

Your Story is Our Story



**Pacific Financial
Corporation**

Annual Report
2023

OTCQX: PFLC



Dear Fellow Shareholders:

For over 50 years our Company has prospered from our humble beginnings on the Washington coast to operating in two states with record earnings in 2023. Our long-term success stems from strong board oversight and exceptional employees who are committed to our values, with unwavering dedication to our customers and communities.

We are very pleased with our financial performance in the recent year, especially against the backdrop of deposit volatility in the industry and the fastest increase in interest rates in several decades. Pacific Financial reported record net income of \$14.6 million, or \$1.40 per diluted share, compared to \$10.9 million, or \$1.04 per diluted share, for the full year of 2022. Earnings for 2023 were fueled by strong loan growth of over 7%, an excellent core deposit franchise and an increase in our net interest margin. Coming into 2023, the board and management positioned the Bank well for a rising rate environment, benefitting from a large cash position which repriced immediately with the Federal Reserve's 500 basis point interest rate increases throughout the last two years, and a deposit base comprised of over 40% non-interest bearing balances. Leadership of the Bank resisted the temptation to invest long-term in a low rate environment through the pandemic and remained disciplined in pricing and duration of our loans and investments. As a result, our operating performance and healthy net interest margin positively set us apart from our peers.

In consideration of the Company's outstanding earnings and strong capital position, the board of directors of Pacific Financial increased dividends paid to our shareholders to \$5.5 million during the four quarter period. This represented a dividend yield of 5.16% for our shareholders. Additionally, during 2023, the Company's tangible book value per share increased 13% to \$9.75 per share, up from \$8.62 in 2022.

Given our strong financial results, our strategic initiatives for 2023 included investing in our Company for the long-term by enhancing our presence and visibility in Western Washington and Oregon. In November 2023, we celebrated the relocation of our offices in Olympia and Vancouver, WA. These branch and commercial banking centers feature a blend of new technology including Interactive Teller Machines and a team of relationship bankers ready to serve the community. Also, in December 2023, we announced the addition of a new commercial banking team in the Portland suburb of Lake Oswego, OR. These growth markets are an important component of our long-term strategic plan. We see great opportunity here and look forward to contributing to the positive momentum in those markets.

As we look to 2024, we do expect some headwinds on earnings related to persistent elevated interest rates and the impact on deposit costs and mortgage volume. Our focus for 2024 includes executing on our growth initiatives set forth in 2023, managing expenses amidst ongoing wage pressures and the continued high cost of technology and regulatory compliance, while helping our customers achieve success in order to drive long-term shareholder value.

Lastly, on behalf of management and the board, I'd like to express our deepest appreciation for retiring board member, Randy Rust. Thank you Randy for your 21 years of remarkable leadership, fiscal responsibility, thoughtful guardianship of the Company's capital, and steadfast support of our mission, vision and values.

Please join us for our annual Shareholders' meeting to be held via webcast on Wednesday, April 24, 2024 at 10:00 a.m. Pacific Time. You may access the meeting virtually via the internet at www.virtualshareholdermeeting.com/PFLC2024.

Thank you for your investment and continued confidence in Pacific Financial Corporation.

Sincerely,



Denise Portmann
President & CEO

Enhancing Our Presence and Visibility in Western Washington



Olympia, WA **Vancouver, WA**

We are an integral part of the community, and your story is our story.

We've recently celebrated the opening of new offices in Olympia and Vancouver, WA which were relocated to improve visibility, customer access and expand banking services in those locations. Both offices are designed to serve as financial solution centers where customers can connect with a banker in meaningful ways, including both in-person or utilizing financial technology that enables our clients to bank with us anytime, anywhere. With these investments, we are better positioning ourselves to serve our customers and succeed over the long-term.

	For the Year Ended December 31,				
	2023	2022	2021	2020	2019
	(dollars in thousands, except per share data)				
	(unaudited)				
Operations Data					
Interest and dividend income	\$ 55,480	\$ 42,152	\$ 37,159	\$ 39,574	\$ 41,570
Interest expense	6,280	1,206	1,254	2,380	2,928
Net interest income	49,200	40,946	35,905	37,194	38,642
Provision (benefit) for credit losses	520	-	(3,650)	3,500	-
Noninterest income	6,172	7,227	16,729	20,146	13,895
Noninterest expense	36,856	34,974	40,702	39,594	35,556
Income before income taxes	17,996	13,199	15,582	14,246	16,981
Income tax expense	3,391	2,311	2,885	2,862	3,223
Net income	\$ 14,605	\$ 10,888	\$ 12,697	\$ 11,384	\$ 13,758
Net income per share:					
Basic	\$ 1.40	\$ 1.05	\$ 1.22	\$ 1.08	\$ 1.30
Diluted	\$ 1.40	\$ 1.04	\$ 1.22	\$ 1.07	\$ 1.29
Dividends declared per share ⁽¹⁾	\$ 0.53	\$ 0.52	\$ 0.52	\$ 0.38	\$ 0.31
Dividends declared	\$ 5,524	\$ 5,407	\$ 5,418	\$ 4,023	\$ 3,288
Dividend payout ratio	38%	50%	43%	35%	24%
Performance Ratios					
Return on average equity	13.48%	10.24%	10.85%	10.33%	13.70%
Return on average assets	1.22%	0.82%	1.00%	1.07%	1.50%
Net interest margin	4.39%	3.29%	3.00%	3.73%	4.58%
Efficiency ratio	66.56%	72.60%	77.33%	69.05%	67.68%
Balance Sheet Data					
Total assets	\$ 1,148,899	\$ 1,306,203	\$ 1,319,966	\$ 1,167,293	\$ 929,415
Loans, net	676,023	631,722	620,036	717,330	675,445
Total deposits	1,009,292	1,180,362	1,178,940	1,028,424	798,638
Total borrowings	13,403	13,403	13,806	13,956	16,606
Shareholders' equity	114,691	103,162	117,642	114,186	105,293
Equity to assets ratio	9.98%	7.90%	8.91%	9.78%	11.33%
Book value per share	\$ 11.04	\$ 9.91	\$ 11.32	\$ 10.94	\$ 9.90
Tangible book value per share	\$ 9.75	\$ 8.62	\$ 10.03	\$ 9.65	\$ 8.64
Asset Quality Ratios					
Allowance for credit losses to total loans	1.25%	1.29%	1.32%	1.65%	1.31%
Allowance for credit losses to nonperforming loans	1284.64%	947.76%	679.52%	504.52%	873.96%
Nonperforming loans to total loans	0.10%	0.14%	0.19%	0.33%	0.15%
Nonperforming assets to total assets	0.06%	0.07%	0.11%	0.20%	0.11%

⁽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 and Subsidiary
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 Subsidiary (the Company), which comprise the consolidated statements of financial condition, as of December 31, 2023 and 2022, 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 Subsidiary as of December 31, 2023 and 2022, 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 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) and the Board of Governors of the Federal Reserve System Instructions for Preparation of Parent Company Only Financial Statements for Small Holding Companies (FR Y-9SP instructions) as of December 31, 2023, 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 14, 2024, 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 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.

Change in Accounting Principle

As discussed in Note 1 to the consolidated financial statements, effective January 1, 2023, Pacific Financial Corporation and Subsidiary, Bank of the Pacific adopted new accounting guidance for the measurement of credit losses on financial instruments through a cumulative-effect adjustment to retained earnings. Our opinion is not modified with respect to this matter.

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 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 Subsidiary's ability to continue as a going concern for a reasonable period of time.


Board of Directors
Pacific Financial Corporation and Subsidiary

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.

A handwritten signature in cursive script that reads "CliftonLarsonAllen LLP".

CliftonLarsonAllen LLP

Bellevue, Washington
March 14, 2024

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

ASSETS	<u>2023</u>	<u>2022</u>
Cash on hand and in banks	\$ 16,716	\$ 18,673
Interest bearing deposits	<u>90,105</u>	<u>295,563</u>
Cash and cash equivalents	<u>106,821</u>	<u>314,236</u>
Other interest earning deposits	1,250	4,250
Investment securities available for sale, at fair value	238,125	226,784
Investment securities held to maturity (fair value of \$53,235 and \$56,513, respectively)	55,454	59,513
Loans held for sale	1,103	-
Loans, net of deferred fees	684,553	639,958
Allowance for credit losses	<u>(8,530)</u>	<u>(8,236)</u>
Total loans, net	<u>676,023</u>	<u>631,722</u>
Nonmarketable equity securities	1,783	2,583
Premises and equipment, net	13,136	12,871
Operating lease right-of-use assets	2,443	1,077
Cash surrender value of life insurance	27,497	26,776
Goodwill	12,168	12,168
Other intangible assets, net	1,268	1,268
Accrued interest receivable	4,434	4,044
Prepaid expenses and other assets	<u>7,394</u>	<u>8,911</u>
Total assets	<u>\$ 1,148,899</u>	<u>\$ 1,306,203</u>
 LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits	\$ 1,009,292	\$ 1,180,362
Junior subordinated debentures	13,403	13,403
Operating lease liabilities	2,567	1,149
Accrued expenses and other liabilities	<u>8,946</u>	<u>8,127</u>
Total liabilities	<u>1,034,208</u>	<u>1,203,041</u>
Shareholders' Equity:		
Preferred Stock, no par value; 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2023 and December 31, 2022	-	-
Common Stock, \$1 par value; 25,000,000 shares authorized, 10,388,724 and 10,414,276, shares issued and outstanding at December 31, 2023 and 2022, respectively	10,389	10,414
Additional paid-in-capital	41,793	42,065
Retained earnings	78,473	69,844
Accumulated other comprehensive loss, net	<u>(15,964)</u>	<u>(19,161)</u>
Total shareholders' equity	<u>114,691</u>	<u>103,162</u>
Total liabilities and shareholders' equity	<u>\$ 1,148,899</u>	<u>\$ 1,306,203</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,	
	2023	2022
INTEREST AND DIVIDEND INCOME		
Interest and fees on loans	\$ 37,038	\$ 30,079
Taxable interest on investment securities	8,665	4,418
Nontaxable interest on investment securities	585	1,048
Interest and dividends on other interest earning assets	9,192	6,607
Total interest and dividend income	55,480	42,152
INTEREST EXPENSE		
Deposits	5,351	742
Junior subordinated debentures	929	460
Federal Home Loan Bank advances	-	4
Total interest expense	6,280	1,206
Net interest income	49,200	40,946
Provision for credit losses	520	-
Net interest income after provision for credit losses	48,680	40,946
NONINTEREST INCOME		
Service charges on deposits	1,975	1,621
Gain on sale of loans, net	635	1,812
Loss on sale of investment securities, net	(154)	-
Earnings on bank owned life insurance	685	682
Other income	3,031	3,112
Total noninterest income	6,172	7,227
NONINTEREST EXPENSE		
Compensation and employee benefits	22,793	22,401
Occupancy	2,215	2,023
Equipment	1,109	1,184
Data processing	3,770	3,506
Professional services	875	709
Marketing	549	400
State and local taxes	1,018	693
Federal deposit insurance premium	550	357
Other expense	3,977	3,701
Total noninterest expense	36,856	34,974
Income before income taxes	17,996	13,199
Income tax expense	3,391	2,311
Net income	\$ 14,605	\$ 10,888
Basic earnings per common share	\$ 1.40	\$ 1.05
Diluted earnings per common share	\$ 1.40	\$ 1.04

See accompanying Notes to Consolidated Financial Statements.

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

	Twelve Months Ended December 31,	
	2023	2022
Net Income	\$ 14,605	\$ 10,888
Other comprehensive income (loss), net of tax:		
Change in unrealized gain (loss)—		
securities available for sale, net of tax	3,146	(20,707)
Reclassification for net loss on securities—		
available-for-sale realized in earnings, net of tax	122	-
Defined benefit plans, net of tax	(71)	539
Total other comprehensive income (loss), net of tax	3,197	(20,168)
Comprehensive income (loss)	\$ 17,802	\$ (9,280)

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, 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
Adoption of new accounting standard	-	-	-	(452)	-	(452)
Net income	-	-	-	14,605	-	14,605
Other comprehensive income, net of tax	-	-	-	-	3,197	3,197
Stock option exercises/stock unit vested	12,948	13	(56)	-	-	(43)
Stock based compensation expense	-	-	145	-	-	145
Stock repurchase and cancellation of shares	(38,500)	(38)	(361)	-	-	(399)
Cash dividends declared (\$0.53 per share)	-	-	-	(5,524)	-	(5,524)
Balance at December 31, 2023	10,388,724	\$ 10,389	\$ 41,793	\$ 78,473	\$ (15,964)	\$ 114,691

See accompanying Notes to Consolidated Financial Statements.

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

	Twelve Months Ended	
	December 31,	
	2023	2022
Cash flows from operating activities:		
Net Income	\$ 14,605	\$ 10,888
Adjustments to reconcile net income to net cash on hand and in banks from operating activities		
Provision for credit losses	520	-
Depreciation and amortization	1,335	3,357
Deferred income taxes	(270)	59
Originations of loans held for sale	(22,734)	(65,030)
Proceeds from sales of loans	22,266	71,690
Gain on sale of loans, net	(635)	(1,812)
Loss on sale of premises and equipment	11	13
Loss on sale of securities, net	154	-
Earnings on bank owned life insurance	(685)	(682)
Net change in accrued interest receivable	(390)	(687)
Net change in accrued interest payable	385	73
Net change in prepaid expenses	173	(184)
Other operating activities	1,082	7,689
Net cash provided by operating activities	15,817	25,374
Cash flows from investing activities:		
Net change in loans	(44,972)	(10,150)
Maturities and paydowns of investment securities held to maturity	4,504	3,470
Maturities and paydowns of investment securities available for sale	14,663	18,047
Purchase of investment securities available for sale	(43,533)	(40,309)
Purchase of investment securities held to maturity	-	(61,839)
Purchases of nonmarketable equity securities	-	(184)
Decrease (Increase) in other interest earning deposits	3,000	(1,000)
Purchase of bank owned life insurance	(36)	(36)
Purchases of premises and equipment	(1,347)	(1,174)
Proceeds from sales of investment securities available for sale	20,709	-
Proceeds from sales of nonmarketable equity securities	800	17
Proceeds from bank owned life insurance death benefit	-	14
Proceeds from sales of premises and equipment	5	-
Net cash used in investing activities	(46,207)	(93,144)
Cash flows from financing activities:		
Net (decrease) increase in deposits	(171,070)	1,422
Repayments of FHLB Advances	-	(403)
Net cash from stock option exercises	6	52
Repurchase of common stock	(399)	-
Stock awards issued	-	-
Taxes related to net share settlement for equity awards	(38)	(24)
Cash dividends paid	(5,524)	(5,407)
Net cash used in financing activities	(177,025)	(4,360)
Net decrease in cash and cash equivalents	(207,415)	(72,130)
Cash and cash equivalents at beginning of year	314,236	386,366
Cash and cash equivalents at end of year	\$ 106,821	\$ 314,236
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$ 5,895	\$ 1,133
Cash paid for taxes	\$ 4,252	\$ 115
Supplemental non-cash disclosures of cash flow information:		
Transfer of loans held for sale to loans held for investment	\$ -	\$ 850

See accompanying Notes to Consolidated Financial Statements.

Pacific Financial Corporation and Subsidiary
Notes to Consolidated Financial Statements
For the Years Ended December 31, 2023 and December 31, 2022

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 fifteen branches located in communities in Grays Harbor, Pacific, Thurston, Whatcom, Clark, Skagit and Wahkiakum counties in the state of Washington and two branches in Clatsop County, Oregon. In addition, the Bank operates loan production offices in Burlington, Washington; Salem, Oregon; and Lake Oswego, 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 subsidiary. All intercompany accounts and transactions have been eliminated in consolidation.

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

Certain prior year amounts have been reclassified to conform with the 2023 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 provision and allowance for credit losses, the valuation and identification of deferred tax assets, the valuation of goodwill, and the estimate of the fair value of financial instruments.

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 14, 2024, 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 and collateralized mortgage obligations, 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 and collateralized mortgage obligations, 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.

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 total assets and FHLB advances. At December 31, 2023 and 2022 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 that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at amortized cost. Amortized cost is the principal balance outstanding, net of purchase premiums and discounts and deferred fees and costs. Accrued interest receivable related to loans totaled \$3.2 million at December 31, 2023 and was reported in accrued interest receivable on the consolidated balance sheets. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using methods that approximate a level yield without anticipating prepayments.

The accrual of interest is generally discontinued when a loan becomes 90 days past due and is not well collateralized and in the process of collection, or when management believes, after considering economic and business conditions and collection efforts, that the principal or interest will not be collectible in the normal course of business. Past due status is based on contractual terms of the loan. Loans with payments scheduled monthly are reported as past due when the borrower is in arrears two or more monthly payments. Loans with payment obligations other than monthly, are reported as past due when one scheduled payment is due and unpaid for 30 days or more.

All accrued interest is reversed against interest income when a loan is placed on nonaccrual status. Interest received on such loans is accounted for using the cost-recovery method, until qualifying for return to accrual. Under the cost-recovery method, interest income is not recognized until the loan balance is reduced to zero. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current, there is a sustained period of repayment performance, and future payments are reasonably assured.

Purchased credit deteriorated (PCD) loans: The Company may purchase loans, some of which have experienced more than insignificant credit deterioration since origination. In those cases, the Company will consider internal loan grades, delinquency status and other relevant factors in assessing whether purchased loans are PCD. PCD loans are recorded at the amount paid. An initial allowance for credit losses is determined using the same methodology as other loans held for investment, but with no impact to earnings. The initial allowance for credit losses determined on a collective basis is allocated to individual loans. The sum of the loan's purchase price and allowance for credit losses becomes its initial amortized cost basis. The difference between the initial amortized cost basis and the par value of the loan is a noncredit discount or premium, which is amortized into interest income over the life of the loan. Subsequent to initial recognition, PCD loans are subject to the same interest income recognition and impairment model as non-PCD loans, with changes to the allowance for credit losses recorded through provision expense.

Allowance for credit losses—Held-to-Maturity securities: Management measures expected credit losses on held-to-maturity debt securities on a collective basis by major security type. The Company's held-to maturity portfolio contains securities issued by U.S. government entities and agencies. These securities are either explicitly or implicitly guaranteed by the U.S. government, are highly rated by major rating agencies and have a long history of no credit losses. The Company's held-to-maturity portfolio also contains municipal bonds that are rated at an equivalent of Moody's Aaa or Aa2. The Company has never incurred a loss on a municipal bond, therefore the expectation of credit losses on these securities is insignificant. The Company uses industry historical default information adjusted for current conditions to establish the allowance for credit losses on the municipal bond portfolio. Accrued interest receivable on held-to-maturity debt securities was excluded from the estimate of credit losses. As a result, no allowance for credit losses was recorded on held-to-maturity securities at December 31, 2023.

Allowance for credit losses—Available-for-Sale securities: For available-for-sale securities, management evaluates all investments in an unrealized loss position on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation.

If the Company has the intent to sell the security, or it is more likely than not that the Company will be required to sell the security, the security is written down to fair value, and the entire loss is recorded in earnings.

If either of the above criteria is not met, the Company evaluates whether the decline in fair value is the result of credit losses or other factors. In making the assessment, the Company may consider various factors including the extent to which fair value is less than amortized cost, performance on any underlying collateral, downgrades in the ratings of the security by a rating agency, the failure of the issuer to make scheduled interest or principal payments and adverse conditions specifically related to the security. If the assessment indicates that a credit loss exists, the present value of cash flows expected to be collected is compared to the amortized cost basis of the security and any excess is recorded as an allowance for credit losses, limited to the amount that the fair value is less than the amortized cost basis. Any amount of unrealized loss that has not been recorded through an allowance for credit losses is recognized in other comprehensive income.

Changes in the allowance for credit losses are recorded as provision for (or reversal of) credit loss expense. Losses are charged against the allowance for credit losses when management believes an available-for-sale security is confirmed to be uncollectible or when either of the criteria regarding intent or requirement to sell is met. Accrued interest receivable on available-for-sale debt securities was excluded from the estimate of credit losses. At December 31, 2023, there was no allowance for credit losses related to the available-for-sale portfolio.

Allowance for credit losses (ACL)–Loans: The allowance for credit losses is a valuation account that is deducted from the loans' amortized cost basis to present the net amount expected to be collected on the loans. Loans are charged off against the allowance when management believes the uncollectibility of a loan balance is confirmed. Expected recoveries do not exceed the aggregate of amounts previously charged-off and expected to be charged-off. Accrued interest receivable is excluded from the estimate of credit losses.

The ACL represents management's estimate of lifetime credit losses inherent in loans as of the balance sheet date. The allowance for credit losses is estimated by management using relevant available information, from both internal and external sources, relating to past events, current conditions, and reasonable and supportable forecasts.

Management assesses the adequacy of the ACL on loans on a quarterly basis. The ACL on loans are calculated either on a pooled basis, when similar risk characteristics exist, or individually evaluated if they do not share similar risk characteristics, including nonaccrual loans. Loans evaluated individually are not included in the pool evaluations and typically represent collateral dependent loans. The Company has elected to use the practical expedient to measure individually evaluated loans as collateral dependent when repayment is expected to be provided substantially through the operation or sale of the collateral. The credit loss is measured as the difference between the amortized cost basis of the loan and the fair value of the underlying collateral. The fair value of the collateral is adjusted for the estimated costs to sell as appropriate.

The allowance for pooled basis loans is comprised of the quantitative and qualitative allowance. The quantitative allowance is calculated using either a discounted cash flow methodology (DCF) or a weighted-average remaining maturity (WARM) methodology.

Under the DCF quantitative approach the probability of default is an assumption derived from regression models which determines the relationship between historical defaults and national unemployment. The Company determines a reasonable and supportable forecast and applies that forecast to the regression model to determine defaults over the forecast period. The Company leverages economic projections from independent third-parties on quarterly basis. Following the forecast period, the economic variables used to calculate the probability of default reverts to its historical mean on a straight-line basis. Management selected a reasonable and supportable forecast period of 4 quarters with a reversion period of 4 quarters. Both the reasonable and supportable forecast period and the reversion period are periodically reviewed by management. Other assumptions relevant to the DCF model to derive the quantitative allowance include the loss given default, which is the estimate of loss for a defaulted loan, the discount rate, and prepayment speed applied to future cash flows. The DCF model calculates the net present value of each loan using both the contractual and expected cash flows, respectively.

The Company has identified the following portfolio segments and calculates the allowance for credit losses using the DCF methodology:

Commercial: Commercial loans generally are loans to sole proprietorships, partnerships, corporations, and other business enterprises to finance working capital, capital investment, or for other business related purposes. Collateral generally consists of pledges of business assets or interests, including but not limited to accounts receivable, inventory, plant and equipment, and real estate interests,

if applicable. The primary repayment sources for commercial loans are the cash flow of the operating businesses which can be adversely affected by company, industry and economic business cycles. Commercial loans may be secured or unsecured.

Commercial Real Estate Owner Occupied: Owner occupied commercial real estate loans are properties that are owned and operated by the borrower and the primary source for repayment is the cash flow from the ongoing operations and activities conducted by the borrower's business. The primary risk characteristics are specific to the underlying business and its ability to generate sustainable profitability and positive cash flow. Also, certain types of businesses also may require specialized facilities that can increase costs and may not be economically feasible to an alternative user, which could adversely impact the market value of the collateral. Factors that may influence a borrower's ability to repay their loan include demand for the business' products or services, the quality and depth of management, the degree of competition, regulatory changes, and general economic conditions.

Commercial Real Estate Non-Owner Occupied: Non-owner occupied commercial real estate loans are investment properties and the primary source for repayment of the loan is derived from rental income associated with the property or proceeds of the sale of the property. Non-owner occupied commercial real estate loans consist of mortgage loans to finance investments in real property that may include, but are not limited to, commercial/retail office space, multifamily properties, industrial/warehouse space, hotels, assisted living facilities and other specific use properties. The primary risk characteristics include impacts of overall leasing rates, absorption timelines, levels of vacancy rates and operating expenses, and general economic conditions.

HELOC & Consumer: Home equity line of credit (HELOC) and consumer loans generally include personal lines of credit and amortizing loans made to qualified individuals for various purposes such as auto loans, debt consolidation loans, home improvements, and personal expense. The primary risk characteristics associated with HELOC and consumer loans typically include major changes to the borrower's financial or personal circumstances, including unemployment or other loss of income, unexpected significant expenses, such as for major medical expenses, catastrophic events, divorce or death. In addition, fluctuations in collateral values can significantly impact the credit quality of these loans.

Land & Land Development: Land and development loans are generally loans to acquire raw land or finance land development of industrial, commercial, or multifamily buildings secured by real estate. The primary risk characteristics are specific to the uncertainty on whether the development will be completed according to the specifications and schedules and the reliance on the sale of the completed project as the primary repayment source for the loan. Factors that may influence the development may be customer specific, such as the quality and depth of property management, or related to changes in general economic conditions. Trends in the commercial and residential construction industries can significantly impact the credit quality of these loans due to supply and demand imbalances. In addition, fluctuations in real estate values can significantly impact the credit quality of these loans, as property values may determine the economic viability of construction projects and adversely impact the value of the collateral securing the loan.

Residential Real Estate: Residential real estate loans are 1-4 family mortgage loans generally to finance loans on owner occupied and non-owner occupied properties. Residential real estate loans are secured by first or second liens on the property. The degree of risk in residential mortgage lending involving owner occupied properties depends primarily on the borrower's ability to repay and the loan amount in relation to collateral value. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrower's capacity to repay their obligations may be deteriorating. Residential real estate loans include credits to finance non-owner occupied properties used as rentals. These loans can involve additional risks as the borrower's ability to repay is based on the net operating income from the property which can be impacted by occupancy levels, rental rates, and operating expenses. Declines in net operating income can negatively impact the value of the property which increases the credit risk in the event of default.

Speculative Residential Construction: Speculative residential construction loans are generally loans to finance the construction of new structures, additions or alterations to existing structures, or the demolition of existing structures to make way for new residential structures. Speculative residential construction loans are generally secured by real estate. The primary risk characteristics are specific to the uncertainty on whether the construction will be completed according to the specifications and schedules. Factors that may influence the completion of residential construction may be customer specific or related to changes in general economic conditions.

Under the WARM quantitative approach relevant historical loss experience from peer bank data over a specific lookback period, and an estimated life for each segment, are applied to current segment loan balances to calculate the allowance for credit losses.

The Company has identified the following portfolio segments and calculates the allowance for credit losses using the WARM methodology:

Credit Card Receivables: Credit card receivables include personal and business lines of credit for various personal and business purposes. The primary risk characteristics associated typically include the borrower's financial circumstances including loss of income, and/or unexpected significant expense(s).

Farmland: Farmland loans are loans secured by farmland and improvements thereon. Farmland includes all land known to be used or usable for agriculture purposes, such as crops and livestock production. The primary repayment sources for farmland loans are the cash flow of the agriculture business, therefore primary risk characteristics can be adversely affected by weather conditions, disease, and commodity prices.

Ready Reserve, Overdrafts, & Fresh Start Loans: Ready Reserve, Overdrafts, & Fresh Start loans generally include unsecured smaller balance loans, at the individual and aggregate level, resulting from overdrawing deposit accounts. The primary risk characteristics associated with these loans typically include the borrower's financial or personal circumstances.

In addition to the quantitative portion of the allowance for credit losses, qualitative factors are used to cover losses that are expected but, in the Company's assessment, may not be adequately represented in the quantitative analysis. These qualitative factors serve to compensate for additional areas of uncertainty inherent in the portfolio. Each qualitative loss factor, for each loan segment within the portfolio, incorporates consideration for a minimum to maximum range for loss factors. These qualitative factor adjustments may increase or decrease the Company's estimate of expected credit losses and are applied to each loan segment. The qualitative factors applied to each loan segment include:

- Economic conditions
- Changes in nature and volume of the portfolio
- Credit and lending staff/administration
- Problem loan trends
- Concentrations
- Loan review results
- Collateral values
- Regulatory and business environment

Allowance for credit losses—Unfunded Commitments: 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 on the balance sheet when they are funded. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for off-balance sheet loan commitments is represented by the contractual amount of those instruments.

The Company records an allowance for credit losses on off-balance sheet credit exposures, unless the commitments to extend credit are unconditionally cancelable, through a charge to provision for unfunded commitments in the Company's income statements. The allowance for credit losses on off-balance sheet credit exposures is estimated by loan segment at each balance sheet date under the current expected credit loss model using the same methodologies as portfolio loans, taking into consideration the likelihood that funding will occur as well as any third-party guarantees. The allowance for unfunded commitments is included in other liabilities on the Company's consolidated balance sheets.

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 of 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 credit 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.

Goodwill and other intangible assets: At December 31, 2023 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, 2023 and 2022, 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.

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, 2023, 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, 2023 and December 31, 2022 and recognized during the years ended December 31, 2023, and 2022 were immaterial. The tax years that remain subject to examination by federal and state taxing authorities are the years ended December 31, 2022, 2021 and 2020.

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 withdrawal 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 182,000 and 122,000 in 2023 and 2022, 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.

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, 2023 and 2022.

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, 2023 and 2022. Items outside the scope of ASC 606 are noted as such.

	Twelve Months Ended	
	December 31,	
	2023	2022
	(in thousands)	
Service charges on deposits	\$ 1,975	\$ 1,621
Gain on sale of loans, net ⁽¹⁾	635	1,812
Loss on sale of investment securities, net ⁽¹⁾	(154)	-
Earnings on bank owned life insurance ⁽¹⁾	685	682
Interchange and other fees	2,963	3,113
Other ⁽¹⁾	<u>68</u>	<u>(1)</u>
Total noninterest income	\$ <u>6,172</u>	\$ <u>7,227</u>

⁽¹⁾ Not within the scope of ASC 606

Accounting Standards Adopted in 2023: On January 1, 2023, the Company adopted ASU 2016-13 Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (ASC 326). This standard replaced the incurred loss methodology with an expected loss methodology that is referred to as the current expected credit loss (“CECL”) methodology. CECL requires an estimate of credit losses for the remaining estimated life of the financial asset using historical experience, current conditions, and reasonable and supportable forecasts and generally applies to financial assets measured at amortized cost, including loan receivables and held-to-maturity debt securities, and some off-balance sheet credit exposures such as unfunded commitments to extend credit. Financial assets measured at amortized cost will be presented at the net amount expected to be collected by using an allowance for credit losses.

In addition, CECL made changes to the accounting for available-for-sale debt securities. One such change is to require credit losses to be presented as an allowance rather than as a write-down on available-for-sale debt securities if management does not intend to sell and does not believe that it is more likely than not they will be required to sell.

The Company adopted ASC 326 and all related subsequent amendments thereto effective January 1, 2023, using the modified retrospective approach for all financial assets measured at amortized cost and off-balance sheet credit exposures. The transition adjustment of the adoption of CECL included a decrease in the allowance for credit losses on loans of \$157,000, which is presented as a reduction to net loans outstanding, and an increase in the allowance for credit losses on unfunded loan commitments of \$609,000, which is recorded within Other Liabilities. The adoption of CECL had an insignificant impact on the Company’s held-to-maturity and available-for-sale securities portfolios. The Company recorded a net decrease to retained earnings of \$452,000 as of January 1, 2023, for the cumulative effect of adopting CECL. Results for reporting periods beginning after January 1, 2023, are presented under CECL while prior period amounts continue to be reported in accordance with previously applicable accounting standards (“Incurred Loss”).

The following table presents the impact of adopting CECL:

	<u>January 1, 2023 Pre- CECL Adoption</u>	<u>Impact of CECL Adoption</u>	<u>As Reported Under CECL</u>
	(in thousands)		
Assets:			
Loans			
Commercial and agricultural	\$ 980	\$ 348	\$ 1,328
Real estate:			
Construction and development	497	(98)	399
Residential 1-4 family	706	911	1,617
Multi-family	362	(7)	355
Commercial real estate -- owner occupied	1,047	509	1,556
Commercial real estate -- non owner occupied	1,468	(230)	1,238
Farmland	<u>409</u>	<u>(163)</u>	<u>246</u>
Total real estate	4,489	922	5,411
Consumer	1,874	(534)	1,340
Unallocated	<u>893</u>	<u>(893)</u>	<u>-</u>
Total	<u>\$ 8,236</u>	<u>\$ (157)</u>	<u>\$ 8,079</u>
Liabilities:			
Allowance for Credit Losses on Off-balance Sheet Credit Exposures	\$ 203	\$ 609	\$ 812

The Company elected not to measure an allowance for credit losses for accrued interest receivable and instead elected to reverse interest income on loans or securities that are placed on nonaccrual status, which is generally when the instrument is 90 days past due, or earlier if the Company believes the collection of interest is doubtful. The Company has concluded that this policy results in the timely reversal of uncollectible interest.

In March 2022, the FASB issued ASU 2022-02, Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures. This ASU updates guidance in Topic 326 to eliminate the accounting guidance for troubled debt restructurings, or TDRs, by creditors in Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors, while enhancing disclosure requirements for certain loan refinancing and restructuring activities by creditors when a borrower is experiencing financial difficulty. Additionally, the amendments to ASC 326 require that an entity disclose current period gross write offs by year of origination within the vintage disclosures, which requires that an entity disclose the amortized cost basis of financial receivables by credit quality indicator and class of financing receivables by year of origination. The Company adopted this standard during the first quarter of 2023 and the adoption of this standard did not have a material impact on the Company’s 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, collateralized mortgage obligations and mortgaged backed securities (“MBS”). Investment securities have been classified according to management’s intent. There was no allowance for credit losses on investment securities as of December 31, 2023.

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

December 31, 2023				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(in thousands)				
Available for Sale				
Collateralized mortgage obligations	\$ 135,658	\$ 194	\$ 8,368	\$ 127,484
Mortgage backed securities	19,635	67	722	18,980
Municipal securities	48,474	9	6,058	42,425
U.S. government and agency obligations	55,165	-	5,929	49,236
Total available for sale	<u>\$ 258,932</u>	<u>\$ 270</u>	<u>\$ 21,077</u>	<u>\$ 238,125</u>
Held to maturity				
Collateralized mortgage obligations	\$ 15,656	-	\$ 1,110	\$ 14,546
Mortgage backed securities	8,049	-	429	7,620
Municipal securities	2,354	10	22	2,342
U.S. government	29,395	-	668	28,727
Total held to maturity	<u>\$ 55,454</u>	<u>\$ 10</u>	<u>\$ 2,229</u>	<u>\$ 53,235</u>
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>

Unrealized losses and fair value for which an allowance for credit losses has not been recorded, aggregated by investment category and length of time that individual securities have been in continuous unrealized loss position, as of December 31, 2023 and 2022 were as follows:

	December 31, 2023					
	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	\$ 36,248	\$ 609	\$ 71,580	\$ 7,759	\$ 107,828	\$ 8,368
Mortgage backed securities	3,277	17	10,406	705	13,683	722
Municipal securities	2,191	58	37,828	6,000	40,019	6,058
U.S. government and agency obligations	-	-	49,236	5,929	49,236	5,929
Total	<u>\$ 41,716</u>	<u>\$ 684</u>	<u>\$ 169,050</u>	<u>\$ 20,393</u>	<u>\$ 210,766</u>	<u>\$ 21,077</u>

	December 31, 2023					
	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	\$	\$	\$ 14,546	\$ 1,110	\$ 14,546	\$ 1,110
Mortgage backed securities			7,620	429	7,620	429
Municipal securities	628	1	712	21	1,340	22
U.S. government and agency obligations			28,727	668	28,727	668
Total	<u>\$ 628</u>	<u>\$ 1</u>	<u>\$ 51,605</u>	<u>\$ 2,228</u>	<u>\$ 52,233</u>	<u>\$ 2,229</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
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>

At December 31, 2023, there were 220 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 and widening pricing spreads, 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

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. The Company has not recorded impairments related to credit losses through earnings for the years ended December 31, 2023.

At December 31, 2022, there were 241 available for sale and held to maturity investment securities in an unrealized loss position. For periods prior to adoption of ASC 326, management conducted a review and evaluation of its securities for other than temporary impairment. The Company evaluated the securities 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, these investments were not considered to be other-than-temporarily impaired at December 31, 2022.

The following table provides gross realized gains and losses on the sales of securities for the periods indicated:

	Twelve Months Ended	
	December 31,	
	2023	2022
	(in thousands)	
Gross realized gain on sale of securities	\$ 92	\$ -
Gross realized loss on sale of securities	<u>(246)</u>	<u>-</u>
Net realized loss on sale of securities	<u>\$ (154)</u>	<u>\$ -</u>

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, 2023 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, 2023			
	Held to Maturity		Available for Sale	
	Amortized		Amortized	
	Cost	Fair Value	Cost	Fair Value
	(in thousands)			
Due in one year or less	\$ 9,984	\$ 9,899	\$ 5,764	\$ 5,629
Due after one year through five years	21,388	20,778	37,500	34,134
Due after five years through ten years	7,037	6,715	63,054	56,781
Due after ten years	<u>17,045</u>	<u>15,843</u>	<u>152,614</u>	<u>141,581</u>
Total investment securities	<u>\$ 55,454</u>	<u>\$ 53,235</u>	<u>\$ 258,932</u>	<u>\$ 238,125</u>

At December 31, 2023, the Company had no securities held-to-maturity that were past due 30 days or more as to principal or interest payments. The Company had no securities held-to-maturity classified as nonaccrual for the year ended December 31, 2023.

At December 31, 2023 and 2022, investment securities with an estimated fair value of \$197.3 million and \$135.3 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 of 0.06% of total assets plus 4.50% of outstanding advances. Participating banks record the value of FHLB stock equal to its par value at \$100 per share. At December 31, 2023 and 2022 the Company held \$783,000 and \$1.6 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, 2023 and maintains capital ratios that exceed “well capitalized” standards for regulatory purposes.

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

Loans held in the portfolio at December 31, 2023 and 2022 were as follows:

	<u>December 31,</u>	
	<u>2023</u>	<u>2022</u>
	(in thousands)	
Commercial and agricultural	\$ 75,322	\$ 75,705
PPP	122	515
Real estate:		
Construction and development	48,720	37,287
Residential 1-4 family	96,301	82,653
Multi-family	51,025	41,122
Commercial real estate -- owner occupied	164,443	154,380
Commercial real estate -- non owner occupied	155,280	153,707
Farmland	<u>27,273</u>	<u>26,935</u>
Total real estate	<u>543,042</u>	<u>496,084</u>
Consumer	<u>66,863</u>	<u>68,412</u>
Gross loans	685,349	640,716
Deferred fees, net	<u>(796)</u>	<u>(758)</u>
Loans, net of deferred fees	<u>\$ 684,553</u>	<u>\$ 639,958</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 \$4,000 and \$17,000 at December 31, 2023 and 2022, 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 ranging 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 \$104,000 and \$108,000 at December 31, 2023 and 2022, respectively.

At December 31, 2023 and 2022, \$395.6 million and \$289.1 million, respectively, of loans were pledged as collateral on FHLB advances. The Company has also pledged \$89.4 million and \$80.8 million of loans to the FRB for additional borrowing capacity at December 31, 2023 and 2022, respectively.

Allowance for credit losses and credit quality

The following table summarizes the activity related to the allowance for credit losses for the year ended December 31, 2023 under the CECL methodology. Balance(s) as of December 31, 2022, reflect CECL methodology adoption loan segment reclassifications from under the incurred loss methodology.

	Commercial and agricultural	Construction and development	Residential 1-4 family	Multi-family	CRE -- owner occupied	CRE -- non owner occupied	Farmland	Consumer	Unallocated	Total
	(in thousands)									
Balance, December 31, 2022	\$ 980	\$ 497	\$ 706	\$ 362	\$ 1,047	\$ 1,468	\$ 409	\$ 1,874	\$ 893	\$ 8,236
Impact of CECL adoption	348	(98)	911	(7)	509	(230)	(163)	(534)	(893)	(157)
Charge-offs	(83)	-	-	-	-	-	-	(196)	-	(279)
Recoveries	77	-	-	-	-	-	-	20	-	97
Provision for credit losses	(22)	102	338	72	45	(18)	3	113	-	633
Balance, December 31, 2023	\$ 1,300	\$ 501	\$ 1,955	\$ 427	\$ 1,601	\$ 1,220	\$ 249	\$ 1,277	\$ -	\$ 8,530

Prior to the adoption of ASC 326 on January 1, 2023, the Company calculated the allowance for credit losses under the incurred loss methodology. The following table is disclosures related to the allowance for credit losses in prior periods.

	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>

Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the 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 credit losses, thereby reducing that reserve.

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

The following table presents the Company's recorded investment in loans by credit quality indicators by year of origination as of December 31, 2023:

Term Loans by Year of Origination								
	2023	2022	2021	2020	2019	Prior	Revolving	Total
(in thousands)								
Commercial and agricultural								
Pass	\$ 20,825	\$ 13,414	\$ 5,296	\$ 6,221	\$ 5,418	\$ 5,508	\$ 14,866	\$ 71,548
Other loans especially mentioned	447	-	-	-	-	-	-	447
Substandard	395	534	121	505	-	-	1,772	3,327
Total commercial and agriculture loans	\$ 21,667	\$ 13,948	\$ 5,417	\$ 6,726	\$ 5,418	\$ 5,508	\$ 16,638	\$ 75,322
Current period gross write-offs	\$ -	\$ 3	\$ -	\$ 80	\$ -	\$ -	\$ -	\$ 83
PPP								
Pass	\$ -	\$ -	\$ 122	\$ -	\$ -	\$ -	\$ -	\$ 122
Total PPP loans	\$ -	\$ -	\$ 122	\$ -	\$ -	\$ -	\$ -	\$ 122
Construction and development								
Pass	\$ 32,467	\$ 13,754	\$ 1,300	\$ 289	\$ 241	\$ 560	\$ 109	\$ 48,720
Total construction and development loans	\$ 32,467	\$ 13,754	\$ 1,300	\$ 289	\$ 241	\$ 560	\$ 109	\$ 48,720
Residential 1-4 family								
Pass	\$ 20,794	\$ 23,178	\$ 9,530	\$ 6,023	\$ 3,506	\$ 15,947	\$ 17,046	\$ 96,024
Other loans especially mentioned	-	-	-	-	-	-	53	53
Substandard	-	-	-	-	-	-	224	224
Total residential 1-4 family loans	\$ 20,794	\$ 23,178	\$ 9,530	\$ 6,023	\$ 3,506	\$ 15,947	\$ 17,323	\$ 96,301
Multi-family								
Pass	\$ 11,251	\$ 6,231	\$ 9,799	\$ 9,096	\$ 7,450	\$ 7,198	\$ -	\$ 51,025
Total Multi-family loans	\$ 11,251	\$ 6,231	\$ 9,799	\$ 9,096	\$ 7,450	\$ 7,198	\$ -	\$ 51,025
CRE -- owner occupied								
Pass	\$ 25,438	\$ 38,114	\$ 34,039	\$ 29,394	\$ 8,625	\$ 28,568	\$ 210	\$ 164,388
Substandard	55	-	-	-	-	-	-	55
Total CRE --owner occupied loans	\$ 25,493	\$ 38,114	\$ 34,039	\$ 29,394	\$ 8,625	\$ 28,568	\$ 210	\$ 164,443
CRE -- non owner occupied								
Pass	\$ 19,510	\$ 34,193	\$ 35,242	\$ 32,032	\$ 9,810	\$ 22,861	\$ 247	\$ 153,895
Other loans especially mentioned	-	-	-	1,385	-	-	-	1,385
Total CRE -- non owner occupied loans	\$ 19,510	\$ 34,193	\$ 35,242	\$ 33,417	\$ 9,810	\$ 22,861	\$ 247	\$ 155,280
Farmland								
Pass	\$ 5,414	\$ 5,493	\$ 3,396	\$ 1,712	\$ 3,047	\$ 3,676	\$ 50	\$ 22,788
Other loans especially mentioned	-	2,784	-	-	-	-	-	2,784
Substandard	-	110	-	-	-	1,591	-	1,701
Total Farmland loans	\$ 5,414	\$ 8,387	\$ 3,396	\$ 1,712	\$ 3,047	\$ 5,267	\$ 50	\$ 27,273
Consumer								
Pass	\$ 16,847	\$ 22,048	\$ 9,889	\$ 5,116	\$ 2,015	\$ 7,738	\$ 2,830	\$ 66,483
Substandard	277	-	16	14	-	73	-	380
Total consumer loans	\$ 17,124	\$ 22,048	\$ 9,905	\$ 5,130	\$ 2,015	\$ 7,811	\$ 2,830	\$ 66,863
Current period gross write-offs	\$ 92	\$ -	\$ 21	\$ -	\$ 2	\$ -	\$ 81	\$ 196
Total loans	\$ 153,720	\$ 159,853	\$ 108,750	\$ 91,787	\$ 40,112	\$ 93,720	\$ 37,407	\$ 685,349
Total period gross write-offs	\$ 92	\$ 3	\$ 21	\$ 80	\$ 2	\$ -	\$ 81	\$ 279

Credit Quality indicators as of December 31, 2022 were as follows:

	December 31, 2022				
	Other Loans				Total
	Pass	Especially 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>

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 2023 and 2022. Total related party loans outstanding at December 31, 2023 and 2022 to executive officers and directors were \$2.6 million and \$2.6 million, respectively. During 2023 and 2022, new loans or advances on existing loans of \$12,000 and \$350,000, respectively, were made, and repayments totaled \$72,000 and \$490,000, 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, 2023.

Aging Analysis and Nonaccrual Loans

The following tables summarize the Company's loans past due, both accruing and non-accruing, by type as of December 31, 2023 and 2022. The Company did not recognize any interest income on non-accrual loans during the years ended December 31, 2023 and 2022. No allowance was established on non-accrual loans as of December 31, 2023 and 2022.

	2023						
	30-59 Days Past Due	60-89 Days Past Due	Total Past Due	Nonaccrual with ACL	Nonaccrual without ACL	Loans Not Past Due	Total
	(in thousands)						
Commercial and agricultural	\$ 227	\$ 14	\$ 241	\$ -	\$ 264	\$ 74,817	\$ 75,322
PPP	-	-	-	-	-	122	122
Real estate:							
Construction and development	-	-	-	-	-	48,720	48,720
Residential 1-4 family	289	-	289	-	50	95,962	96,301
Multi-family	-	-	-	-	-	51,025	51,025
Commercial real estate -- owner occupied	-	38	38	-	-	164,405	164,443
Commercial real estate -- non owner occupied	-	-	-	-	-	155,280	155,280
Farmland	-	-	-	-	-	27,273	27,273
Total real estate	289	38	327	-	50	542,665	543,042
Consumer	12	10	22	-	350	66,491	66,863
Gross Loans	<u>\$ 528</u>	<u>\$ 62</u>	<u>\$ 590</u>	<u>\$ -</u>	<u>\$ 664</u>	<u>\$ 684,095</u>	<u>\$ 685,349</u>

2022

	30-59 Days Past Due	60-89 Days Past Due	Total Past Due	Nonaccrual with ACL	Nonaccrual without ACL	Loans Not Past Due	Total
	(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

The following table represents the accrued interest receivable written off by reversing interest income during the year ended December 31, 2023:

	For the Year Ended December 31, 2023 (in thousands)
Commercial and agricultural	\$ 13
Residential 1-4 family	1
Consumer	11
Gross Loans	\$ 25

Collateral Dependent Loans

The Company designates individually evaluated loans on nonaccrual status as collateral-dependent loans, as well as other loans that management of the Company designates as having higher risk. Collateral-dependent loans are loans for which the repayment is expected to be provided substantially through the operation or sale of the collateral and the borrower is experiencing financial difficulty. These loans do not share common risk characteristics and are not included within the collectively evaluated loans for determining the allowance for credit losses. Under CECL, for collateral-dependent loans, the Company has adopted the practical expedient to measure the allowance for credit losses based on the fair value of collateral. The allowance for credit losses is calculated on an individual loan basis based on the shortfall between the fair value of the loan's collateral, which is adjusted for liquidation costs/discounts, and amortized cost. If the fair value of the collateral exceeds the amortized cost, no allowance is required.

The following table presents an analysis of collateral-dependent loans of the Company as of December 31, 2023:

	Primary Type of Collateral			
	Real Estate	Business Assets	Automobile	Total
	(in thousands)			
Commercial and agricultural	\$ 215	\$ 49	\$ -	\$ 264
Residential 1-4 family	50	-	-	50
Consumer	-	-	350	350
Total	\$ 265	\$ 49	\$ 350	\$ 664

Impaired Loans

Prior to the adoption of ASU 2016-13, loans were considered impaired when, based on current information and events, it was probable the Company would be unable to collect all amounts due in accordance with the original contractual terms of the loan agreements. Impaired loans include loans on nonaccrual status and accruing troubled debt restructurings. When determining if the Company would be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement, the Company considered the borrower's capacity to pay, which included such factors as the borrower's current financial statements, an analysis of global cash flow sufficient to pay all debt obligations and an evaluation of secondary sources of repayment, such as guarantor support and collateral value. The Company individually assessed for impairment all nonaccrual loans and all troubled debt restructurings. The tables below include all loans deemed impaired, whether or not individually assessed for impairment. If a loan was deemed impaired, a specific valuation allowance was allocated, if necessary, so that the loan was reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment was expected solely from the collateral. Interest payments on impaired loans were typically applied to principal unless collectability of the principal amount was reasonably assured, in which case interest was recognized on a cash basis.

The following table presents loans individually evaluated for impairment by class of loans, excluding PCI loans, as of December 31, 2022:

	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 PPP	\$ 454	\$ -	\$ 454	\$ 494	\$ -	\$ 506	\$ 28
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	<u>533</u>	<u>1,364</u>	<u>1,897</u>	<u>1,963</u>	<u>49</u>	<u>1,982</u>	<u>104</u>
Consumer	101	-	101	127	-	132	9
Total	<u>\$ 1,088</u>	<u>\$ 1,364</u>	<u>\$ 2,452</u>	<u>\$ 2,584</u>	<u>\$ 49</u>	<u>\$ 2,620</u>	<u>\$ 141</u>

Purchased Credit Deteriorated

Loans purchased or acquired in business combinations are recorded at their fair value at the acquisition date. Acquired loans are evaluated upon acquisition and classified as either purchased credit-deteriorated (PCD) or purchase non-credit-deteriorated. There were no PCD loans at December 31, 2023.

Modifications Made to Borrowers Experiencing Financial Difficulty

The allowance for credit losses incorporates an estimate of lifetime expected credit losses and is recorded on each asset upon asset origination or acquisition. The starting point for the estimate of the allowance for credit losses is historical loss information, which includes losses from modifications of receivables to borrowers experiencing financial difficulty. The Company uses a probability of default/loss given default model to determine the allowance for credit losses. An assessment of whether a borrower is experiencing financial difficulty is made on the date of a modification.

Because the effect of most modifications made to borrowers experiencing financial difficulty is already included in the allowance for credit losses because of the measurement methodologies used to estimate the allowance, a change to the allowance for credit losses is generally not recorded upon modification. Occasionally, the Company modifies loans by providing principal forgiveness on its real estate loans. When principal forgiveness is provided, the amortized cost basis of the asset is written off against the allowance for credit losses. The amount of the principal forgiveness is deemed to be uncollectible; therefore, that portion of the loan is written off, resulting in a reduction of the amortized cost basis and a corresponding adjustment to the allowance for credit losses.

In some cases, the Company will modify a certain loan by providing multiple types of concessions. Typically, one type of concession, such as a term extension, is granted initially. If the borrower continues to experience financial difficulty, another concession, such as

principal forgiveness, may be granted. For the real estate loans included in the “combination” columns below, multiple types of modifications have been made on the same loan within the current reporting period. The combination is at least two of the following: a term extension, principal forgiveness, and interest rate reduction.

Upon the Company's determination that a modified loan (or portion of a loan) has subsequently been deemed uncollectible, the loan (or a portion of the loan) is written off. Therefore, the amortized cost basis of the loan is reduced by the uncollectible amount and the allowance for credit losses is adjusted by the same amount.

For the twelve months ended December 31, 2023, the Company modifications to borrowers experiencing financial difficulty were immaterial to the financial statements.

Troubled Debt Restructured Loans

Prior to the adoption of ASU 2016-13 and ASU 2022-02, 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.

Effective January 1, 2023 the Company adopted the provision of ASU 2022-02, which eliminated the accounting for TDRs, while expanding loan modification and vintage disclosure requirements. Prior to the adoption of ASU 2022-02, during the twelve months ended December 31, 2022, there was a \$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 following table presents TDRs by type as of December 31, 2022 all of which were modified due to financial stress of the borrower:

	December 31, 2022		
	Number of Loans	Pre-TDR Outstanding Recorded Investment	Post-TDR Outstanding 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>

⁽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 year ended December 31, 2022.

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

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

	December 31, 2022		
	Accrual Status	Non-Accrual Status	Total TDRs
	(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>

Unfunded Commitments

The Company maintains a separate reserve for credit losses on off-balance-sheet credit exposures, including unfunded loan commitments, which is included in other liabilities on the consolidated balance sheet. The reserve for credit losses on off-balance-sheet credit exposures is adjusted as a provision for credit losses in the income statement. The estimate includes consideration of the likelihood that funding will occur and an estimate of expected credit losses on commitments expected to be funded over its estimated life, utilizing the same models and approaches for the Company's other loan portfolio segments described above, as these unfunded commitments share similar risk characteristics as its loan portfolio segments. The Company has identified the unfunded portion of certain lines of credit as unconditionally cancellable credit exposures, meaning the Company can cancel the unfunded commitment at any time. No credit loss estimate is reported for off-balance-sheet credit exposures that are unconditionally cancellable by the Company or for undrawn amounts under such arrangements that may be drawn prior to the cancellation of the arrangement.

On January 1, 2023, the Company recorded an adjustment for unfunded commitments of \$609,000 for the adoption of ASC Topic 326. For the year ended December 31, 2023, the Company recorded a reversal for credit losses for unfunded commitments of \$113,000. At December 31, 2023, the liability for credit losses on off-balance-sheet credit exposures included in other liabilities was \$698,000.

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, 2023 and 2022.

	<u>Investment Securities</u>	<u>Defined Benefit Plans</u>	<u>Total</u>
	(in thousands)		
Balance, December 31, 2022	\$ (19,364)	\$ 203	\$ (19,161)
Change in fair value of investment securities available for sale, net of tax	3,146	-	3,146
Reclassification adjustment of net loss from sale of investment securities available for sale included in income, net of tax	122	-	122
Unrecognized net actuarial loss during the period, net of tax	-	(31)	(31)
Amortization of net actuarial loss included in income, net of tax	-	(40)	(40)
Net current period other comprehensive income (loss)	<u>3,268</u>	<u>(71)</u>	<u>3,197</u>
Balance, December 31, 2023	<u>\$ (16,096)</u>	<u>\$ 132</u>	<u>\$ (15,964)</u>

	<u>Investment Securities</u>	<u>Defined Benefit Plans</u>	<u>Total</u>
	(in thousands)		
Balance, December 31, 2021	\$ 1,343	\$ (336)	\$ 1,007
Change in fair value of investment securities available for sale, net of tax	(20,707)	-	(20,707)
Unrecognized net actuarial gain during the period, net of tax	-	483	483
Amortization of net actuarial gain included in income, net of tax	-	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>

The following table presents the components of other comprehensive income for the twelve months ended December 31, 2023 and 2022. Reclassification adjustments related to losses on securities available-for-sale are included in loss 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.

	<u>Twelve Months Ended December 31, 2023</u>		
	<u>Before Tax</u>	<u>Tax Effect</u>	<u>Net of Tax</u>
	(in thousands)		
Net unrealized losses on investment securities:			
Net unrealized losses arising during the period	\$ 4,043	\$ 897	\$ 3,146
Reclassification adjustments for net loss realized in net income	154	32	122
Net unrealized losses on investment securities	4,197	929	3,268
Defined benefit plans:			
Net unrecognized actuarial loss	(39)	(8)	(31)
Reclassification adjustment of amortization of net actuarial loss	(51)	(11)	(40)
Net pension plan liability adjustment	(90)	(19)	(71)
Other comprehensive income (loss)	<u>\$ 4,107</u>	<u>\$ 910</u>	<u>\$ 3,197</u>

	Twelve Months Ended December 31, 2022		
	Before Tax	Tax Effect	Net of Tax
	(in thousands)		
Net unrealized losses on investment securities:			
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>

NOTE 6 – PREMISES AND EQUIPMENT

The components of premises and equipment at December 31, 2023 and 2022 were as follows:

	December 31,	
	2023	2022
	(in thousands)	
Land and premises	\$ 21,118	\$ 20,535
Equipment, furniture and fixtures	10,427	10,030
Construction in progress	<u>104</u>	<u>78</u>
	31,649	30,643
Less accumulated depreciation and amortization	<u>(18,513)</u>	<u>(17,772)</u>
Total premises and equipment	<u>\$ 13,136</u>	<u>\$ 12,871</u>

Depreciation expense was \$1.1 million for years ending December 31, 2023 and 2022.

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, 2023 are as follows:

	December 31,
	2023
	(in thousands)
2024	\$ 683
2025	544
2026	386
2027	374
Thereafter	<u>972</u>
Total future minimum lease payments	\$ 2,959
Amounts representing interest	<u>(392)</u>
Total operating lease liabilities	<u>\$ 2,567</u>

At December 31, 2023 the weighted-average remaining lease term was 5.5 years and the weighted-average discount rate was 4.07%. Amortization of ROU assets, short term lease cost, interest on lease liabilities and non-lease component expenses was \$755,000 and \$647,000 for the years ending December 31, 2023 and 2022, respectively.

NOTE 8 – OTHER REAL ESTATE OWNED

The Company had no activity related to OREO for the years ended December 31, 2023 and 2022 and had no properties classified as OREO at December 31, 2023 and 2022.

NOTE 9 – DEPOSITS

Time deposits that meet or exceed the FDIC Insurance limit of \$250,000 at December 31, 2023 and 2022 were \$36.5 million and \$9.8 million, respectively.

The composition of deposits at December 31, 2023 and 2022 was as follows:

	<u>December 31,</u>	
	<u>2023</u>	<u>2022</u>
	(in thousands)	
Interest-bearing demand ("NOW") \$	183,436	\$ 253,272
Money market deposits	179,344	195,814
Savings deposits	136,408	174,887
Time deposits ("CDs")	<u>100,832</u>	<u>48,754</u>
Total interest-bearing deposits	600,020	672,727
Non-interest bearing demand	<u>409,272</u>	<u>507,635</u>
Total deposits	<u>\$ 1,009,292</u>	<u>\$ 1,180,362</u>

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

	<u>Maturities</u>
2024	\$ 71,011
2025	24,517
2026	3,143
2027	1,157
2028	<u>1,004</u>
Total	<u>\$ 100,832</u>

NOTE 10 – BORROWINGS

Advances from the Federal Home Loan Bank

Utilizing a pledge agreement, qualifying securities and loans receivable at December 31, 2023 and 2022, were pledged as security for Federal Home Loan Bank (FHLB) borrowings. At December 31, 2023, the Bank had no outstanding borrowings against its \$260.1 million borrowing capacity with the FHLB, as compared to no outstanding against a borrowing capacity of \$195.8 million at December 31, 2022. 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, 2023 and 2022 is as follows:

	<u>December 31,</u>	
	<u>2023</u>	<u>2022</u>
	(dollars in thousands)	
Amount outstanding at end of period	\$ -	\$ -
Average balance during the year	\$ -	190
Average interest rate during the year ⁽¹⁾		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, 2023, the Bank had an available discount window primary credit line with the Federal Reserve Bank of San Francisco of approximately \$66.3 million with no balance outstanding. The Company did not utilize any Federal Reserve borrowing facility, other than for operational testing, during the twelve months ended December 31, 2023.

At December 31, 2023, 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, 2023. Availability of lines is subject to continued borrower eligibility.

NOTE 11 – JUNIOR SUBORDINATED DEBENTURES

At December 31, 2023, 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, 2023 and 2022 for the common capital securities issued by the issuer trusts.

As of December 31, 2023 and 2022, regular accrued interest on junior subordinated debentures totaled \$155,000 and \$126,000, 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, 2023 and 2022 are:

Trust Name	Issue Date	Issued Amount	Rate	Maturity Date
(dollars in thousands)				
Pacific Financial Corporation Statutory Trust I	December 2005	\$ 5,000	7.10% ⁽¹⁾	March 2036
Pacific Financial Corporation Statutory Trust II	June 2006	<u>8,000</u> <u>\$ 13,000</u>	7.26% ⁽²⁾	July 2036

⁽¹⁾ Variable rate of 3-month CME Term SOFR plus 1.71%, adjusted quarterly
3-month SOFR 5.38% at December 13, 2023

⁽¹⁾ Variable rate of 3-month libor plus 1.45%, adjusted quarterly
3-month LIBOR 4.77% at December 13, 2022

⁽²⁾ Variable rate of 3-month CME Term SOFR plus 1.86%, adjusted quarterly
3-month LIBOR 5.39% at October 13, 2023

⁽²⁾ Variable rate of 3-month libor plus 1.60%, adjusted quarterly
3-month LIBOR 4.08% at October 13, 2022

NOTE 12 – INCOME TAXES

The Company recorded an income tax provision for the twelve months ended December 31, 2023 and 2022. 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, 2023, 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, 2023.

Income taxes for the years ended December 31, 2023 and 2022 was as follows:

	<u>December 31,</u>	
	<u>2023</u>	<u>2022</u>
	(in thousands)	
Current	\$ 3,661	\$ 2,252
Deferred	(270)	59
Total income tax expense	<u>\$ 3,391</u>	<u>\$ 2,311</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, 2023 and 2022 are:

	<u>December 31,</u>	
	<u>2023</u>	<u>2022</u>
	(in thousands)	
Deferred Tax Assets		
Allowance for credit losses	\$ 2,043	\$ 1,868
Deferred compensation	4	7
Supplemental executive retirement plan	663	689
Compensation expense	45	64
Unrealized loss on securities available for sale	4,577	5,506
Other	223	335
Total deferred tax assets	<u>\$ 7,555</u>	<u>\$ 8,469</u>
Deferred Tax Liabilities		
Depreciation	\$ 199	\$ 189
Loan fees/costs	2,306	2,534
Prepaid expenses	272	245
Other	210	273
Total deferred tax liabilities	<u>2,987</u>	<u>3,241</u>
Net deferred tax assets	<u>\$ 4,568</u>	<u>\$ 5,228</u>

The following is a reconciliation between the statutory and effective federal income tax rate for the years ended December 31, 2023 and 2022:

	December 31,			
	2023		2022	
	Amount	Percent of Pre-tax Income	Amount	Percent of Pre-tax Income
	(dollars in thousands)			
Income tax at statutory rate	\$ 3,779	21.0%	\$ 2,772	21.0%
Adjustments resulting from:				
State income taxes, net of federal benefit	43	0.2%	95	0.7%
Tax-exempt income	(182)	-1.0%	(291)	-2.2%
Net earnings on life insurance policies	(144)	-0.8%	(143)	-1.1%
Other	(105)	-0.6%	(122)	-0.9%
Total income tax expense	<u>\$ 3,391</u>	<u>18.8%</u>	<u>\$ 2,311</u>	<u>17.5%</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 \$1.7 million and \$1.0 million in 2023 and 2022, 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 \$703,000 and \$743,000 for 2023 and 2022, 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 2023 and 2022. 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 \$3.2 million and \$3.1 million at December 31, 2023 and 2022, respectively. In 2023 and 2022, the net benefit recorded from these plans, including the cost of the related life insurance, was \$121,000 and \$183,000, 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 \$19,000 and \$34,000 at December 31, 2023 and 2022, respectively.

Long-Term Compensation Agreements – The Company has long-term compensation agreements with selected employees that provide incentive for those covered employees to remain employed with the Company for a defined period of time. A cost of \$61,000 and a benefit of \$42,000 was recorded for these agreements for the years ended December 31, 2023 and 2022, 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 \$7.5 million and \$7.3 million at December 31, 2023 and 2022, 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, 2023 and 2022:

	<u>December 31,</u>	
	<u>2023</u>	<u>2022</u>
Net periodic pension cost:	(dollars in thousands)	
Service cost	\$ 45	\$ 58
Interest cost	117	69
Amortization of net (gain) loss	<u>(40)</u>	<u>56</u>
Net periodic pension cost	<u>\$ 122</u>	<u>\$ 183</u>

The following table sets forth the change in benefit obligation at December 31, 2023 and 2022:

	<u>December 31,</u>	
	<u>2023</u>	<u>2022</u>
Change in benefit obligation:	(in thousands)	
Benefit obligation at the beginning of year	\$ 2,428	\$ 3,018
Service cost	45	58
Interest cost	117	69
Benefits paid	(234)	(234)
Actuarial loss (gain)	<u>31</u>	<u>(483)</u>
Benefit obligation at end of year	<u>\$ 2,387</u>	<u>\$ 2,428</u>

Amounts recognized in accumulated other comprehensive income at December 31, 2023 and 2022 was as follows:

	<u>December 31,</u>	
	<u>2023</u>	<u>2022</u>
	(in thousands)	
Gain	\$ (132)	\$ (203)
Prior service cost	-	-
Total recognized in AOCI	<u>\$ (132)</u>	<u>\$ (203)</u>

The following table summarizes the projected and accumulated benefit obligations at December 31, 2023 and 2022:

	<u>December 31,</u>	
	<u>2023</u>	<u>2022</u>
	(in thousands)	
Projected benefit obligation	\$ 2,387	\$ 2,429
Accumulated benefit obligation	\$ 2,387	\$ 2,429

Estimated future benefit payments as of December 31, 2023 were as follows (in thousands):

2024	\$ 234
2025	234
2026	234
2027	234
2028	328
2029-2033	<u>1,140</u>
Total	<u>\$ 2,404</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, 2023 and 2022 is as follows:

	<u>December 31,</u>	
	<u>2023</u>	<u>2022</u>
	(in thousands)	
Commitments to extend credit	\$ 183,593	\$ 202,331
Standby letters of credit	\$ 4,451	\$ 4,420

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.

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, 2023	6.5 years	3.58%	27.24%	4.82%	\$ 1.92
December 31, 2022	6.5 years	4.18%	27.42%	4.98%	\$ 1.93

The following tables summarize the stock option activity for the years ended December 31, 2023 and 2022:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)
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	(2,400)	12.69	
Outstanding at December 31, 2022	147,350	\$ 11.25	
Granted	86,000	10.81	
Exercised	(7,500)	5.14	
Forfeited or canceled	(12,400)	11.82	
Expired	(17,200)	12.05	
Outstanding at December 31, 2023	196,250	\$ 11.18	7.21
Vested and exercisable at December 31, 2023	86,450	\$ 11.52	5.46

The following table summarizes nonvested stock option activity for the years ended December 31, 2023 and 2022:

	<u>Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
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>	<u>1.03</u>
Nonvested Outstanding at December 31, 2022	54,500	\$ 1.28
Granted	86,000	1.92
Vested	(18,300)	1.09
Forfeited	<u>(12,400)</u>	<u>1.21</u>
Nonvested Outstanding at December 31, 2022	<u>109,800</u>	<u>\$ 1.82</u>

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

	<u>2023</u>	<u>2022</u>
	(in thousands)	
Intrinsic value of options exercised	\$ 46	\$ 142
Cash received from option exercises	\$ 39	\$ 130

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, 2023 and 2022:

	<u>Twelve Months Ended December 31,</u>	
	<u>2023</u>	<u>2022</u>
	(in thousands)	
Compensation Expense	\$ 48	\$ 31
Tax Effect	<u>10</u>	<u>7</u>
Compensation Expense, net	<u>\$ 38</u>	<u>\$ 24</u>

As of December 31, 2023, there was \$165,000 of total unrecognized compensation cost related to stock options. The cost is expected to be recognized over a weighted-average period of 2.42 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, 2023 and 2022:

	<u>Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
Outstanding at December 31, 2021	25,850	
Granted	11,000	\$ 11.85
Vested	(7,100)	
Forfeited	-	
Outstanding at December 31, 2022	29,750	
Granted	2,000	\$ 11.00
Vested	(11,750)	
Forfeited	-	
Outstanding at December 31, 2023	<u>20,000</u>	

The following table summarizes RSU compensation expense during the twelve months ended December 31, 2023 and 2022:

	<u>Twelve Months Ended</u>	
	<u>2023</u>	<u>2022</u>
	(in thousands)	
Compensation Expense	\$ 97	\$ 119
Tax Effect	20	25
Compensation Expense, net	<u>\$ 77</u>	<u>\$ 94</u>

As of December 31, 2023, there was \$67,000 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, 2023 and 2022, 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, 2023 and 2022 are presented in the table below.

	<u>Actual</u>		<u>Minimum Requirements</u>		<u>Well-Capitalized Requirements</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
(dollars in thousands)						
As of December 31, 2023						
Company						
Common equity Tier 1 capital to risk-weighted assets	\$ 117,220	14.9%	\$ 35,402	4.5%	N/A	N/A
Tier 1 leverage capital to average assets	130,220	11.3%	46,096	4.0%	N/A	N/A
Tier 1 capital to risk-weighted assets	130,220	16.5%	47,353	6.0%	N/A	N/A
Total capital to risk-weighted assets	139,448	17.7%	63,027	8.0%	N/A	N/A
Bank						
Common equity Tier 1 capital to risk-weighted assets	129,220	16.4%	35,457	4.5%	\$ 51,215	6.5%
Tier 1 leverage capital to average assets	129,220	11.2%	46,150	4.0%	57,688	5.0%
Tier 1 capital to risk-weighted assets	129,220	16.4%	47,276	6.0%	63,034	8.0%
Total capital to risk-weighted assets	138,448	17.6%	62,931	8.0%	78,664	10.0%
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%

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 yield curves models that 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, 2023 or 2022.

The following table presents the balances of assets measured at fair value on a recurring basis at December 31, 2023 and 2022.

Description	At December 31, 2023			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale securities:		(in thousands)		
Collateralized mortgage obligations	\$ 127,484	\$ -	\$ 127,484	\$ -
Mortgage-backed securities	18,980	-	18,980	-
Municipal securities	42,425	-	41,815	610
U.S. government and agency obligations	49,236	49,236	-	-
Total assets measured at fair value	\$ <u>238,125</u>	\$ <u>49,236</u>	\$ <u>188,279</u>	\$ <u>610</u>

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 and agency obligations	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>

As of December 31, 2023, the Company had one available-for-sale security classified as a Level 3 investment which consists 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, 2023 and 2022.

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, 2023 and 2022, respectively.

	Twelve Months Ended December 31,	
	2023	2022
	(in thousands)	
Balance beginning of period	\$ 640	\$ 680
Transfers in to level 3	-	-
Change in FV (included in other comprehensive income)	<u>(30)</u>	<u>(40)</u>
Balance end of period	<u>\$ 610</u>	<u>\$ 640</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 individually evaluated, 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:

Loans individually evaluated (Impaired Loans prior to January 1, 2023) – The Company individually evaluates loans when a loan over \$5,000 is in nonaccrual status or, prior to 2023, when a loan had its terms restructured in a trouble-debt-restructuring (TDR). On January 1, 2023, the Company adopted ASU 2022-02 prospectively. As a result, loans that were restructured prior to adoption are no longer considered TDRs and are not individually evaluated.

In accordance with the provisions of the individually evaluated loan guidance, credit loss is measured on loans when it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement. The Company has elected to use the practical expedient to measure individually evaluated loans as collateral dependent when repayment is expected

to be provided substantially through the operation or sale of the collateral. The credit loss is measured as the difference between the amortized cost basis of the loan and the fair value of the underlying collateral. The fair value of the collateral is adjusted for the estimated cost to sell if repayment or satisfaction of a loan is dependent on the sale of the collateral. Those individually evaluated loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceeds the recorded investments in such loans. Individually evaluated loans for which an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. Collateral values are estimated using Level 3 inputs based on customized discounting criteria.

Credit loss amounts on individually evaluated loans represent specific valuation allowance and write-downs during the period presented that were individually evaluated for impairment based on the estimated fair value of the collateral less estimated selling costs, excluding impaired loans fully charged-off.

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 credit 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.

There were no assets held at the end of December 31, 2023 that were measured at fair value on a nonrecurring basis. The following table present the Company’s assets that were held at the end of December 31, 2022 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>

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 (dollars in thousands):

Description	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%

The estimated fair value of the Company's financial instruments at December 31, 2023 and 2022 was as follows:

As of December 31, 2023			
	Fair Value Hierarchy	Carrying	Estimated
	Level	Value	Fair Value
(in thousands)			
Financial assets:			
Cash and cash equivalents	Level 1	\$ 106,821	\$ 106,821
Other interest earning deposits	Level 1	1,250	1,250
Investment securities available-for-sale	See previous table	238,125	238,125
Investment securities held-to-maturity	Level 1	24,727	24,211
Investment securities held-to-maturity	Level 2	30,212	28,509
Investment securities held-to-maturity	Level 3	515	515
Loans held-for-sale	Level 2	1,103	1,103
Loans receivable, net	Level 3	676,023	654,594
Accrued interest receivable	Level 1	4,434	4,434
Financial liabilities:			
Deposits	Level 2	\$ 1,009,292	\$ 1,008,028
Junior subordinated debentures	Level 3	13,403	14,023
Accrued interest payable	Level 1	540	540
As of December 31, 2022			
	Fair Value Hierarchy	Carrying	Estimated
	Level	Value	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

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>2023</u>	<u>2022</u>
	(dollars in thousands, except per share amounts)	
<u>Basic:</u>		
Net income (numerator)	\$ 14,605	\$ 10,888
Weighted average shares outstanding (denominator)	<u>10,420,431</u>	<u>10,396,268</u>
Basic earnings per share	<u>\$ 1.40</u>	<u>\$ 1.05</u>
 <u>Diluted:</u>		
Net income (numerator)	\$ 14,605	\$ 10,888
Weighted average shares outstanding	10,420,431	10,396,268
Effect of dilutive stock options	<u>8,756</u>	<u>27,033</u>
Weighted average shares outstanding assuming dilution (denominator)	<u>10,429,187</u>	<u>10,423,301</u>
Diluted earnings per share	<u>\$ 1.40</u>	<u>\$ 1.04</u>
	 For the Year Ended December 31,	
	<u>2023</u>	<u>2022</u>
Shares subject to outstanding options	155,500	82,600

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 September 21, 2023 the Board of Directors for the Company authorized the repurchase of up to \$2.5 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 38,500 shares, at a weighted average share price of \$10.37, during the year ended December 31, 2023. No shares were repurchased during the year ended December 31, 2022

NOTE 20 – CONDENSED FINANCIAL INFORMATION – PARENT COMPANY ONLY

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

	December 31, 2023	December 31, 2022
ASSETS		
Cash and cash equivalents:	\$ 582	\$ 593
Investment in bank	126,692	115,386
Other assets	975	711
Total assets	\$ 128,249	\$ 116,690
 LIABILITIES AND SHAREHOLDERS' EQUITY		
Junior subordinated debentures	\$ 13,403	\$ 13,403
Other liabilities	155	125
Total liabilities	13,558	13,528
Total shareholders' equity	114,691	103,162
Total liabilities and shareholders' equity	\$ 128,249	\$ 116,690

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

	Twelve Months Ended December 31,	
	2023	2022
INTEREST EXPENSE		
Junior subordinated debentures	\$ 929	\$ 460
Total interest expense	929	460
NONINTEREST INCOME		
Dividends from subsidiary bank	7,124	6,207
Equity in undistributed income from subsidiary bank	8,560	5,370
Other income	32	11
Total noninterest income	15,716	11,588
NONINTEREST EXPENSE		
Other expense	451	454
Total noninterest income	451	454
Income before income taxes	14,336	10,674
Income tax benefit	269	214
Net income	\$ 14,605	\$ 10,888
Comprehensive income (loss)	\$ 17,802	\$ (9,280)

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

	Twelve Months Ended	
	December 31,	
	2023	2022
Cash flows from operating activities:		
Net Income	\$ 14,605	\$ 10,888
Adjustments to reconcile net income to cash and cash equivalents from operating activities		
Equity in undistributed income of subsidiary	(8,560)	(5,370)
Net change in other assets	(264)	(77)
Net change in other liabilities	30	88
Stock compensation expense	145	149
Net cash provided by operating activities	5,956	5,678
Cash flows from financing activities:		
Net cash from stock option exercises	6	83
Taxes paid related to net share settlement for equity awards	(50)	(24)
Repurchase of common stock	(399)	-
Cash dividends paid	(5,524)	(5,407)
Net cash used in financing activities	(5,967)	(5,348)
Net increase (decrease) in cash and cash equivalents	(11)	330
Cash and cash equivalents at beginning of year	593	263
Cash and cash equivalents at end of year	\$ 582	\$ 593

NOTE 21 – SELECTED DATA

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

	Year Ended December 31, 2023			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(dollars in thousands, except per share amounts)			
Interest and dividend income	\$ 13,690	\$ 13,735	\$ 14,242	\$ 13,813
Interest expense	593	1,564	1,962	2,161
Net interest income	13,097	12,171	12,280	11,652
Provision for loan losses	156	8	245	111
Noninterest income	1,287	1,747	1,610	1,528
Noninterest expense	9,188	9,007	9,142	9,519
Income before income taxes	5,040	4,903	4,503	3,550
Income tax expense	930	994	859	608
Net income	\$ 4,110	\$ 3,909	\$ 3,644	\$ 2,942
Earnings per common share				
Basic	\$ 0.39	\$ 0.38	\$ 0.35	\$ 0.28
Diluted	\$ 0.39	\$ 0.38	\$ 0.35	\$ 0.28
	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

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 24th, 2024, at 10:00 AM, Pacific 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 Darla Johnson, 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

Terri McKinnis
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

Darla Johnson
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

Benjamin Ertischek
Chief Financial Officer
EOS Worldwide



Lynden

Bellingham
(3 Locations)

Anacortes Burlington (ATM/ITM)

Taholah

Ocean Shores
Hoquiam
Montesano
Olympia
Aberdeen

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

Vancouver

Lake Oswego

Salem

Pacific Financial Corporation | 1216 Skyview Drive | Aberdeen, WA 98520

360-533-8873 | BankofthePacific.com

NMLS #417480

