2022 FINANCIAL STATEMENTS
AND INDEPENDENT AUDITOR'S REPORT

Years Ended December 31, 2022 and 2021

SANTA CRUZ COUNTY BANK

SANTA CRUZ COUNTY BANK

FINANCIAL STATEMENTS
December 31, 2022 and 2021

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INDEPENDENT AUDITOR'S REPORT

The Shareholders and Board of Directors
Santa Cruz County Bank
Santa Cruz, California

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of Santa Cruz County Bank, which comprise the balance sheets as of December 31, 2022 and 2021, and the related statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of Santa Cruz County Bank as of December 31, 2022 and 2021, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with auditing standards generally accepted in the United States of America, Santa Cruz County Bank's internal control over financial reporting as of December 31, 2022, based on criteria established in the *Internal Control – Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) relevant to reporting objectives for the express purpose of meeting the regulatory requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and our report dated March 21, 2023 expressed an unmodified 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 Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of Santa Cruz County Bank and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the 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 financial statements that are free from material misstatement, whether due to fraud or error.

(Continued)

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about Santa Cruz County Bank’s ability to continue as a going concern for one year from the date the financial statements are available to be issued.

Auditor’s Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s 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 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 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 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 financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about Santa Cruz County Bank’s ability to continue as a going concern for a reasonable period of time.

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

Crowe LLP

Crowe LLP

Sacramento, California
March 21, 2023

BALANCE SHEETS
As of December 31, 2022 and 2021
Dollar amounts in thousands

ASSETS	2022	2021
Cash and due from financial institutions	$ 42,692	$ 135,626
Federal funds sold	1	3,796
Cash and cash equivalents	42,693	139,422
Interest-bearing deposits in other financial institutions	34,690	21,666
Debt securities available-for-sale	320,730	272,802
Debt securities held-to-maturity (fair value 2022: $2,834; 2021: $3,493)	2,840	3,242
Loans held for sale	45,263	69,507
Loans	1,222,476	1,132,298
Allowance for loan and lease losses	(21,444)	(19,978)
Loans, net of allowance	1,201,032	1,112,320
Non-marketable equity investment, at cost	8,630	5,932
Premises and equipment, net	15,026	12,285
Goodwill	25,762	25,762
Core deposit intangible asset, net	2,034	2,440
Bank owned life insurance	17,605	17,172
Accrued interest receivable and other assets	28,182	18,699
Total assets	$ 1,744,487	$ 1,701,249
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	$ 669,489	$ 716,888
Interest-bearing	861,293	779,448
Total deposits	1,530,782	1,496,336
Accrued interest payable and other liabilities	16,029	18,823
Total liabilities	1,546,811	1,515,159
Commitments and contingencies – See Note 16		
Shareholders' equity		
Preferred stock, no par value; 10,000,000 shares authorized; no shares issued or outstanding	–	–
Common stock, no par value; 30,000,000 shares authorized; 8,477,272 and 8,536,000 shares issued at December 31, 2022 and 2021	124,628	125,828
Retained earnings	89,239	62,332
Accumulated other comprehensive loss	(16,191)	(2,070)
Total shareholders' equity	197,676	186,090
Total liabilities and shareholders' equity	$ 1,744,487	$ 1,701,249

See accompanying notes.

STATEMENTS OF INCOME
Years ended December 31, 2022 and 2021
Dollar amounts in thousands, except per share data

	2022	2021
Interest and dividend income		
Loans, including fees	$ 65,744	$ 61,090
Interest-bearing deposits in other financial institutions	2,003	557
Taxable securities	3,270	1,255
Tax-exempt securities	77	90
Dividends on FHLB, PCBB and TIB stock	437	311
Federal funds sold	530	48
Total interest and dividend income	72,061	63,351
Interest expense		
Deposits	1,850	1,804
Federal Home Loan Bank advances and other borrowings	2	12
Total interest expense	1,852	1,816
Net interest income before provision for loan losses	70,209	61,535
Provision for loan losses	1,592	6,858
Net interest income after provision for loan losses	68,617	54,677
Noninterest income		
Service charges on deposits	457	444
Net gains on sales of loans	1,245	1,311
Loan servicing fees	735	736
ATM fee income	916	870
Other	1,191	1,415
Total noninterest income	4,544	4,776
Noninterest expense		
Salaries and employee benefits	17,076	17,562
Occupancy	2,074	1,937
Furniture and equipment	1,744	1,574
Marketing and business development	718	608
Data and item processing	1,364	1,142
Federal deposit insurance and other assessment	694	652
Amortization of core deposit intangibles	406	486
Other	5,326	5,427
Total noninterest expense	29,402	29,388
Income before income taxes	43,759	30,065
Income tax expense	12,815	8,791
Net income	$ 30,944	$ 21,274
Earnings per share:		
Basic	$ 3.63	$ 2.50
Diluted	$ 3.62	$ 2.49

See accompanying notes.

STATEMENTS OF COMPREHENSIVE INCOME
Years ended December 31, 2022 and 2021
Dollar amounts in thousands

	2022	2021
Net income	$ 30,944	$ 21,274
Other comprehensive income (loss)		
Unrealized losses on available-for-sale securities		
Unrealized holding loss arising during the year	(21,034)	(4,013)
Amortization of unrealized frozen gain during the year	1	3
Tax effect	6,219	1,186
Net of tax	(14,814)	(2,824)
Defined benefit pension plans		
Actuarial net gain arising during the period	984	130
Reclassification adjustment for amortization of prior service cost and net gain included in net periodic pension cost	–	53
Tax effect	(291)	(55)
Net of tax	693	128
Total other comprehensive loss	(14,121)	(2,696)
Comprehensive income	$ 16,823	$ 18,578

See accompanying notes.

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years ended December 31, 2022 and 2021
Dollar amounts in thousands, except per share data

	Shares	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance at December 31, 2020	7,704,682	$ 107,761	$ 60,099	$ 626	$ 168,486
Net income	–	–	21,274	–	21,274
Other comprehensive loss	–	–	–	(2,696)	(2,696)
Cash dividends declared ($0.2375 per share)	–	–	(1,890)	–	(1,890)
Stock dividends declared	775,366	17,151	(17,151)	–	–
Stock-based compensation-stock options	–	328	–	–	328
Exercise of stock options	33,378	203	–	–	203
Stock-based compensation-restricted stock	–	385	–	–	385
Restricted stock awards granted	22,574	–	–	–	–
Balance at December 31, 2021	8,536,000	125,828	62,332	(2,070)	186,090
Net income	–	–	30,944	–	30,944
Stock repurchased, net of commissions	(81,000)	(2,001)	–	–	(2,001)
Other comprehensive loss	–	–	–	(14,121)	(14,121)
Cash dividends declared ($0.4750 per share)	–	–	(4,037)	–	(4,037)
Stock-based compensation-stock options	–	483	–	–	483
Exercise of stock options	13,472	218	–	–	218
Stock-based compensation-restricted stock	–	100	–	–	100
Restricted stock awards granted	8,800	–	–	–	–
Balance at December 31, 2022	8,477,272	$ 124,628	$ 89,239	$ (16,191)	$ 197,676

See accompanying notes.

STATEMENTS OF CASH FLOWS
Years ended December 31, 2022 and 2021
Dollar amounts in thousands

	2022	2021
Cash flows from operating activities		
Net income	$ 30,944	$ 21,274
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	1,592	6,858
Depreciation and amortization of premises and equipment	1,002	1,088
Amortization of core deposit intangibles	406	486
Net amortization or interest-bearing deposits in other financial institutions	37	16
Net amortization of securities	1,912	1,020
Net accretion of acquired loans	(582)	(790)
Deferred income tax benefit	(323)	(734)
Net loss on sale of securities	1	–
Net gain on sale of loans	(1,245)	(1,311)
Stock-based compensation expense	583	713
Earnings on bank owned life insurance	(433)	(410)
Originations of loans held for sale	(37,484)	(59,683)
Proceeds from sales of loans originated for sale	21,881	17,404
Provision for unfunded credit commitments	19	68
Non-cash lease expense	21	31
Deferred post-retirement benefit expense	63	510
Increase in deferred loan fees, net of costs	(3,665)	(4,320)
(Increase) decrease in accrued interest receivable and other assets	(3,064)	1,402
(Decrease) increase in accrued interest payable and other liabilities	(1,652)	1,542
Net cash from (used in) operating activities	10,013	(14,836)
Cash flows from investing activities		
Net change in interest-bearing deposits in other financial institutions	(13,061)	36,424
Available-for-sale securities:		
Sales	110	–
Maturities, prepayments, calls, and principal repayments	30,206	10,244
Purchases	(101,161)	(241,042)
Held-to-maturity securities:		
Maturities, prepayments, calls, and principal repayments	406	3,968
Loan originations and payments, net	(45,426)	78,749
Purchases of premises and equipment	(3,744)	(3,001)
Purchase of bank owned life insurance	–	(1,200)
Purchases of non-marketable equity investments	(2,698)	(1,915)
Net cash used in investing activities	(135,368)	(117,773)

See accompanying notes.

STATEMENTS OF CASH FLOWS
Years ended December 31, 2022 and 2021
Dollar amounts in thousands

	2022	2021
Cash flows from financing activities		
Increase in deposits	34,446	301,552
Federal Home Loan Bank and other debt advances	30,430	6,800
Federal Home Loan Bank and other debt repayments	(30,430)	(47,164)
Cash dividends paid	(4,037)	(1,890)
Proceeds from exercise of stock options, including tax benefit	218	203
Cash paid for stock repurchases	(2,001)	–
Net cash from financing activities	28,626	259,501
Net change in cash and cash equivalents	(96,729)	126,892
Beginning cash and cash equivalents	139,422	12,530
Ending cash and cash equivalents	$ 42,693	$ 139,422
Supplemental cash flow information		
Interest paid	$ 1,706	$ 1,876
Income taxes paid	$ 17,000	$ 7,500
Supplemental noncash disclosure		
Transfer from loans held for sale to portfolio loans	$ 39,950	$ 7,251

See accompanying notes.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations: Santa Cruz County Bank ("the Bank") is a California state-chartered bank, which offers a full range of commercial and personal banking services to residents and businesses in Santa Cruz County and contiguous counties, through its eight full-service offices located in Aptos, Capitola, Cupertino, Monterey, Salinas, Santa Cruz, Scotts Valley, and Watsonville. The Bank was incorporated on September 10, 2003, as Santa Cruz County Bank (In Organization) and commenced banking operations on February 3, 2004 (Inception), upon receipt of final regulatory approval. The Bank is subject to regulations and undergoes periodic examinations by the Department of Financial Protection and Innovation ("DFPI") and the Federal Deposit Insurance Corporation ("FDIC"). The Bank's deposits are insured by the FDIC up to applicable legal limits.

The majority of the Bank's business is conducted with customers located in Santa Cruz County and adjacent Monterey and Santa Clara counties. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are commercial, commercial real estate, construction, multifamily, and agriculture loans supported by single-family home equity loans, municipal loans, government guaranteed loans, and installment loans. Substantially all loans are secured by specific items of collateral including business assets, consumer assets, and commercial and residential real estate. Bank products are also supported by various government guarantee programs. Commercial loans are expected to be repaid from cash flow from operations of businesses. There are no significant concentrations of loans to any one industry or customer. However, the customers' ability to repay their loans is dependent on the real estate and general economic conditions in the area.

Presentation of Notes 2 to 17: All dollar amounts presented in the tables in Notes 2 to 17 are in thousands, unless otherwise indicated, except per share information. Dollar amounts in paragraphs are in whole dollars, unless otherwise indicated.

Subsequent Events: The Bank has evaluated subsequent events for recognition and disclosure from December 31, 2022 through March 21, 2023, which is the date the financial statements were available to be issued.

Use of Estimates: The preparation of these financial statements, in conformity with U.S. generally accepted accounting principles, requires management to make estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and actual results could differ.

Cash Flows: For purposes of reporting cash flows, cash and cash equivalents include cash, deposits with other financial institutions with maturities at origination fewer than 90 days, and federal funds sold. Federal funds are sold for a one-day period and are highly liquid investments. Net cash flows are reported for customer loan and deposit transactions, interest-bearing deposits in other financial institutions with maturities shorter than 90 days at origination, and federal funds purchased.

Interest-Bearing Deposits in Other Financial Institutions: Interest bearing deposits in other financial institutions mature beyond 90 days at origination are carried at amortized cost.

Debt Securities: Debt securities are classified as held-to-maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Debt securities are classified as available-for-sale when they might be sold before maturity. Securities available-for-sale are carried at fair value with unrealized holding gains and losses reported in other comprehensive income, net of tax. At the time of purchase, the Bank designates securities as either held-to-maturity or available-for-sale based on its investment objectives, operational needs, and intent.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method to prepayment date for mortgage backed securities where prepayments are anticipated. For callable debt securities purchased at a premium, premiums are amortized to the earliest call date. Gains and losses on sales are recorded on the settlement date and determined using the specific identification method.

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the magnitude and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses the intent and ability of the Bank to retain its investment in the securities for duration sufficient to allow for an anticipated recovery in fair value. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

Loans Held for Sale: Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. These loans are generally held for approximately one and a half years from their origination date at which time they are reclassified to loans for held for investment at the lower of cost or fair value.

Loans held for sale are generally sold with servicing rights retained. The carrying value of loans sold is reduced by the amount allocated to the servicing right. If the loans are sold with servicing retained, the fair value of the servicing asset or liability is recorded on the balance sheet. Gains and losses on the sold portion of the loans are recognized at the time of sale based on the difference between the sale proceeds and the carrying value of the related loans sold.

Loans: Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or payoff, are reported at the amount of unpaid principal balances outstanding, net of deferred loan fees and costs, and an allowance for loan losses. Interest income is accrued on the unpaid principal balance daily and credited to income as it is earned. When a loan pays off or is sold, any unamortized balance of any related premiums, discounts, loan origination fees, and direct loan origination costs is recognized in income. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income over the expected life of the loan using a method that approximates the level yield method without anticipating prepayments.

Interest income on loans is generally discontinued and placed on nonaccrual status at the time the loan is 90 days delinquent or when management believes, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of interest is doubtful unless the loan is well-secured and in the process of collection. Past-due status is based on the contractual terms of the loan. A loan is moved to nonaccrual status in accordance with the Bank's policy, typically after 90 days of non-payment. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

When a loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period interest income. Interest received on such loans is accounted for on the cash-basis method and recognized only to the extent that cash is received and where the future collection of principal is probable, until qualifying for return to accrual. Generally, loans will be restored to an accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Concentration of Credit Risk: More than half of the Bank's business activity is with customers located within Santa Cruz County. Therefore, the Bank's exposure to credit risk is significantly affected by changes in the economy in the Santa Cruz County area.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable credit losses in the Bank's loan portfolio that have been incurred as of the balance sheet date. The allowance is established through a provision for loan losses, which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Cash received on previously charged-off amounts is recorded as a recovery to the allowance. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Generally, the Bank identifies loans to be reported as impaired when such loans are in nonaccrual status or classified in part or in whole as either doubtful or loss. Loans for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Commercial and commercial real estate loans over $50,000 are individually evaluated for impairment. Typically, loans below $50,000 from all class types are excluded from individual impairment analysis. When a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral.

A restructuring of a debt constitutes a troubled debt restructuring ("TDR") if the Bank, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loan modifications or concessions granted to borrowers resulting directly from the effects of the COVID-19 pandemic, who were otherwise in current payment status, were not considered to be TDRs. Troubled debt restructurings are individually evaluated for impairment and included in the separately identified impairment disclosures.

TDRs are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a TDR is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral less estimated costs to sell. For TDRs that subsequently default, the Bank determines the amount of the allowance on that loan in accordance with the accounting policy for the allowance for loan losses on loans individually identified as impaired. The Bank incorporates recent historical experience related to TDRs including the performance of TDRs that subsequently default into the calculation of the allowance by loan portfolio segment.

The general reserve component covers loans that are collectively evaluated for impairment. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures. The general allowance component also includes loans that are not individually identified for impairment evaluation, such as commercial loans below the individual evaluation threshold, as well as those loans that are individually evaluated but are not considered impaired. The determination of the general reserve is based on estimates made by management, that include, but are not limited to, consideration of historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on considerations of both the Bank's actual historical loss history and losses of the peer group in which the Bank has operated over the most recent 14 years. This is supplemented with other economic factors based on the risks present for each portfolio segment and internal asset classifications. These qualitative factors include economic trends in the Bank's service areas, industry experience and trends, geographic concentrations, estimated collateral values, the Bank's underwriting policies, the character of the loan portfolio, and probable losses inherent in the portfolio taken as a whole.

The Bank calculates the allowance by each portfolio segment (loan type). These portfolio segments include commercial and industrial, commercial real estate, land and construction, agricultural land, real estate and production, and consumer loans (principally home equity loans). Portfolio classes are not distinguished from segments for reporting purposes. The allowance for loan losses attributable to each portfolio segment, which includes both impaired loans and loans that are not impaired, is combined to determine the Bank's overall allowance, and hence, is included on the balance sheet.

The general reserve component of the allowance for loan losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk, (2) historical losses, and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below.

Commercial and Industrial – Commercial and industrial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Commercial Real Estate – Commercial real estate mortgage loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except land and construction loans. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Land and Construction – Land and construction loans generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified cost and timelines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Agricultural Land, Real Estate and Production – Agricultural real estate mortgage loans generally possess a lower inherent risk of loss than other real estate portfolio segments, including land and construction loans. Adverse economic developments may result in troubled loans. Loans related to crop production and livestock are especially vulnerable to two risk factors that are largely outside the control of Bank and borrowers: commodity prices and weather conditions.

Consumer – Comprised of single-family residential real estate, home equity lines of credit and personal lines. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate, and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments. 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 borrowers' capacity to repay their obligations may be deteriorating.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Bank's primary regulators, FDIC and DFPI, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

Allowance for Credit Losses on Unfunded Commitments: The Bank maintains a separate allowance for unfunded credit commitments. Management estimates anticipated losses using historical data and probability of utilization assumptions. The allowance for unfunded credit commitments totaled $403,000 and $384,000 at December 31, 2022 and 2021, respectively, and is included in other liabilities on the balance sheet.

Loan Servicing Rights: When loans are sold with servicing retained, servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sales of loans. Fair value is based on market prices for comparable loan servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. All classes of servicing assets are subsequently measured using the amortization method, which requires servicing rights to be amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans. Loan servicing rights were $859,000 and $717,000 at December 31, 2022 and 2021, respectively, and were included in other assets on the balance sheets.

Servicing rights are evaluated for impairment based upon the fair value of the rights as compared to carrying amount. Impairment is determined by stratifying rights into groupings based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual grouping, to the extent that fair value is less than the carrying amount. If the Bank later determines that all or a portion of the impairment no longer exists for a particular grouping, a reduction of the allowance may be recorded as an increase to income. Changes in valuation allowances are reported with loan servicing fees income on the income statement. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

Servicing fee income, which is reported on the income statement as loan servicing fees, is recorded for fees earned on servicing loans. The fees are based on a fixed amount per loan and recorded as income when earned. The amortization of servicing rights is netted against loan servicing fee income. Servicing fees totaled $735,000 and $736,000 for December 31, 2022 and 2021, respectively. Late fees and ancillary fees related to loan servicing are not material.

Non-marketable Equity Investments Carried at Cost: Equity securities without readily determinable fair values are carried at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment. The carrying amount of equity securities without readily determinable fair values totaled $8,630,000 and $5,932,000 at December 31, 2022 and 2021, respectively, and include the following:

Federal Home Loan Bank Stock: The Bank, as a member of the Federal Home Loan Bank ("FHLB") system, is required to maintain an investment in the capital stock of the FHLB of San Francisco based on the Bank's asset size or the level of borrowings and other factors. FHLB stock is carried at cost, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends, if any, are reported as income. The FHLB stock cannot be purchased or sold except between the FHLB and its members and is redeemable at its par value of $100 per share at the discretion of the FHLB of San Francisco and therefore is classified as restricted investment without readily determinable fair values. The FHLB can suspend dividends and redemptions upon notification to its members.

Bankers' Bank Stock: Stock of Pacific Coast Bankers Bank ("PCBB") and The Independent Bankers Bank ("TIB") are classified as restricted securities carried at cost, and are periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends, if any, are reported as income.

Premises and Equipment: Land is carried at cost. Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is determined using the straight-line method over the estimated useful lives of the related asset. The Bank's building and related components are depreciated over 39½ years. Furniture, fixtures and equipment are depreciated with useful lives ranging from 5 to 7 years. Leasehold improvements are amortized over the shorter of the estimated useful life of the assets or the initial term of the respective leases. The useful lives of leasehold improvements are estimated to be 3 to 15 years. When assets are sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized in income for the period. All other maintenance and repair expenditures are charged to expense as incurred.

Goodwill and Intangible Assets: Goodwill arises from business combinations and is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. The Bank accounted for the acquisition of Lighthouse Bank in 2019 using the acquisition method of accounting. Under the acquisition method, assets and liabilities assumed are recorded at their estimated fair values at the date of acquisition. Management utilizes various valuation techniques to determine these fair values. Any excess of the purchase price over amounts allocated to the acquired assets, including identifiable intangible assets, and liabilities assumed is recorded as goodwill.

Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually or more frequently if events and circumstances exists that indicate that a goodwill impairment test should be performed. The Bank will perform qualitative impairment analysis as of each quarter end. Management assessed qualitative factors including performance trends and noted no factors indicating goodwill impairment. Goodwill is the only intangible asset with an indefinite life on our balance sheet.

Core deposit intangibles represent the estimated fair value of the core deposit relationships acquired in the business combination with Lighthouse Bank and are being amortized using an accelerated basis based on dollar weighted deposit runoff on an annualized basis over an estimated life of ten years from the date of acquisition.

Bank Owned Life Insurance: The Bank has purchased life insurance policies on certain key executives and former executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Loan Commitments and Related Financial Instruments: Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Revenue Recognition: In general, for revenue not associated with financial instruments, guarantees and lease contracts, the Bank applies the following steps when recognizing revenue from contracts with customers: (i) identify the contract, (ii) identify the performance obligations, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations and (v) recognize revenue when a performance obligation is satisfied. Contracts with customers are generally short term in nature, typically due within one year or less or cancellable by the Bank or its customer upon a short notice period. Performance obligations for the Bank's customer contracts are generally satisfied at a single point in time, typically when the transaction is complete, or over time. For performance obligations satisfied over time, the Bank primarily uses the output method, directly measuring the value of the products/services transferred to the customer, to determine when performance obligations have been satisfied. The Bank typically receives payment from customers and recognize revenue concurrent with the satisfaction of its performance obligations. In most cases, this occurs within a single financial reporting period. For payments received in advance of the satisfaction of performance obligations, revenue recognition is deferred until such time as the performance obligations have been satisfied. In cases where the Bank has not received payment despite satisfaction of our performance obligations, an estimate of the amount due in the period the performance obligations have been satisfied is accrued. For contracts with variable components, only amounts for which collection is probable are accrued.

The Bank generally acts in a principal capacity, in most of its contracts with customers. In such transactions, the Bank recognizes revenue and the related costs to provide services on a gross basis in the financial statements. These transactions primarily relate to service charges on deposit accounts, which consist of monthly maintenance fees, business accounting analysis fees and business online banking fees that are generally recognized monthly when the Bank satisfies its performance obligation each month. Certain transaction-based services, such as check order charges and wire transfer fees, are recognized at a point in time typically when the transaction is completed.

In some cases, the Bank acts in an agent capacity, deriving revenue through assisting other entities in transactions with our customers. In such transactions, the Bank recognizes revenue and the related costs to provide these services on a net basis in the financial statements. These transactions recognized on a net basis primarily relate to fees derived from the Bank's customers' use of various interchange and ATM/debit card networks.

Stock-Based Compensation: Compensation cost is recognized for stock options and restricted stock awards issued to employees and directors, based on the fair value of these awards at the date of grant. The Bank estimates the fair value of each stock option award as of the date of grant using a Black-Scholes model, while the market price of the Bank's common stock at the date of grant is used for restricted stock awards.

Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. The Bank's accounting policy is to recognize forfeitures as they occur.

Income Taxes: Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred taxes are computed using the asset and liability method, which represents the tax effects for the temporary differences between carrying amounts and tax bases of assets and liabilities, based on current tax law, of future deductible or taxable amounts attributable to events that have been recognized in the financial statements. A valuation allowance is established to reduce the deferred tax asset to the level at which it is "more likely than not" that the tax asset or benefits will be realized. Deferred tax assets and liabilities are calculated by applying current enacted tax rates against future deductible or taxable amounts. Realization of tax benefits of deductible temporary differences and operating loss carry forwards depends on having sufficient taxable income of an appropriate character within the carry forward periods.

Accounting for Uncertainty in Income Taxes: The Bank uses a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

The Bank recognizes interest and/or penalties related to income tax matters in income tax expense.

Retirement Plans: Pension expense is the net of service and interest cost, return on plan assets and amortization of gains and losses not immediately recognized. Employee 401(k) plan expense is the amount of employer matching contributions. Deferred compensation and supplemental retirement plan expense allocates the benefits over years of service.

Earnings Per Common Share: Basic earnings per common share are calculated by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options. There is no adjustment to the number of outstanding shares for potential dilutive instruments, such as stock options, when a loss occurs because the conversion of potential common stock is anti-dilutive or when stock options are not in-the-money. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issuance of the financial statements.

Comprehensive Income: Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes the adjustment to fully recognize the liability associated with the supplemental executive retirement plan and unrealized gains and losses on securities available-for-sale, which are also recognized as separate components of equity.

Loss Contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

Restrictions on Cash and Due from Banks: The Bank is subject to Federal Reserve Act Regulation D, which requires banks to maintain average reserve balances with the Federal Reserve Bank. Reserve requirements are offset by usable cash reserves. The Bank had no reserve requirement at December 31, 2022 or 2021 to meet regulatory reserve and clearing requirements.

Dividend Restriction: Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to shareholders.

Fair Value of Financial Instruments: The Bank's estimated fair value amounts have been determined by the Bank using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect these estimates.

Reclassifications: Certain reclassifications have been made to prior period financial statements to conform to the current year presentation. These reclassifications had no impact on prior year Bank's net income or shareholders' equity.

Newly Issued Not Effective Accounting Standards:

FASB Accounting Standard Update ("ASU") No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, as amended - In June 2016, FASB issued new guidance ("Topic 326") to replace the incurred loss model for loans and other financial assets with an expected loss model, which is referred to as the current expected credit loss ("CECL") model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables and held-to-maturity debt securities. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in certain leases recognized by a lessor. In addition, the amendments in Topic 326 require credit losses on available-for-sale to be presented as a valuation allowance rather than as a direct write-down on available-for-sale debt securities. The Bank has adopted the standard effective January 1, 2023, including interim periods in the fiscal year beginning thereafter. The adoption of the CECL standards will result in a 15% to 25% increase to the allowance for credit losses, which will be recorded as a cumulative-effect adjustment to retained earnings, net of tax as of January 1, 2023.

ASU No. 2017-04, Intangibles - Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment – ASU 2017-04 eliminates Step 2 from the goodwill impairment test, which required entities to compute the implied fair value of goodwill. Under this guidance, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. ASU 2017-04 became effective on January 1, 2020 and did not have a significant impact on the Bank's financial statements.

ASU No. 2020-04, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting, as amended - In March 2020, the FASB issued guidance to ease the potential burden in accounting for reference rate reform. The amendments in Update 2020-04 are elective and apply to all entities that have contracts, hedging relationships, and other transactions that reference London Interbank Offered Rate ("LIBOR") or another reference rate expected to be discontinued due to reference rate reform.

The new guidance provides a number of optional expedients that reduce costs and complexity of accounting for reference rate reform. Under the guidance, the Bank could elect not to apply certain modification accounting requirements to contracts affected by reference rate transition, if certain criteria are met. A company that makes this election would not be required to re-measure the contracts at the modification date or reassess a previous accounting determination. This guidance also permits a company to elect various optional expedients that would allow it to continue applying hedge accounting for hedging relationships affected by reference rate transition, if certain criteria are met. The guidance is effective upon issuance and generally can be applied through December 31, 2022.

ASU No.2022-02, Financial Instruments - Credit Losses (Topic 326) - Troubled Debt Restructurings and Vintage Disclosures – In March 2022, the FASB issued an Update to eliminate the recognition and measurement guidance for troubled debt restructurings ("TDRs") by creditors in ASC 310-40, Receivables-Troubled Debt Restructurings by Creditors, while enhancing disclosure requirements for certain loan refinancings and restructurings by creditors when a borrower is experiencing financial difficulty. Specifically, rather than applying the recognition and measurement guidance for TDRs, an entity will apply the loan refinancing and restructuring guidance to determine whether a modification or other form of restructuring results in a new loan or a continuation of an existing loan.

Additionally, for public business entities, the amendments in this ASU require a public business entity to disclose current-period gross write-offs by year of origination for financing receivables and net investments in leases in the existing vintage disclosures. The amendments in this guidance is effective for entities upon the adoption of ASU 2016-13, for fiscal years beginning after December 15, 2022. The Bank does not expect the adoption of this standard to have a material impact on the financial statements.

ASU No. 2022-06, Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848. ASU 2022-06 extends the period of time preparers can utilize the reference rate reform relief guidance provided by ASU 2020-04, which are discussed above. ASU 2022-06, which was effective upon issuance, defers the sunset date of this prior guidance from December 31, 2022 to December 31, 2024, after which entities will no longer be permitted to apply the relief guidance in Topic 848. The Bank does not anticipate a material impact on its financial statements.

NOTE 2 - DEBT SECURITIES

The fair value of available-for-sale securities reflected net unrealized losses of $23,963,000 and $2,929,000 at December 31, 2022 and 2021, respectively. The unrealized loss recorded is net of $7,084,000 and $865,000 tax effect as accumulated other comprehensive income within shareholders' equity at December 31, 2022 and 2021, respectively.

The following tables summarize the carrying value and estimated fair value of securities available-for-sale and held-to-maturity at December 31, 2022 and 2021:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2022				
Available-for-sale:				
U.S. Treasury Bonds	$ 266,862	$ –	$ (19,898)	$ 246,964
U.S. Government sponsored agencies	19,879	–	(856)	19,023
SBA backed securities	15,481	1	(170)	15,312
Mortgage-backed securities: residential	6,581	–	(768)	5,813
Mortgage-backed securities: commercial	31,217	–	(1,596)	29,621
Collateralized mortgage obligations	128	–	(3)	125
State and political subdivision	4,545	–	(673)	3,872
Total available-for-sale	$ 344,693	$ 1	$ (23,964)	$ 320,730
Held-to-maturity:				
Mortgage-backed securities: residential	$ 290	$ –	$ (7)	$ 283
Collateralized mortgage obligations	721	3	(26)	698
State and political subdivision	1,829	24	–	1,853
Total held-to-maturity	$ 2,840	$ 27	$ (33)	$ 2,834

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2021				
Available-for-sale:				
U.S. Treasury bonds	$ 210,140	$ 16	$ (2,784)	$ 207,372
U.S. Government sponsored agencies	5,961	1	(161)	5,801
SBA backed securities	20,835	1	(278)	20,558
Mortgage-backed securities: residential	7,820	–	(95)	7,725
Mortgage-backed securities: commercial	26,369	334	(128)	26,575
Collateralized mortgage obligations	273	5	–	278
State and political subdivision	4,333	160	–	4,493
Total available-for-sale	$ 275,731	$ 517	$ (3,446)	$ 272,802
Held-to-maturity:				
Mortgage-backed securities: residential	$ 496	$ 28	$ –	$ 524
Collateralized mortgage obligations	941	60	–	1,001
State and political subdivision	1,805	163	–	1,968
Total held-to-maturity	$ 3,242	$ 251	$ –	$ 3,493

There were no transfers between available-for-sale and held-to-maturity during 2022 or 2021.

A downgraded available-for-sale municipal bond was sold in 2022 with proceeds of $110,000 and a loss of $1,000 recorded. There were no sales of investment securities in 2021.

The amortized cost and estimated fair value of debt securities at December 31, 2022 are shown by contractual maturity. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately. The overall modified duration of our investment portfolio was 2.5 years at December 31, 2022.

	December 31, 2022	
	Amortized Cost	Estimated Fair Value
Available-for-sale:		
Within one year	$ 57,222	$ 55,930
One to five years	201,425	186,004
Five to ten years	31,136	26,632
Beyond ten years	1,503	1,293
SBA-backed securities	15,481	15,312
Mortgage-backed securities	37,798	35,434
Collateralized mortgage obligations	128	125
Total	$ 344,693	$ 320,730
Held-to-maturity:		
Within one year	$ 990	$ 991
One to five years	487	492
Five to ten years	352	370
Beyond ten years	–	–
Mortgage-backed securities	290	283
Collateralized mortgage obligations	721	698
Total	$ 2,840	$ 2,834

Securities pledged at December 31, 2022 and 2021 to secure public deposits had an amortized cost of $40,107,000 and $36,288,000, respectively and a fair value of $37,050,000 and $36,768,000, respectively.

In addition, securities pledged at December 31, 2022 and 2021 to secure the State of California deposits had an amortized cost of $24,105,000 and $23,276,000, respectively and a fair value of $22,608,000 and $23,079,000, respectively.

At December 31, 2022 and 2021, there were no holdings of securities of any one issuer, other than those issued by U.S. Government and its sponsored agencies, in an amount greater than 10% of shareholders' equity.

The following table summarizes investment securities with unrealized losses at December 31, 2022 and 2021, aggregated by major security type and length of time in a continuous unrealized or unrecognized loss position:

	Less Than 12 Months		12 Months or More		Total	
December 31, 2022	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-sale:						
U.S. Treasury bonds	$ 65,595	$ (2,108)	$ 181,369	$ (17,790)	$ 246,964	$ (19,898)
U.S. Government sponsored agencies	13,911	(184)	5,113	(672)	19,024	(856)
SBA-backed securities	–	–	14,845	(170)	14,845	(170)
Mortgage-backed securities: residential	–	–	5,813	(768)	5,813	(768)
Mortgage-backed securities: commercial	21,846	(905)	7,775	(691)	29,621	(1,596)
Collateralized mortgage obligations	125	(3)	–	–	125	(3)
State and political subdivision	3,872	(673)	–	–	3,872	(673)
Total available-for-sale	$ 105,349	$ (3,873)	$ 214,915	$ (20,091)	$ 320,264	$ (23,964)
Held-to-maturity:						
Mortgage-backed securities: residential	$ 283	$ (7)	$ –	$ –	$ 283	$ (7)
Collateralized mortgage obligations	580	(26)	–	–	580	(26)
Total held-to-maturity	$ 863	$ (33)	$ –	$ –	$ 863	$ (33)

	Less Than 12 Months		12 Months or More		Total	
December 31, 2021	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-sale:						
U.S. Treasury bonds	$ 197,504	$ (2,784)	$ –	$ –	$ 197,504	$ (2,784)
U.S. Government sponsored agencies	2,747	(62)	2,896	(99)	5,643	(161)
SBA-backed securities	14,311	(217)	5,236	(61)	19,547	(278)
Mortgage-backed securities: residential	7,725	(95)	–	–	7,725	(95)
Mortgage-backed securities: commercial	7,290	(86)	1,139	(42)	8,429	(128)
Total available-for-sale	$ 229,577	$ (3,244)	$ 9,271	$ (202)	$ 238,848	$ (3,446)

The Bank had no investment securities held-to-maturity with unrealized losses at December 31, 2021.

As of December 31, 2022, the Bank performed an analysis of the investment portfolio to determine whether any of the investments held in the portfolio had an other-than-temporary impairment (“OTTI”). Management evaluated all investment securities with an unrealized loss at December 31, 2022 and separated those that had an unrealized loss for at least a consecutive 12-month period. There were no OTTI losses recorded during the twelve months ended December 31, 2022 or 2021.

As of December 31, 2022, the Bank's security portfolio consisted of 151 investment securities, 64 of which were in an unrealized loss position for less than twelve months and 80 were in a loss position and had been in a loss position for twelve months or more. The majority of losses are related to U.S. Treasury bonds. With regard to U.S. Treasury and residential and commercial mortgage-backed securities issued by the U.S. government, or debentures issued by its sponsored agencies thereof, it is expected that the securities will not be settled at prices less than the amortized cost bases of the securities, as such securities are backed by the full faith and credit of and/or guaranteed by the U.S. government. The decline in fair value on these investments in is attributable to changes in interest rates and or factors other than credit quality. As of December 31, 2022, the Bank neither had the intent to sell these securities, nor is more likely than not that it will be required to sell the securities before their anticipated recovery; therefore, the Bank does not consider these securities to be other-than-temporarily impaired at December 31, 2022.

With regard to securities issued by states and political subdivisions, management considers (i) issuer bond ratings, (ii) historical probability of default and loss given default rates for given bond ratings and remaining maturity, (iii) whether issuers continue to make timely principal and interest payments under the contractual terms of the securities, (iv) internal and external credit review of the latest financial information of the issuers, and (v) whether or not such securities are guaranteed by insurance or the Texas Permanent School Fund ("PSF"), have other credit enhancements, contain a defeasance clause, or pre-refunded by the issuers. Based on the comprehensive analysis, the Bank does not consider these securities to be other-than-temporarily impaired at December 31, 2022.

NOTE 3 - LOANS RECEIVABLE

The outstanding loan portfolio balances at December 31, 2022 and 2021 were as follows:

	2022	2021
Commercial and industrial	$ 221,173	$ 280,177
Commercial real estate	737,132	637,085
Land and construction	170,963	145,121
Agricultural land, real estate and production	44,362	31,227
Consumer	45,875	39,964
Gross loans held for investment	1,219,505	1,133,574
Net deferred loan costs (fees)	2,971	(1,276)
Gross loans net of costs (fees)	1,222,476	1,132,298
Allowance for loan losses	(21,444)	(19,978)
Loans receivable, net	$ 1,201,032	$ 1,112,320

At December 31, 2022 and 2021, loans held for sale that were originated under Small Business Administration ("SBA") programs totaled $45,263,000 and $69,507,000, respectively. The Bank participated in the SBA Paycheck Protection Program ("PPP") to originate loans to support our community and classified in Commercial and Industrial loan category above. At December 31, 2022 and 2021, outstanding Paycheck Protection Program loan balances totaled $3,202,000 and $93,278,000, respectively.

Salaries and employee benefits totaling $5,082,000 and $4,010,000 have been deferred as loan origination costs for the years ended December 31, 2022 and 2021, respectively.

The following table presents the activity in the allowance for loan losses by portfolio segment for each of the years ending December 31, 2022 and 2021.

	Commercial and Industrial	Commercial Real Estate	Land and Construction	Agricultural Land, Real Estate and Production	Consumer	Total
December 31, 2022						
Allowance for loan losses:						
Beginning balance	$ 5,264	$ 5,831	$ 8,448	$ 137	$ 298	$ 19,978
Provision for loan losses	372	863	294	20	43	1,592
Loans charged-off	(87)	(2)	–	(69)	–	(158)
Recoveries	32	–	–	–	–	32
Ending balance	$ 5,581	$ 6,692	$ 8,742	$ 88	$ 341	$ 21,444

	Commercial and Industrial	Commercial Real Estate	Land and Construction	Agricultural Land, Real Estate and Production	Consumer	Total
December 31, 2021						
Allowance for loan losses:						
Beginning balance	$ 3,367	$ 4,632	$ 4,490	$ 219	$ 313	$ 13,021
Provision for loan losses	1,801	1,196	3,958	(82)	(15)	6,858
Recoveries	96	3	–	–	–	99
Ending balance	$ 5,264	$ 5,831	$ 8,448	$ 137	$ 298	$ 19,978

The following table presents the balance in the allowance for loan losses and the recorded investment excluding deferred fees/costs in loans by portfolio segment and based on impairment method as of December 31, 2022 and 2021:

	Commercial and Industrial	Commercial Real Estate	Land and Construction	Agricultural Land, Real Estate and Production	Consumer	Total
December 31, 2022						
Allowance for loan losses:						
Allowance balance attributable to loans:						
Individually evaluated for impairment	$ 1,526	$ –	$ –	$ –	$ –	$ 1,526
Collectively evaluated for impairment	4,055	6,692	8,742	88	341	19,918
Ending balance	$ 5,581	$ 6,692	$ 8,742	$ 88	$ 341	$ 21,444
Loans:						
Individually evaluated for impairment	$ 1,526	$ –	$ 990	$ –	$ 824	$ 3,340
Collectively evaluated for impairment	219,647	737,132	169,973	44,362	45,051	1,216,165
Ending balance	$ 221,173	$ 737,132	$ 170,963	$ 44,362	$ 45,875	$ 1,219,505

	Commercial and Industrial	Commercial Real Estate	Land and Construction	Agricultural Land, Real Estate and Production	Consumer	Total
December 31, 2021						
Allowance for loan losses:						
Allowance balance attributable to loans:						
Individually evaluated for impairment	$ 1,736	$ –	$ –	$ 68	$ –	$ 1,804
Collectively evaluated for impairment	3,528	5,831	8,448	69	298	18,174
Ending balance	$ 5,264	$ 5,831	$ 8,448	$ 137	$ 298	$ 19,978
Loans:						
Individually evaluated for impairment	$ 1,852	$ –	$ 990	$ 68	$ 60	$ 2,970
Collectively evaluated for impairment	278,325	637,085	144,131	31,159	39,904	1,130,604
Ending balance	$ 280,177	$ 637,085	$ 145,121	$ 31,227	$ 39,964	$ 1,133,574

The Bank had five loans with a recorded investment excluding deferred fees/costs of $3,340,000 impaired as of December 31, 2022. The Bank had eight loans with a recorded investment excluding deferred fees/costs of $2,974,000 as of December 31, 2021.

Nonaccrual loans and loans past due over 89 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. The Bank had $3,153,000 and $375,000 in nonaccrual as of December 31, 2022 and 2021 respectively.

The following table presents the recorded investment excluding deferred fees/costs in loans past due over 89 days by class of loans as of December 31, 2022 and 2021.

	Nonaccrual		Loans Past Due Over 89 Days and Still Accruing	
	2022	2021	2022	2021
Commercial and industrial	$ 1,363	$ 247	$ 11	$ 105
Land and construction	990	–	–	–
Agricultural land, real estate and production	–	68	–	–
Consumer	800	60	–	–
Total	$ 3,153	$ 375	$ 11	$ 105

The following table presents the aging of the recorded investment excluding deferred fees/costs in past due loans as of December 31, 2022 and 2021 by class of loans.

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Loans Not Past Due	Total
December 31, 2022						
Commercial and industrial	$ 500	$ 477	$ 1,374	$ 2,351	$ 218,822	$ 221,173
Commercial real estate	–	–	–	–	737,132	737,132
Land and construction	–	–	990	990	169,973	170,963
Agricultural land, real estate and production	–	–	–	–	44,362	44,362
Consumer	–	–	800	800	45,075	45,875
Total	$ 500	$ 477	$ 3,164	$ 4,141	$ 1,215,364	$ 1,219,505

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Loans Not Past Due	Total
December 31, 2021						
Commercial and industrial	$ 33	$ 33	$ 261	$ 327	$ 279,850	$ 280,177
Commercial real estate	–	–	–	–	637,085	637,085
Land and construction	–	–	–	–	145,121	145,121
Agricultural land, real estate and production	–	–	68	68	31,159	31,227
Consumer	–	–	60	60	39,904	39,964
Total	$ 33	$ 33	$ 389	$ 455	$ 1,133,119	$ 1,133,574

The Bank had a recorded investment excluding deferred fees/costs of $23,000 in one consumer troubled debt restructure as of December 31, 2022. No specific allowance had been set aside for the troubled debt restructure loan. The modification terms included a payment reduction but no permanent reduction in the recorded investment of the loan. The loan was performing according to its modified terms at December 31, 2022.

The Bank had a recorded investment excluding deferred fees/costs of $90,000 in one consumer troubled debt restructure as of December 31, 2021.

Credit Quality Indicators: The Bank assigns loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial condition of borrowers and guarantors, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Bank analyzes all loans individually by classifying the loans as to credit risk. This analysis includes loans with an outstanding balance greater than $25,000 and non-homogeneous loans, such as commercial and commercial real estate loans. The loans are evaluated and rated at the time of underwriting, at renewal, if payment becomes past due, or if an event of default occurs. These risk ratings are also subject to examination by independent specialists engaged by the Bank and the Bank's regulators. The risk categories can be grouped into four major categories, defined as follows:

Pass – A pass loan is a credit with no existing or known potential weaknesses deserving of management's close attention.

Special Mention – A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Bank's credit position at some future date. Special Mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.

Substandard – A substandard loan is inadequately protected by the current net worth and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time, or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable, and improbable.

Overdraft lines of credit and loans that do not meet the criteria above are considered to be pass-rated loans.

The following table shows the risk category of the loan portfolio by class at December 31, 2022 and 2021:

	Pass	Special Mention	Substandard	Doubtful	Total
December 31, 2022					
Commercial and industrial	$ 217,127	$ 1,624	$ 2,422	$ –	$ 221,173
Commercial real estate	728,898	6,260	1,974	–	737,132
Land and construction	169,973	–	990	–	170,963
Agricultural land, real estate and production	43,831	531	–	–	44,362
Consumer	45,852	–	23	–	45,875
Total	$ 1,205,681	$ 8,415	$ 5,409	$ –	$ 1,219,505

	Pass	Special Mention	Substandard	Doubtful	Total
December 31, 2021					
Commercial and industrial	$ 274,315	$ 3,789	$ 2,073	$ –	$ 280,177
Commercial real estate	627,155	7,913	2,017	–	637,085
Land and construction	144,131	–	990	–	145,121
Agricultural land, real estate and production	30,716	443	68	–	31,227
Consumer	39,904	–	60	–	39,964
Total	$ 1,116,221	$ 12,145	$ 5,208	$ –	$ 1,133,574

The following tables show information related to impaired loans at ended December 31, 2022 and 2021:

	Unpaid Principal Balance	Recorded Investment Excluding Deferred Fees/Costs	Allowance for Loan Losses Allocated	Average Recorded Investment Excluding Deferred Fees/Costs	Interest Income Recognized
December 31, 2022					
With no related allowance recorded:					
Land and construction	$ 990	$ 990	$ –	$ 990	$ 21
Consumer	824	824	–	826	27
Total	$ 1,814	$ 1,814	$ –	$ 1,816	$ 48
With an allowance recorded:					
Commercial and industrial	$ 1,526	$ 1,526	$ 1,526	$ 1,554	$ 85
Total:					
Commercial and industrial	$ 1,526	$ 1,526	$ 1,526	$ 1,554	$ 85
Land and construction	990	990	–	990	21
Consumer	824	824	–	826	27
Total	$ 3,340	$ 3,340	$ 1,526	$ 3,370	$ 133

	Unpaid Principal Balance	Recorded Investment Excluding Deferred Fees/Costs	Allowance for Loan Losses Allocated	Average Recorded Investment Excluding Deferred Fees/Costs	Interest Income Recognized
December 31, 2021					
With no related allowance recorded:					
Land and construction	$ 990	$ 990	$ –	$ 990	$ 51
Consumer	62	62	–	64	–
Total	$ 1,052	$ 1,052	$ –	$ 1,054	$ 51
With an allowance recorded:					
Commercial and industrial	$ 1,854	$ 1,854	$ 1,736	$ 1,997	$ 84
Agricultural land, real estate and production	68	68	68	68	–
Total	$ 1,922	$ 1,922	$ 1,804	$ 2,065	$ 84
Total:					
Commercial and industrial	$ 1,854	$ 1,854	$ 1,736	$ 1,997	$ 84
Land and construction	990	990	–	990	51
Agricultural land, real estate and production	68	68	68	68	–
Consumer	62	62	–	64	–
Total	$ 2,974	$ 2,974	$ 1,804	$ 3,119	$ 135

NOTE 4 - FAIR VALUE

Fair Value Hierarchy: Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Bank groups its assets and liabilities measured at fair value into three levels. Valuations within these levels are based upon:

Level 1 – Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 – Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 – Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Bank used the following methods and significant assumptions to estimate fair value:

Cash and Cash Equivalents: The carrying amount of cash and cash equivalents is a reasonable estimate of fair value and are classified as Level 1.

Interest-Bearing Deposits in Other Financial Institutions: The fair values were calculated using discounted cash flow models based on market rates resulting in a Level 2 classification.

Debt Securities: The fair values of debt securities classified as available-for-sale and held-to-maturity are based on quoted market prices, if available (Level 1) at the reporting date. For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2), using matrix pricing. Matrix pricing is a mathematical technique commonly used to price debt securities that are not actively traded, values debt securities without relying exclusively on quoted prices for the specific securities but rather relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3).

Loans Held for Sale: Loans held for sale are carried at the lower of cost or fair value, which is evaluated on a pool-level basis. The fair value of loans held for sale is determined using quoted prices for similar assets, adjusted for specific attributes of that loan or other observable market data, such as outstanding commitments from third party investors (Level 2).

Loans: The fair value of loans is determined as the present value of expected future cash flows discounted at the rate that represents current market rates for new origination of comparable loans and included adjustments for interest rate, credit, equity return, servicing and liquidity risk factors, resulting in a Level 3 classification. Loans are grouped according to similar characteristics such as loan type, risk classification, past due status, fixed or variable terms, repricing frequency, amortization and terms. The estimated fair values of financial instruments disclosed below follow the guidance in ASU 2016-01, which prescribes an "exit price" approach in estimating and disclosing fair value of financial instruments.

Accrued Interest Receivable/Payable: The respective carrying values of certain on-balance-sheet financial instruments approximated their fair values. These financial instruments include accrued interest receivable and accrued interest payable. Carrying values were assumed to approximate fair values for these financial instruments as they are short term in nature and their recorded amounts approximate fair values or are receivable or payable on demand. The Bank does not use derivative financial instruments. The carrying amounts of accrued interest approximate their fair value resulting in a Level 2 or Level 3 classification.

Deposits: The fair values of demand deposits, savings deposits, and money market deposits without defined maturities were the amounts payable on demand at the reporting date resulting in a Level 1 classification. For variable rate deposits where the Bank has the contractual right to change rates, carrying value was assumed to approximate fair value resulting in a Level 1 classification. For certificates of deposit with defined maturities, the fair values were calculated using discounted cash flow models based on market interest rates for different product types and maturity dates. The discount rates used were based on rates for comparable deposits resulting in a Level 2 classification.

Assets Recorded at Fair Value: The Bank's assets measured at fair value on a recurring basis as of December 31, 2022 and 2021 are summarized below:

	Fair Value Measurements at December 31, 2022 Using:			
	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total Fair Value
Securities available-for-sale:				
U.S. Treasury bonds	$ -	$ 246,964	$ -	$ 246,964
U.S. Government sponsored agencies	-	19,023	-	19,023
SBA-backed securities	-	15,312	-	15,312
Mortgage-backed securities: residential	-	5,813	-	5,813
Mortgage-backed securities: commercial	-	29,621	-	29,621
Collateralized mortgage obligations	-	125	-	125
State and political subdivision	-	3,872	-	3,872
Total assets measured at fair value	$ -	$ 320,730	$ -	$ 320,730

	Fair Value Measurements at December 31, 2021 Using:			
	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total Fair Value
Securities available-for-sale:				
U.S. Treasury bonds	$ -	$ 207,372	$ -	$ 207,372
U.S. Government sponsored agencies	-	5,801	-	5,801
SBA-backed securities	-	20,558	-	20,558
Mortgage-backed securities: residential	-	7,725	-	7,725
Mortgage-backed securities: commercial	-	26,575	-	26,575
Collateralized mortgage obligations	-	278	-	278
State and political subdivision	-	4,493	-	4,493
Total assets measured at fair value	$ -	$ 272,802	$ -	$ 272,802

There were no transfers between Level 1 and Level 2 during 2022 and 2021. There were no recurring Level 3 assets or liabilities measured at fair value during 2022 or 2021.

The Bank may be required, from time to time, to measure certain assets at fair value on a non-recurring basis. These include assets that are measured at the lower of cost or market value that were recognized at fair value, which was below cost at the reporting date. There were no assets measured at fair value at year-end 2022 or 2021.

Fair Value of Financial Instruments: The carrying amounts and estimated fair values of financial instruments not carried at fair value, at December 31, 2022 and 2021 are as follows:

	Fair Value Measurements at December 31, 2022 Using:				
	Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value
Financial assets:					
Cash and cash equivalents	$ 42,693	$ 42,693	$ -	$ -	$ 42,693
Interest-bearing deposits in other financial institutions	34,690	-	34,632	-	34,632
Securities held-to-maturity	2,840	-	2,834	-	2,834
Loans held for sale	45,263	-	48,623	-	48,623
Loans, net	1,201,032	-	-	1,147,561	1,147,561
Accrued interest receivable	6,825	-	1,693	5,132	6,825
Financial liabilities:					
Noninterest-bearing deposits	$ 669,489	$ 669,489	$ -	$ -	$ 669,489
Interest-bearing deposits	861,293	613,450	111,894	-	725,344
Accrued interest payable	240	16	224	-	240

	Fair Value Measurements at December 31, 2021 Using:				
	Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value
Financial assets:					
Cash and cash equivalents	$ 139,422	$ 139,422	$ -	$ -	$ 139,422
Interest-bearing deposits in other financial institutions	21,666	-	21,666	-	21,666
Securities held-to-maturity	3,242	-	3,493	-	3,493
Loans held for sale	69,507	-	69,507	-	69,507
Loans, net	1,112,320	-	-	1,102,284	1,102,284
Accrued interest receivable	5,393	-	873	4,520	5,393
Financial liabilities:					
Noninterest-bearing deposits	$ 716,888	$ 716,888	$ -	$ -	$ 716,888
Interest-bearing deposits	779,448	654,427	114,359	-	768,786
Accrued interest payable	95	14	81	-	95

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

There were no transfers between Level 1, Level 2, and Level 3 during 2022 or 2021.

NOTE 5 - PREMISES AND EQUIPMENT

The following presents the cost of premises and equipment including leasehold improvements and the related accumulated depreciation and amortization at December 31, 2022 and 2021:

	2022	2021
Land	$ 2,512	$ 2,512
Building	9,168	6,434
Furniture, fixtures and equipment	3,410	2,808
Software and capitalized data & item processing	391	292
Computer equipment	1,664	1,422
Automobile	16	16
Leasehold improvements	3,284	3,189
Construction-in-progress	728	757
Total premises and equipment	21,173	17,430
Less accumulated depreciation and amortization	(6,147)	(5,145)
Premises and equipment, net	$ 15,026	$ 12,285

Depreciation expense was $1,002,000 and $1,088,000 for 2022 and 2021, respectively.

NOTE 6 - LEASES

Lessee Arrangements: The Bank enters into leases in the normal course of business primarily for branches, back-office operations, and loan production offices. The Bank's leases have remaining terms ranging from 1 to 12 years, some of which include renewal options to extend the lease for up to 5 years. The weighted average lease term at December 31, 2022 is 6.64 years, and the weighted average discount rate used in the calculations is 1.68%. The Bank's leases do not include residual value guarantees or covenants.

The Bank leases certain branch properties and equipment under long-term operating lease agreements. These leases expire on various dates through 2033 and have various renewal options of five years each. Some leases may include a free rent period or have net operating costs associated with them.

The Bank includes lease extension options in the lease term if, after considering relevant economic factors, it is reasonably certain the Bank will exercise the option. In addition, the Bank has elected to account for any non-lease components in its real estate leases as part of the associated lease component. The Bank has also elected not to recognize leases with original lease terms of 12 months or less (short-term leases) on the Bank's balance sheet.

Building and kiosk rent expense for the years ended December 31, 2022 and 2021, was approximately $850,000 and $847,000, respectively.

Leases are classified as operating or finance leases at the lease commencement date. Lease expense for operating leases and short-term leases is recognized on a straight-line basis over the lease term. Right-of-use assets represent our right to use an underlying asset for the lease term and lease liabilities represent our obligation to make lease payments arising from the lease. Right-of-use assets and lease liabilities are recognized at the lease commencement date based on the estimated present value of lease payments over the lease term.

The Bank uses its incremental borrowing rate at lease commencement to calculate the present value of lease payments when the rate implicit in a lease is not known. The Bank's incremental borrowing rate is based on the FHLB amortizing advance rate, adjusted for the lease term and other factors.

Right-of-use assets and lease liabilities by lease type, and the associated balance sheet classifications, as follows:

	Balance Sheet Classification	2022	2021
Right-of-use assets:			
Operating leases	Accrued interest receivable and other assets	$ 4,591	$ 4,853
Lease liabilities:			
Operating leases	Accrued interest payable and other liabilities	$ 4,811	$ 5,052

Lease Expense: The components of total lease cost were as follows for the period ending:

	2022	2021
Operating lease cost	$ 850	$ 840
Short-term lease cost	-	7
Total lease cost, net	$ 850	$ 847

Lease Obligations: Future undiscounted lease payments for operating leases with initial terms of one year or more as of December 31, 2022 are as follows:

	Operating Leases
2023	$ 812
2024	698
2025	644
2026	562
2027	473
Thereafter	2,253
Total undiscounted lease payments	5,442
Less: imputed interest	(631)
Net lease liabilities	$ 4,811

NOTE 7 - GOODWILL AND INTANGIBLE ASSETS

Business combinations involving the Bank's acquisition of the equity interests or net assets of another enterprise give rise to goodwill. Total goodwill at December 31, 2022 and 2021 of $25,762,000 represented the excess of the purchase consideration of Lighthouse Bank over the fair value of assets acquired net of fair value liabilities assumed in the 2019 business combination accounted for under the purchase method of accounting. The value of goodwill is dependent on the Bank's ability to generate net earnings after the acquisition and is not deductible for tax purposes. Goodwill is assessed at least quarterly for impairment at the reporting unit level. There was no change or impairment on goodwill in 2022 or 2021.

Other Acquired Intangible Assets: Other acquired intangible assets were as follows for the years ended December 31, 2022 and 2021:

	2022		2021	
	Carrying Amount	Gross Accumulated Amortization	Carrying Amount	Gross Accumulated Amortization
Amortized intangible assets:				
Core deposit intangibles	$ 3,707	$ 1,673	$ 3,707	$ 1,267

The other acquired intangible assets at December 31, 2022 represent the estimated fair value of the core deposit relationships acquired in the acquisition of Lighthouse Bank in 2019 of $3,707,000. Core deposit intangibles are being amortized using a dollar weighted deposit runoff on an annualized basis over an estimated life of ten years from the date of acquisition. At December 31, 2022, the weighted average remaining amortization period is 6.75 years. The carrying value of intangible assets at December 31, 2022 and 2021 was $2,034,000 and $2,440,000, net of accumulated amortization expense. Amortization expense recognized was $406,000 for 2022 and $486,000 for 2021.

The following table summarizes the Bank's estimated core deposit intangible amortization expense for each of the next five years:

December 31, 2022		Estimated Core Deposit Intangible Amortization
2023	$	363
2024		331
2025		312
2026		293
2027		276
Thereafter		459
Total	$	2,034

NOTE 8 - DEPOSITS

Interest-bearing deposits at December 31, 2022 and 2021, consisted of the following:

		2022		2021
Demand deposit	$	246,265	$	219,072
Money market		363,092		314,541
Time deposits $250,000 or more		66,491		63,030
Time deposits less than $250,000		47,637		51,352
Savings		137,808		131,453
Total interest-bearing deposits	$	861,293	$	779,448

The ten largest depositors, excluding fully collateralized government agency deposits, represent approximately 13% of total deposits as of December 31, 2022.

Aggregate annual maturities of time deposits are as follows:

2023	$	106,591
2024		2,074
2025		1,851
2026		659
2027		2,953
	$	114,128

NOTE 9 - BORROWED FUNDS

At December 31, 2022, the Bank had unsecured lines of credit with its correspondent banks in an aggregate amount of $71,000,000, at interest rates that vary with market conditions. As of December 31, 2022, the Bank had no federal funds purchased.

The Bank has established a secured borrowing arrangement, secured by loans totaling approximately $769,380,000 with the Federal Home Loan Bank of San Francisco ("FHLB"). The Bank had a remaining borrowing capacity of $354,677,000 and $315,709,000 as of December 31, 2022 and 2021, respectively, through the FHLB under which overnight and term advances were available. These advances are secured by assets including the Bank's ownership interest in the capital stock of the FHLB, securities and loans. As of December 31, 2022, the Bank had no overnight advances nor any term advances through the FHLB. The Bank's credit limit varies according to the amount and composition of the investments and loan portfolios pledged as collateral.

NOTE 10 - PENSION AND OTHER POSTRETIREMENT BENEFIT PLANS

The Bank established the Supplemental Executive Retirement Plan ("SERP"), an unfunded noncontributory defined benefit pension plan, to provide supplemental retirement benefits to a select group of key executives and senior officers. The Bank uses December 31 as the measurement date for this plan.

The following table reflects the changes in obligations and plan assets of the defined benefit pension plan as of December 31, 2022 and 2021:

	2022	2021
Change in benefit obligation:		
Beginning benefit obligation	$ 4,230	$ 3,998
Service cost	381	419
Interest cost	99	88
Actuarial (gain) loss	(984)	(130)
Benefits paid	(153)	(145)
Ending benefit obligation	3,573	4,230
Change in plan assets:		
Beginning plan assets	–	–
Employer contributions	153	145
Benefits paid	(153)	(145)
Ending plan assets	–	–
Funded status at end of year	$ (3,573)	$ (4,230)

Amounts recognized in accumulated other comprehensive income at December 31 consist of:

	2022	2021
Change in benefit obligation:		
Unrecognized net actuarial (gain) loss	$ (978)	$ 6
Unrecognized prior service cost	–	–
	$ (978)	$ 6

The following components of net periodic benefit cost, other than the service cost component, are included in the line item “other noninterest expense” in the income statement:

Components of net periodic benefit cost	2022	2021
Service cost	$ 381	$ 419
Interest cost	99	88
Amortization of prior service cost	–	53
Amortization of unrecognized actuarial gains	–	–
Net periodic benefit cost	$ 480	$ 560

	2022	2021
Net gain	$ (984)	$ (130)
Amortization of gain	–	–
Amortization of prior service cost	–	(53)
Total recognized in other comprehensive income	(984)	(183)
Total recognized in net periodic benefit cost and other comprehensive (income) loss	$ (504)	$ 377

Assumptions: Weighted average assumptions used to determine pension benefit obligations and net periodic pension cost at December 31:

	2022	2021
Discount rate used to determine net periodic benefit cost	2.38%	2.23%
Discount rate used to determine benefit obligations	4.78%	2.38%
Future salary increases	N/A	N/A

NOTE 11 - EMPLOYEE BENEFIT PLANS

401(k) Plan: All employees of the Bank are eligible to participate in the Bank’s 401(k) benefit plan, which is a tax-deferred savings plan designed to assist employees in preparing for their retirement years. The 401(k) Plan allows employees to contribute to the plan up to certain limits prescribed by the Internal Revenue Service. The Bank matches 30% of contributions up to 6% of compensation. Total expense for the years ended December 31, 2022 and 2021 was $305,000 and $307,000, respectively.

Split-Dollar Life Insurance: The Bank accounts for split-dollar life insurance in accordance with ASC 715-60, Compensation – Non-retirement Post-employment Benefits, which requires that endorsement split-dollar life insurance arrangements which provide a post-retirement benefit to an employee be recorded based on the substance of the agreement with the employee. When the Bank has effectively agreed to maintain a life insurance policy during the covered employees’ retirement, the present value of the cost of future premiums of insurance policy during post-retirement is accrued. The total liability recorded as of December 31, 2022 and 2021 was $1,336,000 and $1,655,000, respectively. Total (income) expense recognized for the years ended December 31, 2022 and 2021 was ($319,000) and $37,000, respectively.

NOTE 12 - INCOME TAXES

The provision for income taxes is as follows for the years ended December 31, 2022 and 2021:

	2022	2021
Current expense:		
Federal	$ 8,145	$ 5,918
State	4,993	3,607
Total current	13,138	9,525
Deferred expense (benefit):		
Federal	(98)	(378)
State	(225)	(356)
Total deferred	(323)	(734)
Total provision for income taxes	$ 12,815	$ 8,791

The effective tax rates differ from the federal statutory rate of 21% for 2022 and 2021 applied to income before income taxes due to the following:

	2022	2021
Federal statutory rate	21.00%	21.00%
State income tax, net of federal effect	8.63%	8.54%
Tax exempt interest	(0.30%)	(0.48%)
Bank owned life insurance	(0.21%)	(0.29%)
Split dollar expense	(0.15%)	0.03%
Stock-based compensation	0.13%	0.13%
Other	0.18%	0.29%
Total	29.28%	29.22%

Deferred income taxes are the result of differences between income tax accounting and accounting principles generally accepted in the United States of America, with respect to income and expense recognition. The net deferred taxes are reported in Accrued Interest Receivable and Other Assets in the Balance Sheets as of December 31, 2022 and 2021.The tax effects of temporary differences that gave rise to deferred tax assets and deferred tax liabilities at December 31, 2022 and 2021 are as follows:

	2022	2021
Deferred tax assets:		
Allowance for loan losses	$ 6,340	$ 5,906
Deferred compensation	1,345	1,249
Accruals	739	748
Current state income tax	1,007	711
Fair value adjustment on loans and deposits	415	589
Lease liability	1,422	1,493
Unrealized losses on available-for-sale securities	7,086	867
Unrealized losses on pension	-	2
Other deferred tax assets	187	164
Gross deferred tax assets	18,541	11,729

	2022	2021
Deferred tax liabilities:		
Deferred loan costs	(2,354)	(1,919)
Core deposit intangibles	(601)	(723)
Premises and equipment	(880)	(332)
Right-of-use asset	(1,357)	(1,435)
Other deferred tax liabilities	(83)	(594)
Unrealized gain on pension	(289)	-
Gross deferred tax liabilities	(5,564)	(5,003)
Net deferred tax asset	$ 12,977	$ 6,726

Management believes that it is more likely than not, that the deferred tax assets will be realized as a result of expected continued profitability. Accordingly, no valuation allowance has been established as of December 31, 2022 and 2021.

The Bank has no material unrecognized tax benefits at December 31, 2022 and 2021 and does not expect the total amount of unrecognized tax benefits to significantly increase or decrease within the next twelve months.

The Bank did not have any interest and penalties recorded in the income statement for the year ended December 31, 2022 and 2021 from unrecognized tax benefits.

The Bank is subject to U.S. Federal income tax as well as income tax of the state of California. The Bank is no longer subject to examination by taxing authorities for years before 2019 and 2018, for federal and California purposes.

NOTE 13 - RELATED PARTY TRANSACTIONS

Loan related activity to principal officers, directors, and their affiliates during 2022 were as follows:

	2022
Beginning balance	$ 27,428
New loans or disbursements	3,093
Changes in borrower status	(10,250)
Principal repayments	(2,671)
Ending balance	$ 17,600

At December 31, 2022 and 2021, no related party loans were on nonaccrual or classified for regulatory reporting purposes. Deposits from principal officers, directors, and their affiliates at December 31, 2022 and 2021 were $7,225,000 and $8,448,000, respectively.

The Bank engaged a member of our Board of Directors to provide project management services related to the construction of the Salinas branch, which was completed in the fourth quarter of 2022. The Board of Directors authorized $30,000 for the project management service fees and total amount paid to him totaled $10,000 in 2022. In addition, the Bank also solicited services from another member of our Board of Directors for legal services and incurred legal expenses of $8,000 and $6,000 in 2022 and 2021, respectively.

NOTE 14 - STOCK-BASED COMPENSATION

The Bank has two share-based compensation plans as described below. Total compensation cost that has been charged against income for those plans was $583,000 and $713,000 for December 31, 2022 and 2021, respectively. The total income tax benefit was ($2,200) and $29,000 for December 31, 2022 and 2021, respectively.

The Bank estimates the fair value of each option award as of the date of grant using a closed form option valuation (Black-Scholes-Merton) model and the following assumptions. Expected volatilities are based on historical volatilities of the Bank’s common stock commensurate with the expected term of the option. The "simplified" method described in the Securities and Exchange Commission's Staff Accounting Bulletin No. 110 is used to determine the expected term of the options due to the lack of sufficient historical data. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant with substantially the same term as the expected term of the option.

The fair value of options granted was determined using the following weighted average assumptions as of grant date.

	2022	2021
Risk-free interest rate	2.93%	0.68%
Expected term (yrs.)	5.44	5.78
Expected stock price volatility	36.27%	35.87%
Dividend yield	0.38%	0.35%

2003 Stock Option Plan: The Bank adopted a qualified stock option plan (the “Option Plan”) for employees, non-employee directors and Bank founders, under which a maximum of 1,000,404 shares of Bank’s common stock may be issued. The Option Plan calls for the exercise prices of the options to be equal to or greater than the fair market value of the stock at the time of grant. Options granted to Bank founders who are not also Bank directors or Bank officers were fully vested upon the date of grant. All other options shares granted have daily vesting over the first four years of the option contract. All option contracts for founders who are not also Bank directors or Bank officers have expiration dates of 10 years from the date of grant. All director and employee option contracts have expiration dates on the earlier of termination of service or 10 years from the date of grant. The Option Plan expired during 2014 and was replaced with the 2014 Omnibus Plan (the “Omnibus Plan”).

All options granted under the Option Plan have a 10-year term and have been issued with exercise prices at the fair market value of the underlying shares at the date of grant. The non-qualified stock option awards to the organizers vested 100% immediately, whereas regular stock option awards to directors and employees vest over a four-year period from the date the options were granted.

The following is a summary of the activity relating to the Bank's Option Plan for 2022 as presented below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding at beginning of year	1,320	$ 7.09		
Granted	–	–		
Exercised	(1,000)	7.09		
Expired	–	–		
Forfeited	–	–		
Options outstanding at end of year	320	$ 7.09	0.58 years	$ 6
Options fully vested and expected to vest	320			$ 6
Exercisable at end of year	320	$ 7.09	0.58 years	$ 6

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

	2022	2021
Intrinsic value of options exercised	$ 18	$ 380
Cash received from option exercises	$ 7	$ 47
Tax benefit realized from option exercises	$ –	$ 29
Weighted average fair value of options granted	–	–

As of December 31, 2022, there was no unrecognized compensation cost related to non-vested stock options granted under the Option Plan. All shares issued under this plan fully vested during the year 2016.

2014 Omnibus Plan: The Bank adopted the Omnibus Plan in May 2014 for employees and non-employee directors, which will continue in effect until February 19, 2024. The Omnibus Plan allows qualified stock option grants for employees and non-qualified restricted stock awards for officers and non-employee directors. The maximum number of shares of common stock that may be issued under this plan is 939,940 unless amended by the Board or the shareholders of the Bank.

The Omnibus Plan permits the grant of non-statutory options, incentive stock options and restricted stock awards to directors and employees of the Bank. Options granted under the Omnibus Plan may be incentive stock options or non-statutory stock options, as determined by the plan administrator at the time of grant of an option, however incentive stock options may be granted only to employees. In addition, restricted stock awards may be granted under the Omnibus Plan to directors and employees. On October 19, 2021, the Bank declared a 10% stock dividend for shareholders of record as of November 8, 2021. Stock option awards and the related price per share amounts reflected in the table below have been restated to give retroactive effect to the 10% stock dividend declared in October 2021.

Stock Options: The per share exercise price for the shares to be issued upon exercise of any option shall be such price as is determined by the plan administrator, but no less than 100 percent of the fair market value per share on the date of grant. All option contracts have expiration dates on the earlier of termination of service or 10 years from the date of grant.

The following is a summary of the activity relating to the Bank's Omnibus Plan for 2022 as presented below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding at beginning of year	261,972	$ 20.43		
Granted	82,000	23.50		
Exercised	(12,472)	16.91		
Expired	(5,890)	21.32		
Forfeited	(8,946)	19.50		
Options outstanding at end of year	316,664	$ 21.43	7.17 years	$ 1,148
Options fully vested and expected to vest	309,371			$ 1,129
Exercisable at end of year	191,505	$ 20.62	6.13 years	$ 848

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

	2022	2021
Intrinsic value of options exercised	$ 102	$ 324
Cash received from option exercises	$ 211	$ 156
Tax benefit realized from option exercises	$ (5)	$ –
Weighted average fair value of options granted	$ 8.21	$ 7.07

As of December 31, 2022, there was $895,000 of total unrecognized compensation cost related to non-vested stock options granted under the plan. The cost is expected to be recognized over a weighted average period of 3.04 years.

Restricted Stock Awards: The following is a summary of the activity relating to the Bank's non-vested shares under this plan for the year ended December 31, 2022 as presented below:

	Shares	Weighted Average Grant Date Fair Value
Non-vested awards at January 1, 2022	9,982	$ 22.86
Granted	8,800	$ 21.87
Vested	(11,297)	$ 22.09
Non-vested awards at December 31, 2022	7,485	$ 22.86

As of December 31, 2022, there was $128,000 in unrecognized compensation cost related to non-vested shares granted under the Omnibus Plan. The cost is expected to be recognized over a weighted average period of 2.27 years. The total fair value of shares vested during the years ended December 31, 2022 and 2021 was $247,000 and $309,000, respectively.

NOTE 15 - REGULATORY CAPITAL MATTERS

Regulatory Capital: The Bank is subject to various regulatory capital adequacy requirements administered by the banking regulatory agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if not undertaken, would have a direct material effect on the Bank's financial statements. Management believes as of December 31, 2022, the Bank meets all capital adequacy requirements to which it is subject.

Prompt corrective action regulations define five classifications: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At December 31, 2022 and 2021, the most recent regulatory notifications categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institution's category.

Actual and required capital amounts and ratios are presented below at year-end.

	Actual		Required for Capital Adequacy Purposes including the Capital Conservation Buffer		To Be Well-Capitalized Under Prompt Corrective Action Regulations	
As of December 31, 2022						
Total capital to risk weighted assets	$ 203,119	14.94%	$ 142,699	10.50%	$ 135,904	10.00%
Tier 1 (Core) capital to risk weighted assets	$ 186,071	13.69%	$ 115,519	8.50%	$ 108,723	8.00%
Common Tier 1 (CET1) to risk weighted assets	$ 186,071	13.69%	$ 95,133	7.00%	$ 88,338	6.50%
Tier 1 (Core) capital to average assets	$ 186,071	10.39%	$ 71,622	4.00%	$ 89,527	5.00%

	Actual		Required for Capital Adequacy Purposes including the Capital Conservation Buffer		To Be Well-Capitalized Under Prompt Corrective Action Regulations	
As of December 31, 2021						
Total capital to risk weighted assets	$ 174,706	14.88%	$ 123,289	10.50%	$ 117,418	10.00%
Tier 1 (Core) capital to risk weighted assets	$ 159,959	13.62%	$ 99,805	8.50%	$ 93,935	8.00%
Common Tier 1 (CET1) to risk weighted assets	$ 159,959	13.62%	$ 82,193	7.00%	$ 76,322	6.50%
Tier 1 (Core) capital to average assets	$ 159,959	9.50%	$ 67,344	4.00%	$ 84,180	5.00%

Dividend Restrictions: The Board of Directors may, to the extent of such earnings and the Bank's net capital requirements and subject to the provisions of the California Financial Code, declare and pay a portion of such earnings to its shareholders as dividends. No cash dividend will be declared without a complete analysis of capital impact, current economic assessment, and current risk analysis.

NOTE 16 - LOAN COMMITMENTS AND OTHER RELATED ACTIVITIES

Correspondent Banking: At times, the Bank maintains deposit amounts at corresponding banks that exceed federally insured limits. Uninsured deposits totaled $8,952,000 at December 31, 2022. The Bank has not experienced any losses on amounts exceeding the insured limits.

Financial Investments with Off-Balance Sheet Risk: The Bank is a 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, standby letters of credit, overdraft protection and financial guarantees. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets. The contract amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit, standby letters of credit, and financial guarantees is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

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 Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include cash, securities, accounts receivable, inventory, property, plant and equipment, residential real estate and income-producing commercial properties.

Standby letters of credit and financial guarantees written 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.

The contractual amounts of financial instruments with off-balance-sheet risk as of December 31, were as follows:

	December 31, 2022		December 31, 2021	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commitments to make loans	$ 4,112	$ 342,045	$ 3,427	$ 331,069
Unused lines of credit	496	57,618	528	48,850
Standby letters of credit	–	–	–	–
	$ 4,608	$ 399,663	$ 3,955	$ 379,919

Commitments to make loans are generally made for periods of 90 days or less.

NOTE 17 - EARNINGS PER SHARE

The factors used in the earnings per share computation follow:

	2022	2021
Basic earnings per share:		
Net income	$ 30,944	$ 21,274
Weighted average common shares outstanding	8,513,839	8,508,098
Basic earnings per common share	$ 3.63	$ 2.50
Diluted earnings per share:		
Net income	$ 30,944	$ 21,274
Weighted average common shares outstanding for basic earnings per common share	8,513,839	8,508,098
Add: Dilutive effects of assumed exercises of stock options	25,252	27,788
Weighted average outstanding and dilutive potential common shares	8,539,091	8,535,886
Diluted earnings per common share	$ 3.62	$ 2.49

Stock options for 164,000 and 225,500 shares of common stock were not considered in computing diluted earnings per common share as of December 31, 2022 and 2021, respectively, because they were anti-dilutive.

SANTA CRUZ COUNTY BANK