2022

NORTH STATE BANCORP

CONSOLIDATED FINANCIAL STATEMENTS

NORTH STATE BANCORP
INDEX TO THE CONSOLIDATED FINANCIAL STATEMENTS

FORV/S

Independent Auditors' Report

Shareholders and the Board of Directors
North State Bancorp
Raleigh, NC

Opinion

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

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

We have also audited in accordance with auditing standards generally accepted in the United States of America (GAAS), the Company's internal control over financial reporting as of December 31, 2022, based on the criteria established in *Internal Control—Integrated Framework (2013),* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 29, 2023 expressed an unmodified opinion thereon.

Basis for Opinion

We conducted our audits in accordance with GAAS. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are required to be independent of the Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Consolidated Financial Statements

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

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

FORV/S

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not absolute assurance, and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the consolidated financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances.

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

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

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

FORVIS, LLP

Tysons, VA
March 29, 2023

NORTH STATE BANCORP
CONSOLIDATED BALANCE SHEETS
December 31, 2022 and 2021

	2022	2021
	(Dollars in thousands)	
ASSETS		
Cash and due from banks	$ 11,912	$ 9,426
Interest-earning deposits with banks	122,816	366,040
Certificates of deposit with banks	101	101
Investment securities available for sale, at fair value	3,221	4,252
Investment securities held to maturity, at amortized cost	53,050	43,561
Loans held for sale	4,797	7,218
Loans held for investment	1,044,841	917,982
Less allowance for loan losses	7,543	6,742
Net loans	**1,037,298**	**911,240**
Accrued interest receivable	3,683	2,753
Federal Home Loan Bank and Federal Reserve stock, at cost	1,785	1,630
Premises and equipment, net	28,029	22,617
Bank owned life insurance	22,064	22,185
Prepaid for unexchanged common stock	-	3
Other assets	15,600	4,829
Total Assets	**$ 1,304,356**	**$ 1,395,855**
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Demand	$ 505,069	$ 513,146
Savings, money market and NOW	637,943	716,306
Time	45,829	60,886
Total deposits	**1,188,841**	**1,290,338**
Accrued interest payable	423	394
Payable for unexchanged common stock	-	3
Short-term borrowings	264	239
Long-term borrowings, net	34,151	33,573
Accrued expenses and other liabilities	9,802	6,151
Total Liabilities	**1,233,481**	**1,330,698**
Commitments	-	-
Shareholders' equity:		
Preferred stock, no par value, 1,000,000 shares authorized, none issued	-	-
Common stock, no par value; 8,136,382 shares authorized; 6,361,718 and 6,184,714 shares issued and outstanding, December 31, 2022 and 2021, respectively	14,214	11,215
Retained earnings	57,344	53,973
Accumulated other comprehensive loss	(683)	(31)
Total Shareholders' Equity	70,875	65,157
Total Liabilities and Shareholders' Equity	**$ 1,304,356**	**$ 1,395,855**

See accompanying notes.

NORTH STATE BANCORP
CONSOLIDATED STATEMENTS OF OPERATIONS
Years Ended December 31, 2022 and 2021

	December 31,			
	2022		2021	
	(Dollars in thousands, except per share data)			
INTEREST INCOME				
Loans	$	44,344	$	42,674
Loans held for sale		263		498
Investments		962		692
Dividends and interest-earning deposits		4,211		443
Total interest income		**49,780**		**44,307**
INTEREST EXPENSE				
Savings, money market and NOW		1,915		1,597
Time deposits		408		613
Short-term borrowings		2		-
Long-term borrowings		1,463		1,202
Total interest expense		**3,788**		**3,412**
Net interest income		**45,992**		**40,895**
PROVISION FOR LOAN LOSSES		665		-
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES		**45,327**		**40,895**
NON-INTEREST INCOME				
Fees from mortgage operations		4,403		12,152
Fees and gains on sales from SBA operations		3,573		2,918
Other		3,359		2,469
Total non-interest income		**11,335**		**17,539**
NON-INTEREST EXPENSE				
Salaries and employee benefits		24,665		24,655
Occupancy and equipment		3,621		3,532
Data processing and other outsourced services		7,339		6,610
Net cost of foreclosed assets		1		6
Other		7,968		7,476
Total non-interest expense		**43,594**		**42,279**
NET INCOME	**$**	**13,068**	**$**	**16,155**
NET INCOME PER COMMON SHARE:				
Basic	$	2.08	$	2.64
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:				
Basic		6,268,942		6,126,429

See accompanying notes.

NORTH STATE BANCORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
Years Ended December 31, 2022 and 2021

	December 31,	
	2022	**2021**
	(Dollars in thousands)	
Net income	$ 13,068	$ 16,155
Other comprehensive loss:		
Investment securities:		
Unrealized holding loss on available for sale securities	(652)	(44)
Total other comprehensive loss	(652)	(44)
Comprehensive income	**$ 12,416**	**$ 16,111**

See accompanying notes.

NORTH STATE BANCORP
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years Ended December 31, 2022 and 2021

	Common Stock				
	Shares	Amount	Retained earnings	Accumulated other comprehensive income (loss)	Total shareholders' equity
			(Dollars in thousands)		
Balance as of December 31, 2020	6,095,594	$ 9,668	$ 49,579	$ 13	$ 59,260
Net income	-	-	16,155	-	16,155
Other comprehensive income	-	-	-	(44)	(44)
Cash distributions to shareholders	-	-	(11,761)	-	(11,761)
Issuance of shares to ESOP	56,381	1,032	-	-	1,032
Issuance of common stock	32,739	515	-	-	515
Balance as of December 31, 2021	6,184,714	$ 11,215	$ 53,973	$ (31)	$ 65,157
Net income	-	-	13,068	-	13,068
Other comprehensive loss	-	-	-	(652)	(652)
Cash distributions to shareholders	-	-	(9,697)	-	(9,697)
Capital Reinvestment Plan	136,721	2,262	-	-	2,262
Issuance of common stock	40,283	737	-	-	737
Balance as of December 31, 2022	6,361,718	$ 14,214	$ 57,344	$ (683)	$ 70,875

See accompanying notes.

NORTH STATE BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2022 and 2021

	December 31, 2022	December 31, 2021
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 13,068	$ 16,155
Adjustments to reconcile net income to net cash used by operating activities:		
Provision for loan losses	665	-
Depreciation and net amortization (accretion)	2,078	(1,401)
Amoritzation of debt issuance costs	47	47
Net amortization of premiums and discounts on investment securities	423	287
Loss on disposal of fixed assets	-	528
Originations of loans held for sale	(279,816)	(435,802)
Proceeds from sales of loans held for sale	195,116	413,781
Gain on sale of loans held for sale	(4,403)	(12,152)
Issuance of common stock to ESOP	-	1,032
Issuance of common stock for board compensation	737	515
Income from bank owned life insurance	(362)	(301)
Changes in assets and liabilities:		
Decrease in other assets	507	975
(Increase) decrease in accrued interest receivable	(930)	862
Increase (decrease) in accrued expenses and other liabilities	16	(454)
Increase (decrease) in accrued interest payable	29	(141)
Net cash used in operating activities	**(72,825)**	**(16,069)**
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities, calls, and repayments of investment securities available for sale	370	452
Proceeds from maturities, calls, and repayments of investments securities held to maturity	940	6,975
Purchases of investment securities held to maturity	(10,843)	(20,592)
Proceeds from (purchases of) bank owned life insurance	483	(5,000)
(Purchase of) proceeds from Federal Home Loan Bank and Federal Reserve stock	(155)	254
Net (increase) decrease in loans	(35,312)	94,158
Purchases of premises and equipment	(5,894)	(1,301)
Net cash (used in) provided by investing activities	**(50,411)**	**74,946**
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase (decrease) in short term borrowings	25	(80)
Repayments of long-term borrowings	(78)	(30)
Issuance of common stock from Capital Reinvestment Plan	2,262	-
Net (decrease) increase in deposit accounts	(110,014)	217,995
Cash distributions to shareholders	(9,697)	(11,761)
Net cash (used in) provided by financing activities	**(117,502)**	**206,124**

See accompanying notes.

NORTH STATE BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
Years Ended December 31, 2022 and 2021

	December 31,	
	2022	2021
	(Dollars in thousands)	
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	$ (240,738)	$ 265,001
CASH AND CASH EQUIVALENTS BEGINNING	375,567	110,566
CASH AND CASH EQUIVALENTS ENDING	$ 134,829	$ 375,567
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Interest paid	$ 3,712	$ 3,506
SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING ACTIVITIES		
Unrealized loss on investment securities available for sale	$ (652)	$ (44)
Transfer of mortgage loans held for sale to held for investment	91,524	54,455
Change in unexchanged common stock	(3)	(122)
Initial right of use assets recognized upon adoption of ASC 842	4,151	-
Initial lease liabilities recognized upon adoption of ASC 842	4,246	-

See accompanying notes.

NOTE A - ORGANIZATION AND OPERATIONS

On June 28, 2002, North State Bancorp (the "Company") was formed as a holding company for North State Bank (the "Bank"). Upon formation, one share of the Company's $1.00 par value common stock was exchanged for each of the outstanding shares of the Bank's $5.00 par value common stock. On May 9, 2007, the Company's shareholders approved the decrease of the Company's par value of common stock from $1.00 per share to no par value per share. The Company currently has no operations and conducts no business on its own other than owning the Bank, North State Statutory Trust I, North State Statutory Trust II and North State Statutory Trust III, all of which are wholly owned by the Company. The Company is subject to the rules and regulations of the Federal Reserve Bank and the North Carolina Commissioner of Banks. During 2015, the Company's Board of Directors approved a plan of reorganization providing for the reorganization of the Company's ownership that would permit the Company to qualify for an election under Subchapter S of the Internal Revenue Code of 1986 ("IRC").

The Bank was incorporated May 25, 2000, and began banking operations on June 1, 2000. The Bank is engaged in general commercial and retail banking in central North Carolina, principally Wake County, and in southeast North Carolina in New Hanover County, operating under the banking laws of North Carolina and the rules and regulations of the Federal Reserve Bank and the North Carolina Commissioner of Banks. The Bank undergoes periodic examinations by those regulatory authorities. The Bank's wholly owned subsidiary, North State Wealth Advisors, Inc., offers wealth management and brokerage services. North State Bank Mortgage ("NSB Mortgage"), a division of the Bank, began operations during February 2010 for the purpose of originating and selling single-family, residential first mortgage loans. During 2016, the Bank established a small business lending services division. A significant portion of the loans originated (generally 75%) are guaranteed by the Small Business Administration ("SBA") under the 7(a) Loan Program. At management's discretion, the guaranteed portion of these 7(a) loans is sold in the secondary market. In October of 2017, the Bank's wholly owned subsidiary, North State Title, LLC purchased a 5% interest in North Carolina Title Center, LLC, a title insurance agency.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation
The accompanying consolidated financial statements include the accounts and transactions of North State Bancorp and its wholly owned subsidiary North State Bank. All significant intercompany transactions and balances are eliminated in consolidation. North State Bancorp and its subsidiary are collectively referred to herein as the "Company".

Under Financial Accounting Standards Board ("FASB") accounting standards for the consolidation of variable interest entities, North State Statutory Trust I, North State Statutory Trust II and North State Statutory Trust III are not included in the Company's consolidated financial statements. The junior subordinated debentures issued by the Company to the three Trusts are included in long-term borrowings and the Company's equity interest in the three Trusts is included in other assets.

Use of Estimates
The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the 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 and valuation of foreclosed assets.

Cash and Cash Equivalents and Certificates of Deposit with Other Banks
For presentation purposes in the consolidated statements of cash flows, cash and cash equivalents include cash and due from banks and interest-earning deposits with banks (including certificates of deposit with other banks). As discussed in Note J - Borrowings, the Company's long-term FHLB advances are secured by cash of $850,000 and short-term repurchase agreements are secured by cash of $1 million. Certificates of deposit with other banks have a maturity of April 24, 2023, and bear an interest rate of 0.4%. All investments in certificates of deposit are with FDIC insured financial institutions and none exceed the maximum insurable amount of $250 thousand.

Investment Securities
Available for sale securities are reported at fair value and consist of mortgage-backed securities not classified as trading securities or as held to maturity securities. Unrealized holding gains and losses on available for sale securities are reported in other comprehensive income. Gains and losses on the sale of available for sale securities are determined using the specific-identification method and are recorded in other noninterest income on a trade date basis. Bonds for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using a method that

approximates the interest method over the period to maturity. Declines in the fair value of available for sale and held to maturity securities below their cost that are other than temporary would result in write-downs of the individual securities to their fair value. If the Company does not intend to sell the security prior to recovery and it is more likely than not the Company will not be required to sell the impaired security prior to recovery, the credit loss portion of the impairment is recognized in earnings and the remaining impairment is recognized in other comprehensive income. Otherwise, the full impairment loss is recognized in earnings. The classification of securities is generally determined at the date of purchase.

Certain equity security investments that do not have readily determinable fair values and for which the Company does not exercise significant influence are carried at cost. The Company has investments in the stock of the Federal Home Loan Bank of Atlanta ("FHLB") and the Federal Reserve Bank ("FRB") as a requirement for membership. All the equity securities are reviewed for impairment at least annually or sooner if events or changes in circumstances indicate the carrying value may not be recoverable. As of December 31, 2022 and 2021, the stock in these equity securities totaled $1.8 million and $1.6 million, respectively. Due to redemption provisions, the Company estimates that fair value equals cost.

Loans Held for Sale
Mortgage loans held for sale represent single-family, residential first mortgage loans on a pre-sold basis originated by our mortgage division. Generally, commitments to sell these loans are made after the intent to proceed with mortgage applications are initiated with borrowers, and all necessary components of the loan are approved according to secondary market underwriting standards of the investor that purchases the loan. Upon closing, these loans, together with their servicing rights, are sold to mortgage loan investors under prearranged terms. Beginning in 2022, loans held for sale are valued under a fair value option with changes in fair value reflected in current period earnings. In 2021 and prior years, loans held for sale were subsequently measured at the lower of cost or estimated fair value on an aggregated basis within the consolidated balance sheet under the caption "loans held for sale". The Company recognizes certain origination and service release fees from the sale, which are included in fees from mortgage operations. The fair value of loans held for sale is based on the loan amount, the interest rate and other characteristics of the underlying loan, any discount or fees to be collected from the borrower, the price at which the loan my be sold, and the value of service released premiums. Fair value adjustments on loans held for sale are classified and included in the loans held for sale balance.

The Company is exposed to certain risks relating to its ongoing mortgage origination business. The Company enters into both best-efforts and mandatory delivery contracts with mortgage loan investors. For best-efforts contracts, the Company will deliver individual mortgage loans. Under a best-efforts contract, the Company is not contractually obligated to deliver a maximum principal amount of mortgage loans and is not required to pay a "pair off" fee on any delivery shortfall. Because the best-efforts contract does not have a specified underlying or determinable notional amount or does not require net settlement, the contract does not meet the definition of a derivative. Beginning in 2022, the Company elected to account for best-efforts interest rate lock commitments under a fair value option with changes in fair value reflected in 'Fees from mortgage operations'. The period of time between the issuance of a loan commitment and the closing and sale of the loan generally ranges from 30 to 60 days. The Company had a notional amount of $4.6 million of best-efforts commitments as of December 31, 2022. ASC 825 *Financial Instruments* allows but does not require financial instruments to be recorded at fair value under the 'fair value option'. Loans held for sale and best-efforts interest rate lock commitments meet the definition of a financial instrument and the Company has elected to account for these financial instruments at fair value.

The Company also will enter into mandatory delivery contracts with mortgage loan investors where the Company commits to deliver a specified principal amount of mortgage loans to an investor at a specified price on or before a specified date. Failure to deliver the amount of mortgages necessary to fulfill the commitment by the specified date could result in the Company being obligated to pay a "pair off" fee, (depending on market conditions at the specified time of delivery, the investor may not charge a pair off fee). Based on these characteristics, the mandatory delivery contract meets the definition of a derivative at the time the Company enters the contract. As such, the Company accounts for these derivatives at fair value with changes in the fair value reflected in 'Fees from mortgage operations'. The Company had a notional amount of $3.2 million of open mandatory delivery commitments as of December 31, 2022.

The fair value of interest rate lock commitments is based on the loan amount, the interest rate and other characteristics of the underlying loan, the price at which the loan may be sold, discount points and fees to be collected from the borrower, the value of service release premiums, estimated pull-through, and an estimate of direct costs to complete the interest rate lock into a closed loan. The gains and losses from the future sales of the mortgages are recognized when the Company and the borrower enter into the interest rate lock commitment and the resulting gain or loss is recorded in fees from mortgage operations. Fair value adjustments on best-efforts interest rate lock commitments are classified and included in the other assets balance. Fair value adjustments on mandatory delivery interest rate lock commitments are reported gross and are classified and included in the other assets and other liabilities balances.

Beginning in 2022, the Company began working with a third-party specializing in hedging the mortgage pipeline, specifically hedging the fair value of mandatory delivery interest rate lock commitments in which the Company has essentially taken the 'long' position. To hedge the 'long' position, the Company sells (or goes 'short') TBA mortgage-backed securities (mandatory forward loan commitments or 'hedge instruments'). In order to do this, the Company, assisted by the third-party, matches up like notional amounts and interest rates to best hedge the change in fair value that occurs due to the natural movement of interest rates. The Company had a notional amount of $4.5 million of open hedge instruments as of December 31, 2022. Fair value adjustments on hedge instruments are reported gross and are classified and included in the other assets and other liabilities balances.

The Company accounts for mandatory delivery interest rate lock commitments and their associated hedge instruments as free-standing derivatives which require fair value on a recurring basis. Since these are accounted for as free-standing derivatives, ASC 815 *Derivatives and Hedging* does not apply and there is no impact to Other Comprehensive Income.

For more information on loans held for sale, interest rate lock commitments, and hedge instruments, please refer to Note O – Fair Value Measurements.

Loans

Originated commercial and retail loans for which management has the intent and ability to hold for the foreseeable future are classified as held for investment and carried at the principal amount outstanding net of any unearned income, charge-offs and unamortized fees and costs. Nonrefundable fees collected and certain direct costs incurred related to loan originations are deferred and recorded as an adjustment to loans outstanding. The net amount of the nonrefundable fees and costs is amortized to interest income over the contractual lives using methods that approximate a constant yield. Interest income is recorded as earned on an accrual basis.

The Company provides loans guaranteed by the U.S. Small Business Administration ("SBA") for the purchase of businesses, business startups, business expansion, equipment, and working capital. All SBA loans are underwritten and documented as prescribed by the SBA. SBA loans are generally fully amortizing and have maturity dates and amortizations of up to 25 years. SBA loans may be originated and held for interest income purposes or, at management's discretion, the portion of SBA loans that are guaranteed can be sold at a gain in the secondary market. If a guaranteed portion of an SBA loan is sold, the servicing rights are retained. The portion of SBA loans that are retained (the unguaranteed portion) are also adjusted for a retained discount to reflect the effective interest rate on the retained unguaranteed portion of the loans if a sale takes place. Additionally, the Company defers direct origination costs on these loans. When a guaranteed portion of a loan is sold, the guaranteed portion of the deferred cost is recognized in the income statement as a reduction to the overall gain on sale as well as an increase in the retained discount. The remaining deferred cost on the unguaranteed portion amortizes into interest income in a manner which reflects the effective interest rate on the retained unguaranteed portion of the loan. The net value of the retained loans is included in the appropriate loan classification for disclosure purposes. These loans are primarily commercial real estate or commercial and industrial.

The Small Business Administration Paycheck Protection Program ("PPP") is central to the Coronavirus Aid Relief and Economic Security Act (the "CARES Act"), which was passed on March 27, 2020 ("Round 1"), in response to the outbreak of coronavirus ("COVID-19") and was supplemented with subsequent legislation. Overseen by the United States Treasury Department, the program offers cash-flow assistance to nonprofit and small business employers through guaranteed loans for expenses incurred between prescribed dates. Borrowers are eligible for forgiveness of principal and accrued interest on PPP loans to the extent that the proceeds were used to cover eligible payroll costs, interest costs, rent, and utility costs over a period of between eight and 24-weeks after the loan is made if the borrower retains its employees and their compensation levels. The CARES Act authorized the SBA to temporarily guarantee these loans. The SBA began processing forgiveness payments during the fourth quarter of 2020. The Consolidated Appropriations Act 2021 was signed into law during the fourth quarter of 2020 and contained provisions for a second round of funding of SBA-PPP loans ("Round 2"). The Company participated in both rounds of PPP. PPP loan origination fee income is capitalized into the carrying amount of the loans and is deferred and recognized over the life of the loan (or up unto forgiveness, whichever comes first) and accrete into interest income using the effective interest method.

Unsecured loans are charged-off against the Company's allowance for loan losses as soon as the loan becomes uncollectible. Unsecured loans are considered uncollectible when no regularly scheduled monthly payment has been made within three months and the analysis of the borrower and any guarantors would indicate no further support can be provided, the loan matured over 90 days ago and has not been renewed or extended or the borrower files for bankruptcy. Secured loans are considered uncollectible when the liquidation of collateral is deemed to be the most likely source of repayment and the collateral or guarantors are deemed unable to repay any shortfall. Once secured loans reach 90 days past due, they are placed into non-accrual status. If the loan is deemed to be solely collateral dependent, the principal balance is written down immediately to reflect the current market valuation based on current independent appraisal/evaluation. Included in the write-down is the estimated expense to liquidate the property and typically an additional allowance for the foreclosure discount. Generally, if the loan is unsecured the loan must be charged-off in full while if it is secured the loan is charged down to the net liquidation value of the collateral.

Loans, including impaired loans, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. Loans that are current or past due less than 90 days may also be classified as nonaccrual if repayment in full of principal and/or interest is in doubt (as determined by the contractual terms of the note). Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in accordance with the contractual terms.

While a loan (including an impaired loan) is classified as nonaccrual and the future collectability of the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to the principal outstanding. When the future collectability of the recorded loan balance is not in doubt, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged-off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Troubled Debt Restructurings (“TDRs”) are loans that have been modified due to deterioration in the borrower’s financial condition, resulting in more favorable terms for the borrower. Accrual of interest is continued for restructured loans when the borrower was performing prior to the restructuring and there is reasonable assurance of repayment and continued performance under the modified terms. Accrual of interest on restructured loans in nonaccrual status is resumed when the borrower has established a sustained period of performance under the restructured terms of at least six months.

Allowance for Loan Losses
The provision for loan losses is based upon management’s estimate of the amount needed to maintain the allowance for loan losses at an adequate level. In evaluating the allowance for loan losses, the Company prepares an analysis of its current loan portfolio using historical loss rates, other identified factors, and data from its portfolio to calculate a general reserve for loan losses. The Company applies a charge-off rate based on charge-off history applied to twelve classes of loans in its current loan portfolio. In addition, the Company has identified seven factors that are considered as indicators of changes in the level of risk of loss inherent with the Company’s loan portfolio. These factors are payment performance, overall portfolio quality utilizing weighted average risk rating, general economic factors such as unemployment, delinquency and charge-off rates, regulatory examination results, the interest rate environment, levels of highly leveraged transactions and levels of commercial real estate concentrations, which address the risks associated with construction, development and non-owner occupied commercial real estate lending. Each of these factors is assigned a level of risk and this risk factor is applied to only the general pool of loans. In addition to the general reserve calculation, all loans risk rated “substandard”, “doubtful” and “loss” are reviewed for probable losses. If management determines a loan to be impaired, it is removed from its homogeneous group and individually analyzed for impairment. Other groups of loans may also be selected for impairment review. A loan is considered impaired when, based on current information and events, it is considered probable that the Company will be unable to collect the scheduled payments of principal and interest when due according to the original contractual terms of the loan agreement. The measurement of impaired loans is generally based on the present value of expected future cash flows discounted at the original effective interest rate, or upon the fair value of the collateral if the loan is collateral dependent. If the recorded investment in the loan exceeds the measure of fair value, a valuation allowance is established as a component of the allowance for loan losses.

While management uses the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, regulatory examiners may require the Company to recognize adjustments to the allowance for loan losses based on their judgments about information available to them at the time of their examination.

Premises and Equipment
Premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets which are 3 to 10 years for furniture and equipment and 30 to 40 years for buildings. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. Repairs and maintenance costs are charged to operational expense as incurred and additions and improvements to premises and equipment are capitalized. Upon sale or retirement, the cost and related accumulated depreciation are removed from the accounts and any gains or losses are reflected in current operations. Long-lived depreciable assets are evaluated periodically for impairment

when events or changes in circumstances indicate the carrying amount may not be recoverable.

The Company leases certain office equipment under a finance lease. In 2022, the Company adopted *ASU 2016-02, Leases (Topic 842)* related to accounting for leases as further discussed below. Under the new standards, for finance leases other than those considered to be short-term, the Company recognizes lease right-of-use assets and related lease liabilities. Such amounts are reported as components of premises and equipment and other borrowings, respectively, on our accompanying consolidated balance sheet. The Company does not recognize short-term finance leases on our balance sheet. A short-term finance lease has an original term of 12 months or less and does not have a purchase option that is likely to be exercised.

In recognizing finance lease right-of-use assets and related lease liabilities, the Company accounts for lease and non-lease components (such as taxes) separately as such amounts are generally readily determinable under our lease contract. Lease payments over the expected term are discounted using our incremental borrowing rates for borrowings of similar terms.

Leases
The Company leases certain office facilities under operating leases. The Company also owns certain office facilities which are leased to outside parties under operating lessor leases; however, such leases are not significant. In 2022, the Company adopted *ASU 2016-02, Leases (Topic 842)* related to accounting for leases. Under the new standards, for operating leases other than those considered to be short-term, the Company recognizes lease right-of-use assets and related lease liabilities. Such amounts are reported as components of other assets and other liabilities, respectively, on our accompanying consolidated balance sheet. The Company does not recognize short-term operating leases on our balance sheet. A short-term operating lease has an original term of 12 months or less and does not have a purchase option that is likely to be exercised.

In recognizing operating lease right-of-use assets and related lease liabilities, the Company accounts for lease and non-lease components (such as taxes, insurance, and common area maintenance costs) separately as such amounts are generally readily determinable under our lease contracts. Lease payments over the expected term are discounted using our incremental borrowing rates for borrowings of similar terms. The Company also considers renewal and termination options in the determination of the term of the lease. If it is reasonably certain that a renewal or termination option will be exercised, the effects of such options are included in the determination of the expected lease term. Generally, the Company cannot be reasonably certain about whether or not it will renew a lease until such time the lease is within the last two years of the existing lease term. When the Company is reasonably certain that a renewal option will be exercised, the Company measures/remeasures the right-of-use asset and related lease liability using the lease payments specified for the renewal period.

Foreclosed Assets
Assets acquired through, or in lieu of, foreclosure are held for sale and are initially recorded at fair value less anticipated selling costs at the date of foreclosure, establishing a new cost basis. Principal and interest losses existing at the time of acquisition of such assets are charged against the allowance for loan losses and interest income, respectively. The initial recorded value may be subsequently reduced by additional valuation allowances, which are charged to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Costs related to the improvement of the property are capitalized, whereas those related to holding the property are expensed. Revenue and expenses from operations and changes in the valuation allowance are included in other expenses. The Company did not have any foreclosed assets as of December 31, 2022 and 2021, respectively. As of December 31, 2022, there was one loan totaling approximately $3 million in process of foreclosure. As of December 31, 2021, there were no loans in process of foreclosure.

Bank Owned Life Insurance
Bank owned life insurance is carried at cash surrender value as determined by the insurer. The carrying value of life insurance approximates fair value.

Income Taxes
During 2015 the Company's Board of Directors approved a plan of reorganization providing for the reorganization of the Company's ownership that would permit the Company to qualify for an election under Subchapter S of the Internal Revenue Code of 1986 ("IRC"). The change in tax election enables the Company to take advantage of the favorable tax treatment afforded such entities under amendments to the IRC contained in the Small Business Jobs Protection Act of 1996 and subsequent amendments. The effect of an S Corporation election is to eliminate one level of taxation. Under an S Corporation election, corporate income, gains, and losses are passed through to the shareholders and each shareholder's pro rata share of Company income is reported on the shareholders' returns whether or not any cash or property is actually distributed to shareholders. The Company was approved for Subchapter S status with the Internal Revenue Service effective date of January 1, 2016.

SBA Servicing Assets

All sales of SBA-guaranteed loans are executed on a servicing retained basis, and the Company retains the rights and obligations to service the loans. The standard sale structure under the SBA Secondary Participation Guaranty Agreement provides for the Company to retain a portion of the cash flow from the interest payment received on the loan. This cash flow is commonly known as a servicing spread. SBA regulations require the lender to retain a minimum 100 basis points in servicing spread for any guaranteed loan sold for a premium. The minimum servicing spread is further defined as a minimum service fee of 40 basis points and a minimum premium protection fee of 60 basis points. The servicing spread is recognized as a servicing asset to the extent the spread exceeds adequate compensation for the servicing function. Industry practice recognizes adequate compensation for servicing SBA loans as the minimum service fee of 40 basis points. The fair value of the servicing asset is measured at the discounted present value of the premium protection fee over the expected life of the related loan using appropriate discount rates and prepayment assumptions based on industry statistics. SBA servicing assets are initially recognized at fair value and amortized over the expected life of the related loans using the level yield method as a reduction of the servicing income recognized from the servicing spread. The servicing rights are periodically evaluated for impairment based upon the fair value of the rights as compared to carrying amount. If a temporary impairment exists, the servicing asset is written down through a valuation allowance and is charged against servicing income. Loans serviced for others are not included in the consolidated balance sheets. The valuation allowance totaled approximately $217,000, and $0, as of December 31, 2022, and 2021, respectively.

Earnings Per Common Share

Basic earnings per share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. The Company did not have any potential dilutive common shares for the years ended December 31, 2022 and December 31, 2021.

Debt Issuance Costs

Incremental costs directly incurred to issue the Company's subordinated debt are recorded, net of cumulative amortization, on the Company's consolidated balance sheets as a direct reduction of the carrying value of the related debt. The amortization is recorded as an adjustment to the rate paid on the debt.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on investment securities available for sale and unrealized holding gains on hedge instruments are reported as a separate component of the equity section of the balance sheet. Such items, along with net income, are components of total comprehensive income. The Company's only component of accumulated other comprehensive income was unrealized gains and losses on available for sale securities.

Derivative Instruments

The Company's deposit and loan activities are vulnerable to interest rate risk. The associated variability in cash flows may impact the results of operations of the Company. The Company's hedging strategy is generally intended to take advantage of opportunities to reduce, to the extent possible, unpredictable cash flows. The Company may employ a variety of common derivative products that are instruments used by financial institutions to manage interest rate risk. The financial instruments that may be used as part of a hedging strategy include swaps, caps, floors, and collars.

The Company does not enter into derivative financial instruments for speculative or trading purposes. Through its mortgage operations, the Company does enter into mandatory delivery interest rate lock commitments and forward sales of TBA mortgage-backed securities (hedge instruments). Such interest rate lock commitments and hedge instruments represent derivative instruments which are required to be carried at fair value and recorded on a gross basis as other assets and other liabilities. For more information, refer to the 'Loans Held for Sale' section of Note B – Summary of Significant Accounting Policies above.

Segment Reporting

Management is required by accounting pronouncements governing the disclosures about segments of an enterprise and related information to report selected financial and descriptive information about reportable operating segments. It also establishes standards for related disclosures about products and services, geographic areas, and major customers. Generally, disclosures are required for segments internally identified to evaluate performance and resource allocation. Included as a division of the Bank, NSB Mortgage and our SBA division are reported as separate segments as well as the parent company. Segment information regarding the Bank, NSB Mortgage, SBA and the parent company are fully described in Note R – Business Segment Information. The Company has no foreign operations or customers.

Revenue Recognition
Management is required by accounting pronouncements governing the recognition of revenue which require an entity to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the Company expects to be entitled in exchange for those goods or services.

Subsequent Events
The Company has evaluated subsequent events through March 29, 2023.

Recently Issued Accounting Pronouncements

FASB ASU 2022-01 – Derivatives and Hedging (Topic 815): Fair Value Hedging – Portfolio Layer Method: This ASU expands the scope of assets eligible for portfolio layer method hedging to include all financial assets. The amendments remove the requirement that all assets in the closed portfolio have a contractual maturity date on or after the earliest-ending hedge period. The amendments require an entity to maintain fair value hedge basis adjustments at the closed portfolio level for a currently designated hedge and prohibits and entity from considering portfolio layer method fair value hedge basis adjustments on a currently designated hedge in its determination of credit losses. When a breach occurs (that is, the aggregate amount of the hedged layers currently exceeds the amount of the closed portfolio), an entity is required to present the fair value hedge basis adjustments with a breach in interest income and disclose the amount along with the circumstances that led to the breach. The effective date for this guidance is for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. The Company does not anticipate that the impact the adoption this guidance will have on its consolidated financial statements will be material.

FASB ASU 2022-02 – Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures: This ASU requires an entity to apply the loan and refinancing and restructuring guidance to determine whether a modification results in a new loan or a continuation of an existing loan, rather than applying the recognition and measurement guidance for TDRs. The effective date for this guidance is for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. The Company is currently evaluating the impact the adoption this guidance will have on its consolidated financial statements.

FASB ASU 2022-03 – Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions: This ASU clarifies that a contractual restriction on the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring fair value. It clarifies that an entity cannot recognize and measure a contractual sale restriction as a separate unit of account. The amendments include various disclosure requirements. The effective date for this guidance is for fiscal years beginning after December 15, 2024. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance. The Company does not anticipate that the impact the adoption this guidance will have on its consolidated financial statements will be material.

FASB ASU 2021-08 – Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers: This ASU was issued to improve the accounting for acquired revenue contracts with customers in a business combination. Under current GAAP, an acquirer generally recognizes contract assets acquired and contract liabilities assumed in a business combination at the acquisition date fair value. This ASU will now require an acquirer to recognize and measure contract assets acquired and contract liabilities assumed in a business combination in accordance with FASB Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, as if it had originated the contracts. The effective date for this guidance is for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. The ASU should be applied prospectively to business combinations occurring on or after the effective date of the amendments. The Company does not anticipate that the impact the adoption this guidance will have on its consolidated financial statements will be material.

FASB ASU 2021-01 – Reference Rate Reform (Topic 848): The amendments in this Update clarify that certain optional expedients and exceptions in Topic 848 for contract modifications and hedge accounting apply to derivatives that are affected by the discounting transition. Specifically, certain provisions in Topic 848, if elected by an entity, apply to derivative instruments that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform. Amendments in this Update to the expedients and exceptions in Topic 848 capture the incremental consequences of the scope clarification and tailor the existing guidance to derivative instruments affected by the discounting transition. The effective date for this guidance is upon issuance. The Company is currently evaluating the impact the adoption this guidance will have on its consolidated financial statements.

FASB ASU 2020-08 – Codification Improvements to Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs: The amendments in this ASU clarify that an entity should reevaluate whether a callable debt security is within the scope of paragraph 310-

20-35-33 for each reporting period. The amendments in this ASU affect the guidance in ASU 2017-08, *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities.* The effective date for this guidance is for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. The Company is currently evaluating the impact the adoption this guidance will have on its consolidated financial statements.

Other accounting standards that have been issued by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

Recently Adopted Accounting Pronouncements

FASB ASU 2018-15 – Intangibles – Goodwill and Other- Internal-Use Software (Subtopic 350-40): This ASU amends and improves current guidance on accounting for implementation costs of a hosting arrangement that is a service contract. The amendments in this update align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). The effective date for this guidance is for fiscal years beginning after December 15, 2020, and interim periods within annual periods beginning after December 15, 2021. The Company adopted this guidance on January 1, 2021, which did not have a material impact on its consolidated financial statements.

FASB ASU 2016-02, Leases (Topic 842): In February 2016, the FASB issued new guidance related to Leases which will require lessees to record as an asset on the balance sheet the right to use the leased asset and a liability for the corresponding lease obligation for leases with terms of more than 12 months. The accounting treatment for lessors will remain relatively unchanged. The guidance also requires additional qualitative and quantitative disclosures related to the nature, timing and uncertainty of cash flows arising from leases. The effective date for this guidance is for fiscal years beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early adoption is permitted. The Company adopted this guidance on January 1, 2022. Please refer to Note F – Premises and Equipment and Note G – Leases for more information. As a result of adoption, the Company recorded approximately $4.2 million in right-of-use assets and lease liabilities on January 1, 2022.

FASB ASU 2016-13, Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (CECL): In June 2016, the FASB issued new guidance that replaces the incurred loss impairment methodology in current standards with an expected credit loss methodology and requires consideration of a broader range of information to determine credit loss estimates. The guidance requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts and requires enhanced disclosures related to the significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. In addition, the guidance amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The guidance will be effective for the Company for the years beginning after December 15, 2022, including interim periods within those fiscal years. The Company adopted this guidance on January 1, 2023. The Company adopted this guidance on January 1, 2023, which did not have a material impact on its consolidated financial statements.

NOTE C - INVESTMENT SECURITIES

The following table presents the amortized cost and fair value of securities available for sale and securities held to maturity with gross unrealized gains and losses as of December 31, 2022, and 2021, respectively.

	As of December 31, 2022			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(Dollars in thousands)			
Securities available for sale:				
Government-sponsored residential mortgage-backed securities	$ 3,904	$ -	$ 683	$ 3,221
Total securities available for sale	$ 3,904	$ -	$ 683	$ 3,221
Securities held to maturity:				
Corporate bonds	$ 2,750	$ -	$ 319	$ 2,431
Municipal bonds	50,300	10	4,102	46,208
Total securities held to maturity	$ 53,050	$ 10	$ 4,421	$ 48,639

	As of December 31, 2021			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(Dollars in thousands)			
Securities available for sale:				
Government-sponsored residential mortgage-backed securities	$ 4,283	$ 8	$ 39	$ 4,252
Total securities available for sale	$ 4,283	$ 8	$ 39	$ 4,252
Securities held to maturity:				
Corporate bonds	$ 2,250	$ 12	$ 35	$ 2,227
Municipal bonds	41,311	854	188	41,977
Total securities held to maturity	$ 43,561	$ 866	$ 223	$ 44,204

All unrealized losses on investment securities are considered by management to be temporary given the credit ratings on these investment securities, the interest rate environment, and the Company's intent and ability to hold these securities to maturity. As of December 31, 2022, the Company's available for sale securities included three Government-sponsored residential mortgage-backed securities with unrealized losses of approximately $683,000. The unrealized losses on held to maturity securities as of December 31, 2022 relate to one-hundred-three tax-exempt municipal bonds; four corporate securities; and one taxable municipal bond with combined unrealized losses of approximately $4.4 million. As of December 31, 2021, the Company's available for sale securities included two Government-sponsored residential mortgage-backed securities with unrealized losses of approximately $39,000. The unrealized losses on held to maturity securities as of December 31, 2021 relate to twenty-nine tax-exempt municipal bonds; two corporate securities; and one taxable municipal bond with combined unrealized losses of approximately $223,000. All unrealized losses on investment securities are not considered to be other-than-temporary, because they are related to changes in interest rates, lack of liquidity and demand in the general investment market and do not affect the expected cash flows of the underlying collateral or the issuer. Since the Company does not intend to sell the municipal or corporate bonds with unrealized losses prior to maturity and it is more likely than not the Company will not be required to sell any of these securities in unrealized loss positions prior to maturity, they are not deemed to be other than temporarily impaired.

The following table presents the gross unrealized losses on and fair values of the Company's investments as of December 31, 2022 and 2021, respectively, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position.

	As of December 31, 2022					
	Less than 12 months		12 months of more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
			(Dollars in thousands)			
Securities available for sale:						
Government-sponsored residential mortgage-backed securities	$ 510	$ 45	$ 2,711	$ 638	$ 3,221	$ 683
Total temporarily impaired securities	$ 510	$ 45	$ 2,711	$ 638	$ 3,221	$ 683
Securities held to maturity:						
Corporate bonds	$ 1,159	$ 91	$ 1,272	$ 228	$ 2,431	$ 319
Municipal bonds	29,281	1,112	16,927	2,990	46,208	4,102
Total temporarily impaired securities	$ 30,440	$ 1,203	$ 18,199	$ 3,218	$ 48,639	$ 4,421

	As of December 31, 2021					
	Less than 12 months		12 months of more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
			(Dollars in thousands)			
Securities available for sale:						
Government-sponsored residential mortgage-backed securities	$ 4,252	$ 39	$ -	$ -	$ 4,252	$ 39
Total temporarily impaired securities	$ 4,252	$ 39	$ -	$ -	$ 4,252	$ 39
Securities held to maturity:						
Corporate bonds	$ 2,227	$ 35	$ -	$ -	$ 2,227	$ 35
Municipal bonds	41,544	181	433	7	41,977	188
Total temporarily impaired securities	$ 43,771	$ 216	$ 433	$ 7	$ 44,204	$ 223

The following table presents the amortized cost and fair values of securities available for sale and securities held to maturity as of December 31, 2022, by contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	As of December 31, 2022	
	Amortized Cost	Fair Value
	(Dollars in thousands)	
Securities available for sale:		
Government-sponsored residential mortgage-backed securities:		
Due after five but within ten years	$ 554	$ 510
Due after ten years	3,350	2,711
Total securities available for sale	$ 3,904	$ 3,221
Securities held to maturity:		
Corporate bonds:		
Due after five but within ten years	$ 2,750	$ 2,431
	$ 2,750	$ 2,431
Municipal bonds:		
Due within three months	$ -	$ -
Due after one but within five years	12,215	11,836
Due after five but within ten years	17,939	16,452
Due after ten years	20,146	17,920
	$ 50,300	$ 46,208
Total securities held to maturity:	$ 53,050	$ 48,639

No securities were pledged as of December 31, 2022 or 2021. There were no security sales during the years ended December 31, 2022 or 2021.

NOTE D – LOANS

The following table presents a summary of loans segregated by loan category as of December 31, 2022, and 2021.

	As of December 31,	
	2022	2021
	(Dollars in thousands)	
Real estate secured loans:		
Residential construction	$ 68,446	$ 47,073
Commercial construction, all land development and other land loans	56,496	51,505
Residential properties	159,784	139,798
Residential mortgage (1)	180,379	111,248
Commercial real estate - other	474,155	460,242
Total real estate secured loans	939,260	809,866
Other non-real estate loans and leases:		
Commercial and industrial	102,312	104,448
Consumer and other	3,269	3,668
Total loans held for investment	$ 1,044,841	$ 917,982
Single-family residential mortgages held for sale	$ 4,797	$ 7,218

(1) Single-family residential mortgages originated through NSB Mortgage held for investment.

Loans are primarily funded in Wake County and New Hanover County in North Carolina. Real estate loans can be affected by the condition of the local real estate market. Commercial and installment loans can be affected by the local economic conditions. Included in the loan balances above are net unamortized loan costs of approximately $2.7 million and $2.9 million, respectively, as of December 31, 2022 and 2021. PPP loans are included in the 'Commercial and industrial' line item and totaled approximately $4,000 and $5.3 million, respectively as of December 31, 2022, and 2021.

The following describes the risk characteristics relevant to each of the portfolio segments.

Residential construction
The Company provides financing to builders for the construction of speculative and pre-sold custom homes, and from time to time, financing for custom homes where the home buyer is the borrower. Residential construction loans typically are for periods of 12 months or less and the homes are sold to consumers who obtain permanent financing. The loans are underwritten utilizing independent appraisals, sensitivity analysis of absorption and financial analysis of the borrower.

Commercial construction
Commercial real estate construction and land development loans are also underwritten utilizing independent appraisals, sensitivity analysis of absorption and financial analysis of the general contractors and borrowers. Commercial construction loans are generally based upon estimates of costs and value associated with the as-completed project. These estimates may be inaccurate. The loans often involve the disbursement of substantial funds with the repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans or sales of developed property.

All construction loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, government regulation of real property, general economic conditions, and the availability of long-term financing.

Residential properties
Residential real estate secured loans are subject to underwriting based on the purpose of the loan. Residential real estate properties secured by income-producing property typically have a loan-to-value ratio of 85% or less. Residential real estate properties secured by the primary residence of the borrower typically have a loan-to-value ratio less than 90%. Also included are loans that are underwritten and secured by second liens and home equity lines of credit which are revolving extensions of credit that are secured by first or second liens on owner-occupied residential real estate.

Residential mortgage
Residential mortgage loans represent one-to-four family loans originated through NSB Mortgage and selected by the Company to be retained in its portfolio. These loans are subject to strict underwriting standards which, at a minimum, comply with Freddie Mac guidelines and have moderate loan-to-value ratios, typically 80% or less, and with credit scores typically exceeding 720. Additionally, for competitive reasons the Company retains individual jumbo mortgages originated through NSB Mortgage with similar underwriting guidelines to above. Loan balance size for jumbo qualification is updated annually. For 2022, jumbo mortgages began at $647,200 and higher.

Commercial real estate - other
Commercial real estate secured loans are subject to underwriting standards that focus on proper loan to value and cash flow to meet debt service coverage requirements. Commercial real estate lending typically involves higher loan principal amounts, and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the lease income on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in real estate markets or the general economy. The properties securing the Company's commercial real estate portfolio are either owner occupied, or non-owner occupied. Owner-occupied properties include professional practices, retail establishments, service companies and churches. Non-owner-occupied properties include office, retail, industrial and multi-family rental properties. Management monitors and evaluates commercial real estate loans based on collateral, market area and risk grade criteria. The Company also utilizes third-party experts to provide insight and guidance about economic conditions and trends within its market areas.

Commercial and industrial
Non-real estate secured commercial and industrial loans are underwritten after evaluating and understanding the borrowers' ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Management examines current and projected cash flows of the borrower to determine the ability of the borrower to repay its obligation as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower and tertiary, as applicable, the guarantors. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable, inventory or equipment and usually incorporate a personal guarantee. In the case of loans secured by accounts receivable, the availability of the funds for repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Included in commercial and industrial is a small lease portfolio. The primary risk associated with lease financing is the ability of borrowers to achieve business results consistent with those projected at origination. Failure to achieve these projections presents risk the borrower will be unable to service the debt consistent with the contractual terms of the lease. Additionally, SBA loans and PPP loans are included within this category.

Consumer and other
Consumer and other loans include automobile loans, boat, and recreational vehicle financing, other secured or unsecured loans and loans to tax exempt entities. Consumer loans generally carry greater risk than other loans, even if secured, if the collateral consists of rapidly depreciating assets such as automobiles and equipment. Consumer loan collections are sensitive to job loss, illness, and other personal factors. The Company manages risks inherent in consumer and other lending by following established credit guidelines and underwriting practices designed to minimize the risk of loans.

The Company maintains an independent loan review function that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to management and the board of directors. The loan review process compliments and reinforces the risk identification and assessment decisions made by bankers and credit personnel, as well as the Company's policies and procedures.

The Company also originates single-family, residential mortgage loans that have been approved by investors in the secondary market which are included on the consolidated balance sheet under the caption "loans held for sale." The Company recognizes certain origination and service release fees from sale, which are included in non-interest income on the consolidated statements of operations.

Further, the Company elected to account for loans held for sale at fair value with changes in fair value included in non-interest income on the consolidated statements of operations. As of December 31, 2022, and 2021, loans held for sale were $4.8 million and $7.2 million, respectively.

Related party loans
The Company engages in loan transactions with its directors and executive officers. Such loans were made in the ordinary course of business and on substantially the same terms and collateral requirements as those for comparable transactions prevailing at the time and did not involve more than the normal risk of collectability or present other unfavorable features.

The following table presents a roll-forward of related party loans for the years ending December 31, 2022, and 2021.

	2022	2021
	(Dollars in thousands)	
Balance, beginning of year	$ 33,208	$ 18,756
Additional borrowings	18,314	28,806
Loan repayments	(13,488)	(17,438)
Change in board members	-	3,084
Balance, end of year	$ 38,034	$ 33,208
Unused lines of credit	$ 12,721	$ 17,081

Nonaccrual loans
Nonaccrual loans as of December 31, 2022 were $6.0 million compared to $2.2 million as of December 31, 2021. The approximate amount of interest income foregone on nonaccrual loans during the year was $418,000 and $191,000 for the years ending December 31, 2022, and 2021, respectively.

Past due loans
The following table presents an aging analysis of past due loans segregated by loan class as of December 31, 2022, and 2021, respectively.

	As of December 31, 2022				
	30 - 89 Days Past Due	Over 90 Days (1)	Total Past Due	Current	Total Loans
			(Dollars in thousands)		
Real estate secured loans:					
Residential construction	$ -	$ -	$ -	$ 68,446	$ 68,446
Commercial construction, all land development and land loans	-	-	-	56,496	56,496
Residential properties	71	-	71	159,713	159,784
Residential mortgage (2)	-	-	-	180,379	180,379
Commercial real estate - other	215	5,390	5,605	468,550	474,155
Total real estate secured loans	286	5,390	5,676	933,584	939,260
Other non-real estate loans and leases:					
Commercial and industrial	101	602	703	101,609	102,312
Consumer and other	-	-	-	3,269	3,269
Total	$ 387	$ 5,992	$ 6,379	$ 1,038,462	$ 1,044,841

	As of December 31, 2021				
	30 - 89 Days Past Due	Over 90 Days (1)	Total Past Due	Current	Total Loans
			(Dollars in thousands)		
Real estate secured loans:					
Residential construction	$ -	$ -	$ -	$ 47,073	$ 47,073
Commercial construction, all land development and land loans	-	-	-	51,505	51,505
Residential properties	30	-	30	139,768	139,798
Residential mortgage (2)	800	-	800	110,448	111,248
Commercial real estate - other	-	1,393	1,393	458,849	460,242
Total real estate secured loans	830	1,393	2,223	807,643	809,866
Other non-real estate loans and leases:					
Commercial and industrial	79	831	910	103,538	104,448
Consumer and other	-	-	-	3,668	3,668
Total	$ 909	$ 2,224	$ 3,133	$ 914,849	$ 917,982

(1) All in nonaccrual status.
(2) Single-family residential mortgages originated through NSB Mortgage, held for investment.

Impaired loans

The following table presents information regarding impaired loans segregated by loan class as of and for the year ended December 31, 2022, and 2021, respectively.

	As of December 31, 2022				For the year ended December 31, 2022	
	Unpaid Principal Balance	**Partial Charge-offs**	**Recorded Investment**	**Related Allowance**	**Average Recorded Investment**	**Interest Income Recognized**
			(Dollars in thousands)			
Impaired with no related allowance recorded:						
Real estate secured loans:						
Residential properties	$ 199	$ -	$ 199	$ -	$ 199	$ 7
Commercial real estate - other	5,665	(275)	5,390	-	5,721	152
Total real estate secured loans	5,864	(275)	5,589	-	5,920	159
Other non-real estate loans and leases:						
Commercial and industrial	$ 1,076	$ (426)	$ 650	$ -	$ 686	$ 8
Total impaired with no related allowance recorded:	$ 6,940	$ (701)	$ 6,239	$ -	$ 6,606	$ 167
Impaired with a related allowance recorded:						
Total impaired with a related allowance recorded:	$ -	$ -	$ -	$ -	$ -	$ -
Total impaired						
Commercial	$ 6,741	$ (701)	$ 6,040	$ -	$ 6,407	$ 160
Residential	199	-	199	-	199	7
Total	$ 6,940	$ (701)	$ 6,239	$ -	$ 6,606	$ 167

	As of December 31, 2021				For the year ended December 31, 2021	
	Unpaid Principal Balance	**Partial Charge-offs**	**Recorded Investment**	**Related Allowance**	**Average Recorded Investment**	**Interest Income Recognized**
			(Dollars in thousands)			
Impaired with no related allowance recorded:						
Real estate secured loans:						
Residential properties	$ 200	$ -	$ 200	$ -	$ 202	$ 8
Commercial real estate - other	1,147	-	1,147	-	1,179	-
Total real estate secured loans	1,347	-	1,347	-	1,381	8
Other non-real estate loans and leases:						
Commercial and industrial	$ 1,766	$ (868)	$ 898	$ -	$ 956	$ 4
Total impaired with no related allowance recorded:	$ 3,113	$ (868)	$ 2,245	$ -	$ 2,337	$ 12
Impaired with a related allowance recorded:						
Real estate secured loans:						
Commercial real estate - other	$ 246	$ -	$ 246	$ 25	$ 248	$ -
Total real estate secured loans	246	-	246	25	248	-
Other non-real estate loans and leases:						
Total impaired with a related allowance recorded:	$ 246	$ -	$ 246	$ 25	$ 248	$ -
Total impaired						
Commercial	$ 3,159	$ (868)	$ 2,291	$ 25	$ 2,383	$ 4
Residential	200	-	200	-	202	8
Total	$ 3,359	$ (868)	$ 2,491	$ 25	$ 2,585	$ 12

Each loan risk rated "substandard", "doubtful" and "loss" is reviewed to determine if it is an impaired loan. If a loan is determined to be impaired, it is removed from its homogeneous group and individually analyzed for impairment. Other groups of loans based on facts and circumstances may also be selected for impairment review. If a loan is impaired, a specific reserve allowance is allocated if necessary. Interest payments on impaired loans are typically applied to principal. Impaired loans are charged off in full or in part when losses are confirmed.

As of December 31, 2022, the recorded investment in loans considered impaired totaled $6.2 million. There were no specific reserves for probable losses on impaired loan balances noted above. Management analyzed $6.2 million of impaired loans and determined the collateral to be adequate and no additional specific reserve allowance was necessary after recording approximately $701,000 in life-to-date partial charge-offs. Total impaired loans as of December 31, 2022 include $48,000 of restructured but still accruing loans and no restructured nonaccrual loans.

As of December 31, 2021, the recorded investment in loans considered impaired totaled $2.5 million. The Company provided specific reserves of $25,000 for probable losses on impaired loan balances of $246,000. Management analyzed $2.2 million of impaired loans and determined the collateral to be adequate and no additional specific reserve allowance was necessary after recording approximately $868,000 in life-to-date partial charge-offs. Total impaired loans as of December 31, 2021 include $65,000 of restructured but still accruing loans and no restructured nonaccrual loans.

Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, management examines certain credit quality indicators which consider the risk of payment performance, overall portfolio quality utilizing weighted-average risk rating, general economic factors, net charge-offs, non-performing loans, and the level of classified loans. All loans risk rated "substandard", "doubtful" and "loss" are reviewed on an individual basis for probable losses.

A description of our credit quality indicators follows:

Pass – loans with acceptable credit quality and moderate risk.

Special mention – This grade is intended to be temporary and includes loans (1) with potential weaknesses if left uncorrected could result in deterioration or (2) classified as substandard accruing or substandard nonaccruing that have made improvements to their financial profile but do not yet meet the definition of a pass grade.
Substandard, accruing – These loans have a well-defined weakness where the accrual of interest has not been stopped. The defined weakness may make default or principal exposure likely but not certain. These loans are likely to be dependent on collateral liquidation or a secondary source of repayment.

Substandard, nonaccruing – These assets have well defined weakness that jeopardize the liquidation of the debt and are past due over 90 days. The institution may sustain loss if the weaknesses are not corrected. These loans are inadequately protected by the paying capacity of the borrower, any guarantors or of the collateral pledged. These loans are individually analyzed for impairment.

Doubtful – These loans have all the weaknesses of substandard, nonaccruing plus the added characteristic that the weaknesses make collection or liquidation in full based on currently existing facts, conditions and values, highly questionable and improbable.

Loss – These loans are considered uncollectable and of such little value that their continuance as a bankable asset is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off the asset even though partial recovery may be affected in the future.

The following table presents information regarding the Company's credit risk by internally assigned risk grades as of December 31, 2022, and 2021, respectively.

As of December 31, 2022

	Real Estate Loans					Non-Real Estate Loans		
	Construction		Residential	Residential		Commercial &	Consumer &	
	Residential	Commercial	Properties	Mortgage (1)	Commercial	Industrial	Other	Total
	(Dollars in thousands)							
Pass	$ 68,446	$ 56,436	$ 158,579	$ 180,379	$ 464,603	$ 101,616	$ 3,269	$ 1,033,328
Special mention	-	60	1,205	-	4,162	94	-	5,521
Substandard nonaccruing	-	-	-	-	5,390	602	-	5,992
Total by exposure	$ 68,446	$ 56,496	$ 159,784	$ 180,379	$ 474,155	$ 102,312	$ 3,269	$ 1,044,841

As of December 31, 2021

	Real Estate Loans					Non-Real Estate Loans		
	Construction		Residential	Residential		Commercial &	Consumer &	
	Residential	Commercial	Properties	Mortgage (1)	Commercial	Industrial	Other	Total
	(Dollars in thousands)							
Pass	$ 47,073	$ 51,435	$ 138,248	$ 111,248	$ 455,299	$ 103,512	$ 3,668	$ 910,483
Special mention	-	70	1,550	-	3,550	105	-	5,275
Substandard nonaccruing	-	-	-	-	1,393	831	-	2,224
Total by exposure	$ 47,073	$ 51,505	$ 139,798	$ 111,248	$ 460,242	$ 104,448	$ 3,668	$ 917,982

(1) Single-family residential mortgages originated through NSB Mortgage, held for investment.

TDR loans generally occur when a borrower is experiencing, or is expected to experience, financial difficulties in the near-term. As a result, a concessionary modification with more favorable terms that would not otherwise be considered may be granted to the borrower with the intent to prevent further difficulties and improve the likelihood of recovery of the loan. The modifications resulting in a TDR have generally involved a reduction of interest rate or extension of term of the loan or a combination of both. The Company does not generally forgive principal as part of a loan modification. Also, when possible, additional collateral or guarantor support is obtained when modifying the loan. All TDRs are individually reviewed and analyzed for impairment during management's monthly evaluation of the allowance for loan losses. The specific allowance is based on the present value of expected cash flows or the fair value of the collateral or the loan's observable market price.

There were no modifications resulting in new TDRs during the year ending December 31, 2022. Additionally, there were no TDR defaults during the last twelve months. There was one modification made to a loan with an outstanding unpaid principal balance of $65,000 that resulted in a new TDR during the year ending December 31, 2021.

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was signed into law. Section 4013 of the CARES Act, "Temporary Relief from Troubled Debt Restructurings," provides banks the option to temporarily suspend certain requirements under U.S. GAAP related to troubled debt restructurings (TDR) for a limited period of time to account for the effects of COVID-19. The Company elected this guidance during 2021. There was approximately $0 and $354,000 in outstanding unpaid principal balance of Section 4013 loans as of December 31, 2022, and 2021, respectively. The temporary relief provided by Section 4013 lapsed as of January 1, 2022.

NOTE E - ALLOWANCE FOR LOAN LOSSES

The following table presents activity in the allowance for loan losses by loan category for the years ended December 31, 2022, and 2021, respectively. Allocation of a portion of the allowance to one class of loan does not preclude its availability to absorb losses in other classes. For both 2022 and 2021, PPP loans are included within the collectively evaluated Commercial & Industrial column, and there was no recorded allowance on these loans due to the government guarantee.

As of and for the Year Ended December 31, 2022

	Real Estate Loans					Non-Real Estate Loans		
	Construction		Residential	Residential		Commercial &	Consumer &	
	Residential	Commercial	Properties	Mortgage (1)	Commercial	Industrial	Other	Total
				(Dollars in thousands)				
Allowance for loan losses:								
Beginning balance	$ 294	$ 279	$ 799	$ 775	$ 2,902	$ 1,615	$ 78	$ 6,742
Charge-offs	-	-	-	-	(298)	(21)	-	(319)
Recoveries	-	-	-	-	152	303	-	455
Provision (recovery)	53	43	122	139	509	(204)	3	665
Ending balance	$ 347	$ 322	$ 921	$ 914	$ 3,265	$ 1,693	$ 81	$ 7,543
Ending balance, individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Ending balance, collectively evaluated for impairment	$ 347	$ 322	$ 921	$ 914	$ 3,265	$ 1,693	$ 81	$ 7,543
Loans:								
Ending balance	$ 68,446	$ 56,496	$ 159,784	$ 180,379	$ 474,155	$ 102,312	$ 3,269	$ 1,044,841
Ending balance, individually evaluated for impairment	$ -	$ -	$ 199	$ -	$ 5,390	$ 650	$ -	$ 6,239
Ending balance, collectively evaluated for impairment	$ 68,446	$ 56,496	$ 159,585	$ 180,379	$ 468,765	$ 101,662	$ 3,269	$ 1,038,602

As of and for the Year Ended December 31, 2021

	Real Estate Loans					Non-Real Estate Loans		
	Construction		Residential	Residential		Commercial &	Consumer &	
	Residential	Commercial	Properties	Mortgage (1)	Commercial	Industrial	Other	Total
				(Dollars in thousands)				
Allowance for loan losses:								
Beginning balance	$ 294	$ 279	$ 799	$ 791	$ 3,074	$ 1,205	$ 76	$ 6,518
Charge-offs	-	-	-	(40)	(272)	(267)	-	(579)
Recoveries	-	-	-	24	100	677	2	803
Provision (recovery)	-	-	-	-	-	-	-	-
Ending balance	$ 294	$ 279	$ 799	$ 775	$ 2,902	$ 1,615	$ 78	$ 6,742
Ending balance, individually evaluated for impairment	$ -	$ -	$ -	$ -	$ 25	$ -	$ -	$ 25
Ending balance, collectively evaluated for impairment	$ 294	$ 279	$ 799	$ 775	$ 2,877	$ 1,615	$ 78	$ 6,717
Loans:								
Ending balance	$ 47,073	$ 51,505	$ 139,798	$ 111,248	$ 460,242	$ 104,448	$ 3,668	$ 917,982
Ending balance, individually evaluated for impairment	$ -	$ -	$ 200	$ -	$ 1,393	$ 898	$ -	$ 2,491
Ending balance, collectively evaluated for impairment	$ 47,073	$ 51,505	$ 139,598	$ 111,248	$ 458,849	$ 103,550	$ 3,668	$ 915,491

(1) Single-family residential mortgages originated through NSB Mortgage, held for investment.

As of December 31, 2022 and 2021, respectively, due to the potential economic impact of COVID-19, the Bank has created a special purpose general reserve category to address loans that may have a collective heightened risk due to the industry in which they operate or from government-mandated closures and/or limitations. This general reserve was established using management's expectation of borrower performance and based upon a COVID-19 residual risk assessment surrounding the different industries in which the Company's borrowers operate. The COVID-19 general reserve contributed approximately $643,000 and $1.2 million of the total $7.5 million and $6.7 million allowance for loan losses as of December 31, 2022 and 2021, respectively.

NOTE F - PREMISES AND EQUIPMENT

Premises and equipment are stated at cost, less accumulated depreciation. Leasehold improvements are amortized over the lives of the respective leases or the estimated useful life of the leasehold improvement, whichever is less. For financial reporting purposes, depreciation is computed by the straight-line method over the estimated useful lives of the assets. Costs of maintenance and repairs are charged to expense as incurred. Costs of replacing structural parts of major units are considered individually and are expensed or capitalized as the facts dictate. Land is carried at cost. Right-of-use assets that are recognized at the initial adoption of a lease arrangement are included in premises and equipment for finance type leases. More information regarding finance type leases can be found in Note J – Borrowings.

The following table presents a summary of premises and equipment as of December 31, 2022, and 2021.

	As of December 31,	
	2022	2021
	(Dollars in thousands)	
Land	$ 6,755	$ 6,755
Buildings	26,057	20,562
Leasehold improvements	1,591	1,591
ROU asset finance type lease	611	-
Furniture, fixtures and equipment	10,528	10,151
	45,542	39,059
Accumulated depreciation	(17,513)	(16,442)
Total	$ 28,029	$ 22,617

Depreciation and amortization expense totaled approximately $1.1 million for both years ended December 31, 2022, and 2021, respectively, and is included in occupancy and equipment expense.

As the business case arises, assets may be sold or disposed of in the normal course of business. Net gains on sale or disposal are recognized in other income while net losses on sale or disposal are recognized in other expense. Losses on the disposal of fixed assets totaled approximately $0 and $528,000 for the year ended December 31, 2022, and 2021, respectively.

The Company leases certain office equipment under a finance lease. For finance leases other than those considered to be short-term, the Company recognizes lease right-of-use assets and related lease liabilities. Such amounts are reported as components of premises and equipment and other borrowings, respectively, on our accompanying consolidated balance sheet. The Company does not recognize short-term finance leases on our balance sheet. A short-term finance lease has an original term of 12 months or less and does not have a purchase option that is likely to be exercised.

The Company's finance lease relates to one contract to lease copiers and printers, with a remaining term of approximately four years. Where lease extensions exist and are considered reasonably certain to be exercised, such extensions are included in the lease terms. As of December 31, 2022, net finance lease ROU assets totaled approximately $560,000 and operating lease liabilities totaled approximately $563,000, compared to $0 and $0 as of December 31, 2021, respectively. Lease costs, which comprise both amortization and interest expense components, associated with this finance lease totaled approximately $58,000 and $0 for the years ended December 31, 2022, and 2021, respectively. The Company currently does not have any related party finance lease agreements.

NOTE G – OPERATING LEASES

Operating lease liabilities, which are included in other liabilities, reflect the Company's obligation to make future lease payments. Lease terms typically comprise contractual terms but may include extension options reasonably certain of being exercised at lease inception. Payments are discounted using the rate the Company would pay to borrow amounts equal to the lease payments over the lease term (the Company's incremental borrowing rate). The Company does not separate lease and non-lease components for contracts in which it is the lessee. Operating lease expense, which is comprised of amortization of the ROU asset and the implicit interest accreted on the operating lease liability, is recognized on a straight-line basis over the lease term, while variable lease payments are recognized as incurred. Common area maintenance and other executory costs are the main components of variable lease payments. Operating and variable lease expenses are recorded in net occupancy expense on the Consolidated Statements of Income.

Operating lease right-of-use (ROU) assets, which are included in other assets, represent the Company’s right to use an underlying asset during the lease term and, like operating lease liabilities, are recognized at lease commencement based on the present value of the remaining lease payments using the Company’s increment borrowing rate at the time of lease commencement. ROU assets are further adjusted for any lease incentives.

The Company’s operating leases relate to three branch office locations, with remaining terms of approximately two to twelve years. Where lease extensions exist and are considered reasonably certain to be exercised, such extensions are included in the lease terms. As of December 31, 2022, net operating lease ROU assets totaled approximately $3.0 million and operating lease liabilities totaled approximately $3.1 million, compared to $0 and $0 as of December 31, 2021, respectively. Lease costs associated with all operating leases totaled approximately $760,000 for the year ended December 31, 2022. The Company currently does not have any related party lease agreements.

The following table summarizes other information related to our operating leases as of and for the year ended December 31, 2022.

	For the year ended December 31, 2022	
	(In thousands except percent and period data)	
Cash paid for amounts included in the measurement of lease liabilities		
Operating cash flows from operating leases	$	623
Right-of-use assets obtained in exchange for new operating lease liabilities		2,963
Weighted-average remaining lease term - operating leases, in years		8.7
Weighted-average discount rate - operating leases		2.0%

The following table summarizes the maturity of remaining lease liabilities as of December 31, 2022.

	As of December 31,	
	(Dollars in thousands)	
2023	$	650
2024		664
2025		307
2026		165
2027		169
2028 and thereafter		1,408
Total lease payments		3,363
Less: interest		(285)
Present value of lease liabilities		3,078

Lease Commitments Disclosure as of December 31, 2021, Prior to Adoption of ASU 2016-02

Operating leases for 2021 were accounted for under ASC 840, *Leases*. Total rental expense related to the operating leases totaled approximately $906,000 for the year ended December 31, 2021 and is included in occupancy and equipment expenses.

The following table presents future minimum lease payments required under the leases as of December 31, 2021.

	For future years ending after December 31, 2021	
	(Dollars in thousands)	
2022	$	689
2023		680
2024		695
2025		296
2026		165
thereafter		595
Total	$	3,120

NOTE H – DEPOSITS

The aggregate amount of time deposits in denominations of $250,000 or more as of December 31, 2022, and 2021, was approximately $19.4 million and $25.2 million, respectively.

The following table presents the scheduled maturities of time deposits as of December 31, 2022.

	As of December 31, 2022					
	Less than $250,000		$250,000 or more		Total	
			(Dollars in thousands)			
2023	$	20,186	$	17,373	$	37,559
2024		3,204		1,025		4,229
2025		2,114		985		3,099
2026		673		-		673
2027		268		-		268
2028		1		-		1
	$	26,446	$	19,383	$	45,829

NOTE I – SERVICING ASSETS

Loans serviced for others are not included in the Company's consolidated balance sheets. The unpaid principal balances of the loans serviced for others was $125.9 million and $110.8 million as of December 31, 2022, and 2021, respectively. Servicing rights totaled $1.8 million and $1.9 million as of December 31, 2022, and 2021, respectively, and are included under other assets on the Company's consolidated balance sheets. Amortization of servicing rights is based upon an effective yield method and can be accelerated by early loan payoffs. Amortization totaled approximately $763,000 and $585,000 for the years ended December 31, 2022, and 2021, respectively.

NOTE J – BORROWINGS

The following table presents a summary of borrowings as of December 31, 2022, and 2021.

	As of December 31, 2022	As of December 31, 2021
	(Dollars in thousands)	
Short-term borrowings		
Repurchase agreements	$ 264	$ 239
	$ 264	$ 239
Long-term borrowings		
FHLB advances	$ 488	$ 518
Right of use liability - finance lease	$ 563	$ -
Subordinated debentures	18,000	18,000
Junior subordinated debentures	15,465	15,465
Less debt issuance costs	(365)	(410)
Long-term borrowings, net	$ 34,151	$ 33,573

The following table presents a summary of the trust preferred securities and related junior subordinated debentures outstanding as of December 31, 2022, and 2021.

	2022	2021	Maturity Date	Interest Rate
	(Dollars in thousands)			
North State Statutory Trust I	$ 5,155	$ 5,155	4/17/2034	3 mo LIBOR plus 2.79%, resets quarterly
North State Statutory Trust II	5,155	5,155	4/15/2035	3 mo LIBOR plus 1.65%, resets quarterly
North State Statutory Trust III	5,155	5,155	12/15/2037	3 mo LIBOR plus 2.75%, resets quarterly
	$ 15,465	$ 15,465		

The following table presents a summary of the subordinated debentures outstanding as of December 31, 2022, and 2021.

	2022	2021	Maturity Date	Interest rate
	(Dollars in thousands)			
Fixed-to-Floating rate subordinated notes	$ 18,000	$ 18,000	11/1/2030	Fixed 4.125% through November 1, 2025, thereafter, 3 mo SOFR plus 390.5 basis points, resets quarterly

Short-term Borrowings
The Company had $264,000 and $239,000, respectively, of repurchase agreements outstanding as of December 31, 2022 and 2021. Securities sold under agreements to repurchase generally mature within one to four days from the transaction date and are secured by $1 million cash as of December 31, 2022 and 2021. These repurchase agreements are due within one year and are classified as short-term borrowings in the accompanying consolidated balance sheets. Interest rates for repurchase agreements vary from 0.00% to 0.05% as of December 31, 2022.

As of and throughout the years ended December 31, 2022 and 2021, the Company had no outstanding Federal Home Loan Bank ("FHLB") short-term advances. Currently, any advances are secured by loans available for collateralization.

As of December 31, 2022, the Company had pre-approved available lines of credit totaling approximately $404.6 million with various financial institutions and the Federal Reserve for borrowing on a short-term basis, with no amounts outstanding at that date. These lines are subject to annual renewals with varying interest rates.

Long-term Borrowings
As of December 31, 2022, and 2021, the Company had $488,000 and $518,000, respectively, outstanding balances in the form of long-term FHLB advances. These advances, fully maturing on October 7, 2025, fund a qualified Community Investment Program loan. The Company pays 2.00% interest for the advance with the loan earning 4.00%. This advance is secured by $850,000 in cash as of December 31, 2022 and 2021.

The Company leases certain office equipment under a finance lease. In 2022, the Company adopted *ASU 2016-02, Leases (Topic 842)* related to accounting for leases and under the new standards, for finance leases other than those considered to be short-term, the Company recognizes lease right-of-use assets and related lease liabilities. Such amounts are reported as components of premises and equipment and other borrowings, respectively, on the accompanying consolidated balance sheets. The Company does not recognize short-term finance leases on the balance sheet. A short-term finance lease has an original term of 12 months or less and does not have a purchase option that is likely to be exercised. As of December 31, 2022, the Company had one finance lease for the use of copiers and printers. The initial lease liability was approximately $611,000 at inception, and the current amount remaining is approximately $563,000. The maturity date is August of 2026 and the discount rate calculated by the Company is 3.39%. The discount rate was calculated by using information on various sources of funds available to the Company with like duration.

On March 17, 2004, the Company issued $5.2 million of junior subordinated debentures to North State Statutory Trust I ("Trust I") in exchange for the proceeds of trust preferred securities issued by Trust I. On December 15, 2005, the Company issued $5.2 million of junior subordinated debentures to North State Statutory Trust II ("Trust II") in exchange for the proceeds of trust preferred securities issued by Trust II. On November 28, 2007, the Company issued $5.2 million of junior subordinated debentures to North State Statutory Trust III ("Trust III") in exchange for the proceeds of trust preferred securities issued by Trust III. The Company owns all the outstanding common securities of Trust I, Trust II and Trust III. The junior subordinated deferrable interest debentures are included in long-term borrowings and the Company's equity interests in Trust I, Trust II and Trust III are included in other assets.

On October 29, 2020, the Company issued $18 million of fixed-to-floating rate subordinated notes, maturing November 1, 2030, if not previously redeemed. Interest on the notes is 4.125% per annum through November 1, 2025, payable semi-annually in arrears. From November 2, 2025, until the maturity date or early redemption date, the interest rate resets quarterly to an interest rate per annum equal to the then current three-month SOFR rate plus 390.5 basis points, payable quarterly in arrears. Interest on the subordinated notes is payable semi-annually on May 1 and November 1 of each year through November 1, 2025, and quarterly thereafter on February 1, May 1, August 1 and November 1 of each year through the maturity date or early redemption date. The first interest payment was made on May 1, 2021. The notes include redemption options for the Company beginning with the interest payment date of November 1, 2025, to redeem the subordinated notes in whole or in part upon giving required notice to the holders at a redemption price equal to 100% of the principal amount plus accrued and unpaid interest. Additionally, the Company has the option to redeem the notes due to a special event such as a change or prospective change in law that would prevent the deduction of the interest for federal tax purposes; or a subsequent event that could preclude the subordinated notes from being recognized as Tier 2 capital for regulatory capital purposes; or the Company could be required to register as an investment company. The subordinated notes are included in long-term borrowings and qualify as Tier 2 capital up to the redemption date. To qualify for Tier 2 capital, the subordinated notes must have an original weighted average maturity of as least five years and capital inclusion in Tier 2 capital will be discounted 20% each year after the remaining maturity is five years or less.

The junior subordinated debentures for Trust I pay interest quarterly at an annual rate, reset quarterly, equal to 3-month LIBOR plus 2.79%. The debentures became redeemable in whole or in part on June 17, 2009, and on any January 17, April 17, July 17, or October 17 thereafter. Redemption is mandatory on April 17, 2034. The Company has fully and unconditionally guaranteed the repayment of the trust preferred securities. The Company's obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company. As of December 31, 2022, the debentures were analyzed to determine if there is a replacement rate fallback provisions in the event LIBOR ceases to be published. There is no such replacement rate or fallback provisions in the legal document. Therefore, because of the passage of the LIBOR Act, it is most likely that the default rate will be based off of term SOFR plus a relevant spread. The Company is working to finalize these details before June 30, 2023.

The junior subordinated debentures for Trust II pay interest quarterly at an annual rate, reset quarterly, equal to 3-month LIBOR plus 1.65%. The debentures became redeemable in whole or in part on March 15, 2011, and on any January 15, April 15, July 15, or

October 15 thereafter. Redemption is mandatory on April 15, 2035. The Company has fully and unconditionally guaranteed the repayment of the trust preferred securities. The Company's obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company. As of December 31, 2022, the debentures were analyzed to determine if there is a replacement rate fallback provisions in the event LIBOR ceases to be published. There is no such replacement rate or fallback provisions in the legal document. Therefore, because of the passage of the LIBOR Act, it is most likely that the default rate will be based off of term SOFR plus a relevant spread. The Company is working to finalize these details before June 30, 2023.

The junior subordinated debentures for Trust III pay interest quarterly at an annual rate, reset quarterly, equal to 3-month LIBOR plus 2.75%. The debentures are redeemable in whole or in part on March 15, 2013, and on any January 15, April 15, July 15, or October 15 thereafter. Redemption is mandatory on December 15, 2037. The Company has fully and unconditionally guaranteed the repayment of the trust preferred securities. The Company's obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company. As of December 31, 2022, the debentures were analyzed to determine if there is a replacement rate fallback provisions in the event LIBOR ceases to be published. There is no such replacement rate or fallback provisions in the legal document. Therefore, because of the passage of the LIBOR Act, it is most likely that the default rate will be based off of term SOFR plus a relevant spread. The Company is working to finalize these details before June 30, 2023.

Current Federal Reserve rules limit the aggregate amount of restricted core capital elements, including trust preferred securities that can be included in Tier 1 capital to not more than 25% of total core capital elements, net of goodwill, less any associated tax liability. Amounts of restricted core capital elements in excess of this limit may be included in Tier 2 capital. However, the aggregate amount of certain restricted core capital elements (including trust preferred securities), term subordinated debt and limited life preferred stock that can be included in Tier 2 capital is limited to 50% of Tier 1 capital.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") changed the ability of bank holding companies to issue trust preferred securities and continue to count them as Tier 1 capital. Bank holding companies with total assets of less than $15 billion as of December 31, 2009, are permitted to include trust preferred securities issued before May 19, 2010, as Tier 1 capital. As such, the Company's existing trust preferred securities are grandfathered as Tier 1 capital under the Dodd-Frank Act.

NOTE K - INCOME TAXES

There were no uncertain tax positions as of December 31, 2022 or 2021. The Company changed tax status to an S Corporation effective January 1, 2016. An S Corporation income, gains and losses are passed directly to the shareholders of the Company in proportion to their per share ownership. As of January 1, 2021, the Company was no longer subject to federal corporate level taxation on unrealized built-in gains since the fiver-year recognition period has fully lapsed.

NOTE L – OTHER NON-INTEREST INCOME AND OTHER NON-INTEREST EXPENSE

The following table presents the major components of non-interest income for the years ended December 31, 2022, and 2021.

	For the year ended December 31,	
	2022	2021
	(Dollars in thousands)	
Merchant and other loan fees	$ 541	$ 743
Service charges and fees on deposit accounts	1,126	283
Income from bank owned life insurance	362	301
Other	1,330	1,142
Total other non-interest income	$ 3,359	$ 2,469

The following table presents the major components of non-interest expense for the years ended December 31, 2022, and 2021.

	For the year ended December 31,	
	2022	2021
	(Dollars in thousands)	
Professional fees	$ 661	$ 698
Postage, printing & office supplies	239	205
Advertising and promotion	1,010	756
Telecommunications	484	556
Directors fees	1,181	860
FDIC insurance premiums	1,200	806
Mortgage processing costs	170	370
Donations	795	709
Loss on disposal of fixed assets	-	528
Other	2,228	1,988
Total other non-interest expense	$ 7,968	$ 7,476

NOTE M – CAPITAL & REGULATORY MATTERS

The Bank, as a North Carolina banking corporation, may pay cash dividends to the Company only out of undivided profits as determined pursuant to North Carolina General Statutes Section 53-87. In conjunction with the Company's S Corporation election, the Bank has and intends to declare dividends to the Company in an amount sufficient for the Company to pay distributions to its shareholders and service its debt obligations. However, the Bank is subject to strict regulatory and legal guidelines regarding capital adequacy, dividend policies and other restrictions and rules. Regulatory authorities may limit payment of dividends by any bank when it is determined that such limitation is in the public interest and is necessary to ensure financial soundness of the bank. During the years ending December 31, 2022, and 2021, the Bank distributed cash dividends to the Company of $9.7 million and $11.7 million, respectively.

The Company has and intends to declare distributions in an amount at least sufficient to enable shareholders to pay federal income tax and state income tax. The Company is dependent on dividends from the Bank and is subject to strict regulatory restrictions like the Bank. During the years ending December 31, 2022, and 2021, the Company declared cash distributions to shareholders of $9.7 million and $11.8 million, respectively.

In 2022, the Company began the Capital Reinvestment Plan through which shareholders are given the option of spending up to fifty percent of their quarterly distributions to purchase additional shares in the Company each quarter. During 2022, the Company raised approximately $2.3 million from the sale of 136,721 shares at a price of $16.55 per share as a result of the Capital Reinvestment Plan. The proceeds are credited to additional paid in capital within the equity portion of the accompanying consolidated balance sheets.

The Bank is subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies. As of December 31, 2022, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum amounts and ratios. There are no conditions or events since that notification that management believes have changed the Bank's category.

In July 2013, the Federal Reserve Board approved and published the final Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations. The Basel III Capital Rules, among other things, (i) introduce Common Equity Tier 1 ("CET1") as a new capital measure, (ii) specify that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions from and adjustments to capital as compared to existing regulations. The Basel III Capital Rules were effective for the Bank on January 1, 2015, and are fully phased in as of December 31, 2022 and 2021. CET1 capital for the Bank consists of common stock, related paid-in capital, and retained earnings. In connection with the adoption of the Basel III Capital Rules, the Company elected to opt-out of the requirement to include most components of accumulated other comprehensive income in CET1. CET1 for the Bank is reduced by goodwill and intangible assets (intangible assets excluding MSAs and goodwill).

Basel III limits capital distributions and certain discretionary bonus payments if the banking organization does not hold a "capital conservation buffer" consisting of 2.50% of CET1 capital, Tier 1 capital and total capital to risk-weighted assets in addition to the amount necessary to meet minimum risk-based capital requirements. The capital conservation buffer was fully phased in as of January 1, 2019. Basel III requires (i) a minimum ratio of CET1 capital to risk-weighted assets of at least 4.50%, plus a 2.50% capital conservation buffer, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.00%, plus the capital conservation buffer, (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.00%, plus the 2.50% capital conservation buffer and (iv) a minimum leverage ratio of 4.00%.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios, as prescribed by regulations, of Total capital to risk-weighted assets, Tier I capital to risk-weighted assets, and CET 1 capital to risk-weighted assets, as well as Tier I capital to average assets. As of December 31, 2022, and 2021, the Bank met the respective capital adequacy requirements.

The following table presents information regarding the Bank's capital and capital ratios as of December 31, 2022, and 2021, respectively.

	Actual		Minimum to be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)			
As of December 31, 2022				
Total capital to risk-weighted assets	$ 111,285	11.60%	$ 95,927	10.00%
Tier I capital to risk-weighted assets	103,742	10.81%	76,742	8.00%
CETI to risk-weighted assets	103,742	10.81%	62,352	6.50%
Tier I capital to average assets	103,742	7.73%	67,103	5.00%
As of December 31, 2021				
Total capital to risk-weighted assets	$ 103,062	11.83%	$ 87,143	10.00%
Tier I capital to risk-weighted assets	96,320	11.05%	69,714	8.00%
CETI to risk-weighted assets	96,320	11.05%	56,643	6.50%
Tier I capital to average assets	96,320	7.08%	68,055	5.00%

The Bank had a capital conservation buffer of 3.60 percent as December 31, 2022. This buffer exceeded the 2.50 percent requirement and, therefore, results in no limit on distributions.

The Bank qualifies as a U.S. Department of Housing and Urban Development, or HUD, approved Title II supervised mortgagee and issues mortgages insured by HUD. For the years ended December 31, 2022, and 2021, the Bank was required to maintain $1 million in baseline adjusted net worth plus an additional net worth of one percent of the total volume in excess of $25 million of FHA single family insured mortgages originated, underwritten, purchased, or serviced during the prior fiscal year, up to a maximum required net worth of $2.5 million. The Company complied with the net worth requirements as of December 31, 2022, and 2021.

NOTE N – OFF-BALANCE SHEET RISK

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company, upon extension of credit is based on management's credit evaluation of the borrower. Collateral obtained varies but may include real estate, stocks, bonds, and certificates of deposit. The liability related to off balance sheet commitments is not considered material as of December 31, 2022 or 2021.

The following table presents a summary of the contractual amount of the Company's exposure to off-balance sheet credit risk as of December 31, 2022.

	December 31, 2022 *(Dollars in thousands)*
Financial instruments whose contract amounts represent credit risk:	
Undisbursed lines of credit	$ 189,514
Other commitments to extend credit	40,622
Letters of credit	2,758
Commitments to originate mortgage loans, fixed and variable	7,807
	$ 240,701

NOTE O - FAIR VALUE MEASUREMENTS

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available-for-sale, best-efforts interest rate lock commitments, mandatory delivery interest rate lock commitments, loans held for sale, and hedge instruments in an open position are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record other assets at fair value on a nonrecurring basis, such as impaired loans, servicing assets, foreclosed assets, and collateral assignment split-dollar loan receivables (CASD). The nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. The Company groups its financial assets and financial liabilities measured 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 fair value. These levels are:

- Level 1 – Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Level 1 also includes U.S. Treasury, other U.S. government and agency mortgage-backed securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

  Level 2 – Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party services for identical or comparable assets or liabilities.

- Level 3 – Valuations for assets and liabilities that are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or brokered facilitated transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

Valuation of Assets and Liabilities Reported at Fair Value in Financial Statements
The fair value of a financial instrument is the estimated amount at which the instrument could be exchanged in an orderly transaction between knowledgeable, unrelated, willing parties. The estimated fair value of a financial instrument may differ from the amount that could be realized if sold in an immediate sale such as a forced transaction. Additionally, the valuation of investments is more subjective when markets are less liquid due to the lack of market-based inputs, which may increase the potential that the estimated fair value of an investment is not reflective of the price at which an actual transaction would occur.

The following is a description of valuation methodologies used by the Company for assets and liabilities recorded at fair value, either on a recurring or nonrecurring basis.

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, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds, and corporate debt securities.

Interest Rate Lock Commitments
The Company enters into best-efforts and mandatory delivery interest rate lock commitments, and these are recorded at fair value on a recurring basis. Changes in the interest rate lock commitments subjected to recurring fair value adjustments are affected by changes in fallout rates and changes in the prevailing secondary market prices for like-kind mortgage loans. Additionally, the fair value of interest rate lock commitments is based on servicing rate premium, origination income net of originations costs, and changes in loan pricing between the commitment date and period end, typically month end. The fallout rate measures the likelihood that an interest rate lock commitment will ultimately not become a closed loan held for sale. Factors contributing to the fallout rate include changes in prevailing interest rates from the time of the interest rate lock commitment as well as other factors such as lower than anticipated appraised values. As of December 31, 2022, the fallout rate averaged approximately 9% and the amount of fair value associated with these interest rate lock commitments was approximately $74,000. As of December 31, 2021, the fallout rate averaged approximately 8% and the amount of fair value associated with these interest rate lock commitments was approximately $555,000. The fair value associated with interest rate lock commitments is included in other assets for best-efforts and included in other assets, other liabilities, or both, for mandatory delivery as these are booked on a gross basis.

Loans Held for Sale
Loans held for sale are recorded at fair value on a recurring basis. Fair values of loans held for sale are based on commitments on hand from investors or, if commitments have not yet been obtained, prevailing market rates. When the fair value of the loans held for sale is based on an observable market rate or current commitments from investors, the Company records the loans held for sale as nonrecurring Level 2. As of December 31, 2022, the amount of fair value adjustments associated with loans held for sale was approximately $57,000. The Company elected to account for loans held for sale at fair value in 2022.

Open Hedge Positions in TBA Mortgage-Backed Securities
Open Hedge positions in TBA mortgage-backed securities are recorded at fair value on a recurring basis. Changes in the open hedge positions are subjected to recurring fair value adjustments and are affected by changes in the market interest rates which impact prevailing secondary market prices for like-kind securities. As such, these changes in fair value based on interest rates run counter to the changes in the fair values of mandatory delivery interest rate lock commitments, thus creating a hedge to interest rate movements. The fair value associated with open hedge positions in TBA mortgage-backed securities is included in other assets, other liabilities, or both, as these are booked on a gross basis. As of December 31, 2022, the amount of fair value associated with open hedge positions was approximately $16,000. The Company did not engage in hedging mandatory delivery interest rate lock commitments in 2021.

Impaired Loans Held for Investment
The Company does not record loans held for investment at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses 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 agreement are considered impaired. Once a loan is identified as impaired, management measures the impairment in accordance with accounting standards. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value or discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the

expected repayments or collateral exceed the recorded investments in such loans. As of December 31, 2022, the Company's impaired loans were evaluated primarily based on the fair value of the collateral. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3. The unobservable inputs include collateral discounts in a range of 5% to 20% of appraised value. The valuation techniques for the Level 3 impaired loans are consistent with techniques used in prior periods.

Foreclosed Assets
Foreclosed assets are adjusted to fair value, less estimated costs to sell, upon transfer of the loans to other real estate owned. The initial recorded value may be subsequently reduced by additional valuation allowances, which are charged to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3. The unobservable inputs include collateral discounts in a range of 5% to 20% of appraised values as well as an estimated cost to sell range of 6% to 8%. The valuation techniques for the Level 3 foreclosed assets are consistent with techniques used in prior periods.

SBA Servicing Rights
SBA servicing rights are initially recorded at fair value when loans are sold with servicing retained. These assets are then amortized in proportion to and over the period of estimated net servicing income. The servicing rights are periodically evaluated for impairment based upon the fair value of the servicing rights compared to their respective carrying amounts. The Company estimates the fair value of its servicing rights using discounted cash flow models incorporating numerous assumptions from the perspective of a market participant including servicing income, servicing costs, market discount rates and prepayment speeds. As a result of the valuation inputs, servicing rights are classified within Level 3 of the valuation hierarchy.

Collateral Assignment Split-Dollar Loan Receivable (CASD)
CASD loan receivables are initially recorded at fair value when the transaction is first initiated. On a nonrecurring basis, the receivables are evaluated for accounting purposes and measured at fair value, and when the cash surrender value plus the sum of the premium deposit accounts fall below the initial CASD loan receivable, an expense is recorded on the income statement in personnel expense with the valuation allowance being the offset. Cash surrender values are quotes provided by the insurers of the life insurance policies and are based on inputs readily available to the insurers such as account age, amount of contributions paid in, market performance of investments, and any surrender fees associated with the policies. As a result, CASD loan receivables are classified within Level 2 of the valuation hierarchy.

The following table presents the balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2022, and 2021, respectively.

	As of December 31, 2022			
	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)			
Assets:				
Securities available for sale:				
Government-sponsored residential mortgage-backed securities	$ 3,221	$ -	$ 3,221	$ -
Total securities available for sale	$ 3,221	$ -	$ 3,221	$ -
Mortgage banking activities:				
Best efforts interest rate lock commitments	$ 34	$ -	$ -	$ 34
Mandatory delivery interest rate lock commitments	40	-	-	40
Loans held for sale	4,797	-	4,797	-
Open Hedge positions in TBA mortgage-backed securities	28	-	-	28
Total mortgage banking activities - assets	$ 4,899	$ -	$ 4,797	$ 102
Liabilities:				
Mortgage banking activities:				
Open Hedge positions in TBA mortgage-backed securities	$ 12	$ -	$ -	$ 12
Total mortgage banking activities - liabilities	$ 12	$ -	$ -	$ 12

	As of December 31, 2021			
	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)			
Assets:				
Securities available for sale:				
Government-sponsored residential mortgage-backed securities	$ 4,252	$ -	$ 4,252	$ -
Total securities available for sale	$ 4,252	$ -	$ 4,252	$ -
Interest rate lock commitments	$ 555	$ -	$ -	$ 555

The following table presents all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the years ended December 31, 2022, and 2021, respectively.

	For the year ended December 31,	
	2022	2021
	(Dollars in thousands)	
Balance, beginning of year	$ 555	$ 1,465
(Losses) gains included in fees from mortgage operations	(465)	(910)
Balance, end of year	$ 90	$ 555

The Company 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 when fair value fell below the carrying amount as of the end of the period under measurement.

The following table presents the balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2022, and 2021, respectively.

	As of December 31, 2022			
	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)			
Servicing assets	$ 1,797	$ -	$ -	$ 1,797
Collateral assignment split-dollar loan receivables	$ 8,338	$ -	$ 8,338	$ -

	As of December 31, 2021			
	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)			
Impaired loans	$ 221	$ -	$ -	$ 221
Servicing assets	$ 1,865	$ -	$ -	$ 1,865

NOTE P - EMPLOYEE AND DIRECTOR BENEFIT PLANS

401(k) and ESOP Retirement Plan

The Company has maintained a qualified 401(k) plan for regular full or part-time eligible employees since June 1, 2000. On January 1, 2015, the Company amended its 401(k) plan and adopted a combined 401(k) and Employee Stock Ownership Plan ("ESOP"). The plan as amended consists of two components (1) a qualified stock bonus plan (ESOP component) and (2) a qualified cash or deferred arrangement, of which no part of can be invested in Company stock, (401(k) component). The purposes of the plan, as restated, are to enable eligible employees to (a) contribute up to an annual maximum as determined under the Internal Revenue Code, (b) share in the growth and prosperity of the Company, (c) accumulate capital for their future economic security, and (d) acquire beneficial stock ownership interests in the Company. In addition, the board of directors can authorize additional discretionary contributions to the plan.

In 2021, the Company matched 100% of employee contributions, not exceeding 6% of the participants' eligible compensation, by contributing to the ESOP component of the plan, which is invested in Company stock. The plan provides that employees' contributions are 100% vested at all times. Company contributions are 100% vested for the years beginning on or after January 1, 2008. In 2022, the Company elected to no longer place Company matched funds into the ESOP component of the plan. The Company did continue matching 100% of employee contributions, not exceeding 6% of the participants' eligible compensation, by contributing to the participant's 401(k) with the funds directed into the participants' choice of investments.

The expense related to the 401(k) and ESOP plan contributions for the years ended December 31, 2022, and 2021 totaled approximately $1.0 million, respectively.

Employment Agreements

The Company has entered into an employment agreement with its chief executive officer to ensure a stable and competent management base. This agreement provides for benefits as spelled out in the contract and cannot be terminated by the Board of Directors, except for cause, without prejudicing the officer's right to receive certain vested rights, including compensation. In the event of a change in control of the Company, as outlined in the agreement, the acquirer will be bound to the terms of this contract.

In addition, the Company entered into two "separation benefit agreements" during 2012 and 2017 with its chief executive officer. Both of the "separation benefit agreements" are fully vested as of December 31, 2022. During 2013 and 2015 the Company entered into "separation benefit and executive bonus agreements" with select officers of the Company. Total compensation expense related to all the separation and bonus agreements totaled approximately $53,000 and $67,000, respectively, for the years ended December 31, 2022 and 2021. The liability related to the "separation benefit agreements" was $3.1 million, respectively, as of December 31, 2022, and 2021.

The Company has entered into agreements with four executive officers and three non-executive officers that provides for severance pay benefits in the event of a change in control of the Company that results in the termination of such officers or diminished compensation, duties, or benefits.

In 2022, the Company entered into agreements with four executive officers and three non-executive officers to ensure a stable and competent management base. The agreements provide for each employee to receive a loan which will fund a premium deposit account which is held at North State Bank. Each year policy premiums are paid out of the premium deposit accounts and into life insurance products. This arrangement is known as a collateral assignment split-dollar (CASD) loan agreement. Generally, the employees are vested by the fourth anniversary of the effective date. The Company will recover its premiums plus additional amounts in installments during the Executive's lifetime and/or from the policy proceeds at the Executive's death pursuant to the terms of the agreements. Employees' taxes for this benefit are paid for by the Company and the amounts are based on the long-term Applicable Federal Rate in effect on the respective loan dates which is characterized as imputed income to the employees and treated as ordinary income for tax purposes. After termination of employment, the Company has no obligation to continue paying taxes on behalf of the employees. Rather, the employees may take distributions from their policies to pay any taxes owed. Importantly, there are no future funding obligations, i.e., the Company is not required to pay any additional amounts into the policies or the premium deposit accounts. The Company is not obligated under any circumstance to maintain a life insurance policy on the employees' lives. Finally, notwithstanding any provision of the agreements to the contrary, benefits to the employees are available solely through the life insurance policies. The employee's sole recourse is with the insurer and not with the Company. As a result, since no amounts are guaranteed to the employees and the Company has no obligation to pay additional amounts, liability accounting is not required under GAAP. Instead, an asset account for the CASD loan receivable is set up along with a contra account for a valuation allowance. These accounts reside within other assets. Periodically, the arrangements are evaluated for accounting purposes, and when the cash surrender value plus the sum of the premium deposit accounts fall below the initial CASD loan receivable, an expense is recorded on the income statement in personnel expense with the valuation allowance being the offset.

Total compensation expense related to the CASD loan agreements totaled approximately $286,000 and $0, respectively, for the years ended December 31, 2022, and 2021. The net CASD loan receivable asset was $8.3 million and $0, respectively, as of December 31, 2022, and 2021. The balance in the premium deposit accounts was $7.3 million and $0, respectively, as of December 31, 2022, and 2021.

NOTE Q - PARENT COMPANY FINANCIAL DATA

The following tables present the condensed financial statements of North State Bancorp as of and for the years ended December 31, 2022, and 2021, respectively.

Condensed Statements of Financial Condition
December 31, 2022 and 2021

	2022	2021
	(Dollars in thousands)	
Assets		
Cash and due from banks	$ 45	$ 1,141
Investment in North State Bank	103,635	96,745
Investment in North State Statutory Trust I	155	155
Investment in North State Statutory Trust II	155	155
Investment in North State Statutory Trust III	155	155
Other assets	-	3
Total Assets	$ 104,145	$ 98,354
Liabilities and Shareholders' equity		
Other liabilities	$ 169	$ 143
Long-term borrowings	33,101	33,054
Shareholders' equity		
Common stock	14,214	11,215
Retained earnings	57,344	53,973
Accumulated other comprehensive (loss) income	(683)	(31)
Total shareholders' equity	70,875	65,157
Total liabilities and shareholders' equity	$ 104,145	$ 98,354

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

	2022	2021
	(Dollars in thousands)	
Equity in undistributed earnings of bank subsidiary	$ 5,279	$ 6,043
Dividends received from bank subsidiary	9,655	11,672
Interest income	19	12
Interest expense	(1,444)	(1,190)
Other expense	(441)	(382)
Net income	$ 13,068	$ 16,155

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

	2022	2021
	(Dollars in thousands)	
Cash flows from operating activities:		
Net income	$ 13,068	$ 16,155
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization	47	47
Proceeds from issuance of common stock to ESOP	-	1,032
Issuance of common stock for board compensation	737	515
Equity in undistributed earnings of subsidiary	(5,279)	(6,043)
Changes in assets and liabilities:		
Decrease in other assets	3	122
Increase (decrease) in other liabilities	25	(123)
Net cash provided by operating activities	8,601	11,705
Cash flows from financing activities:		
Issuance of common stock from Capital Reinvestment Plan	2,262	-
Downstream of capital to bank subsidiary	(2,262)	
Cash distributions to shareholders	(9,697)	(11,761)
Net cash used in financing activities	(9,697)	(11,761)
Net decrease in cash and cash equivalents	(1,096)	(56)
Cash and cash equivalents, beginning	1,141	1,197
Cash and cash equivalents, ending	$ 45	$ 1,141

NOTE R – BUSINESS SEGMENT INFORMATION

The Company has four reportable business segments, the Bank, NSB Mortgage, SBA, and the parent Company. The Bank is engaged in general commercial and retail banking in central and coastal North Carolina. The Bank operates six full-service banking offices located in Wake County and one full-service office in Wilmington, New Hanover County, North Carolina. NSB Mortgage, a division of the Bank, originates and sells single-family residential first mortgage loans. SBA, another division of our Bank, originates and sells loans (generally 75%) guaranteed by the Small Business Administration. The remaining segment consists of activities of the parent Company. Eliminations necessary to accurately report the operations of the Company are also included.

The following table presents selected segment reporting information as of and for the years ended December 31, 2022, and 2021, respectively.

	As of or for the Year Ended December 31, 2022					
	Bank	NSB Mortgage	SBA	Parent Company	Eliminations	Total Company
	(Dollars in thousands)					
Interest income	$ 39,839	$ 5,029	$ 4,893	$ 19	$ -	$ 49,780
Interest expense	2,339	-	5	1,444	-	3,788
Net interest income	37,500	5,029	4,888	(1,425)	-	45,992
Provision for loan losses	665	-	-	-	-	665
Net interest income after provision for loan losses	36,835	5,029	4,888	(1,425)	-	45,327
Noninterest income	3,070	4,403	3,862	-	-	11,335
Noninterest expense	33,384	7,380	2,389	441	-	43,594
Net income (loss)	$ 6,521	$ 2,052	$ 6,361	$ (1,866)	$ -	$ 13,068
Total assets	$ 1,072,010	$ 186,262	$ 45,619	$ 104,145	$ (103,680)	$ 1,304,356
Net loans	814,110	180,379	42,809	-	-	1,037,298
Loans held for sale	-	4,797	-	-	-	4,797
Goodwill	-	141	-	-	-	141

	As of or for the Year Ended December 31, 2021					
	Bank	NSB Mortgage	SBA	Parent Company	Eliminations	Total Company
	(Dollars in thousands)					
Interest income	$ 32,894	$ 1,974	$ 9,427	$ 12	$ -	$ 44,307
Interest expense	2,215	-	7	1,190	-	3,412
Net interest income	30,679	1,974	9,420	(1,178)	-	40,895
Provision for loan losses	-	-	-	-	-	-
Net interest income after provision for loan losses	30,679	1,974	9,420	(1,178)	-	40,895
Noninterest income	2,128	12,145	3,266	-	-	17,539
Noninterest expense	29,939	9,478	2,480	382	-	42,279
Net income (loss)	$ 2,868	$ 4,641	$ 10,206	$ (1,560)	$ -	$ 16,155
Total assets	$ 1,232,013	$ 87,074	$ 76,300	$ 98,354	$ (97,886)	$ 1,395,855
Net loans	758,918	78,505	73,817	-	-	911,240
Loans held for sale	-	7,218	-	-	-	7,218
Goodwill	-	141	-	-	-	141