# CoastalSouth Bancshares, Inc.
# and Subsidiary

***Report on Consolidated Financial Statements***

***As of and for the years ended December 31, 2022 and 2021***

# CoastalSouth Bancshares, Inc. and Subsidiary
# Contents

## Independent Auditor's Report

Board of Directors
CoastalSouth Bancshares, Inc.

**Opinion**

We have audited the consolidated financial statements of CoastalSouth Bancshares, Inc. and Subsidiary (the Company), which comprise the consolidated balance sheets as of December 31, 2022 and 2021, the related consolidated statements of operations, comprehensive income (loss), changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements (collectively, "the financial statements").

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company 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 have also audited, in accordance with auditing standards generally accepted in the United States of America (GAAS), the Company's internal control over financial reporting as of December 31, 2022, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 17, 2023 expressed an unmodified opinion on the effectiveness of the Company's internal control over financial reporting.

**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 the Company 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.

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 the Company's ability to continue as a going concern within one year after the date that the financial statements are 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 the Company'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.

Elliott Davis, PLLC

Raleigh, North Carolina
March 17, 2023

# CoastalSouth Bancshares, Inc. and Subsidiary

***Consolidated Balance Sheets***

***As of and for the years ended December 31, 2022 and 2021***

| *(in thousands of dollars except share and per share amounts)* | 2022 | 2021 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents: | | |
| Cash and due from banks | $ 16,898 | $ 7,748 |
| Interest-bearing accounts with other banks | 2,427 | 7,600 |
| Federal funds sold and securities purchased under agreements to resell | 9,639 | 209,011 |
| Total cash and cash equivalents | 28,964 | 224,359 |
| Investments | | |
| Securities available-for-sale, at fair value | 366,120 | 293,225 |
| Non-marketable equity securities | 5,397 | 1,529 |
| Total investments | 371,517 | 294,754 |
| Loans held for sale | 44,500 | 81,453 |
| Loans held for investment | 1,298,603 | 938,116 |
| Allowance for loan losses | (12,362) | (8,148) |
| Loans held for investment, net | 1,286,241 | 929,968 |
| Bank-owned life insurance | 29,772 | 29,039 |
| Deferred tax asset | 21,800 | 14,498 |
| Premises, furniture and equipment, net | 18,690 | 17,650 |
| Goodwill | 4,708 | 4,708 |
| Intangible assets | 2,159 | 2,856 |
| Other real estate owned | - | 640 |
| Other assets | 27,127 | 11,732 |
| Total assets | $ 1,835,478 | $ 1,611,657 |
| **Liabilities** | | |
| Deposits | | |
| Non-interest bearing transaction accounts | $ 424,490 | $ 432,631 |
| Interest-bearing transaction accounts | 163,123 | 178,614 |
| Savings and money market | 576,615 | 629,974 |
| Time deposits | 384,418 | 182,898 |
| Total deposits | 1,548,646 | 1,424,117 |
| Other borrowings | 140,678 | 44,587 |
| SBA contingency reserve | 2,626 | 5,323 |
| Other liabilities | 24,731 | 12,696 |
| Total liabilities | 1,716,681 | 1,486,723 |
| **Stockholders' Equity** | | |
| Voting common stock, $1 par value at December 31, 2022 and 2021; 50,000,000 shares authorized at December 31, 2022 and 2021; 6,894,345 and 6,614,228 shares issued and outstanding at December 31, 2022 and 2021, respectively | 6,894 | 6,614 |
| Nonvoting common stock, $1 par value at December 31, 2022 and 2021; 10,000,000 shares authorized at December 31, 2022 and 2021; 2,065,029 and 1,990,507 shares issued and outstanding at December 31, 2022 and 2021, respectively | 2,065 | 1,991 |
| Capital surplus | 136,599 | 131,792 |
| Accumulated deficit | (86) | (18,276) |
| Accumulated other comprehensive (loss) income | (26,675) | 2,813 |
| Total stockholders' equity | 118,797 | 124,934 |
| Total liabilities and stockholders' equity | $ 1,835,478 | $ 1,611,657 |

*The accompanying notes are an integral part of these consolidated financial statements.*

# CoastalSouth Bancshares, Inc. and Subsidiary

***Consolidated Statements of Operations***

***For the years ended December 31, 2022 and 2021***

| *(in thousands of dollars, except per share amounts)* | 2022 | 2021 |
|---|---|---|
| **Interest income** | | |
| Loans, including fees | | |
| Loans held for investment | $ 52,586 | $ 35,714 |
| Loans held for sale | 3,779 | 5,524 |
| Investments | | |
| Taxable | 8,449 | 3,014 |
| Non-taxable | 534 | 527 |
| Non-marketable equity securities | 104 | 55 |
| Federal funds sold and resell agreements | 1,091 | 1,141 |
| Other earning assets from banks | 40 | 24 |
| Total | 66,583 | 45,999 |
| **Interest expense** | | |
| Interest-bearing deposits | 7,381 | 3,567 |
| Other borrowings | 2,241 | 1,187 |
| Total | 9,622 | 4,754 |
| **Net interest income** | 56,961 | 41,245 |
| Provision for loan losses | 5,078 | 1,326 |
| **Net interest income after provision for loan losses** | 51,883 | 39,919 |
| **Noninterest income** | | |
| Gain on sale of government guaranteed loans | 1,877 | 2,920 |
| Income from mortgage originations | 1,654 | 3,015 |
| Interchange income and card fees | 1,377 | 1,002 |
| Service charges on deposit accounts | 783 | 643 |
| Bank-owned life insurance | 733 | 931 |
| Bargain purchase gain | - | 1,649 |
| Securities loss, net | - | (59) |
| Other noninterest income | 766 | 1,095 |
| Total noninterest income | 7,190 | 11,196 |
| **Noninterest expenses** | | |
| Salaries and employee benefits | 23,390 | 22,236 |
| Occupancy and equipment | 2,674 | 2,312 |
| Other professional fees | 2,218 | 2,939 |
| Data processing | 2,097 | 1,631 |
| Software and other technology expense | 1,905 | 2,085 |
| Regulatory assessment | 1,157 | 1,012 |
| (Gain) loss on other real estate owned, net | (388) | 382 |
| Other noninterest expense | 2,188 | 3,052 |
| Total noninterest expense | 35,241 | 35,649 |
| **Income before taxes** | 23,832 | 15,466 |
| Income tax provision | 5,642 | 3,144 |
| **Net income** | $ 18,190 | $ 12,322 |
| **Net income per common share:** | | |
| Basic | $ 2.09 | $ 1.51 |
| Diluted | $ 2.05 | $ 1.48 |

*The accompanying notes are an integral part of these consolidated financial statements.*

# CoastalSouth Bancshares, Inc. and Subsidiary
### *Consolidated Statements of Comprehensive Income (Loss)*
### *For the years ended December 31, 2022 and 2021*

| *(In thousands of dollars)* | *2022* | *2021* |
|---|---|---|
| **Net income** | $ 18,190 | $ 12,322 |
| **Other comprehensive income (loss)** | | |
| Change in unrealized loss on available-for-sale securities | (40,967) | (1,110) |
| Reclassification adjustment for net loss on sale of securities included in net income | - | 64 |
| Income tax effect | 9,478 | 198 |
| Unrealized loss on available-for-sale securities, net of tax | (31,489) | (848) |
| **Unrealized gains on derivatives:** | | |
| Change in unrealized gain on cash flow hedges | 2,532 | 1,086 |
| Reclassification adjustment for net loss included in net income | 101 | - |
| Income tax effect | (632) | (261) |
| Unrealized gain on derivative instruments, net of tax | 2,001 | 825 |
| **Other comprehensive loss, net of tax** | (29,488) | (23) |
| **Comprehensive income (loss)** | $ (11,298) | $ 12,299 |

*The accompanying notes are an integral part of these consolidated financial statements.*

## CoastalSouth Bancshares, Inc. and Subsidiary

***Consolidated Statements of Changes in Stockholders' Equity***

***For the years ended December 31, 2022 and 2021***

| | Common Stock | | | | | | Accumulated Other | |
|---|---|---|---|---|---|---|---|---|
| | Voting | | Nonvoting | | Capital | Accumulated | Comprehensive | |
| *(In thousands of dollars except share amounts)* | Shares | Amount | Shares | Amount | Surplus | Deficit | Income/ (Loss) | Total |
| **Balance as of December 31, 2020** | 6,003,146 | $ 6,003 | 1,990,507 | $ 1,991 | $ 121,756 | $ (30,598) | $ 2,836 | $ 101,988 |
| Issuance of common stock under incentive plan | 37,400 | 37 | - | - | (37) | - | - | - |
| Issuance of common stock for the acquisition of Cornerstone Bancshares, Inc. | 573,682 | 574 | - | - | 8,892 | - | - | 9,466 |
| Stock-based compensation expense | - | - | - | - | 1,181 | - | - | 1,181 |
| Net income | - | - | - | - | - | 12,322 | - | 12,322 |
| Other comprehensive loss, net of tax | - | - | - | - | - | - | (23) | (23) |
| **Balance as of December 31, 2021** | 6,614,228 | $ 6,614 | 1,990,507 | $ 1,991 | $ 131,792 | $ (18,276) | $ 2,813 | $ 124,934 |
| Issuance of common stock under incentive plan | 20,050 | 20 | - | - | (3) | - | - | 17 |
| Issuance of common stock upon warrants exercise | 209,597 | 210 | 74,522 | 74 | 3,091 | - | - | 3,375 |
| Issuance of common stock related to the acquisition of Cornerstone Bancshares, Inc. | 50,470 | 50 | - | - | 782 | - | - | 832 |
| Stock-based compensation expense | - | - | - | - | 937 | - | - | 937 |
| Net income | - | - | - | - | - | 18,190 | - | 18,190 |
| Other comprehensive loss, net of tax | - | - | - | - | - | - | (29,488) | (29,488) |
| **Balance as of December 31, 2022** | 6,894,345 | $ 6,894 | 2,065,029 | $ 2,065 | $ 136,599 | $ (86) | $ (26,675) | $ 118,797 |

*The accompanying notes are an integral part of these consolidated financial statements.*

# CoastalSouth Bancshares, Inc. and Subsidiary

***Consolidated Statements of Cash Flows***

***For the years ended December 31, 2022 and 2021***

| *(In thousands of dollars)* | 2022 | 2021 |
|---|---|---|
| **Operating activities** | | |
| Net income | $ 18,190 | $ 12,322 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 5,078 | 1,326 |
| Depreciation expense and software amortization | 1,120 | 985 |
| Increase in cash value of bank-owned life insurance | (733) | (484) |
| Stock-based compensation expense | 937 | 1,181 |
| Net loss on sale of securities available-for-sale | - | 64 |
| Amortization of operating lease right-of-use assets | 509 | 496 |
| Amortization of debt issuance costs | 47 | 48 |
| Impairment of commercial mortgage servicing rights | 175 | 3 |
| Increase in fair value of equity securities | - | (6) |
| Writedown on other real estate owned | 221 | 387 |
| Net gain on sale of premises, furniture and equipment | - | (25) |
| Net gain on sale of other real estate owned | (609) | (5) |
| Gain on sale of government guaranteed loans, including originations of servicing rights | (1,877) | (2,920) |
| Income from mortgage operations | (1,654) | (3,015) |
| Bargain purchase gain | - | (1,649) |
| Discount accretion and premium amortization on securities available-for-sale | 1,166 | 605 |
| Amortization of intangible assets | 815 | 441 |
| Deferred income tax expense (benefit) | 1,544 | (609) |
| Change in SBA contingency reserve | (2,697) | (74) |
| Originations of loans held for sale | (19,683,003) | (5,164,361) |
| Proceeds from loans held for sale | 19,741,062 | 5,227,393 |
| Increase in other assets | (8,246) | (2,268) |
| Increase in other liabilities | 11,493 | 1,044 |
| Net cash provided by operating activities | 83,538 | 70,879 |
| **Investing activities** | | |
| Purchase of securities available-for-sale | (140,463) | (177,356) |
| Proceeds from sales of securities available-for-sale | - | 3,009 |
| Proceeds from paydowns, calls, and maturities on securities available-for-sale | 21,784 | 14,105 |
| Net (purchase) sale of non-marketable equity securities | (3,868) | 233 |
| Loan originations and principal collections, net | (379,219) | (135,688) |
| Net purchase of premises, furniture and equipment | (2,160) | (2,190) |
| Proceeds from sales of other real estate owned | 1,028 | 280 |
| Purchases of bank-owned life insurance | - | (10,000) |
| Proceeds from bank-owned life insurance death benefits | - | 395 |
| Net cash received in business combination | - | 80,911 |
| Net cash used by investing activities | (502,898) | (226,301) |

## CoastalSouth Bancshares, Inc. and Subsidiary
***Consolidated Statements of Cash Flows - Continued***
***For the years ended December 31, 2022 and 2021***

| *(In thousands of dollars)* | 2022 | 2021 |
|---|---|---|
| **Financing activities** | | |
| Net increase in deposits | 124,529 | 324,275 |
| Net proceeds of Federal Home Loan Bank advances | 88,044 | - |
| Net repayment of Federal Reserve Bank advances | - | (111,497) |
| Proceeds from stock warrants exercises | 3,375 | - |
| Proceeds from issuance of common stock, net | 17 | - |
| Proceeds from commercial line of credit | 8,000 | 10,000 |
| Net cash provided by financing activities | 223,965 | 222,778 |
| **Net (decrease) increase in cash and cash equivalents** | (195,395) | 67,356 |
| **Cash and cash equivalents, beginning of year** | 224,359 | 157,003 |
| **Cash and cash equivalents, end of year** | $ 28,964 | $ 224,359 |
| **Cash paid during the year for:** | | |
| Interest | $ 8,049 | $ 5,501 |
| Income taxes | 3,408 | 4,423 |
| **Noncash investing and financing activities:** | | |
| Unrealized loss on securities available-for-sale, net | (31,489) | (848) |
| Unrealized gain on derivatives, net | 2,001 | 825 |
| Transfers of loans to other real estate owned | - | 492 |
| Transfers from loans held for investment to loans held for sale | 17,627 | 25,018 |
| Right-of-use assets obtained in exchange for new operating lease liabilities | 2,322 | 1,320 |
| Lease liabilities arising from obtaining right-of-use assets | 2,377 | 1,756 |
| Issuance of common stock related to the acquisition of Cornerstone Bancshares, Inc. | 832 | 9,466 |

*The accompanying notes are an integral part of these consolidated financial statements.*

## NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Organization*

CoastalSouth Bancshares, Inc. (the "Company"), headquartered in Hilton Head Island, South Carolina, is a registered bank holding company with one banking subsidiary, Coastal States Bank ("CSB"). CSB operates retail banking branches in three main retail markets, including Hilton Head Island/Bluffton, South Carolina, Savannah, Georgia, and north metro Atlanta, Georgia. CSB also has other commercial lines of business that operate on a national platform, such as government guaranteed lending, including both Small Business Association ("SBA") and United States Department of Agriculture ("USDA") lending, senior housing lending, and the Mortgage Banker Finance division, which provides warehouse lending to independent mortgage originators. The deposits of CSB are insured by the Federal Deposit Insurance Corporation ("FDIC"). CSB has one wholly owned subsidiary, Coastal States Mortgage, Inc. ("CSM"), a mortgage company focused on originating residential mortgages to either sell to investors or to retain in the portfolio. The Company was organized on September 28, 2003 as a Virginia corporation, with no activity until August 9, 2004. CSB was organized as a South Carolina state-chartered bank on July 30, 2004 and opened on August 9, 2004.

*Nature of Business*

The Company offers full-service banking services designed to meet the needs of retail and commercial customers in the markets in which it operates. The services offered include transaction and savings deposit accounts, commercial and consumer lending, mortgage banking, and other activities related to commercial banking. The Company and CSB are subject to the regulations of certain federal and state agencies and are periodically examined by those regulatory agencies. CSM is an approved mortgage lender with the Federal Housing Administration, Department of Veterans Affairs, Federal Home Loan Mortgage Corporation, and USDA, and an approved servicer with Federal National Mortgage Association.

*Use of Estimates in the Preparation of Financial Statements*

The accounting and reporting policies of the Company and its subsidiaries are in accordance with accounting principles generally accepted in the United States of America ("US GAAP" or "GAAP") and also conform to general industry practices. Some of our significant accounting principles require complex judgments to estimate the values of assets and liabilities, for instance, the Allowance for Loan Losses ("ALL"), among others. All intercompany accounts and transactions have been eliminated in consolidation. Assets and liabilities of purchased companies are stated at estimated fair values at the date of acquisition. Results of operations of companies purchased are included from the date of acquisition. Certain reclassifications have been made to prior period amounts to conform to the current period presentation.

The impact of the global pandemic caused by the 2019 Novel Coronavirus (or "COVID-19") continued to evolve throughout 2021 and 2022 as variants of COVID-19 emerged, extending the duration and severity of the pandemic. The Company continues to monitor the impact to certain asset classes that may have higher risk of default that may be affected by the macroeconomic impact of government measures to contain the spread of the virus as well as any related government stimulus measures. As a result of the impacts of the COVID-19 pandemic, certain estimates and assumptions, including the allowance for loan losses and the fair values of certain financial instruments required increased judgment and carry a higher degree of variability and volatility that could result in material changes to our estimates in future periods. Management believes that in 2022, the impacts of COVID-19 were significantly decreased from 2021 due to a decrease in severe COVID-19 cases and related deaths, increased vaccination programs, and less direct impact on the day to day lives of most Americans.

*Management's Estimates*

The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant changes include:

- Determination of the ALL and provision for credit losses
- Income taxes, including tax provisions and realization of deferred tax assets
- Fair value of assets and liabilities acquired, including intangible assets and goodwill

- Determination of contingency reserves

*Debt Securities*

The Company classifies debt investment securities into three categories: trading, held-to-maturity, and available-for-sale. Management determines the appropriate classification of investment securities at the time of purchase. Debt investment securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the investment securities to maturity. Held-to-maturity investment securities are carried at amortized cost. At December 31, 2022 and 2021, the Company had no investment securities classified as held-to-maturity.

Investment securities classified as trading are held principally for resale in the near term and are recorded at fair value. Gains or losses, either unrealized or realized, are reported in noninterest income. At December 31, 2022 and 2021, the Company had no investment securities classified as trading.

Investment securities not classified as either held-to-maturity or trading are classified as available-for-sale. Investment securities available-for-sale are stated at fair value, with the unrealized gains and losses, net of tax, reported as a separate component of Accumulated other comprehensive income ("AOCI") in the Consolidated Statements of Comprehensive Income.

The amortized cost of debt investment securities classified as either held-to-maturity or available-for-sale is adjusted for amortization of premiums and accretion of discounts to maturity or call, or in the case of mortgage-backed securities, over the estimated life of the security. Such amortization is considered an adjustment to yield on the security and included in interest income from investments. Interest and dividends are included in interest on investment securities in the Consolidated Statements of Operations.

Gains and losses realized from the sales of investment securities are determined by specific identification and are included in noninterest income. Available-for-sale and held-to-maturity investment securities are reviewed quarterly for potential impairment. The Company determines whether it has the intent to sell a debt security or whether it is more likely than not it will be required to sell the debt security before the recovery of its amortized cost basis. If either condition is met, the Company will recognize, in earnings, an impairment loss necessary to reduce the carrying value of the debt security to fair value. For all other debt investment securities for which the Company does not expect to recover the entire amortized cost basis of the security and do not meet either condition, an other-than-temporary loss is considered to have occurred and the Company records the credit loss portion of impairment in earnings and the impairment related to all other factors in other comprehensive loss.

*Equity Securities*

Equity securities are recorded at fair value, with changes in fair value presented in other noninterest income. The fair value of equity securities is based on observable market prices.

*Non-Marketable Equity Securities*

Equity securities without readily determinable fair values (non-marketable) that are not held for trading purposes includes Federal Home Loan Bank ("FHLB") of Atlanta capital stock and various other non-marketable equity investments. Investment in the FHLB of Atlanta is a condition of borrowing from the FHLB of Atlanta, and the stock is pledged to collateralize such borrowings. FHLB stock is carried at cost, classified as a non-marketable security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income. At December 31, 2022 and 2021, the Company's investment in FHLB stock was $5,397 and $1,529, respectively. Dividends received on non-marketable equity securities are included as a separate component in interest income.

*Loans Held for Sale*

Loans held for sale ("LHFS") includes loans acquired through the Company's Mortgage Banker Finance ("MBF") line of business that are acquired with the intent to sell. Interest income on LHFS is recognized in the period earned using the effective interest method. These LHFS are accounted for at the lower of cost or fair value; as of December 31, 2022, and 2021, respectively, there have been no fair value adjustments recorded on this type of LHFS.

LHFS also represents mortgage loans originated by CSM with the intent to sell. Generally, loans originated by CSM with the intent to sell are accounted for at fair value. These loans are initially recorded and carried at fair value, with changes in fair value recognized in income from mortgage originations. There were no LHFS of this type on December 31, 2022 and 2021.

Additionally, the Company may periodically decide to sell other commercial and consumer loans and may reclassify loans from held for investment to held for sale when appropriate. At the time of transfer, the amount by which the amortized cost basis of the LHFS exceeds fair value may be accounted for as a valuation allowance or direct write-down.

*Loans Held for Investment*

Loans held for investment ("LHFI" or "Loans") are stated at their amortized cost basis, net of any charge-offs, on the balance sheet. Interest income on loans is computed based upon the unpaid principal balance. Interest income on loans is recognized in the period earned and is computed using the effective interest method. Loan origination fees and certain direct loan origination costs, as well as purchase premiums and discounts, are deferred and amortized to income over the contractual life of the related loans or commitments, adjusted for prepayments, using a method that approximates a level yield.

Loan processing fees received on Paycheck Protection Program ("PPP") loans ranged from 1% - 5% of the original note amount, with a minimum origination fee of $2.50 or $0 for 2021 and 2020 originations, respectively, and are recognized ratably over the life of the loans. Unamortized fees associated with PPP loans were $62 and $1,095 as of December 31, 2022 and 2021, respectively. PPP fees recognized as income were $1,033 and $4,855 for the years ended December 31, 2022 and 2021, respectively. Costs related to the origination of these loans are deferred. When loans are forgiven or paid off, any unrecognized amount of the net processing fees are recognized.

Loans are considered past due or delinquent when the contractual principal or interest due in accordance with the terms of the loan agreement or any portion thereof remains unpaid after the due date of the scheduled payment. Loans are placed on non-accrual status when it becomes probable that interest is not fully collectable, generally when the loan becomes 90 days past due. Once loans are placed on non-accrual status, previously accrued but unpaid interest is reversed from interest income, and the accrual of interest income is suspended. Future payments received are applied to the principal balance of the loan. If and when borrowers demonstrate the sustained ability to repay such loans in accordance with the loan's contractual terms, the loan may be returned to accrual status. Loans which become 90 days past due are reviewed for collectability of principal. Principal amounts deemed uncollectable are charged off against the ALL, unless such loans are in the process of modification, collection through repossession, or foreclosure. Certain consumer loans are not placed on non-accrual but are monitored and charged-off at 120 days past due.

*Purchased Credit-Impaired Loans*

Purchased credit-impaired ("PCI") loans are those loans acquired with evidence of deterioration of credit quality since origination for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments. At the time of acquisition, PCI loans are either accounted for as specifically-reviewed or as part of a loan pool. The Company may elect to group PCI loans into pools based upon common risk characteristics.

Periodically, the Company re-estimates expected cash flows for each pool or specifically-reviewed loan. Estimated fair values for acquired loans are based upon a discounted cash flows methodology that considers various factors including the type of loan, collateral, credit quality, fixed or variable interest rate, historical payment performance, term of loan and whether or not the loan was amortizing, prepayment speed assumptions, and a discount rate reflecting effective yield of the pool.

Interest income on PCI loans is recognized through accretion of the difference between the recorded investment of the loan pool and the gross expected cash flows, from such pool, on a level-yield basis over the loans' estimated life. For loan pools where the recorded investment has been fully recovered, income is recognized as cash is received utilizing the cost recovery method. PCI loans are excluded from being classified as non-accrual when the Company can reasonably estimate cash flows.

*Impaired Loans*

The Company considers a loan to be impaired when, based upon current information and events, it believes it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Management reviews all impaired loans over $100, and certain loans judgmentally identified under this threshold, individually to determine if a specific allowance based upon the borrower's overall financial condition, resources and payment record, support from guarantors and the realizable value of any collateral is necessary. Specific allowances are based upon discounted cash flows using a loan's initial effective interest rate or the net realizable value of the collateral for collateral-dependent loans. If the recorded investment in the impaired loan exceeds its fair value, a valuation allowance is required as a component of the ALL. Interest income on impaired loans is recorded on a cash basis once the loan's principal has been fully recovered.

*Troubled Debt Restructurings*

A loan is also considered impaired if its terms are modified in a troubled debt restructuring ("TDR"). A restructuring of debt constitutes a TDR if the Company, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to a borrower that it would not otherwise consider. Concessions granted generally involve forgiving or forbearing a portion of interest or principal on any loans or making loans at a rate that is less than prevailing market rates. Prior to modifying a borrower's loan terms, the Company performs an evaluation of the borrower's financial condition and ability to service the debt under the potential modified loan terms. If a loan is accruing at the time of modification, the loan remains on accrual status and is subject to the Company's charge-off and non-accrual policies. If a loan is on non-accrual before it is determined to be a TDR, then the loan remains on non-accrual. TDRs may be returned to accrual status if there has been a sustained period of repayment performance by the borrower.

*Allowance for Loan Losses*

The ALL represents management's estimate of probable and reasonably estimable credit losses incurred in loans held for investment as of the balance sheet date. The estimate of the ALL is based upon management's evaluation of the loan portfolio including such factors as past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, current market and economic conditions, borrower's payment status, internal credit risk ratings and other relevant factors. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant changes. Loans are charged off when management believes that the ultimate collectability of the loan is unlikely. Allocation of the ALL may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, is deemed to be uncollectable. The ALL is increased by provisions charged to expense and decreased by actual charge-offs, net of recoveries.

The ALL adequacy assessment begins with a process of estimating probable and reasonably estimable credit losses incurred within the loan portfolio. These estimates are established by category and based upon the Company's internal system of credit risk ratings and historical loss data. Periodically, management reassesses certain assumptions in the calculation of allowance for loan losses in order to further refine the estimation methodology, as appropriate. The estimate of probable and reasonably estimable credit losses incurred within the loan portfolio may then be adjusted for management's estimate of additional probable and reasonably estimable credit losses as a result of specific credit exposures, trends in delinquent and nonaccrual loans, as well as other factors such as prevailing economic conditions, lending strategies, and other influencing factors.

*Bank-Owned Life Insurance*

Bank Owned Life Insurance ("BOLI") is long-term life insurance on the lives of certain employees where the insurance policy benefits and ownership are retained by the employer. To date, the Company has purchased life insurance policies on certain senior officers. BOLI is recorded at the cash surrender value, which can be adjusted for charges due at settlement at the balance sheet date. The cash value accumulation on BOLI is permanently tax deferred if the policy is held until the insured person's death.

*Core Deposit Intangible*

As a result of business combinations, identifiable intangible assets were recorded representing the estimated value of core deposits assumed. The Company amortizes the intangible assets over their estimated useful lives. Core deposit intangibles are periodically reviewed for reasonableness and are evaluated for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable.

*Commercial Mortgage Servicing Rights*

The Company's commercial mortgage servicing rights ("CMSRs") arise from the sale of participating interests in government guaranteed loans to third parties where servicing is retained by the Company. The Company defines its classes of servicing assets relationship to the government guarantor, such as USDA or SBA guaranteed loans. The Company initially records servicing assets at fair value at the time the sale is recognized. The determination of fair value is based on a discounted cash flow analysis using the contractual terms of the associated loan being serviced and considers assumptions such as discount rate and prepayment speed. Subsequently, the Company amortizes these servicing assets over the expected life of the related loan, adjusting for expected prepayments. Periodically, the Company evaluates these assets for impairment. When the carrying value exceeds the fair value of a class of servicing assets, the Company recognizes impairment of the servicing assets. CMSRs are included in the intangible assets and were $1,302 and $1,736 at December 31, 2022 and 2021, respectively.

*Goodwill*

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in a business combination. Goodwill is not amortized but tested for impairment on an annual basis, or more often, if events or circumstances indicate there may be impairment. Goodwill impairment exists when a reporting unit's carrying value of goodwill exceeds its implied fair value.

If the fair value of the reporting unit exceeds its carrying value, no further testing is required. If the carrying value exceeds the fair value, further analysis is required to determine whether an impairment charge must be recorded based upon the implied fair value of goodwill and, if so, the amount of such charge. The Company performs its Goodwill testing at least on an annual basis unless it is determined that conditions exist to indicate impairment.

*Liabilities for Representations and Warranties*

The Company is exposed to certain liabilities under representations and warranties made to purchasers of mortgage loans and servicing rights that require indemnification or repurchase of loans. At the time it issues a guarantee, the Company is required to recognize an initial liability for the fair value of obligations assumed under the guarantee.

The Company establishes a contingency reserve for its liabilities under representations and warranties provided to purchasers of its mortgage loans. This reserve is maintained at a level considered appropriate by management to provide for known and inherent losses. The reserve is based upon a continuing review of past loss experience, estimates and assumptions of risk elements and future economic conditions. Additions to the reserve are recorded in other expenses.

Management's judgment about the adequacy of the reserve is based upon a number of assumptions about future events which it believes to be reasonable. There is no assurance that additional increases in the reserve will not be required. The Company may from time-to-time be required to repurchase loans previously sold to investors due to loan nonperformance. At December 31, 2022 and 2021, the Company had a contingency reserve of $35 and $104, respectively, for potential mortgage indemnifications to other third-party purchasers.

The Company also establishes a contingency reserve for repairs or denials of guarantees on certain SBA loans sold into the secondary market where the guarantee could be at risk in the SBA Contingency Reserve. Management's judgment about the adequacy of the reserve is based on assumptions about future events which it believes to be reasonable. There is no assurance that additional increases in the reserve will not be required. At December 31, 2022 and 2021, the Company had an SBA contingency reserve of $2,626 and $5,323, respectively, for denials or repairs of SBA guarantees on loans sold to third-party purchasers that were related to SBA loans acquired from Cornerstone Bank.

*Premises, Furniture and Equipment*

Premises, furniture, and equipment are stated at cost, less accumulated depreciation. The provision for depreciation is computed by the straight-line method, based on the estimated useful lives for buildings of 30 to 40 years and software, furniture, and equipment of 3 to 10 years. Leasehold improvements are amortized over the shorter of the life of the respective leases or the useful life of the asset. The cost of assets sold or otherwise disposed of and the related allowance for depreciation are eliminated from the accounts and the resulting gains or losses are reflected in the Consolidated Statements of Operations when incurred. Routine maintenance and repairs are charged to current expense. The costs of major repairs and improvements are capitalized. Premises and equipment are evaluated for impairment whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable.

*Other Real Estate Owned*

Other real estate owned ("OREO") includes assets that have been acquired in satisfaction of debt through foreclosure. OREO is recorded at the lower of cost or fair value, minus estimated costs to sell. Subsequent to foreclosure, losses resulting from the periodic revaluation of the property are charged to loss on other real estate owned, net and a new carrying value is established. Any gains or losses realized at the time of disposal or subsequent write-downs are reflected in the Consolidated Statements of Operations. Expenses to maintain such assets are included in net cost of operation of other real estate owned.

*Other Borrowings*

The FHLB allows the Company to obtain advances through its credit program. These advances are secured by securities owned by the Company and held in safekeeping by the FHLB, FHLB stock owned by the Company, and certain qualifying loans secured by real estate, including residential mortgage loans, home equity lines of credit and commercial real estate loans.

The Company also obtains advances through the Federal Reserve Bank of Richmond ("FRB") through the discount window. Discount window advances are secured by investment securities pledged to the FRB. The Company also had access to the Paycheck Protection Program Liquidity Facility ("PPPLF") provided through the FRB which was secured by PPP loans. The PPPLF program ended on July 31, 2021.

The Company also has issued subordinated notes to certain qualified institutional buyers and institutional accredited investors and opened a commercial line of credit with a third party commercial bank that is used for general corporate purposes, including continued growth and maintenance of the bank level regulatory capital ratios.

*Derivative Financial Instruments*

The Company is exposed to certain risks relating to its ongoing business operations and uses interest rate derivatives as part of its asset-liability management strategy to help manage its interest rate risk position. The Company records all derivative assets and liabilities on the Consolidated Balance Sheets at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting in accordance with ASC 815, *Derivatives and Hedging*. The Company currently has derivatives that are designated as qualifying hedging relationships. There are no other derivatives that are not designated as qualifying hedging relationships.

Changes in fair value of the Company's cash flow hedges are recognized in AOCI and reclassified to earnings in the period during which the hedged transaction affects earnings and is presented in the same income statement line item as the earnings effect of the hedged item. For fair value hedges, the gain or loss on the derivative as well as the offsetting gain or loss on the hedged item are recognized in current earnings as fair value changes. The change in fair value of the hedged item is recorded as a basis adjustment to the hedged assets or liabilities.

For fair value hedges meeting certain specific criteria, the Company applies the shortcut method of hedge accounting. For other derivatives that do not fall under shortcut method, the Company assesses the effectiveness of each hedging relationship by comparing the changes in the cash flows of the derivative hedging instrument with the changes in cash flows of the designated hedged transactions.

*Income Taxes*

Income tax expense is based upon income before income taxes and generally differs from income taxes paid due to deferred income taxes and benefits arising from income and expenses being recognized in different periods for financial and income tax reporting purposes, as well as permanent differences. The Company uses the asset and liability method to account for deferred income taxes. The objective of the asset and liability method is to establish deferred tax assets and liabilities for the temporary differences between the financial reporting basis and the income tax basis of the Company's assets and liabilities at the effective rates expected to be in effect when such amounts are realized or settled. The Company evaluates the realization of deferred tax assets based upon all positive and negative evidence available at the balance sheet date. Realization of deferred tax assets is based upon the Company's judgments, including taxable income within any applicable carryback periods, future projected taxable income, reversal of taxable temporary differences and other tax-planning strategies to maximize realization of the deferred tax assets. A valuation allowance is recognized for a deferred tax asset if, based upon the weight of available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized. In computing the income tax provision or benefit, the Company evaluates the technical merits of its income tax positions based upon current legislative, judicial, and regulatory guidance.

The Company continually monitors and evaluates the potential impact of current events on the estimates used to establish income tax expense and income tax liabilities. The Company and its Subsidiary file a consolidated federal income tax return and separate state income tax returns based upon current tax law, positions taken by various tax auditors within the jurisdictions that the Company is required to file income tax returns, as well as potential or pending audits or assessments by such tax auditors. If the Company incurs interest and/or penalties related to income tax matters it will report them as a part of income tax expense.

The Company believes that its income tax filing positions taken or expected to be taken in its tax returns will more likely than not be sustained upon audit by the taxing authorities and does not anticipate any adjustments that will result in a material adverse impact on the Company's financial condition, results of operations, or cash flow. Therefore, no reserves for uncertain income tax positions have been recorded.

*Retirement Plan*

The Company has a 401(k) profit sharing plan (the "Plan"), which provides retirement benefits to officers and employees who meet certain age and service requirements. The Plan includes a salary reduction feature pursuant to Section 401(k) of the Internal Revenue Code of 1986, as amended (the "Code"). At its discretion, the Bank makes matching contributions to the Plan. Employer contributions for the 401(k) profit sharing plan were $618 and $482 in 2022 and 2021, respectively, and are included in salaries and employee benefits.

*Net Income Per Common Share*

Basic net income per common share represents income available to stockholders divided by the weighted-average number of common shares outstanding during the period. Dilutive income per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate solely to outstanding options, warrants and restricted stock units and are determined using the treasury stock method. Potential common shares are not included in the denominator of the diluted per share computation when inclusion would be anti-dilutive.

*Other Comprehensive Income (Loss)*

Other comprehensive income (loss) is defined as the change in stockholders' equity during the period from transactions and other events and circumstances from nonowner sources. Accumulated other comprehensive income (loss) includes the reclassification for realized gains and losses from investment securities sales during the period, the unrealized holding gains and losses from investment securities available-for-sale and change in fair value of derivatives.

*Statement of Cash Flows*

For purposes of reporting cash flows in the financial statements, the Company considers certain highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents. Cash equivalents include amounts due from banks, interest bearing accounts with other banks, resell agreements and federal funds sold. Generally, federal funds are sold for one-day periods. Resell agreements are sold for approximately 30-day periods.

*Off-Balance Sheet Financial Instruments*

In the ordinary course of business, the Company enters into off-balance sheet financial instruments consisting of commitments to extend credit and letters of credit. These financial instruments are recorded in the financial statements when they become payable by the customer.

*Stock-Based Compensation*

The Company grants stock options, restricted stock units, and other equity awards to purchase its common stock to certain key officers/employees and directors. Stock options are for a fixed number of shares with an exercise price equal to the fair value of the shares at the grant date. The fair value of stock options is determined using the Black-Scholes model. The fair value of restricted stock units when granted is the fair value of the stock on the grant date. Stock-based compensation expense is recognized in the Consolidated Statements of Operations on a straight-line basis over the vesting period. In addition, the Company estimates the number of awards for which vesting is probable and adjusts compensation cost accordingly. For nonqualified stock options, as compensation expense is recognized, a deferred tax asset is recorded that represents an estimate of the future tax deduction from exercise. At the time that stock-based awards are exercised, cancelled, or expire, the Company may be required to recognize an adjustment to income tax expense. For incentive stock options, the Company does not recognize an income tax benefit related to compensation expense in the period incurred or when exercised, unless there is a disqualifying disposition. The Company recognizes forfeitures of stock-based awards as they occur.

*Fair Value*

US GAAP requires the use of fair values in determining the carrying values of certain assets and liabilities, as well as for specific disclosures. Fair value is defined as the price that would be received to sell an asset or transfer a liability in an orderly transaction between willing market participants at the measurement date. When determining the fair value measurements for assets and liabilities, the Company considers the principal or most advantageous market in which those assets or liabilities are sold and considers assumptions that market participants would use when pricing those assets or liabilities.

Individual fair value estimates are classified on a three-tiered scale based upon the relative reliability of the inputs used in the valuation. Fair values determined using Level 1 inputs rely on active and observable markets to price identical assets or liabilities. In situations where identical assets and liabilities are not traded in active markets, fair values may be determined based upon Level 2 inputs, which are used when observable data exists for similar assets and liabilities. Fair values for assets and liabilities that are not actively traded in observable markets are based upon Level 3 inputs, which are considered to be unobservable.

*Business Combinations*

The Company applies the acquisition method of accounting for all business combinations. The acquirer is the entity that obtains control of one or more businesses in the business combination and the acquisition date is the date the acquirer achieved control. The acquirer recognizes the fair value of assets acquired, liabilities assumed and any non-controlling interest in the acquiree at the acquisition date. If the fair value of assets purchased exceeded the fair value of liabilities assumed, it results in a gain on acquisition. If the consideration given exceeds the fair value of the net assets received, goodwill is recognized. Generally, fair values are subject to refinement for up to one year after the closing date of an acquisition as information relative to closing date fair values becomes available (the "measurement period"). During the measurement period, the Company may recognize adjustments to the initial amounts recorded as if the accounting for the business combination had been completed at the acquisition date. Adjustments are typically recorded as a result of new information received after the acquisition date that is necessary to identify and measure identifiable assets acquired and liabilities assumed. In many cases, the determination of acquisition-date fair values requires management to make estimates about discount rates, future expected cash flows, market conditions, and other future events that are subjective in nature and subject to change.

The following is a description of the methods used to determine the fair values of significant assets and liabilities acquired:

Cash and Due from Banks
The carrying amount of these assets is expected to reasonably approximate fair value given the short-term nature of the assets.

Investment Securities Available-for-sale
The fair value of investment securities is determined by quoted market prices at the time of acquisition.

Loans
The fair value of acquired loans is based upon a discounted cash flow methodology that considered factors including the type of loans and related collateral, classification status, fixed or variable interest rate, loan term, whether or not the loan was amortizing, and a market discount rate reflecting risks inherent in the acquired loans, including potential prepayments. The fair value of acquired loans includes both a rate-based valuation mark, representing the carrying value of discount required to establish the appropriate effective yield for acquired loans, as well as a credit-based valuation mark representing the valuation adjustment applied to acquired loans related to credit loss assumptions.

Other Real Estate Owned
The fair value of other real estate owned is estimated based upon the value that management expects to receive when the property is sold, net of related costs of disposal.

Core Deposit Intangibles
The fair value of core deposit intangibles is estimated based upon a discounted cash flow methodology that gives consideration to expected customer attrition rates, cost of the deposit base, and the net maintenance cost attributable to customer deposits.

Premises and Equipment
The fair value of premises and equipment is estimated based upon independent appraisals or broker price opinions.

Other Assets
Other assets generally include accrued interest that has been earned on borrowers' loans or investment securities not yet received and prepaid expenses. The carrying value of these assets is expected to reasonably approximate fair value.

Deposits
The fair values used for the transaction, money market, and savings accounts acquired closely approximate the amount payable on demand at the acquisition date and thus reasonably approximate fair value. The fair value of time deposits is estimated based upon a discounted cash flow methodology. The discount rate is estimated using market rates currently offered for deposits of similar remaining maturities.

Deferred Tax Assets and Liabilities
Deferred tax assets and liabilities are temporary differences between the carrying amount of an asset or a liability recognized in the Consolidated Balance Sheets and the related tax basis for the asset or liability using enacted tax rates in effect for the year in which the differences are expected to be recovered.

SBA Contingency Reserve
The SBA Contingency Reserve is an estimate of the Company's exposures related to denials or repairs of government guarantees on SBA 7A loans that have been sold in the secondary market. This estimate considers the balance of sold loans and considers the risk of loss and probability of denial or repair of government guarantee given historical information from the acquired entity.

Other Liabilities
Other liabilities generally include accrued interest on deposit accounts, accrued expenses, and additional accounts held in escrow. The carrying value of these liabilities is expected to reasonably approximate fair value.

*Operating Segments*

Accounting standards require that information be reported about a company's operating segments using a "management approach." Reportable segments are identified in these standards as those revenue producing components for which separate financial information is produced internally and which are subject to evaluation by the chief operating decision maker. While the chief operating decision maker monitors the revenue streams of the various products and services, operations are managed, and financial performance is evaluated on a Company-wide basis. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable segment.

*Reclassifications*

Certain captions and amounts in the 2021 Consolidated Financial Statements were reclassified to conform with the 2022 presentation. These reclassifications had no effect on the net results of operations or stockholders' equity.

*Recently Issued Accounting Pronouncements Not Yet Adopted*

The Company's common stock is quoted on OTCQX, (Ticker: COSO), and as a result, the Company is classified as a public business entity for the purposes of adopting new accounting pronouncements. The table below summarizes Accounting Standard Updates ("ASUs") which update various topics of the Accounting Standards Codification ("ASC") recently issued by the Financial Accounting Standards Board ("FASB") that could have a material effect on the Company's financial statements.

In March 2022, the FASB issued ASU 2022-02, which eliminates the accounting guidance on troubled debt restructurings ("TDRs") for creditors in ASC 310-40 and amends the guidance on "vintage disclosures" to require disclosure of current-period gross write-offs by year of origination. This ASU also updates the requirements related to accounting for credit losses under ASC 326, *Financial Instruments—Credit Losses*, and adds enhanced disclosures for creditors with respect to loan refinancings and restructurings for borrowers experiencing financial difficulty. The effective date for entities that have not yet adopted ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326)*, as amended, is effective upon adoption of ASU 2016-13. Early adoption of these amendments is permitted, including adoption in any interim period, provided that the amendments are adopted as of the beginning of the annual reporting period that includes the interim period of adoption. In addition, entities are permitted to elect to early adopt the amendments related to TDR accounting and related disclosure enhancements separately from the amendments related to the vintage disclosures. The adoption of this standard on January 1, 2023, is not expected to have a material effect on the Company's Consolidated Financial Statements.

In March 2020, the FASB issued ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*, as amended. This ASU addresses the expected cessation of the London Interbank Offered Rate (LIBOR), the most commonly used benchmark interest rate in the world, which is expected to cease publication during 2023. This ASU provides optional guidance, for a limited time, to ease the potential burden in accounting for or recognizing the effects of reference rate reform on financial reporting. The amendments in this Update are elective and apply to all entities, subject to meeting certain criteria, that have contracts, hedging relationships, and other transactions that reference LIBOR or another reference rate expected to be discontinued because of reference rate reform. The optional expedients for contract modifications apply consistently for all contracts or transactions within the relevant Codification Topic, Subtopic, or Industry Subtopic that contains the guidance that otherwise would be required to be applied, while those for hedging relationships can be elected on an individual hedging relationship basis. The optional amendments were effective for all entities as of March 12, 2020, through December 31, 2022. In December 2022, the FASB issued ASU 2022-06, *Deferral of the Sunset Date of Topic 848*, which defers the sunset date of the guidance in ASC 848 on reference rate reform to December 31, 2024. ASU 2022-06 ASU became effective upon issuance. The adoption of this standard is not expected to have a material effect on the Company's Consolidated Financial Statements.

In June 2016, the FASB issued ASU 2016-13, as amended, to replace the incurred loss model with an expected credit 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 similar instruments) and net investments in leases recognized by a lessor. For debt securities with other-than-temporary impairment (OTTI), the guidance will be applied prospectively. Existing purchased credit impaired (PCI) assets will be grandfathered and classified as purchased credit deteriorated (PCD) assets at the date of adoption. The assets will be grossed up for the allowance of expected credit losses for all PCD assets at the date of adoption and will continue to recognize the noncredit discount in interest income based on the yield of such assets as of the adoption date. Subsequent changes in expected credit losses will be recorded through the allowance. Adoption is effective for interim and annual reporting periods beginning after December 15, 2022. The Company adopted this ASU on January 1, 2023, and currently estimates the allowance for credit losses on loans will increase by approximately $1.5 million to $2.5 million. In addition, the Company expects to recognize a liability for the unfunded commitments of approximately $3.9 million to $4.9 million upon adoption. The impact to retained earnings is expected to be approximately $3.4 million to $5.0 million, net of tax. The adoption of this ASU will not have a significant impact to the Bank's regulatory capital. The Company will elect to phase-in over a three-year period the ASU's initial impact on regulatory capital as permitted by the regulatory transition rules. The Company will finalize the adoption during the first quarter of 2023.

The Company has further evaluated other Accounting Standards Updates issued during 2022 but does not expect Updates other than those summarized above to have a material impact on the Consolidated Financial Statements.

## NOTE 2 — BUSINESS COMBINATIONS

Cornerstone Bancshares, Inc.

On October 1, 2021, the Company acquired 100% of the outstanding shares of Cornerstone Bancshares, Inc. (“Cornerstone”), the parent company of Georgia state-chartered Cornerstone Bank (“CRNB”), headquartered in Atlanta, Georgia. Upon consummation of the acquisition, Cornerstone was merged with and into the Company, with the Company as the surviving entity in the merger; concurrently, CRNB was merged with and into CSB. Through the acquisition, the Company expanded its footprint and deposit base in Atlanta, Georgia.

Under the terms of the acquisition, Cornerstone’s accredited common shareholders received 0.04717 shares of the Company’s common stock in exchange for each share of Cornerstone common stock and $0.07392 in cash. Cornerstone shareholders also received cash in lieu of fractional shares based on the share issuance price of $16.50. Nonaccredited investors and certain other shareholders received $0.85219 in cash for each share of Cornerstone common stock in lieu of shares of the Company's stock. There were 144 Cornerstone accredited common shareholders who received the Company's common stock. The $11,459 of total consideration transferred was comprised of 573,682 shares of the Company’s voting common stock issued at $16.50 per share, $1,593 in cash in lieu of common stock, and $400 of contingent consideration. The share issuance price per the merger agreement of $16.50 approximated the 60-day day weighted average closing price of the Company's stock and was considered to be the fair value of the stock, given the Company's low trading volume.

The contingent consideration arrangement identified a specific population of twelve problem loan relationships and specified that if they were resolved within twelve months of the date of acquisition then the Company will pay additional consideration. The range of consideration possible from the arrangement was from $0 to $5,732. Given the likelihood of recovery and anticipated timing of recovery, management estimated that the value of contingent consideration was $400 at the time of acquisition. Following the resolution of the contingent period, the amount of contingent consideration actually paid during 2022 was $890.

A bargain purchase of $1,649 was realized as a result of this acquisition. The bargain purchase gain was driven by conservative underwriting and the Company's willingness to take on risks and uncertainties related to the acquired loan portfolio.

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

Acquisition- related costs of $2,076 were included in other noninterest expense in the Company's Consolidated Statements of Operations for the year ended December 31, 2021.

The following table summarizes the consideration paid for Cornerstone and the amounts of the assets and liabilities acquired and assumed, respectively, recognized at the acquisition date:

| | Carrying Value Acquired | Purchase Adjustments | As Recorded by CSB |
|---|---|---|---|
| **Assets** | | | |
| Cash and due from banks | $ 82,504 | $ - | $ 82,504 |
| Investment securities | 15,942 | 31 | 15,973 |
| Loans held for investment, net | 128,597 | (2,886) | 125,711 |
| Premises, furniture and equipment, net | 90 | (27) | 63 |
| Intangible assets | 232 | 941 | 1,173 |
| Deferred tax asset | - | 3,841 | 3,841 |
| Other assets | 1,853 | 10 | 1,863 |
| Total assets acquired | $ 229,218 | $ 1,910 | $ 231,128 |
| **Liabilities** | | | |
| Deposits | | | |
| Noninterest-bearing | 67,428 | - | 67,428 |
| Interest-bearing | 139,357 | 1,505 | 140,862 |
| Total deposits | 206,785 | 1,505 | 208,290 |
| SBA contingency reserve | 1,149 | 4,248 | 5,397 |
| Other liabilities | 3,154 | 1,179 | 4,333 |
| Total liabilities assumed | 211,088 | 6,932 | 218,020 |
| Net identifiable assets acquired | $ 18,130 | $ (5,022) | $ 13,108 |
| **Consideration** | | | |
| Voting common stock | | | $ 9,466 |
| Cash | | | 1,593 |
| Contingent consideration | | | 400 |
| Total consideration transferred to CRN | | | 11,459 |
| **Bargain Purchase Gain** | | | $ (1,649) |

No measurement period adjustments were identified following the acquisition.

Acquired loans held for investment had gross contractual amounts receivable of $146,356. At the acquisition date, CSB's estimated expected cash flows to be collected was $142,730. Acquired loans were evaluated to determine if they were purchased credit-impaired ("PCI"). PCI loans are loans with evidence of deterioration of credit quality since origination for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments receivable. PCI loans that were identified as part of this business combination amounted to $39,625 and was comprised of 143 loans. The determination of the basis of PCI loans is presented in the table below:

| | October 1, 2021 |
|---|---|
| Contractual principal and interest at acquisition | $ 52,461 |
| Nonaccretable difference | 5,665 |
| Expected Cash flows at acquisition | 46,796 |
| Accretable yield | 7,171 |
| Basis in PCI loans at acquisition - estimated fair value | $ 39,625 |

**(Amounts** ***in Thousands Except Share and Per Share Amounts*****)**

## NOTE 3 — INVESTMENT SECURITIES

The amortized cost and estimated fair values of securities available-for-sale at December 31, 2022 and 2021 are shown in the tables below:

| | 2022 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. Treasuries | $ 56,836 | $ - | $ 3,370 | $ 53,466 |
| Municipal obligations | 71,551 | 43 | 11,535 | 60,059 |
| Mortgage-backed securities | 172,395 | 36 | 20,257 | 152,174 |
| Asset-backed securities | 59,293 | 157 | 2,424 | 57,026 |
| Corporate debt securities | 44,472 | 61 | 1,138 | 43,395 |
| Total securities available-for-sale | $ 404,547 | $ 297 | $ 38,724 | $ 366,120 |

| | 2021 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. Treasuries | $ 25,957 | $ - | $ 103 | $ 25,854 |
| Municipal obligations | 65,527 | 1,749 | 602 | $ 66,674 |
| Mortgage-backed securities | 117,394 | 425 | 965 | 116,854 |
| Asset-backed securities | 52,093 | 686 | 77 | 52,702 |
| Corporate debt securities | 29,714 | 1,463 | 36 | 31,141 |
| Total securities available-for-sale | $ 290,685 | $ 4,323 | $ 1,783 | $ 293,225 |

There were no sales of securities available-for-sale during 2022. Proceeds from sales of securities available-for-sale during 2021 were $3,009, resulting in gross realized loss of $64.

The following is a summary of maturities of securities available-for-sale as of December 31, 2022. The amortized cost and estimated fair values are based on the contractual maturity dates. Actual maturities may differ from contractual maturities because borrowers may have the right to call or repay obligations with or without penalty. Mortgaged-backed securities are not presented by maturity date because pay-downs are expected before contractual maturity dates.

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| Three months or less | $ 3,303 | $ 3,296 |
| Over three months through one year | 2,697 | 2,582 |
| Due after one year but within five years | 74,192 | 70,224 |
| Due after five years but within ten years | 103,954 | 98,660 |
| Due after ten years | 48,006 | 39,184 |
| Mortgage backed securities | 172,395 | 152,174 |
| Total | $ 404,547 | $ 366,120 |

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

The following table shows gross unrealized losses and fair value of securities available for sale, aggregated by investment category, and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2022:

| | Less than Twelve months | | Twelve months or more | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized losses | Fair Value | Unrealized losses | Fair Value | Unrealized losses |
| U.S. Treasuries | $ 25,157 | $ 724 | $ 28,309 | $ 2,646 | $ 53,466 | $ 3,370 |
| Municipal obligations | 21,017 | 3,042 | 37,839 | 8,493 | 58,856 | 11,535 |
| Mortgage-backed securities | 53,098 | 3,508 | 96,588 | 16,749 | 149,686 | 20,257 |
| Asset-backed securities | 35,752 | 1,692 | 11,883 | 732 | 47,635 | 2,424 |
| Corporate debt securities | 26,301 | 218 | 9,170 | 920 | 35,471 | 1,138 |
| | $ 161,325 | $ 9,184 | $ 183,789 | $ 29,540 | $ 345,114 | $ 38,724 |

The following table shows gross unrealized losses and fair value of securities available for sale, aggregated by investment category, and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2021:

| | Less than Twelve months | | Twelve months or more | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized losses | Fair Value | Unrealized losses | Fair Value | Unrealized losses |
| U.S. Treasuries | $ 15,846 | $ 103 | $ - | $ - | $ 15,846 | $ 103 |
| Municipal obligations | 25,856 | 511 | 3,434 | 91 | 29,290 | 602 |
| Mortgage-backed securities | 76,749 | 947 | 1,807 | 18 | 78,556 | 965 |
| Asset-backed securities | 13,853 | 77 | - | - | 13,853 | 77 |
| Corporate debt securities | 2,964 | 36 | - | - | 2,964 | 36 |
| | $ 135,268 | $ 1,674 | $ 5,241 | $ 109 | $ 140,509 | $ 1,783 |

Securities classified as available-for-sale are recorded at fair market value. Of the securities in an unrealized loss position at December 31, 2022, one-hundred-five securities were in a continuous loss position for twelve months or more. The Company believes, based on industry analyst reports, credit ratings and/or government guarantees, that the deterioration in value is attributable to changes in market interest rates and is not in the credit quality of the issuer and therefore, these losses are not considered other-than-temporary.

The Company evaluates securities available-for-sale for other-than-temporary impairment on a quarterly basis. As a result of this evaluation, at December 31, 2022, the Company has determined that the declines summarized in the tables above are not deemed to be other-than-temporary. There can be no assurance that the Company will not conclude in future periods that conditions existing at that time indicate some or all of these securities may be sold or are other than temporarily impaired, which would require a charge to earnings in such periods.

During the year ended December 31, 2022, there were no gains or losses recognized on changes in market value of equity securities. During the year ended December 31, 2021, the Company recognized a net gain on changes in market value of $6 to reflect the change in fair value of equity securities.

At December 31, 2022 and 2021, investment securities with a book value of $73,259 and $48,904, respectively, and a market value of $63,952 and $50,389, respectively, were pledged to secure federal funds lines of credit and Federal Home Loan Bank borrowings.

## NOTE 4 — LOANS AND ALLOWANCE FOR LOAN LOSSES

*Composition of Loan Portfolio*

The Company engages in a full complement of lending activities, including real estate-related loans, construction loans, commercial and industrial loans, and consumer purpose loans. While risk of loss in the Company's portfolio is primarily tied to the credit quality of the various borrowers, risk of loss may increase due to factors beyond the Company's control, such as local, regional and/or national economic downturns. General conditions in the real estate market may also impact the relative risk in the real estate portfolio.

Construction and land loans include loans for the development of residential neighborhoods, construction of one-to-four family residential construction loans to builders, commercial real estate construction loans, primarily for owner-occupied properties, and other loans for land investment. Construction loans generally carry a higher degree of risk than long-term financing of existing properties because repayment depends upon the ultimate completion of the project and usually on the subsequent lease-up and/or sale of the property. The Company limits its construction lending risk through adherence to established underwriting procedures.

Commercial real estate loans include loans secured by owner-occupied commercial buildings for office, storage, retail, farmland, and warehouse space. They also include non-owner-occupied commercial buildings such as leased retail and office space, multi-family properties, and senior housing developments. The primary risk associated with loans secured with income-producing property is the inability of that property to produce adequate cash flow to service the debt. High unemployment, generally weak economic conditions and/or an oversupply in the market may result in our customers having difficulty achieving adequate occupancy rates. Payments on such loans are often dependent on successful operation or management of the properties.

Commercial and industrial loans include both secured and unsecured loans for working capital, expansion, and other business purposes. Short-term working capital loans may be secured by non-real estate collateral such as accounts receivable, inventory, and/or equipment. The Company evaluates the financial strength, cash flow, management, credit history of the borrower and the quality of the collateral securing the loan. Repayment is primarily dependent on the ability of the borrower to achieve business results consistent with those projected at loan origination resulting in cash flow sufficient to service the debt. To the extent that a borrower's business results are significantly unfavorable versus the original projections, the ability for the loan to be serviced on a basis consistent with the contractual terms may be at risk. The Company often requires personal guarantees and secondary sources of repayment on commercial and industrial loans.

The Paycheck Protection Program was introduced during 2020 as part of the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") in response to the COVID-19 pandemic. These 100% government guaranteed unsecured commercial loans were originated to small businesses seeking aid due to difficulties caused by COVID-19. Under the program, the SBA will forgive loans, in whole or in part, made by approved lenders to eligible borrowers for payroll and other permitted purposes in accordance with the requirements of the program. These loans carry a fixed rate of 1.00% and a term of two or five years, depending on the origination date, if not forgiven. The loan application, qualifications for credit, and loan terms are defined by the SBA and United States Department of the Treasury and are underwritten and approved according to the terms of the program. If proceeds from the loans were used for qualified purposes as specified in the program, the loans are 100% forgivable by the SBA. The borrower is not required to make any payments until the forgiveness amount is remitted to the lender by the SBA. Because these loans are 100% guaranteed by the SBA, the Company has not currently assigned any allowance for loan losses to this loan type. Additionally, any past due PPP loans that are in the process of forgiveness are not accounted for as nonaccrual due to the SBA guarantee.

Residential real estate loans include permanent mortgage financing, construction loans to individual consumers, and home equity lines of credit. These loans are secured by residential properties. Significant and rapid declines in real estate values can result in residential mortgage loan borrowers having debt levels in excess of the current market value of the collateral.

**(Amounts** ***in Thousands Except Share and Per Share Amounts*****)**

Consumer other purpose loans primarily includes student loans and other secured and unsecured consumer purpose loans. Certain loans are secured by marine vessels, recreational vehicles, and other such tangible property. These types of loans may be impacted by negative macroeconomic conditions impacting individual consumers, such as increased unemployment, which can reduce a borrower's ability to repay the loan.

Loans held for sale are comprised of loans acquired through mortgage warehouse lending activities and origination of mortgage loans. The Company serves as a warehouse lender by purchasing loans originated by third-party mortgage originators and selling these loans to other third-party investors. The Company also originates mortgage loans with customers through CSM and sells the majority of these loans to third-party investors.

The Company also has a portfolio of PCI loans at December 31, 2022. See Note 1, "*Summary of Significant Accounting Policies*" for additional information regarding PCI loans.

Following is a summary of the composition of the loan portfolio at December 31, 2022 and 2021:

| | 2022 | 2021 |
|---|---|---|
| Commercial loans: | | |
| Construction and land | $ 110,003 | $ 77,249 |
| Commercial real estate | 580,403 | 431,640 |
| Commercial and industrial | 231,987 | 173,295 |
| Paycheck Protection Program | 3,135 | 47,655 |
| Consumer loans: | | |
| Residential real estate | 122,485 | 103,610 |
| Other consumer | 250,590 | 104,667 |
| Total gross LHFI | 1,298,603 | 938,116 |
| Less allowance for loan losses | (12,362) | (8,148) |
| LHFI, net | $ 1,286,241 | $ 929,968 |
| LHFS | $ 44,500 | $ 81,453 |

Credit Quality Indicators

The Company monitors the credit quality of its commercial loan portfolio using internal credit risk ratings. These credit risk ratings are based upon established regulatory guidance and are assigned upon initial approval of credit to borrowers. Credit risk ratings are updated periodically after the initial assignment or whenever management becomes aware of information affecting the borrowers' ability to fulfill their obligations. The Company utilizes the following categories of credit grades to evaluate its commercial loan portfolio:

***Pass*** — Loans classified as pass are higher quality loans that do not fit any of the other categories below.

***Special Mention*** — Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the Company's credit position at some future date.

***Substandard*** — Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

***Doubtful*** — Loans classified as 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 existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is high, but because of certain important and reasonably specific pending factors that may work to the advantage and strengthening of the credit quality of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans.

**(Amounts** ***in Thousands Except Share and Per Share Amounts*****)**

The following table presents the credit quality indicators associated with the Company's commercial loan portfolio, as of December 31, 2022:

| | Construction and Land | Commercial Real Estate | Commercial and Industrial | Paycheck Protection Program | Purchased Credit Impaired | Total |
|---|---|---|---|---|---|---|
| Pass | $ 109,416 | $ 557,313 | $ 226,828 | $ 3,135 | $ 14,787 | $ 911,479 |
| Special mention | - | 1,459 | 296 | - | 1,229 | 2,984 |
| Substandard | - | 4,213 | 685 | - | 6,167 | 11,065 |
| Doubtful | - | - | - | - | - | - |
| Total | $ 109,416 | $ 562,985 | $ 227,809 | $ 3,135 | $ 22,183 | $ 925,528 |

The following table presents the credit quality indicators associated with the Company's commercial loan portfolio, as of December 31, 2021:

| | Construction and Land | Commercial Real Estate | Commercial and Industrial | Paycheck Protection Program | Purchased Credit Impaired | Total |
|---|---|---|---|---|---|---|
| Pass | $ 73,712 | $ 399,380 | $ 166,797 | $ 47,655 | $ 19,974 | $ 707,518 |
| Special mention | 2,835 | 3,328 | 403 | - | 4,535 | 11,101 |
| Substandard | - | 2,089 | 160 | - | 8,971 | 11,220 |
| Doubtful | - | - | - | - | - | - |
| Total | $ 76,547 | $ 404,797 | $ 167,360 | $ 47,655 | $ 33,480 | $ 729,839 |

The Company monitors the credit quality of its consumer portfolio based primarily on payment activity and credit scores. Payment activity is the primary factor considered in determining whether a consumer loan should be classified as nonperforming.

The following table presents the credit quality indicators associated with the Company's consumer loan portfolio, as of December 31, 2022:

| | Residential Real Estate | Other Consumer | Purchased Credit Impaired | Total |
|---|---|---|---|---|
| Performing | $ 120,057 | $ 250,590 | $ 1,175 | $ 371,822 |
| Nonperforming | 1,253 | - | - | 1,253 |
| Total | $ 121,310 | $ 250,590 | $ 1,175 | $ 373,075 |

The following table presents the credit quality indicators associated with the Company's consumer loan portfolio, as of December 31, 2021:

| | Residential Real Estate | Other Consumer | Purchased Credit Impaired | Total |
|---|---|---|---|---|
| Performing | $ 100,132 | $ 104,664 | $ 2,415 | $ 207,211 |
| Nonperforming | 1,066 | - | - | 1,066 |
| Total | $ 101,198 | $ 104,664 | $ 2,415 | $ 208,277 |

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

*Delinquency*

The following is a summary of past due and nonaccrual loans as of December 31, 2022:

| | 30-59 Days Past Due | 60-89 Days Past Due | Over 90 Days and Accruing | Nonaccrual | Total Past Due and Nonaccrual | Current | Total Loans Receivable |
|---|---|---|---|---|---|---|---|
| Construction and land | $ - | $ - | $ - | $ - | $ - | $ 109,416 | $ 109,416 |
| Commercial real estate | - | - | - | 4,117 | 4,117 | 558,868 | 562,985 |
| Commercial and industrial | 477 | - | - | 126 | 603 | 227,206 | 227,809 |
| Paycheck Protection Program | - | 222 | 1,932 | - | 2,154 | 981 | 3,135 |
| Residential real estate | 1,044 | 174 | - | 1,253 | 2,471 | 118,839 | 121,310 |
| Other consumer | 79 | 57 | - | - | 136 | 250,454 | 250,590 |
| Purchased credit impaired | - | 835 | 652 | - | 1,487 | 21,871 | 23,358 |
| | $ 1,600 | $ 1,288 | $ 2,584 | $ 5,496 | $ 10,968 | $ 1,287,635 | $ 1,298,603 |

The following is a summary of past due and nonaccrual loans as of December 31, 2021:

| | 30-59 Days Past Due | 60-89 Days Past Due | Over 90 Days and Accruing | Nonaccrual | Total Past Due and Nonaccrual | Current | Total Loans Receivable |
|---|---|---|---|---|---|---|---|
| Construction and land | $ - | $ - | $ - | $ - | $ - | $ 76,547 | $ 76,547 |
| Commercial real estate | - | - | - | 959 | 959 | 403,838 | 404,797 |
| Commercial and industrial | 75 | - | - | 160 | 235 | 167,125 | 167,360 |
| Paycheck Protection Program | 583 | 26 | 24 | - | 633 | 47,022 | 47,655 |
| Residential real estate | 5,102 | 95 | - | 1,065 | 6,262 | 94,936 | 101,198 |
| Other consumer | 4 | - | - | - | 4 | 104,660 | 104,664 |
| Purchased credit impaired | 2,222 | 1 | 1,365 | - | 3,588 | 32,307 | 35,895 |
| | $ 7,986 | $ 122 | $ 1,389 | $ 2,184 | $ 11,681 | $ 926,435 | $ 938,116 |

*Purchased Credit-Impaired ("PCI") Loans*

At December 31, 2022, the unpaid principal balance of PCI loans was $29,273. Changes in the amount of accretable yield on PCI loans for the year ended December 31, 2022 was as follows:

| | 2022 | 2021 |
|---|---|---|
| Accretable yield, beginning of period | $ 6,615 | $ - |
| Additions | - | 7,171 |
| Accretion | (1,804) | (556) |
| Reclassification from nonaccretable difference | 1,217 | - |
| Other changes, net | 722 | - |
| Accretable yield, end of period | $ 6,750 | $ 6,615 |

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

For PCI loans, if the Company has a reasonable expectation about the timing and amount of cash flows expected to be collected, the loans meet the criteria for the recognition of income and are considered to be accruing loans.

*Impaired Loans*

The following summarizes the Company's impaired loans, excluding PCI loans, at December 31, 2022:

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| **With no related allowance needed:** | | | | | |
| Construction and land | $ - | $ - | $ - | $ - | $ - |
| Commercial real estate | 4,117 | 4,332 | - | 4,156 | 115 |
| Commercial and industrial | 126 | 178 | - | 143 | - |
| Paycheck Protection Program | - | - | - | - | - |
| Residential real estate | 1,266 | 1,315 | - | 1,274 | - |
| Other consumer | 3 | 13 | - | 5 | - |
| Ending balance | $ 5,512 | $ 5,838 | $ - | $ 5,578 | $ 115 |
| **With an allowance recorded:** | | | | | |
| Construction and land | $ - | $ - | $ - | $ - | $ - |
| Commercial real estate | - | - | - | - | - |
| Commercial and industrial | - | - | - | - | - |
| Paycheck Protection Program | - | - | - | - | - |
| Residential real estate | 372 | 372 | 372 | 373 | 4 |
| Other consumer | - | - | - | - | - |
| Ending balance | $ 372 | $ 372 | $ 372 | $ 373 | $ 4 |
| **Total:** | | | | | |
| Construction and land | $ - | $ - | $ - | $ - | $ - |
| Commercial real estate | 4,117 | 4,332 | - | 4,156 | 115 |
| Commercial and industrial | 126 | 178 | - | 143 | - |
| Paycheck Protection Program | - | - | - | - | - |
| Residential real estate | 1,638 | 1,687 | 372 | 1,647 | 4 |
| Other consumer | 3 | 13 | - | 5 | - |
| Ending balance | $ 5,884 | $ 6,210 | $ 372 | $ 5,951 | $ 119 |

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

The following summarizes the Company's impaired loans, excluding PCI loans, at December 31, 2021:

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| **With no related allowance needed:** | | | | | |
| Construction and land | $ - | $ - | $ - | $ - | $ - |
| Commercial real estate | 959 | 1,127 | - | 1,023 | - |
| Commercial and industrial | 160 | 191 | - | 176 | - |
| Paycheck Protection Program | - | - | - | - | - |
| Residential real estate | 1,452 | 1,741 | - | 1,473 | 36 |
| Other consumer | 7 | 7 | - | 8 | 1 |
| Ending balance | $ 2,578 | $ 3,066 | $ - | $ 2,680 | $ 37 |
| **With an allowance recorded:** | | | | | |
| Construction and land | $ - | $ - | $ - | $ - | $ - |
| Commercial real estate | - | - | - | - | - |
| Commercial and industrial | - | - | - | - | - |
| Paycheck Protection Program | - | - | - | - | - |
| Residential real estate | - | - | - | - | - |
| Other consumer | - | - | - | - | - |
| Ending balance | $ - | $ - | $ - | $ - | $ - |
| **Total:** | | | | | |
| Construction and land | $ - | $ - | $ - | $ - | $ - |
| Commercial real estate | 959 | 1,127 | - | 1,023 | - |
| Commercial and industrial | 160 | 191 | - | 176 | - |
| Paycheck Protection Program | - | - | - | - | - |
| Residential real estate | 1,452 | 1,741 | - | 1,473 | 36 |
| Other consumer | 7 | 7 | - | 8 | 1 |
| Ending balance | $ 2,578 | $ 3,066 | $ - | $ 2,680 | $ 37 |

*Allowance for Loan Losses*

The following is a summary of information pertaining to the allowance for loan losses for the loan portfolio at December 31, 2022:

| | Construction and Land | Commercial Real Estate | Commercial and Industrial | Paycheck Protection Program | Residential Real Estate | Other Consumer | Total |
|---|---|---|---|---|---|---|---|
| **Allowance for loan losses:** | | | | | | | |
| Beginning balance: | $ 1,469 | $ 3,198 | $ 1,258 | $ - | $ 820 | $ 1,403 | $ 8,148 |
| Charge-offs | - | - | (1,174) | - | - | (80) | (1,254) |
| Recoveries | - | - | 112 | - | 256 | 22 | 390 |
| Provision (Release) | 889 | 128 | 1,887 | - | 100 | 2,074 | 5,078 |
| Ending balance | $ 2,358 | $ 3,326 | $ 2,083 | $ - | $ 1,176 | $ 3,419 | $ 12,362 |
| Ending balances: | | | | | | | |
| Individually evaluated for impairment | - | - | - | - | 372 | - | 372 |
| Collectively evaluated for impairment | 2,358 | 3,326 | 2,083 | - | 465 | 3,419 | 11,651 |
| Purchased credit impaired | - | - | - | - | 339 | - | 339 |
| **Loans held for investment:** | | | | | | | |
| Individually evaluated for impairment | - | 4,117 | 126 | - | 1,638 | 3 | 5,884 |
| Collectively evaluated for impairment | 109,416 | 558,868 | 227,683 | 3,135 | 119,672 | 250,587 | 1,269,361 |
| Purchased credit impaired | 587 | 17,418 | 4,178 | - | 1,175 | - | 23,358 |
| Ending balance - total LHFI | $ 110,003 | $ 580,403 | $ 231,987 | $ 3,135 | $ 122,485 | $ 250,590 | $ 1,298,603 |

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

The following is a summary of information pertaining to the allowance for loan losses for the loan portfolio at December 31, 2021:

| | Construction and Land | Commercial Real Estate | Commercial and Industrial | Paycheck Protection Program | Residential Real Estate | Other Consumer | Total |
|---|---|---|---|---|---|---|---|
| **Allowance for loan losses:** | | | | | | | |
| Beginning balance: | $ 926 | $ 3,394 | $ 1,115 | $ - | $ 625 | $ 981 | $ 7,041 |
| Charge-offs | - | - | - | - | (100) | (244) | (344) |
| Recoveries | - | - | 25 | - | 83 | 17 | 125 |
| Provision (Release) | 543 | (196) | 118 | - | 212 | 649 | 1,326 |
| Ending balance | $ 1,469 | $ 3,198 | $ 1,258 | $ - | $ 820 | $ 1,403 | $ 8,148 |
| Ending balances: | | | | | | | |
| Individually evaluated for impairment | - | - | - | - | - | - | - |
| Collectively evaluated for impairment | 1,469 | 3,198 | 1,258 | - | 820 | 1,403 | 8,148 |
| Purchased credit impaired | - | - | - | - | - | - | - |
| **Loans held for investment:** | | | | | | | |
| Individually evaluated for impairment | - | 959 | 160 | - | 1,452 | 7 | 2,578 |
| Collectively evaluated for impairment | 76,547 | 403,838 | 167,200 | 47,655 | 99,746 | 104,657 | 899,643 |
| Purchased credit impaired | 702 | 26,843 | 5,935 | - | 2,412 | 3 | 35,895 |
| Ending balance - total LHFI | $ 77,249 | $ 431,640 | $ 173,295 | $ 47,655 | $ 103,610 | $ 104,667 | $ 938,116 |

*Troubled Debt Restructurings*

The following table summarizes the carrying balance of troubled debt restructurings ("TDRs") as of December 31, 2022 and 2021:

| | 2022 | 2021 |
|---|---|---|
| Performing TDRs | $ 389 | $ 394 |
| Nonperforming TDRs | - | 144 |
| Total TDRs | $ 389 | $ 538 |

Loans classified as TDRs may be removed from this status for disclosure purposes after a specified period of time if a subsequent restructured agreement specifies an interest rate equal to or greater than the rate that the lender was willing to accept at the time of the restructuring for a new loan with comparable risk, and the loan is performing in accordance with the terms specified by the restructured agreement.

There were no TDRs identified during the year ended December 31, 2022 or 2021. There were no TDRs that were restructured in the previous twelve months which re-defaulted during the years ended December 31, 2022 and 2021.

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

## NOTE 5 — PREMISES, FURNITURE AND EQUIPMENT

Premises, furniture, and equipment owned and utilized in the operations of the Company are summarized as follows as of December 31:

| | 2022 | 2021 |
|---|---|---|
| Buildings and improvements | $ 12,022 | $ 12,022 |
| Land | 4,023 | 4,023 |
| Furniture and equipment | 4,158 | 3,538 |
| Leasehold and land improvements | 4,283 | 2,903 |
| Software | 1,010 | 888 |
| Vehicles | 19 | 19 |
| Construction in progress | 66 | 44 |
| Total | 25,581 | 23,437 |
| Less: accumulated depreciation and amortization | (6,891) | (5,787) |
| Premises, furniture and equipment, net | $ 18,690 | $ 17,650 |

Depreciation expense for the years ended December 31, 2022 and 2021 was $1,055 and $949, respectively. Software amortization expense for the years ended December 31, 2022 and 2021 was $65 and $36, respectively.

## NOTE 6 — OTHER ASSETS

Other assets consisted of the following as of December 31:

| | 2022 | 2021 |
|---|---|---|
| Derivative assets | $ 10,949 | $ 1,710 |
| Accrued interest receivable | 7,476 | 3,928 |
| Right-of-use assets | 4,657 | 2,977 |
| Prepaid expenses | 1,383 | 1,345 |
| Other | 2,662 | 1,772 |
| Total | $ 27,127 | $ 11,732 |

## NOTE 7 — OTHER REAL ESTATE OWNED

The following summarizes the activity in the other real estate owned for the years ended December 31:

| | 2022 | 2021 |
|---|---|---|
| Balance, beginning of year | $ 640 | $ 810 |
| Additions - foreclosures | - | 492 |
| Sales | (419) | (275) |
| Writedowns | (221) | (387) |
| Balance, end of year | $ - | $ 640 |

A net gain of $609 and $5 was recognized on the sale of other real estate owned for the years ended December 31, 2022 and 2021, respectively, and are included in the net loss on other real estate owned in the Consolidated Statements of Operations. Other real estate expenses for the years ended December 31, 2022 and 2021 were $145 and $103, respectively, and are included in other noninterest expense.

There were no repossessed assets at December 31, 2022 and 2021, respectively. There were no repossessed asset write-downs for the years ended December 31, 2022 and 2021.

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

There were $377 residential real estate loans in the process of foreclosure at December 31, 2022, and no residential real estate loans in the process of foreclosure at December 31, 2021.

## NOTE 8 — GOODWILL AND INTANGIBLE ASSETS

The Company's carrying amount of goodwill at December 31, 2022, and 2021 and changes to the goodwill are summarized as follows:

| | 2022 | 2021 |
|---|---|---|
| Beginning of year | $ 4,708 | $ 4,708 |
| Acquired goodwill | - | - |
| Impairment | - | - |
| End of year | $ 4,708 | $ 4,708 |

Goodwill was recognized as a result of the Company's acquisition of First Citizens Financial Corporation in 2018. As of October 1, 2022, the Company bypassed qualitative assessment and performed its annual goodwill impairment evaluation conducting a business valuation analysis using a quantitative method for determining the fair value. The Company determined the fair value of our reporting unit exceeded its carrying amount and that goodwill was not impaired. There are no events that have occurred since the last annual goodwill impairment assessment that would necessitate an interim goodwill impairment. No goodwill was recognized in conjunction with the acquisition of Cornerstone Bank in 2021.

The Company also had other intangible assets at December 31, 2022 and 2021, presented in the following table:

| | 2022 | | | 2021 | | |
|---|---|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
| Definite-lived intangible assets: | | | | | | |
| Core deposit intangibles | $ 1,850 | $ 993 | $ 857 | $ 1,850 | $ 730 | $ 1,120 |
| Commercial mortgage servicing rights | 2,652 | 1,350 | 1,302 | 2,359 | 623 | 1,736 |
| Total | $ 4,502 | $ 2,343 | $ 2,159 | $ 4,209 | $ 1,353 | $ 2,856 |

Core deposit intangibles are amortized over their estimated useful lives, which the Company determined is ten years. Amortization expense of $263 and $205 at December 31, 2022 and 2021, respectively, was recognized in other noninterest expense.

Commercial mortgage servicing rights arise from the sale of participating interests in government guaranteed loans to third parties where servicing is retained by the Company. These assets are amortized over the expected remaining life of the related loan. Amortization expense of $552 and $236 at December 31, 2022 and 2021, respectively, was recognized in other noninterest income related to these intangible assets. Impairment for the commercial mortgage servicing rights was $175 and $3 at December 31, 2022 and 2021, respectively.

The Company's estimated future amortization of intangible assets at December 31, 2022 is presented in the following table:

| | |
|---|---|
| 2023 | $ 486 |
| 2024 | 384 |
| 2025 | 329 |
| 2026 | 259 |
| 2027 | 201 |
| **Thereafter** | 500 |
| **Total expected amortization** | $ 2,159 |

Contractually specified servicing fees related to commercial mortgage servicing rights of $1,202 and $814 was recognized in other noninterest income during the years ended December 31, 2022, and 2021, respectively. The principal balance of loans serviced for third parties was $145,846 and $127,990 at December 31, 2022 and 2021, respectively.

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

A rollforward of each class of commercial mortgage servicing rights is presented as follows:

| | For the years ended December 31, | | | |
|---|---|---|---|---|
| | 2022 | | 2021 | |
| | SBA | USDA | SBA | USDA |
| Beginning carrying value, net | $ 1,207 | $ 529 | $ 541 | $ 358 |
| Amortization | (134) | (418) | (186) | (50) |
| Servicing rights originated | 192 | 101 | 292 | 221 |
| Servicing rights purchased | - | - | 563 | - |
| Servicing rights sold | - | - | - | - |
| Impairment | (125) | (50) | (3) | - |
| Ending carrying value, net | $ 1,140 | $ 162 | $ 1,207 | $ 529 |

The estimated fair value of the commercial mortgage servicing rights was $1,302 and $1,797 at December 31, 2022 and 2021, respectively.

## NOTE 9 — DEPOSITS

At December 31, 2022, the scheduled maturities of certificates of deposit were as follows:

| Maturing In | Amount |
|---|---|
| 2023 | $ 310,754 |
| 2024 | 68,199 |
| 2025 | 3,041 |
| 2026 | 1,775 |
| 2027 and thereafter | 649 |
| Total | $ 384,418 |

The Company had $75,990 and $916 in brokered deposits at December 31, 2022 and 2021, respectively. The Company also had reciprocal deposits of $60,161 and $68,802 at December 31, 2022 and 2021.

Time deposits that exceed the FDIC Insurance limit of $250 at December 31, 2022 and 2021 were $112,071 and $39,123, respectively.

**(Amounts** ***in Thousands Except Share and Per Share Amounts*****)**

## NOTE 10 — OTHER BORROWINGS

The Company had the following other borrowings at December 31, 2022 and 2021:

| | Average Interest Rate | | | Amount | |
|---|---|---|---|---|---|
| | 2022 | 2021 | Maturity Date | 2022 | 2021 |
| Federal Home Loan Bank advances: | | | | | |
| Bermudan 10-year advance with 3 month call [1] | – | 0.82% | 11/20/2029 | $ - | $ 10,000 |
| Bermudan 10-year advance with 3 month call [2] | – | 0.68% | 2/6/2030 | - | 10,000 |
| Fixed Rate Advance | 4.19% | – | 1/23/2023 | 25,000 | - |
| Fixed Rate Advance | 4.21% | – | 1/9/2023 | 20,000 | - |
| Fixed Rate Advance | 4.23% | – | 1/30/2023 | 45,444 | - |
| Fixed Rate Advance | 4.23% | – | 1/30/2023 | 17,600 | - |
| Revolving commercial line of credit | 4.89% | 3.25% | 12/10/2023 | 18,000 | 10,000 |
| Subordinated debt | 5.95% | 5.95% | 9/15/2030 | 14,634 | 14,587 |
| Total | | | | $ 140,678 | $ 44,587 |

[1] Paid-off on May 20, 2022
[2] Paid-off on May 6, 2022

The Company had pledged investment securities at December 31, 2022 and 2021, totaling $12,079 and $16,704, respectively, as collateral for the FHLB advances. The Company's FHLB stock is also pledged to secure the borrowings. In addition, the Company has pledged blanket liens on its first mortgages 1-4 family residential loans, second mortgages 1-4 family residential loans, including open-ended loans and closed-end 1-4 family residential properties, and commercial real estate loans. The aggregate balance of identified pledgable loans totaled $154,243 and $125,728 at December 31, 2022 and 2021, respectively.

On December 10, 2021, the Company ("Borrower") entered into a Loan and Security Agreement with ServisFirst Bank ("Lender"), for the Lender to extend a revolving line of credit in the maximum principal amount of $18,000 (the "Loan") and commitment. Interest on the principal balance of the Loan from time to time outstanding is payable at a per annum rate (the “Interest Rate”) equal to the greater of (i) the Prime Rate in effect from time to time; or (ii) a floor rate of three and twenty-five hundredths percent (3.25%). At December 31, 2022, the Company had $18,000 of the Loan outstanding.

The Company had pledged investment securities at December 31, 2022 and 2021, totaling $23,394 and $1,517, respectively, as collateral for federal funds purchased. The Company had pledged investment securities at December 31, 2022 and 2021 totaling $24,625 and $29,507, respectively, as collateral at the Federal Reserve Bank.

On September 9, 2020, the Company issued a private placement of $15,000 of 5.95% fixed-to-floating rate subordinated notes due 2030 (the "Notes") to certain qualified institutional buyers and institutional accredited investors (the "Private Placement"). The Notes have been structured to qualify as Tier 2 capital for regulatory capital purposes. The Notes are unsecured and have a ten-year term, maturing September 15, 2030, and bear interest at a fixed annual rate of 5.95%, payable semi-annually in arrears, for the first five years of the term. Thereafter, the interest rate will reset quarterly to an interest rate per annum equal to the then current three-month Secured Overnight Financing Rate ("Three-Month SOFR"), plus a spread of 582 basis points, payable quarterly in arrears, provided, however, that, in the event the Three-Month SOFR is less than zero, the Three-Month SOFR shall be deemed to be zero. As provided in the Notes, under specified conditions, the interest rate on the Notes during the Floating Rate Period may be determined based upon a rate other than Three-Month SOFR. The Company may redeem the Notes, in whole or in part, on any interest payment date on or after September 15, 2025, and to redeem the Notes at any time in whole upon certain other specified events. Unamortized debt issuance costs related to the subordinated debt were $366 and $413 at December 31, 2022 and 2021, respectively.

The Company incurred $940 and $945 of interest expense related to subordinated debt for the year ended December 31, 2022 and 2021, respectively.

**(Amounts** ***in Thousands Except Share and Per Share Amounts*****)**

## NOTE 11 — INCOME TAXES

Income tax expense for the years ended December 31, 2022 and 2021 is summarized as follows:

| | 2022 | 2021 |
|---|---|---|
| Current portion: | | |
| Federal | $ 3,396 | $ 3,147 |
| State | 702 | 606 |
| | 4,098 | 3,753 |
| Deferred income tax (benefit) expense | 1,544 | (609) |
| Total tax expense | $ 5,642 | $ 3,144 |

A reconciliation between the income tax expense and the amount computed by applying the Federal statutory rate of 21% to income before income taxes follows:

| | 2022 | 2021 |
|---|---|---|
| Tax at U.S. Statutory Rate | $ 5,005 | $ 3,248 |
| Increase (decrease) resulting from: | | |
| State income tax, net of federal income tax effect | 627 | 379 |
| Stock-based compensation | 88 | 92 |
| Tax exempt income | (90) | (98) |
| Bank-owned life insurance | (154) | (194) |
| Bargain purchase gain | - | (346) |
| Contingent consideration | 112 | - |
| Other items, net | 54 | 63 |
| Total tax expense | $ 5,642 | $ 3,144 |

The gross amounts of deferred tax assets and deferred tax liabilities at December 31, 2022 and 2021 are as follows:

| | 2022 | 2021 |
|---|---|---|
| **Deferred tax assets:** | | |
| Net operating loss carryforward | $ 8,472 | $ 9,007 |
| Unrealized loss on securities available for sale | 8,923 | - |
| Purchase accounting adjustments | 1,544 | 2,453 |
| Allowance for loan losses | 2,892 | 1,927 |
| Lease liability | 1,288 | 921 |
| Accrued expenses | 687 | 599 |
| Origination costs and fees | - | 442 |
| Depreciation | - | 244 |
| Stock-based compensation | 332 | 225 |
| Other real estate owned | - | 260 |
| Nonaccrual loan interest | 56 | 36 |
| Other | 16 | 28 |
| Total deferred tax asset | 24,210 | 16,142 |
| **Deferred tax liabilities:** | | |
| Lease right-of-use asset | (1,084) | (693) |
| Unrealized gain on cash flow hedges | (893) | (261) |
| Unrealized gain on securities available for sale | - | (555) |
| Origination costs and fees | (240) | - |
| Depreciation | (153) | - |
| Prepaid expenses | (4) | (72) |
| Other | (36) | (63) |
| Total deferred tax liabilities | (2,410) | (1,644) |
| Net deferred tax asset | $ 21,800 | $ 14,498 |

Deferred tax assets represent the future benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. After review of all positive and negative factors and potential tax planning strategies, as of December 31, 2022 and 2021, management has determined that a valuation allowance is not necessary. Management has determined that it is more likely than not that the remaining deferred tax asset at December 31, 2022 will be realized, and accordingly, has not established a valuation allowance.

In October 2021, the Company acquired Cornerstone Bancshares, Inc. and its wholly owned subsidiary Cornerstone Bank and recorded $3,841 in acquired deferred tax assets. These entities incurred an ownership change within the meaning of Section 382 of the Internal Revenue Code. As such, the Company's ability to benefit from the use of Cornerstone's pre-ownership change net operating loss carry forwards will be limited to $159 annually. Management only recorded a deferred tax asset for the loss carryforwards determined to be utilizable under the annual Section 382 limitations.

The Company has federal net operating losses of $35,553 and $38,065 at December 31, 2022 and 2021, respectively. These net operating losses expire at various times from 2028 through 2037. The Company's ability to benefit from the use of these net operating loss carryforwards is limited annually under Section 382 of the Internal Revenue Code. The Company has state net operating losses of $26,664 and $26,805 at December 31, 2022 and 2021, respectively. These net operating losses expire at various times from 2028 through 2038.

The Company has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions in accordance with applicable regulations. Tax returns for 2019 and subsequent years are subject to examination by taxing authorities.

## NOTE 12 — LEASES

The Company has entered into several operating leases for properties for branch banking and other banking operations. The leases have various initial terms and expire on various dates. The lease agreements generally provide that the Bank is responsible for ongoing repairs and maintenance, insurance, and real estate taxes. The leases also provide for renewal options and certain scheduled increases in monthly lease payments. The Company does not consider exercise of any of these lease renewal options reasonably certain.

Leases with an initial term of 12 months or less are not recorded on the balance sheet. For these short-term leases, lease expense is recognized on a straight-line basis over the lease term. Rental expenses recorded under short-term leases for the years ended December 31, 2022 and 2021 were $66 and $27, respectively. At December 31, 2022 and 2021, the Company had no leases classified as finance leases.

Operating lease Right-of-Use ("ROU") assets represents the Company's right to use an underlying asset during the lease term and operating lease liabilities represent its obligation to make lease payments arising from the lease. ROU assets and operating lease liabilities are recognized at lease commencement based on the present value of the remaining lease payments using a discount rate that represents the Company's incremental collateralized borrowing rate provided by the FHLB fixed-rate advances at the lease commencement date. ROU assets are further adjusted for lease incentives, if any. Operating lease expense, which is comprised of amortization of the ROU asset and the implicit interest accreted on the operating lease liability, is recognized on a straight-line basis over the lease term and is recorded in occupancy expense in the Consolidated Statements of Operations. The Company has elected as a practical expedient, an accounting policy election by class of underlying asset, not to separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component.

At December 31, 2022 and 2021, the Company had an operating lease Right-of-Use ("ROU") asset of $4,657 and $2,977 and an operating lease liability of $5,533 and $3,956, respectively. The ROU asset and operating lease liability are recorded in other assets and other liabilities, respectively, in the Consolidated Balance Sheets.

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

Rental expense recorded under long-term leases for the years ended December 31, 2022 and 2021 was $915 and $650, respectively.

The weighted-average remaining lease term and the weighted-average discount rate for operating leases were 6.15 years and 2.29%, respectively, at December 31, 2022.

A maturity analysis of the Company's operating lease liabilities and reconciliation of the undiscounted cash flows to the operating lease liability at December 31, 2022 is as follows:

| | | |
|---|---|---|
| 2023 | $ | 1,060 |
| 2024 | | 1,075 |
| 2025 | | 1,054 |
| 2026 | | 736 |
| 2027 | | 644 |
| Thereafter | | 1,767 |
| Total undiscounted cash flows | | 6,336 |
| Discount on cash flows | | (803) |
| Total lease liability | $ | 5,533 |

## NOTE 13 — OTHER NONINTEREST EXPENSE

A summary of the components of other noninterest expense is as follows for the years ended December 31:

| | | 2022 | | 2021 |
|---|---|---|---|---|
| Marketing and business development | $ | 828 | $ | 398 |
| General and administrative expense | | 791 | | 746 |
| Fair market value adjustment of contingent consideration | | 477 | | 12 |
| Other loan expense | | 415 | | 411 |
| Amortization expense | | 328 | | 241 |
| Board of directors fees | | 315 | | 265 |
| Dues, subscriptions, and licenses | | 257 | | 208 |
| SBA contingency reserve | | (2,697) | | (74) |
| Other | | 1,474 | | 845 |
| Total | $ | 2,188 | $ | 3,052 |

## NOTE 14 — RELATED PARTY TRANSACTIONS

Certain parties (principally certain directors and executive officers of the Company, their immediate families and business interests) were loan customers of and had other transactions in the normal course of business with the Company. Related party loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than the normal risk of collectability.

The following table presents a rollforward of the related party loans as of December 31, 2022 and 2021:

| | For the Years Ended December 31, | | | |
|---|---|---|---|---|
| | | 2022 | | 2021 |
| Balance, beginning of year | $ | 575 | $ | 1,756 |
| New loans | | - | | 354 |
| Less loan repayments | | (49) | | (1,535) |
| Balance, end of year | $ | 526 | $ | 575 |

**(Amounts** ***in Thousands Except Share and Per Share Amounts*****)**

At December 31, 2022 and 2021, total deposits held by related parties were $12,023 and $11,556, respectively.

## NOTE 15 — COMMITMENTS AND CONTINGENCIES

The following table presents a rollforward for the contingent consideration liability related to our recent acquisition of Cornerstone Bancshares, Inc. as at December 31, 2022 and 2021:

| | 2022 | 2021 |
|---|---|---|
| Beginning Balance | $ 413 | $ 400 |
| Change in fair value | 477 | 13 |
| Settlement | (890) | - |
| Ending Balance | $ - | $ 413 |

The Company is subject to claims and lawsuits which arise primarily in the ordinary course of business. Management is not aware of any legal proceedings which could have a material adverse effect on the financial position or operating results of the Company.

## NOTE 16 — STOCK-BASED COMPENSATION

In 2017, the stockholders of the Company approved the CoastalSouth Bancshares, Inc. 2017 Incentive Plan ("2017 Plan") to motivate, attract and retain the services of employees, officers, and directors. The 2017 Plan originally provided 627,450 shares to be available for stock-based awards, including options, stock appreciation rights, restricted stock, restricted stock units, deferred stock units, or any other right or interest related to stock or cash granted to a participant. In 2019, the number of shares available under the plan increased to 704,000, following the acquisition of First Citizens Financial Corporation ("FCFC"). In 2020, the Board of Directors approved an additional 150,943 shares to the plan, bringing the total shares available under the plan to 854,943. In 2021, the Board of Directors approved an additional 56,965 shares to the plan following the Cornerstone acquisition, bringing to the total awards to 911,908. The terms of each stock-based award are indicated in an award certificate. At December 31, 2022, there were 63,650 remaining shares available to be awarded under the 2017 Plan.

Stock-based awards are recognized over the vesting period and reflected as salaries and employee benefits within the Consolidated Statements of Operations, which was $937 and $1,181 for the years ended December 31, 2022 and 2021, respectively.

*Stock Options*

The Company's stock options vest over four years of continuous service, with a majority vesting 25% on the anniversary of the grant date and a minority vesting 100% on the fourth anniversary of the grant date. The terms of all of the options are for ten years expiring on the tenth anniversary of the grant date.

The grant date fair value of stock options is determined using the Black-Scholes model. Volatility is based on a peer group of similar community banks in the southeast United States. The risk-free rate is the treasury rate that most closely relates to the expected life on the grant date.

A summary of stock option activity for the years ended December 31, 2022 and 2021 is presented below:

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Grant Date Fair Value |
|---|---|---|---|
| Outstanding at December 31, 2020 | 696,250 | $ 12.93 | $ 4.75 |
| Granted | 44,000 | 16.37 | 8.19 |
| Exercised | - | - | - |
| Forfeited or Expired | (10,500) | 15.29 | 6.02 |
| Outstanding at December 31, 2021 | 729,750 | $ 13.11 | $ 4.94 |
| Granted | 43,000 | 16.93 | 7.83 |
| Exercised | (1,250) | 14.00 | 4.59 |
| Forfeited or Expired | (17,750) | 14.23 | 5.06 |
| Outstanding at December 31, 2022 | 753,750 | $ 13.30 | $ 5.10 |

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Award Value [(1)] |
|---|---|---|---|---|
| Outstanding at December 31, 2021 | 729,750 | $ 13.11 | | |
| Outstanding at December 31, 2022 | 753,750 | $ 13.30 | 6.08 | $ 3,543 |
| Vested & exercisable at December 31, 2021 | 470,247 | $ 13.39 | | |
| Vested & exercisable at December 31, 2022 | 539,125 | $ 13.48 | 5.41 | $ 2,437 |

[(1)] *Presented in thousands and considering a $18.00 market value at December 31, 2022.*

A summary of assumptions used in the valuation for stock options granted during the years ended December 31, 2022 and 2021 is below:

| | 2022 Black-Scholes Inputs | 2021 Black-Scholes Inputs |
|---|---|---|
| Expected dividend yield | 0.00% | 0.00% |
| Expected volatility | 39.29% - 39.66% | 42.87% - 46.51% |
| Risk-free interest rate | 1.67% - 4.15% | 0.60% - 1.32% |
| Expected life (in years) | 6.25 | 6.25 |

As of December 31, 2022 and 2021, there was $753 and $980 of total unrecognized compensation cost related to stock options granted under the 2017 Plan. As of December 31, 2022, the cost is expected to be recognized over a weighted-average period of 1.60 years.

*Restricted Stock Units*

Periodically, the Company issues restricted stock units to its directors, executive and senior officers. Compensation expense is recognized over the vesting period of the awards based upon the fair value of the stock at grant date. In 2022, the Company granted restricted stock units to members of the Board of Directors of 15,400 that vested on December 31, 2022. In 2021, the Company granted restricted stock units to members of the Board of Directors of 9,900 with a one-year vesting period. Additionally, in 2022 and 2021, 17,500 and 10,000 restricted stock units, respectively, were granted to members of management which vest over three years with 34% vesting in the first year, 33% vesting in the second year, and 33% vesting in the third year.

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

A summary of restricted stock unit activity for the years ended December 31, 2022 and 2021 is below:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---|---|---|
| Outstanding at December 31, 2020 | 27,500 | $ 13.00 |
| Granted | 19,900 | 14.84 |
| Delivered | (37,400) | 12.88 |
| Forfeited | - | - |
| Outstanding at December 31, 2021 | 10,000 | $ 17.11 |
| Granted | 32,900 | 18.11 |
| Delivered | (18,800) | 18.04 |
| Forfeited | - | - |
| Outstanding at December 31, 2022 | 24,100 | $ 17.75 |

As of December 31, 2022 and 2021, there was $305 and $139 of total unrecognized compensation cost related to nonvested restricted stock units shares granted under the 2017 Plan. As of December 31, 2022, the cost is expected to be recognized over a weighted-average period of 1.44 years. There were no restricted stock units awards that were vested but were not delivered during the year ended December 31, 2022.

## NOTE 17 — STOCK WARRANTS

In conjunction with the July 28, 2017 capital raise, the Company issued stock warrants in conjunction with the issuance of voting common stock and preferred stock. At the time of the capital raise, insufficient shares of common stock were authorized to permit classification of the warrants as equity, and $1,335 was recorded as a liability to reflect the fair value of warrants on July 28, 2017. Following the authorization of the nonvoting common stock class at the Company's shareholder meeting on September 22, 2017, the fair value of the warrants was reclassified to equity. The warrants vested immediately upon issuance and are outstanding for five years. Under the warrants, there were 385,204 shares of nonvoting common stock permitted for purchase with an exercise price of $13.00 per share. At December 31, 2021, none of the warrants had been exercised and all the warrants were considered in-the-money. As of December 31, 2022, 371,564 warrants were exercised, resulting in issuance of 284,119 shares considering net settlement, 13,640 warrants expired, and no warrants were outstanding.

## NOTE 18 — NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income by the weighted-average number of common shares outstanding. Diluted income per share is computed by dividing net income by the weighted-average number of common shares outstanding and dilutive common share equivalents using the treasury stock method. Dilutive common share equivalents include common shares issuable upon exercise of outstanding in-the-money stock warrants and options, as well as restricted stock units. Potential common shares are not included in the denominator of the diluted per share computation when inclusion would be anti-dilutive. As of December 31, 2022, and 2021, there were 82,500 and 143,034, potential common shares that were not included in the potentially dilutive stock options, restricted stock units and warrants, respectively.

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

Net income per common share were calculated as follows:

| | 2022 | 2021 |
|---|---|---|
| **Net income per share - basic computation:** | | |
| Net income available to common stockholders | $ 18,190 | $ 12,322 |
| Average common shares outstanding - basic | 8,707,535 | 8,144,215 |
| Basic net income per share | $ 2.09 | $ 1.51 |
| | | |
| **Diluted net income per share computation:** | | |
| Net income available to common stockholders | $ 18,190 | $ 12,322 |
| Average common shares outstanding - basic | 8,707,535 | 8,144,215 |
| Incremental shares from assumed conversions | | |
| Stock options | 135,058 | 83,395 |
| Restricted stock units | 10,951 | 20,012 |
| Stock warrants | - | 76,090 |
| Average common shares outstanding - diluted | 8,853,544 | 8,323,712 |
| Diluted net income per share | $ 2.05 | $ 1.48 |

## NOTE 19 — REGULATORY MATTERS

CSB is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct adverse material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, CSB must meet specific capital guidelines that involve quantitative measures of CSB's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. CSB's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum ratios (set forth in the table below) of Tier 1 Capital, Common Equity Tier 1 (CET1), and total capital as a percentage of assets and off-balance-sheet exposures, adjusted for risk-weights ranging from 0% to 150%. Tier 1 capital of the CSB consists of common stockholders' equity, excluding the unrealized gain or loss on securities available-for-sale, minus certain intangible assets, while CET1 is comprised of Tier 1 capital, adjusted for certain regulatory deductions and limitations. Tier 2 capital consists of the allowance for loan losses subject to certain limitations. Total capital for purposes of computing the capital ratios consists of the sum of Tier 1 and Tier 2 capital.

CSB is also required to maintain capital at a minimum level based on total assets, which is known as the Tier 1 leverage ratio. Only the strongest banks are allowed to maintain capital at the minimum requirement of 3%. All others are subject to maintaining ratios 1% to 2% above the minimum.

Effective March 31, 2015, quantitative measures established by applicable regulatory standards, including the newly implemented Basel III revised capital adequacy standards and relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act"), require CSB to maintain (i) a minimum ratio of Tier 1 capital to average total assets, after certain adjustments, of 4.00%, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of 6.00%, (iii) a minimum ratio of total-capital to risk-weighted assets of 8.00% and (iv) a minimum ratio of CET1 to risk-weighted assets of 4.50%. A "well-capitalized" institution must generally maintain capital ratios 2% higher than the minimum guidelines. Because the Company is a small bank holding company under the guidelines of the Federal Reserve System and is not required to report consolidated capital ratios for regulatory purposes, capital ratios are presented for CSB only.

In order to avoid restrictions on capital distributions or discretionary bonus payments to executives, CSB is required to maintain a "capital conservation buffer" in addition to its minimum risk-based capital requirements. This buffer is required to consist solely of CET1, but the buffer applies to all three risk-based measurements (CET1, Tier 1 and total capital). The capital conservation buffer consists of an additional amount of Tier 1 capital equal to 2.5% of risk-weighted assets. The capital conservation buffer in effect for the year ended December 31, 2022 was 2.77%.

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

*Prompt Corrective Action* — In July 2013, the final rules implementing Basel III capital guidelines increased regulatory capital requirements of U.S. banking organizations in a manner that more closely reflected risk exposures and brought the regulatory capital framework into compliance with Basel III. The final rules revised the level at which the Bank becomes subject to corrective action. The federal banking agencies have broad powers with which to require companies to take prompt corrective action to resolve problems of insured depository institutions that do not meet minimum capital requirements. The law establishes five capital categories for this purpose: (i) well-capitalized; (ii) adequately capitalized; (iii) undercapitalized; (iv) significantly undercapitalized; and (v) critically undercapitalized. The final rules amended the thresholds in the prompt corrective action framework to reflect the higher capital ratios required.

Even though the prompt corrective action rules apply to banks and not bank holding companies, the FRB is authorized to take actions at the holding company level. Failure to meet applicable capital standards could subject the bank holding company or the financial institution to a variety of enforcement remedies available to the federal regulatory authorities. These include limitations on the ability to pay dividends, the issuance by the regulatory authorities of a capital directive to increase capital, and the termination of deposit insurance by the FDIC. CoastalSouth Bancshares, Inc. is not subject to the provisions of prompt corrective action.

The following table summarizes the capital amounts and ratios of CSB and the regulatory minimum requirements at December 31, 2022 and 2021:

| | Actual | | For Capital Adequacy Purposes | | To Be Well-Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| **December 31, 2022** | **Amount** | **Ratio** | **Amount** | **Ratio** | **Amount** | **Ratio** |
| **Coastal States Bank** | | | | | | |
| Total capital | $ 171,848 | 10.77% | $ 127,693 | 8.00% | $ 159,617 | 10.00% |
| Tier 1 capital | 159,486 | 9.99% | 95,770 | 6.00% | 127,693 | 8.00% |
| Tier 1 leverage | 159,486 | 8.97% | 71,099 | 4.00% | 88,873 | 5.00% |
| Common Equity Tier 1 Capital | 159,486 | 9.99% | 71,827 | 4.50% | 103,751 | 6.50% |
| **December 31, 2021** | | | | | | |
| **Coastal States Bank** | | | | | | |
| Total capital | $ 139,006 | 11.63% | $ 95,650 | 8.00% | $ 119,563 | 10.00% |
| Tier 1 capital | 130,858 | 10.94% | 71,738 | 6.00% | 95,650 | 8.00% |
| Tier 1 leverage | 130,858 | 8.25% | 63,431 | 4.00% | 79,289 | 5.00% |
| Common Equity Tier 1 Capital | 130,858 | 10.94% | 53,803 | 4.50% | 77,716 | 6.50% |

The Bank's regulatory capital ratios are currently well in excess of the minimum standards and continue to be in the "well-capitalized" regulatory classification.

## NOTE 20 — LINES OF CREDIT

As of December 31, 2022, and 2021, the Company had unused lines of credit to purchase federal funds from unrelated banks totaling $55,500 and $49,325, respectively, a portion of which is secured by investment securities. These lines of credit are available on a one-day basis for general corporate purposes. The Company had no outstanding balances under these lines of credit at December 31, 2022 and 2021.

As of December 31, 2022 and 2021, the Company had an unused line of credit to borrow from the Federal Reserve Bank of Richmond discount window totaling $21,606 and $27,858, respectively, which was fully secured by investment securities. This line of credit was available on an overnight basis for general corporate purposes. As of December 31, 2022 and 2021, the Company had no outstanding balances.

CSB had the ability to borrow an additional $22,484 and $88,893 at December 31, 2022 and 2021, respectively, from the FHLB secured by a blanket lien on one-to-four family first mortgage loans, multifamily residential loans, and revolving, open-end loans, marketable securities or cash. FHLB has approved borrowings up to 20% of CSB's total assets less advances outstanding. The borrowings are available by pledging collateral and purchasing additional stock in the FHLB. All of the lines discussed above can be revoked at the lender's discretion.

The Company also has a revolving commercial line of credit with a maximum principal amount of $18,000 through ServisFirst Bank. Refer to Note 10, *Other Borrowings*, for additional information about this line of credit.

## NOTE 21 — STOCKHOLDERS' EQUITY

**Voting Common Stock —** The Company issued 18,800 and 37,400 shares of voting common stock for vested restricted stock units ("RSU's") in 2022 and 2021, respectively. On October 1, 2021, 573,682 shares of voting common stock were issued as consideration for Cornerstone Bank acquisition; in addition, 50,470 shares of voting common stock were issued as a result of a contingent consideration payment for the Cornerstone Bank acquisition. During the third quarter of 2022, 209,597 shares of voting common stock were issued as a result of warrants exercise. At December 31, 2022, there were 6,894,345 shares of $1.00 par value voting common stock outstanding.

**Nonvoting Common Stock** — During the third quarter of 2022, 74,522 shares of nonvoting common stock were issued as a result of warrants exercise. At December 31, 2022, there were 2,065,029 shares of $1.00 par value nonvoting common stock outstanding.

**Dividends** — The ability of the Company to pay cash dividends to stockholders is dependent upon receiving cash in the form of dividends from its banking subsidiary. However, certain restrictions exist regarding the ability of the subsidiary to transfer funds in the form of cash dividends to the Company. South Carolina banking regulators restrict the amount of dividends that can be paid to stockholders. All of CSB's dividends to the Company are payable only from the undivided profits of CSB. At December 31, 2022, CSB had retained earnings of $16,296.

**Accumulated Other Comprehensive Loss ("AOCL")** — Stockholders' equity as of December 31, 2022 was negatively impacted by the decline of fair value for our available-for-sale ("AFS") investment portfolio driven by the rising interest rates. The Company reviews its AFS securities portfolio quarterly for other-than temporary impairment, and none was recognized. Management believes that the decreases in value are driven by these interest rate movements and are not indicative of credit or other performance issues within the securities portfolio. The Company's AOCL as of December 31, 2022 was $26,675.

As a State chartered bank under South Carolina law, the Bank is authorized to pay cash dividends up to 100% of net income in any calendar year without obtaining the prior approval of the South Carolina State Board of Financial Institutions ("State Board") or the Commissioner of Banking provided that the Bank received a composite rating of one or two at the last examination conducted by the State or Federal regulatory authority. Otherwise, the Bank must file an income and expense report and obtain the specific approval of the State Board. Under Federal Reserve Board regulations, the amount of loans or advances from the banking subsidiary to the parent company are also restricted.

## NOTE 22 — FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

The Company 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 consist of commitments to extend credit and standby letters of credit. 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 Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit written is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. Financial instruments where contract amounts represent credit risk as of December 31, 2022 and 2021 include:

**(Amounts** ***in Thousands Except Share and Per Share Amounts*****)**

| | 2022 | 2021 |
|---|---|---|
| Commitments to extend credit | $ 445,087 | $ 295,948 |
| Letters of credit | 460 | 837 |
| Total | $ 445,547 | $ 296,785 |

Commitments to extend credit, including unused lines of 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. A commitment involves, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The Company's exposure to credit loss in the event of nonperformance by the other party to the instrument is represented by the contractual notional amount of the instrument. Since certain commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit are conditional commitments issued to guarantee a customer's performance to a third party and have essentially the same credit risk as other lending facilities. Collateral held for commitments to extend credit and letters of credit varies but may include accounts receivable, inventory, property, plant, equipment and income-producing commercial properties. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers.

The Company maintains cash deposits with a financial institution that during the year are in excess of the insured limitation of the Federal Deposit Insurance Corporation. If the financial institution were not to honor its contractual liability, the Company could incur losses. Management is of the opinion that there is not material risk because of the financial strength of the institution.

## NOTE 23 — FAIR VALUE OF FINANCIAL INSTRUMENTS

US GAAP provides a framework for measuring and disclosing fair value which requires disclosures about the fair value of assets and liabilities recognized in the balance sheet, whether the measurements are made on a recurring basis (for example, available-for-sale investment securities) or on a nonrecurring basis (for example, impaired loans).

Fair value is defined as the exchange in price that would be received for an asset or paid to transfer a liability (an 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. US GAAP also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Company utilizes fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Securities available-for-sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as loans held for sale, loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

<u>*Fair Value Hierarchy*</u>

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine the fair value. These levels are:

**Level 1** Valuation is based upon quoted prices for identical instruments traded in active markets.

**Level 2** Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

**Level 3** Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models and similar techniques.

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

***Investment Securities Available-for-Sale*** — Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

***Equity Securities —*** Equity securities are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices. There were no equity securities held at December 31, 2022 and 2021.

***Loans Held for Sale —*** Loans held for sale are comprised of loans originated for sale in the ordinary course of business. The fair value of loans originated for sale in the secondary market is based on purchase commitments or quoted prices for the same or similar loans and are classified as recurring Level 2. There were no loans held for sale requiring fair value adjustments at December 31, 2022 and 2021.

***Impaired Loans*** — The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment. The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring a specific allowance represents loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At December 31, 2022 and 2021, substantially all of the impaired loans were evaluated based upon the fair value of the collateral. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.

***OREO*** — Foreclosed assets are adjusted to fair value upon transfer of the loans to OREO. Real estate acquired in settlement of loans is recorded initially at estimated fair value of the property less estimated selling costs at the date of foreclosure. The initial recorded value may be subsequently reduced by additional allowances, which are charges to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. OREO presented as measured on a non-recurring basis includes only those properties that had changes in valuation. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral.

**(Amounts** ***in Thousands Except Share and Per Share Amounts*****)**

***Derivative Financial Instruments*** — The Company's derivative financial instruments, which are interest rate contracts, are valued using a discounted cash flow method that incorporates current market interest rates.

The table below presents the balances of assets and liabilities measured at fair value on a recurring basis by level within the hierarchy at December 31, 2022 and 2021:

| | December 31, 2022 | | | |
|---|---|---|---|---|
| | **Total** | **Level 1** | **Level 2** | **Level 3** |
| **Assets:** | | | | |
| ***Available-for-sale securities*** | | | | |
| U.S. Treasuries | $ 53,466 | $ - | $ 53,466 | $ - |
| Municipal obligations | 60,059 | - | 60,059 | - |
| Mortgage-backed securities | 152,174 | - | 152,174 | - |
| Asset-backed securities | 57,026 | - | 57,026 | - |
| Corporate debt securities | 43,395 | - | 42,895 | 500 |
| Total | $ 366,120 | $ - | $ 365,620 | $ 500 |
| ***Other*** | | | | |
| Derivative assets | $ 10,949 | $ - | $ 10,949 | $ - |
| **Liabilities:** | | | | |
| Derivative liabilities | $ (1,374) | $ - | $ (1,374) | $ - |

| | December 31, 2021 | | | |
|---|---|---|---|---|
| | **Total** | **Level 1** | **Level 2** | **Level 3** |
| **Assets:** | | | | |
| ***Available-for-sale securities*** | | | | |
| U.S. Treasuries | $ 25,854 | $ - | $ 25,854 | $ - |
| Municipal obligations | 66,674 | - | 66,674 | - |
| Mortgage-backed securities | 116,854 | - | 116,854 | - |
| Asset-backed securities | 52,702 | - | 52,702 | - |
| Corporate debt securities | 31,141 | - | 30,641 | 500 |
| Total | $ 293,225 | $ - | $ 292,725 | $ 500 |
| ***Other*** | | | | |
| Derivative assets | $ 1,710 | $ - | $ 1,710 | $ - |

Level 3 assets and liabilities measured at fair value on a recurring basis for the years ended December 31, 2022 and 2021 were $500. There were no changes in the value in either of those years.

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following table presents the assets and liabilities carried on the balance sheet by caption and by level within the valuation hierarchy (as described above) for which a nonrecurring change in fair value has been recorded during the years ended December 31, 2022 and 2021.

| | December 31, 2022 | | | |
|---|---|---|---|---|
| | **Total** | **Level 1** | **Level 2** | **Level 3** |
| Impaired loans, net | $ 5,512 | $ - | $ - | $ 5,512 |
| Total | $ 5,512 | $ - | $ - | $ 5,512 |

| | December 31, 2021 | | | |
|---|---|---|---|---|
| | **Total** | **Level 1** | **Level 2** | **Level 3** |
| Impaired loans, net | $ 2,578 | $ - | $ - | $ 2,578 |
| Total | $ 2,578 | $ - | $ - | $ 2,578 |

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

There were no liabilities measured at fair value on a nonrecurring basis at December 31, 2022 and 2021.

The following tables presents quantitative information about the unobservable inputs used in Level 3 fair value measurements at December 31, 2022 and 2021:

| Financial Instrument | Net Carrying Value | Valuation Technique | Unobservable Input | Range of Inputs |
|---|---|---|---|---|
| **December 31, 2022** | | | | |
| Impaired loans, net | $ 5,512 | Third party appraisal or broker's price opinion | Management discount for costs to sell | 0% -10% |
| **December 31, 2021** | | | | |
| Impaired loans, net | $ 2,578 | Third party appraisal or broker's price opinion | Management discount for costs to sell | 0% -10% |

### *Fair Value of Financial Instruments*

The following tables includes the estimated fair value of the Company's financial assets and financial liabilities. The methodologies for estimating the fair value of financial assets and financial liabilities measured on a recurring and nonrecurring basis are discussed above. The methodologies for estimating the fair value for other financial assets and financial liabilities are discussed below. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgement is required to interpret market data in order to develop the estimates of fair value. Accordingly, the estimates presented below are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation techniques may have a material effect on the estimated fair value amounts at December 31, 2022.

| | December 31, 2022 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Fair Value | Level 1 | Level 2 | Level 3 |
| *Financial Assets:* | | | | | |
| Cash and cash equivalents | $ 28,964 | $ 28,964 | $ 28,964 | $ - | $ - |
| Loans held for sale | 44,500 | 44,500 | - | 44,500 | |
| Loans held for investment, net | 1,286,241 | 1,252,089 | - | - | 1,252,089 |
| Non-marketable equity securities | 5,397 | 5,397 | - | - | 5,397 |
| *Financial Liabilities:* | | | | | |
| Deposits | 1,548,646 | 1,392,538 | - | 1,392,538 | - |
| Other borrowings | 140,678 | 141,907 | - | 141,907 | - |

| | December 31, 2021 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Fair Value | Level 1 | Level 2 | Level 3 |
| *Financial Assets:* | | | | | |
| Cash and cash equivalents | $ 224,359 | $ 224,359 | $ 224,359 | $ - | $ - |
| Loans held for sale | 81,453 | 81,453 | - | 81,453 | |
| Loans held for investment, net | 929,968 | 929,992 | - | - | 929,992 |
| Non-marketable equity securities | 1,529 | 1,529 | - | - | 1,529 |
| *Financial Liabilities:* | | | | | |
| Deposits | 1,424,117 | 1,359,790 | - | 1,359,790 | - |
| Other borrowings | 44,587 | 46,544 | - | 46,544 | - |

**Cash and cash equivalents —** The carrying amounts of cash and due from banks, federal funds sold and resell agreements approximates their fair values.

**Loans held for sale —** Loans held for sale are carried at the lower of cost or fair value. These loans currently consist of one-to-four family residential real estate loans originated for sale to qualified third parties. Fair value is based upon the contractual price to be received from these third parties, which may be different than cost.

**Loans held for investment, net —** Fair values are estimated for portfolios of loans with similar financial characteristics if collateral-dependent. Loans are segregated by type. The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect observable market information incorporating the credit, liquidity, yield and other risks inherent in the loan. The estimate of maturity is based upon the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of the current economic and lending conditions. Fair value for significant non-performing loans is generally based upon recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discounted rates are judgmentally determined using available market information and specific borrower information.

**Non-marketable equity securities —** Non-marketable equity securities are carried at original cost basis, as cost approximates fair value and there is no ready market for such investments.

**Deposits —** The fair value of deposits with no stated maturity date, such as noninterest-bearing demand deposits, savings and money market and checking accounts, is based on the discounted value of estimated cash flows. The fair value of time deposits is based upon the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

**Other borrowings —** The fair value of the Company's FHLB, PPPLF, line of credit and subordinated debt advances are estimated based upon the discounted value of contractual cash flows. The fair value of investment securities sold under agreements to repurchase approximates the carrying amount because of the short maturity of these borrowings. The discount rate is estimated using rates quoted for the same or similar issues or the current rates offered to the Company for debt of the same remaining maturities.

## NOTE 24 — REVENUE RECOGNITION

Accounting Standards Codification ("ASC") 606, *Revenue from Contracts with Customers* ("ASC 606"), establishes principles for reporting information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity's contracts to provide goods or services to customers. The core principle requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it expects to be entitled to receive in exchange for those goods or services recognized as performance obligations are satisfied.

The Company's sources of revenue are generated from both interest and noninterest revenue streams. The majority of our revenue-generating transactions are not subject to ASC 606. Revenue streams generated by fees and interest from financial instruments, investments, and transfers and servicing of these assets are excluded from this disclosure.

The Company has certain revenue streams within the scope of ASC 606 contained within noninterest income. The Company's contracts with customers generally do not contain terms that require significant judgement to determine the amount of revenue to recognize.

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

The table below presents the revenue streams within the scope of the standard and is followed by a description of each noninterest income revenue stream for the years ended December 31, 2022 and 2021:

| | December 31, 2022 | | |
|---|---|---|---|
| | Within Scope | Out of Scope | Total |
| Noninterest income: | | | |
| Gain on sale of government guaranteed loans | $ - | $ 1,877 | $ 1,877 |
| Income from mortgage originations | - | 1,654 | 1,654 |
| Interchange income and card fees | 1,377 | - | 1,377 |
| Service charges on deposit accounts | 783 | - | 783 |
| Bank-owned life insurance | - | 733 | 733 |
| Other noninterest income | 79 | 687 | 766 |
| Total noninterest income | $ 2,239 | $ 4,951 | $ 7,190 |

| | December 31, 2021 | | |
|---|---|---|---|
| | Within Scope | Out of Scope | Total |
| Noninterest income: | | | |
| Income from mortgage originations | $ - | $ 3,015 | $ 3,015 |
| Gain on sale of government guaranteed loans | - | 2,920 | 2,920 |
| Bargain purchase gain | - | 1,649 | 1,649 |
| Interchange income and card fees | 1,002 | - | 1,002 |
| Bank-owned life insurance | - | 931 | 931 |
| Service charges on deposit accounts | 643 | - | 643 |
| Securities loss, net | - | (59) | (59) |
| Other noninterest income | 45 | 1,050 | 1,095 |
| Total noninterest income | $ 1,690 | $ 9,506 | $ 11,196 |

***Gain on sale of government guaranteed loans —*** The Company records a gain from the sale of government guaranteed loans to third parties at the time the transfer is complete. The gain on sale is recognized as a result of the recognition of mortgage servicing rights and premiums paid by the buyer for the purchase of the loan.

***Income from mortgage originations —*** The Company earns mortgage production income which is comprised primarily of activity related to the sale of consumer mortgage loans as well as loan origination fees such as closing charges, document review fees, application fees, other loan origination fees, and loan processing fees.

***Interchange income and card fees —*** The Company earns interchange fees from debit cardholder transactions conducted through a payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are earned daily.

***Bank-owned life insurance —*** The Company's income from bank-owned life insurance primarily represents changes in the cash surrender value of such life insurance policies held on certain key employees, for which the Company is the owner and beneficiary. Revenue is recognized in each period based on the change in cash surrender value during the period.

***Service charges on deposit accounts —*** The Company earns fees from its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as ATM use fees and stop payment charges, are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges are withdrawn from the customer's account balance.

***Securities gains and loss, net —*** The Company recognizes realized gains or losses from the sale of its available-for-sale securities at the trade date and recognizes periodic mark-to-market adjustments on equity securities resulting from changes in fair value.

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

***Other noninterest income* —** Other noninterest income consists primarily of loan fees, which are out of the scope of ASC Topic 606. The items within scope of the standard primarily relate to contracts with third parties for miscellaneous referral or broker income.

***Contract assets and liabilities*** — A contract asset balance typically occurs when an entity performs a service for a customer before the customer payment of consideration, creating a contract receivable, or before payment is due, creating a contract asset. In contrast, a contract liability balance is an entity's obligation to transfer a service to a customer for which the entity has already received payment of consideration from the customer. The Company's noninterest revenue streams that are within the scope of ASC 606 are largely based on transactional activity which typically occurs at a point in time immediately after the performance obligations have been satisfied. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers. Therefore, the Company does not experience significant contract balances. As of December 31, 2022 and 2021, the Company did not have any significant contract balances.

## NOTE 25 — DERIVATIVE FINANCIAL INSTRUMENTS

The Company utilizes interest rate swaps agreements as part of its asset-liability management strategy to help mitigate its interest rate risk. The notional amount of the interest rate swaps does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual interest rate swap agreements. Derivative financial instruments are recorded in the Consolidated Balance Sheets as either an asset or a liability (in other assets or other liabilities, respectively) and measured at fair value.

The Company presents derivative position gross on the balance sheet. The following table reflects the derivatives recorded on the balance sheet as of December 31, 2022 and 2021:

| | 2022 | | 2021 | |
|---|---|---|---|---|
| | Notional Amount | Fair Value | Notional Amount | Fair Value |
| **Included in Other assets:** | | | | |
| Derivatives designated as hedges: | | | | |
| Interest rate swaps related to cash flow hedges | $ 175,000 | $ 6,698 | $ 25,000 | $ 1,087 |
| Interest rate swaps related to fair value hedges | 38,110 | 4,251 | 38,110 | 623 |
| Total included in Other assets | | $ 10,949 | | $ 1,710 |
| **Included in Other liabilities:** | | | | |
| Derivatives designated as hedges: | | | | |
| Interest rate swaps related to cash flow hedges | $ 35,000 | $ (1,374) | $ - | $ - |
| Total included in Other liabilities | | $ (1,374) | | $ - |

The Company did not have any derivatives that are not designated as hedges as of December 31, 2022 and 2021.

<u>*Fair Value Hedges*</u>

Fair value hedge interest rate swaps mature on various dates with a combined notional amount of $38,110 at December 31, 2022. The risk management objective with respect to the fair value hedges is to hedge the risk of certain corporate and municipal securities. These fair value hedges convert the fixed rates of the bonds to a 3-Month LIBOR synthetic floating rate bond. The hedges were determined to be effective during the periods presented. The Company expects these hedges to remain effective during the remaining term of the swap.

**(Amounts** ***in Thousands Except Share and Per Share Amounts*****)**

The following table presents the amounts recorded on the balance sheet related to cumulative basis adjustment for the fair value hedges as of December 31, 2022 and 2021:

| Line Item in the Balance Sheet in Which the Hedged Item is Included | Carrying Amount of the Hedged Assets (Liabilities) | | Cumulative Amount of Fair Value Hedging Adjustment Included in the Carrying Amount of the Hedged Assets (Liabilities) | |
|---|---|---|---|---|
| | 2022 | 2021 | 2022 | 2021 |
| Securities available for sale | $ 34,189 | $ 37,898 | $ (4,353) | $ (701) |

There were no discontinued hedging relationships, and therefore, the above balances do not include any adjustments on discontinued hedging relationships. As of December 31, 2022, the total notional amount of the pay-fixed/receive variable interest rate swap portfolio was $38,110.

The following table summarizes information about the non-forward starting interest rate swaps designated as fair value hedges at December 31, 2022:

| | |
|---|---|
| Notional Amount of *non-forward* starting fair value hedges | $ 12,575 |
| Weighted average fixed pay rate | 0.389% |
| Weighted average LIBOR receive rate | 1.758% |
| Weighted average maturity in years | 2.20 |

The following table summarizes information about the forward starting interest rate swaps designated as fair value hedges at December 31, 2022:

| | |
|---|---|
| Notional Amount of *forward starting* fair value hedges | $ 25,535 |
| Weighted average maturity in years | 6.99 |

The following table presents the change in fair value for derivatives designated as fair value hedges as well as the offsetting change in fair value on the hedged item for the years ended December 31, 2022 and 2021:

| | Year Ended December Gain / (Loss) | |
|---|---|---|
| | 2022 | 2021 |
| Interest rate contracts: Gain or (Loss) | | |
| Change in fair value of interest rate swaps hedging available-for-sale securities | $ 3,628 | $ 647 |
| Change in fair value of hedged available-for-sale securities | $ (3,652) | $ (725) |

The following table presents the effect of Fair Value Hedge Accounting on the Consolidated Statements of Operations and the location and amount of gain or (loss) recognized in income on Fair Value hedging relationships for the years ended December 31, 2022 and 2021:

| | Year Ended December | |
|---|---|---|
| | 2022 | 2021 |
| | Interest Income (Offset to Int Inc) | Interest Income (Offset to Int Inc) |
| Gain or (loss) on fair value hedging relationships | | |
| Interest contracts: | | |
| Change in fair value of interest rate swaps hedging available-for-sale securities | $ 3,628 | $ 647 |
| Change in fair value of hedged available-for-sale securities | $ (3,652) | $ (725) |

**(Amounts** ***in Thousands Except Share and Per Share Amounts*****)**

*Cash Flow Hedges*

A cash flow hedge interest rate collar that matures on November 2, 2025 had a notional amount of $150,000 as of December 31, 2022. The risk management objective with respect to this cash flow hedge is to hedge floating rate interest receipts based on the contractually specified SOFR rate. Initially, these receipts are made up of the interest payments received on the first of a previously unhedged $150,000 pool of customer loans indexed to SOFR for interest payments received from November 2, 2022 through November 2, 2025. The company designates this interest rate collar (the hedging instrument) as a cash flow hedge, hedging the risk of changes in its cash flows between 4.00% and 1.00% attributable to changes in the contractually specified interest rate, currently the SOFR rate, on its customer floating rate loan pool. To reduce upfront premium expense, the company is capping any benefit on its customer floating rate loan pool by selling a 6.00% cap. The combination of the purchased option and the sold option creates a collar costing $1,700. A $12,500 portion of the cash flow utilize 1-month LIBOR as their reference rate. These cash flows will transition to the SOFR rate due to the required LIBOR transition for all LIBOR variable rate instruments. This hedge designation references the optional expedients referenced under ASC 848, *Reference Rate Reform* due to the hedged cash flows currently referencing LIBOR at time of designation. This hedge was determined to be effective during the periods presented. The Company expects the hedge to remain effective during the remaining term of the option.

A cash flow hedge interest rate swap that matures on February 3, 2024 had a notional amount of $35,000 as of December 31, 2022. The risk management objective with respect to this cash flow hedge is to hedge floating rate interest receipts on the first previously unhedged $35,000 pool of floating rate assets indexed to LIBOR with a 0% floor for interest payments received from February 3, 2022 through February 3, 2024. The company designates the $35,000 interest rate swap (the hedging instrument) as a cash flow hedge, hedging the risk of changes in its cash flows attributable to changes in the contractually specified interest rate, the LIBOR rate, on its floating rate asset pool. The Company has chosen to execute a Federal Funds hedge on LIBOR assets due to the current market transition away from LIBOR. The hedge was determined to be effective during the periods presented. The Company expects the hedge to remain effective during the remaining term of the swap.

A cash flow hedge interest rate swap that matures on October 21, 2030 had a notional amount of $25,000 as of December 31, 2022. The risk management objective with respect to the cash flow hedge is to hedge the risk of variability in the Company's cash flows (future interest payments) attributable to changes in the 3-month LIBOR rate pertaining to fluctuations in market interest rates on $25,000 of FHLB, brokered Certificate of Deposits or other fixed rate advances for that period. The objective of the hedge is to offset the variability of cash flows due to the rollover of its fixed-rate 3-month FHLB or another fixed rate advance every quarter from October 31, 2022 to October 21, 2030. The hedge was determined to be effective during the periods presented. The Company expects the hedge to remain effective during the remaining term of the swap.

The tables below present the gains and (losses) recognized in AOCI and the location in the Consolidated Statements of Operations of the gains and (losses) reclassified from OCI into earnings for derivatives designated as cash flow hedges for the years ended December 31, 2022 and 2021:

| | 2022 | | |
|---|---|---|---|
| **Derivatives in Cash Flow Hedging Relationships** | **Amount of Gain (Loss) Recognized in OCI on Derivative** | **Location of Gain (Loss) Reclassified from OCI into Income** | **Amount of Gain (Loss) Reclassified from OCI into Income (pre-tax)** |
| Interest rate swap contracts | | Interest income (expense) | |
| Effective portion | $ 1,900 | Effective portion | $ (6) |
| Deferred tax | $ 632 | Amount excluded from the assessment of effectiveness and amortized into earnings | $ (95) |

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

| | 2021 | | | | |
|---|---|---|---|---|---|
| **Derivatives in Cash Flow Hedging Relationships** | **Amount of Gain (Loss) Recognized in OCI on Derivative** | | **Location of Gain (Loss) Reclassified from OCI into Income** | **Amount of Gain (Loss) Reclassified from OCI into Income (pre-tax)** | |
| Interest rate swap contracts | | | Interest income (expense) | | |
| Effective portion | $ | 825 | Effective portion | $ | - |
| Deferred tax | $ | 261 | Amount excluded from the assessment of effectiveness and amortized into earnings | $ | - |

Gains and losses on interest rate swaps related to funding liabilities are recorded in interest income/expense. To the extent these derivatives are effective in offsetting the variability of the hedged cash flows, changes in the derivatives' fair value will not be included in current earnings but are reported as a component of OCI in the Consolidated Statements of Changes in Shareholders' Equity. These changes in fair value will be included in earnings of future periods when earnings are also affected by the changes in the hedged cash flows. To the extent these derivatives are not effective, changes in their fair values are immediately included in other income or expense.

The following tables summarizes information about the interest rate swaps and option collar designated as a cash flow hedge at December 31, 2022:

| | | |
|---|---|---|
| Notional Amount - Pay Fixed Swap | $ | 25,000 |
| Weighted average fixed pay rate | | 1.059% |
| Weighted average 3-month LIBOR receive rate | | 4.358% |
| Weighted average maturity in years | | 7.81 |
| During the next twelve months, the Company estimates that will be reclassified from OCI as a decrease to interest expense | $ | 734 |
| During the next twelve months, the Company estimates that will be reclassified from Deferred Tax as a decrease to interest expense | $ | 232 |
| | | |
| Notional Amount Received Fixed Swap | $ | 35,000 |
| Weighted average fixed pay rate | | 1.14% |
| Weighted average 1-month Federal funds pay rate | | 1.88% |
| Weighted average maturity in years | | 2.84 |
| During the next twelve months, the Company estimates that will be reclassified from OCI as a decrease to interest income | $ | 962 |
| During the next twelve months, the Company estimates that will be reclassified from Deferred Tax as a decrease to interest income | $ | 304 |
| | | |
| Notional Amount Collar | $ | 150,000 |
| Floor strike | | 4.00% |
| Cap strike | | 6.00% |
| Weighted average maturity in years | | 2.84 |
| During the next twelve months, the Company estimates that will be reclassified from OCI as a decrease to interest income | $ | - |
| During the next twelve months, the Company estimates that will be reclassified from Deferred Tax as a decrease to interest income | $ | - |

**(Amounts *in Thousands Except Share and Per Share Amounts*)**

## NOTE 26 — ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following were changes in accumulated other comprehensive income (loss) by component, net of tax, for the years ended December 31, 2022 and 2021:

| | Gains and Losses on Securities Available-for-Sale | Gains and Losses on Cash Flow Hedges | Total |
|---|---|---|---|
| ***Year Ended December 31, 2022*** | | | |
| Beginning Balance | $ 1,987 | $ 826 | $ 2,813 |
| Other comprehensive income (loss) before reclassification, net of tax | (31,489) | 1,924 | (29,565) |
| Amounts reclassified from accumulated other comprehensive income, net of tax | - | 77 | 77 |
| Net current period other comprehensive income (loss) | (31,489) | 2,001 | (29,488) |
| Ending Balance | $ (29,502) | $ 2,827 | $ (26,675) |
| ***Year Ended December 31, 2021*** | | | |
| Beginning Balance | $ 2,835 | $ 1 | $ 2,836 |
| Other comprehensive income (loss) before reclassification, net of tax | (897) | 825 | (72) |
| Amounts reclassified from accumulated other comprehensive income, net of tax | 49 | - | 49 |
| Net current period other comprehensive income (loss) | (848) | 825 | (23) |
| Ending Balance | $ 1,987 | $ 826 | $ 2,813 |

The following were significant amounts reclassified out of each component of other comprehensive income (loss) for the years ended December 31, 2022 and 2021:

| Details about Accumulative Other Comprehensive Income (Loss) Components | Year Ended December 31, 2022 | Year Ended December 31, 2021 | Affected Line Item Where Net Income is Presented |
|---|---|---|---|
| Realized (gains) losses on available-for-sale securities | $ - | $ 64 | Securities loss, net |
| | - | (15) | Income tax provision (benefit) |
| | $ - | $ 49 | Net income |
| Realized (gains) losses on cash flow hedges | $ 95 | $ - | Interest Income - Loans held for investment |
| | 166 | - | Interest Income - Investments, Taxable |
| | (160) | - | Interest Expense - Other borrowings |
| | (24) | - | Income tax provision (benefit) |
| | $ 77 | $ - | Net income |

## NOTE 27 — CONDENSED FINANCIAL INFORMATION OF COASTALSOUTH BANCSHARES, INC. (PARENT COMPANY ONLY)

### Condensed Balance Sheets
### December 31, 2022 and 2021

| *(Dollars in thousands)* | 2022 | 2021 |
|---|---|---|
| **Assets** | | |
| Cash and due from banks [1] | $ 4,551 | $ 2,170 |
| Investment in bank subsidiary [1] | 145,115 | 146,861 |
| Other assets | 2,067 | 1,238 |
| Total assets | 151,733 | 150,269 |
| **Liabilities** | | |
| Other borrowings | 32,634 | 24,587 |
| Accrued expenses and other liabilities | 302 | 748 |
| Total liabilities | 32,936 | 25,335 |
| **Shareholders' equity** | | |
| Common stock | 8,959 | 8,605 |
| Capital surplus | 136,599 | 131,792 |
| Accumulated deficit | (86) | (18,276) |
| Accumulated other comprehensive (loss) income | (26,675) | 2,813 |
| Total stockholders' equity | 118,797 | 124,934 |
| Total liabilities and stockholders' equity | $ 151,733 | $ 150,269 |

[1] *Eliminated in consolidation*

### Condensed Statements of Operations
### Years Ended December 31, 2022 and 2021

| *(Dollars in thousands)* | 2022 | 2021 |
|---|---|---|
| **Income** | | |
| Other income | $ 9 | $ 6 |
| Total income | 9 | 6 |
| **Expenses** | | |
| Other borrowings | 1,453 | 964 |
| Other expenses | 540 | 78 |
| Total expenses | 1,993 | 1,042 |
| Income (loss) before taxes and equity in undistributed income of subsidiary | (1,984) | (1,036) |
| Income tax benefit | (369) | (264) |
| Income (loss) before equity in undistributed income of subsidiary | (1,615) | (772) |
| Equity in undistributed income of subsidiary [1] | 19,805 | 13,094 |
| **Net income** | $ 18,190 | $ 12,322 |

[1] *Eliminated in consolidation*

**Condensed Statements of Cash Flows**
**Years Ended December 31, 2022 and 2021**

| *(Dollars In thousands)* | 2022 | 2021 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net income | $ 18,190 | $ 12,322 |
| Adjustments to reconcile net income to net used by operating activities: | | |
| Equity in undistributed net income of subsidiary | (19,805) | (13,094) |
| Debt issuance cost amortization | 47 | 48 |
| Increase in tax receivable | (312) | (210) |
| Increase in other assets | (586) | (104) |
| Decrease in accrued expenses and other liabilities | 455 | 19 |
| Net cash used by operating activities | (2,011) | (1,019) |
| **Cash flows from investing activities** | | |
| Net sale of non-marketable equity securities | - | 163 |
| Investment in subsidiary | (7,000) | (14,500) |
| Net cash received in business combination | - | (1,590) |
| Net cash used by investing activities | (7,000) | (15,927) |
| **Cash flows from financing activities** | | |
| Proceeds from commercial line of credit | 8,000 | 10,000 |
| Issuance of common stock upon warrants exercise | 3,375 | - |
| Issuance of common stock under incentive plan | 17 | - |
| Net cash provided by financing activities | 11,392 | 10,000 |
| **Net increase (decrease) in cash and cash equivalents** | 2,381 | (6,946) |
| **Cash and cash equivalents, beginning of year** | 2,170 | 9,116 |
| **Cash and cash equivalents, end of year** | $ 4,551 | $ 2,170 |

## NOTE 28 — SUBSEQUENT EVENTS

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date.

Between March 10, 2023 and March 12, 2023, two financial institutions unrelated to the Company experienced a significant run on deposits, leading to insolvency. These institutions failed and were placed into receivership by the FDIC. These institutions also had deposit concentrations related to higher-risk customer types, such as venture capital and cryptocurrency. The Federal Reserve determined that these institutions were a systemic risk and therefore, in concert with the FDIC, have determined that all deposits held by these two institutions will be insured. These events have created market volatility for the financial sector; however, the ongoing ramifications of these events have yet to be seen. These events have not caused any significant changes in deposit balances at Coastal States Bank.

The Company evaluated subsequent events through the date its financial statements were issued, and there were no other subsequent events requiring accrual or disclosure through March 17, 2023.