



Cashmere Valley Bank

2022 Annual Report

“The little Bank with the big circle of friends”

Member FDIC

Cashmere Valley Bank

2022 Annual Report

Financial Highlights

Performance Results	Year Ended December 31,				
	2022	2021	2020	2019	2018
Return on average equity	14.68%	12.24%	11.59%	11.55%	12.35%
Return on average assets	1.22%	1.36%	1.41%	1.49%	1.45%
Equity to assets	7.59%	10.75%	11.97%	12.44%	12.33%
Earnings per share - Basic	\$6.70	\$7.42	\$6.43	\$5.70	\$5.29
Dividends per share	\$1.70	\$1.55	\$3.40	\$1.30	\$2.70
Book value per share	\$40.78	\$61.61	\$60.09	\$51.78	\$45.54
Year-end market value per share	\$44.95	\$71.50	\$52.61	\$63.00	\$54.01
Average earning assets to average total assets	97.88%	95.01%	94.75%	95.56%	95.72%
Allowance for credit losses to total loans at December 31	1.37%	1.46%	1.44%	1.22%	1.16%
Efficiency ratio	58.36%	53.11%	51.71%	55.02%	53.45%
Yield and Cost of Funds					
Tax equivalent yield on cash and investments	2.45%	1.90%	2.21%	2.94%	2.98%
Tax equivalent yield on loans	4.09%	4.19%	4.08%	4.25%	4.03%
Cost of funds	0.29%	0.35%	0.44%	0.54%	0.39%
Tax equivalent net interest margin	2.99%	2.70%	2.82%	3.27%	3.46%
Selected Items (in thousands)					
Total cash and cash equivalents	\$180,312	\$114,004	\$135,725	\$141,393	\$55,231
Total investments	\$816,486	\$1,103,232	\$856,327	\$542,087	\$439,952
Total loans	\$1,005,741	\$940,802	\$950,970	\$918,541	\$976,619
Total assets	\$2,087,762	\$2,224,302	\$1,994,288	\$1,651,499	\$1,520,773
Total deposits	\$1,900,019	\$1,936,577	\$1,719,971	\$1,423,347	\$1,314,877
Total equity	\$158,390	\$239,098	\$238,678	\$205,404	\$187,503

To the shareholders and friends of Cashmere Valley Bank

With COVID-19 mostly behind us, we greeted 2022 with much optimism, only to be hit with the fastest rise in Fed Funds rates in history! With Fed Funds increasing in excess of 400 basis points from March to December, the macro-environment proved extremely challenging. While we model and stress test for these events, the dynamics make reality far more complicated than you would expect.

The rapid rate increase followed two years of dramatic increases in deposits, which meant a bubble of investing in securities at the worst possible time. Our deposits remained stable until approximately September 2022. Deposits started moving rapidly, and we increased our focus on deposit retention. That effort was largely effective. We are happy to report that our deposits were only down 1.89% for the year. The Banking Industry as a whole reported the first year of a decline in deposits in the commercial banking space since 1948!

We made some strategic sales of investments at a loss, along with some movement to the held to maturity portfolio to stem the growth of unrealized losses due to dropping bond prices. Fortunately, we had strong capital and liquidity that provided a cushion for taking losses. Additionally, our strong overnight cash balances at the Fed went from earning 0.07% at the start of 2022 to 4.40% by year end. This has resulted in an increasing net interest margin and strong core earnings. Our net income of \$26.0 million was after realizing losses on security sales of \$8.2 million. Positive results moving forward will be highly dependent on the magnitude and duration of Fed monetary policy.

Credit quality remains good. There seems to be lots of on again off again opinions about the possibility of a recession and the impact to banks' loan portfolios. Clearly, a significant recession will have an adverse impact on the industry. Charge-offs for the past two years were 0.06% and 0.11% of average gross loans.

The construction of the new Union Gap branch is in full swing and should be complete by September 1st, 2023. We are already hearing some positive feedback from customers in the Yakima area.

If you have any questions about your Bank, don't hesitate to call me at (509) 782-2092.

Our annual meeting will be held at a new time and location on Tuesday, May 16, 2023 at 6:30PM. We will hold the meeting in person at our Financial Services Center, 127 East Penny Road, 2nd floor in Wenatchee. We will also hold the meeting telephonically by calling 1 (844) 506-8367 with an access code of 11580.

Although we have faced some significant challenges over the past few years, we continue to expand our footprint while remaining *"the little bank with the big circle of friends."*

Sincerely,

A handwritten signature in black ink, appearing to read "Greg Oakes", with a stylized, flowing script.

Greg Oakes,
President and CEO



MOSSADAMS

Report of Independent Auditors

The Board of Directors and Shareholders
Cashmere Valley Bank and its subsidiary

Report on the Audit of the Financial Statements

Opinion

We have audited the consolidated financial statements of Cashmere Valley Bank and its subsidiary, which comprise the consolidated balance sheet as of December 31, 2022 and 2021, and the related consolidated statements of income and comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

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

Report on Internal Control Over Financial Reporting

We also have audited, in accordance with auditing standards generally accepted in the United States of America, Cashmere Valley Bank's internal control over financial reporting as of December 31, 2022, based on criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) relevant to internal reporting objectives for the express purpose of meeting the regulatory requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and our report dated March 14, 2023, expressed an unmodified opinion.

Basis for Opinion

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

Responsibilities of Management for the Financial Statements

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

In preparing the consolidated financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about Cashmere Valley Bank and its 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 GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the consolidated financial statements.

In performing an audit in accordance with GAAS, we:

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

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

Other Information Included in the Annual Report

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

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

Moss Adams LLP

Spokane, Washington
March 14, 2023

Cashmere Valley Bank and Subsidiary
Consolidated Balance Sheets

(Dollars in Thousands, Except Share Amounts)

	December 31,	
	2022	2021
Assets		
Cash and cash equivalents:		
Cash and due from banks	\$27,706	\$22,450
Interest-bearing deposits at other financial institutions	142,617	81,399
Federal funds sold	9,989	10,155
Total cash and cash equivalents	180,312	114,004
Securities available for sale at fair value	670,077	1,103,232
Securities held to maturity	146,409	--
Federal Home Loan Bank stock, at cost	2,669	2,393
Loans held for sale	142	1,148
Loans and leases	1,005,741	940,802
Allowance for credit losses	(13,746)	(13,774)
Net loans and leases	991,995	927,028
Premises and equipment, net	18,275	17,058
Accrued interest receivable	8,199	8,553
Bank Owned Life Insurance	26,105	26,485
Goodwill	7,576	7,576
Intangibles, net	3,796	4,285
Mortgage servicing rights	2,685	2,802
Net deferred tax assets	21,021	--
Other assets	8,501	9,738
Total assets	\$2,087,762	\$2,224,302
Liabilities		
Deposits:		
Noninterest-bearing demand	\$457,666	\$432,621
Savings and interest-bearing demand	1,228,375	1,301,169
Time	213,978	202,787
Total deposits	1,900,019	1,936,577
Accrued interest payable	434	403
Short-term borrowings	17,166	34,504
Other liabilities	11,753	13,720
Total liabilities	1,929,372	1,985,204
Commitments and contingencies (Note 14)		
Shareholders' Equity		
Common stock (no par value); authorized 10,000,000 shares;		
Issued and outstanding: 2022 – 3,883,956; 2021 – 3,880,811	--	--
Additional paid-in capital	4,540	4,186
Treasury stock	(16,784)	(16,784)
Retained earnings	259,839	240,440
Other comprehensive income	(89,239)	11,256
Total Cashmere Valley Bank shareholders' equity	158,356	239,098
Noncontrolling interest	34	--
Total shareholders' equity	158,390	239,098
Total liabilities and shareholders' equity	\$2,087,762	\$2,224,302

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

Cashmere Valley Bank and Subsidiary
Consolidated Statements of Income

(Dollars in Thousands, Except Per Share Amounts)

	Year Ended December 31,	
	2022	2021
Interest Income		
Loans and leases	\$39,950	\$39,151
Federal funds sold and deposits at other financial institutions	2,199	106
Securities available for sale:		
Taxable	16,528	12,041
Tax-exempt	5,653	6,595
Securities held to maturity:		
Taxable	1,856	--
Tax-exempt	58	--
Total interest income	66,244	57,893
Interest Expense		
Deposits	4,319	5,094
Short-term borrowings	63	50
Total interest expense	4,382	5,144
Net interest income	61,862	52,749
Provision for credit losses	800	81
Net interest income after provision for credit losses	61,062	52,668
Noninterest Income		
Service charges on deposit accounts	2,130	1,634
Mortgage banking operations	2,320	5,531
Net (loss)/gain on sales of securities available for sale	(8,179)	1
Brokerage commissions	1,136	1,327
Insurance commissions and fees	7,552	5,368
Net interchange income	3,997	3,948
Earnings from Bank Owned Life Insurance	1,247	578
Other	1,463	1,513
Total noninterest income	11,666	19,900
Noninterest Expense		
Salaries and employee benefits	24,558	22,120
Occupancy and equipment	3,317	3,123
Audits and examinations	546	433
State and local business and occupation taxes	1,248	1,032
FDIC insurance & WA state assessments	687	627
Legal and professional fees	809	991
Check losses and charge-offs	495	540
Low income housing fund losses	656	588
Data processing	5,541	4,637
Product delivery	1,222	1,126
Other	3,831	3,369
Total noninterest expense	42,910	38,586
Income before income taxes	29,818	33,982
Income taxes	3,818	4,949
Net income	26,000	29,033
Net income attributable to noncontrolling interest	--	--
Net income attributable to Cashmere Valley Bank	\$26,000	\$29,033
Earnings per common share – Basic	\$6.70	\$7.42
Earnings per common share – Diluted	\$6.69	\$7.39

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

Cashmere Valley Bank and Subsidiary
Consolidated Statements of Comprehensive Income

(Dollars in Thousands)

	Year Ended December 31,	
	2022	2021
Net income	\$26,000	\$29,033
Other comprehensive (loss):		
Change in the fair value of securities available for sale	(114,948)	(20,404)
Reclassification adjustment for losses/(gain) included in net income	8,179	(1)
Unrealized loss on securities transferred from available for sale to held to maturity	(17,675)	--
Amortization of net unrealized losses on securities transferred from available for sale to held to maturity	1,528	--
Other comprehensive (loss), before tax	(122,916)	(20,405)
Deferred tax (benefit)	(22,421)	(4,285)
Other comprehensive (loss), net of tax	(100,495)	(16,120)
Comprehensive (loss) income, net of tax	<u><u>\$(74,495)</u></u>	<u><u>\$12,913</u></u>

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

Cashmere Valley Bank and Subsidiary
Consolidated Statements of Shareholders' Equity

(Dollars in Thousands, Except Share Information)

	Shares of Common Stock	Additional Paid-In Capital	Treasury Stock	Retained Earnings	Other Comprehensive Income (Loss)	Total Cashmere Valley Bank Equity	Non- controlling Interest	Total Equity
Balance as of December 31, 2020	3,972,149	\$3,723	\$(9,908)	\$217,487	\$27,376	\$238,678	\$--	\$238,678
Net income	--	--	--	29,033	--	29,033	--	29,033
Other comprehensive (loss), net of tax	--	--	--	--	(16,120)	(16,120)	--	(16,120)
Cash dividends paid	--	--	--	(6,080)	--	(6,080)	--	(6,080)
Stock based compensation expense	--	145	--	--	--	145	--	145
Exercise of common stock options	6,845	318	--	--	--	318	--	318
Restricted stock grants	40	--	--	--	--	--	--	--
Shares repurchased	(98,223)	--	(6,876)	--	--	(6,876)	--	(6,876)
Balance as of December 31, 2021	3,880,811	\$4,186	\$(16,784)	\$240,440	\$11,256	\$239,098	\$--	\$239,098
Net income	--	--	--	26,000	--	26,000	--	26,000
Other comprehensive (loss), net of tax	--	--	--	--	(100,495)	(100,495)	--	(100,495)
Transactions with minority shareholders	--	(34)	--	--	--	(34)	34	--
Cash dividends paid	--	--	--	(6,601)	--	(6,601)	--	(6,601)
Stock based compensation expense	--	219	--	--	--	219	--	219
Exercise of common stock options	3,020	169	--	--	--	169	--	169
Restricted stock grants	125	--	--	--	--	--	--	--
Balance as of December 31, 2022	3,883,956	\$4,540	\$(16,784)	\$259,839	\$(89,239)	\$158,356	\$34	\$158,390

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

Cashmere Valley Bank and Subsidiary
Consolidated Statements of Cash Flows

(Dollars in Thousands)

	Year Ended December 31,	
	2022	2021
Cash Flows from Operating Activities		
Net income	\$26,000	\$29,033
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,164	3,494
Provision for credit losses	800	81
Investment amortization – net	8,960	10,587
Stock based compensation	219	145
Net loss/(gain) on sale of securities and loans	7,386	(5,114)
Earnings from Bank Owned Life Insurance	(1,247)	(578)
Originations of loans held for sale	(47,704)	(121,370)
Proceeds from sales of loans held for sale	49,794	126,596
Net change in:		
Accrued interest receivable	354	(724)
Accrued interest payable	31	(209)
Deferred income tax	(383)	(72)
Federal income tax payable	496	174
Deferred compensation	491	304
Other – net	(387)	(2,632)
Net cash provided by operating activities	47,974	39,715
Cash Flows from Investing Activities		
Activity in securities available for sale:		
Sales proceeds	220,282	27,629
Maturities, prepayments, and calls	61,764	90,062
Purchases	(112,278)	(395,636)
Activity in securities held to maturity:		
Maturities, prepayments, and calls	6,622	--
Purchases	(29,698)	--
Purchase of Federal Home Loan Bank stock	(276)	(411)
Loans and leases originated (greater)/less than principal collected	(65,900)	10,027
Investment in low income housing fund	(210)	(1,036)
Purchase of Bank Owned Life Insurance	--	(10,000)
Proceeds from Bank Owned Life Insurance	1,627	--
Purchases of premises and equipment	(3,291)	(2,906)
Cash paid for acquisitions	--	(1,245)
Proceeds from sale of premises and equipment	20	3
Net cash provided by/(used in) investing activities	78,662	(283,513)
Cash Flows from Financing Activities		
Net (decrease)/increase in deposits	(36,558)	216,606
Net (decrease)/increase in short-term borrowings	(17,338)	18,109
Cash dividends paid	(6,601)	(6,080)
Exercise of stock options	169	318
Repurchase of common stock	--	(6,876)
Net cash (used in)/provided by financing activities	(60,328)	222,077
Net change in cash and due from banks	66,308	(21,721)
Cash and due from banks at beginning of year	114,004	135,725
Cash and due from banks at end of year	\$180,312	\$114,004

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

Note 1 – Summary of Significant Accounting Policies

Cashmere Valley Bank (the Company) is a Washington State chartered bank established in 1932 and operates 11 branches in North Central Washington. The Company's lending and other banking activities are carried out in and around Chelan, Douglas, Kittitas, and Yakima counties and to a lesser degree, areas of Western Washington. The Company provides loan and deposit services to predominantly small and middle-market business and retail customers. The consolidated financial statements include the accounts of Cashmere Valley Bank and the Bank's subsidiary, Mitchell, Reed and Schmitten Insurance, Inc. (MRS), an insurance agency. MRS is based in Wenatchee, Washington and brokers personal and commercial lines of insurance, including property, casualty, life and health insurance, with locations in Chelan, Kittitas, Yakima and King counties.

Consolidated Financial Statement Presentation

The consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) and practices within the financial services industry. GAAP defines a public business entity as an entity whose securities are not subject to contractual restrictions on transfer and that is by law, contract, or regulation required to prepare U.S. GAAP financial statements and make them publicly available on a periodic basis. As the Company meets the definition of a public business entity, certain disclosures are required. Intercompany transactions and balances have been eliminated. The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities, as of the date of the consolidated balance sheet, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate primarily to the determination of the allowance for credit losses and valuations of securities, goodwill, and mortgage servicing rights.

Noncontrolling Interest

Noncontrolling interest in the Bank's subsidiary, Mitchell, Reed and Schmitten Insurance, Inc., is limited to ownership by key employees of Mitchell, Reed & Schmitten Insurance, Inc. The Company reports noncontrolling interest in shareholders' equity, separate from the Bank's shareholders' equity, on the consolidated balance sheets. The Company reports net income attributable to noncontrolling interest in the consolidated statements of income.

Cash and Cash Equivalents

The Company considers federal funds sold, cash and amounts due from banks, and interest-bearing deposits at other financial institutions with original maturities of less than 90 days to be cash and cash equivalents, and are reported as such on the consolidated balance sheets and statement of cash flows. Cash flows from loans, deposits, and short-term borrowings are reported net. Additional cash flow information was as follows (dollars in thousands):

	Year Ended December 31,	
	2022	2021
Cash paid for interest	\$4,352	\$5,353
Cash paid for income taxes	\$3,695	\$4,821
Significant non-cash transactions:		
Fair value adjustment of securities available for sale, net of tax	\$(100,495)	\$(16,120)
Assets acquired	\$--	\$2,523
Fair value transfer of securities from available for sale to held to maturity	\$122,502	\$--

Stock Based Compensation

The Company has stock-based compensation plans which are more fully discussed in Note 16. Under the plans, certain key employees have been awarded restricted stock grants and options to purchase common stock. Under the accounting guidance for stock-based compensation, compensation expense recognized includes the cost of stock-based awards associated with restricted stock grants and incentive stock options which are recognized as compensation expense over the

vesting period on a straight-line basis. The Company recognized stock-based compensation expense totaling \$219,000 and \$145,000 in 2022 and 2021, respectively.

Securities Available for Sale

Securities available for sale consist of debt securities that the Company intends to hold for an indefinite period, but not necessarily to maturity. Such securities may be sold to implement the Company's asset/liability management strategies, interest rate risk strategies, and in response to changes in interest rates and similar factors. Securities available for sale are reported at fair value. Unrealized gains and losses, net of the related deferred tax effect, are reported as a net amount in a separate component of shareholders' equity entitled "other comprehensive income." Realized gains and losses on securities available for sale, determined using the specific identification method, are included in earnings. Generally, amortization of premiums and accretion of discounts are recognized in interest income over the contractual life of the security using the effective interest method. As principal repayments are received on securities, a proportionate amount of the related premium or discount is recognized so that the effective interest rate on the remaining portion of the security continues unchanged.

The Company evaluates the portfolio for impairment each quarter. In estimating other-than-temporary losses, the Company considers the following factors: (1) the length of time and the extent to which the market value has been less than cost; (2) the financial condition and near-term prospect of the issuer; (3) the intent and ability of the Company to retain its investment in a security for a period of time sufficient to allow for any anticipated recovery in market value; (4) implicit or implied guarantees of the U.S. government; (5) whether it is more likely than not that the Company will be required to sell the securities before recovery; and (6) general market conditions which reflect prospects for the economy as a whole, including interest rates and sector credit spreads. In the event a security becomes impaired and it becomes more likely than not that the Company will sell the security before recovering its amortized cost basis, the entire impairment would be recognized in earnings. As of December 31, 2022, the Company had no impaired securities. If a loss is deemed to be other-than-temporary, the Company then calculates a credit loss charge against earnings by subtracting the estimated present value of estimated future cash flows on the security from its amortized cost. The other-than-temporary impairment less the credit loss charge against earnings is a component of other comprehensive income.

Securities Held to Maturity

Debt securities which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized in interest income over the period to maturity.

Securities transferred from available for sale to held to maturity are recorded at fair value at the date of transfer. The unrealized gain or loss at the date of transfer is included in accumulated other comprehensive income (loss), net of tax, in the consolidated balance sheets. The unrealized gains or losses at the date of transfer are amortized or accreted over the contractual life of the security.

Federal Home Loan Bank Stock

The Company, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in capital stock of the FHLB based on the sum of the two following calculations (calculated at least annually as of the preceding December 31):

- The Membership Stock Purchase Requirement: based on a percentage of assets as shown in table below:

	<u>Current Requirement</u>	<u>Minimum Investment</u>	<u>Maximum Investment</u>
Percent of Total Assets	0.12%	0.05%	0.25%
Membership Stock Cap	\$10 million	\$1 million	\$30 million
Membership Stock Floor	\$10,000	\$10,000	\$30,000

- The Activity Based Stock Purchase Requirement: based on a percentage of the book value held and records of the transactions shown in the table below:

<u>Transaction</u>	<u>Current Requirement</u>	<u>Minimum Requirement</u>	<u>Maximum Requirement</u>
Outstanding Advances	4.00%	2.00%	5.00%
Outstanding Acquired Member Assets	4.00%	0.00%	5.00%
Standby Letters of Credit	0.10%	0.00%	0.175%
Advance Commitments	0.00%	0.00%	0.35%
Acquired Member Asset Commitments	0.00%	0.00%	0.60%

The recorded amount of FHLB stock equals its fair value because the shares can only be redeemed by the FHLB at the \$100 per share par value.

The Company views its investment in the FHLB stock as a long-term investment. Accordingly, when evaluating for impairment, the value is determined based on the ultimate recovery of the par value rather than recognizing temporary declines in value. The determination of whether a decline affects the ultimate recovery is influenced by criteria such as: (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and length of time a decline has persisted; (2) impact of legislative and regulatory changes on the FHLB; and (3) the liquidity position of the FHLB. Management has determined there was no impairment on its FHLB stock as of December 31, 2022 and 2021.

Loans Held for Sale

Loans originated for sale in the secondary market, which is our principal market, or as whole loan sales are classified as loans held for sale. Freddie Mac qualifying single family loans are originated with the intent to be held for sale and are recorded at the lower of cost or market. The fair value of loans held for sale is generally based on observable market prices from other loans in the secondary market that have similar collateral, credit, and interest rate characteristics. If quoted market prices are not readily available, the Company may consider other observable market data such as dealer quotes for similar loans or forward sale commitments. In certain cases, the fair value may be based on a discounted cash flow model. Gains and losses on loans held for sale are recognized in net gain on mortgage loan origination and sale activities within noninterest income. Direct loan origination costs and fees for single family loans originated as held for sale are recognized in earnings.

Loans Held for Investment

Loans held for investment are reported at the principal amount outstanding, net of cumulative charge-offs, interest applied to principal, for loans accounted for using the cost recovery method, unamortized net deferred loan origination fees and costs, and unamortized premiums or discounts on purchased loans. Deferred fees, deferred costs, premiums and discounts are recognized over the contractual terms of the underlying loans using the constant effective yield, known as the interest method. Interest on loans is accrued and recognized as interest income at the contractual rate of interest. As of the loan commitment date, a determination is made as to whether a loan will be held for sale or held for investment. This determination is based primarily on the type of loan or loan program and its related profitability characteristics.

When a loan is designated as held for investment, the intent is to hold these loans until maturity or pay-off. If subsequent changes occur, the Company may change its intent to hold these loans. Once a determination has been made to sell such loans, they are immediately transferred to loans held for sale and carried at the lower of cost or fair value.

Direct financing leases are carried at the aggregate of lease payments plus estimated residual value of the leased property less unearned income. Interest income from direct financing leases is recognized over the term of the lease to achieve a constant periodic rate of return on the outstanding investment.

From time to time, the Company will originate loans to facilitate the sale of other real estate owned without a sufficient down payment from the borrower. Such loans are accounted for using the installment method and any gain on sale is deferred.

Nonaccrual Loans

Loans are placed on nonaccrual status when the full and timely collection of principal and interest is doubtful, generally when the loan becomes 90 days or more past due for principal or interest payment, or if part of the principal balance has been charged off.

All payments received on nonaccrual loans are accounted for using the cost recovery method. Under the cost recovery method, all cash collected is applied to first reduce the principal balance. A loan may be returned to accrual status if all delinquent principal and interest payments are brought current and the collectability of remaining contractual payments are reasonably assured. Loans that are well-secured and in the process of collection are maintained on accrual status, even if they are 90 days or more past due.

Impaired Loans

A loan is considered impaired when it is probable that all contractual principal and interest payments due will not be collected in accordance with the terms of the loan agreement. Factors considered by management in determining whether loan is impaired include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due.

Troubled Debt Restructurings

A loan is accounted for and reported as a troubled debt restructuring (TDR) when, for economic or legal reasons, the Company grants a concession to a borrower experiencing financial difficulty. A restructuring that results in only an insignificant delay in payment is not considered a concession. A delay may be considered insignificant if the payments subject to the delay are insignificant relative to the unpaid principal or collateral value and the contractual amount due, or the delay in timing of the restructured payment period is insignificant relative to the frequency of payments, the debt's original contractual maturity, or original expected duration.

TDRs are designated as impaired because interest and principal payments will not be received in accordance with original contract terms. TDRs that are performing and on accrual status as of the date of the modification remain on accrual status. TDRs that are nonperforming as of the date of modification generally remain as nonaccrual until the prospect of future payments in accordance with the modified loan agreement is reasonably assured, generally demonstrated when the borrower maintains compliance with the restructured terms for a predetermined period, normally at least six months. TDRs with temporary below-market concessions remain designated as a TDR and impaired regardless of the accrual or performance status until the loan is paid off. However, if the TDR loan has been modified in a subsequent restructure with market terms and the borrower is not currently experiencing financial difficulty, then the loan may have its TDR designation removed.

Allowance for Credit Losses

The allowance for credit losses is maintained at a level sufficient to provide for probable credit losses based on evaluating known and inherent risks in the loan and lease portfolio. The allowance is provided based upon management's continuing analysis of the pertinent factors underlying the quality of the loan and lease portfolio. These factors include changes in the size and composition of the loan and lease portfolio, delinquency levels, actual loan loss experience, current economic conditions, and detailed analysis of individual loans for which full collectability may not be assured. The detailed analysis includes techniques to estimate the fair value of loan collateral and the existence of potential alternative sources of repayment. The allowance consists of specific, general, and unallocated components. For impaired loans, a specific allowance is established when the discounted cash flows, collateral value, or observable market price is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover the risk of loss due to general economic uncertainties that could affect the loan portfolio and management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. The appropriateness of the allowance for credit losses is estimated based upon these factors and trends identified by management at the time consolidated financial statements are prepared.

When available information confirms that specific loans or portions thereof are uncollectible, identified amounts are charged against the allowance for credit losses. The existence of some or all of the following criteria will generally confirm that a loss has been incurred: the loan is significantly delinquent and the borrower has not demonstrated the ability or intent to bring the loan current; the Company has no recourse to the borrower, or if it does, the borrower has insufficient assets to

pay the debt; the estimated fair value of the loan collateral is significantly below the current loan balance, and there is little or no near-term prospect for improvement.

A provision for credit losses is charged against income and added to the allowance for credit losses based on regular assessments of the loan and lease portfolio. The allowance for credit losses is allocated to certain loan and lease categories based on the relative risk characteristics, asset classifications and actual loss experience of the loan and lease portfolio. While management has allocated the allowance for credit losses to various loan and lease portfolio segments, the allowance is general in nature and is available for the loan and lease portfolio in its entirety.

The ultimate recovery of all loans and leases is susceptible to future market factors beyond the Company's control. These factors may result in losses or recoveries differing significantly from those provided in the consolidated financial statements. In addition, regulatory agencies periodically review the Company's allowance for credit losses as an integral part of their examination process. As a result, the Company may be required to make additions to the allowance based on the regulatory agency's judgment about information available at the time of their examinations.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation, which is computed on the straight-line method over the estimated useful lives of the assets, which range from 35 to 40 years for buildings and 3 to 15 years for furniture, fixtures, and equipment. These assets are reviewed for impairment under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 360, "*Property, Plant, and Equipment*" when events indicate that the carrying amount may not be recoverable. Gains or losses on dispositions are reflected in earnings.

Foreclosed Real Estate

Real estate properties acquired through, or in lieu of, foreclosure are to be sold and are initially recorded at the fair value of the properties, less estimated costs of disposal, which becomes the new cost basis. Any write-down to fair value at the time of transfer to foreclosed real estate is charged to the allowance for credit losses. Properties are evaluated regularly to ensure that the recorded amounts are supported by their current fair values. Any subsequent reductions in carrying values and revenue and expense from the operations of properties are recognized in the consolidated statements of income.

Mortgage Servicing Rights

Mortgage servicing rights (MSR) are recognized as separate assets when rights are acquired through purchase or through sale of loans. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Capitalized servicing rights are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

MSRs are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Subsequent fair value measurements of single family MSRs, which are not traded in an active market with readily observable market prices, are determined by considering the present value of estimated future net servicing cash flows. Changes in the fair value of single family MSRs result from changes in (1) model inputs and assumptions and (2) modeled amortization, representing the collection and realization of expected cash flows and curtailments over time. The significant model inputs used to measure the fair value of single family MSRs include assumptions regarding market interest rates, projected prepayment speeds, discount rates, estimated costs of servicing, and other income and additional expenses associated with the collection of delinquent loans. Impairment is recognized through a valuation allowance to the extent that fair value is less than the recorded value. If the Company later determines that all or a portion of the impairment no longer exists, a reduction of the allowance will be recorded as an increase to income.

Servicing fee income 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. The amortization of MSRs is netted against loan servicing fee income.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Company; (2) the transferee

obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets; and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Income Taxes

Deferred tax assets and liabilities result from differences between the consolidated financial statement carrying amounts and the tax basis of assets and liabilities, and are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. The deferred tax provision represents the difference between the net deferred tax asset or liability at the beginning and end of the year. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The determination of the realization of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence. The calculation of the Company's tax provision for federal income taxes is complex and requires the use of estimates and significant judgments in arriving at the amount of tax benefits to be recognized in the financial statements for a given tax position. It is possible that the tax benefits realized upon the ultimate resolution of a tax position may result in tax benefits that are significantly different from those estimated.

Management has reviewed all tax positions taken on all its income tax returns and has determined there to be no uncertain positions. Any interest and penalties would be recorded in income tax expense. Therefore, no further disclosures are deemed necessary.

The Bank is subject to routine audits by taxing jurisdictions; however, there are currently no audits in progress for any tax periods. Management believes it is no longer subject to income tax examinations for years prior to 2018.

Bank Owned Life Insurance

Bank owned life insurance (BOLI) policies are recorded at their cash surrender value or the amount that can be realized upon surrender of the policy. Income from BOLI is recognized when it is earned.

Goodwill

Goodwill represents costs in excess of net assets acquired and is evaluated at least annually for impairment, in accordance with FASB ASC 350, "*Intangibles – Goodwill and Other*." The Company tested goodwill for impairment as of December 31, 2021 using the Step 0 method to evaluate impairment and concluded that the fair value of the goodwill is greater than the carrying value, noting no impairment of recorded goodwill. No events have occurred since December 31, 2022 that would require re-evaluation.

Intangible Assets

Intangible assets include non-competition and licensing agreements, and customer contracts and lists. The non-competition and licensing agreements are amortized by the straight-line method over four to five years. The customer contracts and lists are amortized over a period of up to fifteen years, on either a straight-line method or performance basis. In 2022 and 2021, no circumstances existed that would indicate the intangible assets were potentially impaired. If such circumstances had existed, the assets would have been tested for impairment in accordance with FASB ASC 350, "*Intangibles – Goodwill and Other*."

Insurance Revenue

Insurance revenue consists of commissions and fees from the sales of insurance policies and related insurance services. Insurance commission income is recognized as of the effective date of the insurance policy, net of adjustments. Such adjustments are recorded when the amount can be reasonably estimated, which is generally in the period in which they occur. Commission revenues related to installment billings are recognized on the latter of effective or invoiced date. Contingent commissions are estimated and accrued relative to the recognition of corresponding commissions. Management determines a policy cancellation reserve based upon historical cancellation experience adjusted for any known circumstances. Subsequent commission adjustments were recognized upon receipt of notification from insurance companies concerning such adjustments.

Advertising

Advertising costs are charged to expense as incurred. Advertising expense was \$265,000 and \$188,000 for the years ended December 31, 2022 and 2021, respectively.

Derivative Financial Instruments

The Company enters into interest rate swaps to convert fixed rate long-term loans to floating rate loans. Management individually evaluates and converts fixed rate loans to floating rate loans depending on the size, maturity, and planned amortization of each loan. The interest rate swap instruments are recognized as derivatives on the balance sheet at their fair value. On the date the Company enters into the derivative contract, the derivative is designated by the Company as a hedge of fair value of a recognized asset or liability. Changes in the fair value of a derivative that is highly effective, and that is designated and qualifies as a fair value hedge, along with the loss or gain on the hedged asset or liability that is attributable to the hedged risk, are recorded in current period earnings.

The Company formally documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedged transactions. This process includes linking all derivatives that are designated as fair value hedges to specific assets and liabilities on the balance sheet and statement of cash flows. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values of hedged items. When it is determined that a derivative is not highly effective as a hedge or that it has ceased to be a highly effective hedge, the Company discontinues hedge accounting prospectively, as discussed below. The Company discontinues hedge accounting prospectively when: (1) it is determined that the derivative is no longer effective in offsetting changes in the fair value of a hedged item; (2) the derivative expires or is sold, terminated, or exercised; or (3) management determines that designation of the derivative as a hedge instrument is no longer appropriate.

When hedge accounting is discontinued because it is determined that the derivative no longer qualifies as an effective fair value hedge, the derivative will continue to be carried on the balance sheet at its fair value with changes in its fair value recognized in current period earnings, and the hedged asset or liability will no longer be adjusted for changes in fair value.

Fair Value

The Company measures or monitors many of its assets and liabilities on a fair value basis. Fair value is used on a recurring basis for certain assets and liabilities in which fair value is the primary basis of accounting. Examples of these include interest rate swap derivatives and available for sale securities. Additionally, fair value is used on a non-recurring basis to evaluate assets or liabilities for impairment or for disclosure purposes. Examples of these non-recurring uses of fair value include certain loans held for sale accounted for on a lower of cost or market basis, impaired loans, foreclosed real estate, mortgage servicing rights, goodwill and long-lived assets.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability, known as an exit price, in an orderly transaction between market participants at the measurement date. Fair value estimates are based on quoted market prices, if available. If quoted market prices are not available, fair value estimates are based on quoted market prices of similar assets or liabilities or the present value of expected future cash flows and other valuation techniques. These valuations are significantly affected by discount rates, cash flow assumptions, risk and other assumptions used. Therefore, fair value estimates may not be substantiated by comparison to independent markets and are not intended to reflect the proceeds that may be realizable in an immediate settlement of the instruments.

Fair value is determined at one point in time and is not representative of future value. Fair value amounts also do not reflect the total value of a going concern organization. Management does not have the intention to dispose of a significant portion of its assets and liabilities and therefore, the unrealized gains or losses should not be interpreted as a forecast of future earnings and cash flows.

In support of these representations, FASB ASC 820, "*Fair Value Measurements and Disclosures*," establishes fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy is as follows:

Level 1 inputs are observable inputs, based upon the quoted prices for identical instruments in active markets that are accessible as of the measurement date, and are to be used whenever available.

Level 2 inputs are other types of observable inputs, such as quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are inactive; or other inputs that are observable or can be derived from or supported by observable market data. Level 2 inputs are to be used whenever Level 1 inputs are not available.

Level 3 inputs are significantly unobservable and are supported by little or no market activity. These Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair values requires significant management judgment or estimation. Level 3 inputs are to only be used when Level 1 and Level 2 inputs are unavailable.

When determining the fair value measurements for assets and liabilities, the Company considers the principal or most advantageous market in which it would transact, and considers assumptions that market participants would use when pricing the asset or liability. When possible, the Company looks to active and observable markets to price identical assets or liabilities. When identical assets or liabilities are not traded in active markets, the Company looks to market observable data for similar assets and liabilities.

Basic and Diluted Earnings per Common Share

Earnings per common share is computed under the two-class method. Pursuant to the two-class method, unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are participating securities and are included in the computation of diluted earnings per share. The Company has determined that the outstanding unvested restricted stock awards are participating securities.

Under the two-class method, basic earnings per common share is computed by dividing net earnings allocated to common stock by the weighted-average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the dilutive effect of stock compensation using the treasury stock method. A reconciliation of the weighted-average shares used in calculating basic earnings per common share and the weighted average common shares used in calculating diluted earnings per common share for the reported periods is provided in Note 19.

Business Segments

The Company is managed by legal entity and not by lines of business. The Bank is chartered in the State of Washington and is a community oriented commercial bank. The Bank's primary business is that of a traditional banking institution, gathering deposits and originating loans for portfolio in its respective primary market areas. The Bank offers a wide variety of deposit products to its consumer and commercial clients. Lending activities include the origination of real estate, commercial and agricultural business, dealer financing, leasing and consumer loans. The Bank is also an active participant in the secondary market, originating residential loans for sale with servicing retained. In addition to interest income on loans and investment securities, the Bank receives other income from deposit service charges, loan servicing fees and from the sale of loans and investments. The performance of the Bank is reviewed by the Company's executive management and Board of Directors on a monthly basis. All of the executive officers of the Company are members of Cashmere Valley Bank's management team. Generally accepted accounting principles establish standards to report information about operating segments in annual financial statements. The Company has determined that its current business and operations consist of a single business segment and a single reporting unit.

Reclassifications

Certain prior period amounts were reclassified to conform to the presentation for 2021. These reclassifications had no impact on net income or total shareholders' equity.

Recent Accounting Pronouncements

ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326)," as amended by ASU 2018-19, ASU 2019-04 and ASU 2019-05, was originally issued in June 2016. This ASU replaces the existing incurred loss impairment methodology that recognizes credit losses when a probable loss has been incurred with new methodology where loss estimates are based upon lifetime expected credit losses. The amendments in this ASU require a financial asset that is measured at amortized cost to be presented at the net amount expected to be collected. The income statement would then reflect the measurement of credit losses for newly recognized financial assets as well as changes to the expected credit losses that have taken place during the reporting period. The measurement of expected credit losses will be based on historical information, current conditions, and reasonable and supportable forecasts that impact the collectability of the reported amount. Available-for-sale securities will bifurcate the fair value mark and establish an allowance for credit losses (ACL) through the income statement for the credit portion of that mark. The interest portion will continue to be recognized through accumulated other comprehensive income or loss. The change in allowance recognized as a result of adoption will occur through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the ASU is adopted.

This ASU is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years, with early adoption permitted. The Company has evaluated its current expected loss methodology on the loan and investment portfolios to identify the necessary modifications in accordance with this standard and expects a change in processes and procedures to calculate the ACL. Changes include calculated assumptions and estimates to consider expected credit losses over the life of the loan versus the current accounting practice that utilizes the incurred loss model. A valuation adjustment in converting the ALLL to the ACL for the loan or investment portfolios that is identified in this process will be reflected as a one-time adjustment in equity rather than earnings. ASU 2019-05 issued in April 2019 further provides that entities with certain financial instruments measured at amortized cost that have credit losses, to irrevocably elect the fair value option in Subtopic 825-10, upon adoption of Topic 326. The fair value option applies to available-for-sale debt securities. This ASU is effective upon adoption of ASU 2016-13, and should be applied on a modified-retrospective basis as a cumulative-effect adjustment to the opening balance of retained earnings in the statement of financial condition as of the adoption date. The Company has compiled historical and industry data that will be used to calculate expected credit losses on the loan portfolio to ensure full compliance with the ASU at the adoption date. The Company adopted this ASU in January 2023 and recognized a one-time adjustment of \$1,058,000 to decrease the allowance for credit losses for the Company's loan portfolio. In addition, a one-time adjustment of \$2,138,000 was recognized to increase the reserve for unfunded loan commitments. The Company also established an allowance for credit losses of \$352,000 for the Company's held to maturity debt security portfolio. As a result of the cumulative-effect adjustment recorded on January 1, 2023, the Company recognized a reduction to retained earnings of \$1,131,000, net of tax.

In April 2019, FASB issued *ASU 2019-05, "Financial Instruments--Credit Losses (Topic 326), Targeted Transition Relief."* The amendments in this ASU provide entities that have certain financial instruments measured at amortized cost that have credit losses, to irrevocably elect the fair value option in Subtopic 825-10, upon adoption of Topic 326. The fair value option applies to available-for-sale debt securities. This ASU is effective when ASU 2016-13 is adopted, and will be applied on a modified-retrospective basis as a cumulative-effect adjustment to the opening balance of retained earnings in the statement of financial condition as of the adoption date. Prior to adoption, the Company evaluated the available for sale investment securities portfolio for other-than-temporary impairment on a quarterly basis. The Company adopted this ASU in January 2023, and at the time of adoption the Company did not establish an allowance for the credit loss portion of the unrealized loss on available for sale investment securities. The Company will evaluate the available for sale investment securities portfolio for credit impairment, and will establish an allowance if a credit impairment exists and is likely to be permanent.

In March 2022, the FASB issued *ASU 2022-02, "Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures."* The amendments in this ASU eliminate the current troubled debt restructuring (TDR) recognition and measurement guidance and, instead, require that a creditor evaluate (consistent with the accounting for other loan modifications) whether the modification represents a new loan or a continuation of an existing loan.

The amendments also introduce new requirements related to certain modifications of receivables made to borrowers experiencing financial difficulty. These amendments require vintage disclosures including current-period gross write-offs by year of origination for financing receivables. Gross write-off information must be included in the vintage disclosures in accordance with ASC 326-20-50-6, which requires disclosure of the amortized cost basis of financing receivables by credit quality indicator and class of financing receivable by year of origination.

The amendments in this ASU are effective for fiscal years beginning after December 15, 2022. These amendments should be applied prospectively, though for the transition method related to the recognition and measurement of TDRs, an entity has the option to apply a modified retrospective transition method, resulting in a cumulative effect adjustment to retained earnings in the period of adoption. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

Note 2 – Business Combinations

Gress-Kinney-Parrish Insurance Center, Inc.

On December 31, 2021, the Company acquired Gress-Kinney-Parrish Insurance Center, Inc. (GKP), an insurance agency and brokerage business in Yakima, Washington.

The purchase price for the assets included cash at the time of the merger plus a percentage of the total commissions of the seller earned and collected from January 1, 2024 to December 31, 2028.

The acquisition method of accounting was used for the GKP merger. Accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at estimated fair value on the acquisition date. Preliminary goodwill of \$58,000 was calculated as the purchase premium after adjusting for the fair value of net assets acquired and represents the value expected from the synergies created and the economies of scale expected from combining the two organizations. As part of this acquisition, there were no deferred income tax assets acquired or any liabilities assumed.

Determining the fair value of the acquired assets and assumed liabilities required estimation of cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest.

The following table provides a summary of the purchase price calculation as of the acquisition date, the identifiable assets purchased and the liabilities assumed at their estimated fair values.

Consideration

Cash	\$825,000
Contingent consideration arrangement	1,651,000
Fair value of total consideration transferred	<u>2,476,000</u>

Assets acquired

Supplies	1,000
Non-compete agreement	20,000
Intangible asset – GKP portfolio	2,397,000
Net assets acquired:	<u>2,418,000</u>
Goodwill	<u><u>\$58,000</u></u>

Lee Insurance Service, Inc.

On May 1, 2021, the Company acquired Lee Insurance Service, Inc., an insurance agency and brokerage business in Kirkland, Washington.

The purchase price for the assets included cash at the time of the merger plus a percentage of the total commissions of the seller earned and collected from May 1, 2021 to April 30, 2026.

The acquisition method of accounting was used for the Lee merger. Accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at estimated fair value on the acquisition date. Preliminary goodwill of \$336,000 was calculated as the purchase premium after adjusting for the fair value of net assets acquired and represents the value expected from the synergies created and the economies of scale expected from combining the two organizations. As part of this acquisition, there were no deferred income tax assets acquired or any liabilities assumed.

Determining the fair value of the acquired assets and assumed liabilities required estimation of cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest.

The following table provides a summary of the purchase price calculation as of the acquisition date, the identifiable assets purchased and the liabilities assumed at their estimated fair values.

Consideration

Cash	\$420,000
Contingent consideration arrangement	872,000
Fair value of total consideration transferred	<u>1,292,000</u>

Assets acquired

Premises and equipment	25,000
Supplies	1,000
Non-compete agreement	5,000
Intangible asset – Lee portfolio	925,000
Net assets acquired:	<u>956,000</u>
Goodwill	<u>\$336,000</u>

All merger-related charges were recorded in the consolidated statements of income and consolidated statements of comprehensive income for the year ended December 31, 2021. Such expenses were for human resources and professional services, among other categories, and including legal and accounting support.

Pro forma income statements are not being presented as the information is not practicable to produce. There were no new acquisitions in 2022.

Note 3 – Restricted Assets

On March 15, 2020, the Federal Reserve reduced the reserve requirement ratios to zero percent effective March 26, 2020. This action eliminated reserve requirements for all depository institutions. The elimination of reserve requirements was maintained through December 31, 2022 and therefore, no balance was required to be on deposit with the Federal Reserve Bank for the years ended December 31, 2022 and December 31, 2021.

Note 4 – Securities

Securities have been classified as available for sale or held to maturity according to management's intent and ability. The amortized cost of securities and their approximate fair value are as follows (dollars in thousands):

Securities Available for Sale	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2022				
U.S. Treasury securities	\$6,245	\$--	\$(812)	\$5,433
SBA loans backed by U.S. government agency	18,803	--	(501)	18,302
State and municipal securities	349,884	129	(59,155)	290,858
Collateralized mortgage obligations	246,151	34	(20,268)	225,917
Mortgage-backed securities	68,668	11	(4,576)	64,103
Student loans backed by U.S. government agency	24,145	--	(1,662)	22,483
Corporate securities	48,702	--	(5,721)	42,981
Total	<u>\$762,598</u>	<u>\$174</u>	<u>\$(92,695)</u>	<u>\$670,077</u>

December 31, 2021

U.S. Treasury securities	\$27,326	\$2	\$(219)	\$27,109
SBA loans backed by U.S. government agency	26,276	--	(369)	25,907
State and municipal securities	512,038	23,322	(3,870)	531,490
Collateralized mortgage obligations	351,565	2,103	(4,886)	348,782
Mortgage-backed securities	100,042	892	(1,628)	99,306
Student loans backed by U.S. government agency	24,152	8	(195)	23,965
Corporate securities	47,585	190	(1,102)	46,673
Total	\$1,088,984	\$26,517	\$(12,269)	\$1,103,232

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities Held to Maturity				
December 31, 2022				
State and municipal securities	\$47,260	\$8	\$(3,229)	\$44,039
Collateralized mortgage obligations	68,962	--	(5,455)	63,507
Mortgage-backed securities	30,187	--	(1,886)	28,301
Total	\$146,409	\$8	\$(10,570)	\$135,847

The Company had no held to maturity securities as of December 31, 2021. In April and May 2022, the Company made transfers totaling \$122.5 million of available for sale securities to the held to maturity portfolio. The securities were transferred at their fair value at the date of transfer. The Company intends to and has the ability to hold these securities to maturity. As a result of this transfer, an unrealized net loss of \$17.7 million was recorded as a reduction to the asset with an offsetting entry to accumulated other comprehensive income (loss), and the net loss will be accreted over the remaining life of the security. The original premium or discount will be accreted into income over the remaining life of the security.

In determining that no securities were other-than-temporarily impaired, each security was individually evaluated for impairment by management. On a quarterly basis, the Company evaluates these securities for other-than-temporary impairment (OTTI). During 2022 and 2021, there was no OTTI recorded in earnings. The unrealized losses on securities are primarily due to elevated yield spreads at December 31, 2022 and 2021 as compared to yields prevailing at the time specific securities were purchased. The Company has the intent and ability to retain its investments in securities with unrealized losses for a period of time sufficient to allow for any anticipated recovery in market value. It is not more likely than not that the Company will be required to sell the securities before recovery.

At December 31, 2022, there were 229 securities in a continuous unrealized loss position more than twelve months. The following shows the unrealized gross losses and fair value of securities in the available for sale portfolio at December 31, 2022 and 2021, by length of time that individual securities in each category have been in a continuous loss position (dollars in thousands):

	Less Than 12 Months		More Than 12 Months		Total	
	Unrealized Gross Loss	Fair Value	Unrealized Gross Loss	Fair Value	Unrealized Gross Loss	Fair Value
December 31, 2022						
U.S. Treasury securities	\$--	\$--	\$(812)	\$5,433	\$(812)	\$5,433
SBA loans backed by U.S. government agency	(110)	5,004	(391)	13,298	(501)	18,302
State and municipal securities	(18,263)	144,371	(40,892)	141,667	(59,155)	286,038
Collateralized mortgage obligations	(4,590)	96,713	(15,678)	128,076	(20,268)	224,789
Mortgage-backed securities	(1,102)	39,976	(3,474)	23,777	(4,576)	63,753
Student loans backed by U.S. government agency	(79)	2,779	(1,583)	19,704	(1,662)	22,483
Corporate securities	(740)	4,345	(4,981)	38,636	(5,721)	42,981
Total	\$(24,884)	\$293,188	\$(67,811)	\$370,591	\$(92,695)	\$663,779

	Less Than 12 Months		More Than 12 Months		Total	
	Unrealized Gross Loss	Fair Value	Unrealized Gross Loss	Fair Value	Unrealized Gross Loss	Fair Value
December 31, 2021						
U.S. Treasury securities	\$(219)	\$21,551	\$--	\$--	\$(219)	\$21,551
SBA loans backed by U.S. government agency	(57)	5,203	(312)	20,704	(369)	25,907
State and municipal securities	(2,688)	126,200	(1,182)	22,633	(3,870)	148,833
Collateralized mortgage obligations	(2,798)	135,113	(2,088)	81,907	(4,886)	217,020
Mortgage-backed securities	(1,004)	51,129	(624)	18,272	(1,628)	69,401
Student loans backed by U.S. government agency	(160)	18,010	(35)	3,408	(195)	21,418
Corporate securities	(668)	20,082	(434)	11,566	(1,102)	31,648
Total	\$(7,594)	\$377,288	\$(4,675)	\$158,490	\$(12,269)	\$535,778

The contractual maturities of securities held to maturity and available for sale at December 31, 2022, are shown below (dollars in thousands):

	Held to Maturity		Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$--	\$--	\$21,322	\$20,695
Due from one year to five years	6,076	5,752	71,697	68,101
Due from five years to ten years	29,476	27,903	199,433	174,482
Due after ten years	110,857	102,192	470,146	406,799
Total	\$146,409	\$135,847	\$762,598	\$670,077

Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations, with or without call or prepayment penalties.

Securities carried at approximately \$188.0 million and \$58.1 million at December 31, 2022 and 2021, respectively, were pledged to secure public deposits, repurchase agreements, and other purposes required or permitted by law.

Sales of securities available for sale were as follows (dollars in thousands):

	2022	2021
Proceeds from sales	\$220,282	\$27,629
Gross realized gains included in earnings	\$1,505	\$355
Gross realized losses included in earnings	\$(9,684)	\$(354)

Note 5 – Loans and Leases

Loans and leases at December 31 consist of the following (dollars in thousands):

	2022	2021
Commercial and agricultural	\$139,261	\$106,326
Real estate:		
Residential 1-4 family	111,032	102,405
Commercial	311,744	332,651
Construction	101,996	91,186
Farmland	5,138	5,354
Municipal	82,456	93,903
Consumer	21,165	19,171
Dealer contracts	224,783	183,709
Leases	3,490	1,791
Credit card	4,676	4,306
Total loans and leases	\$1,005,741	\$940,802

The Paycheck Protection Program (PPP), established by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), was implemented by the Small Business Administration (SBA) in an effort to assist small businesses adversely affected by the economic impact of COVID-19. On December 27, 2020, the life of PPP was extended by the Consolidated Appropriations Act, 2021 (CAA, 2021). The CAA, 2021 effectively created a second round of PPP loans for eligible businesses. The Company participated in the CAA's second round of PPP lending, and began processing PPP loan applications in mid-January 2021. In 2021, the Company originated 643 PPP loans totaling \$39,185,000. No PPP loans were originated in 2022.

PPP loan balances totaled \$2.0 million and \$10.0 million as of December 31, 2022 and 2021, respectively. PPP loan balances are included in the commercial and agricultural portfolio segment. The SBA paid lenders fees for processing PPP loans. The Company recognized \$446,000 and \$3,294,000 in net fees in 2022 and 2021, respectively. Net deferred fees remaining totaled \$52,000 and \$440,000 as of December 31, 2022 and 2021, respectively.

The following tables detail activity in the allowance for loan and lease losses (ALLL) by portfolio segment for the years ended December 31, 2022 and 2021 (dollars in thousands). While the allowance is allocated to specific loan and lease categories, the allowance is general in nature and is available for the loan and lease portfolio in its entirety.

	Commercial and Agricultural	Real Estate		Municipal	Consumer and Other	Unallocated	Total ALLL
		Residential 1-4 Family	Commercial, Construction, and Farmland				
2022							
Beginning balance	\$1,726	\$953	\$6,568	\$119	\$3,966	\$442	\$13,774
Provision for (recapture of) loan and lease losses	693	(75)	54	(18)	237	(91)	800
Charge-offs	(626)	--	--	--	(791)	--	(1,417)
Recoveries	192	--	--	--	397	--	589
Ending balance	\$1,985	\$878	\$6,622	\$101	\$3,809	\$351	\$13,746

Period end amount allocated to:

Loans and leases individually evaluated for impairment	\$93	\$322	\$17	\$--	\$4	\$--	\$436
Loans and leases collectively evaluated for impairment	1,892	556	6,605	101	3,805	351	13,310
Ending balance	\$1,985	\$878	\$6,622	\$101	\$3,809	\$351	\$13,746

	Commercial and Agricultural	Real Estate		Municipal	Consumer and Other	Unallocated	Total ALLL
		Residential 1-4 Family	Commercial, Construction, and Farmland				
2021							
Beginning balance	\$1,507	\$1,025	\$6,432	\$114	\$3,784	\$868	\$13,730
Provision for (recapture of) loan and lease losses	127	(72)	136	5	311	(426)	81
Charge-offs	(90)	--	--	--	(684)	--	(774)
Recoveries	182	--	--	--	555	--	737
Ending balance	\$1,726	\$953	\$6,568	\$119	\$3,966	\$442	\$13,774

Period end amount allocated to:

Loans and leases individually evaluated for impairment	\$--	\$357	\$3	\$--	\$3	\$--	\$363
Loans and leases collectively evaluated for impairment	1,726	596	6,565	119	3,963	442	13,411
Ending balance	\$1,726	\$953	\$6,568	\$119	\$3,966	\$442	\$13,774

The reserve for unfunded commitments totaled \$256,000 as of December 31, 2022 and 2021.

The Company's recorded investment in loans and leases as of December 31, 2022 and 2021 related to each balance in the allowance for loan and lease losses by portfolio segment, and disaggregated on the basis of the Company's impairment methodology, was as follows (dollars in thousands):

	Commercial and Agricultural	Real Estate Residential 1-4 Family	Commercial, Construction, and Farmland	Municipal	Consumer and Other	Total Loans and Leases
2022						
Loans and leases individually evaluated for impairment	\$841	\$3,639	\$10,486	\$--	\$113	\$15,079
Loans and leases collectively evaluated for impairment	138,420	107,393	408,392	82,456	254,001	990,662
Ending balance	\$139,261	\$111,032	\$418,878	\$82,456	\$254,114	\$1,005,741
2021						
Loans and leases individually evaluated for impairment	\$689	\$4,461	\$11,137	\$--	\$105	\$16,392
Loans and leases collectively evaluated for impairment	105,637	97,944	418,054	93,903	208,872	924,410
Ending balance	\$106,326	\$102,405	\$429,191	\$93,903	\$208,977	\$940,802

A summary of loans and leases by age, segregated by class of loans and leases, as of December 31, 2022 and 2021, was as follows (dollars in thousands):

	Loans and Leases 30-89 Days Past Due	Loans and Leases 90 or More Days Past Due	Total Past Due Loans and Leases	Current Loans and Leases	Total Loans and Leases	Accruing Loans 90 or More Days Past Due
2022						
Commercial and agricultural	\$941	\$234	\$1,175	\$138,086	\$139,261	\$--
Residential 1-4 family real estate	154	139	293	110,739	111,032	--
Commercial, construction, and farmland real estate	801	152	953	417,925	418,878	--
Municipal	--	--	--	82,456	82,456	--
Consumer and other	1,104	55	1,159	252,955	254,114	14
Total	\$3,000	\$580	\$3,580	\$1,002,161	\$1,005,741	\$14
2021						
Commercial and agricultural	\$92	\$--	\$92	\$106,234	\$106,326	\$--
Residential 1-4 family real estate	364	84	448	101,957	102,405	--
Commercial, construction, and farmland real estate	1,322	--	1,322	427,869	429,191	--
Municipal	--	--	--	93,903	93,903	--
Consumer and other	534	--	534	208,443	208,977	--
Total	\$2,312	\$84	\$2,396	\$938,406	\$940,802	\$--

The following table provides information with respect to nonaccrual loans as of the years ended December 31, 2022 and 2021 (dollars in thousands):

	2022	2021
Commercial and agricultural	\$576	\$--
Residential 1-4 family real estate	139	235
Commercial, construction, and farmland real estate	646	85
Municipal	--	--
Consumer and other	219	84
Total	\$1,580	\$404

The following table provides information with respect to impaired loans as of the years ended December 31, 2022 and 2021 (dollars in thousands):

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment
2022						
Commercial and agricultural	\$841	\$607	\$234	\$841	\$93	\$669
Residential 1-4 family real estate	3,639	693	2,946	3,639	322	3,835
Commercial, construction, and farmland real estate	10,486	10,322	164	10,486	17	10,596
Municipal	--	--	--	--	--	--
Consumer and other	113	23	90	113	4	101
Total	\$15,079	\$11,645	\$3,434	\$15,079	\$436	\$15,201
2021						
Commercial and agricultural	\$689	\$689	\$--	\$689	\$--	\$752
Residential 1-4 family real estate	4,461	1,339	3,122	4,461	357	4,622
Commercial, construction, and farmland real estate	11,137	10,998	139	11,137	3	11,201
Municipal	--	--	--	--	--	--
Consumer and other	105	--	105	105	3	113
Total	\$16,392	\$13,026	\$3,366	\$16,392	\$363	\$16,688

At December 31, 2022, there were no commitments to lend additional funds to borrowers whose loans have been impaired. Loans over 90 days past due still accruing interest totaled \$14,000 at December 31, 2022. At December 31, 2021, there were no loans over 90 days past due still accruing interest.

No interest income was recognized on a cash basis for impaired loans for the years ended December 31, 2022 and December 31, 2021. As of December 31, 2022, nonaccrual loans totaled \$1,580,000. Nonaccrual loans are included in impaired loan totals. All other impaired loans were paying according to terms and were accruing interest income in 2022. All impaired loans paid according to terms and were accruing interest income in 2021.

The Company assigns risk rating classifications to its loans. These risk ratings are divided into the following groups:

Pass – asset is considered of sufficient quality to preclude a Special Mention or an adverse rating. Pass assets generally are well protected by the current net worth and paying capacity of the obligor, by the value of the asset, or the underlying collateral.

Special Mention – asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Company’s credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Substandard – asset is inadequately protected by the current net worth and paying capacity of the obligor or by the collateral pledged, if any. Assets so classified have well-defined weaknesses. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful – asset has the weaknesses of those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Credit quality indicators for the Company's loan portfolio as of December 31, 2022 and 2021 grouped according to internally assigned risk ratings and payment activity (dollars in thousands):

	Commercial and Agricultural	Real Estate		Municipal	Consumer and Other	Total Loans and Leases
		Residential 1-4 Family	Commercial, Construction, and Farmland			
2022						
Pass	\$136,352	\$106,854	\$395,500	\$82,456	\$250,457	\$971,619
Special Mention	1,065	2,168	1,629	--	3,270	8,132
Substandard	1,844	2,010	21,749	--	387	25,990
Doubtful	--	--	--	--	--	--
Total loans and leases	\$139,261	\$111,032	\$418,878	\$82,456	\$254,114	\$1,005,741
Restructured	\$63	\$--	\$--	\$--	\$--	\$63
Nonaccrual	576	139	646	--	219	1,580
Nonperforming	639	139	646	--	219	1,643
Performing	138,622	110,893	418,232	82,456	253,895	1,004,098
Total loans and leases	\$139,261	\$111,032	\$418,878	\$82,456	\$254,114	\$1,005,741
	Commercial and Agricultural	Real Estate		Municipal	Consumer and Other	Total Loans and Leases
		Residential 1-4 Family	Commercial, Construction, and Farmland			
2021						
Pass	\$104,634	\$97,081	\$414,901	\$93,903	\$205,845	\$916,364
Special Mention	780	2,630	2,258	--	2,829	8,497
Substandard	912	2,694	12,032	--	303	15,941
Doubtful	--	--	--	--	--	--
Total loans and leases	\$106,326	\$102,405	\$429,191	\$93,903	\$208,977	\$940,802
Restructured	\$--	\$--	\$519	\$--	\$--	\$519
Nonaccrual	--	235	85	--	84	404
Nonperforming	--	235	604	--	84	923
Performing	106,326	102,170	428,587	93,903	208,893	939,879
Total loans and leases	\$106,326	\$102,405	\$429,191	\$93,903	\$208,977	\$940,802

Restructured loans are defined as the period end outstanding balance of loans that previously underwent a troubled debt restructuring that are not performing in accordance with restructured terms.

The following table presents by class troubled debt restructurings (TDRs) recorded during the years ended December 31, 2022 and 2021 (dollars in thousands, except number of contracts):

2022	Number of Contracts	Pre-Modification	Post-Modification
		Recorded Investment	Recorded Investment
Commercial and agricultural	4	\$390	\$390
Residential 1-4 family real estate	1	104	104
Commercial, construction, and farmland real estate	4	378	378
Municipal	--	--	--
Consumer and other	4	26	26
Total*	13	\$898	\$898

*Amounts exclude specific loan loss reserves

2021	Number of Contracts	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial and agricultural	3	\$611	\$611
Residential 1-4 family real estate	1	401	401
Commercial, construction, and farmland real estate	3	1,336	1,336
Municipal	--	--	--
Consumer and other	--	--	--
Total*	7	\$2,348	\$2,348

*Amounts exclude specific loan loss reserves

The majority of TDRs are determined to be impaired prior to being restructured. As such, they are individually evaluated for impairment, unless they are considered homogeneous loans in which case they are collectively evaluated for impairment.

As of December 31, 2022, the Company had \$341,000 in specific reserves on TDRs. The primary type of concession granted in all TDRs during the year ended December 31, 2022 was maturity extensions. There were no TDRs that were restructured and subsequently defaulted during the year ended December 31, 2022.

Note 6 - Premises and Equipment

Components of premises and equipment at December 31 are as follows (dollars in thousands):

	2022	2021
Land	\$5,234	\$5,234
Buildings and improvements	19,027	18,778
Furniture	5,745	5,815
Equipment	6,462	5,692
Assets in process	2,235	127
Total cost	38,703	35,646
Less accumulated depreciation	(20,428)	(18,588)
Total premises and equipment	\$18,275	\$17,058

As of December 31, 2022, there was a \$4,228,000 commitment for capital expenditures of a Union Gap branch location, which is expected to be completed in 2023. Of the \$4,228,000 commitment, \$1,570,000 had been paid as of December 31, 2022.

Depreciation expense was \$1,975,000 and \$1,792,000 in 2022 and 2021, respectively.

Note 7 – Goodwill and Other Intangible Assets

The Company recorded approximately \$58,000 of goodwill and \$2,417,000 of amortizable intangible assets in connection with the Gress-Kinney-Parrish Insurance Center, Inc. merger that occurred on December 31, 2021. The Company recorded approximately \$336,000 of goodwill and \$930,000 of amortizable intangible assets in connection with the Lee Insurance Service, Inc. merger that occurred on May 1, 2021.

The amortization schedule of intangible assets in connection with all previous Mitchell, Reed & Schmitten Insurance, Inc. acquisitions for future years ending December 31 is as follows (dollars in thousands):

2023	\$291
2024	732
2025	695
2026	562
2027	488
Thereafter	1,028
Total	\$3,796

Note 8– Mortgage Servicing Rights

Mortgage servicing rights are evaluated periodically for possible impairment based on the difference between the carrying amount and current fair value of the MSRs by risk stratification. If a temporary impairment exists, a valuation allowance is established for any excess of amortized cost over the current fair value through a charge to income. A direct write-down is performed when the recoverability of a recorded valuation allowance is determined to be remote. Unlike a valuation allowance, a direct write-down permanently reduces the carrying value of the MSR and the valuation allowance, precluding subsequent reversals.

Mortgage loans serviced for others are not included on the accompanying consolidated balance sheets. The unpaid principal balances of mortgage loans serviced for others were \$428,189,000 and \$436,095,000 at December 31, 2022 and 2021, respectively. Custodial escrow balances maintained in connection with the foregoing loan servicing were approximately \$2,761,000 and \$2,829,000 at December 31, 2022 and 2021, respectively. The weighted average amortization period of the Company's servicing rights was 7.8 years and 5.6 years in 2022 and 2021, respectively. The Company receives mortgage servicing fees from customers for routine and contractually specified maintenance and servicing. Servicing fees earned were \$1,084,000 and \$1,101,000 in 2022 and 2021, respectively, and are included in mortgage banking operations on the consolidated statements of income.

The following summarizes the activity in mortgage servicing rights for the years ended December 31 (dollars in thousands):

	2022	2021
Balance as of beginning of year	\$2,802	\$2,856
Originations	365	801
Amortization	(482)	(855)
Adjustment valuation	--	--
Balance as of end of year	\$2,685	\$2,802

The estimated fair value of the Company's MSR portfolio was \$5,577,000 and \$3,859,000 at December 31, 2022 and 2021, respectively. Fair value of mortgage servicing rights is based on market prices for comparable mortgage servicing contracts when available. In periods of market inactivity, fair value is determined using a discounted cash flow analysis, utilizing observable market data with unobservable adjustments. The analysis takes into consideration existing conditions in the secondary servicing markets, such as prices from recently executed servicing transactions and market discount rates. The adjustments made to observable data include adjustments for delinquency and loss rates.

The follow is a summary of key assumptions used in measuring the fair value of mortgage servicing rights for the years ended December 31:

	2022	2021
Constant prepayment rate	6.58%	12.04%
Discount Rate	9.50%	9.00%
Weighted average life	7.8 years	5.6 years

Note 9 - Deposits

The composition of deposits is as follows (dollars in thousands):

	Deposits at December 31		Interest Expense for the Years Ended December 31	
	2022	2021	2022	2021
Noninterest bearing demand deposits	\$457,666	\$432,621	\$--	\$--
NOW accounts	363,221	388,599	952	752
Money market and savings accounts	865,154	912,570	1,140	1,140
Time deposits greater than \$250,000	55,465	42,285	594	828
Time deposits \$250,000 or less	158,513	160,502	1,633	2,374
Total	\$1,900,019	\$1,936,577	\$4,319	\$5,094

Time deposits at December 31, 2022 are scheduled to mature as follows (dollars in thousands):

	Up to \$250,000	Greater than \$250,000
0 to 90 days	\$18,702	\$3,552
91 to 365 days	65,892	30,727
1 year to 3 years	59,327	19,274
Over 3 years	14,592	1,912
Total	\$158,513	\$55,465

Total demand deposit overdrafts that have been reclassified to loans were \$236,000 and \$206,000 at December 31, 2022 and 2021, respectively.

The Company is a State of Washington Public Depository. All such public depositories are required to be members of Washington State's Public Deposit Protection Commission (PDPC). As such, when there is a loss of public funds at a member institution, those funds are in most instances insured to some extent by the federal government. To the degree a public deposit is not insured by the federal government, the PDPC will assess a claim first against the institution responsible for the loss and then against the pool of collateral held by other PDPC member institutions. Each institution is then responsible to pay its portion of the cost in proportion to the share of public funds held by that institution. The Company held \$59,067,000 and \$71,969,000 of public deposits as of December 31, 2022 and 2021, respectively.

Note 10 - Short-Term Borrowings

Securities sold under agreements to repurchase are secured by specific securities which, in all cases, the Company maintains control.

Securities sold under agreements to repurchase and line of credit advances from the Federal Home Loan Bank Des Moines represent short-term borrowings. At December 31, 2022 and 2021 there were no outstanding balances for credit advances.

The following is a summary of securities sold under agreements to repurchase for the years ended December 31 (dollars in thousands):

	2022	2021
Ending balance at December 31	\$17,166	\$34,504
Average balance	\$31,538	\$24,847
Maximum month end balance	\$36,567	\$34,504
Weighted average interest rate:		
End of year	0.20%	0.20%
During the year	0.20%	0.20%
Carrying value of underlying securities at December 31	\$48,347	\$15,908
Market value of underlying securities at December 31	\$42,770	\$17,071

Note 11 - Long-Term Borrowings

There were no long-term borrowings at December 31, 2022 and 2021.

Note 12 - Income Taxes

Income taxes are comprised of the following for the years ended December 31 (dollars in thousands):

	2022	2021
Current	\$4,108	\$4,914
Deferred	(383)	(72)
State income taxes	93	107
Total income taxes	\$3,818	\$4,949

The following is a reconciliation of the statutory income tax rate to the effective income tax rate for the years ended December 31 (dollars in thousands):

	2022		2021	
	Amount	Percent of Pretax Income	Amount	Percent of Pretax Income
Income tax at statutory rates	\$6,262	21.0%	\$7,136	21.0%
Increase resulting from:				
State income tax	67	0.2%	65	0.2%
Decrease resulting from:				
Tax-exempt income	(1,854)	(6.2)%	(1,862)	(5.5)%
Tax credits	(561)	(1.9)%	(555)	(1.6)%
Other	(96)	(0.3)%	165	0.5%
Total income tax expense	\$3,818	12.8%	\$4,949	14.6%

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities at December 31 are as follows (dollars in thousands):

	2022	2021
Deferred Tax Assets:		
Unrealized loss on securities available for sale	\$19,429	\$--
Allowance for credit losses	2,887	2,893
Deferred compensation	777	673
Other	716	606
Total deferred tax assets	23,809	4,172
Deferred Tax Liabilities:		
Accumulated depreciation and amortization	\$1,552	\$1,714
Deferred loan costs	536	525
Unrealized gain on securities available for sale	--	2,992
Mortgage servicing rights	564	588
FHLB dividends	136	136
Total deferred tax liabilities	2,788	5,955
Net deferred tax assets/(liabilities)	\$21,021	\$(1,783)

Note 13 – Related-Party Transactions

In the ordinary course of business, the Company has transactions with related parties, including but not limited to: directors, principal officers, their immediate families, and affiliated companies in which they are principal shareholders. In the opinion of management, all related party transactions have been on the same terms as the terms for comparable transactions with outside parties.

The following table details the loan activity with related parties at December 31 (dollars in thousands):

	<u>2022</u>	<u>2021</u>
Beginning balance	\$13,362	\$20,140
New loans or advances during period	3,389	1,747
Repayments or reductions due to director retirement during period	<u>(3,464)</u>	<u>(8,525)</u>
Aggregate amount outstanding	<u>\$13,287</u>	<u>\$13,362</u>
 Loan commitments	 \$16,745	 \$14,748
Related party deposits	\$8,826	\$9,165

Note 14 - Commitments and Contingencies

Credit

The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the consolidated balance sheets.

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

A summary of the Company's commitments at December 31 is as follows (dollars in thousands):

	<u>2022</u>	<u>2021</u>
Commitments to extend credit:		
Credit card lines	\$34,955	\$35,236
Commercial real estate, construction and development	56,946	84,335
Home equity lines of credit	68,120	58,022
Other	<u>85,866</u>	<u>87,451</u>
Total commitments to extend credit	<u>\$245,887</u>	<u>\$265,044</u>
 Standby letters of credit	 \$63	 \$63

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. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company's experience has been that between approximately 10% and 25% of loan commitments are drawn upon by customers. The Company evaluates each customer's creditworthiness 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. Associated with the unfunded commitment, the Company has established a loss reserve in the amount of \$256,000 as of December 31, 2022 and 2021.

Standby Letters of Credit

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 loan facilities to customers. In certain circumstances collateral is deemed necessary to secure the commitment.

Legal

The Company is subject to various pending and threatened legal actions which arise in the ordinary course of business. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on the financial position of the Company.

Borrowing Facilities

The Company has agreements with commercial banks for lines of credit totaling \$74,000,000, none of which was used at December 31, 2022. The Company has a credit line with the Federal Home Loan Bank of Des Moines for up to 45% of assets. As of December 31, 2022, the current borrowing capacity was approximately \$250,240,000 due to the Company's eligible collateral pledge, none of which was used at December 31, 2022. This line is secured with a Blanket Pledge Agreement with the Federal Home Loan Bank (Note 10).

Investments

The Company entered into a subscription agreement to purchase one unit at \$1,000,000 for an interest in Homestead Western Communities Fund Limited Partnership (HWCF) for which funding has been completed. HWCF has been formed to invest in partnerships or limited liability companies, which will acquire, construct, rehabilitate, operate, and dispose of low-income housing developments which are located in the states of Oregon, Washington, Idaho, and California. The housing developments will be eligible for the federal low-income housing tax credit and, in some cases, the historic rehabilitation tax credit available under the Internal Revenue Code of 1986, as amended. The Company accounts for the investment under the equity method in accordance with ASC 323, "*Investments – Equity Method and Joint Ventures*," and a pass-through loss of \$5,000 and \$7,000 was recorded during 2022 and 2021, respectively. At December 31, 2022 and 2021, the Company's partnership equity was \$12,000 and \$17,000, respectively.

The Company entered into a subscription agreement to purchase five units at \$1,000,000 per unit for an interest in Homestead Equity Fund X Limited Partnership (HEF-X). HEF-X has been formed to invest in partnerships or limited liability companies, which will acquire, construct, rehabilitate, operate, and dispose of low-income housing developments primarily located in the states of Oregon, Washington, Idaho, and California. The housing developments will be eligible for the federal low-income housing tax credit and, in some cases, the historic rehabilitation tax credit available under the Internal Revenue Code of 1986, as amended. The Company accounts for the investment under the equity method in accordance with ASC 323, "*Investments – Equity Method and Joint Ventures*," and a pass-through loss of \$565,000 and \$497,000 was recorded during 2022 and 2021, respectively. At December 31, 2022 and 2021, the Company's partnership equity was \$1,310,000 and \$1,733,000, respectively.

The Company entered into a subscription agreement to purchase one and a half units at \$1,000,000 per unit for an interest in CREA Corporate Tax Credit Fund 72, LLC (CREA). CREA has been formed to invest in partnerships or limited liability companies, which will acquire, construct, rehabilitate, operate, and dispose of low-income housing developments nationwide. The housing developments will be eligible for the federal low-income housing tax credit and, in some cases, the historic rehabilitation tax credit available under the Internal Revenue Code of 1986, as amended. The Company accounts for the investment under the equity method in accordance with ASC 323, "*Investments – Equity Method and Joint Ventures*," and a pass-through loss of \$87,000 and \$84,000 was recorded during 2022 and 2021, respectively. At December 31, 2022 and 2021, the Company's partnership equity was \$1,149,000 and \$486,000, respectively.

The Company's remaining contractual contribution for CREA Corporate Tax Credit Fund 72, LLC (CREA) of \$118,000 is expected to be paid as follows (dollars in thousands):

2023	\$17
2024	9
2025	33
Thereafter	59
Total	<u><u>\$118</u></u>

Employment Agreements

The Company has entered into employment contracts with certain key employees, which provide for contingent payments subject to future events. These agreements are discussed in Note 16.

Derivatives

For the years ended December 31, 2022 and 2021, the fair value of the hedged loans was a loss of \$4,000 and gain of \$137,000, respectively, and are included in loans held for investment. A related swap asset was recorded at \$4,000 in 2022 and a related swap liability was recorded at \$137,000 in 2021. The Company pledged a certificate of deposit due from the counterparty of the hedging instruments as collateral for the swap liability. This certificate of deposit had a balance of \$100,000 at December 31, 2022 and 2021. The notional amounts of the interest rate swaps were \$1,140,000 and \$1,285,000 at December 31, 2022 and 2021, respectively. The Company recognized no loss in 2022 and 2021 which represents the ineffective portion of all fair value hedges. All components of each derivative's gain or loss are included in the assessment of hedge effectiveness, unless otherwise noted.

Premises and Equipment

As of December 31, 2022, there was a \$4,228,000 commitment for capital expenditures of a Union Gap branch location, which is expected to be completed in 2023. Of the \$4,228,000 commitment, \$1,570,000 had been paid as of December 31, 2022.

COVID-19

Health concerns relating to the COVID-19 outbreak and government actions taken to reduce the spread of the virus have had an adverse effect on the macroeconomic environment. The COVID-19 outbreak has significantly increased economic uncertainty and reduced some forms of economic activity. Governmental responses to limit the spread of the virus have resulted in restrictions, including but not limited to quarantines, shutdowns, operational limitations and lockdowns. Whether the virus itself or the response to the virus, material changes to the labor market and spending from businesses and consumers have occurred. The Company has experienced adverse impacts from the outbreak and pandemic response which are anticipated to continue into the foreseeable future. Adverse impacts may include, but are not limited to, credit losses in affected industries, decline in collateral values, bankruptcies, labor market challenges, service quality from third-parties related to staffing or shipping, and increased cyber and payment fraud risk.

Note 15 – Significant Concentration of Credit Risk

Most of the Company's business activity is with customers located in the state of Washington. Investments in state and municipal securities involve government entities primarily within the state. At December 31, 2022, 10.13% of total loans outstanding were for construction related projects. At December 31, 2022, 1.15% of total loans outstanding were residential lot development loans.

Loans are generally limited, by state banking regulations, to 20% of the Company's capital to any one borrower, excluding accumulated other comprehensive income. At December 31, 2022 the Company's legal lending limit was \$49,733,000. Standby letters of credit were granted primarily to commercial borrowers. The Company, as a matter of practice, generally does not extend credit to any single borrower or group of related borrowers in excess of \$27,500,000. At December 31, 2022, no borrowing relationship was in excess of this limit.

Note 16 - Employee Compensation Plans

Cashmere Valley Bank Stock Option Plan

The Bank has a stock option plan under which directors and certain key employees have been granted options to purchase shares of common stock. Under the plan, 153,345 options were available for grant at December 31, 2022. Options have an exercise price equal to the fair market value of the stock as of the date of grant. In 2018, the Bank adopted a vesting schedule with no vesting on grant date and 20% vesting on each of the five subsequent anniversaries of the grant. Options have a maximum contractual term of ten years. The Black-Scholes model requires the use of assumptions noted in the following table. The dividend yield is based on the Bank's actual and expected dividends paid to shareholders. The Bank uses historical data to estimate the expected life, which represents the period of time the options are expected to be outstanding. Expected stock price volatility is based on the Bank's historical stock price, adjusted for dividends. The risk-free interest rate is based on the U.S. Treasury yield curve rate in effect at grant date with average equivalent term.

The fair value of each option was estimated on the date of grant based on the Black-Scholes option pricing model and used the following weighted average assumptions:

	2022	2021
Dividend yield	2.27%	2.86%
Expected life	6.5 years	6.5 years
Risk-free interest rate	3.19%	0.75%
Expected volatility	23.91%	23.21%

A summary of the status of the Bank's stock option plan as of December 31, 2022, and changes during the years ending on those dates, is presented below:

2022	Shares	Weighted Average Exercise Price	Weighted Average Fair Value at Grant
Outstanding at beginning of year	99,370	\$55.22	\$10.16
Granted	19,496	53.54	11.89
Exercised	3,020	55.89	9.92
Outstanding at end of year	115,846	\$54.92	\$10.46

2022	Shares	Weighted Average Exercise Price	Weighted Average Fair Value at Grant
Vested and expected to vest	103,335	\$54.92	\$10.46
Options exercisable at year end	59,393	\$54.32	\$10.28

The following table summarizes the stock options outstanding and exercisable at December 31, 2022:

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
\$ 25.00 – 40.00	6,700	1.33	\$35.00	6,700	1.33	\$35.00
\$ 40.01 – 50.00	19,485	9.23	\$44.66	2,390	7.67	\$44.48
\$ 50.01 – 58.50	41,346	6.06	\$54.87	23,787	5.25	\$54.15
\$ 58.51 – 72.50	48,315	6.38	\$61.86	26,516	5.72	\$60.23
Balance at December 31, 2022	115,846	6.46	\$54.92	59,393	5.11	\$54.32

The total intrinsic value of the options exercised during 2022 and 2021 was \$43,000 and \$156,000, respectively. At December 31, 2022 and 2021, the total intrinsic value of options outstanding was \$83,000 and \$1,618,000, respectively. Weighted average remaining contractual life of options vested and expected to vest is 6.50 years. Total proceeds from options exercised in 2022 and 2021 were \$169,000 and \$318,000, respectively. As a result of disqualifying dispositions of options exercised, the Bank recorded a tax benefit of \$4,000 in 2022, and \$6,000 in 2021.

At December 31, 2022, unrecognized compensation expense related to unvested options totaled \$494,000 and is expected to be recognized over a weighted average period of 27 months. During 2022, 12,630 options vested with a weighted average fair value at grant date of \$9.74. During 2021, 12,821 options vested with a weighted average fair value at grant date of \$10.28. Total expense recognized by the Bank for stock options for the years ended December 31, 2022 and 2021 was \$145,000 and \$125,000, respectively.

Cashmere Valley Bank Restricted Stock Plan

Restricted stock awards are generally scheduled to vest over a three to five-year period, with the unearned compensation related to restricted stock amortized to expense on a dynamic prorated straight-line basis. Unrecognized compensation cost related to unvested restricted stock awards in 2022 and 2021 totaled \$7,000 and \$13,000, respectively. Total expense

recognized by the Bank for restricted stock awards for the years ended December 31, 2022 and 2021 was \$14,000 and \$21,000, respectively.

The following table summarizes the Bank's restricted stock awards activity:

	Shares	Weighted Average Fair Value at Grant
Outstanding at December 31, 2020	590	\$61.95
Granted	40	\$71.53
Vested	(390)	\$64.15
Outstanding at December 31, 2021	240	\$59.97
Granted	125	\$67.55
Vested	(225)	\$64.23
Outstanding at December 31, 2022	140	\$59.90

As of December 31, 2022, there are 100 outstanding restricted stock awards scheduled to vest in 2023 and 40 outstanding restricted stock awards scheduled to vest in 2024.

Mitchell, Reed & Schmitten Insurance, Inc. Stock Option Plan

In 2022, Mitchell, Reed & Schmitten Insurance, Inc. approved a new stock option plan under which certain key employees have been granted options to purchase shares of common stock. Under the plan, MRS may grant options of its common stock to certain key employees up to 2,000 shares. At December 31, 2022, 625 shares were available for grant. Options have an exercise price equal to a valuation of the stock as of the date of grant. Options have a maximum contractual term of ten years. The Black-Scholes model requires the use of assumptions noted in the following table. The dividend yield is based on MRS's actual and expected dividends paid to shareholders. MRS uses historical data of peer groups to estimate the expected life, which represents the period of time the options are expected to be outstanding. Expected stock price volatility is based on the historical stock price of peer groups, adjusted for dividends. The risk-free interest rate is based on the U.S. Treasury yield curve rate in effect at grant date with average equivalent term.

The fair value of each option was estimated on the date of grant based on the Black-Scholes option pricing model and used the following weighted average assumptions:

	2022
Dividend yield	13.39%
Expected life	6.31 years
Risk-free interest rate	3.78%
Expected volatility	26.52%

A summary of the status of the MRS's stock option plan as of December 31, 2022, and changes during the years ending on those dates, is presented below:

2022	Shares	Weighted Average Exercise Price	Weighted Average Fair Value at Grant
Outstanding at beginning of year	--	\$--	\$--
Granted	1,160	1,190	43.89
Exercised	--	--	--
Outstanding at end of year	1,160	\$1,190	\$43.89

2022	Shares	Weighted Average Exercise Price	Weighted Average Fair Value at Grant
Vested and expected to vest	1,160	\$1,190	\$43.89
Options exercisable at year end	145	\$1,190	\$44.32

Weighted average remaining contractual life of options vested and expected to vest is 5.99 years.

At December 31, 2022, unrecognized compensation expense related to unvested options totaled \$44,000 and is expected to be recognized over a weighted average period of 42 months. During 2022, 145 options vested with a weighted average fair value at grant date of \$44.32. Total expense recognized by MRS for stock options for the year ended December 31, 2022 was \$7,000.

Mitchell, Reed & Schmitten Insurance, Inc. Restricted Stock Plan

Restricted stock awards are scheduled to vest over a five-year period, with the unearned compensation related to restricted stock amortized to expense on a dynamic prorated straight-line basis. Unrecognized compensation cost related to unvested restricted stock awards in 2022 totaled \$203,000. Total expense recognized by MRS for restricted stock awards for the year ended December 31, 2022 was \$53,000.

The following table summarizes the MRS's restricted stock awards activity:

	Shares	Weighted Average Fair Value at Grant
Outstanding at December 31, 2021	--	\$--
Granted	215	\$1,190.00
Vested	(43)	\$1,190.00
Outstanding at December 31, 2022	172	\$1,190.00

Scheduled vesting for outstanding restricted stock awards as of December 31, 2022 is as follows:

2023	43
2024	43
2025	43
2026	43
Total	<u>172</u>

Profit-Sharing Plans

The Company has a 401(k) employee benefit plan for those employees who meet eligibility requirements set forth in the plan. Eligible employees may contribute up to 100% of their compensation, subject to certain IRS limits. The Company provides a Safe Harbor match of 100% of the first 4% contributed by participants, subject to certain IRS limits. The Company contributed \$683,000 and \$620,000 in 2022 and 2021, respectively.

Incentive compensation is awarded to certain employees based on the financial performance of the Company. Cash bonuses were awarded pursuant to a formula targeted on the Company achieving certain performance goals for the years ended in 2022 and 2021, with the amounts awarded in 2023 and 2022. Amounts awarded under the plan for 2022 and 2021 were \$1,066,000 and \$911,000, respectively.

Deferred Compensation Plan

The Company offers a non-qualified deferred compensation plan to members of the Board of Directors and certain employees. The plan permits each participant to defer a portion of their director fees, non-qualified retirement contributions, salary, or bonuses for future receipt. Earnings and contributions are fully vested upon contribution. The Company offers a company funded deferred compensation plan to certain key employees. Under this plan, annual contributions are made and interest is expensed. The plan has cliff vesting at January 1, 2031. As of December 31, 2022 and 2021, liabilities recorded in connection with deferred compensation plan benefits totaled \$3,698,000 and \$3,207,000, respectively. Compensation is charged to expense in the period earned. For the years ended December 31, 2022 and 2021, the Company recognized \$257,000 and \$198,000 in expense, which represented the plan earnings or planned contributions subject to vesting criteria in accordance with the deferred compensation agreements.

Insurance

The Company provides certain health care, disability, and life insurance benefits for current employees. The cost of health care benefits for employees is recognized as expense when paid. Life insurance benefits for employees are provided through

an insurance company whose premiums are based on the benefits paid during the year. The Company recognizes the cost of providing such benefits by expensing the monthly insurance premiums. For 2022 and 2021, the cost of providing health care, disability, and life insurance benefits was \$2,719,000 and \$2,094,000, respectively.

Note 17 - Regulatory Matters

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

Quantitative measures established by regulation to ensure capital adequacy require the Company maintain minimum amounts and ratios of Tier 1 capital to total average assets and minimum ratios of Tier 1 and total capital to risk-weighted assets.

In July 2013, the Board of Governors of the Federal Reserve System and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III). Under the final rules, which became effective for the Company on January 1, 2015 and are subject to a phase-in period through January 1, 2019, minimum requirements increased for both the quantity and the quality of capital held by the Company. The rules include a new Common Equity Tier 1 capital to risk-weighted assets ratio (CET1 ratio) of 4.5% and a capital conservation buffer of 2.5% above the regulatory minimum risk-based capital requirements, which fully phased in, effectively results in a minimum CET1 ratio of 7.0%. Basel III also (i) raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% (which, with the capital conservation buffer, effectively results in a minimum Tier 1 capital to risk-weighted assets ratio of 8.5% when fully phased in); (ii) effectively results in a minimum total capital to risk-weighted assets ratio of 10.5% (with the capital conservation buffer fully phased in); and (iii) requires a minimum leverage ratio of 4.0%. Basel III also makes changes to risk weights for certain assets and off-balance sheet exposures.

As of December 31, 2022, the most recent notification from the Company's regulator categorized the Company as well capitalized under the regulatory framework for prompt corrective action.

The federal banking agencies jointly issued the Community Banking Leverage Ratio (CBLR) final rule effective January 1, 2020. The Company elected to use the CBLR framework effective January 1, 2020, which allows qualifying community banking organizations to calculate a leverage ratio to measure capital adequacy. A CBLR bank is deemed to have met the well-capitalized ratio requirements and complies with the general applicable capital rule. A qualifying community banking organization is defined as having less than \$10 billion in total consolidated assets, a leverage ratio greater than 9%, off-balance sheet exposures of 25% or less of total consolidated assets, and trading assets and liabilities of 5% or less of total consolidated assets.

The Company meets all CBLR requirements as of December 31, 2022.

December 31, 2022	Actual Ratio	CBLR Minimum Ratio	Regulatory Minimum to be "Adequately Capitalized"	Regulatory Minimum to be "Well Capitalized"
Tier 1 leverage	10.68%	9.00%	4.00%	5.00%
December 31, 2021	Actual Ratio	CBLR Minimum Ratio	Regulatory Minimum to be "Adequately Capitalized"	Regulatory Minimum to be "Well Capitalized"
Tier 1 leverage	9.88%	9.00%	4.00%	5.00%

Restrictions on Retained Earnings

The Company is restricted from paying dividends in an amount that would decrease regulatory capital below the minimum amounts shown above.

Note 18 - Fair Value

The Company is required to disclose the estimated fair value of financial instruments, both assets and liabilities on and off the balance sheet, for which it is practicable to estimate fair value. These fair value estimates are made at December 31, 2022 based on relevant market information and information about the financial instruments. Fair value estimates are intended to represent the price at which an asset could be sold, or the price for which a liability could be settled. However, given there is no active market or observable market transactions for many of the Company's financial instruments, the Company has made estimates of many of these fair values. Those estimates, which are subjective in nature, involve uncertainties and matters of significant judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimated values.

Fair Value of Financial Instruments

The carrying amounts and estimated fair value of the Company's financial instruments are as follows (dollars in thousands):

		December 31, 2022		December 31, 2021	
	Level	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets					
Cash and cash equivalents	1	\$180,312	\$180,312	\$114,004	\$114,004
Securities available for sale	1,2,3	670,077	670,077	1,103,232	1,103,232
Securities held to maturity	2	146,409	135,847	--	--
FHLB stock	2	2,669	2,669	2,393	2,393
Loans held for sale	2	142	142	1,148	1,148
Loans and leases, net	3	991,995	929,600	927,028	917,500
Mortgage servicing rights	3	2,685	5,577	2,802	3,859
Accrued interest receivable	2	8,199	8,199	8,553	8,553
Bank Owned Life Insurance	2	26,105	26,105	26,485	26,485
Interest rate swaps	2	4	4	--	--
Financial Liabilities					
Deposits	3	\$1,900,019	\$1,631,900	\$1,936,577	\$2,021,700
Borrowings	3	17,166	17,100	34,504	34,500
Interest rate swaps	2	--	--	137	137
Accrued interest payable	2	434	434	403	403

The Company assumes interest rate risk as a result of its normal operations. As a result of interest rate level changes, fair values of the Company's financial instruments may change in a direction that is either favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities, and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Company's overall interest rate risk.

The following methods and assumptions were used by the Company in estimating the fair value of financial instruments:

Securities Available For Sale

Available for sale securities totaling \$670,077,000 are reported at fair value utilizing Level 1, Level 2 and Level 3 inputs. The fair value of securities utilizing Level 1 inputs include listed stocks, bonds, funds or any other assets that have a liquid market and regular mark-to-market mechanism for establishing a fair value, as described in Note 1. The fair value of securities utilizing Level 2 inputs are based on quoted market prices of similar instruments and dealer quotes or determined using a present value income model that applies observable market-based inputs, as described in Note 1. The fair value of securities utilizing Level 3 inputs are based on pricing models or discounted cash flow methodologies, as described in Note

1. The fair values were obtained from an independent pricing service and internally validated. The fair value measurements consider observable data that 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.

Interest Rate Swap Derivatives

The fair values of interest rate swap derivatives utilizing Level 2 inputs are estimated by an independent third-party using a discounted cash flow method based on current incremental rates for similar types of arrangements. For purposes of potential valuation adjustments to its derivative positions, the Company evaluates the credit risk of its counterparties as well as that of the Company. Accordingly, the Company has considered factors such as the likelihood of default by the Company and its counterparties, its net exposures, and remaining contractual life, among other things, in determining if any fair value adjustments related to credit risk are required. Counterparty exposure is evaluated by considering the amounts of collateral securing the position. The Company reviews its counterparty exposure on a regular basis, and when necessary, appropriate business actions would be taken to adjust the exposures. The Company also uses this approach to estimate its own credit risk on derivative liability positions. The Company has not realized any significant losses due to a counterparty's inability to pay any net uncollateralized position. The change in value of derivative assets and derivative liabilities attributable to credit risk was not significant during the reported periods.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The financial assets and liabilities measured at fair value on a recurring basis, separated by level in the fair value hierarchy, are as follows (dollars in thousands):

	Assets/(Liabilities)	Fair Value Measurement Using		
		Level 1	Level 2	Level 3
December 31, 2022	Total			
U.S. Treasury	\$5,433	\$5,433	\$--	\$--
SBA loans backed by U.S. government agency	18,302	--	18,302	--
State and municipal securities	290,858	--	290,858	--
Collateralized mortgage obligations	225,917	--	225,917	--
Mortgage-backed securities	64,103	--	64,103	--
Student loans backed by U.S. government agency	22,483	--	22,483	--
Corporate securities	42,981	--	26,795	16,186
Total securities available for sale	\$670,077	\$5,433	\$648,458	\$16,186
Interest rate swap derivatives	\$4	\$--	\$4	\$--
December 31, 2021				
U.S. Treasury	\$27,109	\$27,109	\$--	\$--
SBA loans backed by U.S. government agency	25,907	--	25,907	--
State and municipal securities	531,490	--	531,490	--
Collateralized mortgage obligations	348,782	--	348,782	--
Mortgage-backed securities	99,306	--	99,306	--
Student loans backed by U.S. government agency	23,965	--	23,965	--
Corporate securities	46,673	--	29,124	17,549
Total securities available for sale	\$1,103,232	\$27,109	\$1,058,574	\$17,549
Interest rate swap derivatives	\$(137)	\$--	\$(137)	\$--

Assets and Liabilities Measured at Fair Value Using Significant Unobservable Inputs

Certain corporate securities are measured at fair value on a recurring basis using significant unobservable inputs during the reported periods. The Company uses either recent trades of that security or in most cases a valuation technique based on a spread over the U.S. Treasury curve to measure these securities at fair value. The significant unobservable inputs used in the fair value measurement of these securities primarily relate to the credit risk of the corporate security and the probability of default. As of December 31, 2022 and 2021, the weighted-average rate was between 0.0% and 1.0%, for each

unobservable input. A change in the significant unobservable inputs used in the fair value measurement to a different amount may result in a significantly higher or lower fair value measurement at the reporting date.

The following table provides a reconciliation of the securities measured at a fair value using significant unobservable inputs (Level 3) on a recurring basis during the years ended December 31, 2022 and 2021. The unrealized losses are included in the consolidated statements of comprehensive income.

	Corporate Securities
Balance at December 31, 2020	\$18,061
Purchases	--
Total unrealized gains/(losses)	(512)
Balance at December 31, 2021	17,549
Purchases	--
Total unrealized gains/(losses)	(1,363)
Balance at December 31, 2022	\$16,186

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

As of December 31, 2022, and 2021, the Company did not hold any significant assets or liabilities measured at fair value on a nonrecurring basis.

Note 19 – Shareholders’ Equity and Earnings per Common Share

Earnings per Common Share

Earnings per common share is computed using the two-class method. Basic earnings per common share is computed by dividing net earnings allocated to common stock by the weighted-average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include unvested restricted stock awards because holders of these securities receive non-forfeitable dividends at the same rate as holders of the Company’s common stock. Holders of restricted stock awards receive dividend equivalent payments for dividends paid during the performance period at the vesting date of the award based upon the number of units that ultimately vest. Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the dilutive effect of stock compensation using the treasury stock method.

The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share for the years ended December 31 (dollars in thousands, except share and per share amounts):

	2022	2021
Distributed earnings allocated to common stock	\$6,601	\$6,080
Undistributed earnings allocated to common stock	19,399	22,953
Net earnings allocated to common stock	\$26,000	\$29,033
Weighted average common shares outstanding - Basic	3,883,174	3,913,905
Dilutive effect of options outstanding	4,431	13,611
Weighted average common shares outstanding - Diluted	3,887,605	3,927,516
Earnings per common share – Basic	\$6.70	\$7.42
Earnings per common share – Diluted	\$6.69	\$7.39
“Out of the money” stock options	94,536	--

Stock Repurchase Plans

From time to time, the Company’s Board of Directors has authorized stock repurchase plans. In general, stock repurchase plans allow the Company to proactively manage its capital position and return excess capital to shareholders. Shares purchased under such plans also provide the Company with shares of common stock necessary to satisfy obligations related to stock compensation awards.

On April 18, 2021, the Company announced a share repurchase plan allowing the Company to repurchase up to 340,000 shares. Under the repurchase plan, the Company offered to purchase 340,000 shares via a tender offer at a price of \$70.00 per share. The repurchase plan did not require the Company to repurchase a specific number of shares and the tender offer expired on May 13, 2021.

In 2021, the Company repurchased 98,223 shares at a cost of \$6,876,000. No shares were repurchased in 2022.

Note 20 – Revenue from Contracts with Customers

All of the Company's revenue from contracts with customers in the scope of ASC 606 is recognized in noninterest income. The following table presents the Company's sources of noninterest income for the years ended December 31, 2022 and 2021 (dollars in thousands). Items outside of the scope of ASC 606 are noted as such.

	2022	2021
Noninterest income		
Service charges on deposit accounts	\$2,130	\$1,634
Mortgage banking operations ¹	2,320	5,531
Net (loss)/gain on sales of securities available for sale ¹	(8,179)	1
Brokerage commissions	1,136	1,327
Insurance commissions and fees	7,552	5,368
Net interchange income	3,997	3,948
Earnings from Bank Owned Life Insurance ¹	1,247	578
Remaining other ¹	1,463	1,513
Total noninterest income	\$11,666	\$19,900

(1) Not within scope of ASC 606

Deposit Service Charges

The Company earns fees from its deposit customers for account maintenance, transaction-based and overdraft services. Account maintenance fees consist primarily of account fees and analyzed account fees charged on deposit accounts on a monthly basis. The performance obligation is satisfied and the fees are recognized on a monthly basis as the service period is completed. Transaction-based fees on deposit accounts are charged to deposit customers for specific services provided to the customer, such as non-sufficient funds fees, overdraft fees, and wire fees. The performance obligation is completed as the transaction occurs and the fees are recognized at the time each specific service is provided to the customer.

Debit and Credit Card Interchange Fee Income and Expenses

Debit and credit interchange income represent fees earned when a card issued by the Company is used. The Company earns interchange fees from debit cardholder transactions through the *Visa* payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The performance obligation is satisfied and the fees are earned when the cost of the transaction is charged to the cardholders' card. Certain expenses directly associated with the credit and debit card are recorded on a net basis with the interchange income.

Brokerage Revenue

Brokerage fees consist of fees earned from advisory asset management, trade execution and administrative fees from investments. Advisory asset management fees are variable, since they are based on the underlying portfolio value, which is subject to market conditions and asset flows. Advisory asset management fees are recognized quarterly and are based on the portfolio values at the end of each quarter. Brokerage accounts are charged commissions at the time of a transaction and the commission schedule is based upon the type of security and quantity. The amount of revenue earned is determined by the value and type of each instrument sold and is recognized at the time the policy or contract is written. In addition, revenues are earned from selling insurance and annuity policies.

Insurance Revenue

Insurance revenue consists of commissions and fees from the sales of insurance policies and related insurance services. Insurance commission income is recognized at the later of the effective date of the insurance policy or billing date, net of adjustments. Such adjustments are recorded when the amount can be reasonably estimated, which is generally in the period in which they occur. Commission revenues related to installment billings are recognized on the latter of effective or invoiced date. Contingent commissions are estimated and accrued relative to the recognition of corresponding commissions. Management determines a policy cancellation reserve based upon historical cancellation experience adjusted for any known circumstances. Subsequent commission adjustments were recognized upon receipt of notification from insurance companies concerning such adjustments.

Note 21 – Subsequent Events

The Company performed an evaluation of subsequent events through March 14, 2023, the date these consolidated financial statements were available to be issued.

On January 24, 2023, the Company's Board of Directors approved a dividend of \$0.85 per share, payable and paid on February 13, 2023, to shareholders of record as of February 3, 2023.

Directors and Officers

Board of Directors

Lyman Boyd, Chairman
Kris Loomis, CPA
Greg Oakes
John Doyle
Keith Wiggins
Mike Neff
Krista Beck

Administrative Officers

Greg Oakes, President & Chief Executive Officer
Mike Lundstrom, CPA/CIA, EVP & Chief Financial Officer
Jenny Pulver, EVP & Chief Retail Banking Officer
Steve Vradenburg, EVP & Chief Lending Officer
Sue Ozburn, EVP & Chief Information Officer

Mitchell, Reed & Schmitten Insurance Board of Directors

Greg Oakes, Chairman
Lori Reed
Lyman Boyd
Jim Gibbons
Mike Lundstrom
Laura Mounter
Brent Schmitten
Marc Heminger

Finance

Kelly Melton, CPA, AVP & Assistant Controller

Credit Administration

Ann Rankin, AVP & Credit Operations Supervisor
Kyle Bruggman, AVP & Assistant Credit Administrator

Internal Audit

Amanda Brown, AVP & Senior Internal Auditor

Compliance

Deidra Anderson, VP & Compliance Officer
Kayla Ramirez, Assistant Compliance Officer

Retail Operations and Personnel

Jennifer West, VP & Human Resources Director
Jeff Burton, VP & Retail Operations Officer
Christy Tomlinson, AVP & HR Generalist

Contract Purchasing and Equipment Leasing

Chris Ewer, SVP & Indirect Lending
Jeff Miller, VP & Dealer Finance Manager
Jessica Steinburg, Financial Services Supervisor
Elliott McLeod, AVP & Equipment Finance Manager
Thomas Christopherson, AVP & Loan Officer

Electronic Banking and Card Services

Carrie Gerdes, AVP & Treasury Management Officer
Angela Ward, Digital Banking Officer

Information Technology

Terri Howard, VP & Information Systems Operations Officer
Josh Castro, VP & Network Operations

Municipal Banking

Thomas Brown, VP & Municipal Finance Manager

Cashmere Valley Mortgage

Kyle Lewis, SVP & Mortgage Production Manager
Megan Alaniz, Mortgage Operations Officer

Mitchell, Reed & Schmitten Insurance

Brent Schmitten, President & Chief Operations Officer

Cashmere Valley Wealth Management

Timothy Meyers, Division Director

Customer Support Center

Sheryl Rivera, AVP & Customer Support Center Supervisor
Kari Mullins, Officer & CSC Supervisor

Cashmere Branch

Josh Price, AVP & Manager
Jana Flores, AVP & Retail Operations Officer

Maple Street, Wenatchee Branch

Steve Lee, SVP & Regional Manager
Mike Kintner, VP & Commercial Lender
Kelly Walker, AVP & Retail Operations Officer

Leavenworth Branch

Darrin Rylaarsdam, SVP & Regional Manager
Shawna Alexander, VP & Retail Operations Officer
Gary Waunch, AVP & Loan Officer

East Wenatchee Branch

Alex Cruz, VP & Manager
Edith Amante, Retail Operations Officer
Ricardo Zepeda, Loan Officer

Chelan Street, Wenatchee Branch

Tina Graham, Retail Operations Officer

Easy Street, Wenatchee Branch

Claudia De Robles, VP & Manager
Elizabeth Mejia, Retail Operations Officer

Ellensburg Branch

Pam Wilson, VP & Manager
Miriam Nation, Retail Operations Officer
Amanda Blackmore, Loan Officer

Cle Elum Branch

Kimberly Bonjorni, VP & Manager
Caren Reed, Retail Operations Officer

Lake Chelan Branch

Russ Jones, VP & Manager
Griselda Hernandez, Retail Operations Officer

Summitview Avenue, Yakima Branch

Sabrina Hall, Retail Operations Officer

Yakima Avenue, Yakima Branch

Taylor Stormo, SVP & Regional Manager
Kailey Gutierrez, Retail Operations Officer
Darren Reid, AVP & Loan Officer
Kimberly Morrier, AVP & Commercial Lender

Directory

Cashmere Valley Bank:

Website Address

www.cashmerevalleybank.com

Administrative Offices

117 Aplets Way, Cashmere
509-782-2624

Cashmere Branch

117 Aplets Way, Cashmere
509-782-1501

Maple Street, Wenatchee Branch

1100 Maple Street, Wenatchee
509-662-1644

Leavenworth Branch

980 Highway 2, Leavenworth
509-548-5231

East Wenatchee Branch

199 Valley Mall Parkway, East Wenatchee
509-884-0622

Chelan Street, Wenatchee Branch

124 South Chelan Avenue, Wenatchee
509-662-6633

Easy Street, Wenatchee Branch

127 Easy Street, Wenatchee
509-662-5071

Ellensburg Branch

101 West University Way, Ellensburg
509-925-3000

Cle Elum Branch

803 West 1st Street, Cle Elum
509-674-2033

Lake Chelan Branch

329 East Woodin Avenue, Chelan
509-682-7162

Summitview Avenue, Yakima Branch

5800 Summitview Avenue, Yakima
509-457-7895

Yakima Avenue, Yakima Branch

127 West Yakima Avenue, Yakima
509-902-1352

Cashmere Valley Wealth Management

124 East Penny Road, Suite 102, Wenatchee
509-664-7168

Cashmere Valley Mortgage

127 Easy Street, Wenatchee
509-662-7722

Electronic Banking

124 East Penny Road, Suite 103, Wenatchee
509-664-5454

Valley Contract Servicing

124 East Penny Road, Suite 205, Wenatchee
509-664-5452

Card Services

124 East Penny Road, Suite 106, Wenatchee
Credit Cards 509-664-5455
ATM/Debit Cards 509-664-5453

Dealer Financing

124 East Penny Road, Suite 201, Wenatchee
509-664-3820

Equipment Finance Solutions

124 East Penny Road, Suite 202, Wenatchee
509-665-1088

Customer Support Center

124 East Penny Road, Wenatchee
509-665-1070

Municipal Banking

1400 112th Avenue SE, Suite 100, Bellevue
425-688-3935

Mitchell, Reed & Schmitten Insurance:

Wenatchee Office

124 East Penny Road Suite 101, Wenatchee
509-665-0500

Gellatly Insurance Services

22 North Chelan Avenue, Wenatchee
509-662-2151

Cashmere Office

117 Aplets Way, Cashmere
509-782-2751

Ellensburg Office

101 West University Way, Ellensburg
509-962-0902

Yakima Office

5800 Summitview Avenue, Yakima
509-454-5156

Elliott Insurance Service

127 West Yakima Avenue, Suite 201, Yakima
509-248-7711

Leavenworth Office

980 Highway 2, Leavenworth
509-548-6050

Cle Elum Office

803 West 1st Street, Cle Elum
509-674-4433

Lee Insurance

11410 98th Avenue NE, Kirkland
425-576-0464

Gress-Kinney-Parrish (GKP) Insurance Center

3 N 7th Avenue, Yakima
509-575-0300

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Cashmere Valley Bank

CASHMERE VALLEY
MORTGAGE



Cashmere Valley
WEALTH MANAGEMENT

Mitchell, Reed
& Schmitt
INSURANCE, INC.