2022 Annual Report

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Highlands Community Bank

Dear Fellow Shareholder:

Highlands Community Bank had a very positive and successful 2023 as we experienced a 6.5% increase in total assets bringing us over the $200 million mark for the first time. Additionally, the Board of Directors voted on February 28, 2023, to approve a cash dividend of $0.61 per share, payable April 28, 2023, to shareholders of record March 3, 2023. On behalf of the staff and the Board of Directors, we thank you for making these accomplishments possible and providing us with the necessary tools to succeed.

In addition to growing total assets over $200 million, the Bank also produced earnings of $1,814,829 which amounted to $1.23 per share. We also increased total revenues to $8.7 million which was 6.8% over what was produced in 2021. The Bank also grew deposits to $184.5 million which was a $19.4 million increase, or 11.7%, from the previous year-end.

2023 will present different challenges as interest rates continue to climb with the federal reserve attempting to curtail inflation. However, your Bank will continue to research and invest in new products and services that will increase value for you as well as expanding on the ways the Bank serves the community.

Thank you, again, for your commitment to Highlands Community Bank and for understanding the importance of having a local community bank in our community. Your continued dedication and another year of strong financial results enable Your Bank to continue investing in Your community. We look forward to working with you in 2023 towards an even more prosperous year!

Best Regards,

Nicholas J. Moga
Chairman of the Board of Directors

Balance Sheets

December 31, 2022 and 2021

	2022	2021
Assets		
Cash and due from banks	$ 3,256,259	$ 1,608,913
Interest-bearing deposits with banks	13,000	775,000
Certificates of deposit	5,750,000	4,750,000
Cash and cash equivalents	9,019,259	7,133,913
Investment securities available for sale, at fair value	76,783,393	71,224,672
Investment securities held-to-maturity, at amortized cost	2,000,000	2,000,000
Restricted securities, at cost	307,600	306,800
Loans, net of allowance for loan losses of $1,150,202 in 2022 and $1,130,917 in 2021	101,912,870	99,346,995
Property and equipment, net	1,881,701	1,966,826
Bank owned life insurance	5,025,551	4,904,188
Other real estate owned, net	161,326	69,278
Accrued interest receivable	882,584	772,425
Other assets	2,586,610	595,105
Total assets	$ 200,560,894	$ 188,320,202
Liabilities and Stockholders' Equity		
Liabilities		
Noninterest-bearing deposits	$ 38,637,817	$ 30,320,973
Interest-bearing deposits	145,852,996	134,808,228
Total deposits	184,490,813	165,129,201
Accrued interest payable	113,218	109,342
Other liabilities	494,517	493,725
Total liabilities	185,098,548	165,732,268
Commitments and contingencies		
Stockholders' equity		
Common stock, $2.50 par value; 10,000,000 shares authorized; 1,481,032 shares issued and outstanding at December 31, 2022 and 2021	3,702,580	3,702,580
Surplus	3,796,973	3,796,973
Retained earnings	15,434,415	14,508,205
Accumulated other comprehensive (loss) income	(7,471,622)	580,176
Total stockholders' equity	15,462,346	22,587,934
Total liabilities and stockholders' equity	$ 200,560,894	$ 188,320,202

See Notes to Financial Statements

Statements of Income

For the years ended December 31, 2022 and 2021

	2022	2021
Interest income		
Loans and fees on loans	$ 5,867,541	$ 6,030,952
Investment securities, taxable	1,666,218	1,098,862
Investment securities, non-taxable	193,235	200,929
Deposits with banks	165,998	112,510
Total interest income	7,892,992	7,443,253
Interest expense		
Deposits	1,085,516	1,140,627
Federal funds purchased	18,723	57
Total interest expense	1,104,239	1,140,684
Net interest income	6,788,753	6,302,569
Provision for loan losses	335,000	195,034
Net interest income after provision for loan losses	6,453,753	6,107,535
Noninterest income		
Service charges on deposit accounts	280,875	200,719
Other service charges and fees	388,549	369,780
Other income	18,605	51,301
Income from bank owned life insurance	121,363	80,090
Total noninterest income	809,392	701,890
Noninterest expense		
Salaries and employee benefits	2,380,019	2,268,860
Occupancy	155,891	155,909
Equipment	162,462	144,655
State assessments	231,000	220,000
Data processing expense	977,373	828,029
FDIC insurance premium	48,920	45,623
Professional fees	244,067	215,409
Gains/losses on sale and write-downs of other real estate owned, net	76,950	60,000
Other expense	776,581	686,747
Total noninterest expense	5,053,263	4,625,232
Net income before income taxes	2,209,882	2,184,193
Income tax expense	395,053	394,006
Net income	$ 1,814,829	$ 1,790,187
Basic and diluted earnings per share	$ 1.23	$ 1.21
Dividends declared per share	$ 0.60	$ 0.58
Weighted average common shares outstanding - basic and diluted	1,481,032	1,480,857

See Notes to Financial Statements

Statements of Comprehensive (Loss) Income

For the years ended December 31, 2022 and 2021

	2022	2021
Net income	$ 1,814,829	$ 1,790,187
Other comprehensive loss:		
Adjustments related to investment securities available for sale:		
Unrealized losses arising during the period	(10,192,151)	(1,670,791)
Tax effect	2,140,353	350,865
Total other comprehensive loss	(8,051,798)	(1,319,926)
Total comprehensive (loss) income	$ (6,236,969)	$ 470,261

See Notes to Financial Statements

Statements of Changes in Stockholders' Equity

For the years ended December 31, 2022 and 2021

	Common Stock				Accumulated Other Comprehensive	
	Shares	Amount	Surplus	Retained Earnings	Income (Loss)	Total
Balance, December 31, 2020	1,480,017	$ 3,700,043	$ 3,773,374	$ 13,577,016	$ 1,900,102	$ 22,950,535
Net income	-	-	-	1,790,187	-	1,790,187
Other comprehensive loss	-	-	-	-	(1,319,926)	(1,319,926)
Stock issued under stock award plan	2,065	5,162	48,011	-	-	53,173
Stock purchased from shareholders	(1,050)	(2,625)	(24,412)	-	-	(27,037)
Cash dividends	-	-	-	(858,998)	-	(858,998)
Balance, December 31, 2021	1,481,032	$ 3,702,580	$ 3,796,973	$ 14,508,205	$ 580,176	$ 22,587,934
Balance, December 31, 2021	1,481,032	$ 3,702,580	$ 3,796,973	$ 14,508,205	$ 580,176	$ 22,587,934
Net income	-	-	-	1,814,829	-	1,814,829
Other comprehensive loss	-	-	-	-	(8,051,798)	(8,051,798)
Stock issued under stock award plan	1,831	4,578	41,197	-	-	45,775
Stock purchased from shareholders	(1,831)	(4,578)	(41,197)	-	-	(45,775)
Cash dividends	-	-	-	(888,619)	-	(888,619)
Balance, December 31, 2022	1,481,032	$ 3,702,580	$ 3,796,973	$ 15,434,415	$ (7,471,622)	$ 15,462,346

See Notes to Financial Statements

Statements of Cash Flows

For the years ended December 31, 2022 and 2021

	2022	2021
Cash flows from operating activities		
Net income	$ 1,814,829	$ 1,790,187
Adjustments to reconcile net income		
to net cash provided by operations:		
Property and equipment depreciation and amortization	140,326	141,603
Provision for loan losses	335,000	195,034
Stock award expense	45,775	53,173
Deferred tax expense	59,475	2,741
Write-downs of other real estate owned	80,800	60,000
Gains on sales of other real estate owned	(3,849)	-
Amortization of premium on investment securities, net of accretion	28,582	114,364
Income from bank owned life insurance	(121,363)	(80,090)
Changes in assets and liabilities:		
Accrued interest receivable	(110,159)	27,740
Other assets	89,374	206,306
Accrued interest payable	3,876	(24,810)
Other liabilities	790	108,866
Net cash flows provided by operating activities	2,363,456	2,595,114
Cash flows from investing activities		
Purchases of investment securities held-to-maturity	-	(2,000,000)
Purchases of investment securities available for sale	(31,217,257)	(40,440,451)
Sales, maturities, calls and paydowns of investment securities available for sale	15,437,803	21,987,326
Purchases of restricted equity securities	(800)	(1,600)
Purchases of property and equipment	(55,201)	(20,719)
Proceeds from sales of other real esate owned	150,797	-
Purchase of bank owned life insurance	-	(2,000,000)
Net (increase) decrease in loans	(3,220,670)	3,413,376
Net cash flows used in investing activities	(18,905,328)	(19,062,068)
Cash flows from financing activities		
Net increase in noninterest-bearing deposits	8,316,844	3,149,050
Net increase in interest-bearing deposits	11,044,768	14,261,999
Common stock repurchased	(45,775)	(27,037)
Dividends paid	(888,619)	(858,998)
Net cash flows provided by financing activities	18,427,218	16,525,014
Net increase in cash and cash equivalents	1,885,346	58,060
Cash and cash equivalents, beginning	7,133,913	7,075,853
Cash and cash equivalents, ending	$ 9,019,259	$ 7,133,913
Supplemental disclosure of cash flows information		
Interest paid	$ 1,100,363	$ 1,165,494
Income taxes paid	$ 344,791	$ 371,545
Supplemental disclosure of noncash activities		
Unrealized losses on investment securities available for sale, net	$ (10,192,151)	$ (1,670,791)
Transfer of foreclosed loans to other real estate owned	$ 319,795	$ -

See Notes to Financial Statements

Notes to Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies

Organization

Highlands Community Bank (the “Bank”) was organized and incorporated under the laws of the Commonwealth of Virginia on May 21, 2001 and commenced operations on September 16, 2002. The Bank currently serves Alleghany County, Virginia, the City of Covington, Virginia, the Town of Clifton Forge, Virginia and surrounding areas. As a state chartered bank which is a member of the Federal Reserve System, the Bank is subject to regulation by the Virginia Bureau of Financial Institutions, the Federal Deposit Insurance Corporation and the Federal Reserve Board.

The accounting and reporting policies of the Bank follow generally accepted accounting principles and general practices within the financial services industry. The following is a summary of the more significant policies.

Use of Estimates

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

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses. In connection with the determination of the allowances for losses, management obtains independent appraisals for significant properties.

Substantially all of the Bank’s loan portfolio consists of loans in its market area. Accordingly, the ultimate collectability of a substantial portion of the Bank’s loan portfolio are susceptible to changes in local market conditions. The regional economy is diverse, but influenced by the manufacturing and retirement segments and to an extent by the tourism and agricultural segments.

While management uses available information to recognize loan losses, future additions to the allowance may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as a part of their routine examination process, periodically review the Bank’s allowances for loan and losses. Such agencies may require the Bank to recognize additions to the allowances based on their judgments about information available to them at the time of their examinations. Because of these factors, it is reasonably possible that the allowances for loans may change materially in the near term.

Note 1. Organization and Summary of Significant Accounting Policies, continued

Cash and Cash Equivalents

For the purpose of presentation in the statement of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet captions “cash and due from banks”, “interest-bearing deposits with banks”, and “certificates of deposits with banks”.

Trading Activities

The Bank does not hold securities for short-term resale and, therefore, does not maintain a trading securities portfolio.

Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as “held to maturity” and recorded at amortized cost. Securities not classified as held to maturity or trading, are classified as “available for sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive (loss) income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Equity securities with readily determinable fair values are carried at fair value, with changes in fair value reported in net income. Any equity securities without readily determinable fair values are carried at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for identical or similar investments. Restricted securities are carried at cost and are periodically evaluated for impairment based on the ultimate recovery of par value. The entirety of any impairment on equity securities is recognized in earnings.

Loans Receivable

Loans receivable that management has the intent and ability to hold for the foreseeable future, or until maturity or pay-off, are reported at their adjusted outstanding principal amount. Adjustments include charge-offs, the allowance for loan losses and deferred fees.

Loan origination fees are deferred and recognized as an adjustment of the yield of the related loan.

Interest is accrued and credited to income based on the principal amount outstanding. The accrual of interest on loans is discontinued when, in management’s opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized according to the cost recovery method. When facts and circumstances indicate the borrower has regained the ability to meet required payments the loan is returned to accrual status. Previously lost interest during non-accrual is deferred and recognized over the remaining life of the loan. Past due status of loans is based on contractual terms.

Note 1. Organization and Summary of Significant Accounting Policies, continued

Loans Receivable, continued

The loan portfolio is comprised of the following classes:

- Residential real estate construction loans carry risks that the home will not be finished according to schedule, will not be finished according to the budget and the value of the collateral, at any point in time, may be less than the principal amount of the loan. Construction loans also bear the risk that the general contractor may be unable to finish the construction project as planned because of financial pressure unrelated to the project.
- Residential real estate loans carry risks associated with the continued creditworthiness of the borrower and changes in the value of the collateral.
- Commercial real estate loans carry risks associated with the successful operation of a business or a real estate project, in addition to other risks associated with the ownership of real estate, because the repayment of these loans may be dependent upon the profitability and cash flows of the business or project.
- Commercial, industrial and agricultural loans carry risks associated with the successful operation of a business. Typically, repayment is dependent on the cash flow of the business, and is secured by business assets, such as accounts receivable, equipment, and inventory. There is risk associated with the value of the collateral which may depreciate over time and cannot be appraised with as much precision.
- Consumer loans carry risks associated with the continued creditworthiness of the borrower and the value of the collateral (e.g., rapidly depreciating assets such as automobiles), or lack thereof. Consumer loans are more likely than real estate loans to be immediately adversely affected by job loss, divorce, illness or personal bankruptcy.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral less cost to sell and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance for loan losses consists of specific and general components. The specific component relates to loans that are classified as impaired. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan 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.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral less cost to sell if the loan is collateral dependent.

Note 1. Organization and Summary of Significant Accounting Policies, continued

Allowance for Loan Losses, continued

Troubled Debt Restructurings (TDRs) occur when the Bank agrees to significantly modify the original terms of a loan due to the deterioration in the financial condition of the borrower. TDRs are considered impaired loans. Upon designation as a TDR, the Bank evaluates the borrower's payment history, past-due status and ability to make payments based on the revised terms of the loan. If a loan was accruing prior to being modified as a TDR and if the Bank concludes that the borrower is able to make such payments, and there are no other factors or circumstances that would cause it to conclude otherwise, the loan will remain on an accruing status. If a loan was on nonaccrual status at the time of the TDR, the loan will remain on nonaccrual status following the modification and may be returned to accrual status based on a record of making payments as scheduled for a period of six consecutive months.

Stock Compensation Plans

The Bank recognizes compensation cost related to share-based payment transactions. Generally accepted accounting principles requires entities to measure the cost of employee services received in exchange for stock based on the grant-date fair value of the award.

Compensation cost has been measured using the fair value of an award on the grant date and is recognized over the service period, which is usually the vesting period.

Advertising Expense

The Bank expenses advertising costs as they are incurred. Advertising expense for the years ended December 31, 2022 and 2021 was $110,286 and $106,036, respectively.

Property and Equipment

Land is carried at cost. Bank premises and furniture and equipment are carried at cost, less accumulated depreciation and amortization computed principally by the straight-line method over the following estimated useful lives:

	Years
Buildings and improvements	10-40
Furniture and equipment	5-10
Software	3-5

Leasehold improvements are carried at cost and depreciated over the life of the lease.

Other Real Estate Owned

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less costs to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in losses on sales and write-downs of other real estate owned.

As of December 31, 2022 and 2021, the balance of other real estate owned includes no foreclosed residential real estate properties recorded as a result of obtaining physical possession of the property. As of December 31, 2022, there were two residential real estate loans totaling $106,796 in the process of foreclosure.

Note 1. Organization and Summary of Significant Accounting Policies, continued

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 Bank, (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 Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Income Taxes

Provision for income taxes is based on amounts reported in the statements of income (after exclusion of non-taxable income such as interest on state and municipal securities) and consists of taxes currently due plus deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred tax assets and liabilities are included in the financial statements 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. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Deferred income tax liability relating to unrealized gains (or the deferred tax asset in the case of unrealized losses) on investment securities available for sale is recorded in other assets. Such unrealized gains or losses is recorded as an adjustment to equity in the financial statements and not included in income determination until realized. Accordingly, the resulting deferred income tax liability or asset is also recorded as an adjustment to equity.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50% likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with a tax position taken that exceeds the amount measured as described above would be reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Management is not aware of any material uncertain tax positions and no liability has been recognized at December 31, 2022 or 2021. Interest and penalties associated with unrecognized tax benefits would be classified as additional interest expense or other expense, respectively, in the statement of income.

Basic Earnings per Share

Basic earnings per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding during the period.

Diluted Earnings per Share

The computation of diluted earnings per share is similar to the computation of basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of those potential common shares. The Bank had no potentially dilutive instruments at December 31, 2022 or 2021.

Notes to Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Comprehensive (Loss) Income

Comprehensive (loss) income reflects the change in the Bank's equity arising from transactions and events other than investments by and distributions to stockholders. It consists of net income plus certain other changes in assets and liabilities that are reported as separate components of stockholders' equity rather than as income or expense, primarily unrealized gains and losses on investment securities available for sale.

Credit Related Financial Instruments

In the ordinary course of business, the Bank has entered into commitments to extend credit, including commitments under home equity arrangements, commercial letters of credit and standby letters of credit. Such financial instruments are recorded when they are funded.

Fair Value of Financial Instruments

The Bank uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, an "exit" price. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted prices for the Bank's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of an instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (this is, not a forced liquidation or distress sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation techniques or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgement. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Bank Owned Life Insurance

The Bank has purchased life insurance policies on certain employees. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value.

Reclassifications

Certain reclassifications have been made to the prior year's financial statements to place them on a comparable basis with the current year. Net income and stockholders' equity previously reported were not affected by these reclassifications.

Note 1. Organization and Summary of Significant Accounting Policies, continued

The following is a summary of recent authoritative pronouncements:

During June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The ASU, as amended, requires an entity to measure expected credit losses for financial assets carried at amortized cost based on historical experience, current conditions, and reasonable and supportable forecasts. Among other things, the ASU also amended the impairment model for available for sale securities and addressed purchased financial assets with deterioration. The Bank adopted ASU 2016-13 as of January 1, 2023 in accordance with the required implementation date and recorded the impact of adoption to retained earnings, net of deferred income taxes, as required by the standard. The adjustment recorded at adoption was not significant to the overall allowance for credit losses or shareholders' equity as compared to December 31, 2022 and consisted of adjustments to the allowance for credit losses on loans and held-to-maturity securities, as well as an adjustment to the Bank's reserve for unfunded loan commitments. Subsequent to adoption, the Bank will record adjustments to its allowance(s) for credit losses and reserves for unfunded commitments through the provision for credit losses in the statements of income.

The Bank is utilizing a third-party model to tabulate its estimate of current expected credit losses, using a probability of default/loss given default driven discounted cashflow methodology. In accordance with ASC 326, the Bank has segmented its loan portfolio based on similar risk characteristics which included call report code. For its reasonable and supportable forecast, the Bank is using forecasted economic metrics, after which loss rates revert to the historical loss experience. To further adjust the allowance for credit losses for expected losses not already included within the quantitative component of the calculation, the Bank may consider the following qualitative adjustment factors: volume and severity of non-performing assets, changes in economic and business conditions, the Bank's lending policies and procedures, and the nature and volume of the Bank's financial assets. The Bank's CECL implementation process was overseen by the Chief Financial Officer and the CECL Committee and included an assessment of data availability and gap analysis, data collection, consideration and analysis of multiple loss estimation methodologies, an assessment of relevant qualitative factors and correlation analysis of multiple potential loss drivers and their impact on the Bank's historical loss experience. During 2022, the Bank calculated its current expected credit losses model in parallel to its incurred loss model in order to further refine the methodology and model. In addition, the Bank engaged a third-party to perform a comprehensive model validation.

In March 2022, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2022-02, "Financial Instruments-Credit Losses (Topic 326), Troubled Debt Restructurings and Vintage Disclosures." ASU 2022-02 addresses areas identified by the FASB as part of its post-implementation review of the credit losses standard (ASU 2016-13) that introduced the CECL model. The amendments eliminate the accounting guidance for troubled debt restructurings by creditors that have adopted the CECL model and enhance the disclosure requirements for loan refinancings and restructurings made with borrowers experiencing financial difficulty. In addition, the amendments require a public business entity to disclose current-period gross write-offs for financing receivables and net investment in leases by year of origination in the vintage disclosures. The amendments in this ASU should be applied prospectively, except 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. For entities that have adopted ASU 2016-13, ASU 2022-02 is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For entities that have not yet adopted ASU 2016-13, the effective dates for ASU 2022-02 are the same as the effective dates in ASU 2016-13. Early adoption is permitted if an entity has adopted ASU 2016-13. An entity may elect to early adopt the amendments about TDRs and related disclosure enhancements separately from the amendments related to vintage disclosures. The Bank is currently assessing the impact that ASU 2022-02 will have on its financial statements.

Note 2. Restrictions on Cash

The Bank is typically required to maintain a reserve against its deposits in accordance with Regulation D of the Federal Reserve Act. At December 31, 2022 and 2021, there was no minimum reserve requirement as a result of a rule adopted by the Federal Reserve in March 2020 eliminating the reserve requirement.

Notes to Financial Statements

Note 3. Investment Securities

Debt securities have been classified in the balance sheets according to management's intent. The amortized cost, estimated fair value and unrealized gains and losses of investment securities are as follows:

	2022							
		Amortized Cost		**Unrealized Gains**		**Unrealized Losses**		**Fair Value**
Securities available for sale:								
U.S. Treasuries	$	4,742,064	$	-	$	(569,710)	$	4,172,354
Government sponsored enterprises		20,463,474		-		(2,146,477)		18,316,997
State and municipal bonds		37,145,776		5,714		(4,374,954)		32,776,536
Mortgage-backed securities		10,398,158		-		(944,430)		9,453,728
Other debt securities		13,491,671		-		(1,427,893)		12,063,778
Total securities available for sale	$	86,241,143	$	5,714	$	(9,463,464)	$	76,783,393
Securities held to maturity:								
Other debt securities	$	2,000,000	$	-	$	(109,864)	$	1,890,136
Total securities held to maturity	$	2,000,000	$	-	$	(109,864)	$	1,890,136
Total securities	$	88,241,143	$	5,714	$	(9,573,328)	$	78,673,529

	2021							
Securities available for sale:		**Amortized Cost**		**Unrealized Gains**		**Unrealized Losses**		**Fair Value**
U.S. Treasuries	$	7,744,579	$	445	$	(52,268)	$	7,692,756
Government sponsored enterprises		11,241,926		33,357		(233,653)		11,041,630
State and municipal bonds		36,934,623		1,011,601		(221,378)		37,724,846
Corporate bonds		3,514,746		24,199		(40,953)		3,497,992
Mortgage-backed securities		11,054,397		306,863		(93,812)		11,267,448
Total securities available for sale	$	70,490,271	$	1,376,465	$	(642,064)	$	71,224,672
Securities held to maturity:								
Other debt securities	$	2,000,000	$	-	$	-	$	2,000,000
Total securities held to maturity	$	2,000,000	$	-	$	-	$	2,000,000
Total securities	$	72,490,271	$	1,376,465	$	(642,064)	$	73,224,672

Total proceeds from the sales, maturities, calls and paydowns amounted to $15,437,803 and $21,987,326 in 2022 and 2021, respectively. The Bank had no realized gains for the years ended December 31, 2022 and 2021.

The Bank's investment in Federal Reserve Bank stock totaled $225,000 and $224,200 at December 31, 2022 and December 31, 2021. Federal Reserve Bank stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock other than the Federal Reserve Bank and member institutions. Therefore, when evaluating Federal Reserve Bank stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Bank does not consider this investment to be other-than-temporarily impaired at December 31, 2022 and no impairment has been recognized. Federal Reserve Bank stock is included in a separate line item on the balance sheet (Restricted securities, at cost) and is not part of the Bank's investment securities portfolio. The Bank's restricted securities also include an investment in Community Bankers Bank totaling $82,600 at both December 31, 2022 and 2021, which is carried at cost.

Notes to Financial Statements

Note 3. Investment Securities, continued

The following table details unrealized losses and related fair values in the Bank's investment securities portfolio. This information is aggregated by the length of time that individual securities have been in a continuous unrealized loss position as of December 31, 2022 and December 31, 2021.

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2022						
U.S. Treasuries	$ 484,707	$ 13,647	$ 3,687,647	$ 556,063	$ 4,172,354	$ 569,710
Government sponsored enterprises	9,191,474	561,910	9,125,523	1,584,567	18,316,997	2,146,477
State and municipal bonds	17,641,826	1,218,972	12,995,194	3,155,982	30,637,020	4,374,954
Mortgage-backed securities	6,053,286	406,150	3,400,442	538,280	9,453,728	944,430
Other debt securities	8,706,415	576,205	3,357,363	851,688	12,063,778	1,427,893
	$ 42,077,708	$ 2,776,884	$ 32,566,169	$ 6,686,580	$ 74,643,877	$ 9,463,464
Securities held to maturity:						
Other debt securities	$ 1,890,136	$ 109,864	$ -	$ -	$ 1,890,136	$ 109,864
	$ 1,890,136	$ 109,864	$ -	$ -	$ 1,890,136	$ 109,864
	$ 43,967,844	$ 2,886,748	$ 32,566,169	$ 6,686,580	$ 76,534,013	$ 9,573,328
December 31, 2021						
U.S. Treasuries	$ 6,697,952	$ 52,268	$ -	$ -	$ 6,697,952	$ 52,268
Government sponsored enterprises	5,393,685	117,585	2,970,346	116,068	8,364,031	233,653
State and municipal bonds	7,762,108	163,183	1,289,547	58,195	9,051,655	221,378
Mortgage-backed securities	2,906,098	40,953	-	-	2,906,098	40,953
Other debt securities	3,628,443	93,812	-	-	3,628,443	93,812
	$ 26,388,286	$ 467,801	$ 4,259,893	$ 174,263	$ 30,648,179	$ 642,064

Management considers the nature of the investment, the underlying causes of the decline in market value, the severity and duration of the decline in market value and other evidence, on a security-by-security basis, in determining if the decline in market value is other than temporary. At December 31, 2022, the Bank had nine US Treasuries with an unrealized loss of $569,710, forty Government Sponsored Enterprise securities with an aggregate unrealized loss of $2,146,477, eighty-one state and municipal bonds with an aggregate unrealized loss of $4,374,954, twenty-one mortgage-backed securities with an aggregated unrealized loss of $944,430 and twenty-nine other debt securities with an aggregated unrealized loss of $1,537,757. Management does not believe that gross unrealized losses, which total 11.12% of the amortized costs of the related investment securities, represent an other-than-temporary impairment. The Bank has both the ability and the intent to hold all of these securities for a period of time necessary to recover the amortized cost. The unrealized losses were related to changes in market rates and not credit concerns of the issuers. There were no other-than-temporary impairment charges during the periods.

Note 3. Investment Securities, continued

The scheduled maturities of securities available for sale at December 31, 2022 were as follows:

	Amortized Cost	Fair Value
Due in one year or less	$ 1,933,708	$ 1,917,564
Due in one year through five years	32,837,561	30,721,371
Due after five years through ten years	46,567,631	40,248,546
Due after ten years through fifteen years	4,902,243	3,895,912
	$ 86,241,143	$ 76,783,393

The Bank also owned one security with an amortized cost of $2,000,000 and fair value of $1,890,136 classified as held-to-maturity as of December 31, 2022. The security has a maturity in one year through five years.

Expected maturities may differ from contractual maturities if borrowers have the right to call or repay obligations with or without prepayment penalties.

Investment securities with market values of $3,725,859 and $2,935,156 at December 31, 2022 and 2021, respectively were pledged as collateral on public deposits and for other banking purposes as required or permitted by law.

Note 4. Property and Equipment

Components of Property and Equipment

Components of property and equipment and total accumulated depreciation at December 31, 2022 and 2021 are as follows:

	2022	2021
Land	$ 264,049	$ 264,034
Buildings and improvements	2,270,588	2,270,588
Furniture and equipment	1,486,620	1,431,435
Property and equipment, total	4,021,257	3,966,057
Less accumulated depreciation	(2,139,556)	(1,999,231)
Property and equipment, net	$ 1,881,701	$ 1,966,826

Depreciation expense was $140,326 and $141,603 during 2022 and 2021, respectively.

Note 5. Leases

The Bank records its leases in accordance with ASC 842. The right-of-use asset and lease liability are included in other assets and other liabilities, respectively, in the Balance Sheets. Lease liabilities represent the Bank’s obligation to make lease payments and are presented at each reporting date as the net present value of the remaining contractual cash flows. Cash flows are discounted at the Bank’s incremental borrowing rate in effect at the commencement date of the lease. Right-of-use assets represent the Bank’s right to use the underlying asset for the lease term and are calculated as the sum of the lease liability and if applicable, prepaid rent, initial direct costs and any incentives received from the lessor.

Notes to Financial Statements

Note 5. Leases, continued

The Bank's long-term lease agreement is classified as an operating lease. This lease offers the option to extend the lease term and the Bank has included such extensions in its calculation of the lease liabilities to the extent the options are reasonably assured of being exercised. The lease agreement does not provide for residual value guarantees and has no restrictions or covenants that would impact dividends or require incurring additional financial obligations.

The following tables present information about the Bank's lease:

	December 31, 2022		December 31, 2021	
Lease liabilities	$	14,882	$	23,470
Right-of-use assets	$	14,882	$	23,470
Weighted average remaining lease term		1.67 years		2.67 years
Weighted average discount rate		2.78%		2.78%

Lease cost	For the Year Ended December 31, 2022		For the Year Ended December 31, 2021	
Operating lease cost	$	9,120	$	9,120
Variable lease cost		-		-
Short-term lease cost		-		-
Total lease cost	$	9,120	$	9,120
Cash paid for amounts included in the measurements of lease liabilities	$	9,120	$	9,120

A maturity analysis of operating lease liabilities and reconciliation of the undiscounted cash flows to the total of operating lease liabilities is as follows:

Lease payments due	December 31, 2022	
Twelve months ending December 31, 2023	$	9,120
Twelve months ending December 31, 2024		6,080
Total undiscounted cash flows	$	15,200
Discount		(318)
Lease liabilities	$	14,882

Notes to Financial Statements

Note 6. Loans Receivable

The major components of loans in the balance sheets at December 31, 2022 and 2021 are as follows (in thousands):

	2022	2021
Commercial and industrial	$ 13,049	$ 14,957
Real estate:		
Construction and land development	5,664	1,262
1-4 family residential and multifamily	36,042	34,817
Nonfarm, nonresidential	24,250	24,714
Consumer	24,058	24,728
	103,063	100,478
Allowance for loan losses	(1,150)	(1,131)
	$ 101,913	$ 99,347

The above loan totals include deferred loan fees of $141 thousand and $330 thousand as of December 31, 2022 and 2021, respectively.

Overdrafts totaling $199,755 and $34,321 at December 31, 2022 and 2021, respectively, were reclassified from deposits to loans.

Included in the Commercial and industrial total above is $38,191 and $4,991,416 of SBA Paycheck Protection Loans (PPP) as of December 31, 2022 and 2021, respectively. Additionally, fees collected but not yet recognized through forgiveness of these loans totaled $7,327 and $209,845 as of December 31, 2022 and 2021, respectively.

Note 7. Allowance for Loan Losses

The allocation of the allowance for loan losses by loan components (in thousands) at December 31, 2022 and 2021 is as follows:

	Construction & Land Development	1-4 Family Residential & Multifamily	Nonfarm, Nonresidential	Commercial & Industrial[1]	Consumer	Total
2022						
Allowance for loan losses:						
Beginning balance: January 1, 2022	$ 9	$ 327	$ 183	$ 194	$ 418	$ 1,131
Charge-offs	-	(4)	-	(20)	(352)	(376)
Recoveries	-	-	-	2	58	60
Provision	32	(61)	(8)	55	317	335
Ending balance: December 31, 2022	$ 41	$ 262	$ 175	$ 231	$ 441	$ 1,150
Ending balance: individually evaluated for impairment	$ -	$ -	$ -	$ 77	$ -	$ 77
Ending balance: collectively evaluated for impairment	$ 41	$ 262	$ 175	$ 154	$ 441	$ 1,073
Loans receivable:						
Ending balance: December 31, 2022	$ 5,664	$ 36,042	$ 24,250	$ 13,049	$ 24,058	$ 103,063
Ending balance: individually evaluated for impairment	$ -	$ 870	$ -	$ 314	$ -	$ 1,184
Ending balance: collectively evaluated for impairment	$ 5,664	$ 35,172	$ 24,250	$ 12,735	$ 24,058	$ 101,879

[1] Includes PPP loans, which are guaranteed by the SBA and have no related allowance.

Note 7. Allowance for Loan Losses, continued

	Construction & Land Development	1-4 Family Residential & Multifamily	Nonfarm, Nonresidential	Commercial & Industrial[1]	Consumer	Total
2021						
Allowance for loan losses:						
Beginning balance: January 1, 2021	$ 12	$ 351	$ 184	$ 288	$ 472	$ 1,307
Charge-offs	-	(6)	-	(121)	(302)	(429)
Recoveries	-	-	-	3	55	58
Provision	(3)	(18)	(1)	24	193	195
Ending balance: December 31, 2021	$ 9	$ 327	$ 183	$ 194	$ 418	$ 1,131
Ending balance: individually evaluated for impairment	$ -	$ 77	$ -	$ 27	$ -	$ 104
Ending balance: collectively evaluated for impairment	$ 9	$ 250	$ 183	$ 167	$ 418	$ 1,027
Loans receivable:						
Ending balance: December 31, 2021	$ 1,262	$ 34,817	$ 24,714	$ 14,957	$ 24,728	$ 100,478
Ending balance: individually evaluated for impairment	$ -	$ 1,466	$ -	$ 218	$ -	$ 1,684
Ending balance: collectively evaluated for impairment	$ 1,262	$ 33,351	$ 24,714	$ 14,739	$ 24,728	$ 98,794

[1] Includes PPP loans, which are guaranteed by the SBA and have no related allowance.

Notes to Financial Statements

Note 7. Allowance for Loan Losses, continued

The following table presents impaired loans by class of loan (in thousands) as of December 31, 2022 and 2021:

	Recorded[1] Investment	Upaid[2] Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
2022					
With no related allowance recorded:					
Construction and land development	$ -	$ 402	$ -	$ -	$ -
1-4 family residential and multifamily	870	1,173	-	1,267	38
Nonfarm, nonresidential	-	-	-	-	-
Commercial and industrial	116	135	-	125	-
Consumer	-	-	-	-	-
	$ 986	$ 1,710	$ -	$ 1,392	$ 38
With an allowance recorded:					
Construction and land development	$ -	$ -	$ -	$ -	$ -
1-4 family residential and multifamily	-	-	-	-	-
Nonfarm, nonresidential	-	-	-	-	-
Commercial and industrial	198	206	77	207	7
Consumer	-	-	-	-	-
	$ 198	$ 206	$ 77	$ 207	$ 7
Combined:					
Construction and land development	$ -	$ 402	$ -	$ -	$ -
1-4 family residential and multifamily	870	1,173	-	1,267	38
Nonfarm, nonresidential	-	-	-	-	-
Commercial and industrial	314	341	77	332	7
Consumer	-	-	-	-	-
	$ 1,184	$ 1,916	$ 77	$ 1,599	$ 45
2021					
With no related allowance recorded:					
Construction and land development	$ -	$ 402	$ -	$ -	$ -
1-4 family residential and multifamily	1,178	1,326	-	1,226	10
Nonfarm, nonresidential	-	-	-	-	-
Commercial and industrial	127	130	-	129	-
Consumer	-	-	-	-	-
	$ 1,305	$ 1,858	$ -	$ 1,355	$ 10
With an allowance recorded:					
Construction and land development	$ -	$ -	$ -	$ -	$ -
1-4 family residential and multifamily	288	375	77	274	9
Nonfarm, nonresidential	-	-	-	-	-
Commercial and industrial	91	93	27	95	-
Consumer	-	-	-	-	-
	$ 379	$ 468	$ 104	$ 369	$ 9
Combined:					
Construction and land development	$ -	$ 402	$ -	$ -	$ -
1-4 family residential and multifamily	1,466	1,701	77	1,500	19
Nonfarm, nonresidential	-	-	-	-	-
Commercial and industrial	218	223	27	224	-
Consumer	-	-	-	-	-
	$ 1,684	$ 2,326	$ 104	$ 1,724	$ 19

[1] The amount of the investment in a loan, which is not net of a valuation allowance, but which does reflect any direct write-down of the investment and interest paid while a loan is in nonaccrual status.

[2] The contractual amount due, which reflects paydowns applied in accordance with loan documents, but which does not reflect any direct write-downs.

Note 7. Allowance for Loan Losses, continued

Past due loans and impaired loans are defined differently. As such, some loans may be included in both categories, whereas other loans may only be included in one category. The following represents by class, an aging analysis of the Bank's accruing and non-accruing loans as of December 31, 2022 and 2021 (in thousands).

	30-89 Days Past Due	90 Days Plus Past Due	Total Past Due	Current	Total Loans Receivable	Recorded Investment > 90 Days and Accruing
2022						
Construction and development	$ 7	$ -	$ 7	$ 5,657	$ 5,664	$ -
1-4 family residential and multifamily	1,232	433	1,665	34,377	36,042	125
Nonfarm, nonresidential	79	51	130	24,120	24,250	-
Commercial and industrial	110	375	485	12,564	13,049	80
Consumer	1,165	554	1,719	22,339	24,058	121
Total	$ 2,593	$ 1,413	$ 4,006	$ 99,057	$ 103,063	$ 326
2021						
Construction and development	$ -	$ -	$ -	$ 1,262	$ 1,262	$ -
1-4 family residential and multifamily	557	935	1,492	33,325	34,817	1
Nonfarm, nonresidential	57	183	240	24,474	24,714	-
Commercial and industrial	105	389	494	14,463	14,957	61
Consumer	865	376	1,241	23,487	24,728	58
Total	$ 1,584	$ 1,883	$ 3,467	$ 97,011	$ 100,478	$ 120

Credit Quality Indicators:

The Bank has established a standard risk grading (also referred to as loan grade) system to assist management and lenders in their analysis and supervision of the loan portfolio. Loan officers assign a grade to each credit at its inception; this grade is changed as required thereafter based on the borrower's financial condition, payment performance, and other material information. The Bank uses the following definitions for risk ratings:

Pass Loans that are not adversely rated, are contractually current as to principal and interest, and are otherwise in compliance with the contractual terms of the loan agreement. Management believes that there is a low likelihood of loss related to those loans that are considered pass.

Special Mention Borrowers currently posing a higher than normal risk. Loans are protected, but have potentially developing weaknesses, which could include stale credit or some degree of difficulty in servicing debt, increased leverage, marginal profitability or interim unprofitability, etc. indicative of a possible transition in financial condition. Risk concern has heightened, but concern has not escalated to a point where reclassification of the asset to impaired is warranted.

Substandard Relationships which have one or more well defined credit weaknesses, impairing collectability and necessitating workout. Factors might include: inadequate repayment capacity; severe erosion of equity; likely reliance on collateral for repayment, which may be questionable; guarantors with limited resources; obvious deterioration in financial condition/adverse trends; possibility of loss or protracted workout exists if immediate corrective action is not taken.

Doubtful Relationship displays many of the same weaknesses as a substandard; however, those risk factors are more dominant. Collectability is severely jeopardized and loss potential is extreme; however, there are sufficiently compelling reasons which may positively impact the collectability to warrant deferral of a loss classification until outcome is determined.

Loss Asset has been determined to have such little value/collectability likelihood that continuing to carry the asset is not justified even though some future recovery potential may exist.

Note 7. Allowance for Loan Losses, continued

The following represents by class, loans by risk grade at December 31, 2022 and 2021 (in thousands).

	Total	Pass Credits	Substandard	Doubtful	Loss
2022					
Construction and development	$ 5,664	$ 5,664	$ -	$ -	$ -
1-4 family residential and multifamily	36,042	35,535	434	73	-
Nonfarm, nonresidential	24,250	24,048	151	51	-
Commercial and industrial	13,049	12,753	83	213	-
Consumer	24,058	23,439	55	564	-
Total	$ 103,063	$ 101,439	$ 723	$ 901	$ -
	100.0%	98.4%	0.7%	0.9%	0.0%
2021					
Construction and development	$ 1,262	$ 1,262	$ -	$ -	$ -
1-4 family residential and multifamily	34,817	34,038	668	111	-
Nonfarm, nonresidential	24,714	24,531	180	3	-
Commercial and industrial	14,957	14,634	93	230	-
Consumer	24,728	24,574	-	154	-
Total	$ 100,478	$ 99,039	$ 941	$ 498	$ -
	100.0%	98.6%	0.9%	0.5%	0.0%

Nonaccrual Loans

The following table provides the composition of our nonaccrual loans as of December 31, 2022 and 2021 (in thousands):

	2022	2021
1-4 family residential and multifamily	$ 426	$ 934
Nonfarm, nonresidential	202	183
Commercial and industrial	296	328
Consumer	604	318
Total	$ 1,528	$ 1,763

Troubled Debt Restructurings

During the years ended December 31, 2022 and 2021, the Bank did not modify any loans that were considered to be a troubled debt restructuring. There were no loans that defaulted during the years ended December 31, 2022 or 2021 that were considered to be troubled debt restructurings that were restructured in the twelve-month periods preceding the period-ends.

As of December 31, 2022 and 2021, there were no Troubled Debt Restructurings that subsequently defaulted.

Notes to Financial Statements

Note 8. Deposits

The aggregate amount of time deposits in denominations of $250,000 or more at December 31, 2022 and 2021 was $16.5 million and $12.0 million, respectively. At December 31, 2022 the scheduled maturities of time deposits are as follows:

2023	$	29,015,561
2024		15,645,440
2025		6,259,074
2026		6,668,787
2027		8,064,042
	$	65,652,904

Included in time deposits are deposits acquired through a third party ("brokered deposits") totaling $5,000,000 at December 31, 2022. There were no brokered deposits at December 31, 2021.

Note 9. Other Borrowings

Lines of credit

The Bank has established an unsecured Line of Credit for $6,500,000 with First National Bankers' Bank in Birmingham, Alabama and an unsecured Line of Credit for $3,000,000 with Community Bankers Bank in Richmond, Virginia. Funds were advanced once for each line during 2022 for testing purposes. No balance was outstanding at December 31, 2022 and 2021. The lender may withdraw these lines at their discretion.

Note 10. Fair Value of Financial Instruments

Fair Value of Financial Instruments

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal and most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. U.S. GAAP requires that valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. U.S. GAAP also established a fair value hierarchy which prioritize the valuation inputs into three broad levels.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Bank's financial instruments as of December 31, 2022 and 2021. These tables exclude financial instruments for which the carrying amount approximates fair value including cash and cash equivalents, bank-owned life insurance, restricted securities, accrued interest receivable, and accrued interest payable. For short-term financial assets such as cash and cash equivalents, federal funds sold/purchased and accrued interest, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization.

Note 10. Fair Value of Financial Instruments, continued

Fair Value of Financial Instruments, continued

			Fair Value Measurements		
(dollars in thousands)	Carrying Amount	Fair Value	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2022					
Financial Instruments - Assets					
Loans, net of allowance for loan losses	$ 101,913	$ 95,791	$ -	$ -	$ 95,791
Investment securities available for sale	76,783	76,783	-	76,783	-
Investment securities held-to-maturity	2,000	1,890	-	-	1,890
Financial Instruments – Liabilities					
Deposits	$ 184,491	$ 184,431	$ -	$ 184,431	$ -
December 31, 2021					
Financial Instruments - Assets					
Loans, net of allowance for loan losses	$ 99,347	$ 100,343	$ -	$ -	$ 100,343
Investment securities available for sale	71,225	71,225	-	71,225	-
Investment securities held-to-maturity	2,000	2,000	-	-	2,000
Financial Instruments – Liabilities					
Deposits	$ 165,129	$ 166,170	$ -	$ 166,170	$ -

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

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. GAAP also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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

Fair Value Hierarchy

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

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

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

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

Note 10. Fair Value of Financial Instruments, continued

Fair Value Hierarchy, continued

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

Investment Securities Available for Sale

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

Impaired Loans

The Bank does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment. The fair value of impaired loans is estimated using one of several methods, including the collateral value less cost to sell, market value of similar debt and discounted cash flows. Those impaired loans not requiring a specific allowance represents loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At December 31, 2022 and 2021, substantially all of the impaired loans were evaluated based upon the fair value of the collateral less cost to sell. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. The fair value of impaired loans is generally based on unobservable assumptions and therefore is classified as nonrecurring Level 3.

Other Real Estate Owned

Foreclosed assets are initially measured at fair value less cost to sell establishing a new cost basis, based on an appraisal conducted by an independent, licensed appraiser outside of the Bank. If the collateral value is significantly adjusted due to differences in the comparable properties, or is discounted by the Bank because of marketability, then the fair value is considered Level 3. Foreclosed assets are measured at fair value on a nonrecurring basis. Any initial fair value adjustment is charged against the Allowance for Loan Losses. Subsequent fair value adjustments are recorded in the period incurred and included in Gains/losses on sales and write-downs of other real estate owned on the Statements of Income.

Note 10. Fair Value of Financial Instruments, continued

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis.

	Total	Level 1	Level 2	Level 3
December 31, 2022				
U.S. Treasuries	$ 4,172,354	$ -	$ 4,172,354	$ -
Government sponsored enterprises	18,316,997	-	18,316,997	-
State and municipal bonds	32,776,536	-	32,776,536	-
Mortgage-backed securities	9,453,728	-	9,453,728	-
Other debt securities	12,063,778	-	12,063,778	-
Investment securities available for sale	76,783,393	-	76,783,393	-
Total assets at fair value	$ 76,783,393	$ -	$ 76,783,393	$ -
December 31, 2021				
U.S. Treasuries	$ 7,692,756	$ -	$ 7,692,756	$ -
Government sponsored enterprises	11,041,630	-	11,041,630	-
State and municipal bonds	37,724,846	-	37,724,846	-
Mortgage-backed securities	3,497,992	-	3,497,992	-
Other debt securities	11,267,448	-	11,267,448	-
Investment securities available for sale	71,224,672	-	71,224,672	-
Total assets at fair value	$ 71,224,672	$ -	$ 71,224,672	$ -

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

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The Bank may be required from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Assets measured at fair value on a nonrecurring basis are included in the tables below.

December 31, 2022	Total	Level 1	Level 2	Level 3
Impaired loans, net	$ 120,800	$ -	$ -	$ 120,800
Other real estate owned, net	161,326	-	-	161,326

December 31, 2021	Total	Level 1	Level 2	Level 3
Impaired loans, net	$ 274,450	$ -	$ -	$ 274,450
Other real estate owned, net	69,278	-	-	69,278

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

Notes to Financial Statements

Note 10. Fair Value of Financial Instruments, continued

Level 3 Valuation Techniques

For Level 3 assets measured at fair value on a recurring or non-recurring basis as of December 31, 2022 and 2021, the valuation techniques and the significant unobservable inputs used in the fair value measurements are as follows:

	Fair Value at December 31, 2022	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)
Impaired Loans				
Commercial and industrial	120,800	Appraised Value	Discounts on appraisals	8%-100%(22%)
			Selling costs	6%
Other Real Estate Owned	161,326	Appraised Value	Selling costs	10%

	Fair Value at December 31, 2021	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)
Impaired Loans				
1-4 family residential	$ 210,750	Appraised Value	Discounts on appraisals	24%-44%(34%)
			Selling costs	6%
Commercial and industrial	63,700	Appraised Value	Discounts on appraisals	14%-34%(22%)
			Selling costs	6%
Other Real Estate Owned	69,278	Appraised Value	Discounts on appraisals	0%-18%(6%)
			Selling costs	6%

Note 11. Benefit Plans

Defined Contribution Plan

The Bank has adopted a profit-sharing plan pursuant to Section 401(k) of the Internal Revenue Code. The plan covers substantially all employees who have completed 3 months of service. Participants may contribute a percentage of compensation, subject to a maximum allowed under the Code. The Bank makes non-discretionary contributions of 3% of eligible employee's compensation. In addition, the Bank may make additional contributions at the discretion of the Board of Directors. The Bank's contributions were $48,177 and $46,903 for the years ended December 31, 2022 and 2021, respectively.

Stock Awards Plan

During 2005, the Board of Directors adopted a Stock Awards Plan. Under terms of the plan 200,000 shares of the Bank's common stock may be issued in the form of stock awards to employees as additional compensation and to members of the Board of Directors in lieu of director's fees. Awards vest immediately when the common stock is issued and the fair value associated with the stock is expensed at time of issuance. Sales of stock issued as a result of the stock award are governed by the securities laws concerning unregistered securities. As of December 31, 2022, 21,958 shares had been issued under the plan, leaving 178,042 shares ungranted. The stock award expense as a result of the grants was $45,775 and $53,173 during 2022 and 2021, respectively. Award date fair value was $25.00 per share during 2022 and 2021.

Note 12. Income Taxes

Current and Deferred Income Tax Components

The components of income tax expense (all federal) are as follows for the years ended December 31:

	2022	2021
Current	$ 335,578	$ 391,265
Deferred tax expense	59,475	2,741
Income tax expense	$ 395,053	$ 394,006

Rate Reconciliation

A reconciliation of expected income tax expense computed at the statutory federal income tax rate to income tax expense included in the statements of income is as follows for the years ended December 31:

	2022	2021
Tax at statutory federal rate	$ 464,075	$ 458,681
Tax exempt interest, net of disallowed portion	(43,587)	(47,907)
Other	(25,435)	(16,768)
Income tax expense	$ 395,053	$ 394,006

Deferred Income Tax Analysis

The significant components of net deferred tax assets (all federal) at December 31, 2022 and 2021 are summarized as follows:

	2022	2021
Deferred tax assets		
Allowance for loan losses	$ 166,879	$ 160,622
Deferred loan fees	29,561	69,092
Other real estate owned	16,968	23,738
Core deposit intangible	2,255	1,882
Lease liability	3,125	4,929
Interest on nonaccrual loans	19,977	18,939
Unrealized loss on securities available for sale	1,986,127	-
Deferred tax asset	2,224,892	279,202
Deferred tax liabilities		
Accretion on bond discount	$ (42,414)	$ (19,203)
Depreciation	(47,622)	(50,200)
Goodwill	(957)	(748)
Right-of-use asset	(3,125)	(4,929)
Unrealized gain on securities available for sale	-	(154,224)
Deferred tax liability	(94,118)	(229,304)
Net deferred tax asset	$ 2,130,774	$ 49,898

Deferred tax assets represent the future tax benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. As of December 31, 2022, management believes it will fully realize 100% of the Bank's deferred tax asset. The Bank has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions. The Bank's policy is to classify any interest or penalties recognized as interest expense or noninterest expense, respectively. Years ended December 31, 2019 through December 31, 2022 remain open for audit for all major jurisdictions.

Note 13. Commitments and Contingencies

Litigation

In the normal course of business, the Bank may be involved in various legal proceedings. Management believes that any liability resulting from such proceedings will not be material to the financial statements.

Financial Instruments with Off-Balance Sheet Risk

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, credit risk in excess of the amount recognized in the balance sheets. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as for on-balance sheet instruments. A summary of the Bank's commitments at December 31, 2022 and 2021 is as follows (in thousands):

	2022	**2021**
Commitments to extend credit	$ 14,987	$ 11,706
Standby letters of credit	830	191
	$ 15,817	$ 11,897

Financial Instruments with Off-Balance Sheet Risk, continued

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. 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. Collateral held varies as specified above and is required in instances which the Bank deems necessary.

Concentrations of Credit Risk

Substantially all of the Bank's loans, commitments to extend credit, and standby letters of credit have been granted to customers in the Bank's market area and such customers are generally depositors of the Bank. The concentrations of credit by type of loan are set forth in Note 6. The distribution of commitments to extend credit approximates the distribution of loans outstanding.

The Bank from time to time has cash and cash equivalents on deposit with financial institutions which exceed federally insured limits. As of December 31, 2022, cash balances in excess of amounts insured by the Federal Deposit Insurance Corporation (FDIC) were $109.

Note 14. Regulatory Restrictions

Dividends

The Bank, as a Virginia banking corporation, may pay dividends only out of its retained earnings. However, regulatory authorities may limit payment of dividends by any bank when it is determined that such a limitation is in the public interest and is necessary to ensure financial soundness of the bank.

Capital Requirements

Banks are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. The net unrealized gain or loss on available for sale securities is not included in computing the regulatory capital. Management believes as of December 31, 2022, the Bank met all capital adequacy requirements to which it is subject.

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

In 2019, the federal banking agencies jointly issued a final rule that provides for an optional, simplified measure of capital adequacy, the community bank leverage ratio framework (CBLR framework), for qualifying community banking organizations, consistent with Section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act. The final rule became effective on January 1, 2020 and was elected by the Bank as of December 31, 2020. In April 2020, the federal banking agencies issued an interim final rule that makes temporary changes to the CBLR framework, pursuant to section 4012 of the Coronavirus Aid, Relief and Economic Security (CARES) Act, and a second interim final rule that provides a graduated increase in the community bank leverage ratio requirement after the expiration of the temporary changes implemented pursuant to section 4012 of the CARES Act.

The community bank leverage ratio removes the requirement for qualifying banking organizations to calculate and report risk-based capital but rather only requires a Tier 1 to average assets (leverage) ratio. Qualifying banking organizations that elect to use the community bank leverage ratio framework and that maintain a leverage ratio of greater than required minimums will be considered to have satisfied the generally applicable risk based and leverage capital requirements in the agencies' capital rules (generally applicable rule) and, if applicable, will be considered to have met the well capitalized ratio requirements for purposes of section 38 of the Federal Deposit Insurance Act. Under the interim final rules, the community bank leverage ratio minimum requirement was 8% as of December 31, 2020, 8.5% for calendar year 2021, and 9% for calendar year 2022 and beyond. The interim rule allows for a two-quarter grace period to correct a ratio that falls below the required amount, provided that the bank maintains a leverage ratio of 7% as of December 31, 2020, 7.5% for calendar year 2021, and 8% for calendar year 2022 and beyond.

Under the final rule, an eligible banking organization can opt out of the CBLR framework and revert back to the risk-weighting framework without restriction. As of December 31, 2022, the Bank was a qualifying community banking organization as defined by the federal banking agencies and elected to measure capital adequacy under the CBLR framework.

Note 14. Regulatory Restrictions, continued

Capital Requirements, continued

The Bank's actual capital amounts and ratios are also presented in the table (in thousands).

	Actual		Minimum	
	Amount	Ratio	Amount	Ratio
December 31, 2022				
Tier I Capital to Average Assets	$ 22,900	11.59%	$ 17,779	9.000%
December 31, 2021				
Tier I Capital to Average Assets	$ 21,970	11.74%	$ 15,911	8.500%

Note 15. Transactions with Related Parties

The Bank has entered into transactions with its directors, significant shareholders and their affiliates (related parties). Such transactions were made in the ordinary course of business on substantially the same terms and conditions, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other customers, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features.

Aggregate loan transactions with related parties were as follows:

	2022	2021
Balance, beginning	$ 4,630,578	$ 5,454,853
New loans and advances	2,391,836	863,170
Repayments and other reductions	(1,869,709)	(1,687,445)
Balance, ending	$ 5,152,705	$ 4,630,578

Deposit with related parties were $2,944,555 and $4,845,394 at December 31, 2022 and 2021, respectively.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and the Board of Directors of Highlands Community Bank

Opinion on the Financial Statements

We have audited the accompanying balance sheets of Highlands Community Bank (the Bank) as of December 31, 2022 and 2021, the related statements of income, comprehensive (loss) income, changes in stockholders' equity and cash flows for the years then ended, and the related notes to the financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Bank as of December 31, 2022 and 2021, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on the Bank's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Bank in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Bank is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits, we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters

The critical audit matter communicated below is a matter arising from the current period audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing separate opinions on the critical audit matter or on the accounts or disclosures to which it relates.

Allowance for Loan Losses – Loans Collectively Evaluated for Impairment – Qualitative Factors

Description of the Matter

As described in Note 1 (Organization and Summary of Significant Accounting Policies) and Note 7 (Allowance for Loan Losses) to the financial statements, the Bank maintains an allowance for loan losses to provide for probable losses inherent in the loan portfolio. The Bank's allowance for loan losses has two basic components, the general allowance and the specific allowance. As of December 31, 2022, the general allowance represented $1.07 million of the total allowance for loan losses of $1.12 million. For loans that are not specifically identified for impairment, the general allowance uses historical loss experience along with various qualitative factors to develop adjusted loss factors. The qualitative adjustments to the historical loss experience are established and determined based on management's continuing evaluation of inputs and assumptions underlying the quality of the loan portfolio. Management evaluates qualitative factors, primarily considering levels of and trends in delinquencies and impaired loans; trends in volume and terms of loans; effects of changes in lending policies and procedures; experience, ability and depth of lending management and staff; national and local economic trends and conditions; credit concentrations; and levels of and trends in charge offs and recoveries. This adjusted loss percentage is applied to non-impaired and non-guaranteed loan balances. As of December 31, 2022 qualitative factor adjustments represented $778 thousand.

Management exercised significant judgment when assessing the qualitative factors in estimating the allowance for loan losses. We identified the assessment of the qualitative factors as a critical audit matter as auditing the qualitative factors involved especially complex and subjective auditor judgment in evaluating management's assessment of the inherently subjective estimates.

How We Addressed the Matter in Our Audit

The primary audit procedures we performed to address this critical audit matter included:

- Substantively testing management's process, including evaluating their judgments and assumptions for developing the qualitative factors, which included:
    - Evaluating the completeness and accuracy of data inputs used as a basis for the qualitative factors.
    - Evaluating the reasonableness of management's judgments related to the determination of qualitative factors.
    - Evaluating the qualitative factors for directional consistency and for reasonableness.
    - Testing the mathematical accuracy of the allowance calculation, including the application of the qualitative factors.

/s/ Yount, Hyde & Barbour, P.C.

We have served as the Bank's auditor since 2016.

Winchester, Virginia
March 20, 2023

Management's Discussion and Analysis

To accurately understand the change in Highlands Community Bank's (the "Bank") financial statements, the following information is provided. The Bank commenced operations on September 16, 2002. The Bank currently serves Alleghany County, Virginia, the City of Covington, Virginia, the Town of Clifton Forge, Virginia, Bath County, Virginia and surrounding areas. As a state-chartered bank, which is a member of the Federal Reserve System, the Bank is subject to regulation by the Virginia Bureau of Financial Institutions, Federal Reserve Board, and the Federal Deposit Insurance Corporation.

The bank acquired a branch from Carter Bank & Trust in Mitchelltown, Virginia in May 2018.

This commentary provides an overview of the Bank's financial condition, changes in financial condition and results of operations for 2022 and 2021. The following discussion should assist readers in the analysis of the accompanying financial statements.

Critical Accounting Policies

The Bank's financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The notes to the audited financial statements included herein contain a summary of the significant accounting policies. Management believes the Bank's policies with respect to the methodology for the determination of the allowance for loan losses involve a higher degree of complexity and require management to make difficult and subjective judgments that often require assumptions or estimates about highly uncertain matters. Accordingly, management considers the policies related as critical.

The allowance for loan losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: (i) Accounting for contingencies, which requires that losses be accrued when they are probable of occurring and estimable, and (ii) Accounting by creditors for Impairment of a Loan, which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market, and the Bank's investment in the loan.

The allowance for loan losses has three basic components: (i) the formula allowance, (ii) the specific allowance, and (iii) the qualitative allowance. Each of the components is determined based upon estimates that can and do change when the actual events occur. The formula allowance uses a historical loss view as an indicator of future losses and, as a result, could differ from the loss incurred in the future. However, since this history is updated with the most recent loss information, the errors that might otherwise occur are mitigated. The specific allowance uses various techniques to arrive at an estimate of loss. Historical loss information, expected cash flow and fair market value of collateral are used to estimate these losses. The use of these values is inherently subjective and our actual losses could be greater or less than the estimates. The qualitative allowance captures losses that are attributable to various economic environmental factors or changes in industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowance. For further information regarding the allowance for loan losses, see Notes 1 and 7 to the financial statements.

Management’s Discussion and Analysis

Summary of Results of Operations

Operating Income

The Bank had net income for the year ended December 31, 2022 of $1,814,829 compared to net income of $1,790,187 for the year ended December 31, 2021, an increase of 1.4%. Return on average assets was 0.91% and return on average stockholders’ equity was 10.27% in 2022. Basic and diluted earnings per share were $1.23 and $1.21 for 2022 and 2021, respectively.

Net Interest Income

The principal source of earnings for the Bank is net interest income. Net interest income is defined as the difference between interest and fees generated by earning assets and the cost of funds supporting those assets. As such, net interest income represents the gross profit from the Bank’s lending, investment and funding activities.

A large number of variables interact to effect net interest income. Included are variables such as changes in mix and volume of earning assets and interest-bearing liabilities, market interest rates and the statutory Federal tax rate. It is management’s ongoing policy to maximize net interest income through the development of balance sheet and pricing strategies while maintaining appropriate risk levels as set by the Board of Directors.

The Bank’s net interest income totaled $6,788,753 and $6,302,569 for 2022 and 2021, respectively, representing an increase of $486,184 or 7.7% in 2022. This increase was primarily the result of an increase in interest income on investment securities of $567,356.

Noninterest Income and Expenses

Noninterest income increased from $701,890 to $809,392, an increase of $107,502 or 15.3% from 2021 to 2022. This was mostly due to an increase of $80,156 in service charges on deposit accounts as the Bank added new accounts. Additionally, the Bank experienced a $41,273 increase in income from bank owned life insurance as the Bank purchased more bank owned life insurance late in 2021.

Noninterest expenses increased to $5,053,263 in 2022 from $4,625,232 in 2021, an increase of $428,031 or 9.3%. Salaries and employee benefits increased $111,159, or 4.9%, from the previous year as a result of budgeted salary increases. Data processing expense increased $149,344 as the Bank added new accounts as well as investing in new products and services. In addition, other expense experienced a $89,834 increase year-over-year mostly as a result of increased director fees along with an increase in expenses relating to repossessed vehicles.

Income Taxes

The Bank provided $395,053 for income taxes during 2022, compared to a provision for income taxes of $394,006 for 2021. The Bank’s effective tax rates were 17.9% and 18.0% for 2022 and 2021, respectively.

Summary of Statements of Financial Condition

Assets

At December 31, 2022, the Bank had total assets of $200.6 million, representing an increase of $12.2 million or 6.5% over the December 31, 2021 balance of $188.3 million. Proceeds from deposit growth were used mostly to increase investment securities as loan growth was modest.

Summary of Statements of Financial Condition, continued

Loans

The net loan portfolio totaled $101.9 million and $99.3 million for 2022 and 2021, respectively, representing an increase of $2.6 million or 2.6%. Real estate loans, both mortgage, commerical and construction, increased by $5.2 million to $66.0 million. Consumer loans decreased $0.7 million to $24.1 million while commercial loans decreased from $15.2 million to $13.0 million. Consistent with its focus on providing community based financial services, the Bank generally does not make loans outside its principal market regions. By policy it does not originate or purchase leveraged loans or loans to foreign entities or individuals.

The Bank had impaired loans of $1.2 million at December 31, 2022. This was 1.15% of gross loans outstanding, as compared to $1.7 million and 1.68% of gross loans outstanding in 2021. The level of impaired loans was the result of problem loan scenarios encountered during the normal course of business. The Bank actively monitors its loan portfolio for the early recognition of impaired loans.

Provision and Allowance for Loan Losses

The provision for loan losses is a charge against earnings necessary to maintain the allowance for loan losses at a level consistent with management's evaluation of the credit quality and risk of the loan portfolio. The Bank maintains an allowance which management believes represents an accurate estimate of probable losses inherent in the Bank's loan portfolio. To achieve this goal, the loan loss provision must be sufficient to cover loans charged off, loans identified as impaired and the probable losses that exist in the portfolio. In determining the adequacy of the allowance for loan losses, management uses a methodology, which specifically identifies and reserves for high-risk loans. A general reserve is established for non-impaired loans. Loans in non-accrual status and over ninety days past due are considered in this evaluation as well as other loans, which may be a potential loss.

From the Bank's inception, management and the Board have endeavored to provide for an adequate allowance. The 2022 provision was $335,000 as the allowance increased to $1,150,202 at December 31, 2022 as compared to $1,130,917 at December 31, 2021. There was a provision of $195,034 in 2021. Management and the Board of Directors believe that the allowance at year-end was adequate relative to the current levels of risk in the portfolio. The allowance for loan losses as a percentage of gross loans was 1.12% and 1.13% at December 31, 2022 and 2021, respectively.

The general reserve component of the allowance for loan losses increased as compared to prior year, which was primarily the result of an increase in loans outstanding after adjusting for PPP loans. In addition, the Bank's specific reserves are down as compared to December 31, 2021, primarily as a result of one consumer real estate loan being foreclosed during the year. This loan had previously held a reserve as of December 31, 2021. Historical loss reserves increased slightly as compared to prior year due to both volume and rate. The historical loss rate and associated reserves increased for the consumer loan segment, but that was partially off-set by an decrease in the loss rate and associated reserves for the commercial loan segment.

Loan charge-offs totaled $376 thousand in 2022 and $429 thousand in 2021. The Bank had recoveries of $60 thousand in 2022 and $58 thousand in 2021.

Summary of Statements of Financial Condition, continued

Securities and Federal Funds Sold

At year-end 2022, investment securities available for sale totaled $76.8 million compared to $71.2 million on December 31, 2021, an increase of $5.6 million or 7.8%. In addition, the Bank has $2 million of subordinated debt which is classified as held-to-maturity. There were no federal funds sold as of December 31, 2022 and 2021.

Deposits

Deposits totaled $184.5 million and $165.1 million at December 31, 2022 and 2021, respectively, representing an increase of $19.4 million or 11.7%. Non-interest bearing accounts increased from $30.3 million to $38.6 million, or 27.4%. This was largely due to the Bank experiencing an increase in deposits due to some local branch closures of other institutions. Interest-bearing accounts increased from $134.8 million to $145.9 million, or 8.2%.

Stockholders' Equity

Future growth and expansion of the Bank is dictated by its capital base. The adequacy of the Bank's capital is reviewed by management on an ongoing basis with reference to the size, composition and quality of the Bank's asset and liability levels and consistent with regulatory requirements and industry standards. Management seeks to maintain a capital structure that assures an adequate level to support anticipated asset growth and absorb potential losses. The Bank significantly exceeds all minimum regulatory capital requirements.

During 2022, equity decreased to $15.5 million. While the Bank had net operating income of $1.8 million, the net decrease in equity was a result of a net decrease of $8.1 million in unrealized losses on the Bank's available for sale investment portfolio as well as a dividend payment of $889 thousand. Management believes the Bank has sufficient capital to fund its operations on an ongoing basis.

Liquidity

The objective of the Bank's liquidity management policy includes providing adequate funds to meet the needs of depositors and borrowers at all times, as well as providing funds to meet the basic needs for ongoing operations, to allow funding of longer-term investment opportunities and meet regulatory requirements. Sufficient assets are maintained on a short-term basis to meet the liquidity demands anticipated by management. The most immediate and efficient source of liquidity are short-term investments, which include federal funds sold and securities maturing within one year. The Bank also has credit facilities of $9.5 million available as a source of liquidity.

The liquidity ratio (the level of liquid assets divided by total deposits plus short-term liabilities) was 46% and 47% at December 31, 2022 and 2021, respectively. Management believes that the Bank has sufficient liquidity on a short-term basis to meet any funding needs it may have and expects that its long-term liquidity needs can be achieved through deposit growth, however there can be no assurance that such growth will develop.

Statistical Disclosures

The following tables provide additional information for the years ended December 31, 2022 and 2021.

Table 1. Average Balances and Interest Rates

Years ended December 31, (In thousands)	2022			2021		
	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
Assets:						
Interest-earning assets:						
Deposits in other banks	$ 8,348	$ 166	1.99%	$ 9,683	$ 113	1.17%
Taxable investment securities	68,228	1,666	2.44%	50,869	1,099	2.16%
Nontaxable investment securities	8,965	193	2.15%	8,931	201	2.25%
Loans [3], [4]	101,287	5,868	5.79%	104,784	6,031	5.76%
Total interest-earning assets	186,828	7,893	4.22%	174,267	7,444	4.27%
Noninterest-earning assets:						
Cash and due from banks	2,338			1,878		
Premises and equipment	1,925			2,035		
Other assets	7,706			4,272		
Allowance for loan losses	(1,177)			(1,270)		
Total assets	$ 197,620			$ 181,182		
Liabilities and stockholders' equity:						
Interest-bearing liabilities:						
Interest checking	$ 20,286	72	0.35%	$ 17,391	57	0.33%
Savings deposits	60,678	190	0.31%	47,248	145	0.31%
Time deposits	27,180	328	1.21%	27,601	386	1.40%
Large denomination deposits	35,724	496	1.39%	35,312	553	1.57%
Federal funds purchased	421	18	4.28%	27	-	0.00%
Total interest-bearing liabilities	144,289	1,104	0.77%	127,579	1,141	0.89%
Noninterest-bearing liabilities:						
Demand deposits	34,839			30,271		
Other liabilities	825			895		
Total liabilities	179,953			158,745		
Stockholders' equity	17,667			22,437		
Total liabilities and stockholders' equity	$ 197,620			$ 181,182		
Net interest earnings		$ 6,789			$ 6,303	
Net interest spread [1]			3.45%			3.38%
Net interest margin [2]			3.63%			3.62%

(1) Net interest spread is the difference between the average interest rate received on earning assets and the average interest rate paid for interest-bearing liabilities.
(2) Net interest margin is calculated by dividing net interest earnings by total average earning assets.
(3) Average loan balances include nonaccrual loans.
(4) Interest income includes deferred loan fees.

Table 2. Rate/Volume Variance Analysis

	2022 Compared to 2021			2021 Compared to 2020		
		Increase (Decrease) Due To			Increase (Decrease) Due To	
	Total	Rate	Volume	Total	Rate	Volume
December 31, (In thousands)						
Interest-earning assets						
Deposits in other banks	$ 53	$ 66	$ (13)	$ (33)	$ (122)	$ 89
Taxable investment securities	567	157	410	105	(116)	221
Nontaxable investment securities	(8)	(9)	1	(58)	(33)	(25)
Loans	(163)	40	(203)	(308)	(462)	154
Total	449	254	195	(294)	(733)	439
Interest-earning liabilities						
Interest checking	15	5	10	15	4	11
Savings deposits	45	3	42	17	(12)	29
Time deposits	(58)	(52)	(6)	(101)	(87)	(14)
Large denomination deposits	(57)	(63)	6	(148)	(129)	(19)
Federal funds purchased	18	18	-	-	-	-
Total	(37)	(89)	52	(217)	(224)	7
Net interest income	$ 486	$ 343	$ 143	$ (77)	$ (509)	$ 432

Table 3. Average Asset Mix

December 31, (In thousands)	2022		2021	
	Average Balance	%	Average Balance	%
Interest-earning assets				
Deposits in other banks	$ 8,348	4.22%	$ 9,683	5.34%
Taxable investment securities	68,228	34.52	50,869	28.08
Nontaxable investment securities	8,965	4.54	8,931	4.93
Loans	101,287	51.26	104,784	57.83
Total interest-earning assets	186,828	94.54	174,267	96.18
Noninterest-earning assets				
Cash and due from banks	2,338	1.18	1,878	1.04
Premises and equipment	1,925	0.97	2,035	1.12
Other assets	7,706	3.90	4,272	2.36
Allowance for loan losses	(1,177)	(0.59)	(1,270)	(0.70)
Total assets	$ 197,620	100%	$ 181,182	100%

Table 4. Loan Mix and Maturity Schedule

	Due in One Year Or Less	After One Year Through Five Years	After Five Years Through Ten Years	After Ten Years Through Fifteen Years	After Fifteen Years	Total
December 31, 2022 (In Thousands)						
Construction and land development	$ 2,183	$ 1,366	$ 197	$ 1,088	$ 830	$ 5,664
1-4 family residential and multifamily	1,022	1,632	4,617	11,109	17,662	36,042
Nonfarm, nonresidential	1,806	2,625	5,344	8,236	6,239	24,250
Commercial and industrial	1,745	8,140	3,153	11	-	13,049
Consumer	2,242	17,166	4,650	-	-	24,058
Total	$ 8,998	$ 30,929	$ 17,961	$ 20,444	$ 24,731	$ 103,063
Loans with fixed interest rates:						
Construction and land development	$ 2,183	$ 1,366	$ 68	$ -	$ -	$ 3,617
1-4 family residential and multifamily	723	221	75	38	1,146	2,203
Nonfarm, nonresidential	1,060	1,586	1,124	897	1,446	6,113
Commercial and industrial	1,157	8,057	2,960	1	-	12,175
Consumer	1,529	17,166	4,631	-	-	23,326
Total	$ 6,652	$ 28,396	$ 8,858	$ 936	$ 2,592	$ 47,434
Loans with floating interest rates:						
Construction and land development	$ -	$ -	$ 129	$ 1,088	$ 830	$ 2,047
1-4 family residential and multifamily	299	1,411	4,542	11,071	16,516	33,839
Nonfarm, nonresidential	746	1,039	4,220	7,339	4,793	18,137
Commercial and industrial	588	83	193	10	-	874
Consumer	713	-	19	-	-	732
Total	$ 2,346	$ 2,533	$ 9,103	$ 19,508	$ 22,139	$ 55,629

Table 5. Investment Securities

December 31, 2022	Amortized Cost									
	One Year or Less		After One Year Through Five Years		After Five Year Through Ten Years		After Ten Year Through Fifteen Years		Total	
	Amount	Weighted Average Yield (1)	Amount	Weighted Average Yield (1)	Amount	Weighted Average Yield (1)	Amount	Weighted Average Yield (1)	Amount	Weighted Average Yield (1)
Investment securities available for sale:										
U.S. Treasuries	$ -	-	$ 2,508,410	1.51%	$ 2,233,654	1.19%	$ -	-	$ 4,742,064	1.36%
Government sponsored enterprises	-	-	9,450,398	1.97%	10,630,777	2.17%	382,299	4.02%	20,463,474	2.11%
State and municipal bonds	933,727	3.65%	10,447,550	2.89%	21,244,555	2.33%	4,519,944	2.09%	37,145,776	2.49%
Mortgage-backed securities	-	-	5,412,174	2.76%	4,985,984	1.95%	-	-	10,398,158	2.37%
Other debt securities	999,980	3.00%	5,019,030	3.12%	7,472,661	2.48%	-	-	13,491,671	2.75%
Total	$ 1,933,707	3.31%	$ 32,837,562	2.53%	$ 46,567,631	2.22%	$ 4,902,243	2.24%	$ 86,241,143	2.37%
Investment securities held-to-maturity:										
Other debt securities	$ -	-	$ 2,000,000	3.56%	$ -	-	$ -	-	$ 2,000,000	3.56%
Total	$ -	-	$ 2,000,000	3.56%	$ -	-	$ -	-	$ 2,000,000	3.56%

(1) Investment yields are calculated on a tax-equivalent basis using a tax rate of 21%.

Table 6. Deposit Mix

December 31, (In thousands)	2022 Average Balance	2022 %	2021 Average Balance	2021 %
Interest-bearing deposits:				
Interest checking	$ 20,286	11.3%	$ 17,391	11.0%
Savings deposits	60,678	34.0	47,248	29.9
Time deposits	27,180	15.2	27,601	17.5
Large denomination deposits	35,724	20.0	35,312	22.4
Total interest-bearing deposits	143,868	80.5	127,552	80.8
Noninterest-bearing deposits	34,839	19.5	30,271	19.2
Total deposits	$ 178,707	100%	$ 157,823	100%

Table 7. Large Denomination Deposits $250,000 and Over

Analysis of time deposits in excess of $250,000 at December 31, 2022:

Time remaining to maturity:	
Three months or less	$ 3,817,414
Over three months through six months	2,858,163
Over six months through twelve months	2,483,689
Over twelve months	7,390,317
Total time deposits in excess of $250,000	$ 16,549,583

Table 8. Loan Losses

Year ended December 31, (In thousands)	2022	2021
Balance at beginning of year	$ 1,131	$ 1,307
Provision charged to expense	335	195
	1,466	1,502
Loans charged off:		
Commercial and industrial	(20)	(121)
1-4 family residential and multifamily	(4)	(6)
Consumer	(352)	(302)
Total charge-offs	(376)	(429)
Recoveries of loans previously charged off:		
Commercial	2	3
Consumer	58	55
Total recoveries	60	58
Net recoveries (charge – offs)	(316)	(371)
Balance at end of year	$ 1,150	$ 1,131
Total Allowance for Loan Losses to Total Loans	1.12%	1.13%

Table 9. Allocation of the Allowance for Loan Losses

December 31, (In thousands)	2022 Amount	2022 % (1)	2021 Amount	2021 % (1)
Balance at end of period applicable to:				
Commercial and industrial	$ 231	12.7%	$ 194	14.9%
Construction and development	41	5.5	9	1.3
1-4 family residential and multifamily	262	35.0	327	34.7
Nonfarm, nonresidential	175	23.5	183	24.6
Consumer	441	23.3	418	24.5
Total	$ 1,150	100.0%	$ 1,131	100.0%

(1) Represents the percentage of loans in each category.

Table 10. Nonaccrual Loans

December 31 (In thousands)	2022	2021
Commercial and industrial	$ 296	$ 328
1-4 family residential and multifamily	426	934
Nonfarm, nonresidential	202	183
Consumer	604	318
Total nonperforming assets	$ 1,528	$ 1,763
Nonaccrual Loans to Total Loans	1.48%	1.75%
Total Allowance for Loan Losses to Nonaccrual Loans	75.3%	64.2%

Table 11. Loan Charge-Offs

December 31, (In thousands)	2022 Net Charge-Offs	2022 Average Balance	2022 % of Average Balance	2021 Net Charge-Offs	2021 Average Balance	2021 % of Average Balance
Construction and land development	$ -	$ 3,447	-	$ -	$ 1,404	-
1-4 family residential and multifamily	4	35,261	0.01%	6	36,804	0.02%
Nonfarm, nonresidential	-	24,366	-	-	24,519	-
Commercial and industrial	18	13,936	0.13%	118	16,487	0.72%
Consumer	294	24,277	1.21%	247	25,570	0.97%
Total	$ 316	$ 101,287	0.31%	$ 371	$ 104,784	0.35%

Board of Directors

Ronald S. Bowers .... *Owner*
Alleghany Highlands Mechanical, Inc.

Debra Byer .... *Clerk of the Court*
Alleghany County

John S. Franson .... *President & Owner*
Alleghany Asphalt & Construction, Inc.

James N. Garcia .... *Former Owner*
Standard Printing & Office Supply, Inc.

Nicholas J. Moga .... *Chairman of the Board*
President - PCSS, LLC

David M. Oliver .... *President & Owner*
Oliver Distributing Company, Inc.

Michael H. Persinger .... *Vice President & Chief Financial Officer*
Dawn Warehousing, Inc. & Kemper Properties, LLC

H.C. Rhodes, Jr. .... *Interim President & CEO*
Highlands Community Bank

Lisa Schoppmeyer .... *President*
Schoppmeyer Financial

Daniel C. Lawson .... *Chief Financial Officer*
Highlands Community Bank

Staff

Megan Angle........*Teller*

Kaitlyne Baker........*Teller*

Brittany Belcher........*Customer Service*

Amy Boguess........*Teller*

Brandon Caldwell........*Vice President-Loans*

Donna Craft........*Loan Officer*

Kathy Dobson........*Branch Manager-Clifton Forge*

Christian Filips........*IT Administrator & Project Coordinator*

Joy D. Fridley........*Vice President & Loan Administration Officer*

Tammy B. Graham........*Assistant Cashier*

Jacob Grimes........*Director of Human Resources*

Joy Hale........*Loan Administration*

Pamela Kincaid........*Customer Service*

Daniel C. Lawson........*Chief Financial Officer*

Kim Lewis........*Operations & Customer Service*

Nikki Lowry........*Teller Supervisor*

Debra Martin........*Teller*

Linda Morris........*Teller*

Kim Moses........*Customer Service*

Jennifer Mundy........*Loan Administration*

Katherine Nelson........*Teller*

Kristin Nicely........*Compliance Officer*

Leslie P. Nicely........*Security Officer & BSA Officer*

Christina Roark........*Loan Administration*

Kimberly Robertson........*Teller*

Donna A. Rock.. *Assistant Vice President & Operations Officer*

Melissa Shifflett........*Branch Manager-Hot Springs*

Matt Smith........*Loan Officer*

Gina Tingler........*Loan Officer*

Britney Via........*Teller*

Stockholder Information

Annual Meeting

The annual meeting of stockholders will be held April 25, 2023 at 7pm in our lobby at our main office, 307 Thacker Avenue, Covington, Virginia 24426.

Requests for Information

Requests for information should be directed to Mr. Daniel C. Lawson, CFO, at Highlands Community Bank, Post Office Box 1059, Covington, Virginia, 24426; telephone (540) 962-2265.

Independent Registered Public Accounting Firm

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Winchester, VA 22604

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Attorneys at Law
Post Office Box 40013
Roanoke, Virginia 24022

Federal Deposit Insurance Corporation

The Bank is a member of the FDIC. This statement has not been reviewed or confirmed for accuracy or relevance by the Federal Deposit Insurance Corporation.