amortized and (ii) modifications of lease agreements should be accounted for as a continuation of the existing agreement with no reassessments of the lease classification and the discount rate or remeasurements of lease payments that otherwise would be required for modifications not accounted for as separate contracts. ASU 2020-04 also provides numerous optional expedients for derivative accounting and is effective March 12, 2020 through December 31, 2022. In December 2022, the FASB issued ASU 2022-06 Reference Rate Reform (Topic 848) Deferral of the Sunset Date of Topic 848. This amendment provides an update to defer the sunset date of Topic 848 from December 31, 2022, to December 31, 2024, after which all entities will no longer be permitted to apply the relief in Topic 848. The Company's LIBOR exposure is with trust preferred securities, LIBOR indexed CMO's, and LIBOR indexed loans. The Company is finalizing the modifications for the transfer away from LIBOR and not expecting the adoption of this ASU to have a material impact on the Company's business operations and the Consolidated Financial Statements.

NOTE 2 – RESTRICTED ASSETS

The Federal Reserve has the authority to establish reserve requirements on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or deposits with the Federal Reserve Bank. Effective on March 26, 2020, the Federal Reserve reduced requirements to zero percent. The Federal Reserve may adjust reserve requirement ratios in the future at its discretion.

NOTE 3 – INVESTMENT SECURITIES AND NONMARKETABLE INVESTMENT SECURITIES

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 governments, other corporations, and mortgaged backed securities (“MBS”). Investment securities have been classified according to management’s intent.

The amortized cost of securities and their approximate fair value were as follows:

	December 31, 2022			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in thousands)			
Available for Sale				
Collateralized mortgage obligations	\$ 110,573	\$ 8	\$ 8,623	\$ 101,958
Mortgage backed securities	14,023	9	922	13,110
Municipal securities	69,707	84	8,020	61,771
Corporate debt securities	2,000	-	1	1,999
U.S. government and agency obligations	55,407	-	7,461	47,946
Total available for sale	<u>\$ 251,710</u>	<u>\$ 101</u>	<u>\$ 25,027</u>	<u>\$ 226,784</u>
Held to maturity				
Collateralized mortgage obligations	\$ 18,072	\$ -	\$ 1,219	\$ 16,853
Mortgage backed securities	9,857	-	558	9,299
Municipal securities	2,506	32	38	2,500
U.S. government	29,078	-	1,217	27,861
Total held to maturity	<u>\$ 59,513</u>	<u>\$ 32</u>	<u>\$ 3,032</u>	<u>\$ 56,513</u>
	December 31, 2021			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in thousands)			
Available for Sale				
Collateralized mortgage obligations	\$ 92,320	\$ 712	\$ 982	\$ 92,050
Mortgage backed securities	17,345	270	180	17,435
Municipal securities	68,996	3,099	546	71,549
Corporate debt securities	2,001	9	-	2,010
U.S. government and agency obligations	50,629	12	738	49,903
Total available for sale	<u>\$ 231,291</u>	<u>\$ 4,102</u>	<u>\$ 2,446</u>	<u>\$ 232,947</u>
Held to maturity				
Mortgage backed securities	\$ 2	\$ -	\$ -	\$ 2
Municipal securities	786	-	-	786
Total held to maturity	<u>\$ 788</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 788</u>

Unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in continuous unrealized loss position, as of December 31, 2022 and 2021 were as follows:

	December 31, 2022					
	Less Than 12 Months		12 Months or More		Total	
	Unrealized		Unrealized		Unrealized	
	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
Available for sale	(in thousands)					
Collateralized mortgage obligations	\$ 44,373	\$ 1,557	\$ 56,895	\$ 7,066	\$ 101,268	\$ 8,623
Mortgage backed securities	7,239	370	5,545	552	12,784	922
Municipal securities	33,564	1,884	20,497	6,136	54,061	8,020
Corporate debt securities	1,999	1	-	-	1,999	1
U.S. government and agency obligations	-	-	47,946	7,461	47,946	7,461
Total	<u>\$ 87,175</u>	<u>\$ 3,812</u>	<u>\$ 130,883</u>	<u>\$ 21,215</u>	<u>\$ 218,058</u>	<u>\$ 25,027</u>

	December 31, 2022					
	Less Than 12 Months		12 Months or More		Total	
	Unrealized		Unrealized		Unrealized	
	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
Held to maturity	(in thousands)					
Collateralized mortgage obligations	\$ 16,853	\$ 1,219	\$ -	\$ -	\$ 16,853	\$ 1,219
Mortgage backed securities	9,299	558	-	-	9,299	558
Municipal securities	1,340	38	-	-	1,340	38
U.S. government and agency obligations	27,862	1,217	-	-	27,862	1,217
Total	<u>\$ 55,354</u>	<u>\$ 3,032</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 55,354</u>	<u>\$ 3,032</u>

	December 31, 2021					
	Less Than 12 Months		12 Months or More		Total	
	Unrealized		Unrealized		Unrealized	
	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
Available for sale	(in thousands)					
Collateralized mortgage obligations	\$ 57,016	\$ 702	\$ 5,299	\$ 280	\$ 62,315	\$ 982
Mortgage backed securities	9,269	154	1,634	26	10,903	180
Municipal securities	17,897	441	2,256	105	20,153	546
U.S. government and agency obligations	48,002	738	-	-	48,002	738
Total	<u>\$ 132,184</u>	<u>\$ 2,035</u>	<u>\$ 9,189</u>	<u>\$ 411</u>	<u>\$ 141,373</u>	<u>\$ 2,446</u>

At December 31, 2022, there were 241 available for sale and held to maturity investment securities in an unrealized loss position. The unrealized losses on these securities were caused by changes in interest rates, widening pricing spreads and market illiquidity, leading to a decline in the fair value subsequent to their purchase. The Company has evaluated the securities shown above and anticipates full recovery of amortized cost with respect to these securities at maturity or sooner in the event of a more favorable market environment. Based on management's evaluation, and because the Company does not have the intent to sell these securities and it is not more likely than not that it will have to sell the securities before recovery of cost basis, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2022.

For collateralized mortgage obligations ("CMOs") the Company estimates expected future cash flows of the underlying collateral, together with any credit enhancements. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which considers current delinquencies, future expected default rates and collateral value by vintage) and prepayments. The expected cash flows of the security are then discounted to arrive at a present value amount. For the years ended December 31, 2022 and 2021, no CMO was determined to be other-than-temporarily-impaired. The Company has not recorded impairments related to credit losses through earnings for the years ended December 31, 2022 and 2021.

There were no sales of securities for the years ended December 31, 2022 and 2021.

The Company did not engage in originating subprime mortgage loans, and it does not believe that it has material exposure to subprime mortgage loans or subprime mortgage backed securities.

The amortized cost and estimated fair value of investment securities at December 31, 2022 by maturity is presented in the following table. The amortized cost and estimated fair value of CMOs and MBS are presented by the contractual maturity date. Expected maturities may differ from contractual maturities because borrowers may have the right to prepay underlying loans without prepayment penalties.

		December 31, 2022			
		Held to Maturity		Available for Sale	
		Amortized		Amortized	
		Cost	Fair Value	Cost	Fair Value
		(in thousands)			
Due in one year or less	\$	-	\$	43	\$ 42
Due after one year through five years		30,793	29,548	26,735	24,943
Due after five years through ten years		5,255	5,003	91,312	81,529
Due after ten years		<u>23,465</u>	<u>21,962</u>	<u>133,620</u>	<u>120,270</u>
Total investment securities	\$	<u>59,513</u>	\$ <u>56,513</u>	\$ <u>251,710</u>	\$ <u>226,784</u>

At December 31, 2022 and 2021, investment securities with an estimated fair value of \$135.3 million and \$126.3 million were pledged to secure public deposits, certain nonpublic deposits and borrowings, respectively.

Nonmarketable investment securities

As required of all members of the FHLB system, the Company maintains an investment in the capital stock of the FHLB in an amount equal to the greater of \$500,000 or 0.5% of home mortgage loans and pass-through securities plus 5.0% of the outstanding balance of mortgage home loans sold to FHLB under the Mortgage Purchase Program. Participating banks record the value of FHLB stock equal to its par value at \$100 per share. At December 31, 2022 and 2021 the Company held \$1.6 million and \$1.4 million in FHLB stock, respectively.

The Company owns \$1.0 million in common stock in PCBB, from which the Company receives a variety of corresponding banking services through its banking subsidiary Pacific Coast Bankers Bank. When evaluating this investment for impairment, the value is determined based on the recovery of the par value through any redemption by PCBB or from the sale to another eligible purchaser, rather than by recognizing temporary declines in value. PCBB disclosed that it reported net income for the twelve month period ended December 31, 2022 and maintains capital ratios that exceed “well capitalized” standards for regulatory purposes.

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

Loans held in the portfolio at December 31, 2022 and 2021 were as follows:

	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
	(in thousands)	
Commercial and agricultural	\$ 75,705	\$ 85,309
PPP	515	25,081
Real estate:		
Construction and development	37,287	28,318
Residential 1-4 family	82,653	67,393
Multi-family	41,122	39,854
Commercial real estate -- owner occupied	154,380	154,901
Commercial real estate -- non owner occupied	153,707	148,730
Farmland	<u>26,935</u>	<u>23,905</u>
Total real estate	<u>496,084</u>	<u>463,101</u>
Consumer	<u>68,412</u>	<u>56,269</u>
Gross loans	640,716	629,760
Deferred fees, net	<u>(758)</u>	<u>(1,427)</u>
Loans, net of deferred fees	<u>\$ 639,958</u>	<u>\$ 628,333</u>

Commercial and Agricultural. The Company's commercial and agricultural loans consist primarily of secured revolving operating lines of credit, equipment financing, accounts receivable and inventory financing and business term loans, some of which may be partially guaranteed by the Small Business Administration or the U.S. Department of Agriculture. The Company's credit policies determine advance rates against the different forms of collateral that can be pledged against commercial loans. Typically, the majority of loans will be limited to a percentage of the underlying collateral values such as equipment, eligible accounts receivable and finished inventory. Individual advance rates may be higher or lower depending upon the financial strength of the borrower, quality of the collateral and/or term of the loan.

Paycheck Protection Program ("PPP"). This program was established by the Coronavirus Aid, Relief and Economic Security Act ("CARES Act"), enacted on March 27, 2020, in response to the Coronavirus Disease 2019 ("COVID-19") pandemic. The PPP was administered by the Small Business Administration (SBA). PPP loans may be forgiven by the SBA and are 100 percent guaranteed by the SBA. These loans have either a two-year or five-year maturity date and earn interest at 1%. The Bank also earns a fee based on the size of the loan, which is recognized over the life of the loan. The balance of unamortized net deferred fees on SBA PPP loans was \$17,000 and \$944,000 at December 31, 2022 and 2021, respectively.

Real Estate. The Company originates owner occupied and non-owner occupied commercial real estate and multifamily loans within its primary market areas. Commercial real estate and multifamily loans typically involve a greater degree of risk than single-family residential mortgage loans. Payments on loans secured by multifamily and commercial real estate properties are dependent on successful operation and management of the properties and repayment of these loans is affected by adverse conditions in the real estate market or the economy. The Company seeks to minimize these risks by scrutinizing the financial condition of the borrower, the quality and value of the collateral, and the management of the property securing the loan. In addition, commercial real estate loan portfolios are reviewed annually to evaluate the performance of individual loans that are \$1 million and larger for potential changes in interest rates, occupancy, and collateral values.

Non-owner occupied commercial real estate loans are loans in which less than 50% of the property is occupied by the owner and include loans such as apartment complexes, hotels and motels, retail centers and mini-storage facilities. Repayment of non-owner occupied commercial real estate loans is dependent upon the lease or resale of the subject property. Loan amortizations range from 10 to 30 years, although terms typically do not exceed 10 years. Interest rates can be either floating or fixed. Floating rates are typically indexed to the prime rate, SOFR, or Federal Home Loan Bank advance rates plus a defined margin. Fixed rates are generally set for periods of three to ten years with either a rate reset provision or a payment due at maturity. Prepayment penalties are often sought on term commercial real estate loans.

The Company originates single-family residential construction loans for custom homes where the home buyer is the borrower. It has also provided financing to builders for the construction of pre-sold homes and to builders for the construction of speculative residential property. The Company endeavors to limit construction lending risks through adherence to specific underwriting guidelines and procedures. Repayment of construction loans is dependent upon the sale of individual homes to consumers or in some cases to other developers. Construction loans are generally short-term in nature and most loans mature in one to two years. Interest rates are usually floating and fully indexed to a short-term rate index. The Company's credit policies address maximum loan to value, cash equity requirements, inspection requirements, and overall credit strength.

The majority of one-to-four family residential loans are secured by single-family residences located in the Company's primary market areas. Single-family portfolio loans are generally owner-occupied with terms typically range from 15 to 30 years. Repayment of these loans comes from the borrower's personal cash flows and liquidity, and collateral values are a function of residential real estate values in the markets we serve. These loans include primary residences, second homes, rental homes and home equity loans and home equity lines of credit.

Consumer. The Company originates consumer loans and lines of credit that are both secured and unsecured. Underwriting standards ensures a qualifying primary and secondary source of repayment. Underwriting standards for home equity loans are significantly influenced by statutory requirements. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. The majority of consumer loans are disbursed among many individual borrowers which reduces the credit risk for this type of loan. The Company also purchases indirect consumer loans for classic and exotic cars. Deposit account overdrafts reported as consumer loans totaled \$108,000 and \$110,000 at December 31, 2022 and 2021, respectively.

At December 31, 2022 and 2021, \$289.1 million and \$262.5 million, respectively, of loans were pledged as collateral on FHLB advances. The Company has also pledged \$80.8 million and \$81.2 million of loans to the FRB for additional borrowing capacity at December 31, 2022 and 2021, respectively.

Allowance for loan losses and credit quality

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

- The Company classifies loans into relatively homogeneous pools by loan type in accordance with regulatory guidelines for regulatory reporting purposes. The Company regularly reviews all loans within each loan category to establish risk ratings for them that include Pass, Watch, Special Mention, Substandard, Doubtful and Loss. Pursuant to ASC 310 "Accounting by Creditors for Impairment of a Loan", the impaired portion of collateral dependent loans is charged-off. Other risk-related loans not considered impaired have loss factors applied to the various loan pool balances to establish loss potential for provisioning purposes.
- Analyses are performed to establish the loss factors based on historical experience, as well as expected losses based on qualitative evaluations of such factors, as such economic trends and conditions, industry conditions, levels and trends in delinquencies and impaired loans, levels and trends in charge-offs and recoveries, among others. The loss factors are applied to loan category pools segregated by risk classification to estimate the loss inherent in the Company's loan portfolio pursuant to ASC 450 "Accounting for Contingencies."
- Additionally, impaired loans are evaluated for loss potential on an individual basis in accordance with ASC 310 "Accounting by Creditors for Impairment of a Loan" and specific reserves are established based on thorough analysis of collateral values where loss potential exists. When an impaired loan is collateral dependent and a deficiency exists in the fair value of collateral securing the loan in comparison to the associated loan balance, the deficiency is charged-off at that time or a specific reserve is established. Impaired loans are reviewed no less frequently than quarterly.

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

Changes in the allowance for loan losses for the twelve months ended December 31, 2022 and 2021 were as follows:

	Twelve Months Ended December 31, 2022					
	Balance at				Provision	Balance at
	Beginning of	Charge-offs	Recoveries	(benefit) for	End of Year	
	Year			Loan Losses		
	(in thousands)					
Commercial and agricultural	\$ 668	\$ -	\$ -	\$ 336	\$ 1,004	
PPP	-	-	-	-	-	
Real estate:						
Residential 1-4, Multi family, Const & Dev	1,071	-	-	132	1,203	
Commercial real estate -- owner occupied	1,299	-	-	(252)	1,047	
Commercial real estate -- non owner occupied	2,479	-	-	(673)	1,806	
Farmland	478	-	-	(69)	409	
Total real estate	5,327	-	-	(862)	4,465	
Consumer	1,464	(90)	29	471	1,874	
Unallocated	838	-	-	55	893	
Total	<u>\$ 8,297</u>	<u>\$ (90)</u>	<u>\$ 29</u>	<u>\$ -</u>	<u>\$ 8,236</u>	

	Twelve Months Ended December 31, 2021					
	Balance at				Provision	Balance at
	Beginning of	Charge-offs	Recoveries	(benefit) for	End of Year	
	Year			Loan Losses		
	(in thousands)					
Commercial and agricultural	\$ 1,524	\$ (34)	\$ 42	\$ (864)	\$ 668	
PPP	-	-	-	-	-	
Real estate:						
Residential 1-4, Multi family, Const & Dev	1,055	-	49	(33)	1,071	
Commercial real estate -- owner occupied	2,187	-	-	(888)	1,299	
Commercial real estate -- non owner occupied	4,037	-	-	(1,558)	2,479	
Farmland	839	-	-	(361)	478	
Total real estate	8,118	-	49	(2,840)	5,327	
Consumer	1,386	(196)	18	256	1,464	
Unallocated	1,040	-	-	(202)	838	
Total	<u>\$ 12,068</u>	<u>\$ (230)</u>	<u>\$ 109</u>	<u>\$ (3,650)</u>	<u>\$ 8,297</u>	

The allowance for loan losses disaggregated on the basis of the Company's impairment method as of December 31, 2022 and 2021 were as follows:

	December 31, 2022		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Allowance for Loan Losses
	(in thousands)		
Commercial and agricultural	\$ -	\$ 1,004	\$ 1,004
PPP	-	-	-
Real estate:			
Residential 1-4, Multi family, Const & Dev	-	1,203	1,203
Commercial real estate -- owner occupied	48	999	1,047
Commercial real estate -- non owner occupied	-	1,806	1,806
Farmland	<u>1</u>	<u>408</u>	<u>409</u>
Total real estate	49	4,416	4,465
Consumer	-	1,874	1,874
Unallocated	-	893	893
Total	<u>\$ 49</u>	<u>\$ 8,187</u>	<u>\$ 8,236</u>

	December 31, 2021		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Allowance for Loan Losses
	(in thousands)		
Commercial and agricultural	\$ 4	\$ 664	\$ 668
PPP	-	-	-
Real estate:			
Residential 1-4, Multi family, Const & Dev	-	1,071	1,071
Commercial real estate -- owner occupied	86	1,213	1,299
Commercial real estate -- non owner occupied	-	2,479	2,479
Farmland	<u>22</u>	<u>456</u>	<u>478</u>
Total real estate	108	5,219	5,327
Consumer	-	1,464	1,464
Unallocated	-	838	838
Total	<u>\$ 112</u>	<u>\$ 8,185</u>	<u>\$ 8,297</u>

The recorded investment of loans disaggregated on the basis of the Company's impairment method as of December 31, 2022 and 2021, were as follows:

	December 31, 2022		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Gross Loans
	(in thousands)		
Commercial and agricultural	\$ 454	\$ 75,251	\$ 75,705
PPP	-	515	515
Real estate:			
Residential 1-4, Multi family, Const & Dev	313	160,749	161,062
Commercial real estate -- owner occupied	1,290	153,090	154,380
Commercial real estate -- non owner occupied	-	153,707	153,707
Farmland	294	26,641	26,935
Total real estate	<u>1,897</u>	<u>494,187</u>	<u>496,084</u>
Consumer	<u>101</u>	<u>68,311</u>	<u>68,412</u>
Total	<u>\$ 2,452</u>	<u>\$ 638,264</u>	<u>\$ 640,716</u>

	December 31, 2021		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Gross Loans
	(in thousands)		
Commercial and agricultural	\$ 780	\$ 84,529	\$ 85,309
PPP	-	25,081	25,081
Real estate:			
Residential 1-4, Multi family, Const & Dev	343	135,222	135,565
Commercial real estate -- owner occupied	1,321	153,580	154,901
Commercial real estate -- non owner occupied	-	148,730	148,730
Farmland	299	23,606	23,905
Total real estate	<u>1,963</u>	<u>461,138</u>	<u>463,101</u>
Consumer	<u>110</u>	<u>56,159</u>	<u>56,269</u>
Total	<u>\$ 2,853</u>	<u>\$ 626,907</u>	<u>\$ 629,760</u>

Credit Quality Indicators

As part of the on-going monitoring of the credit quality of Bank's loan portfolio, management tracks certain credit quality indicators including trends related to risk rating classifications of loans, the level of classified loans, net charge-offs, past due and non-performing loans, as well as general economic conditions of the United States of America and specifically the states of Washington and Oregon.

Numerical risk rating classifications for loans are established at origination. Changes to the risk rating classification are considered as new information about the performance of the loan becomes available, including but not limited to receipt of updated financial information from the borrower, results of annual term loan reviews and scheduled loan reviews.

Federal regulations require that the Bank periodically evaluate the risks inherent in its loan portfolios. In addition, the Washington Division of Banks and the Federal Deposit Insurance Corporation ("FDIC") have authority to identify problem loans and, if appropriate, require them to be reclassified.

There are three classifications for problem loans: Substandard, Doubtful, and Loss. These terms are used as follows:

- "Substandard" loans have one or more defined weaknesses and are characterized by the distinct possibility some loss will be sustained if the deficiencies are not corrected.

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

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

Credit quality indicators as of December 31, 2022 and 2021 were as follows:

December 31, 2022					
	Other Loans Especially				Total
	Pass	Mentioned	Substandard	Doubtful	
(in thousands)					
Commercial and agricultural	\$ 69,072	\$ 5,453	\$ 1,180	\$ -	\$ 75,705
PPP	515	-	-	-	515
Real estate:					
Construction and development	37,287	-	-	-	37,287
Residential 1-4 family	82,206	53	394	-	82,653
Multi-family	41,122	-	-	-	41,122
Commercial real estate -- owner occupied	154,160	-	220	-	154,380
Commercial real estate -- non owner occupied	152,296	1,411	-	-	153,707
Farmland	25,027	-	1,908	-	26,935
Total real estate	492,098	1,464	2,522	-	496,084
Consumer	68,361	-	51	-	68,412
Gross Loans	<u>\$ 630,046</u>	<u>\$ 6,917</u>	<u>\$ 3,753</u>	<u>\$ -</u>	<u>\$ 640,716</u>

December 31, 2021					
	Other Loans Especially				Total
	Pass	Mentioned	Substandard	Doubtful	
(in thousands)					
Commercial and agricultural	\$ 82,390	\$ 1,551	\$ 1,368	\$ -	\$ 85,309
PPP	25,081	-	-	-	25,081
Real estate:					
Construction and development	27,984	334	-	-	28,318
Residential 1-4 family	66,002	116	1,275	-	67,393
Multi-family	39,854	-	-	-	39,854
Commercial real estate -- owner occupied	151,957	2,449	495	-	154,901
Commercial real estate -- non owner occupied	137,878	6,764	4,088	-	148,730
Farmland	20,154	856	2,895	-	23,905
Total real estate	443,829	10,519	8,753	-	463,101
Consumer	56,189	-	80	-	56,269
Gross Loans	<u>\$ 607,489</u>	<u>\$ 12,070</u>	<u>\$ 10,201</u>	<u>\$ -</u>	<u>\$ 629,760</u>

Impaired Loans

Impaired loans by type as of December 31, 2022 and 2021, and interest income recognized for the twelve months ended December 31, 2022 and 2021 were as follows:

December 31, 2022							
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance	Average Recorded Investment	Interest Income Recognized
	(in thousands)						
Commercial and agricultural	\$ 454	\$ -	\$ 454	\$ 494	\$ -	\$ 506	\$ 28
PPP	-	-	-	-	-	-	-
Real Estate:							
Residential 1-4, Multi family, Const & Dev	313	-	313	352	-	357	20
Commercial real estate -- owner occupied	220	1,070	1,290	1,316	48	1,328	69
Commercial real estate -- non owner occupied	-	-	-	-	-	-	-
Farmland	-	294	294	295	1	297	15
Total real estate	533	1,364	1,897	1,963	49	1,982	104
Consumer	101	-	101	127	-	132	9
Total	\$ 1,088	\$ 1,364	\$ 2,452	\$ 2,584	\$ 49	\$ 2,620	\$ 141

December 31, 2021							
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance	Average Recorded Investment	Interest Income Recognized
	(in thousands)						
Commercial and agricultural	\$ 636	\$ 144	\$ 780	\$ 820	\$ 4	\$ 881	\$ 43
PPP	-	-	-	-	-	-	-
Real Estate:							
Residential 1-4, Multi family, Const & Dev	343	-	343	360	-	376	22
Commercial real estate -- owner occupied	241	1,080	1,321	1,335	86	1,339	69
Commercial real estate -- non owner occupied	-	-	-	-	-	-	-
Farmland	-	299	299	299	22	300	14
Total real estate	584	1,379	1,963	1,994	108	2,015	105
Consumer	110	-	110	136	-	137	10
Total	\$ 1,330	\$ 1,523	\$ 2,853	\$ 2,950	\$ 112	\$ 3,033	\$ 158

Insider Loans

Certain related parties of the Company, principally directors and their affiliates, were loan customers of the Bank in the ordinary course of business during 2022 and 2021. Total related party loans outstanding at December 31, 2022 and 2021 to executive officers and directors were \$2.6 million and \$2.8 million, respectively. During 2022 and 2021, new loans or advances on existing loans of \$350,000 and \$376,000, respectively, were made, and repayments totaled \$490,000 and \$310,000, respectively. In management's opinion, these loans and transactions were on the same terms as those for comparable loans and transactions with non-related parties. No loans to related parties were on non-accrual, past due or restructured at December 31, 2022.

Aging Analysis

The following tables summarize the Company's loans past due, both accruing and non-accruing, by type as of December 31, 2022 and 2021. The Company did not recognize any interest income on non-accrual loans during the years ended December 31, 2022 and 2021. No allowance was established on non-accrual loans as of December 31, 2022 and 2021.

	2022						
	30-59 Days	60-89 Days	Greater	Total Past	Non-accrual	Loans Not	Total
	Past Due	Past Due	Than	Due	Loans	Past Due	
			90 Days	(in thousands)			
Commercial and agricultural	\$ 199	\$ 191	\$ -	\$ 390	\$ 336	\$ 74,979	\$ 75,705
PPP	-	-	-	-	-	515	515
Real estate:							
Construction and development	-	-	-	-	-	37,287	37,287
Residential 1-4 family	49	-	-	49	313	82,291	82,653
Multi-family	-	-	-	-	-	41,122	41,122
Commercial real estate -- owner occupied	-	-	-	-	220	154,160	154,380
Commercial real estate -- non owner occupied	-	-	-	-	-	153,707	153,707
Farmland	-	-	-	-	-	26,935	26,935
Total real estate	49	-	-	49	533	495,502	496,084
Consumer	101	4	-	105	-	68,307	68,412
Gross Loans	\$ 349	\$ 195	\$ -	\$ 544	\$ 869	\$ 639,303	\$ 640,716

	2021						
	30-59 Days	60-89 Days	Greater	Total Past	Non-accrual	Loans Not	Total
	Past Due	Past Due	Than	Due	Loans	Past Due	
			90 Days	(in thousands)			
Commercial and agricultural	\$ -	\$ -	\$ -	\$ -	\$ 636	\$ 84,673	\$ 85,309
PPP	-	-	-	-	-	25,081	25,081
Real estate:							
Construction and development	-	-	-	-	-	28,318	28,318
Residential 1-4 family	-	-	-	-	343	67,050	67,393
Multi-family	-	-	-	-	-	39,854	39,854
Commercial real estate -- owner occupied	-	-	-	-	242	154,659	154,901
Commercial real estate -- non owner occupied	-	-	-	-	-	148,730	148,730
Farmland	-	-	-	-	-	23,905	23,905
Total real estate	-	-	-	-	585	462,516	463,101
Consumer	55	-	-	55	-	56,214	56,269
Gross Loans	\$ 55	\$ -	\$ -	\$ 55	\$ 1,221	\$ 628,484	\$ 629,760

Troubled Debt Restructured Loans

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

Loans modified in a TDR are considered impaired loans and typically already on non-accrual status. Partial charge-offs have in some cases already been taken against the outstanding loan balance. Loans modified in a TDR for the Company may have the financial effect of increasing the specific allowance associated with the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the estimated fair value of the collateral, less any selling costs, if the loan is collateral dependent. The Company's practice is to re-appraise collateral dependent loans every six to twelve months. During the twelve months ended December 31, 2022, there was \$63,000 decrease on the allowance from TDRs during the period. The Company had \$87,000 in commitments to lend additional funds for loans classified as TDRs at December 31, 2022.

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

The following table presents TDRs by type as of December 31, 2022 and 2021, all of which were modified due to financial stress of the borrower. There were not any subsequent defaulted TDRs as of December 31, 2022 and 2021:

	December 31, 2022		
	Number of Loans	Pre-TDR	Post-TDR
		Outstanding	Outstanding
		Recorded Investment	Recorded Investment
	(dollars in thousands)		
Commercial and agriculture	2	\$ 554	\$ 340
Commercial real estate -- owner occupied	1	1,080	1,070
Farmland	1	303	295
Consumer	1	137	101
Total TDRs ⁽¹⁾	<u>5</u>	<u>\$ 2,074</u>	<u>\$ 1,806</u>

	December 31, 2021		
	Number of Loans	Pre-TDR	Post-TDR
		Outstanding	Outstanding
		Recorded Investment	Recorded Investment
	(dollars in thousands)		
Commercial and agriculture	2	\$ 554	\$ 376
Commercial real estate -- owner occupied	1	1,080	1,080
Farmland	1	303	299
Consumer	1	137	110
Total TDRs ⁽¹⁾	<u>5</u>	<u>\$ 2,074</u>	<u>\$ 1,865</u>

⁽¹⁾ The period end balances are inclusive of all partial pay-downs and charge-offs since the modification date.

The following table presents TDRs modified or recorded during the years ended December 31, 2022 and 2021.

	<u>December 31, 2022</u>	
	<u>Number</u>	<u>Recorded</u>
	<u>of Loans</u>	<u>Investment</u>
	(dollars in thousands)	
Commercial and agriculture	1	\$ 222
Total	<u>1</u>	<u>\$ 222</u>

	<u>December 31, 2021</u>	
	<u>Number</u>	<u>Recorded</u>
	<u>of Loans</u>	<u>Investment</u>
	(dollars in thousands)	
Commercial and agriculture	1	\$ 1,080
Farmland	1	299
Consumer	1	110
Total	<u>3</u>	<u>\$ 1,489</u>

The following tables present troubled debt restructurings by accrual or nonaccrual status as of December 31, 2022 and 2021:

	<u>December 31, 2022</u>		
	<u>Accrual</u>	<u>Non-Accrual</u>	<u>Total TDRs</u>
	<u>Status</u>	<u>Status</u>	
	(in thousands)		
Commercial and agriculture	\$ 118	\$ 222	\$ 340
Commercial real estate -- owner occupied	1,070	-	1,070
Farmland	295	-	295
Consumer	101	-	101
Total TDRs	<u>\$ 1,584</u>	<u>\$ 222</u>	<u>\$ 1,806</u>

	<u>December 31, 2021</u>		
	<u>Accrual</u>	<u>Non-Accrual</u>	<u>Total TDRs</u>
	<u>Status</u>	<u>Status</u>	
	(in thousands)		
Commercial and agriculture	\$ 144	\$ 232	\$ 376
Commercial real estate -- owner occupied	1,080	-	1,080
Farmland	299	-	299
Consumer	110	-	110
Total TDRs	<u>\$ 1,633</u>	<u>\$ 232</u>	<u>\$ 1,865</u>

Section 4013 of the CARES Act, "Temporary Relief From Troubled Debt Restructurings," allows financial institutions the option to temporarily suspend certain requirements under U.S. GAAP related to TDRs for a limited period of time during the COVID-19 pandemic. In March 2020, various regulatory agencies, including the Board of Governors of the Federal Reserve System and the FDIC, (the "agencies") issued an interagency statement on loan modifications and reporting for financial institutions working with customers affected by COVID-19. The interagency statement was effective immediately and impacted accounting for loan modifications. The agencies confirmed with the staff of the FASB that short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief, are not to be considered TDRs. This includes short-term (e.g., six months) modifications, such as payment deferrals, fee waivers, extensions of repayment terms, or other delays in payment that are insignificant. Borrowers considered current are those that are less than 30 days past due on their contractual payments at the time a modification program is implemented.

The Company had total outstanding principle balance of \$0 and \$74,000 of COVID-19 related loan modifications under these provisions as of December 31, 2022 and 2021, respectively. These loans did not have financial difficulty prior to the COVID-19 pandemic and were generally modified for principal and interest payment deferral or interest only payments for up to six months. Modified loans continue to accrue interest and are evaluated for past due status based on the revised payment terms.

NOTE 5 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table presents the changes in each component of accumulated other comprehensive income (loss), net of tax, for the twelve months ended December 31, 2022 and 2021.

	Investment Securities	Defined Benefit Plans	Total
	(in thousands)		
Balance, December 31, 2021	\$ 1,343	\$ (336)	\$ 1,007
Change in fair value of investment securities available for sale	(20,707)	-	(20,707)
Unrecognized net actuarial gain during the period, net of tax	-	483	483
Amortization of net actuarial loss included in income	-	56	56
Net current period other comprehensive income (loss)	<u>(20,707)</u>	<u>539</u>	<u>(20,168)</u>
Balance, December 31, 2022	<u>\$ (19,364)</u>	<u>\$ 203</u>	<u>\$ (19,161)</u>

	Investment Securities	Defined Benefit Plans	Total
	(in thousands)		
Balance, December 31, 2020	\$ 4,773	\$ (531)	\$ 4,242
Change in fair value of investment securities available for sale	(3,430)	-	(3,430)
Unrecognized net actuarial loss during the period, net of tax	-	120	120
Amortization of net actuarial loss included in income	-	75	75
Net current period other comprehensive income (loss)	<u>(3,430)</u>	<u>195</u>	<u>(3,235)</u>
Balance, December 31, 2021	<u>\$ 1,343</u>	<u>\$ (336)</u>	<u>\$ 1,007</u>

The following table presents the components of other comprehensive income for the twelve months ended December 31, 2022 and 2021. Reclassification adjustments related to gains on securities available-for-sale are included in gain on sale of investment securities, net, in the accompanying consolidated statements of income. Reclassification adjustments related to defined benefit plans are included in compensation and employee benefits in the accompanying consolidated statements of income.

	Twelve Months Ended December 31, 2022		
	Before Tax	Tax Effect	Net of Tax
Net unrealized losses on investment securities:		(in thousands)	
Net unrealized losses arising during the period	\$ (26,595)	\$ (5,888)	\$ (20,707)
Reclassification adjustments for net gains realized in net income	-	-	-
Net unrealized losses on investment securities	<u>(26,595)</u>	<u>(5,888)</u>	<u>(20,707)</u>
Defined benefit plans:			
Net unrecognized actuarial gain	611	128	483
Reclassification adjustment of amortization of net actuarial loss	<u>71</u>	<u>15</u>	<u>56</u>
Net pension plan liability adjustment	<u>682</u>	<u>143</u>	<u>539</u>
Other comprehensive income (loss)	<u>\$ (25,913)</u>	<u>\$ (5,745)</u>	<u>\$ (20,168)</u>

	Twelve Months Ended December 31, 2021		
	Before Tax	Tax Effect	Net of Tax
Net unrealized gains on investment securities:		(in thousands)	
Net unrealized losses arising during the period	\$ (4,315)	\$ (885)	\$ (3,430)
Reclassification adjustments for net gains realized in net income	-	-	-
Net unrealized losses on investment securities	<u>(4,315)</u>	<u>(885)</u>	<u>(3,430)</u>
Defined benefit plans:			
Net unrecognized actuarial gain	152	32	120
Reclassification adjustment of amortization of net actuarial loss	<u>95</u>	<u>20</u>	<u>75</u>
Net pension plan liability adjustment	<u>247</u>	<u>52</u>	<u>195</u>
Other comprehensive income (loss)	<u>\$ (4,068)</u>	<u>\$ (833)</u>	<u>\$ (3,235)</u>

NOTE 6 – PREMISES AND EQUIPMENT

The components of premises and equipment at December 31, 2022 and 2021 were as follows:

	December 31,	
	2022	2021
	(in thousands)	
Land and premises	\$ 20,535	\$ 19,786
Equipment, furniture and fixtures	10,030	10,159
Construction in progress	<u>78</u>	<u>177</u>
	30,643	30,122
Less accumulated depreciation and amortization	<u>(17,772)</u>	<u>(17,118)</u>
Total premises and equipment	<u>\$ 12,871</u>	<u>\$ 13,004</u>

Depreciation expense was \$1.1 million and \$1.2 million for years ending December 31, 2022 and 2021, respectively.

NOTE 7 – OPERATING LEASE RIGHT-OF-USE ASSET

Future minimum payments for operating leases with initial or remaining terms of one year or more as of December 31, 2022 are as follows:

	December 31,	
	2022	
	(in thousands)	
2023	\$	561
2024		401
2025		191
2026		23
Thereafter		-
Total future minimum lease payments	\$	<u>1,176</u>
Amounts representing interest		<u>(27)</u>
Total operating lease liabilities	\$	<u><u>1,149</u></u>

At December 31, 2022 the weighted-average remaining lease term was 2.3 years and the weighted-average discount rate was 1.38%. Amortization of ROU assets, short term lease cost, interest on lease liabilities and non-lease component expenses was \$647,000 and \$654,000 for the years ending December 31, 2022 and 2021, respectively.

NOTE 8 – OTHER REAL ESTATE OWNED

The Company had no activity related to OREO for the years ended December 31, 2022 and 2021 and had no properties classified as OREO at December 31, 2022 and 2021.

NOTE 9 – DEPOSITS

Time deposits that meet or exceed the FDIC Insurance limit of \$250,000 at December 31, 2022 and 2021 were \$9.8 million and \$12.8 million, respectively.

The composition of deposits at December 31, 2022 and 2021 was as follows:

	December 31,	
	2022	2021
	(in thousands)	
Interest-bearing demand ("NOW")	\$ 253,272	\$ 242,789
Money market deposits	195,814	210,344
Savings deposits	174,887	174,929
Time deposits ("CDs")	<u>48,754</u>	<u>58,724</u>
Total interest-bearing deposits	672,727	686,786
Non-interest bearing demand	<u>507,635</u>	<u>492,154</u>
Total deposits	\$ <u><u>1,180,362</u></u>	\$ <u><u>1,178,940</u></u>

Scheduled maturities of CDs were as follows for future years ending December 31 (in thousands):

	<u>Maturities</u>
2023	\$ 32,690
2024	8,494
2025	3,507
2026	1,776
2027	2,129
Thereafter	<u>158</u>
Total	<u>\$ 48,754</u>

NOTE 10 – BORROWINGS

Advances from the Federal Home Loan Bank

Utilizing a pledge agreement, qualifying loans receivable at December 31, 2022 and 2021, were pledged as security for Federal Home Loan Bank (FHLB) borrowings. At December 31, 2022, the Bank had no outstanding borrowings against its \$195.8 million in established borrowing capacity with the FHLB, as compared to \$403,000 outstanding against a borrowing capacity of \$169.1 million at December 31, 2021. The Bank's borrowing facility with the FHLB is subject to collateral and stock ownership requirements.

A summary of FHLB advances as of December 31, 2022 and 2021 is as follows:

	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
	(dollars in thousands)	
Amount outstanding at end of period	\$ -	\$ 403
Average balance during the year	\$ 190	\$ 472
Average interest rate during the year ⁽¹⁾	2.23%	2.23%

⁽¹⁾ Fixed rate

Federal Reserve Bank of San Francisco and Other Borrowings

The Bank may borrow funds on an overnight basis from the Federal Reserve Bank through the Borrower-In-Custody program. Such borrowings are secured by a pledge of eligible loans. At December 31, 2022, the Bank had an available discount window primary credit line with the Federal Reserve Bank of San Francisco of approximately \$57.6 million with no balance outstanding.

At December 31, 2022, the Bank had unsecured federal funds lines of credit agreements with other financial institutions totaling \$60.0 million. No balances were outstanding under these agreements as of December 31, 2022. Availability of lines is subject to continued borrower eligibility.

NOTE 11 – JUNIOR SUBORDINATED DEBENTURES

At December 31, 2022, two wholly-owned subsidiary grantor trusts established by the Company had outstanding \$13.4 million of Trust Preferred Securities. Trust preferred securities accrue and pay distributions periodically at specified annual rates as provided in the indentures. The trusts used the net proceeds from the offering of trust preferred securities to purchase a like amount of Junior Subordinated Debentures (the "Debentures") of the Company. The Debentures are the sole assets of the trusts. The Company's obligations under the Debentures and the related documents, taken together, constitute a full and unconditional guarantee by the Company of the obligations of the trusts. The trust preferred securities are mandatorily redeemable upon the maturity of the Debentures, or upon earlier redemption as provided in the indentures. The Company has the right to redeem the Debentures in whole or in part, at a redemption price specified in the indentures plus any accrued but unpaid interest to the redemption date.

The Debentures issued by the Company to the grantor trusts totaling \$13.0 million are reflected in the consolidated balance sheet in the liabilities section under the caption "junior subordinated debentures." The Company records interest expense on the corresponding junior subordinated debentures in the consolidated statements of income. The Company recorded \$403,000 in the consolidated balance sheet at December 31, 2022 and 2021 for the common capital securities issued by the issuer trusts.

As of December 31, 2022 and 2021, regular accrued interest on junior subordinated debentures totaled \$126,000 and \$38,000, respectively, and is included in accrued expenses and other liabilities on the consolidated balance sheet.

The terms of the junior subordinated debentures as of December 31, 2022 and 2021 are:

<u>Trust Name</u>	<u>Issue Date</u>	<u>Issued Amount</u>	<u>Rate</u>	<u>Maturity Date</u>
(dollars in thousands)				
Pacific Financial Corporation Statutory Trust I	December 2005	\$ 5,000	LIBOR + 1.45% ⁽¹⁾	March 2036
Pacific Financial Corporation Statutory Trust II	June 2006	<u>8,000</u> <u>\$ 13,000</u>	LIBOR + 1.60% ⁽²⁾	July 2036

⁽¹⁾ Variable rate of 3-month libor, adjusted quarterly
3-month LIBOR 4.77% at December 13, 2022 and 0.20% at December 13, 2022

⁽²⁾ Variable rate of 3-month libor, adjusted quarterly
3-month LIBOR 4.08% at October 13, 2022 and 0.12% at October 13, 2022

NOTE 12 – INCOME TAXES

The Company recorded an income tax provision for the twelve months ended December 31, 2022 and 2021. The amount of the provision for each period was commensurate with the estimated tax liability associated with the net income earned during the period. As of December 31, 2022, the Company believes that it is more likely than not that it will be able to fully realize its deferred tax asset and therefore has not recorded a valuation allowance.

The Company's provision for income taxes includes both federal and state income taxes and reflects the application of federal and state statutory rates to the Company's income before taxes. The principal difference between statutory tax rates and the Company's effective tax rate is the benefit derived from investing in tax-exempt securities, tax-exempt loans and bank owned life insurance.

Income taxes are accounted for using the asset and liability method. Under this method, a deferred tax asset or liability is determined based on the enacted tax rates which will be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in the Company's income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are established to reduce the net carrying amount of deferred tax assets if it is determined to be more likely than not that all or some portion of the potential deferred tax asset will not be realized.

The Company applies the provisions of ASC 740, "Income Taxes", relating to the accounting for uncertainty in income taxes. The Company periodically reviews its income tax positions based on tax laws and regulations, and financial reporting considerations, and records adjustments as appropriate. This review takes into consideration the status of current taxing authorities' examinations of the Company's tax returns, recent positions taken by the taxing authorities on similar transactions, if any, and the overall tax environment. The Company did not have any uncertain tax positions as of December 31, 2022.

Income taxes for the years ended December 31, 2022 and 2021 was as follows:

	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
	(in thousands)	
Current	\$ 2,252	\$ 1,442
Deferred	<u>59</u>	<u>1,443</u>
Total income tax expense	<u>\$ 2,311</u>	<u>\$ 2,885</u>

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities and net deferred tax assets (liabilities) are recorded in prepaid expenses and other assets in the consolidated financial statements at December 31, 2022 and 2021 are:

	December 31,	
	2022	2021
Deferred Tax Assets	(in thousands)	
Allowance for loan losses	\$ 1,868	\$ 1,882
Deferred compensation	7	11
Supplemental executive retirement plan	689	878
Compensation expense	64	87
Unrealized loss on securities available for sale	5,506	-
Other	335	242
Total deferred tax assets	<u>\$ 8,469</u>	<u>\$ 3,100</u>
Deferred Tax Liabilities		
Depreciation	\$ 189	\$ 292
Loan fees/costs	2,534	2,606
Unrealized gain on securities available for sale	-	382
Prepaid expenses	245	237
Other	273	258
Total deferred tax liabilities	<u>3,241</u>	<u>3,775</u>
Net deferred tax assets (liabilities)	<u>\$ 5,228</u>	<u>\$ (675)</u>

The following is a reconciliation between the statutory and effective federal income tax rate for the years ended December 31, 2022 and 2021:

	December 31,			
	2022		2021	
	Amount	Percent of Pre-tax Income	Amount	Percent of Pre-tax Income
	(dollars in thousands)			
Income tax at statutory rate	\$ 2,772	21.0%	\$ 3,272	21.0%
Adjustments resulting from:				
State income taxes, net of federal benefit	95	0.7%	158	0.9%
Tax-exempt income	(291)	-2.2%	(287)	-1.8%
Net earnings on life insurance policies	(143)	-1.1%	(285)	-1.8%
Other	(122)	-0.9%	27	0.2%
Total income tax expense	<u>\$ 2,311</u>	<u>17.5%</u>	<u>\$ 2,885</u>	<u>18.5%</u>

NOTE 13 – 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 \$1.0 million and \$1.1 million in 2022 and 2021, respectively.

401(k) Plans – The Bank has established a 401(k) plan for those employees who meet the eligibility requirements set forth in the plan. During any calendar year, eligible employees may contribute up to an amount of salary compensation as allowed by applicable IRS code. Matching contributions by the Bank are at the discretion of the Board of Directors. Contributions totaled \$743,000 and \$806,000 for 2022 and 2021, respectively.

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 is currently one participant receiving payments in the director and employee deferred compensation plan. There were no deferrals or ongoing expense to the Company for these plans in 2022 and 2021.

The directors of a bank acquired by the Company in 1999 adopted two deferred compensation plans for directors. One plan provides retirement income benefits for all directors and the other, a deferred compensation plan, covers 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 \$3.1 million and \$3.0 million at December 31, 2022 and 2021, respectively. In 2022 and 2021, the net benefit recorded from these plans, including the cost of the related life insurance, was \$183,000 and \$195,000, respectively. Both of these plans were fully funded and frozen as of September 30, 2001. 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. The liability associated with these plans totaled \$34,000 and \$48,000 at December 31, 2022 and 2021, respectively.

Long-Term Compensation Agreements – The Company has long-term compensation agreements to selected employees that provide incentive for those covered employees to remain employed with the Company for a defined period of time. A benefit of \$42,000 and a cost of \$73,000 was recorded for these agreements for the years ended December 31, 2022 and 2021, respectively.

Supplemental Executive Retirement Plan – Effective January 1, 2007, the Company adopted a non-qualified Supplemental Executive Retirement Plan (“SERP”) that provides retirement benefits to key officers. The SERP is unsecured and unfunded and there are no plan assets. The post-retirement benefit provided by the SERP is designed to supplement a participating officer’s retirement benefits from social security, in order to provide the officer with a certain percentage of final average income at retirement age. The benefit is generally based on average earnings, years of service and age at retirement. At the inception of the SERP, the Company recorded a prior service cost to accumulated other comprehensive income of \$704,000. The Company has purchased bank owned life insurance covering all participants in the SERP. The cash surrender value of these policies totaled \$7.3 million and \$7.1 million at December 31, 2022 and 2021, respectively.

The following table sets forth the net periodic pension cost and obligation assumptions used in the measurement of the benefit obligation for the years ended December 31, 2022 and 2021:

	December 31,	
	2022	2021
	(dollars in thousands)	
Net periodic pension cost:		
Service cost	\$ 58	\$ 60
Interest cost	69	59
Amortization of net loss	56	75
Net periodic pension cost	<u>\$ 183</u>	<u>\$ 194</u>
Weighted average assumptions:		
Discount rate	2.38%	1.87%
Salary scale	n/a	n/a
Expected return on plan assets	n/a	n/a

The following table sets forth the change in benefit obligation at December 31, 2022 and 2021:

	December 31,	
	2022	2021
	(in thousands)	
Change in benefit obligation:		
Benefit obligation at the beginning of year	\$ 3,018	\$ 3,253
Service cost	58	60
Interest cost	69	59
Benefits paid	(234)	(234)
Actuarial loss (gain)	(483)	(120)
Benefit obligation at end of year	<u>\$ 2,428</u>	<u>\$ 3,018</u>

Amounts recognized in accumulated other comprehensive income at December 31, 2022 and 2021 was as follows:

	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
	(in thousands)	
(Gain) Loss	\$ (203)	\$ 336
Prior service cost	-	-
Total recognized in AOCI	<u>\$ (203)</u>	<u>\$ 336</u>

The following table summarizes the projected and accumulated benefit obligations at December 31, 2022 and 2021:

	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
	(in thousands)	
Projected benefit obligation	\$ 2,429	\$ 3,018
Accumulated benefit obligation	\$ 2,429	\$ 3,018

Estimated future benefit payments as of December 31, 2022 were as follows (in thousands):

2023	\$ 234
2024	234
2025	234
2026	234
2027	234
2028-2032	<u>1,329</u>
Total	<u>\$ 2,499</u>

NOTE 14 – 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 its customers. These financial instruments include commitments to extend credit and standby letters of credit, and involve, to varying degrees, elements of credit risk in excess of the amount recognized on the consolidated balance sheets.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as they do for on-balance-sheet instruments. A summary of the Bank's off-balance sheet commitments at December 31, 2022 and 2021 is as follows:

	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
	(in thousands)	
Commitments to extend credit	\$ 202,331	\$ 172,216
Standby letters of credit	\$ 4,420	\$ 600

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. Many of the commitments expire without being drawn upon; therefore total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the customer. 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. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

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

In connection with certain loans held for sale, the Bank typically makes representations and warranties that the underlying loans conform to specified guidelines. If the underlying loans do not conform to the specifications, the Bank may have an obligation to repurchase the loans or indemnify the purchaser against loss. The Bank believes that the potential for loss under these arrangements is remote. Accordingly, no contingent liability is recorded in the consolidated financial statements.

The Company is currently not party to any material pending litigation. However, because of the nature of its activities, the Company may be subject to or threatened with legal actions 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 results of operations or financial condition of the Company.

NOTE 15 – SIGNIFICANT CONCENTRATION OF CREDIT RISK

Most of the Bank’s business activity is with customers and governmental entities located in the states of Washington and Oregon. Loans to any single borrower or group of borrowers are generally limited by state banking regulations to 20% of the Bank’s capital and surplus, excluding accumulated other comprehensive income (loss). 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 \$13.0 million.

NOTE 16 – STOCK BASED COMPENSATION

The Company’s 2021 Equity Incentive Plan, (the “2021 Equity Plan”), provides for the issuance of up to 750,000 shares in connection with incentive and nonqualified stock options, restricted stock, restricted stock units and other equity-based awards. Prior to adoption of the 2021 Equity Plan, the Company made equity-based awards under the Company’s 2011 Equity Incentive Plan, which expired April 1, 2021.

Stock Options

The 2021 Plan authorizes the issuance of incentive and non-qualified stock options, as defined under current tax laws, to key personnel. Options granted under the 2021 Plan either become exercisable ratably over five years or in a single installment five years from the date of grant.

The Company uses the Black-Scholes option pricing model to calculate the fair value of stock option awards based on assumptions in the following table. Expected volatility is based on historical volatility of the Company’s common stock. The expected term of stock options granted is based on the simplified method, which is the simple average between contractual term and vesting period. The risk-free rate is based on the expected term of stock options and the applicable U.S. Treasury yield in effect at the time of grant.

Grant period ended	Expected Life	Risk Free Interest Rate	Expected Stock Price Volatility	Dividend Yield	Weighted Average Fair Value of Options Granted
December 31, 2022	6.5 years	4.18%	27.42%	4.98%	\$ 1.93
December 31, 2021	7.5 years	1.51%	29.23%	4.48%	\$ 1.98

The following tables summarize the stock option activity for the years ended December 31, 2022 and 2021:

	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term (in Years)</u>
Outstanding at December 31, 2020	210,450	\$ 10.46	
Granted	2,500	11.60	
Exercised	(9,500)	6.72	
Forfeited or canceled	(24,100)	12.36	
Expired	<u>(5,200)</u>	10.91	
Outstanding at December 31, 2021	174,150	\$ 10.42	
Granted	5,000	10.45	
Exercised	(25,500)	5.11	
Forfeited or canceled	(3,900)	12.47	
Expired	<u>(2,400)</u>	12.69	
Outstanding at December 31, 2022	<u>147,350</u>	<u>\$ 11.25</u>	<u>6.36</u>
Vested and exercisable at December 31, 2022	<u>92,850</u>	<u>\$ 11.03</u>	<u>5.80</u>

The following table summarizes nonvested stock option activity for the years ended December 31, 2022 and 2021:

	<u>Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
Nonvested Outstanding at December 31, 2020	127,600	\$ 1.10
Granted	2,500	1.98
Vested	(27,200)	1.00
Forfeited	<u>(24,100)</u>	1.11
Nonvested Outstanding at December 31, 2021	78,800	\$ 1.18
Granted	5,000	1.93
Vested	(25,400)	1.15
Forfeited	<u>(3,900)</u>	1.03
Nonvested Outstanding at December 31, 2022	<u>54,500</u>	<u>\$ 1.28</u>

Information related to the stock option plan during each year follows:

	<u>2022</u>	<u>2021</u>
	(in thousands)	
Intrinsic value of options exercised	\$ 142	\$ 48
Cash received from option exercises	\$ 130	\$ 64

The Company accounts for stock based compensation in accordance with GAAP, which requires measurement of compensation cost for all stock-based awards based on grant date fair value and recognition of compensation cost over the service period of each award.

The following information summarizes information about stock option compensation expense for the years ended December 31, 2022 and 2021:

	Twelve Months Ended	
	December 31,	
	2022	2021
	(in thousands)	
Compensation Expense	\$ 31	\$ 29
Tax Effect	7	6
Compensation Expense, net	<u>\$ 24</u>	<u>\$ 23</u>

As of December 31, 2022, there was \$63,000 of total unrecognized compensation cost related to stock options. The cost is expected to be recognized over a weighted-average period of 1.84 years.

Restricted Stock Units

The Company grants restricted stock units (“RSUs”) to employees qualifying for awards under the Company’s Annual Incentive Compensation Plan. Recipients of RSUs will be issued a specified number of shares of common stock under the 2021 Plan upon the lapse of applicable restrictions. Outstanding RSUs are subject to forfeiture if the recipient’s employment terminates prior to expiration.

The following table summarizes RSU activity during the twelve months ended December 31, 2022 and 2021:

	Shares	Weighted Average Grant Date Fair Value	
Outstanding at December 31, 2020	21,850		
Granted	11,000	\$	10.71
Vested	(7,000)		
Forfeited	-		
Outstanding at December 31, 2021	25,850		
Granted	11,000	\$	11.85
Vested	(7,100)		
Forfeited	-		
Outstanding at December 31, 2022	<u>29,750</u>		

The following table summarizes RSU compensation expense during the twelve months ended December 31, 2022 and 2021:

	Twelve Months Ended	
	2022	2021
	(in thousands)	
Compensation Expense	\$ 119	\$ 97
Tax Effect	25	20
Compensation Expense, net	<u>\$ 94</u>	<u>\$ 77</u>

As of December 31, 2022, there was \$142,000 of total unrecognized compensation cost related to nonvested RSUs. The cost is expected to be recognized over a weighted-average period of 1.4 years.

NOTE 17 – 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 material adverse effect on the Company’s consolidated financial statements. Under capital adequacy guidelines on the regulatory framework for prompt corrective action, the Bank must meet specific capital adequacy guidelines that involve quantitative measures of the Bank’s assets, liabilities and certain off-balance-sheet items as calculated under

regulatory accounting practices. The Bank's capital classification is also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Effective January 1, 2015 (with some changes transitioned into full effectiveness over two to four years), the Bank became subject to new capital adequacy requirements approved by the Federal Reserve and the FDIC that implement the revised standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of the Dodd-Frank Act. Pursuant to minimum capital requirements of the FDIC effective on January 1, 2015, all FDIC-insured financial institutions are required to maintain a minimum common equity Tier 1 risk-based capital to risk-weighted assets ratio of 4.5%, a minimum Tier 1 leverage ratio to average assets of 4.0% and minimum risk-based capital ratios of Tier 1 capital to risk-weighted assets and total capital to risk-weighted assets of 6.0% and 8.0%, respectively.

The Company is subject to the Basel III regulatory capital framework ("Basel III Capital Rules"), which includes a 2.5% capital conservation buffer. The capital conservation buffer is designed to absorb losses during periods of economic stress and requires increased capital levels for the purpose of capital distributions and other payments. Failure to meet the full amount of the buffer will result in restrictions on the Company's ability to make capital distributions, which includes dividend payments, and stock repurchases and certain discretionary bonus payments based on percentages of eligible retained income that could be utilized for such actions.

As of December 31, 2022 and 2021, the Bank was 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.

Actual capital amounts and ratios for December 31, 2022 and 2021 are presented in the table below.

	Actual		Minimum Requirements		Well-Capitalized Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(dollars in thousands)						
As of December 31, 2022						
Company						
Common equity Tier 1 capital to risk-weighted assets	\$ 108,888	14.3%	\$ 34,265	4.5%	N/A	N/A
Tier 1 leverage capital to average assets	121,888	9.4%	51,867	4.0%	N/A	N/A
Tier 1 capital to risk-weighted assets	121,888	16.0%	45,708	6.0%	N/A	N/A
Total capital to risk-weighted assets	130,327	17.1%	60,972	8.0%	N/A	N/A
Bank						
Common equity Tier 1 capital to risk-weighted assets	121,112	15.9%	34,277	4.5%	\$ 49,511	6.5%
Tier 1 leverage capital to average assets	121,112	9.1%	53,236	4.0%	66,545	5.0%
Tier 1 capital to risk-weighted assets	121,112	15.9%	45,703	6.0%	60,937	8.0%
Total capital to risk-weighted assets	129,551	17.0%	60,965	8.0%	76,206	10.0%
As of December 31, 2021						
Company						
Common equity Tier 1 capital to risk-weighted assets	\$ 103,191	14.6%	\$ 31,805	4.5%	N/A	N/A
Tier 1 leverage capital to average assets	116,191	8.8%	52,814	4.0%	N/A	N/A
Tier 1 capital to risk-weighted assets	116,191	16.4%	42,509	6.0%	N/A	N/A
Total capital to risk-weighted assets	124,692	17.6%	56,678	8.0%	N/A	N/A
Bank						
Common equity Tier 1 capital to risk-weighted assets	115,733	16.4%	31,756	4.5%	\$ 45,870	6.5%
Tier 1 leverage capital to average assets	115,733	8.8%	52,606	4.0%	65,757	5.0%
Tier 1 capital to risk-weighted assets	115,733	16.4%	42,341	6.0%	56,455	8.0%
Total capital to risk-weighted assets	124,234	17.6%	56,470	8.0%	70,588	10.0%

NOTE 18 – FAIR VALUE MEASUREMENTS

Fair Value Hierarchy

The Company uses an established hierarchy for measuring fair value that is intended to maximize the use of observable inputs and minimize the use of unobservable inputs. This hierarchy uses three levels of inputs to measure the fair value of assets and liabilities as follows:

Level 1 – Valuations based on quoted prices in active exchange markets for identical assets or liabilities; also includes certain corporate debt securities actively traded in over-the-counter markets.

Level 2 – Valuations of assets and liabilities traded in less active dealer or broker markets. Valuations include quoted prices for similar assets and liabilities traded in the same market; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable. Valuations may be obtained from, or corroborated by, third-party pricing services. This category generally includes certain U.S. Government, agency and non-agency securities, state and municipal securities, mortgage backed securities, corporate securities, and residential mortgage loans held for sale.

Level 3 – Valuation based on unobservable inputs supported by little or no market activity for financial instruments whose value is determined using pricing models, discounted cash flow methodologies, yield curves and similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities, but in all cases are corroborated by external data, which may include third-party pricing services.

Investment Securities Available for Sale

The Company uses an independent pricing service to assist management in determining fair values of investment securities available for sale. This service provides pricing information by utilizing evaluated pricing models supported with market based information. Standard inputs include benchmark yields, reported trades, broker/dealer quotes, credit ratings, bids and offers, relative credit information and reference data from market research publications. Investment securities that are deemed to have been trading in illiquid or inactive markets may require the use of significant unobservable inputs.

The pricing service provides quoted market prices when available. Quoted prices are not always available due to bond market inactivity. For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows. Discounted cash flows are calculated using spread to swap and LIBOR curves that are updated to incorporate loss severities, volatility, credit spread and optionality. Additionally, the pricing service may obtain a broker quote when sufficient information is not available to produce a valuation. Valuations and broker quotes are non-binding and do not represent quotes on which one may execute the disposition of the assets.

The Company generally obtains one value from its primary external third-party pricing service. The Company's third-party pricing service has established processes for us to submit inquiries regarding quoted prices. The Company's third-party pricing service will review the inputs to the evaluation in light of any new market data presented by us. The Company's third-party pricing service may then affirm the original quoted price or may update the evaluation on a going forward basis.

Management reviews the pricing information received from the third party-pricing service through a combination of procedures that include an evaluation of methodologies used by the pricing service, analytical reviews and performance analyses of the prices against statistics and trends. Based on this review, management determines whether the current placement of the security in the fair value hierarchy is appropriate or whether transfers may be warranted. As necessary, the Company compares prices received from the pricing service to discounted cash flow models or through performing independent valuations of inputs and assumptions similar to those used by the pricing service in order to ensure prices represent a reasonable estimate of fair value. Although the Company does identify differences from time to time as a result of these validation procedures, the Company did not make any significant adjustments as of December 31, 2022 or 2021.

The following table presents the balances of assets measured at fair value on a recurring basis at December 31, 2022 and 2021.

At December 31, 2022				
Description	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)				
Available-for-sale securities:				
Collateralized mortgage obligations	\$ 101,958	\$ -	\$ 101,958	\$ -
Mortgage-backed securities	13,110	-	13,110	-
Municipal securities	61,771	-	61,131	640
Corporate debt securities	1,999	-	1,999	-
U.S. government	47,946	47,946	-	-
Total assets measured at fair value	<u>\$ 226,784</u>	<u>\$ 47,946</u>	<u>\$ 178,198</u>	<u>\$ 640</u>

At December 31, 2021				
Description	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)				
Available-for-sale securities:				
Collateralized mortgage obligations	\$ 92,050	\$ -	\$ 92,050	\$ -
Mortgage-backed securities	17,435	-	17,435	-
Municipal securities	71,549	-	70,869	680
Corporate debt securities	2,010	-	2,010	-
U.S. government	49,903	49,903	-	-
Total assets measured at fair value	<u>\$ 232,947</u>	<u>\$ 49,903</u>	<u>\$ 182,364</u>	<u>\$ 680</u>

As of December 31, 2022, the Company had one available-for-sale security classified as Level 3 investment which consist of a non-rated municipal bond. The valuation of this security is supported by analysis prepared by an independent third party. Their approach to determining fair value involves using recently executed transactions and market quotations for similar securities. The security is not rated by the rating agencies and there is no trading volume, management determined that this security should be classified as Level 3 within the fair value hierarchy.

Transfers between level categorizations may occur due to changes in the availability of market observable inputs, which generally are caused by changes in market conditions such as liquidity, trading volume or bid-ask spreads. Transfers between level categorizations may also occur due to changes in the valuation source. For example, in situations where a fair value quote is not provided by the Company's independent third-party valuation service provider and as a result the price is stale, the security is transferred into Level 3. There were no transfers in or out of Level 3 during the years ended December 31, 2022 and 2021.

The following table presents a reconciliation of assets that are measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the twelve months ended December 31, 2022 and 2021, respectively.

	Twelve Months Ended	
	December 31,	
	2022	2021
	(in thousands)	
Balance beginning of period	\$ 680	\$ 700
Transfers in to level 3	-	-
Change in FV (included in other comprehensive income)	(40)	(20)
Balance end of period	<u>\$ 640</u>	<u>\$ 680</u>

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Certain assets and liabilities are measured at fair value on a nonrecurring basis after initial recognition such as loans measured for impairment, loans held for sale and other real estate owned. The following methods were used to estimate the fair value of each such class of financial instrument:

Impaired loans – A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (both interest and principal) according to the contractual terms of the loan agreement. Impaired loans are classified as Level 3 in the fair value hierarchy. In determining the net realizable value of the underlying collateral, we consider third party appraisals by qualified licensed appraisers, less estimated costs to sell. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach.

Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available and include consideration for variations in location, size, and income production capacity of the property. The income approach commonly utilizes a discount or cap rate to determine the present value of expected future cash flows. Additionally, the appraisals are periodically further adjusted by the Company in consideration of charges that may be incurred in the event of foreclosure and are based on management’s historical knowledge, changes in business factors and changes in market conditions.

Impaired loans are reviewed and evaluated quarterly for additional impairment and adjusted accordingly, based on the same factors identified above. Because of the high degree of judgment required in estimating the fair value of collateral underlying impaired loans and because of the relationship between fair value and general economic conditions, we consider the fair value of impaired loans to be highly sensitive to changes in market conditions.

Other real estate owned – OREO is initially recorded at the fair value of the property less estimated costs to sell. This amount becomes the property’s new basis. Management considers third party appraisals in determining the fair value of particular properties. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach.

Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available and include consideration for variations in location, size, and income production capacity of the property. Additionally, the appraisals are periodically further adjusted by the Company based on management’s historical knowledge, changes in business factors and changes in market conditions.

Any write-downs based on the property fair value less estimated costs to sell at the date of acquisition are charged to the allowance for loan losses. Management periodically reviews OREO to ensure the property is carried at the lower of its new basis or fair value, net of estimated costs to sell. Any additional write-downs based on re-evaluation of the property fair value are charged to non-interest expense. Because of the high degree of judgment required in estimating the fair value of OREO and because of the relationship between fair value and general economic conditions, we consider the fair value of OREO to be sensitive to changes in market conditions.

The following tables present the Company's assets that were held at the end of December 31, 2022 and 2021 that were measured at fair value on a nonrecurring basis:

Description	At December 31, 2022			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(in thousands)			
Loans measured for impairment, net of specific reserves	\$ 1,316	\$ -	\$ -	\$ 1,316
Total assets measured on a nonrecurring basis	<u>\$ 1,316</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,316</u>

Description	At December 31, 2021			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(in thousands)			
Loans measured for impairment, net of specific reserves	\$ 1,411	\$ -	\$ -	\$ 1,411
Total assets measured on a nonrecurring basis	<u>\$ 1,411</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,411</u>

The following table presents quantitative information about Level 3 inputs for financial instruments measured at fair value on a nonrecurring basis at December 31, 2022 and 2021 (dollars in thousands):

Description	At December 31, 2022			
	Fair Value	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)
Loans measured for impairment, net of specific reserves	\$ 1,316	Income approach	Probability of default, discount rate	3.95%, 5.12%

Description	At December 31, 2021			
	Fair Value	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)
Loans measured for impairment, net of specific reserves	\$ 1,411	Income approach	Probability of default, discount rate	7.50%, 5.08%

The estimated fair value of the Company's financial instruments at December 31, 2022 and 2021 was as follows:

As of December 31, 2022			
	Fair Value Hierarchy Level	Carrying Value	Estimated Fair Value
(in thousands)			
Financial assets:			
Cash and cash equivalents	Level 1	\$ 314,236	\$ 314,236
Other interest earning deposits	Level 1	4,250	4,250
Investment securities available-for-sale	See previous table	226,784	226,784
Investment securities held-to-maturity	Level 1	24,517	23,544
Investment securities held-to-maturity	Level 2	34,345	32,318
Investment securities held-to-maturity	Level 3	651	651
Loans receivable, net	Level 3	631,722	617,533
Accrued interest receivable	Level 1	4,044	4,044
Financial liabilities:			
Deposits	Level 2	\$ 1,180,362	\$ 1,178,435
Junior subordinated debentures	Level 3	13,403	13,785
Accrued interest payable	Level 1	155	155
As of December 31, 2021			
	Fair Value Hierarchy Level	Carrying Value	Estimated Fair Value
(in thousands)			
Financial assets:			
Cash and cash equivalents	Level 1	\$ 386,366	\$ 386,366
Other interest earning deposits	Level 1	3,250	3,250
Investment securities available-for-sale	See previous table	232,947	232,947
Investment securities held-to-maturity	Level 3	788	788
Loans held-for-sale	Level 2	6,104	6,104
Loans receivable, net	Level 3	620,036	619,091
Accrued interest receivable	Level 1	3,357	3,357
Financial liabilities:			
Deposits	Level 2	\$ 1,178,940	\$ 1,178,962
Long-term borrowings	Level 2	403	407
Junior subordinated debentures	Level 3	13,403	13,775
Accrued interest payable	Level 1	82	82

NOTE 19 – SHAREHOLDERS' EQUITY

Earnings Per Share

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

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

	For the Year Ended December 31,	
	<u>2022</u>	<u>2021</u>
	(dollars in thousands, except per share amounts)	
<u>Basic:</u>		
Net income (numerator)	\$ 10,888	\$ 12,697
Weighted average shares outstanding (denominator)	<u>10,396,268</u>	<u>10,412,845</u>
Basic earnings per share	<u>\$ 1.05</u>	<u>\$ 1.22</u>
<u>Diluted:</u>		
Net income (numerator)	\$ 10,888	\$ 12,697
Weighted average shares outstanding	10,396,268	10,412,845
Effect of dilutive stock options	<u>27,033</u>	<u>28,570</u>
Weighted average shares outstanding assuming dilution (denominator)	<u>10,423,301</u>	<u>10,441,415</u>
Diluted earnings per share	<u>\$ 1.04</u>	<u>\$ 1.22</u>

	For the Year Ended December 31,	
	<u>2022</u>	<u>2021</u>
Shares subject to outstanding options	82,600	109,400

Shares subject to outstanding options had exercise prices in excess of the current market value. Those specific shares are not included in the computation of earnings per share above, as exercise of these options would not be dilutive to shareholders.

Stock Repurchase Program

On February 17, 2021 the Board of Directors for the Company authorized the repurchase of up to \$2.61 million, or approximately 2%, of the outstanding common stock of the Company. Stock repurchases may be made from time to time on the open market or through privately negotiated transactions. The timing of purchases and the exact number of shares to be purchased are subject to market conditions and may be suspended as deemed appropriate.

The Company repurchased no shares during the year ended December 31, 2022, and repurchased 57,592 shares, at a weighted average share price of \$12.44, during the year ended December 31, 2021.

NOTE 20 – CONDENSED FINANCIAL INFORMATION – PARENT COMPANY ONLY

Pacific Financial Corporation – Parent Company Only
Consolidated Statements of Financial Condition
(in thousands)

	<u>December 31,</u> <u>2022</u>	<u>December 31,</u> <u>2021</u>
ASSETS		
Cash and cash equivalents:	\$ 593	\$ 263
Investment in bank	115,386	130,185
Other assets	<u>711</u>	<u>634</u>
Total assets	<u>\$ 116,690</u>	<u>\$ 131,082</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Junior subordinated debentures	\$ 13,403	\$ 13,403
Other liabilities	<u>125</u>	<u>37</u>
Total liabilities	<u>13,528</u>	<u>13,440</u>
Total shareholders' equity	<u>103,162</u>	<u>117,642</u>
Total liabilities and shareholders' equity	<u>\$ 116,690</u>	<u>\$ 131,082</u>

Pacific Financial Corporation – Parent Company Only
Consolidated Statements of Income
(in thousands)

	<u>Twelve Months Ended</u> <u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
INTEREST EXPENSE		
Junior subordinated debentures	\$ 460	\$ 232
Total interest expense	<u>460</u>	<u>232</u>
NONINTEREST INCOME		
Dividends from subsidiary bank	6,207	6,310
Equity in undistributed income from subsidiary bank	5,370	6,915
Other income	<u>11</u>	<u>7</u>
Total noninterest income	<u>11,588</u>	<u>13,232</u>
NONINTEREST EXPENSE		
Other expense	<u>454</u>	<u>439</u>
Total noninterest expense	<u>454</u>	<u>439</u>
Income before income taxes	<u>10,674</u>	<u>12,561</u>
Income tax benefit	<u>214</u>	<u>136</u>
Net income	<u>\$ 10,888</u>	<u>\$ 12,697</u>
Comprehensive income (loss)	<u>\$ (9,280)</u>	<u>\$ 9,462</u>

Pacific Financial Corporation – Parent Company Only
Consolidated Statements of Cash Flows
(Dollars in thousands)

	Twelve Months Ended	
	December 31,	
	2022	2021
Cash flows from operating activities:		
Net Income	\$ 10,888	\$ 12,697
Adjustments to reconcile net income to cash and cash equivalents from operating activities		
Equity in undistributed income of subsidiary	(5,370)	(6,915)
Net change in other assets	(77)	23
Net change in other liabilities	88	(120)
Stock compensation expense	149	125
Net cash provided by operating activities	5,678	5,810
Cash flows from financing activities:		
Net cash from stock option exercises	83	64
Taxes paid related to net share settlement for equity awards	(24)	(61)
Repurchase of common stock	-	(717)
Stock awards issued	-	-
Cash dividends paid	(5,407)	(5,418)
Net cash used in financing activities	(5,348)	(6,132)
Net increase (decrease) in cash and cash equivalents	330	(322)
Cash and cash equivalents at beginning of year	263	585
Cash and cash equivalents at end of year	\$ 593	\$ 263

NOTE 21 – SELECTED DATA

Results of operations on a quarterly basis were as follows (unaudited):

	Year Ended December 31, 2022			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(dollars in thousands, except per share amounts)			
Interest and dividend income	\$ 8,526	\$ 9,097	\$ 11,177	\$ 13,352
Interest expense	238	253	298	417
Net interest income	8,288	8,844	10,879	12,935
Benefit for loan losses	-	-	-	-
Noninterest income	2,112	1,864	1,692	1,559
Noninterest expense	8,576	8,800	8,950	8,648
Income before income taxes	1,824	1,908	3,621	5,846
Income tax expense	167	310	705	1,129
Net income	\$ 1,657	\$ 1,598	\$ 2,916	\$ 4,717
Earnings per common share				
Basic	\$ 0.17	\$ 0.15	\$ 0.28	\$ 0.45
Diluted	\$ 0.16	\$ 0.15	\$ 0.28	\$ 0.45

	Year Ended December 31, 2021			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(dollars in thousands, except per share amounts)			
Interest and dividend income	\$ 9,612	\$ 9,318	\$ 9,188	\$ 9,040
Interest expense	387	324	284	259
Net interest income	9,225	8,994	8,904	8,781
Benefit for loan losses	(1,400)	(1,600)	(500)	(150)
Noninterest income	5,164	4,616	3,951	2,998
Noninterest expense	10,504	10,497	10,375	9,325
Income before income taxes	5,285	4,713	2,980	2,604
Income tax expense	1,057	977	368	483
Net income	\$ 4,228	\$ 3,736	\$ 2,612	\$ 2,121
Earnings per common share				
Basic	\$ 0.41	\$ 0.36	\$ 0.25	\$ 0.20
Diluted	\$ 0.41	\$ 0.36	\$ 0.25	\$ 0.20

GENERAL CORPORATE AND SHAREHOLDER INFORMATION (unaudited)

Administrative Headquarters

1216 Skyview Drive
Aberdeen, WA 98520
(360) 533-8870

Transfer Agent and Registrar

Broadridge Financial Solutions, Inc.
51 Mercedes Way
Edgewood, NY 11717
www.broadridge.com/

Independent Auditors

CliftonLarsonAllen LLP

Shareholder Services

Broadridge, our transfer agent, maintains the records for our registered shareholders and can help you with a variety of shareholder related services at no charge including:

Change of name or address

Consolidation of accounts

Duplicate mailings

Lost stock certificates

Transfer of stock to another person

Additional administrative services

As a Pacific Financial Corporation shareholder, you are invited to take advantage of our convenient shareholder services or request more information about Pacific Financial Corporation. Access your account directly through Client Support at www.broadridge.com/.

Annual Meeting

The annual meeting of shareholders will be held via webcast on April 26th, 2023, at 4:00 p.m., local time.

Annual Report

This annual report, including accompanying financial statements and schedules, is available without charge to shareholders or beneficial owners of our common stock upon written request to Lisa Dutton, Corporate Secretary, Pacific Financial Corporation, 1216 Skyview Drive, Aberdeen, Washington 98520. It is also furnished upon request to customers of Bank of the Pacific pursuant to the requirements of the FDIC to provide an annual disclosure statement. This statement has not been reviewed or confirmed for accuracy or relevance by the FDIC.

Subsidiaries

Bank of the Pacific
1216 Skyview Drive
Aberdeen, WA 98520
(360) 533-8870
www.bankofthepacific.com

Officers

Denise J. Portmann
President and Chief Executive Officer of the Company and the Bank

Carla Tucker
Executive Vice President and Chief Financial Officer of the Company and the Bank

Daniel E. Kuenzi
Vice President of the Company and Executive Vice President and Chief Credit Officer of the Bank

Thomas Baker
Vice President of the Company and Executive Vice President and Chief Operating Officer of the Bank

Walker Evans
Vice President of the Company and Executive Vice President and Chief Lending Officer of the Bank

Lisa Dutton
Corporate Secretary

Board of Directors

Randy W. Rognlin, Chairman
Co-Owner
Rognlins, Inc

Douglas M. Schermer, Vice Chairman
Owner and President
Schermer Construction Inc. & Wishkah Rock Products

Denise Portmann
President & CEO
Pacific Financial Corporation and Bank of the Pacific

Randy J. Rust
Private Investor

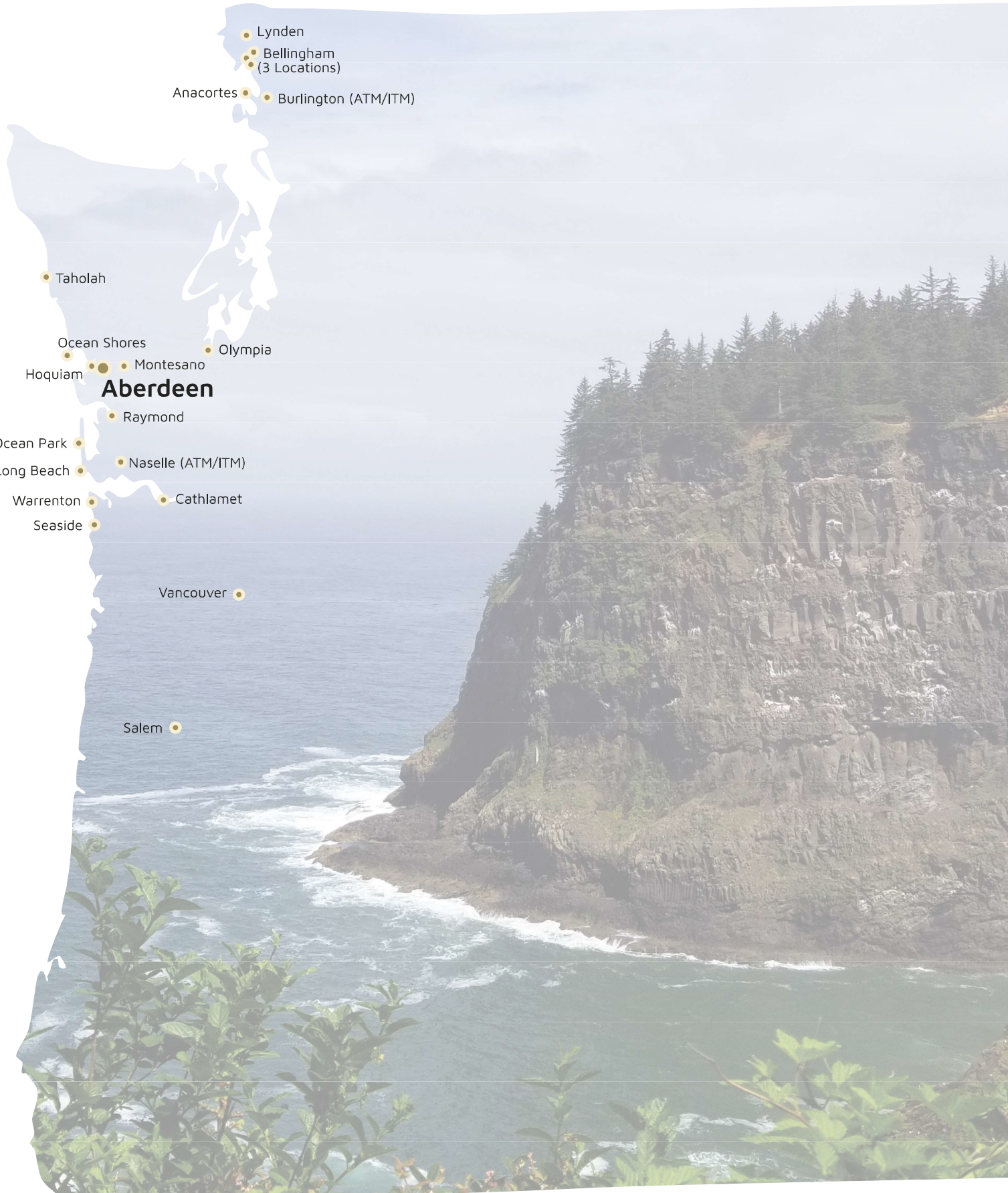
Daniel Tupper
Vice President & General Manager
Crown Distributing Co. of Aberdeen, Inc.

Susan C. Freese
Pharmacist

Doug Biddle
Retired CFO
Pacific Financial Corporation and Bank of the Pacific

Dwayne Carter
Retired President & General Manager
Brooks Manufacturing Co.

Kristi Gundersen
Partner & Chief Financial Officer
Knutzen Farms, LP



Lynden
 Bellingham (3 Locations)
 Anacortes • Burlington (ATM/ITM)

Taholah

Ocean Shores
 Hoquiam • Montsesano • Olympia
Aberdeen
 Raymond

Ocean Park • Naselle (ATM/ITM)
 Long Beach • Cathlamet
 Warrenton
 Seaside

Vancouver

Salem



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