Redwood Capital Bancorp

Audited Financial Statements

December 31, 2022

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Redwood Capital Bancorp

April 6, 2023

Dear Shareholders,

2022 was another record year for Redwood Capital Bancorp ("the Company") and Redwood Capital Bank ("the Bank"). As we acknowledge the Bank's sixteenth consecutive year of profitability, the Board of Directors and senior management remain encouraged by the Bank's continued success. With shareholder value and community service as core values, the Company's strong performance and financial position continues to increase our ability to serve all of our stakeholders.

On March 24, 2023, the Bank celebrated its nineteenth anniversary. Our core mission statement, "Redwood Capital Bank will deliver superior community banking services" has not changed since inception. We take great pride in our relationship-focused business model and remain honored to serve our customers and shareholders as Humboldt County's local choice for community banking.

Last year, the Bank garnered five prestigious awards for its financial performance and customer service. The Bank received the distinction of being one of California's *Super Premier Performing Banks* by *The Findley Reports* and the *5-Star* designation from Bauer Financial, Inc. These are the highest ratings available from both well-known and respected bank rating firms. Locally, readers of the *Times-Standard* voted Redwood Capital Bank as the "Best Bank" in their annual *Best of the North Coast Reader's Choice Awards*. In 2022, the Bank was named the #1 SBA Lender in Humboldt County for the 7th consecutive year. Additionally, the Bank received the Customer Service Award from the Greater Eureka Chamber of Commerce at their Annual 2023 Gala this past January. We are grateful to be recognized by these reputable organizations and these distinctions are another demonstration of our financial strength and security.

At year-end 2022, the Company's net income after taxes was $6 million, or $3.03 per common share, fully diluted. A strong balance sheet and expense control were key drivers for the Company's earnings. Total loans (excluding PPP loans) grew by 17.88%. In 2022, Loan Loss Reserves increased 6% to $6 million. Loan Loss Reserves equal 1.61% of total loans as of year-end 2022. Deposits strategically decreased 12.95% for the year, increasing the Bank's Leverage Capital Ratio to 10.62% compared to 8.57% at year-end 2021, exceeding the regulatory benchmark for well-capitalized institutions of 5.00%. The balance sheet remains very strong and is well positioned.

Maximizing shareholder wealth continues to be a top priority for the Company. In June of 2012, the Company paid its first quarterly cash dividend of $0.05 per share. As of Third Quarter 2022, the Company paid its 43rd consecutive quarterly cash dividend, which was increased from $0.07 to $0.08 per share. As of December 31, 2022, RWCB stock was trading at $18.50 per share with a book value per share of $19.54.

On behalf of our staff, senior management team and Board of Directors, thank you for the trust you have placed in us and the relationships we have developed over the past 19 years. Taking care of our shareholders and customers is paramount to how we do business every day. We look forward to seeing you in-person at our Annual Shareholder Meeting on Wednesday, May 17, 2023, at 6:00 p.m. at the Sequoia Conference Center, located at 901 Myrtle Avenue in Eureka.

Sincerely,

REDWOOD CAPITAL BANCORP

John E. Dalby
President and CEO

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INDEPENDENT AUDITOR'S REPORT

The Shareholders and
Board of Directors
Redwood Capital Bancorp and Subsidiary
Eureka, California

Opinion

We have audited the accompanying consolidated financial statements of Redwood Capital Bancorp and Subsidiary, which comprise the consolidated balance sheets as of December 31, 2022 and 2021, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity and cash flows for the years then ended, and the related notes to the financial statements.

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

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 Redwood Capital Bancorp and Subsidiary, and to meet our other ethical responsibilities in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

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

In preparing the consolidated financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about Redwood Capital Bancorp and Subsidiary's ability to continue as a going concern within one year after the date that the consolidated financial statements are available to be issued.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated 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 generally accepted auditing standards 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, including omissions, are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgement made by a reasonable user based on the financial statements.

The Shareholders and
Board of Directors
Redwood Capital Bancorp and Subsidiary

In performing an audit in accordance with generally accepted auditing standards, we:

- Exercise professional judgement 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, but not for the purpose of expressing an opinion on the effectiveness of Redwood Capital Bancorp and Subsidiary's internal control. Accordingly, no such opinion is expressed.

- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the consolidated financial statements.

- Conclude whether, in our judgement, there are conditions or events, considered in the aggregate, that raise substantial doubt about Redwood Capital Bancorp and Subsidiary's ability to continue as a going concern for a reasonable period of time.

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

Richardson & Company, LLP

March 27, 2023

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

December 31, 2022 and 2021

	2022	2021
ASSETS		
Cash and due from banks	$ 9,489,411	$ 10,913,224
Federal funds sold	12,383,000	77,668,000
Interest-bearing deposits in other financial institutions	24,022,971	85,018,930
Cash and cash equivalents	45,895,382	173,600,154
Investment securities available-for-sale, at fair value	74,203,349	67,980,742
Mortgages held for sale		480,000
Loans, net of allowance of $5,975,752 and $5,606,075 as of December 31, 2022 and 2021, respectively	373,517,277	326,235,143
Premises and equipment, net	6,658,880	6,905,198
Cash surrender value of life insurance	12,176,256	11,848,268
Mortgage servicing rights, at fair value	1,931,990	1,401,577
Accrued interest receivable and other assets	10,768,921	7,622,312
TOTAL ASSETS	$ 525,152,055	$ 596,073,394
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Deposits		
Non interest-bearing	$ 148,684,626	$ 165,276,521
Interest-bearing	322,749,983	376,279,105
Total deposits	471,434,609	541,555,626
Borrowings	11,000,000	11,000,000
Accrued interest payable and other liabilities	4,073,394	3,340,113
TOTAL LIABILITIES	486,508,003	555,895,739
Commitments and contingencies (see accompanying notes)		
SHAREHOLDERS' EQUITY		
Common stock, no par value; 30,000,000 shares authorized; 1,977,596 and 1,958,002 shares issued and outstanding in 2022 and 2021	13,846,227	13,540,971
Additional paid-in capital	291,738	290,684
Retained earnings	32,159,216	26,708,686
Accumulated other comprehensive (loss) income	(7,653,129)	(362,686)
TOTAL SHAREHOLDERS' EQUITY	38,644,052	40,177,655
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 525,152,055	$ 596,073,394

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

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2022 and 2021

	2022	2021
INTEREST INCOME		
Interest and fees on loans	$ 15,472,307	$ 16,168,975
Interest on taxable investment securities	1,401,398	848,432
Dividend income	154,697	125,853
Interest on federal funds sold	282,989	43,873
Interest on deposits in banks	961,579	109,817
Total interest income	18,272,970	17,296,950
INTEREST EXPENSE		
Interest on deposits	396,818	695,276
Interest on other borrowings	623,738	590,480
Total interest expense	1,020,556	1,285,756
NET INTEREST INCOME	17,252,414	16,011,194
Provision for loan losses	240,000	140,000
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	17,012,414	15,871,194
OTHER INCOME		
Service charges and fees on deposit accounts	1,400,590	1,183,867
Mortgage banking revenue, net	1,231,411	2,335,973
Other income	1,420,033	291,874
Total other income	4,052,034	3,811,714
OTHER EXPENSES		
Salaries and employee benefits	7,318,250	6,487,346
Occupancy and equipment	1,472,510	1,281,248
Other	3,917,830	4,213,891
Total other expenses	12,708,590	11,982,485
INCOME BEFORE PROVISION FOR INCOME TAXES	8,355,858	7,700,423
Provision for income taxes	2,334,568	2,108,330
NET INCOME	$ 6,021,290	$ 5,592,093
NET INCOME PER SHARE	$ 3.06	$ 2.87
NET INCOME PER SHARE – ASSUMING DILUTION	$ 3.03	$ 2.82

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

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Years Ended December 31, 2022 and 2021

	2022	2021
NET INCOME	$ 6,021,290	$ 5,592,093
Other comprehensive income, net of tax		
Available for sale securities		
Unrealized losses arising during the year, net of tax benefit of $(3,059,418) and $(322,676) as of 2022 and 2021, respectively	(7,290,443)	(813,674)
Total other comprehensive income	(7,290,443)	(813,674)
COMPREHENSIVE INCOME	$ (1,269,153)	$ 4,778,419

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

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the Years Ended December 31, 2022 and 2021

	Common Stock		Additional		Accumulated Other	Total
	Shares	Amount	Paid-In Capital	Retained Earnings	Comprehensive Income (Loss)	Shareholders' Equity
Balance at January 1, 2021	1,939,937	$ 13,278,722	$ 290,931	$ 21,662,163	$ 450,988	$ 35,682,804
Cash dividends on common stock ($0.28 per share)				(545,570)		(545,570)
Redemption and retirement of stock	(8,985)	(185,397)				(185,397)
Restricted stock expense			447,399			447,399
Restricted stock vested	27,050	447,646	(447,646)			
Net income				5,592,093		5,592,093
Other comprehensive loss, net of taxes					(813,674)	(813,674)
Balance at December 31, 2021	1,958,002	13,540,971	290,684	26,708,686	(362,686)	40,177,655
Cash dividends on common stock ($0.29 per share)				(570,760)		(570,760)
Redemption and retirement of stock	(7,456)	(142,390)				(142,390)
Restricted stock expense			448,700			448,700
Restricted stock vested	27,050	447,646	(447,646)			
Net income				6,021,290		6,021,290
Other comprehensive loss, net of taxes					(7,290,443)	(7,290,443)
Balance at December 31, 2022	1,977,596	$ 13,846,227	$ 291,738	$ 32,159,216	$ (7,653,129)	$ 38,644,052

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

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2022 and 2021

	2022	2021
OPERATING ACTIVITIES		
Net income	$ 6,021,290	$ 5,592,093
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	240,000	140,000
Deferred loan origination fees and costs, net	(252,395)	(404,601)
Depreciation and amortization	630,062	983,629
Gain on sale of assets	(24,529)	
Change in mortgage servicing rights carried at fair value	(530,413)	(522,478)
Stock-based compensation expense	448,700	447,399
Net change in loans held for sale	480,000	5,479,883
Earnings on cash surrender value of life insurance	(300,469)	(258,351)
Net change in accrued interest receivable and other assets	44,009	162,419
Net change in accrued interest payable and other liabilities	733,281	340,546
NET CASH PROVIDED BY OPERATING ACTIVITIES	7,489,536	11,960,539
INVESTING ACTIVITIES		
Purchase of available-for-sale investment securities	(25,696,630)	(28,585,224)
Proceeds from maturity of available-for-sale investment securities	1,150,000	2,950,000
Proceeds from paydowns on mortgage-backed securities	7,766,475	10,240,622
Purchase of Federal Home Loan Bank stock	(131,200)	(425,500)
Purchases of life insurance	(27,519)	(3,020,079)
Loan originations and payments, net	(47,269,739)	7,742,237
Proceeds from sale of premises and equipment	59,705	
Purchases of premises and equipment	(211,233)	(639,723)
NET CASH USED BY INVESTING ACTIVITIES	(64,360,141)	(11,737,667)
FINANCING ACTIVITIES		
Net (decrease) increase in deposits	(70,121,017)	93,295,893
Repurchase of common stock	(142,390)	(185,397)
Proceeds from borrowings		2,000,000
Dividends paid on common stock	(570,760)	(545,570)
NET CASH (USED) PROVIDED BY FINANCING ACTIVITIES	(70,834,167)	94,564,926
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(127,704,772)	94,787,798
Cash and cash equivalents at beginning of year	173,600,154	78,812,356
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 45,895,382	$ 173,600,154

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

For the Years Ended December 31, 2022 and 2021

	2022	2021
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for:		
Interest	$ 1,020,480	$ 1,292,590
Income taxes	2,000,000	2,915,000
SUPPLEMENTAL DISCLOSURES OF NONCASH ACTIVITIES		
Net change in unrealized gains/losses on available-for-sale investment securities	$ (10,349,861)	$ (1,136,350)
Net change in deferred income taxes on unrealized gains and losses on securities available-for-sale	3,059,418	322,676

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

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business: Redwood Capital Bancorp (the Company), formed in 2007, is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiary, Redwood Capital Bank (the Bank). The Bank was incorporated on November 3, 2003 and commenced operations on March 24, 2004. The Bank is subject to regulation, supervision, and regular examination by the California Department of Financial Protection and Innovation (DFPI) and the Federal Deposit Insurance Corporation (FDIC). The regulations of these agencies govern most aspects of the Bank's business. The financial statements of the Company are prepared in conformity with generally accepted accounting principles and general practices within the banking industry. The following is a summary of the significant accounting and reporting policies used in preparing these financial statements.

Principles of Consolidation: The consolidated financial statements include the accounts of the Company and the Bank. All material intercompany accounts and transactions have been eliminated.

Nature of Operations: The Bank provides commercial, industrial, agricultural, residential and personal credit and other banking services through its branches located in Eureka, Fortuna, and Arcata, California.

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

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral. The Company's loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on local economic conditions. While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Investment Securities: Securities are classified as held-to-maturity if the Company has both the intent and ability to hold those debt securities to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost, adjusted for amortization of premiums and accretion of discounts, computed by the interest method over their contractual lives or through the call date for investment securities at a premium.

Securities are classified as available-for-sale if the Company intends to hold those debt securities for an indefinite period of time, but not necessarily to maturity. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Securities held as available-for-sale are carried at fair value. Unrealized holding gains or losses are reported as increases or decreases in other comprehensive income as a separate component of shareholders' equity, net of the related deferred tax effect. Realized gains or losses at the trade date are determined on the basis of the cost of specific securities sold and are included in earnings.

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

Mortgages Held for Sale: Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Mortgage loans held for sale are generally sold with servicing rights retained. The carrying value of mortgage loans sold is reduced by the amount allocated to the servicing right. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold.

Loans: Loans are stated at the amount of unpaid principal, including unamortized premiums, reduced by net deferred loan fees. Premiums are recognized over the estimated life of the loan as yield adjustments. Loan origination fees, net of direct origination costs, are deferred and recognized as an adjustment of the yield on the related loan. Amortization of net deferred loan fees is discontinued when the loan is placed on nonaccrual status. Interest on loans is accrued and credited to income based on the principal amount outstanding.

Allowance for Loan Losses: The allowance is maintained at a level which, in the opinion of management, is adequate to absorb probable losses inherent in the loan portfolio. Credit losses related to off-balance-sheet instruments are included in other liabilities. Management determines the adequacy of the allowance based upon reviews of individual loans, recent loss experience, current economic conditions, the risk characteristics of the various categories of loans and other pertinent factors. The allowance is based on estimates, and ultimate losses may vary from the current estimates. These estimates are reviewed monthly and, as adjustments become necessary, they are reported in earnings in the periods in which they become known. Loans deemed uncollectible are charged to the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance.

All loans, except those to individuals, are considered impaired, based on current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Allowances on impaired loans are established based on the present value of expected future cash flows discounted at the loan's historical effective interest rate or, for collateral-dependent loans, on the fair value of the collateral. Cash receipts on impaired loans are used to reduce principal.

Income Recognition on Impaired and Nonaccrual Loans: Loans, including those considered impaired, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. If a loan or a portion of a loan is classified as doubtful or is partially charged off, the loan is classified as nonaccrual. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual if repayment in full of principal and/or interest is in doubt.

Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower, in accordance with the contractual terms of interest and principal.

While a loan is classified as nonaccrual and the future collectability of the recorded balance is doubtful, collections of interest and principal are generally applied as a reduction to the principal outstanding. When the future collectability of the recorded balance is expected, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded balance at the contractual interest rate. Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Leases: Leases are classified as operating or finance leases as of the lease commencement date. The Company leases certain bank branch buildings, as discussed in Note Q. The Company records leases on the balance sheet in the form of a lease liability for the present value of future minimum payments under the lease terms and a right-of-use asset equal to the lease liability adjusted for items such as deferred or prepaid rent, lease incentives, and an impairment of the right-of-use asset, if applicable. The discount rate used in determining the lease liability is based upon incremental borrowing rates the Company could obtain for similar loans as of the date of commencement or renewal. The Company does not record leases on the consolidated balance sheets that are classified as short term (less than one year).

At lease inception, the Company determines the lease term by considering the minimum lease term and all optional renewal periods that the Company is reasonably certain to renew. The lease term is also used to calculate straight-line rent expense. The depreciable life of leasehold improvements is limited by the estimated lease term, including renewals if they are reasonably certain to be renewed. The Company's leases do not contain residual value guarantees or material variable lease payments that will impact the Company's ability to pay dividends or cause the Company to incur additional expenses.

Operating lease expense consists of a single lease cost allocated over the remaining lease term on a straight-line basis, variable lease payments not included in the lease liability, and any impairment of the right-of-use asset. Rent expense and variable lease expense are included in occupancy and equipment expense on the Company's consolidated statements of operations. The Company's variable lease expense includes rent escalators that are based on market conditions. The amortization of the right-to-use asset arising from financing leases is expensed through occupancy and equipment expense and the interest on the related lease liability is expensed through interest expense on borrowings on the Company's consolidated statements of income. The Company does not currently have any financing leases.

Premises and Equipment: Premises and equipment are stated at cost, less accumulated depreciation and amortization. The provision for depreciation and amortization is computed principally by the straight-line method over estimated useful lives of the related assets.

Investment in Federal Home Loan Bank Stock: As a member of the Federal Home Loan Bank (FHLB) System, the Bank is required to maintain an investment in capital stock of the FHLB. The investment exceeds the minimum requirement at December 31, 2022 and 2021. The investment is stated at cost in the accompanying balance sheets and is reported as part of other assets.

Mortgage Servicing Rights: When mortgage loans are sold with servicing retained, servicing rights are initially recorded at fair value with the income statement effect recorded in mortgage banking revenue. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income.

Under the fair value measurement method, the Company measure servicing rights at fair value at each reporting date and reports changes in fair value of servicing assets in earnings in the period in which the changes occur, and are included with mortgage banking revenue, net on the income statement. The fair values of servicing rights are subjected to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses. Servicing fee income, which is reported on the income statement as mortgage banking revenue, net, is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal; or a fixed amount per loan and are recorded as income when earned.

Retirement Plans: Retirement plan expense is the net of service and interest cost and amortization of gains and losses not immediately recognized. Employee 401(k) expense is the amount of matching contributions. Retirement plan expense allocates the benefits over years of service.

Income Taxes: Provisions for income taxes are based on amounts reported in the statements of operations (after exclusion of non-taxable income such as interest on state and municipal securities) and include deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

taxes are computed using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are recognized for deductible temporary differences and tax credit carryforwards, and then a valuation allowance is established to reduce that deferred tax asset if it is "more likely than not" that the related tax benefits may not be realized.

Net Income Per Share of Common Stock: Net income per share of common stock is computed by dividing net income by the weighted average number of shares of common stock outstanding during the year, after giving retroactive effect to stock dividends and splits. Net income per share assuming dilution is computed similar to net income per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. Included in the denominator is the dilutive effect of stock options computed under the treasury method.

Advertising: Advertising costs are charged to operations in the year incurred.

Off-Balance-Sheet Financial Instruments: In the ordinary course of business the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they become payable.

Stock-Based Compensation Accounting: Compensation cost is recognized for restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. The market price of the Company's common stock at the date of grant is used as fair value for restricted stock awards.

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

Operating Segments: Reportable segments are based on products and services, geography, legal structure, management structure and any other manner in which management desegregates a company for making operating decisions and assessing performance. The Company has determined that its business is comprised of a single operating segment.

Cash and Cash Equivalents: For the purpose of presentation in the Statement of Cash Flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption "Cash and due from banks," "Federal funds sold" and "interest-bearing deposits in other financial institutions."

Subsequent events: The Company has evaluated subsequent events for recognition and disclosure through March 27, 2023, which is the date the financial statements were available to be issued.

New Pronouncements: In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326) providing guidance to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss (CECL) model. The CECL model is applicable to the measurement of credit losses on financial assets measure at amortized cost, including loan receivables and held to maturity debt securities. It also applies to off balance sheet credit exposure not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in certain leases recognized by a lessor. In addition, the amendments in this Update require credit losses be presented as an allowance rather than as a write-down on available-for-sale debt securities. The amendments in this update are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. An entity will apply the amendments in this update through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (that is, a modified-retrospective approach). The expected impact of the implementation of this Update is disclosed in Note V.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In March 2022, the FASB issued ASU No. 2022-02, Financial Instruments – Credit Losses (Topic 326), Troubled Debt Restructurings and Vintage Disclosures. This Update eliminates the recognition and measurement guidance for troubled debt restructurings ("TDRs") by creditors in ASC 310-40. This Update also enhances disclosure requirements for certain loan restructurings by creditors when a borrower is experiencing financial difficulty. Specifically, rather than applying the recognition and measurement guidance for TDRs, an entity will apply the loan refinancing and restructuring guidance to determine whether a modification or other form of restructuring results in a new loan or a continuation of an existing loan. This Update is effective for entities that have adopted ASU 2016-13 for fiscal years beginning after December 15, 2023. The Company is currently analyzing the impact of this Update.

NOTE B – RESTRICTIONS ON CASH AND DUE FROM BANKS

Cash and due from banks include amount the Bank is required to maintain to meet certain average reserve and compensating balance requirements of the Federal Reserve Bank. The Federal Reserve Bank suspended the reserve requirement due to the COVID-19 pandemic. Consequently, the Bank did not have a reserve requirement with the Federal Reserve Bank at December 31, 2022 and 2021.

NOTE C – INVESTMENT SECURITIES

The amortized cost and approximate fair value of investment securities are summarized as follows:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2022				
Securities Available-for-Sale				
U.S. Treasury Notes	$ 22,530,722		$ (2,056,698)	$ 20,474,024
U.S. government agency securities	3,999,741		(351,557)	3,648,184
Small Business Adminstration Securities	3,211,404	$ 3,058	(67,613)	3,146,849
Mortgage-backed securities	31,355,243	313	(4,623,665)	26,731,891
Municipal securities	10,853,746	616	(2,502,409)	8,351,953
Collateralized mortgage obligations	13,117,240	1,406	(1,268,198)	11,850,448
Total	$ 85,068,096	$ 5,393	$ (10,870,140)	$ 74,203,349
December 31, 2021				
Securities Available-for-Sale				
U.S. Treasury Notes	$ 9,897,254		$ (37,293)	$ 9,859,961
U.S. government agency securities	2,000,000		(15,252)	1,984,748
Small Business Adminstration Securities	4,947,816	$ 18,556	(61,987)	4,904,385
Mortgage-backed securities	31,024,595	132,007	(520,394)	30,636,208
Municipal securities	11,863,819	105,645	(122,687)	11,846,777
Collateralized mortgage obligations	8,762,144	97,031	(110,512)	8,748,663
Total	$ 68,495,628	$ 353,239	$ (868,125)	$ 67,980,742

NOTE C – INVESTMENT SECURITIES (Continued)

The maturities of investment securities at December 31, 2022 were as follows:

	Available-for-Sale	
	Amortized Cost	Fair Value
Due within one year	$ -	$ -
Due from one year to five years	28,589,451	25,994,007
Due from five years to ten years	7,284,346	6,498,370
Due after ten years	49,194,299	41,710,972
	$ 85,068,096	$ 74,203,349

The amortized cost and fair value of mortgage-backed securities and collateralized mortgage obligations are presented by contractual maturity in the preceding table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations without call or prepayment penalties.

There were no sales of investment securities available-for-sale during 2022 and 2021.

Investment securities with an amortized cost of $17,149,400 and a fair value of $15,959,068 at December 31, 2022 were pledged to secure public deposits. Investment securities with an amortized cost of $20,494,714 and a fair value of $20,984,452 at December 31, 2021 were pledged to secure public deposits.

The following table shows the investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2022 and 2021.

	2022			
	Less than 12 months		More than 12 Months	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury	$ 4,745,624	$ (172,452)	$ 15,728,399	$ (1,884,247)
Agency	1,895,705	(104,036)	1,752,479	(247,521)
Small Business Administration securities	1,094,365	(23,419)	1,064,474	(44,194)
Mortgage-backed securities	6,812,761	(612,611)	18,960,993	(4,011,053)
Municipal securities	712,336	(11,736)	7,322,053	(2,490,672)
Collateralized mortgage obligations	6,886,851	(377,962)	4,898,862	(890,237)
	$ 22,147,642	$ (1,302,216)	$ 49,727,260	$ (9,567,924)

	2021			
	Less than 12 months		More than 12 Months	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury	$ 9,859,961	$ (37,292)		
Agency	1,984,748	(15,252)		
Small Business Administration securities			$ 1,687,824	$ (61,987)
Mortgage-backed securities	17,268,024	(277,325)	7,453,709	(243,069)
Municipal securities	3,159,272	(44,810)	2,511,795	(77,878)
Collateralized mortgage obligations	4,455,296	(107,398)	495,743	(3,114)
	$ 36,727,301	$ (482,077)	$ 12,149,071	$ (386,048)

NOTE C – INVESTMENT SECURITIES (Continued)

There were three U.S treasury securities, two agency securities, five Small Business Administration securities, sixteen mortgage-backed securities, two municipal securities, and thirteen collateralized mortgage obligations that were in a continuous loss position for less than 12 months as of December 31, 2022. There were ten U.S treasury securities, two agency securities, six Small Business Administration securities, twenty nine mortgage-backed securities, seventeen municipal securities, and nine collateralized mortgage obligations that were in a continuous loss position for 12 months or more as of December 31, 2022.

There were six U.S treasury securities, two agency securities, nineteen mortgage-backed securities, five municipal securities, and five collateralized mortgage obligations that were in a continuous loss position for less than 12 months as of December 31, 2021. There were six Small Business Administration securities, ten mortgage-backed security, six municipal securities, and two collateralized mortgage obligations that were in a continuous loss position for 12 months or more as of December 31, 2021.

The unrealized losses on these securities were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investment. Because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2022 and 2021.

NOTE D – LOANS, NET

Major classifications of loans at December 31 are summarized as follows:

	2022	2021
Commercial real estate	$ 289,624,278	$ 229,232,837
Commercial loans, including unamortized purchase premiums of $1,064,797 in 2022 and $726,963 in 2021	36,235,394	50,326,618
Construction and land loans	12,118,446	13,763,066
Residential real estate	16,894,480	15,110,110
Loans to individuals	20,684,086	18,302,520
Agricultural	3,976,167	5,398,283
	379,532,851	332,133,434
Net deferred loan fees and costs	(39,822)	(292,217)
Allowance for loan losses	(5,975,752)	(5,606,075)
	$ 373,517,277	$ 326,235,142

The Company receives fees for servicing retained on loans sold. Loans being serviced by the Company for others totaled approximately $201,290,858 and $200,616,904 for the years ended December 31, 2022 and 2021, respectively.

In response to the COVID-19 crisis, the federal government created the Paycheck Protection Program (PPP), sponsored by the SBA, under the CARES Act. The Bank participated in the PPP to originate SBA loans designated to help businesses maintain their workforce and cover other working capital needs during the COVID-19 pandemic. As of December 31, 2022 and 2021, the Bank had 1 PPP loan totaling $67,300 and 92 PPP loans totaling $10,646,539, respectively, which are classified as commercial loans. There were no net deferred fees at December 31, 2022 and 2021 $299,795 of net deferred fees as of December 31, 2021 for the PPP loan-related origination fees net of costs to originate these loans. The PPP net deferred fees are a yield adjustment over the remaining term of these loans. The loans are fully guaranteed by the SBA and the maximum term of the loans is either two or five years; however, the majority of the loan balances are expected to be forgiven by the SBA, which will accelerate the recognition of these net deferred costs at the forgiveness date.

NOTE D – LOANS, NET (Continued)

The maturity and repricing of the loan portfolio is as follows at December 31:

	2022	2021
Fixed rate loan maturities		
Three months or less	$ 2,072,027	$ 1,688,194
Over three months to twelve months	2,571,494	4,292,559
Over one year to five years	12,442,711	18,359,045
Over five years to fifteen years	16,209,669	7,959,136
Over fifteen years	3,255,842	1,650,563
Floating rate loans repricing		
Quarterly or more frequently	157,771,726	122,280,476
Quarterly to annual frequency	17,189,386	17,871,596
One to five years frequency	136,117,700	116,098,250
Five to fifteen years frequency	31,482,105	40,549,192
Non-accrual loans	420,191	1,384,423
	$ 379,532,851	$ 332,133,434

NOTE E – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY

The Company's methodology for assessing the appropriateness of the allowance consists of three key elements, which include the general allowance, the specific allowance and an allowance for changing environmental factors. These various components are factored into a single allowance analysis.

General Allowance: The determination of the general allowance is based on estimates made by management, including but not limited to, consideration of historical losses by portfolio segment, peer bank losses, analysis of the economy, market rate environment, underwriting standards and other criteria as identified by the credit administrator. The portfolio segments include commercial real estate, construction, single family residential, home equity lines of credit, agricultural land, commercial, agricultural loans/lines and consumer. In addition, the Company segregates each of these segments into local and out-of-area loans. Local refers to properties located in Humboldt, Del Norte and Trinity counties, and out-of-area refers to properties located outside of the tri-county area. Peer bank loss information is used for loans that are out-of-area, unless the Company's loss history is higher. The general allowance consists of reserve factors that are based on charge-off history and management's assessment of each portfolio segment. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

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

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

Construction and Land—Construction and land loans generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as

NOTE E – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Residential Real Estate—The loans consist of single family residential loans. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Installment and other loans to individuals—The installment loan portfolio is comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for purchase of heavy equipment or industrial vehicles may also be included.

Agriculture—Loans secured by agricultural land and production are especially vulnerable to two risk factors that are largely outside the control of the Company and borrowers, commodity prices and weather conditions.

Specific Allowance: Regular credit reviews of the portfolio also identify loans that are considered potentially impaired. A loan is considered impaired when, based on current information and events, the Company determines that they will probably not be able to collect all amounts due according to the loan contract, including scheduled interest payments. When the Company identifies a loan as impaired, the Company measures the impairment using discounted cash flows, except when the sole remaining source of repayment for the loans is the liquidation of the collateral. In these cases, the Company uses the current fair value of the collateral, less selling costs. If the Company determines that the value of the impaired loan is less than the recorded investment in the loan, the Company either recognizes an impairment reserve as a specific allowance to be provided for in the allowance or charges-off the impaired balance on collateral dependent loans if it is determined that such amount represents a confirmed loss. Loans determined to be impaired with a specific allowance are excluded from the general allowance so as not to double-count the loss exposure.

Qualitative factors: This component of the allowance is management's best estimate of the probable impact that various qualitative factors may have on the loan portfolio. It is not allocated to specific loans or groups of loans, but rather is intended to absorb losses caused by several factors, including changes in the nature and volume of the portfolio, changes in the terms of loans, changes in lending policies and procedures, underwriting collection practices, changes in international, national, regional, and local economic and business conditions, changes in the experience and ability of lending management and staff, changes in the volume and severity of past due loans, changes in the volume of non-accrual loans, changes in the volume and severity of adversely classified or graded loans, changes in the quality of the Company's loan review system, changes in the value of underlying collateral, the existence and effect of any concentrations of credit, changes in the level of concentrations of credit and the effect of other external factors such as competition and legal and regulatory requirements.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. The Board of Directors review the adequacy of the allowance quarterly, including consideration of current economic conditions, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, or past loan experience and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's primary regulators, the FDIC and the DFPI, review the adequacy of the allowance as an integral part of their examination process. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

The following table summarizes activity related to the allowance for loan losses by loan portfolio segment and the allocation of the allowance for loan losses by loan portfolio segment and by impairment methodology for the years ended December 31, 2022 and 2021:

NOTE E – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

`	Commercial Real Estate	Commercial	Construction and Land	Residential Real Estate	Individual	Agriculture	Unallocated	Total
2022								
Allowance for credit losses:								
Beginning balance	$ 3,533,110	$ 767,196	$ 209,700	$ 230,224	$ 278,864	$ 91,697	$ 495,284	$ 5,606,075
Charge-offs	(2,690)	(125,500)	(3,778)	(58,897)				(190,865)
Recoveries	180,919	139,623						320,542
Provision	382,447	(268,780)	(34,629)	75,354	13,502	(32,446)	104,552	240,000
Ending balance	$ 4,093,786	$ 512,539	$ 171,293	$ 246,681	$ 292,366	$ 59,251	$ 599,836	$ 5,975,752
Ending balance:								
Individually evaluated for impairment								
Collectively evaluated for impairment	$ 4,093,786	$ 512,539	$ 171,293	$ 246,681	$ 292,366	$ 59,251	$ 599,836	$ 5,975,752
Total allowance	$ 4,093,786	$ 512,539	$ 171,293	$ 246,681	$ 292,366	$ 59,251	$ 599,836	$ 5,975,752
Ending balance:								
Individually evaluated for impairment	$ 291,728							$ 291,728
Collectively evaluated for impairment	289,332,550	$ 36,235,394	$ 12,118,446	$ 16,894,480	$ 20,684,086	$ 3,976,167		379,241,123
Total loans	$ 289,624,278	$ 36,235,394	$ 12,118,446	$ 16,894,480	$ 20,684,086	$ 3,976,167		$ 379,532,851

	Commercial Real Estate	Commercial	Construction and Land	Residential Real Estate	Individual	Agriculture	Unallocated	Total
2021								
Allowance for credit losses:								
Beginning balance	$ 3,337,122	$ 724,442	$ 145,757	$ 340,128	$ 293,120	$ 105,752	$ 499,564	$ 5,445,885
Charge-offs								
Recoveries		11,049			9,141			20,190
Provision	195,988	31,705	63,943	(109,904)	(23,397)	(14,055)	(4,280)	140,000
Ending balance	$ 3,533,110	$ 767,196	$ 209,700	$ 230,224	$ 278,864	$ 91,697	$ 495,284	$ 5,606,075
Ending balance:								
Individually evaluated for impairment								
Collectively evaluated for impairment	$ 3,533,110	$ 767,196	$ 209,700	$ 230,224	$ 278,864	$ 91,697	$ 495,284	$ 5,606,075
Total allowance	$ 3,533,110	$ 767,196	$ 209,700	$ 230,224	$ 278,864	$ 91,697	$ 495,284	$ 5,606,075
Ending balance:								
Individually evaluated for impairment	$ 303,672	$ 38						$ 303,710
Collectively evaluated for impairment	228,929,165	50,326,580	$ 13,763,066	$ 15,110,110	$ 18,302,520	$ 5,398,283		331,829,724
Total loans	$ 229,232,837	$ 50,326,618	$ 13,763,066	$ 15,110,110	$ 18,302,520	$ 5,398,283		$ 332,133,434

Credit Quality of Loans

The Company assigns a risk rating to loans over a certain threshold and periodically performs detailed reviews of all such loans to identify credit risks and to assess the overall collectability of the portfolio. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. These risk ratings can be grouped into the following major categories, defined as follows:

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

NOTE E – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

Watch List: A watch list loan has significant weaknesses resulting from performance trends or management concerns.

Special Mention: A special mention loan is currently protected, but is weak due to negative trends in the financial statements of the borrower and current cash flow problems, among other criteria. Special mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard: A substandard loan has well-defined weaknesses where a payment default and/or a loss is possible, but not yet probable. Cash flow is insufficient to service the debt, with prospects that the condition is permanent. Loans classified as substandard are inadequately protected by the current net worth and repayment capacity of the borrower and there is a likelihood that collateral will have to be liquidated and/or guarantor called upon to repay the debt.

Doubtful: Loans classified as doubtful have characteristics of those classified as substandard but available information suggests it is unlikely that the loan will be repaid in its entirety. Cash flow is insufficient to service the debt. If the current material adverse trends continue, it is unlikely the borrower will have the ability to meet the terms of the loan agreement. It may be difficult to project the exact amount of loss, but the probability of some loss is greater than 50%.

Loss: Loans classified as loss have characteristics those classified as of doubtful but the loan will not be repaid in full. Debt service coverage clearly reflects the borrower's inability to service the debt. The borrower cannot generate sufficient cash flow to cover fixed charges. All near-term and long-term trends concerning cash flow and earnings are negative. Collateral and guarantees provide no support.

The following table shows the loan portfolio allocated by management's internal risk ratings at December 31, 2022 and 2021:

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Total
2022							
Grade:							
Pass	$ 286,450,673	$ 34,223,658	$ 10,764,934	$ 16,284,631	$ 20,684,086	$ 3,976,167	$ 372,384,149
Watch	1,035,873	784,377	1,353,512	68,335			3,242,097
Special Mention	470,630	781,061		163,681			1,415,372
Substandard	1,667,102	446,298		377,834			2,491,233
Total	$ 289,624,278	$ 36,235,394	$ 12,118,446	$ 16,894,480	$ 20,684,086	$ 3,976,167	$ 379,532,851

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Total
2021							
Grade:							
Pass	$ 226,402,486	$ 44,655,303	$ 13,763,066	$ 14,621,237	$ 18,126,396	$ 5,398,283	$ 322,966,771
Watch	866,508	604,775		70,804			1,542,087
Special Mention	1,099,107	908,122					2,007,229
Substandard	864,737	4,158,418		418,069	176,124		5,617,348
Total	$ 229,232,838	$ 50,326,618	$ 13,763,066	$ 15,110,110	$ 18,302,520	$ 5,398,283	$ 332,133,434

The following table summarizes the Company's past due loans and non-accrual loans by loan portfolio segment as of December 31, 2022 and 2021:

NOTE E – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
2022							
Commercial real estate						$ 289,624,278	$ 289,624,278
Commercial	$ 21,556			$ 21,556		36,213,838	36,235,394
Construction and land						12,118,446	12,118,446
Residential	68,335	$ 163,681		232,016	$ 420,191	16,242,274	16,894,480
Individual						20,684,086	20,684,086
Agriculture						3,976,167	3,976,167
Total	$ 89,891	$ 163,681		$ 253,572	$ 420,191	$ 378,859,089	$ 379,532,851

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
2021							
Commercial real estate						$ 229,232,837	$ 229,232,837
Commercial	$ 600			$ 600	$ 731,622	49,594,396	50,326,618
Construction and land						13,763,066	13,763,066
Residential	268,822			268,822	652,801	14,188,487	15,110,110
Individual						18,302,520	18,302,520
Agriculture						5,398,283	5,398,283
Total	$ 269,422			$ 269,422	$ 1,384,423	$ 330,479,590	$ 332,133,434

There were no accruing loans past due 90 days or more at December 31, 2022 and 2021.

The following table shows information related to impaired loans by loan portfolio segment as of December 31, 2022 and 2021:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
2022					
With no related allowance recorded:					
Commercial real estate	$ 291,728	$ 291,728		$ 297,700	$ 17,988
Commercial				19	521
Total:					
Commercial real estate	291,728	291,728		297,700	17,988
Commercial				19	521
Total	$ 291,728	$ 291,728		$ 297,719	$ 18,509

NOTE E – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
2021					
With no related allowance recorded:					
Commercial real estate	$ 303,672	$ 303,672		$ 309,313	$ 18,650
Commercial	38	38		487	521
Total:					
Commercial real estate	303,672	303,672		309,313	18,650
Commercial	38	38		487	521
Total	$ 303,710	$ 303,710		$ 309,800	$ 19,171

The Company revised its policy for defining impaired loans during the year ended December 31, 2022 that resulted in fewer loans meeting the definition of impairment. The Company had no commitments to loan additional funds to borrowers of impaired or nonaccrual loans at December 31, 2022 and 2021.

Troubled Debt Restructurings

The terms of certain loans have been modified in troubled debt restructurings. The modification of the terms of such loans included one or more of a combination of the following: a reduction of the stated interest rate of the loan at a stated rate of interest lower than the current market rate for new debt with similar risk; and extension of the maturity date; or a permanent reduction of the recorded investment in the loan. At December 31, 2022 and 2021, the Company had $291,728 and $303,710, respectively, of loans to borrowers whose loan terms were modified in troubled debt restructurings. The Company allocated no specific reserves to these troubled debt restructurings as of December 31, 2022 and 2021, respectively. The Company has not committed to lend additional amounts as of December 31, 2022 and 2021 to borrowers with outstanding loans that are classified as troubled debt restructurings.

There were no loans modified as troubled debt restructurings or restructurings for which there was a default (defined as 90 or more days past due based on restructured terms) within twelve months of the modification date during the years ended December 31, 2022 and 2021.

Additionally, the Company is working with borrowers impacted by COVID-19 and providing modifications to include principal only deferral or principal and interest deferral for 90 days with the possibility of extension for an additional 90 days. These modifications are excluded from the troubled debt restructuring classification under Section 4013 of the CARES Act or under applicable interagency guidance of the federal bank regulators. During 2020, the Company modified 101 commercial loans and 5 consumer loans with outstanding balances of $54,696,197 and $671,796, respectively. All modified loans were performing under the modified terms as of December 31, 2022 and 2021.

NOTE F – PREMISES AND EQUIPMENT

Premises and equipment consisted of the following at December 31:

	2022	2021
Land	$ 894,920	$ 894,920
Building and improvements	8,687,434	8,600,626
Furniture, fixtures and equipment	2,631,146	2,819,436
	12,213,500	12,314,982
Less: Accumulated depreciation	(5,554,620)	(5,409,784)
	$ 6,658,880	$ 6,905,198

Depreciation and amortization included in occupancy expense totaled $443,443 and $468,318 in 2022 and 2021, respectively.

NOTE G – MORTGAGE SERVICING RIGHTS

The following table presents the changes in the Bank's mortgage servicing rights for the years ended December 31:

	2022	2021
Fair value, beginning of year	$ 1,401,577	$ 879,099
Additions for new mortgage servicing rights capitalized	6,469	222,048
Change in fair value due to changes in model inputs and assumptions	523,944	300,430
Fair value, end of year	$ 1,931,990	$ 1,401,577
Balance of mortgage loans serviced for others	$ 201,290,858	$ 200,616,904
Mortgage servicing rights as a percentage of serviced loans	0.96%	0.70%

The amounts of contractually specified servicing fees, late fees and ancillary fees earned, recorded in mortgage banking revenue on the consolidated statements of operations, were $501,674 and $461,766 for the years ended December 31, 2022 and 2021, respectively. Changes in fair value are also included in mortgage banking revenue on the consolidated statements of operations.

The fair value of mortgage servicing rights is determined using a discounted cash flow model. In order to determine the fair value of the mortgage servicing rights, the present value of expected future cash flows is estimated. Assumptions used include market discount rates, anticipated prepayment speeds, delinquency and foreclosure rates, and ancillary fee income. Key assumptions used in measuring the fair value of mortgage servicing rights as of December 31, 2022 and 2021 include a discount rate of 9.50% for both years. A proprietary market implied prepayment model is used by the independent valuation group.

The expected life of the loans can vary from management's estimates due to prepayments by borrowers, especially when rates fall. Prepayments in excess of management's estimates would negatively impact the recorded value of the mortgage servicing rights. The value of the mortgage servicing rights is also dependent upon the discount rate used in the model, which is based on current market rates. A significant increase in the discount rate would reduce the value of mortgage servicing rights. The sensitivities surrounding mortgage servicing rights are expected to have an immaterial impact on fair value.

NOTE H – INTEREST-BEARING DEPOSITS

Interest-bearing deposits consisted of the following at December 31:

	2022	2021
Negotiable order of withdrawal (NOW)	$ 146,907,040	$ 160,693,899
Savings and money markets	154,926,869	177,055,851
Time	20,916,074	38,529,355
	$ 322,749,983	$ 376,279,105

Interest expense on these deposits for the years ended December 31 is as follows:

	2022	2021
Negotiable order of withdrawal (NOW)	$ 47,310	$ 45,192
Savings and money markets	85,343	55,192
Time	264,165	594,892
	$ 396,818	$ 695,276

The maturities of time deposits at December 31 are as follows:

	2022	2021
Three months or less	$ 7,475,714	$ 7,550,073
Over three months through twelve months	9,234,934	24,583,157
Over one year through three years	3,941,370	6,157,613
Over three years	264,056	238,512
	$ 20,916,074	$ 38,529,355

Time deposits that meet or exceed the FDIC insurance limit of $250,000 at December 31, 2022 and 2021 were $4,376,245 and $17,761,967, respectively.

In addition to the Company's on-balance sheet deposits, the Company belongs to special networks that offer reciprocal deposit products to its customers. As of December 31, 2022 and 2021 these deposits total $125,738,450 and $107,561,099, respectively. These products provide the Company's customers a safe and convenient way to safeguard their funds in increments below the standard FDIC insurance maximum of $250,000 so that both principal and interest are eligible for FDIC insurance. Although these deposits are not reflected on the balance sheet, the Bank maintains the client relationship and the funds remain available to the Bank if needed.

NOTE I – LENDING AGREEMENTS

The Company has federal funds line of credit agreements with other banks. The maximum borrowings available under these lines amount to $31,500,000 and $21,500,000 at December 31, 2022 and 2021, respectively. There were no borrowings outstanding under these agreements at December 31, 2022 and 2021.

The Company has an agreement to borrow from the Federal Home Loan Bank to the extent of pledged assets, up to 25% of total assets as of December 31, 2022 and 2021. Assets pledged under the agreement at December 31, 2022 totaled $525,073,859, resulting in a limit on borrowings of $131,268,465. Assets pledged under the agreement at December 31, 2021 totaled $595,995,145, resulting in a limit on borrowings of $148,998,786. The Company also maintains a letter of credit with the Federal Home Loan Bank of $8,000,000, as of December 31, 2022 and 2021,

NOTE I – LENDING AGREEMENTS (Continued)

which serves as collateral for public and other deposits and is collateralized by a portion of the loans discussed above, that expires on April 13, 2022. No amounts were outstanding under this agreement as of December 31, 2022 and 2021.

The Company has an agreement to borrow from the Federal Reserve Bank by obtaining advances or discounting eligible paper to the extent of pledged collateral. Promissory notes and deeds of trust on the Bank's loans totaling $3,845,641 and $4,290,365 for 2022 and 2021, respectively, were held by the Federal Reserve Bank as collateral. There were no borrowings outstanding under this agreement at December 31, 2022 and 2021.

In September 2019, the Company obtained a $9 million unsecured, subordinate loan from a commercial bank which was used to pay off the remaining balance of the loan received to finance the redemption of Series C Preferred Stock issued to the U.S. Treasury. The Company obtained a $2 million principal increase in March 2021 under the same terms as the original loan, bringing the loan balance to $11 million. The principal is due September 25, 2029 and interest is due quarterly. The interest rate will be fixed at 5.25% until September 2024 and will then be reset quarterly based on the Three-Month term SOFR rate for US dollars plus 312 basis points. A different benchmark rate may be substituted if the SOFR rate is not available.

NOTE J – OTHER EXPENSES

Other expenses consisted of the following for the years ended December 31:

	2022	2021
Data processing	$ 1,069,702	$ 1,076,453
Professional fees	348,596	704,122
Marketing and promotion	501,519	484,720
Director and shareholder	428,764	430,144
Loan and collection expense	302,169	304,372
Insurance expense	278,738	300,953
Operating expense	329,518	273,670
Miscellaneous employee expense	203,259	155,248
Telephone expense	114,771	108,809
Postage and delivery	96,161	101,133
Stationery and forms	100,687	100,297
Operational losses	58,879	88,767
Dues and memberships	45,130	39,106
Security expense	27,192	21,883
Fees on borrowing agreements		20,000
Subscriptions	1,513	1,879
Other non-interest expense	11,232	2,335
	$ 3,917,830	$ 4,213,891

NOTE K – RETIREMENT PLANS

The Company has a defined contribution retirement plan covering substantially all of the Company's employees. Employees may elect to have a portion of their compensation contributed to the plan in conformity with the requirements of Section 401(k) of the Internal Revenue Code. The Company will make contributions equal to 100% of the effective deferral made by the employees, up to a maximum of 4% of the employees' eligible earnings. Salaries and employee benefits expense includes the Company's contributions to the plan of $192,000 and $191,000 during 2022 and 2021, respectively.

NOTE K – RETIREMENT PLANS (Continued)

The Company has single premium life insurance policies in connection with the retirement plans for thirteen key officers. The policies provide protection against the adverse financial effects from the death of key officers and to provide income to offset expenses associated with the plan. The officers are insured under the policies, but the Company is the primary owner and beneficiary. At December 31, 2022 and 2021, the cash surrender value of these policies totaled $12,176,256 and $11,848,268, respectively.

The Company has a deferred compensation plan that is unfunded, which allows the Directors to defer a portion of current compensation in exchange for the Company's commitment to pay a deferred benefit at retirement. If death occurs prior to or during retirement, the Company will pay the Director's beneficiary or estate the benefits set forth in the plan. Deferred compensation is vested as to the amounts deferred. At December 31, 2022 and 2021, the liability recorded for the deferred compensation plan totaled $501,431 and $444,480, respectively.

The Company has unfunded noncontributory defined benefit retirement plans that cover certain officers. The plan provides defined benefits that are typically a fixed amount over a ten-year period after retirement. The officers typically need to work ten years, or until the age of 65, from the plan date to be fully vested. The Company uses December 31 as the measurement date for its pension plans.

The ending benefit obligation was $1,658,544 and $1,355,399 at December 31, 2022 and 2021, respectively. There were no employer contributions or benefits paid for 2022 and 2021. The plan is unfunded so there were no plan assets at December 31, 2022 and 2021.

The weighted average discount rate assumptions used to determine the retirement benefit obligations for the years ended December 31, 2022 and 2021 were 5.27% and 5.33%, respectively. The weighted average discount rate assumptions used to determine the net periodic retirement cost for the years ended December 31, 2022 and 2021 was 4.97%.

The Company expects to have no contribution to its retirement plan in 2022 or 2021. Benefit payments, which reflect expected future service, are expected to be $20,833 in 2025, $50,000 in 2026, $50,000 in 2027, $134,040 in 2028 and $1,980,847 in the following five years.

NOTE L – INCOME TAXES

The provision for income taxes was comprised of the following at December 31:

	2022	2021
Current		
Federal	$ 1,573,040	$ 1,328,574
State	1,044,818	799,886
	2,617,858	2,128,460
Deferred		
Federal	(109,404)	(21,944)
State	(173,886)	1,814
	(283,290)	(20,130)
Provision for income taxes	$ 2,334,568	$ 2,108,330

The following is a reconciliation of income taxes computed at the Federal statutory rate of 21% in 2022 and 2021 to the effective rate used for the provision for income taxes for the years ended December 31:

NOTE L – INCOME TAXES (Continued)

	2022	2021
Income benefit at the Federal statutory rate	$ 1,754,730	$ 1,617,090
State franchise tax benefit, less Federal income tax effect	687,165	659,434
Earnings on cash surrender value of life insurance	(63,098)	(76,378)
Tax exempt municipal securities	(47,610)	(53,958)
Vesting of restricted stock grants	(14,492)	(40,394)
Nondeductible expenses and other	17,873	2,536
Net provision for income taxes	$ 2,334,568	$ 2,108,330

The tax effects of temporary differences that give rise to the components of the net deferred tax assets as of December 31 were as follows:

	2022	2021
Deferred tax assets:		
Available-for-sale securities	$ 3,212,011	$ 152,201
Allowance for loan losses	1,533,192	1,181,879
Salary continuation accrual	490,325	400,705
Depreciation	205,795	145,426
State taxes	199,381	171,450
Deferred compensation	148,241	131,523
Non-qualified restricted stock	77,467	77,156
Lease liability	76,072	
Accrued vacation	69,885	66,928
Allowance for loan commitments		35,476
Non-accrual interest		7,007
Other	37,903	6,241
Total deferred tax assets	6,050,272	2,375,992
Deferred tax liabilities:		
Federal Home Loan Bank dividends	(17,933)	(17,916)
Right of use asset	(174,371)	
Mortgage servicing rights	(571,166)	(414,357)
Total deferred tax liabilities	(763,470)	(432,273)
Net deferred tax assets	$ 5,286,802	$ 1,943,719

Amounts presented for the tax effects of temporary differences are based upon estimates and assumptions and could vary from amounts ultimately reflected on the Company's tax returns. Accordingly, the variances from amounts reported in prior years are primarily adjustments to conform to the tax returns as filed. As of December 31, 2022 and 2021, the Company had income taxes receivable of $529,148 and $856,748, respectively.

The Company and its subsidiary file an income tax return in the U.S. federal jurisdiction and a franchise tax return in the State of California jurisdiction. The Company is no longer subject to U.S. federal income tax examinations and State franchise tax examinations by taxing authorities for years prior to 2019 and 2018, respectively.

There have been no adjustments identified for unrecognized tax benefits requiring an adjustment to the income statement. The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. The Company has recognized no interest or penalties since this pronouncement was implemented.

NOTE M– EARNINGS PER SHARE

The following is a computation of basic and diluted earnings per share for the years ended December 31, 2022 and 2021.

	2022	2021
Basic:		
Net income	$ 6,021,290	$ 5,592,093
Weighted-average common shares outstanding	1,967,933	1,948,455
Earnings per share	$ 3.06	$ 2.87
Diluted:		
Net income	$ 6,021,290	$ 5,592,093
Weighted-average common shares outstanding	1,967,933	1,948,455
Net effect of dilutive securities - based on the Treasury stock method using average market price		
Dilutive restricted stock	20,358	31,587
Weighted-average common shares outstanding and common stock equivalents	1,988,291	1,980,042
Earnings per share - assuming dilution	$ 3.03	$ 2.82

NOTE N – RESTRICTED STOCK GRANT PLAN

The Company has a restricted stock grant plan established in 2019 under which restricted stock may be granted. The Company's Restricted Stock Grant Plan provides for the granting of a maximum of 200,000 shares of the Company's authorized but unissued common stock to directors or officers through June 19, 2024 unless terminated earlier by the Board of Directors. The terms of the grants are set by the Board of Directors. Grants vest equally each year over the life of the grant from the date the restricted stock is granted. Generally, if a grantee's continuous status as a director or officer is terminated for various reasons, the non-vested grants expire. The Board of Directors have established a policy for the acceleration of the lessor of two years of vesting or the current unvested shares if certain conditions are met and Board of Director approval is obtained. The Bank estimates the number of awards that are expected to vest when determining the compensation costs. A summary of restricted stock activity follows for the years ended December 31:

	Restricted Stock					
	2022			2021		
	Shares	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value	Shares	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested at beginning of year	79,150	$ 16.54		108,200	$ 16.55	
Granted	2,000	19.10				
Shares vested and issued	(27,050)	16.55		(27,050)	16.55	
Forfeited				(2,000)	16.71	
Nonvested at end of year	54,100	16.64	$ 1,000,850	79,150	16.54	$ 1,642,363

NOTE N – RESTRICTED STOCK GRANT PLAN (Continued)

As of December 31, 2022 and 2021, there was $659,254 and $1,057,413 of total unrecognized compensation cost related to non-vested restricted stock. That cost is expected to be recognized over a weighted-average period of 1.47 and 2.47 years, respectively.

Total compensation cost for all share-based payments recognized in net income for 2022 and 2021 totaled $448,700 and $447,398, respectively. A tax benefit of $132,652 and $132,267 was recognized during 2022 and 2021, respectively, related to this compensation cost.

NOTE O – RELATED PARTY TRANSACTIONS

During the normal course of business, the Company has entered into transactions with its directors, executive officers, significant shareholders and their affiliates (related parties). The aggregate amount of loans to such related parties totaled $11,332,283 and $11,353,806 at December 31, 2022 and 2021, respectively. At December 31, 2022 and 2021, commitments to related parties of $3,508,641 and $3,808,900, respectively, were undisbursed. The Company has received deposits from directors and officers and their related interests totaling $5,584,941 and $3,935,075 at December 31, 2022 and 2021, respectively.

NOTE P – CONTINGENT LIABILITIES AND COMMITMENTS

Financial Instruments with Off-Balance-Sheet Risk: The Company's financial statements do not reflect various commitments and contingent liabilities which arise in the normal course of business and which involve elements of credit risk, interest rate risk and liquidity risk. These commitments and contingent liabilities are commitments to extend credit, standby letters of credit and credit card arrangements. A summary of the Company's commitments and contingent liabilities at December 31, 2022 and 2021 are as follows:

	Contractual Amounts	
	2022	2021
Commitments to extend credit	$ 79,482,120	$ 81,120,981
Standby letters of credit	252,255	242,255

Commitments to extend credit, standby letters of credit and credit card arrangements include exposure to some credit loss in the event of nonperformance of the customer. The Company's credit policies and procedures for credit commitments and financial guarantees are the same as those for extension of credit that are recorded on the balance sheet. Because most of these instruments have fixed maturity dates, and because many of them expire without being drawn upon, they do not generally present any significant liquidity risk to the Company. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, deeds of trust on residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending facilities to customers.

The Company did not incur any losses on its commitments in 2022 and 2021.

NOTE Q –LEASES

Lease arrangement: On February 1, 2014, the Company entered into an agreement with Humboldt State University (University) for the transfer of a Company-owned building to the University in exchange for a reduced lease rate on a building owned by the University that the Company is leasing from the University. The initial term of the lease will be five years with an option to extend the lease for seven periods of five years. The lease will be extended automatically the first five periods unless the Bank elects to decline the lease option. The monthly rental rate is $5,840 per month, but the rent is reduced by $3,327 per month for the first twenty years of the lease as consideration for the transfer of the Bank building valued at $505,000 and the Bank paying for $95,000 of renovation costs at the Bank-owned building. The lease does not include residual value guarantees or covenants.

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

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

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

Right-of-use assets and lease liabilities by lease type, and the associated balance sheet classifications, are as follows for the years ended December 31:

	Balance Sheet Classification	December 31, 2022	December 31, 2021
Right-of-use assets:			
Operating leases	Accrued interest receivable and other assets	$ 589,818	$ 640,095
Total right-of-use assets		$ 589,818	$ 640,095
Lease liabilities:			
Operating leases	Accrued interest payable and other liabilities	$ 257,318	$ 277,595
Total lease liabilities		$ 257,318	$ 277,595

Lease Expense: The operating lease cost for the years ended December 31, 2022 and 2021 were $112,045 and $60,156 respectively.

NOTE Q –LEASES (Continued)

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

	Operating Leases
2023	$ 30,156
2024	30,156
2025	30,156
2026	30,156
2027	30,156
Thereafter	180,936
Total undiscounted lease payments	331,716
Less: imputed interset	(74,398)
Net lease liabilities	$ 257,318

Supplemental Lease Information	December 31, 2022	December 31, 2021
Operating lease weighted average remaining lease term (years)	11.08	12.08
Operating lease weighted average discount rate	4.30%	4.30%
Cash paid for amounts included in the measurement of lease liabilities		
Operating cash flows from operating leases	$ 30,156	$ 30,156

NOTE R – CONCENTRATIONS OF CREDIT RISK

Most of the Company's business activity is with customers located within the State of California, primarily in and around the counties of Humboldt, Del Norte, and Trinity. Most of the Company's loans have been granted to customers in the Company's market area. General economic conditions or natural disasters affecting the primary market area could affect the ability of customers to repay loans and the value of real property used as collateral. The loans are expected to be repaid from cash flow or proceeds from the sale of selected assets of the borrowers. The Company requires that all loans have adequate collateral to secure the loan or that the borrower has evidence of sufficient cash flows to repay loans when the loans are made. All collateral must have an appraisal, if applicable, and collateral is generally secured by liens. The Company's access to this collateral is through judicial procedures.

NOTE S – REGULATORY MATTERS

The Bank is subject to the dividend restrictions set forth by the FDIC. Under such restrictions, the Bank may not, without the prior approval of the FDIC, declare dividends in excess of the sum of the current year's net income plus the retained earnings from the prior two years. As of December 31, 2022, $18,184,578 was available for cash dividend distribution without prior approval.

The Bank is subject to various regulatory capital requirements administered by its primary federal regulator, the FDIC. Failure to meet minimum capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under U.S. GAAP, regulatory reporting requirements and regulatory capital standards. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

NOTE S – REGULATORY MATTERS (Continued)

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2022, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2022, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier I risk-based, Common Equity Tier 1 risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios are also presented in the table. There are no conditions or events since that notification that management believes have changed the institution's category (amounts and ratios for capital adequacy purposes below do not include capital conservation buffer).

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(in thousands)			
As of December 31, 2022						
Total Capital (to Risk Weighted Assets)	$ 62,245	15.63%	≥ $ 31,862	≥ 8.00%	≥ $ 39,828	≥ 10.00%
Tier I Capital (to Risk Weighted Assets)	$ 57,253	14.38%	≥ $ 23,897	≥ 6.00%	≥ $ 31,862	≥ 8.00%
Common Equity Tier I Capital (to Risk Weighted Assets)	$ 57,253	14.38%	≥ $ 17,922	≥ 4.50%	≥ $ 25,888	≥ 6.50%
Tier I Capital (to Average Assets)	$ 57,253	10.62%	≥ $ 21,563	≥ 4.00%	≥ $ 26,953	≥ 5.00%
As of December 31, 2021						
Total Capital (to Risk Weighted Assets)	$ 55,298	15.88%	≥ $ 27,863	≥ 8.00%	≥ $ 34,829	≥ 10.00%
Tier I Capital (to Risk Weighted Assets)	$ 50,928	14.62%	≥ $ 20,897	≥ 6.00%	≥ $ 27,863	≥ 8.00%
Common Equity Tier I Capital (to Risk Weighted Assets)	$ 50,928	14.62%	≥ $ 15,673	≥ 4.50%	≥ $ 22,639	≥ 6.50%
Tier I Capital (to Average Assets)	$ 50,928	8.57%	≥ $ 23,773	≥ 4.00%	≥ $ 29,717	≥ 5.00%

Under the Basel III Capital Rules, in order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common equity tier 1 capital above its minimum risk-based capital requirements. The effects of accumulated other comprehensive income items are not excluded from common equity tier 1 capital; however, the Bank made a one-time permanent election to exclude these items in order to avoid significant variations in the level of capital depending on the impact of interest rate fluctuations on the fair value of the Bank's investments portfolio. A banking organization with a buffer greater than 2.5 percent would not be subject to limits on capital distributions or discretionary bonus payments. The Bank does not expect to be subject to limits on capital distributions or discretionary bonus payments due to these requirements.

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants

NOTE T – FAIR VALUE MEASUREMENT

on the measurement date. The following tables present information about financial instruments, whether or not recognized or recorded at fair value in the balance sheet. In general, fair values are determined by:

Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access.

Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any market activity for the asset or liability.

In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments.

Fair value is a market-based measure considered from the perspective of a market participant who holds the asset or owes the liability rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, the Company's own assumptions are set to reflect those that market participants would use in pricing the asset or liability at the measurement date. The Company uses prices and inputs that are current as of the measurement date, including during periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or Level 2 to Level 3.

The carrying amount and estimated fair values of the Company's financial instruments are as follows:

	Carrying	Fair Value			
	Amount	Level 1	Level 2	Level 3	Total
December 31, 2022					
Financial assets:					
Cash and due from banks	$ 9,489,411	$ 9,489,411			$ 9,489,411
Federal funds sold	12,383,000	12,383,000			12,383,000
Interest-bearing deposits in other banks	24,022,971	24,022,971			24,022,971
Investment securities available-for-sale	74,203,349		$ 74,203,349		74,203,349
Mortgages held for sale					
Loans, net	373,517,277			$ 351,958,000	351,958,000
Cash surrender value of life insurance	12,176,256	12,176,256			12,176,256
Federal Home Loan Bank and correspondent bank stock	2,748,570	2,748,570			2,748,570
Accrued interest receivable	1,444,802	1,444,802			1,444,802
Mortgage servicing rights	1,931,990			1,931,990	1,931,990
Financial liabilities:					
Deposits					
Non interest-bearing	148,684,626	148,684,626			148,684,626
Interest-bearing	322,749,983	301,833,910	20,234,000		322,067,910
Borrowings	11,000,000		10,268,884		10,268,884
Accrued interest payable	16,199	16,199			16,199

NOTE T – FAIR VALUE MEASUREMENT (Continued)

	Carrying Amount	Fair Value Level 1	Level 2	Level 3	Total
December 31, 2021					
Financial assets:					
Cash and due from banks	$ 10,913,224	$ 10,913,224			$ 10,913,224
Federal funds sold	77,668,000	77,668,000			77,668,000
Interest-bearing deposits in other banks	85,018,930	85,018,930			85,018,930
Investment securities available-for-sale	67,980,742		$ 67,980,742		67,980,742
Mortgages held for sale	480,000		485,876		485,876
Loans, net	326,235,143			$ 330,072,215	330,072,215
Cash surrender value of life insurance	11,848,268	11,848,268			11,848,268
Federal Home Loan Bank and correspondent bank stock	2,617,370	2,617,370			2,617,370
Accrued interest receivable	1,279,246	1,279,246			1,279,246
Mortgage servicing rights	1,401,577			1,401,577	1,401,577
Financial liabilities:					
Deposits					
Non interest-bearing	165,276,521	165,276,521			165,276,521
Interest-bearing	376,279,105	337,749,750	38,168,399		375,918,149
Borrowings	11,000,000		11,069,993		11,069,993
Accrued interest payable	16,121	16,121			16,121

The carrying amounts in the preceding table are included in the balance sheet under the applicable captions. The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash and due from banks, federal funds sold and interest-bearing deposits in other financial institutions: The carrying amount approximates fair value and is classified as level 1.

Investment securities: Fair values for investment securities are based on quoted market prices, where available, and are classified as level 1. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments and indications of value provided by brokers and are classified as level 2. The carrying amount of accrued interest receivable approximates its fair value and is classified as level 1.

Mortgages held for sale: The fair value for mortgages held for sale is based on the actual selling price, if available or quoted market prices of comparable loans, which are classified as level 2.

Loans, net: For variable-rate loans that reprice frequently and fixed rate loans that mature in the near future, with no significant change in credit risk, fair values are based on carrying amounts, resulting in a level 3 classification. The fair values for other fixed rate loans are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality, resulting in a level 3 classification. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics and are adjusted for the allowance for loan losses. The carrying amount of accrued interest receivable approximates its fair value and is classified as level 1.

Cash surrender value of life insurance: The carrying amount approximates fair value and is classified as level 1.

FHLB and correspondent bank stock: For FHLB and correspondent bank stock, the carrying amount is equal to the par value at which the stock may be sold back to FHLB or the correspondent bank, which approximates fair value and is classified as level 1.

NOTE T – FAIR VALUE MEASUREMENT (Continued)

Deposits: The fair values disclosed for demand deposits (for example, interest-bearing checking, money market and savings accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts), resulting in a level 1 classification. The fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on the certificates to a schedule of aggregated contractual maturities on such time deposits, resulting in a level 2 classification. The carrying amount of accrued interest payable approximates fair value and is classified as level 1.

Borrowings: The fair value is estimated using a discounted cash flow calculation that applies interest rates on similar borrowings.

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring and nonrecurring basis as of December 31, 2022 and 2021, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value.

	Fair Value	Level 1	Level 2	Level 3	Total Gains (Losses)
December 31, 2022:					
Measured at fair value on a recurring basis					
Investment securities	$ 74,203,349		$ 74,203,349		$ (10,864,746)
Mortgage servicing rights	1,931,990			$ 1,931,990	523,944
Total recurring	$ 76,135,339	$ -	$ 74,203,349	$ 1,931,990	$ (10,340,802)
Measured at fair value on a nonrecurring basis					
Impaired loans	$ 291,728			$ 291,728	
Total nonrecurring	$ 291,728	$ -	$ -	$ 291,728	$ -
December 31, 2021:					
Measured at fair value on a recurring basis					
Investment securities	$ 67,980,742		$ 67,980,742		$ (514,886)
Mortgage servicing rights	1,401,577			$ 1,401,577	300,430
Total recurring	$ 69,382,319	$ -	$ 67,980,742	$ 1,401,577	$ (214,456)
Measured at fair value on a nonrecurring basis					
Impaired loans	$ 303,710			$ 303,710	
Total nonrecurring	$ 303,710	$ -	$ -	$ 303,710	$ -

The following methods were used to estimate the fair value of each class of financial instrument above:

Securities Available-for-Sale: To value securities available-for-sale, the Company obtains fair value measurements from an independent pricing service. The fair value measurement considers observable data that

NOTE T – FAIR VALUE MEASUREMENT (Continued)

may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions among other things.

Mortgage Servicing Rights: Mortgage servicing rights do not trade in an active market with readily observable prices. Accordingly, the Company determines the fair value of mortgage servicing rights using a valuation model that calculates the present value of estimated future net servicing income. Fair value measurements of the mortgage servicing rights use significant unobservable inputs and, accordingly, are classified as Level 3. Total gains (losses) recognized in earnings during 2022 and 2021 were $523,944 and $300,430, respectively, which are reflected in mortgage banking revenue, on the consolidated statements of operations.

Impaired Loans: The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. 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 appraisal value, the Company records the impaired 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 impaired loan as nonrecurring Level 3. Management typically reduces the appraisal value by 10% or more to determine the fair value of the collateral.

Foreclosed Real Estate: Foreclosed real estate is held for sale and is initially recorded at fair value less estimated costs of disposition at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or estimated fair value less costs of disposition. The fair value of foreclosed real estate is determined using various valuation techniques which are not readily observable in the market place, including consideration of appraised values and other pertinent real estate market data. Management typically reduces the appraisal value by 10% to determine the fair value of the property.

No amounts were transferred among level 1, level 2 or level 3 during 2022 or 2021.

The following table presents quantitative information about level 3 fair value measurement for assets measured at fair value at December 31, 2022 and 2021:

	Fair Value	Valuation Techniques	Unobservable Inputs	Range	Weighted Average
December 31, 2022:					
Nonrecurring:					
Impaired loans	$ 291,728	Discounted cash flow approach	Discount rate	4.50% to 5.63%	5.63%
Recurring:					
Mortgage servicing rights	1,931,990	Discounted cash flow approach	Conditional prepayment rate	6.80% to 7.33%	7.24%
			Discount rate	9.50%	9.50%
December 31, 2021:					
Nonrecurring:			Discount rate		
Impaired loans	$ 303,710	Discounted cash flow approach		4.50% to 5.63%	4.50%
Recurring:					
Mortgage servicing rights	1,401,577	Discounted cash flow approach	Conditional prepayment rate	11.56% to 14.14%	13.62%
			Discount rate	9.50%	9.50%

NOTE U – REVENUE FROM CONTRACTS WITH CUSTOMERS

All of the Company's revenue from contracts with customers under the scope of Accounting Standards Codification Topic 606, *Revenue from Contracts with Customers,* (ASC 606) is recognized within Other Income reported in the Consolidated Statements of Operations. Service charges and fees on deposit accounts of $1,400,590 and $1,183,867 for the years ended December 31, 2022 and 2021, respectively, and are within the scope of ASC 606.

A description of the Company's revenue streams accounted for under ASC 606 follows:

<u>Service charges and fees on deposit accounts</u>: The Company earns service charges and fees from its deposit customers for transaction-based, account maintenance and overdraft services. Transaction-based based fees consist primarily of ATM usage charges and wire transfer fees and are recognized at the time the transaction is fulfilled. Account maintenance fees, which are mainly monthly maintenance fees on deposit accounts, are earned over the course of a month, representing the period the Company satisfies the performance obligation. Overdraft fees are recognized at the point the overdraft occurs. Services charges and fees on deposit accounts are generally withdrawn from the customer's account.

<u>Gain on sale of foreclosed real estate:</u> The Company records a gain or loss from the sale of foreclosed property when control of the property transfers to the buyer, which generally occurs at the time a deed is executed. When the Company finances the sale of foreclosed real estate to the buyer, the Company assess whether the buyer is committed to perform their obligation under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the foreclosed real estate asset is derecognized and the gain or loss on sale is recorded upon transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Company adjusts the transaction price and related gain on sale if a significant financing component is present.

NOTE V – SUBSEQUENT EVENTS

In January 2023, the Company declared a cash dividend of $0.08 per share, or approximately $158,208, to shareholders of record on January 30, 2023 that was paid on February 14, 2023.

As described in Note A, the Company is required to implement ASU 2016-13, Financial Instruments – Credit Losses (Topic 326), during the year ended December 31, 2023. The Company prepared a rough pro forma allowance calculation under ASU 2016-13 as of December 31, 2022 that is not expected to add to the existing required allowance for loan losses due to the change in calculation. The calculation is subject to additional refinement by management, approval by the Management Asset-Liability Management Committee and Board of Directors, as well as changes to the balance and composition of loans outstanding during the year ended December 31, 2023.

Redwood Capital Bancorp

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