Burke & Herbert Financial Services Corp.

2022 Audited Consolidated Financial Statements

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Burke & Herbert Financial Services Corp. Audited Consolidated Financial Statements

Burke & Herbert Financial Services Corp.
Consolidated Balance Sheets
December 31, 2022 and 2021
(In thousands, except share and per share data)

	2022	2021
Assets		
Cash and due from banks	$ 9,124	$ 8,989
Interest-bearing deposits with banks	41,171	68,374
Cash and cash equivalents	50,295	77,363
Securities available-for-sale, at fair value	1,371,757	1,605,681
Restricted stock, at cost	16,443	12,079
Loans held for sale, at fair value	—	1,249
Loans	1,887,221	1,745,073
Allowance for loan losses	(21,039)	(31,709)
Net loans	1,866,182	1,713,364
Premises and equipment, net	53,170	36,875
Accrued interest receivable	15,481	15,253
Company-owned life insurance	92,487	91,062
Other assets	97,083	68,817
Total Assets	$ 3,562,898	$ 3,621,743
Liabilities and Shareholders’ Equity		
Liabilities		
Non-interest-bearing deposits	$ 960,692	$ 930,847
Interest-bearing deposits	1,959,708	2,002,570
Total deposits	2,920,400	2,933,417
Borrowed funds	343,100	275,000
Accrued interest and other liabilities	25,945	23,699
Total Liabilities	3,289,445	3,232,116
Commitments and contingent liabilities (see Note 13)		
Shareholders’ Equity		
Preferred Stock, $0.025 par value per share; 80,000,000 shares authorized; no shares issued or outstanding	—	—
Common Stock	4,000	4,000
$0.50 par value; 20,000,000 shares authorized and 8,000,000 issued at December 31, 2022 and December 31, 2021; 7,425,760 shares outstanding at December 31, 2022 and 7,423,760 shares outstanding at December 31, 2021		
Additional paid-in capital	12,282	10,374
Retained earnings	424,391	396,120
Accumulated other comprehensive income (loss)	(139,495)	6,955
Treasury stock	(27,725)	(27,822)
574,240 shares, at cost, at December 31, 2022 and 576,240 shares, at cost, at December 31, 2021		
Total Shareholders' Equity	273,453	389,627
Total Liabilities and Shareholders' Equity	$ 3,562,898	$ 3,621,743

See Notes to Consolidated Financial Statements.

Burke & Herbert Financial Services Corp.
Consolidated Statements of Income (Loss)
Years Ended December 31, 2022, 2021 and 2020
(In thousands, except share and per share data)

	2022	2021	2020
Interest income			
Loans, including fees	$ 73,640	$ 73,170	$ 78,262
Taxable securities	29,616	17,537	13,288
Tax-exempt securities	8,940	9,907	8,737
Other interest income	437	206	710
Total interest income	112,633	100,820	100,997
Interest expense			
Deposits	3,742	2,746	9,696
Borrowed funds	5,136	1,432	1,579
Other interest expense	63	39	6
Total interest expense	8,941	4,217	11,281
Net interest income	103,692	96,603	89,716
Non-interest income			
Fiduciary and wealth management	5,309	5,162	4,451
Service charges and fees	6,855	6,328	5,700
Net gains (losses) on securities	(454)	(4)	1,944
Income from Company-owned life insurance	2,656	2,325	2,303
Other non-interest income	2,721	3,440	4,606
Total non-interest income	17,087	17,251	19,004
Total revenue	120,779	113,854	108,720
Provision for (recapture of) loan losses	(7,466)	(1,002)	12,648
Non-interest expense			
Salaries and wages	39,438	37,099	33,377
Pensions and other employee benefits	7,700	7,621	7,568
Occupancy	5,621	6,444	6,003
Equipment rentals, depreciation and maintenance	5,768	5,481	4,935
Other operating expenses	17,419	17,769	15,750
Total non-interest expense	75,946	74,414	67,633
Income before income taxes	52,299	40,442	28,439
Income tax expense	8,286	4,277	1,940
Net income	$ 44,013	$ 36,165	$ 26,499
Earnings per common share:			
Basic	$ 5.93	$ 4.87	$ 3.56
Diluted	5.89	4.87	3.55

See Notes to Consolidated Financial Statements.

Burke & Herbert Financial Services Corp.
Consolidated Statements of Comprehensive Income (Loss)
Years Ended December 31, 2022, 2021 and 2020
(In thousands, except share and per share data)

	2022	2021	2020
Net income	$ 44,013	$ 36,165	$ 26,499
Other comprehensive income (loss), net of tax:			
Unrealized gains (losses) on securities:			
Unrealized gain (loss) arising during period, net of tax of $38,333 for 2022, $4,236 for 2021 and ($6,008) for 2020	(144,209)	$ (15,933)	$ 22,603
Reclassification adjustment for loss (gain) on securities, net of tax of $95 for 2022, $1 for 2021, and ($408) for 2020	359	$ 3	$ (1,536)
Defined benefit pension plans:			
Changes in pension plan benefits, net of tax of $263 for 2022, ($81) for 2021 and ($23) for 2020	(1,011)	305	87
Unrealized gain (loss) on cash flow hedge			
Unrealized holding gain (loss) on cash flow hedge, net of tax $457 for 2022 and $0 for 2021 and 2020	(1,721)	—	—
Reclassification adjustment for losses (gains) included in net income, net of tax ($35) for 2022 and $0 for 2021 and 2020	132	—	—
Total other comprehensive income (loss)	(146,450)	(15,625)	21,154
Comprehensive income (loss)	$ (102,437)	$ 20,540	$ 47,653

See Notes to Consolidated Financial Statements.

Burke & Herbert Financial Services Corp.
Consolidated Statements of Changes in Shareholders' Equity
Years Ended December 31, 2022, 2021 and 2020
(In thousands, except share and per share data)

	Common Stock						
	Shares Outstanding	Amount	Paid-in Capital	Retained Earnings	Comprehensive Income (Loss)	Treasury Stock	Shareholders' Equity
Balance December 31, 2019	7,478,320	$ 4,000	$ 10,032	$ 363,232	$ 1,426	$ (25,162)	$ 353,528
Net income	—	—	—	26,499	—	—	26,499
Other comprehensive income (loss)	—	—	—		21,154	—	21,154
(Purchase) sale of treasury stock, net	(30,240)	—	—	—	—	(1,545)	(1,545)
Cash dividends, declared	—	—	—	(14,905)	—	—	(14,905)
Share-based compensation expense, net	—	—	146	—	—	—	146
Balance December 31, 2020	7,448,080	$ 4,000	$ 10,178	$ 374,826	$ 22,580	$ (26,707)	$ 384,877
Net income	—	—	—	36,165	—	—	36,165
Other comprehensive income (loss)	—	—	—	—	(15,625)	—	(15,625)
(Purchase) sale of treasury stock, net	(24,320)	—				(1,115)	(1,115)
Cash dividends, declared	—	—	—	(14,871)	—	—	(14,871)
Share-based compensation expense, net	—	—	196	—	—	—	196
Balance December 31, 2021	7,423,760	$ 4,000	$ 10,374	$ 396,120	$ 6,955	$ (27,822)	$ 389,627
Net income	—	—	—	44,013	—	—	44,013
Other comprehensive income (loss)	—	—	—		(146,450)	—	(146,450)
(Purchase) sale of treasury stock, net	2,000	—	—	—	—	97	97
Cash dividends, declared	—	—	—	(15,742)	—	—	(15,742)
Share-based compensation expense, net	—	—	1,908	—	—	—	1,908
Balance December 31, 2022	7,425,760	$ 4,000	$ 12,282	$ 424,391	$ (139,495)	$ (27,725)	$ 273,453

See Notes to Consolidated Financial Statements.

Burke & Herbert Financial Services Corp.
Consolidated Statements of Cash Flows
Years Ended December 31, 2022, 2021 and 2020
(In thousands, except share and per share data)

	2022	2021	2020
Cash Flows from Operating Activities			
Net Income	$ 44,013	$ 36,165	$ 26,499
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization of fixed assets	3,053	3,205	2,937
Amortization of housing tax credits	6,147	6,778	7,046
Realized (gain) loss on sales of available-for-sale securities	454	4	(1,944)
Provision for (recapture of) loan losses	(7,466)	(1,002)	12,648
Income from Company-owned life insurance	(2,656)	(2,325)	(2,303)
Deferred tax expense (benefit)	1,397	(1,659)	(3,830)
(Gain) Loss on Disposal of fixed assets	(4,533)	(1,063)	7
Accretion of securities	(1,622)	(1,380)	(1,087)
Amortization of securities	11,117	9,870	5,791
Stock based compensation expense	2,000	283	146
Repayment of operating lease liabilities	(2,330)	(2,076)	(2,020)
(Gain) on loans held for sale	(58)	(194)	(122)
Proceeds from sale of loans held for sale	9,585	50,194	59,896
Change in fair value of loans held for sale	23	(23)	—
Originations of loans held for sale	(2,300)	(42,969)	(66,016)
(Increase) in accrued interest receivable	(228)	(1,469)	(5,671)
(Increase) decrease in other assets	501	2,581	(2,334)
Increase (decrease) in accrued interest payable and other liabilities	3,960	32	(6,453)
Net cash flows provided by operating activities	$ 61,057	$ 54,952	$ 23,190
Cash Flows from Investing Activities			
Proceeds from maturities, prepayments, and calls of securities available-for-sale, net	213,596	194,578	188,653
Proceeds from sale of securities available-for-sale, net	195,907	700	49,233
Purchases of securities available-for-sale, net	(367,615)	(669,951)	(679,933)
Sales of restricted stock	22,718	1,988	2,252
Purchases of restricted stock	(27,081)	(1,875)	(8,500)
Proceeds from sales of property and equipment	8,260	2,561	—
Purchases of property and equipment	(23,075)	(1,083)	(2,697)
(Purchases of) proceeds from Company-owned life insurance	1,231	240	(7)
Repayment of finance lease liabilities	(152)	(152)	(16)
(Increase) decrease in loans made to customers, net	(151,352)	88,716	45,277
Net cash flows (used in) investing activities	$ (127,563)	$ (384,278)	$ (405,738)
Cash Flows from Financing Activities			
Net increase in non-interest-bearing accounts	29,845	78,838	230,997
Net increase (decrease) in interest-bearing accounts	(42,862)	65,133	162,958
Increase in other borrowed funds	68,100	50,000	150,000
Cash dividends paid	(15,742)	(14,871)	(14,905)
(Purchase) sale of treasury stock	97	(1,115)	(1,545)
Net cash flows provided by financing activities	$ 39,438	$ 177,985	$ 527,505
Increase (decrease) in cash and cash equivalents	(27,068)	(151,341)	144,957
Cash and cash equivalents			
Beginning of year	77,363	228,704	83,747
End of year	$ 50,295	$ 77,363	$ 228,704

Burke & Herbert Financial Services Corp.
Consolidated Statements of Cash Flows
Years Ended December 31, 2022, 2021 and 2020
(In thousands, except share and per share data)

	2022	2021	2020
Supplemental Disclosures of Cash Flow Information			
Cash payments for:			
Interest paid to depositors	$ 3,411	$ 2,856	$ 10,194
Interest paid on other borrowed funds	4,324	1,430	1,456
Interest paid on finance lease	63	39	6
Income taxes	950	1,347	1,400
Change in unrealized gains on available-for-sale securities	(182,088)	(20,165)	26,668
Change in pension plan benefits	(1,280)	386	110
Lease liability arising from obtaining right of use assets	1,558	2,221	3,310
Premises & equipment transferred to property held for sale	3,449	2,697	447
Transfers from portfolio loans to loans held for sale	19,594	—	—
Financing of sale from loan held for sale	9,000	—	—

See Notes to Consolidated Financial Statements.

Note 1— Nature of Business Activities and Significant Accounting Policies

Nature of operations and principles of consolidation

The consolidated financial statements include Burke & Herbert Financial Services Corp. and its wholly owned subsidiary Burke & Herbert Bank & Trust Company ("the Bank"), together referred to as "the Company." Intercompany transactions and balances are eliminated in consolidation.

Burke and Herbert Financial Services Corp. was organized as a Virginia corporation in 2022 to serve as the holding company for Burke and Herbert Bank & Trust Company. The Company commenced operations as a bank holding company on October 1, 2022 following a reorganization transaction in which it became the Bank's holding company. This transaction was treated as an internal reorganization as all shareholders of the Bank became shareholders of the Company. As a bank holding company, the Company is subject to regulation and supervision by the Federal Reserve. The Company has no material operations and owns 100% of the Bank.

The Bank's primary market area includes northern Virginia and it has over 20 branches throughout the Northern Virginia region and commercial loan offices in Fredericksburg, Loudoun County, and Richmond, Virginia, and in Bethesda, Maryland. The Company's branch locations accept business and consumer deposits from a diverse customer base. The Company's deposit products include checking, savings, and term certificate accounts. The Company's loan portfolio includes commercial and consumer loans, a substantial portion of which are secured by real estate.

A summary of the Company's significant accounting policies follows:

Subsequent events

The Company has evaluated subsequent events for recognition and disclosure through February 24, 2023, which is the date the financial statements were available to be issued.

Use of estimates

To prepare financial statements in conformity with U.S. generally accepted accounting principles ("GAAP"), management makes estimates and assumptions based on available information that affects the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash, cash equivalents and cash flows

For purposes of reporting cash flows, cash and cash equivalents include cash on hand and amounts due from banks, including cash items in process of clearing with maturities fewer than 90 days. Cash flows from loans, federal funds purchased and sold, securities sold under agreements to repurchase and deposits are reported on a net basis.

Restriction on cash

No reserve balances were required at December 31, 2022 and December 31, 2021. There was no reserve requirement with the Federal Reserve as of December 31, 2022 or December 31, 2021.

Debt & equity securities

Management determines the appropriate classification of debt securities at the time of purchase. Debt securities that the Company has both the positive intent and ability to hold to maturity are classified as held to maturity and are reported at cost, adjusted for amortization of premiums and accretion of discounts. Debt securities that the Company intends to hold for an indefinite period of time, but not necessarily to maturity, are classified as available-for-sale and are reported at fair value. Unrealized gains and losses on investments classified as available-for-sale have been accounted for as a separate component of accumulated other comprehensive income or loss, net of the related deferred tax effect. Amortization of premiums and accretion of discounts are recognized in interest income over the

Note 1— Nature of Business Activities and Significant Accounting Policies (continued)

terms of the securities. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations, and other similar factors. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Management evaluates debt securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For debt securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a debt security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized costs and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the statements of income and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

Equity securities are carried at fair value with changes in fair value reported in net income. Equity securities without readily determinable fair values are carried at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical, or a similar, investment.

Due to the nature of, and restrictions placed upon, certain equity securities that have been classified as restricted stock and are carried at cost. These equity securities are not subject to the classifications above.

Loans held for sale

Loans held for sale are those loans the Company has the intent to sell in the foreseeable future. The Company has elected to use the fair value accounting option ("FVO") for loans held for sale. Gains and losses on sales of loans are recognized at settlement dates and are determined by the difference between the sales proceeds and the fair value of the loans. All sales are made without recourse and are sold with servicing released.

Loan commitments and related financial instruments

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Mortgage banking

The Company enters into commitments to originate loans whereby the interest rate on the loan is determined prior to funding (interest rate lock commitments). Interest rate lock commitments on mortgage loans to be held for sale are accounted for as free standing derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 15 to 90 days. The Company protects itself from changes in interest rates through the use of best efforts forward delivery commitments, whereby the Company commits to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed interest rate risk on the loan. As a result, the Company is not exposed to significant losses nor will it realize significant gains related to rate lock commitments due to changes in interest rates. The Company has elected to use the FVO for best effort forward sales commitments.

Derivatives

At the inception of a derivative contract, the Company designates the derivative as one of three types based on the Company's intentions and belief as to the likely effectiveness as a hedge. These three types are (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment ("fair value hedge"), (2) a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or

Note 1— Nature of Business Activities and Significant Accounting Policies (continued)

liability ("cash flow hedge"), or (3) an instrument with no hedging designation ("stand-alone derivative"). For a fair value hedge, the gain or loss on the derivative, as well as the offsetting loss or gain on the hedged item attributable to the hedged risk, are recognized in current earnings as respective fair values change. For a cash flow hedge, the gain or loss on the derivative is reported in other comprehensive income and is reclassified into earnings in the same periods during which the hedged transaction affects earnings. Changes in the fair value of derivatives not designated or that do not qualify for hedge accounting are reported currently in earnings as non-interest income.

Accrued settlements on derivatives that qualify for hedge accounting are recorded in interest income or interest expense based on the item being hedged. Accrued settlements on derivatives not designated or that do not qualify for hedge accounting are reported in non-interest income. Cash flows on hedges are classified in the cash flow statement the same as the cash flows of the items being hedged.

The Company formally documents the relationship between derivatives and hedged items, as well as the risk-management objective and the strategy for undertaking hedge transactions at the inception of the hedging relationship. This documentation includes linking fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Company formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivative instruments that are used are highly effective in offsetting changes in fair values or cash flows of the hedged items. The Company discontinues hedge accounting when it determines that the derivative is no longer effective in offsetting changes in the fair value or cash flows of the hedged item, the derivative is settled or terminates, a hedged forecasted transaction is no longer probable, a hedged firm commitment is no longer firm, or treatment of the derivative as a hedge is no longer appropriate or intended.

When hedge accounting is discontinued, subsequent changes in fair value of the derivative are recorded as non-interest income. When a fair value hedge is discontinued, the hedged asset or liability is no longer adjusted for changes in fair value and the existing basis adjustment is amortized or accreted over the remaining life of the asset or liability. When a cash flow hedge is discontinued but the hedged cash flows or forecasted transactions are still probable of occurring, gains or losses that were accumulated in other comprehensive income are amortized into earnings over the same periods which the hedged transactions will affect earnings.

Loans

The Company loan portfolio segments include (i) commercial real estate, (ii) single family residential (1-4 units), (iii) owner-occupied commercial real estate, (iv) acquisition, construction and development, (v) commercial & industrial, and (vi) consumer non-real estate and other.

Risk factors evaluated include the economic environment's impact on each portfolio segment and the following specific risk factors:

- Commercial real estate loans carry risk associated with either the net operating income generated from the lease of the real estate collateral or income generated from the sale of the collateral. Other risk factors include the credit-worthiness of the sponsor and the value of the collateral.

- Single family residential (1-4 units) loans for consumer purposes carry risk associated with the continued credit-worthiness of the borrower and the value of the collateral. Single family residential (1-4 units) loans for investment purposes carry risk associated with the continued credit-worthiness of the borrower, the value of the collateral, and either the net operating income generated from the lease of the real estate collateral or income generated from the sale of the collateral.

- Owner-occupied commercial real estate loans carry risk associated with the operations of the business that occupies the property and the value of the collateral.

- Acquisition, construction and development loans carry risk associated with the credit-worthiness of the borrower, project completion within budget, sale after completion, and the value of the collateral.

Note 1— Nature of Business Activities and Significant Accounting Policies (continued)

- Commercial & industrial loans carry risk associated with the operations of the business and the value of the collateral, if any.
- Consumer non-real estate and other loans carry risk associated with the credit-worthiness of the borrower and the value of the collateral, if any.

The Company's recorded investments in loans that management has the intent and ability to hold for the foreseeable future, until maturity or until pay-off, generally are reported at their outstanding unpaid principal balances, adjusted for partial charge-offs, the allowance for loan losses, and any deferred fees and costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees and costs are deferred and recognized as an adjustment of the related loan yield using the interest method without anticipating prepayments.

For all portfolio segments, the accrual of interest is discontinued at the time a loan becomes 90 days delinquent, unless the credit is well-secured and in process of collection. Loans also are placed on nonaccrual if collection of principal or interest is considered impaired. All interest accrued, but not received, for loans placed on non-accrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method until qualifying for return to accrual. Under the cost-recovery method, interest income is not recognized until the loan balance is reduced to zero. Under the cash-basis method, interest income is recorded when the payment is received in cash. For all portfolio segments, loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and a history of on-time payments has again been established.

Concentrations of credit

Substantially all of the Company's loans, commitments, and standby letters of credit have been granted to customers in the Company's market area. Such customers are generally depositors of the Company. Some investments in state and municipal securities also involve governmental entities within the Company's market area. The distribution of commitments to extend credit approximates the distribution of loans outstanding. Standby letters of credit are granted primarily to commercial borrowers.

Troubled debt restructuring ("TDR")

Loans are classified as a TDR, if a concession was granted in connection with the modification, for legal or economic reasons, related to the debtor's financial difficulties. Management strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of collateral. In cases where borrowers are granted new terms that provided for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for any impaired loans.

Troubled debt restructurings are individually evaluated for impairment and included in the separately identified impairment disclosures. TDRs are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a TDR is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For TDRs that subsequently default, the Company determines the amount of the allowance on that loan in accordance with the accounting policy for the allowance for loan losses on loans individually identified as impaired. The Company incorporates recent historical experience related to TDRs, including the performance of TDRs that subsequently default, into the calculation of the allowance by loan portfolio segment.

The Company is monitoring COVID-19 related modifications. If loans within this population require subsequent modifications, including payment extensions beyond six months, the Company will consider the borrower's financial status at the time of the request and the effect of all modifications, past and requested, on the loan. If the borrower is deemed to be in financial difficulty that is not short-term and the impact of all modifications is considered to amount to a concession under U.S. GAAP, the loan will be designated a TDR. The Company is also monitoring the COVID-19 related modification population to determine whether other credit-related action should be taken, possibly including downgrading credit risk ratings, designating as nonaccrual, or determining a charge-off.

Note 1— Nature of Business Activities and Significant Accounting Policies (continued)

Allowance for loan losses

The allowance for loan losses is established to absorb probable losses inherent in outstanding loans through a provision for loan losses charged to earnings. Credit losses are charged against the allowance. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a quarterly basis by management and is based upon (i) past loan loss experience for each portfolio segment as adjusted by environmental factors plus a risk adjustment based on the risk rating of the loan, and (ii) a loan by loan analysis of all other loans which are rated as either in a nonaccrual status or classified as troubled debt restructuring. Loan ratings include:

- Pass-rated loans include all loans which are considered to be either high quality, good quality or acceptable quality. Borrowers have an acceptable financial condition with demonstrated repayment ability.
- Special mention loans have potential developing weaknesses that deserve extra attention. If the developing weakness is not corrected or mitigated, there may be deterioration in the ability of the borrower to repay.
- Substandard is a regulatory classification. Loans rated substandard are considered to have well-defined weakness and there is a possibility that some future loss will be sustained if such weakness is not corrected.
- Doubtful is a regulatory classification. Loans rated doubtful have all of the weaknesses inherent in those rated substandard, with the added characteristic that the severity of the weaknesses makes collection or liquidation in full highly questionable. The probability of some loss is high.
- Loss represents a classification for loans which are considered uncollectible and are in the process of being charged off.

Historical credit losses for each portfolio segment are adjusted by environmental factors which include (i) changes in lending policies and procedures, including underwriting standards, and collection, charge-off, and recovery practices; (ii) changes in national and local economic and business conditions, including the conditions of various market segments; (iii) changes in the nature and volume of the portfolio; (iv) changes in the experience, ability, and depth of lending management and staff; (v) changes in the volume and severity of past due and classified loans and the volume of nonaccruals, troubled debt restructurings, and other loan modifications; (vi) changes in the quality of the Company's loan review system and the degree of oversight by the Company's Board of Directors; (vii) the existence and effect of any concentrations of credit and changes in the level of such concentrations; and (viii) the effect of external factors, such as competition and legal and regulatory requirements, on the level of estimated credit losses in the Company's current portfolio. This evaluation is inherently subjective since it requires estimates that are susceptible to significant revision as additional information becomes available or as economic conditions change.

Impaired, collateral dependent loans may be charged down to the net realizable value of the collateral. Alternatively, a specific allowance may be established when the discounted cash flows (or collateral value of observable market price) of the impaired loan are less than the carrying value of that loan.

For all portfolio segments, a loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Premises and equipment

Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives up to 40 years. Furniture,

Note 1— Nature of Business Activities and Significant Accounting Policies (continued)

fixtures and equipment are depreciated using the straight-line method (or accelerated) method with useful lives ranging from 3 to 10 years. Maintenance and repairs are charged to expense as incurred and major improvements are capitalized.

Company-owned life insurance

The Company has purchased life insurance policies on certain employees. Company-owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Transfers of financial assets

Transfers of financial assets are accounted for as sales when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from the Company, the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Other real estate owned (OREO)

Assets acquired through foreclosure or other proceedings are initially recorded at fair value at the date of foreclosure less estimated costs of disposal, which establishes a new cost. After foreclosure, valuations periodically are performed by management and the foreclosed assets held for sale are carried at the lower of cost or fair value less estimated costs of disposal. Any write-down to fair value at the time of transfer to foreclosed assets is charged to the allowance for loan losses. All subsequent gains on sale, losses on sale, and additional write-downs are included in net gains/(losses) on other real estate owned. Revenue and expenses from the operations of foreclosed assets are included in other non-interest income and other operating expenses.

Income taxes

The Company accounts for income taxes in accordance with income tax accounting guidance. The Company has adopted the accounting guidance related to accounting for uncertainty in income taxes, which sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions.

The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more likely than not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more likely than not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management’s judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

The Company recognizes interest and penalties on income taxes as a component of income tax expense.

Note 1— Nature of Business Activities and Significant Accounting Policies (continued)

Employee benefits

The Company has a noncontributory defined benefit pension plan that was frozen to new participants on June 1, 2005. The Company also has a defined contribution plan (The Investment and Savings Plan) with a salary deferral provision, which covers all employees in the month following their date of hire if they have reached the age of 18. The Company's funding policy for the defined benefit plan is to make annual contributions to the Plan in amounts that are determined based on actuarial valuations and recommendations and which meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974.

Authoritative accounting literature requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in the funded status in the year in which the changes occur through comprehensive income. The funded status of a benefit plan will be measured as the difference between plan assets at fair value and the benefit obligation. For a pension plan, the benefit obligation is the projected benefit obligation. For any other postretirement plan, the benefit obligation is the accumulated postretirement benefit obligation. Authoritative accounting literature also requires an employer to measure the funded status of a plan as of the date of its year-end balance sheet. The guidance also requires additional disclosure in the notes to financial statements about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation.

Per share data

The Company's capital structure includes a stock-based compensation plan, which may be dilutive to earnings per share ("EPS"). Basic EPS is calculated by dividing net income by the weighted average number of shares outstanding during the year. Diluted EPS is calculated by assuming dilution of common shares and adjusting net income for compensation cost attributable to the stock-based compensation plan.

Trust assets and fees

Assets of the trust department, other than trust cash on deposit at the Company, are not included in these financial statements because they are not assets of the Company. Trust fees are recognized in income using the accrual method.

Loss contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

Comprehensive income (loss)

Comprehensive income (loss) consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available-for-sale, unrealized gains and losses on cash flow hedges, and changes in the funded status of the pension plan, which are also recognized as separate components of equity.

Leases

Lease liabilities represent the Company's obligation to make lease payments and are presented at each reporting date as the net present value of the remaining contractual cash flows. Cash flows are discounted at the Company's incremental borrowing rate in effect at the commencement date of the lease. Right-of-use assets represent the Company's right to use the underlying asset for the lease term and are calculated as the sum of the lease liability and if applicable, prepaid rent, initial direct costs and any incentives received from the lessor.

Note 1— Nature of Business Activities and Significant Accounting Policies (continued)

Fair value of financial instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

Stock-based compensation

Compensation cost is recognized for equity awards issued to employees and directors, based on the fair value of these awards at the date of grant using an observable market price. The Company classifies stock awards as equity. Compensation cost is recognized over the required service period on a straight-line basis. The Company's accounting policy is to recognize forfeitures as they occur.

Segment reporting

The Company operates in one segment – Community Banking and the financial performance of this one segment is used to make resource allocations and performance decisions. While the chief decision-maker monitors the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Individual operating results are not reviewed by senior management to make resource allocation or performance decisions. Therefore, all of the financial service operations are considered by management to be aggregated in one reportable operating segment.

Reclassifications

Some items in the prior year financial statements were reclassified to conform to the current presentation. Reclassifications had no effect on prior year net income or shareholder's equity.

Recent Accounting Pronouncements

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update *(ASU) 2016-13: Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* to replace the incurred loss model for loans and other financial assets with an expected credit loss ("CECL") model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables and held-to-maturity debt securities. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in certain leases recognized by a lessor. In addition, the amendments in Topic 326 require credit losses on available-for-sale to be presented as a valuation allowance rather than as a direct write-down (e.g. OTTI). The FASB has issued multiple updates to ASU 2016-13 as codified in Topic 326, including ASUs 2019-04, 2019-05, 2019-10, 2019-11, 2020-02, and 2020-03. These ASUs have provided for various minor technical corrections and improvements to the codification as well as other transition matters.

For public companies that are not SEC filers, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2022. As part of the Company's implementation efforts, we have engaged a third-party vendor, reconciled historical loan, charge-off and recovery data and determined segmentation of the loan portfolio for application of the current expected credit losses calculation. The Company has also designed calculation methodologies under the new guidance and have engaged an external vendor to perform model validation. The Company is currently designing appropriate controls and management review prior to the adoption of the standard.

The adoption of this standard is not expected to have a material effect on the Company's operating results or financial condition. Upon transition:

- the Company does not expect an impact to its debt securities based on not having any debt security classified as held-to-maturity and having no OTTI on our existing portfolio of debt securities.

Note 1— Nature of Business Activities and Significant Accounting Policies (continued)

- for all other assets within the scope of CECL, a cumulative-effect adjustment will be recognized in retained earnings as of the beginning of the first reporting period in which the guidance is effective.

Subsequently, the FASB issued ASU 2022-02, Financial Instruments - Credit Losses - (Topic 326) - Troubled Debt Restructurings and Vintage Disclosures, which eliminates the recognition and measurement guidance for TDRs by creditors in ASC 310-40. This Update also enhances disclosure requirements for certain loan restructurings by creditors when a borrower is experiencing financial difficulty. specifically, rather than applying the recognition and measurement guidance for a TDRs, an entity will apply the loan refinancing and restructuring guidance to determine whether a modification or other form of restructuring results in a new loan or a continuation of an existing loan. The effective date for the amendments in this Update are the same as the effective dates in Update 2016-13. This Update requires prospective transition for the disclosures related to loan restructurings for borrowers experiencing financial difficulty and the presentation of gross write-offs in the vintage disclosures. The adoption of this standard is not expected to have a material effect on the Company's operating results or financial condition.

In March 2020, the FASB issued ASU No. 2020-04: *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting.* These amendments provide temporary optional guidance to ease the potential burden in accounting for reference rate reform. The ASU provides optional expedients and exceptions for applying generally accepted accounting principles to contract modifications and hedging relationships, subject to meeting certain criteria, that reference LIBOR or another reference rate expected to be discontinued. It is intended to help stakeholders during the global market-wide reference rate transition period. The guidance is effective for all entities as of March 12, 2020 through December 31, 2022.

Subsequently, in January 2021, the FASB issued ASU No. 2021-01: *Reference Rate Reform (Topic 848): Scope.* This ASU clarifies 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. The ASU also amends the expedients and exceptions in Topic 848 to capture the incremental consequences of the scope clarification and to tailor the existing guidance to derivative instruments affected by the discounting transition. An entity may elect to apply ASU No. 2021-01 on contract modifications that change the interest rate used for margining, discounting, or contract price alignment retrospectively as of any date from the beginning of the interim period that includes March 12, 2020, or prospectively to new modifications from any date within the interim period that includes or is subsequent to January 7, 2021, up to the date that financial statements are available to be issued. The Company does not believe this will have material impacts on its financial statements.

An entity may elect to apply ASU No. 2021-01 to eligible hedging relationships existing as of the beginning of the interim period that includes March 12, 2020, and to new eligible hedging relationships entered into after the beginning of the interim period that includes March 12, 2020. The Company has limited exposure to the number of loans tied to LIBOR and the loan documents allow for the index to move to an alternative rate if the index currently in place, LIBOR, no longer exists. For any new loans, the Company is using an alternative rate as an index. ASU 2020-01 will not have material impact on the Company.

Note 2— Securities

The carrying amount of securities and their approximate fair values at December 31, 2022 and 2021, are summarized as follows (in thousands):

	December 31, 2022			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities Available-for-Sale				
U.S. Treasuries and government agencies	$ 198,154	$ —	$ 23,161	$ 174,993
Obligations of states and municipalities	550,590	12	96,695	453,907
Residential mortgage backed - agency	57,883	14	4,836	53,061
Residential mortgage backed - non-agency	365,983	2	26,690	339,295
Commercial mortgage backed - agency	61,810	75	1,952	59,933
Commercial mortgage backed - non-agency	191,709	10	8,420	183,299
Asset-backed	101,791	49	3,214	98,626
Other	9,500	—	857	8,643
	$ 1,537,420	$ 162	$ 165,825	$ 1,371,757

	December 31, 2021			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities Available-for-Sale				
U.S. Treasuries and government agencies	$ 185,085	$ 98	$ 742	$ 184,441
Obligations of states and municipalities	651,000	20,285	5,718	665,567
Residential mortgage backed - agency	63,568	372	1,153	62,787
Residential mortgage backed - non-agency	245,794	863	2,349	244,308
Commercial mortgage backed - agency	78,830	411	358	78,883
Commercial mortgage backed - non-agency	170,048	2,492	336	172,204
Asset-backed	192,930	3,127	532	195,525
Other	2,000	—	34	1,966
	$ 1,589,255	$ 27,648	$ 11,222	$ 1,605,681

At December 31, 2022 and 2021, securities with amortized costs of $637.1 million and $498.1 million, respectively, and with estimated fair values of $552.5 million and $518.6 million, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

The gross realized gains, realized losses, and proceeds from the sales of securities for the years ended December 31, 2022, 2021 and 2020 were as follows (in thousands):

	2022	2021	2020
Gross realized gains	$ 1,512	$ —	$ 1,957
Gross realized losses	(1,966)	(4)	(13)
Proceeds from sales of securities	195,907	700	49,233

The tax benefit (provision) related to these net realized gains and losses for 2022, 2021, and 2020 was $95.3 thousand, $0.8 thousand, and $(408.2) thousand, respectively.

The maturities of securities available-for-sale at December 31, 2022, were as follows (in thousands): (Expected maturities of securities not due at a single maturity date are based on average life at estimated prepayment speed.

Note 2— Securities (continued)

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

	December 31, 2022				
	Amortized Cost				
	One Year or Less	One to Five Years	Five to Ten Years	After Ten Years	Total
Securities Available-for-Sale					
U.S. Treasuries and government agencies	$ —	$ 39,854	$ 158,300	$ —	$ 198,154
Obligations of states and municipalities	5,235	1,563	277,320	266,472	550,590
Residential mortgage backed - agency	42	34,100	23,741	—	57,883
Residential mortgage backed - non-agency	28,203	265,190	68,172	4,418	365,983
Commercial mortgage backed - agency	415	56,622	4,773	—	61,810
Commercial mortgage backed - non-agency	32,979	153,572	5,158	—	191,709
Asset-backed	3,255	33,495	65,041	—	101,791
Other	—	—	9,500	—	9,500
	$ 70,129	$ 584,396	$ 612,005	$ 270,890	$ 1,537,420

	December 31, 2022				
	Fair Value				
	One Year or Less	One to Five Years	Five to Ten Years	After Ten Years	Total
Securities Available-for-Sale					
U.S. Treasuries and government agencies	$ —	$ 37,439	$ 137,554	$ —	$ 174,993
Obligations of states and municipalities	5,246	1,529	240,753	206,379	453,907
Residential mortgage backed - agency	42	33,128	19,891	—	53,061
Residential mortgage backed - non-agency	27,182	247,662	60,448	4,003	339,295
Commercial mortgage backed - agency	414	54,960	4,559	—	59,933
Commercial mortgage backed - non-agency	32,400	146,812	4,087	—	183,299
Asset-backed	3,165	32,592	62,869	—	98,626
Other	—	—	8,643	—	8,643
	$ 68,449	$ 554,122	$ 538,804	$ 210,382	$ 1,371,757

At year-end 2022 and 2021, there were no holdings of securities of any one issuer, other than U.S. Government and its agencies, in any mount greater than 10% of shareholders' equity.

Note 2— Securities (continued)

The following table shows the gross unrealized losses and fair value of the Company's securities with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2022 and 2021.

Available-for-sale securities in a continuous unrealized loss position for less than twelve months and more than twelve months are as follows (in thousands):

	December 31, 2022				
	Less Than Twelve Months		More Than Twelve Months		
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Total Unrealized Losses
Securities Available-for-Sale					
U.S. Treasuries and government agencies	$ 28,399	$ 1,131	$ 146,594	$ 22,030	$ 23,161
Obligations of states and municipalities	128,373	12,378	320,287	84,317	96,695
Residential mortgage backed - agency	7,258	26	41,975	4,810	4,836
Residential mortgage backed - non-agency	204,866	11,822	134,056	14,868	26,690
Commercial mortgage backed - agency	23,026	562	34,847	1,390	1,952
Commercial mortgage backed - non-agency	144,193	6,171	23,374	2,249	8,420
Asset-backed	43,472	815	50,088	2,399	3,214
Other	6,877	623	1,766	234	857
	$ 586,464	$ 33,528	$ 752,987	$ 132,297	$ 165,825

	December 31, 2021				
	Less Than Twelve Months		More Than Twelve Months		
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Total Unrealized Losses
Securities Available-for-Sale					
U.S. Treasuries and government agencies	$ 134,379	$ 392	$ 10,082	$ 350	$ 742
Obligations of states and municipalities	218,099	4,938	14,521	780	5,718
Residential mortgage backed - agency	48,167	1,153	—	—	1,153
Residential mortgage backed - non-agency	149,640	1,624	31,024	725	2,349
Commercial mortgage backed - agency	33,703	274	6,456	84	358
Commercial mortgage backed - non-agency	36,307	321	4,137	15	336
Asset-backed	50,005	402	17,372	130	532
Other	1,966	34	—	—	34
	$ 672,266	$ 9,138	$ 83,592	$ 2,084	$ 11,222

The Company determines whether unrealized losses are temporary in nature in accordance with U.S. GAAP and the evaluation is based upon factors such as the creditworthiness of the underlying borrowers, performance of the underlying collateral, if applicable, and the level of credit support in the security structure. The Company also evaluates other factors and circumstances that may be indicative of an OTTI condition. This evaluation includes, but

Note 2— Securities (continued)

is not limited to, an evaluation of the type of security, length of time and extent to which the fair value has been less than cost, and near-term prospects of the issuer.

FASB ASC 320-10 requires the Company to assess if OTTI exists by considering whether the Company has the intent to sell the security or, more likely than not, will be required to sell the security before recovery. If either of these situations applies, the guidance requires the Company to record an OTTI charge to earnings on debt securities for the difference between the amortized cost basis and the fair value of the security. If neither of these situations applies, the Company will assess whether it is expected to recover the entire amortized costs basis of the security. If the Company is not expected to recover the entire amortized cost basis of the security, we will bifurcate the identified OTTI into a credit loss component and a component representing loss related to other factors.

As of December 31, 2022, the Company had no cumulative OTTI. There were no OTTI charges in earnings as a result of credit losses on investments in the years ended December 31, 2022, 2021 and 2020.

Securities of U.S. Treasury and Federal Agencies and Federal Agency Mortgage (Residential and Commercial) Backed Securities

At December 31, 2022, the unrealized losses associated with 12 U.S. Treasuries and Government Agency securities, 19 Residential Mortgage Backed – Agency securities, and 31 Commercial Mortgage Backed – Agency securities were generally driven by changes in interest rates and not due to credit losses given the explicit or implicit guarantees provided by the U.S. government.

Securities of U.S. States and Municipalities

At December 31, 2022, the unrealized losses associated with 230 State and Municipal securities were primarily caused by changes in interest rates and not the credit quality of the securities. These investments are investment grade and were generally underwritten in accordance with our own investment standards prior to the decision to purchase, without relying on a bond insurer's guarantee in making the investment decision. These securities will continue to be monitored as part of our ongoing impairment analysis but are expected to perform, even if the rating agencies reduce the credit rating of the bond insurers. As a result, we expect to recover the entire amortized cost basis of these securities.

Residential & Commercial Mortgage Backed – Non-Agency Securities

At December 31, 2022, the unrealized losses associated with 109 Residential Mortgage Backed – Non-Agency securities and 36 Commercial Mortgage Backed – Non-Agency securities were generally driven by changes in interest rates, credit spreads, and projected collateral losses. We assess for credit impairment by estimating the present value of expected cash flows. The key assumptions for determining expected cash flows include default rates, loss severities, and/or prepayment rates. Based on our assessment of the expected credit losses and the credit enhancement level of the securities, we expect to recover the entire amortized cost of these securities.

Asset-Backed Securities

At December 31, 2022, the unrealized losses associated with 28 Asset-Backed securities were generally driven by changes in interest rates, credit spreads, and projected collateral losses. We assess for credit impairment by estimating the present value of expected cash flows. The key assumptions for determining expected cash flows include default rates, loss severities, and/or prepayment rates. Based on our assessment of the expected credit losses and the credit enhancement level of the securities, we expect to recover the entire amortized cost of these securities.

Other Securities

At December 31, 2022, the unrealized losses associated with 3 securities were primarily driven by interest rates and not the credit quality of the securities. These investments are underwritten in accordance with our own investment standards prior to the decision to purchase, without relying on a bond insurer's guarantee in making the investment decision. Based on our assessment of the expected credit losses, we expect to recover the entire amortized cost basis of the securities.

Note 2— Securities (continued)

Restricted stock, at cost

The Company's investment in FHLB stock totaled $16.4 million and $12.0 million at December 31, 2022 and 2021, respectively. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock other than the FHLB or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at December 31, 2022, and no impairment has been recognized. FHLB stock is included in a separate line item (Restricted stock, at cost) and is not part of the Company's investment securities portfolio. The Company's restricted securities also include an investment in Community Bankers' Bank, totaling $50 thousand at both December 31, 2022 and 2021, which is carried at cost.

Note 3— Loans

Loans at year-end by portfolio segment were as follows (in thousands):

	2022	2021
Commercial real estate	$ 1,109,315	$ 1,031,641
Owner-occupied commercial real estate	127,114	125,613
Acquisition, construction & development	94,450	109,518
Commercial & industrial	53,514	58,818
Single family residential (1-4 units)	499,362	415,594
Consumer non-real estate and other	3,466	3,889
	1,887,221	1,745,073
Allowance for loan losses	(21,039)	(31,709)
Loans, net	$ 1,866,182	$ 1,713,364

Net deferred loan fees included in the above loan categories totaled $3.3 million and $4.4 million at December 31, 2022 and 2021, respectively. The Company holds $7.9 million and $37.8 million in PPP loans, net of deferred fees and costs as of December 31, 2022 and 2021, respectively.

Note 3— Loans (continued)

The following table presents the activity in the allowance for loan losses by portfolio segment for each of the years ending December 31, 2022, 2021, and 2020 (in thousands):

	Commercial real estate	Owner-occupied commercial real estate	Acquisition, construction & development	Commercial & industrial	Single family residential (1-4 units)	Consumer non-real estate and other	Total
December 31, 2022							
Allowance for loan losses							
Beginning balance	$ 25,112	$ 611	$ 3,369	$ 160	$ 2,434	$ 23	$ 31,709
Provision for (recapture of) loan losses	(6,391)	24	(1,287)	298	(239)	129	(7,466)
Loans charged-off	(3,282)	—	—	(20)	—	(148)	(3,450)
Recoveries	38	—	—	—	184	24	246
Total ending allowance balance	$ 15,477	$ 635	$ 2,082	$ 438	$ 2,379	$ 28	$ 21,039
December 31, 2021							
Allowance for loan losses							
Beginning balance	$ 23,356	$ 1,196	$ 4,255	$ 68	$ 3,757	$ 65	$ 32,697
Provision for (recapture of) loan losses	1,870	(602)	(886)	72	(1,490)	34	(1,002)
Loans charged-off	(127)	—	—	—	(16)	(99)	(242)
Recoveries	13	17	—	20	183	23	256
Total ending allowance balance	$ 25,112	$ 611	$ 3,369	$ 160	$ 2,434	$ 23	$ 31,709
December 31, 2020							
Allowance for loan losses							
Beginning balance	$ 11,396	$ 2,310	$ 1,697	$ 5,952	$ 2,791	$ 55	$ 24,201
Provision for (recapture of) loan losses	11,946	(1,114)	2,558	(1,752)	945	65	12,648
Loans charged-off	—	—	—	(5,858)	(44)	(94)	(5,996)
Recoveries	14	—	—	1,726	65	39	1,844
Total ending allowance balance	$ 23,356	$ 1,196	$ 4,255	$ 68	$ 3,757	$ 65	$ 32,697

Note 3— Loans (continued)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method (individually or collectively evaluated for impairment) as of December 31, 2022 and 2021 (in thousands):

	Commercial real estate	Owner-occupied commercial real estate	Acquisition, construction & development	Commercial & industrial	Single family residential (1-4 units)	Consumer non-real estate and other	Total
December 31, 2022							
Allowance for loan losses							
Individually evaluated for impairment	$ 41	$ 102	$ —	$ —	$ 96	$ —	$ 239
Collectively evaluated for impairment	15,436	533	2,082	438	2,283	28	20,800
Total ending allowance balance	$ 15,477	$ 635	$ 2,082	$ 438	$ 2,379	$ 28	$ 21,039
Loan balance:							
Individually evaluated for impairment	$ 331	$ 2,580	$ —	$ —	$ 6,158	$ —	$ 9,069
Collectively evaluated for impairment	1,108,984	124,534	94,450	53,514	493,204	3,466	1,878,152
Total ending loan balance	$ 1,109,315	$ 127,114	$ 94,450	$ 53,514	$ 499,362	$ 3,466	$ 1,887,221
December 31, 2021							
Allowance for loan losses							
Individually evaluated for impairment	$ 7,558	$ 14	$ —	$ —	$ 107	$ —	$ 7,679
Collectively evaluated for impairment	17,554	597	3,369	160	2,327	23	24,030
Total ending allowance balance	$ 25,112	$ 611	$ 3,369	$ 160	$ 2,434	$ 23	$ 31,709
Loan balance:							
Individually evaluated for impairment	$ 20,110	$ 2,843	$ —	$ —	$ 7,831	$ —	$ 30,784
Collectively evaluated for impairment	1,011,531	122,770	109,518	58,818	407,763	3,889	1,714,289
Total ending loan balance	$ 1,031,641	$ 125,613	$ 109,518	$ 58,818	$ 415,594	$ 3,889	$ 1,745,073

Note 3— Loans (continued)

The recorded investment in loans excludes accrued interest receivable and loan origination fees, net due to immateriality. The following table presents the aging of the recorded investment in past due loans as of December 31, 2022 and 2021 by portfolio segment:

Aging and Nonaccrual Loans (in thousands):

	December 31, 2022							
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or More Past Due	Total Past Due	Current Loans	Total Loans	90 Days Past Due & Still Accruing	Non-accrual loans
Commercial real estate	$ —	$ —	$ —	$ —	$ 1,109,315	$ 1,109,315	$ —	$ —
Owner-occupied commercial real estate	—	—	—	—	127,114	127,114	—	1,184
Acquisition, construction & development	—	—	—	—	94,450	94,450	—	—
Commercial & industrial	—	—	—	—	53,514	53,514	—	—
Single family residential (1-4 units)	1,403	154	546	2,103	497,259	499,362	—	4,313
Consumer non-real estate and other	—	4	—	4	3,462	3,466	—	—
Total	$ 1,403	$ 158	$ 546	$ 2,107	$ 1,885,114	$ 1,887,221	$ —	$ 5,497

	December 31, 2021							
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or More Past Due	Total Past Due	Current Loans	Total Loans	90 Days Past Due & Still Accruing	Non-accrual loans
Commercial real estate	$ —	$ —	$ 19,531	$ 19,531	$ 1,012,110	$ 1,031,641	$ —	$ 19,594
Owner-occupied commercial real estate	121	—	820	941	124,672	125,613	—	1,399
Acquisition, construction & development	—	—	—	—	109,518	109,518	—	—
Commercial & industrial	21	—	—	21	58,797	58,818	—	—
Single family residential (1-4 units)	365	—	649	1,014	414,580	415,594	—	5,268
Consumer non-real estate and other	—	—	—	—	3,889	3,889	—	—
Total	$ 507	$ —	$ 21,000	$ 21,507	$ 1,723,566	$ 1,745,073	$ —	$ 26,261

Note 3— Loans (continued)

The following table presents information related to impaired loans by portfolio segment as of December 31, 2022 and 2021 (in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized (1)
December 31, 2022					
With no related allowance recorded:					
Commercial real estate	$ —	$ —	$ —	$ —	$ —
Owner-occupied commercial real estate	1,184	1,394	—	1,291	97
Acquisition, construction & development	—	—	—	—	—
Commercial & industrial	—	—	—	—	—
Single family residential (1-4 units)	5,151	5,576	—	5,131	213
Consumer non-real estate and other	—	—	—	—	—
Subtotal	$ 6,335	$ 6,970	$ —	$ 6,422	$ 310
With an allowance recorded:					
Commercial real estate	$ 331	$ 331	$ 41	$ 350	$ 23
Owner-occupied commercial real estate	1,397	1,397	102	1,420	74
Acquisition, construction & development	—	—	—	—	—
Commercial & industrial	—	—	—		—
Single family residential (1-4 units)	1,007	1,141	96	1,033	57
Consumer non-real estate and other	—	—	—	—	—
Subtotal	$ 2,735	$ 2,869	$ 239	$ 2,803	$ 154
December 31, 2021					
With no related allowance recorded:					
Commercial real estate	$ —	$ —	$ —	$ —	$ —
Owner-occupied commercial real estate	2,327	2,460	—	2,437	129
Acquisition, construction & development	—	—	—	—	—
Commercial & industrial	—	—	—	—	—
Single family residential (1-4 units)	5,673	6,230	—	5,848	245
Consumer non-real estate and other	—	—	—	—	—
Subtotal	$ 8,000	$ 8,690	$ —	$ 8,285	$ 374
With an allowance recorded:					
Commercial real estate	$ 20,110	$ 20,236	$ 7,558	$ 20,130	$ 30
Owner-occupied commercial real estate	516	516	14	530	32
Acquisition, construction & development	—	—	—	—	—
Commercial & industrial	—	—	—		—
Single family residential (1-4 units)	2,159	2,285	107	2,203	122
Consumer non-real estate and other	—	—	—	—	—
Subtotal	$ 22,785	$ 23,037	$ 7,679	$ 22,863	$ 184

(1) Cash basis interest income recognized approximates interest income recognized as of December 31, 2022 and 2021.

Credit Quality Indicators

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public

Note 3— Loans (continued)

information, current economic information and other factors. The Company analyzes loans individually by classifying the loans by credit risk. The Company uses the following definitions for risk ratings:

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

Substandard: Loans classified as substandard have a well defined weakness or weaknesses that jeopardize the liquidation of debt. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful: Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and unlikely.

Loans by credit quality indicators as of December 31, 2022 and 2021 were as follows (in thousands):

	Pass	Special Mention	Substandard	Doubtful	Loss	Total
December 31, 2022						
Commercial real estate	$ 1,011,025	$ 62,907	$ 35,383	$ —	$ —	$ 1,109,315
Owner-occupied commercial real estate	121,621	1,963	3,530	—	—	127,114
Acquisition, construction & development	68,220	836	25,394	—	—	94,450
Commercial & industrial	53,273	—	241	—	—	53,514
Single family residential (1-4 units)	494,994	55	4,313	—	—	499,362
Consumer non-real estate and other	3,466	—	—	—	—	3,466
Total	$ 1,752,599	$ 65,761	$ 68,861	$ —	$ —	$ 1,887,221

	Pass	Special Mention	Substandard	Doubtful	Loss	Total
December 31, 2021						
Commercial real estate	$ 868,787	$ 75,397	$ 87,457	$ —	$ —	$ 1,031,641
Owner-occupied commercial real estate	122,065	2,149	1,399	—	—	125,613
Acquisition, construction & development	72,895	36,623	—	—	—	109,518
Commercial & industrial	58,763	55	—	—	—	58,818
Single family residential (1-4 units)	410,227	99	5,268	—	—	415,594
Consumer non-real estate and other	3,889	—	—	—	—	3,889
Total	$ 1,536,626	$ 114,323	$ 94,124	$ —	$ —	$ 1,745,073

There were no TDRs during the years ended December 31, 2022, 2021, and 2020, respectively.

There were no TDRs that subsequently defaulted within twelve months of restructuring in the years ending, December 31, 2022 and December 31, 2021, respectively.

In accordance with regulatory guidance and provisions in the CARES Act to provide relief during the COVID-19 pandemic, the Company has provided short-term concessions to certain borrowers. The Company holds $35.9

Note 3— Loans (continued)

million and $173.1 million in loans that were under deferral under the CARES Act provisions as of December 31, 2022 and 2021, respectively. For loans to qualify for COVID-19 related modifications, these loans could not be more than 30 days past due as of December 31, 2019. As such, these loans were not considered TDRs based on the relief provisions of the CARES Act and recent regulatory interagency guidance.

For purposes of this disclosure, the Company defines default as any payment that occurs more than 90 days past the due date, charge-off, or foreclosure subsequent to modification.

As of December 31, 2022, 2021 and 2020, there was no other real estate owned. As of December 31, 2022, 2021 and 2020, there were no loans in the process of foreclosure.

Note 4— Premises and Equipment

Premises and equipment are included in the Balance Sheet at December 31, 2022 and 2021 were as follows (in thousands):

	2022	2021
Cost:		
Land	$ 14,626	$ 12,791
Premises	56,999	44,109
Furniture and equipment	18,705	23,792
	90,330	80,692
Less:		
Accumulated depreciation	(37,160)	(43,817)
	$ 53,170	$ 36,875

Depreciation and amortization (e.g. leasehold improvements) expense for the years ended December 31, 2022, 2021 and 2020 was $3.1 million, $3.2 million and $2.9 million, respectively.

In 2022 and 2021, the Company sold premises that resulted in a gain of $4.5 million and $1.1 million, respectively, that is captured in other operating expenses on the statements of income.

Note 5— Deposits

The aggregate amount of time deposits, each with a minimum denomination of $250,000, was approximately $133.3 million and $52.4 million in 2022 and 2021, respectively. Brokered time deposits totaled $100.3 million at December 31, 2022. There were no brokered time deposits at December 31, 2021. Time deposits through the Certificate of Deposit Account Registry Service (CDARS) program totaled $11.7 million at December 31, 2022, compared to $18.9 million at December 31, 2021. Deposits through the CDARS program are generated from major customers with substantial relationships with the Company.

Note 5— Deposits (continued)

At December 31, 2022, the scheduled maturities of time deposits for the next five years were as follows (in thousands):

Years ending December 31,	
2023	$ 153,075
2024	94,816
2025	45,724
2026	3,449
2027	1,827
	$ 298,891

At December 31, 2022 and 2021, amounts included in time deposits for individual retirement accounts totaled $36.9 million and $42.9 million, respectively.

Overdrafts of $503 thousand and $94 thousand were reclassified to loans at year ended December 31, 2022 and 2021.

Note 6— Federal Home Loan Bank Advances and Other Short Term Borrowings

The Company has advances outstanding with the Federal Home Loan Bank of Atlanta of $343.1 million and $275 million at December 31, 2022 and 2021, respectively. At December 31, 2022, the interest rate on this debt ranged from 4.13% to 4.57%. At December 31, 2021, the interest rate on this debt ranged from 0.1800% to 0.7725%. The weighted average interest rate at December 31, 2022 and 2021 was 4.422% and 0.545%, respectively. The average balance outstanding during 2022 and 2021 was $269.5 million and $227.0 million, respectively.

Each advance is payable at its maturity date, with a prepayment penalty for fixed rate advances. The Company has available an $875.3 million line of credit with the Federal Home Loan Bank of Atlanta. Advances on the line are secured by both securities and loans. The amount of securities and loans pledged against the line as of December 31, 2022 and December 31, 2021 was $698.1 million and $637.2 million, respectively.

The contractual maturities of this debt as of December 31, 2022 are as follows (in thousands):

Due in 2023	$ 243,100
Due in 2024	100,000
	$ 343,100

Federal funds purchased

The Bank has unsecured federal fund lines of credit from correspondent banking relationships, which can provide up to $90 million in liquidity. There were no borrowings of federal fund lines of credit outstanding at December 31, 2022 or 2021.

Note 7— Income Taxes

The income tax expense (benefit) for 2022, 2021, and 2020 was as follows (in thousands):

	2022	2021	2020
Current Expense:			
Federal	$ 5,501	$ 5,564	$ 5,770
State	1,388	372	—
	$ 6,889	$ 5,936	$ 5,770
Deferred Expense:			
Federal	$ 1,318	$ (1,401)	$ (3,830)
State	79	(258)	—
	$ 1,397	$ (1,659)	$ (3,830)
Total	$ 8,286	$ 4,277	$ 1,940

Deferred income taxes are provided on the asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and net operating losses and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and net operating loss carry-forwards and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based on the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will realize the benefits of these deferred tax assets.

The Company follows accounting guidance related to accounting for uncertainty in income taxes. Under the "more likely than not" threshold guidelines, the Company recorded $291 thousand of income tax expense. There were no uncertain tax positions as of December 31, 2021 or 2020. The Company's policy is to account for interest and penalties as a component of income tax expense. The Company is no longer subject to examination by federal, state and local taxing authorities for years before January 1, 2019.

The following reconciles income taxes reported in the financial statements to taxes that would be obtained by applying statutory tax rates to income before taxes (in thousands):

	2022	2021	2020
Expected taxes using statutory rates	$ 10,983	$ 8,493	$ 5,972
Benefit of tax exempt income, net of non-deductible interest	(1,694)	(1,993)	(1,644)
Nontaxable income from life insurance	(570)	(502)	(496)
Low income tax credits, net of amortization	(1,840)	(1,843)	(1,231)
State taxes, net of federal benefit	1,159	294	—
Other adjustment, net	248	(172)	(661)
	$ 8,286	$ 4,277	$ 1,940

Note 7— Income Taxes (continued)

The net deferred tax amounts in the accompanying Balance Sheets include the following components (in thousands):

	2022	2021
Deferred tax assets:		
Provision for loan losses	$ 4,418	$ 6,962
Lease liability	2,171	2,451
Compensation accruals	1,773	1,345
Partnership investments	1,907	1,550
Unrealized losses on securities available-for-sale	34,789	—
Tax credit carryforward	7,634	7,272
Deferred state taxes	179	—
Other	422	243
	$ 53,293	$ 19,823
Deferred tax liabilities:		
Unrealized gains on securities available-for-sale	$ —	$ (3,449)
Tax over book depreciation	(1,555)	(1,369)
Pension accrual	(366)	(890)
Right of use asset	(2,074)	(2,349)
	$ (3,995)	$ (8,057)
Net deferred tax asset	$ 49,298	$ 11,766

Note 8— Defined Benefit Pension Plan

The Company provides pension benefits for eligible employees through a defined benefit pension plan. Employees hired prior to June 1, 2005 participate in the retirement plan on a non-contributing basis and were fully vested after five years of service.

Note 8— Defined Benefit Pension Plan (continued)

The following tables set forth the Plan's status and related disclosures (in thousands):

	2022	2021
Changes in benefit obligation:		
Benefit obligation at beginning of year	$ 42,297	$ 43,371
Service cost	786	998
Interest cost	1,141	1,042
Actuarial (gain) loss	(12,549)	(2,131)
Distributions	(1,450)	(983)
Benefit obligation at end of year	$ 30,225	$ 42,297
Change in plan assets:		
Fair value of plan assets at beginning of year	$ 46,017	$ 47,526
Adjustment to beginning of year fair value	—	—
Actual return on plan assets	(12,599)	(526)
Employer contribution	—	—
Distributions	(1,450)	(983)
Fair value of plan assets at end of year	$ 31,968	$ 46,017
Funded status recognized as accrued pension cost	$ 1,743	$ 3,720
Amounts recognized in accumulated other comprehensive (income) loss:		
Net loss	$ 8,901	$ 7,621
Deferred income tax benefit	(1,869)	(1,601)
Total amount recognized	$ 7,032	$ 6,020
Accumulated benefit obligation	$ 28,184	$ 38,315

At December 31, 2022, 2021 and 2020, the assumptions used to determine the pension benefit obligation were as follows:

	2022	2021	2020
Discount rate	5.00 %	2.76 %	2.42 %
Rate of compensation increase	3.00	3.50	3.50

Note 8— Defined Benefit Pension Plan (continued)

Components of net periodic benefit cost and other amounts recognized in other comprehensive income (in thousands):

	2022	2021	2020
Components of net periodic pension cost:			
Service cost	$ 786	$ 998	$ 911
Interest cost	1,141	1,042	1,159
Expected return on plan assets	(1,539)	(1,612)	(1,938)
Amortization of prior service costs	—	—	—
Amortization of net loss	309	393	488
Net periodic pension costs	$ 697	$ 821	$ 620
Other changes recognized in other comprehensive (income) loss			
Net loss	$ 1,589	$ 7	$ 378
Amortization of net loss	(309)	(393)	(488)
Deferred tax expense (benefit)	(269)	81	23
Total recognized in accumulated other comprehensive (income) loss	$ 1,011	$ (305)	$ (87)
Total recognized in net periodic pension costs and other comprehensive loss	$ 1,708	$ 516	$ 533

For the years ended December 31, 2022, 2021 and 2020, the assumptions used to determine net periodic pension cost were as follows:

	2022	2021	2020
Discount rate	5.00 %	2.76 %	2.42 %
Expected long-term rate of return on plan assets	3.75	3.75	5.10
Annual salary increase	3.00	3.50	3.50

The expected long-term return on plan assets assumption was developed as a weighted average rate based on the target asset allocation of the plan and the long-term capital market assumptions. The overall return for each asset class was developed by combining a long-term inflation component and the associated expected real rates. The development of the capital market assumptions utilized a variety of methodologies, including, but not limited to, historical analysis, stock valuation models, such as dividend discount models, and earnings yield models, expected economic growth outlook, and market yields analysis.

The Company's pension plan asset allocations at December 31, 2022 and 2021 were as follows:

	2022	2021
Equity securities	10 %	11 %
Debt securities	90	89
Total	100 %	100 %

Note 8— Defined Benefit Pension Plan (continued)

As of December 31, 2022 and 2021, the fair value of plan assets was as follows (in thousands):

	December 31, 2022			
	Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Assets at Fair Value
Cash and cash equivalents	$ 102	$ —	$ —	$ 102
Equity securities	—	3,181	—	3,181
Debt securities	—	28,749	—	28,749
Total pension assets	$ 102	$ 31,930	$ —	$ 32,032

	December 31, 2021			
	Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Assets at Fair Value
Cash and cash equivalents	$ 82	$ —	$ —	$ 82
Equity securities	—	5,154	—	5,154
Debt securities	—	40,782	—	40,782
Total pension assets	$ 82	$ 45,936	$ —	$ 46,018

Assets are valued using a combination of methods including quoted prices for similar assets in active or non-active markets.

The fund is sufficiently diversified to maintain a reasonable level of risk without imprudently sacrificing return. Investments are selected by officers experienced in financial matters and risk management, and implementation of approved investment strategies is monitored on a regular basis. Both actively and passively managed investment strategies are considered, and funds are allocated across asset classes to develop an efficient investment structure.

It is the responsibility of the trustee to consider costs in administering the portfolio, while maintaining high quality investments. Costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs, and other administrative costs which may be charged to the trust.

The Company does not expect to contribute to its pension plan in 2023.

Estimated future benefit payments, which reflect expected future service, as appropriate, are as follows (in thousands):

Years ending December 31,	
2023	$ 1,391
2024	1,402
2025	1,387
2026	1,434
2027	1,533
Following 5 years	9,116

Note 9— Other Post-Retirement Plans

Investment and Savings Plan

The Company has an investment and savings plan for its employees. In the month following date of hire, an employee is eligible to participate in the investment and savings plan if they are at least 18 years old. A participant may elect to defer up to 90% of their annual compensation, not to exceed limitations established by the Internal Revenue Code. The Company contributes on behalf of each participant who makes the election an amount up to

Note 9— Other Post-Retirement Plans (continued)

3.5% of the amount contributed by the participant. The Company's contributions in 2022, 2021 and 2020 totaled $1.02 million, $1.02 million and $990 thousand, respectively, which were included within pensions and other employee benefits on the Statements of Income.

Other Retirement Plans

The Company has a deferred compensation plan for some of its directors and senior officers that provides benefits payable at age 65. The deferred compensation is to be paid to the individual or beneficiary over a period of 15 years. Amounts deferred are invested in increasing whole life insurance policies on the participants' lives with the Company as owner and beneficiary. Amounts recognized for the increase in the cash surrender value of the policies are offset against the expense. The Company recognized net income of $61 thousand in 2022, $57 thousand in 2021 and $51 thousand in 2020, related to this deferred compensation plan.

In 2010, the Company adopted a Supplemental Executive Retirement Plan for a number of its executive officers. The plan is intended to be unfunded and maintained primarily for the purpose of providing deferred compensation to its participants. The benefits of the plan vest incrementally based on years of service. Plan expenses for the years ending December 31, 2022, 2021 and 2020, amounted to $290 thousand, $459 thousand and $442 thousand, respectively.

In 2021, the Company formed a new deferred compensation plan (2021 Deferred Compensation Plan) for current directors and senior officers. The plan is funded with director fees and salary reductions which are placed in a trust account invested by the Company. The trust investments consist of equity investments, fixed income investments, and cash. The trust account balance totaled $496 thousand and $108 thousand at December 31, 2022 and 2021. This balance is included within other assets and is directly offset within other liabilities. Expenses for the trust totaled $212 thousand and $104 thousand, respectively, in 2022 and 2021.

Note 10— Leased Property

Lessor Arrangements

The Company enters into operating leases with customers to lease vacant space in certain owned premises that is not being used by the Company. These operating leases are typically payable in monthly installments with terms ranging from less than one year to thirteen years and may contain renewal options.

The components of lease income, which was included in non-interest expense on the Statements of Income, were as follows for the year ending (in thousands):

	2022	2021	2020
Operating lease income	$ 1,309	$ 181	$ 190
Total lease income	$ 1,309	$ 181	$ 190

The remaining maturities of operating lease receivables as of December 31, 2022 are as follows (in thousands):

	Operating Leases
Leases	
2023	$ 2,354
2024	1,454
2025	1,418
2026	810
2027	509
Thereafter	1,594
Total lease receivables	$ 8,139

Note 10— Leased Property (continued)

Lessee Arrangements

The Company has entered into leases for branches and office space. The leases are evaluated for whether the lease will be classified as either finance or operating. Certain leases offer the option to extend the lease term, and the Company has included such extensions in its calculation of the lease liabilities to the extent the options are reasonably assured of being exercised. Including renewal options, the Company's leases range from less than one year to thirteen years. The lease agreements do not provide for residual value guarantees and have no restrictions or covenants that would impact dividends or require incurring additional financial obligations.

Lease liabilities represent the Company's obligation to make lease payments and are presented at each reporting date as the net present value of the remaining contractual cash flows. These cash flows are discounted at the Company's incremental borrowing rate in effect at the commencement date of the lease. The right-of-use asset and lease liability are included in other assets and other liabilities, respectively, in the Balance Sheets.

In the fourth quarter of 2022 the Company sold two buildings in separate transactions and entered into sale-leaseback agreements to lease back the properties for up to one year. The lease terms were at market with third-parties and will result in $881 thousand of operating lease expense in 2023. The sale of the two buildings resulted in a realized gain of $3.7 million.

Right-of-use assets and liabilities by lease type, and the associated balance sheet classifications are as follows (in thousands):

	Balance Sheet Classification	2022	2021
Right-of-use assets:			
Operating leases	Other assets	$ 7,255	$ 7,869
Finance leases	Other assets	2,620	2,824
Total right-of-use assets		$ 9,875	$ 10,693
Lease liabilities:			
Operating leases	Other liabilities	$ 7,592	$ 8,268
Finance Leases	Other liabilities	2,745	2,897
Total lease liabilities		$ 10,337	$ 11,165

The components of total lease cost were as follows for the period ending (in thousands):

	2022	2021	2020
Finance lease cost			
Right-of-use asset amortization	$ 204	$ 207	$ 34
Interest expense	63	39	6
Operating lease cost	2,495	2,517	2,344
Total lease cost	$ 2,762	$ 2,763	$ 2,384

The Company's future undiscounted lease payments for finance and operating leases with initial terms of one year or more as of December 31, 2022 are as follows (in thousands):

	Operating Leases	Finance Leases
2023	$ 3,474	$ 220
2024	2,294	224
2025	839	228
2026	415	233
2027	366	238
Thereafter	626	2,033
Total undiscounted lease payments	8,014	3,176

Note 10— Leased Property (continued)

Less: Discount	(422)	(431)
Net lease liabilities	$ 7,592	$ 2,745

The following table presents additional information about the Company's leases as of December 31, 2022 and 2021.

Supplemental lease information (dollars in thousands)	**2022**	**2021**
Finance lease weighted average remaining lease term (years)	12.76	13.76
Finance lease weighted average discount rate	2.22 %	2.22 %
Operating lease weighted average remaining lease term (years)	3.26	4.12
Operating lease weighted average discount rate	3.19 %	2.89 %
Cash paid for amounts included in the measurement of lease liabilities		
Operating cash flows from operating leases	$ 2,557	$ 2,323
Operating cash flows from finance leases	$ 63	$ 39
Financing cash flows from finance leases	$ 152	$ 152
Right-of-use assets obtained in exchange for new finance lease liabilities	$ —	$ —
Right-of-use assets obtained in exchange for new operating lease liabilities	$ 1,558	$ 856

Note 11— Regulatory Capital Matters

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, "prompt corrective action" regulations, involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. Under the Basel Committee on Banking Supervision's capital guidelines for U.S. Banks ("Basel III rules"), an entity must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The net unrealized gain or loss on available-for-sale securities is not included in computing regulatory capital. Management believes as of December 31, 2022, the Company and the Bank meet all capital adequacy requirements to which they are subject.

"Prompt corrective action" regulations provide five classifications: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized," although these terms are not used to represent overall financial condition. If "adequately capitalized," regulatory approval is required to accept brokered deposits. If "undercapitalized," capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. As of December 31, 2022 and 2021, the most recent notification from the FDIC categorized the Bank as "well capitalized" under the regulatory framework for "prompt corrective action."

The table below presents the actual and required capital amounts and ratios for the Company at December 31, 2022 and the Bank at December 31, 2022 and 2021 (in thousands).

Note 11— Regulatory Capital Matters (continued)

	Actual		Minimum Required for Capital Adequacy Purposes (includes applicable capital conservation buffer)		To Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2022						
Total Capital to risk weighted assets						
Consolidated	$ 433,958	18.88 %	$ 183,867	≥ 8.0%	n/a	n/a
Burke & Herbert Bank & Trust	$ 432,290	18.81 %	$ 183,900	≥ 8.0%	$ 229,874	≥ 10.0%
Tier 1 (Core) Capital to risk weighted assets						
Consolidated	412,946	17.97	137,900	≥ 6.0	n/a	n/a
Burke & Herbert Bank & Trust	411,251	17.89	137,925	≥ 6.0	183,900	≥ 8.0
Common Tier 1 (CET 1) to risk-weighted assets						
Consolidated	412,946	17.97	103,425	≥ 4.5	n/a	n/a
Burke & Herbert Bank & Trust	411,251	17.89	103,443	≥ 4.5	149,418	≥ 6.5
Tier 1 (Core) Capital to average assets						
Consolidated	412,946	11.34	145,605	≥ 4.0	n/a	n/a
Burke & Herbert Bank & Trust	411,251	11.30	145,605	≥ 4.0	182,007	≥ 5.0
As of December 31, 2021						
Total Capital to risk weighted assets						
Burke & Herbert Bank & Trust	$ 409,923	18.84 %	$ 174,050	≥ 8.0%	$ 217,562	≥ 10.0%
Tier 1 (Core) Capital to risk weighted assets						
Burke & Herbert Bank & Trust	382,672	17.59	130,537	≥ 6.0	174,050	≥ 8.0
Common Tier 1 (CET 1) to risk-weighted assets						
Burke & Herbert Bank & Trust	382,672	17.59	97,903	≥ 4.5	141,415	≥ 6.5
Tier 1 (Core) Capital to average assets						
Burke & Herbert Bank & Trust	382,672	10.81	141,594	≥ 4.0	176,992	≥ 5.0

The Company's principal source of funds for dividend payments is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies. As of December 31, 2022, approximately $190.9 million of retained earnings was available for dividend declaration without regulatory approval.

Note 12— Derivatives

The Company utilizes interest rate swap agreements as part of its asset liability management strategy to help manage its interest rate risk position. The notional amount of the interest rate swaps does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual interest rate swap agreements.

Cash flow hedges of interest rate risk

The Company's objectives in using interest rate derivatives are to add stability to net interest income and to manage exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. During 2022, such derivatives were used to hedge the variable cash flows associated with variable-rate assets.

For derivatives designated and that qualify as cash flow hedges of interest rate risk, the gain or loss on the derivative is recorded in Accumulated Other Comprehensive Income and subsequently reclassified into interest income in the same period(s) during which the hedged transaction affects earnings. Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest income as interest payments are received on the Company's variable-rate asset. During 2022, the Company estimates that an additional $1.6 million will be reclassified as a reduction to interest income.

Derivatives not designated as hedges

The Company enters into interest rate swaps with its loan customers to facilitate their financing requests. Upon entering into swaps with our loan customers, the Company will enter into corresponding offsetting derivatives with third parties. These derivatives represent economic hedges and do not qualify as hedges for accounting. These back-to-back interest rate swaps are reported at fair value in "other assets" and "other liabilities" in the Company's Balance Sheets. Changes in the fair value of interest rate swaps are recorded in other non-interest expense and sum to zero because of offsetting terms of swaps with borrowers and swaps with dealer counterparties.

The table below presents the fair value of the Company's derivative financial instruments, which includes accrued interest, as well as their classification on the Balance Sheet as of December 31, 2022 and 2021 (in thousands):

	December 31, 2022		
	Balance Sheet Location	Notional Amount	Fair Value
Derivatives designated as hedges:			
Interest rate swaps related to cash flow hedges	Other liabilities	$ 50,000	$ 2,254
Derivatives not designated as hedges:			
Interest rate swaps related to customer loans	Other assets	$ 34,674	$ 1,311
Interest rate swaps related to customer loans	Other liabilities	$ 34,674	$ 1,311

	December 31, 2021		
	Balance Sheet Location	Notional Amount	Fair Value
Derivatives designated as hedges:			
Interest rate swaps related to cash flow hedges	N/A	$ —	$ —
Derivatives not designated as hedges:			
Interest rate swaps related to customer loans	Other liabilities	$ 37,508	$ 1,630
Interest rate swaps related to customer loans	Other assets	$ 37,508	$ 1,630

Note 12— Derivatives (continued)

The effect of cash flow hedge accounting on accumulated other comprehensive income (AOCI) for the years ended December 31 2022, 2021, and 2020 are as follows (in thousands):

Derivatives in Cash Flow Hedging Relationships	Amount of Gain or (Loss) Recognized in AOCI on Derivative 2022	2021	2020	Location of Gain or (Loss) Reclassified from AOCI into Income	Amount of Gain or (Loss) Reclassified from AOCI into Income 2022	2021	2020
Interest Rate Products	$ (2,178)	$ —	$ —	Interest Income	$ (167)	$ —	$ —
Total	$ (2,178)	$ —	$ —		$ (167)	$ —	$ —

The table below presents the effect of the Company's derivative financial instruments on the Statements of Income as of December 31, 2022. Prior to 2022, the Company did not have derivatives designated as hedges.

	Location and Amount of Gain or (Loss) Recognized in Income on Fair Value and Cash Flow Hedging Relationships					
	December 31, 2022		December 31, 2021		December 31, 2020	
	Interest Income	Interest Expense	Interest Income	Interest Expense	Interest Income	Interest Expense
Total amounts of income and expense line items presented in the statement of financial performance in which the effects of fair value or cash flow hedges are recorded.	$ (167)	$ —	$ —	$ —	$ —	$ —
Gain or (loss) on cash flow hedging relationships in Subtopic 815-20						
Interest contracts						
Amount of gain or (loss) reclassified from accumulated other comprehensive income into income	(167)	—	—	—	—	—
Amount of gain or (loss) reclassified from accumulated other comprehensive income into income as a result that a forecasted transaction is no longer probable of occurring	—	—	—	—	—	—

Note 13— Commitments and Contingencies

Interest rate lock commitments

Commitments to fund consumer mortgage loans (interest rate lock commitments) to be sold into the secondary market are considered derivatives. The Company enters into best effort forward commitments for the future delivery of mortgage loans to third-party investors. The Company has elected the FVO option on both the best efforts forward commitments and the consumer mortgage loan held for sale in order to economically hedge the effect of changes in interest rates resulting from the commitment to fund the loans. These mortgage banking derivatives are not designated in hedge relationships.

The net gains (losses) relating to the free-standing derivative instruments (interest rate lock commitments) were $(13) thousand, $13 thousand and $645 thousand at December 31, 2022, 2021 and 2020, respectively. At December 31, 2022, we had no mortgage loans held for sale and no interest rate lock commitments outstanding. In comparison, the notional amount of mortgage loan pipeline that resulted in interest rate lock commitments at December 31, 2021 and 2020 was $926 thousand and $24.7 million. Interest Rate lock commitments are not designated as hedging instruments, and therefore changes in the fair value of these free-standing derivative instruments are reported as non-interest income.

Note 13— Commitments and Contingencies (continued)

Credit extension commitments

The Company's financial statements do not reflect various financial instruments which arise in the normal course of business and which involve elements of credit risk, interest rate risk and liquidity risk. These financial instruments include commitments to extend credit, commercial letters of credit, and revolving lines of credit.

A summary of the contractual amounts of the Company's financial instruments outstanding at December 31, 2022 and 2021, is as follows (in thousands):

	2022	2021
Commitments to extend credit	$ —	$ —
Commercial letters of credit	8,539	7,660
Undisbursed balance - revolving lines of credit	291,265	240,179

Commitments to extend credit, commercial letters of credit and revolving lines of credit all include exposure to some credit loss in the event of nonperformance of the customer. The Company's credit policies and procedures for credit commitments and financial guarantees are the same as those for extensions of credit that are recorded on the Balance Sheets. Many of these instruments have fixed maturity dates, and many of them will expire without being drawn upon; accordingly, they do not generally present any significant liquidity risk to the Company.

Litigation

The Company is a party to litigation and claims arising in the normal course of business. Management, after consultation with legal counsel, believes that the liabilities, if any, arising from such litigation and claims will not be material to the Company's financial position.

Note 14— Transactions with Related Parties

Loans to directors and principal officers, including their immediate families and affiliated companies in which they have a direct or indirect material interest, are considered to be related parties.

Aggregate loan balances with related parties were as follows (in thousands):

	2022
Balance, beginning	$ 73,726
New loans	28,598
Repayments	(5,927)
Balance, ending	$ 96,397

None of the loans are past due, on nonaccrual status or have been restructured to provide a reduction or deferral of interest or principal because of deterioration in the financial position of the borrower. There were no loans to a related party that were considered classified loans at December 31, 2022 or 2021.

Deposits from related parties at year-end 2022 and 2021 were $109,071 and $102,268 (in thousands).

Note 15— Fair Value Measurements

Determination of Fair Value

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1 – Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Note 15— Fair Value Measurements (continued)

Level 2 – Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 – Significant unobservable inputs that reflect our own assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate fair value:

Investment securities

The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2), using matrix pricing Matrix pricing is a mathematical technique commonly used to price debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on securities' relationship to other benchmark quoted securities (Level 2 inputs). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3).

Derivatives

The fair values of derivatives are based on valuation models using observable market data as of the measurement date (Level 2). The Company has contracted with a third-party vendor to provide valuations for interest rate swaps using standard swap valuation techniques. The Company has considered counterparty credit risk in the valuation of its interest rate swap assets and has considered its own credit risk in the valuation of its interest rate swap liabilities. The Company recognizes interest rate lock commitments at fair value. Fair value of interest rate lock commitments is based on the price of underlying loans obtained from an investor for loans that will be delivered on a best effort basis (Level 2).

Loans held for sale, at fair value

The fair value of loans held for sale is determined using quoted prices for similar assets, adjusted for specific attributes of that loan (Level 2). These loans currently consist of one-to-four family residential loans originated for sale in the secondary market.

The following describes the valuation techniques used by the Company to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements:

Impaired loans

Loans are designated as impaired, when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected when due. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Generally, the fair value of impaired loans with specific allocations of the allowance for loan losses is based on recent real estate appraisals. Fair value is measured based on the value of the collateral securing the loans, less estimated costs of disposal. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Statements of Income and will result in a Level 3 fair value classification. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 fair value classification.

Note 15— Fair Value Measurements (continued)

Other real estate owned

Assets acquired through foreclosure or other proceedings are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually. Any fair value adjustments are recorded in the period incurred and expensed against current earnings.

Assets and liabilities measured at fair value on a recurring basis are summarized below (in thousands):

	Fair Value Measurements at December 31, 2022 Using:			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial assets				
Investment Securities				
U.S. Treasuries and government agencies	$ 174,993	$ —	$ —	$ 174,993
Obligations of state and municipalities	—	453,907	—	453,907
Residential mortgage backed - agency	—	53,061	—	53,061
Residential mortgage backed - non-agency	—	339,295	—	339,295
Commercial mortgage backed - agency	—	59,933	—	59,933
Commercial mortgage backed - non-agency	—	183,299	—	183,299
Asset backed	—	98,626	—	98,626
Other	—	8,643	—	8,643
Total investment securities available-for-sale	$ 174,993	$ 1,196,764	$ —	$ 1,371,757
Loans held for sale, at fair value	$ —	$ —	$ —	$ —
Derivatives	$ —	$ 1,311	$ —	$ 1,311
Financial liabilities				
Derivatives	$ —	$ 3,565	$ —	$ 3,565

Note 15— Fair Value Measurements (continued)

	Fair Value Measurements at December 31, 2021 Using:			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial assets				
Investment Securities				
U.S. Treasuries and government agencies	$ 169,382	$ 15,059	$ —	$ 184,441
Obligations of state and municipalities	—	665,567	—	665,567
Residential mortgage backed - agency	—	62,787	—	62,787
Residential mortgage backed - non-agency	—	244,308	—	244,308
Commercial mortgage backed - agency	—	78,883	—	78,883
Commercial mortgage backed - non-agency	—	172,204	—	172,204
Asset backed	—	195,525	—	195,525
Other	—	1,966	—	1,966
Total investment securities available-for-sale	$ 169,382	$ 1,436,299	$ —	$ 1,605,681
Loans held for sale, at fair value	$ —	$ 1,249	$ —	$ 1,249
Derivatives	$ —	$ 1,603	$ —	$ 1,603
Financial liabilities				
Derivatives	$ —	$ 1,589	$ —	$ 1,589

Assets that were measured at fair value on a nonrecurring basis during the period are summarized below (in thousands):

	Fair Value Measurements at December 31, 2022 Using:			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired Loans:				
Commercial Real Estate	$ —	$ —	$ 290	$ 290
Owner-occupied commercial real estate	—	—	1,295	1,295
Acquisition, construction & development	—	—	—	—
Commercial & industrial	—	—	—	—
Single family residential	—	—	911	911
Consumer non-real estate and other	—	—	—	—
Other real estate owned	—	—	—	—

Note 15— Fair Value Measurements (continued)

	Fair Value Measurements at December 31, 2021 Using:			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired Loans:				
Commercial Real Estate	$ —	$ —	$ 12,552	$ 12,552
Owner-occupied commercial real estate	—	—	502	502
Acquisition, construction & development	—	—	—	—
Commercial & industrial	—	—	—	—
Single family residential	—	—	2,052	2,052
Consumer non-real estate and other	—	—	—	—
Other real estate owned	—	—	—	—

The following table presents quantitative information about Level 3 Fair Value Measurements for assets measured at fair value on a non-recurring basis at December 31, 2022 and 2021 (in thousands except for percentages):

Description	Fair Value	Valuation Techniques	Unobservable Inputs	Range	Weighted Average
December 31, 2022					
Impaired loans	$ 2,496	Discounted cash flow analysis	Market rate for borrower	4.5% - 6%	5.2%
December 31, 2021					
Impaired loans	$ 15,106	Discounted appraised value		7% - 9%	8.0%
		Discounted cash flow analysis	Market rate for borrower	4% - 6%	5.4%

Fair value of financial instruments

The carrying amounts and estimated fair values of financial instruments not carried at fair value, at December 31, 2022 and 2021 were as follows (in thousands):

		Fair Value Measurements at December 31, 2022 Using:			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial Assets					
Cash and due from banks	$ 9,124	$ 9,124	$ —	$ —	$ 9,124
Interest-bearing deposits with banks	41,171	41,171	—	—	41,171
Loans, net	1,866,182	—	—	1,768,903	1,768,903
Accrued interest	15,481	—	15,481	—	15,481
Financial liabilities					
Non-interest-bearing	$ 960,692	$ —	$ 960,692	$ —	$ 960,692
Interest-bearing	1,959,708	—	1,951,227	—	1,951,227
Other borrowed funds	343,100	—	342,904	—	342,904
Accrued interest	1,452	—	1,452	—	1,452

Note 15— Fair Value Measurements (continued)

		Fair Value Measurements at December 31, 2021 Using:			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial Assets					
Cash and due from banks	$ 8,989	$ 8,989	$ —	$ —	$ 8,989
Interest-bearing deposits with banks	68,374	68,374	—	—	68,374
Loans, net	1,713,364	—	—	1,697,752	1,697,752
Accrued interest	15,253	—	15,253	—	15,253
Financial liabilities					
Non-interest-bearing	$ 930,847	$ —	$ 930,847	$ —	$ 930,847
Interest-bearing	2,002,570	—	2,002,089	—	2,002,089
Other borrowed funds	275,000	—	274,999	—	274,999
Accrued interest	309	—	309	—	309

Note 16— Common Stock Transactions

On November 15, 2022, the Company effected a forty-for-one stock split of its Common Stock by issuing thirty-nine additional shares of Common Stock for each outstanding share of Common Stock of record as of November 9, 2022. All share and earnings per share information have been retroactively adjusted to reflect the stock split within the financial statements and notes to the financial statements.

In 2022, the Company reissued 2,000 shares of treasury stock to satisfy the vesting of restricted stock units. No other purchase or sale of the Company's Common Stock occurred in 2022.

In 2021, the Company purchased shares of its own Common Stock on the open market in arms-length transactions. It acquired 90,040 shares at an aggregate cost of $4.4 million at prices ranging from $45.25 to $50.00 per share. Additionally, in early August 2021 the Company sold 64,000 shares to certain of its directors, pursuant to a private placement exemption from registration for aggregate consideration of $3.2 million and reissued 1,720 shares of treasury stock to satisfy the vesting of restricted stock units.

In 2020, the Company acquired 30,240 shares at an aggregate cost of $1.545 million at prices ranging from $46.88 to $56.25 per share.

During 2022, 2021 and 2020, the Company declared and paid cash dividends of $2.12, $2.00, and $2.00 per share, respectively.

Note 17— Accumulated Other Comprehensive Income (Loss)

The following table presents changes in accumulated other comprehensive income (loss) by component, net of tax, for the years ending December 31, 2022, 2021 and 2020 (in thousands):

	December 31, 2022			
	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Accumulated Other Comprehensive Income
Beginning Balance	$ —	$ 12,975	$ (6,020)	$ 6,955
Net unrealized gains (losses)	(1,721)	(144,209)	—	(145,930)
Less: net realized (gains) losses reclassified to earnings	132	359	—	491
Net change in pension plan benefits	—	—	(1,011)	(1,011)
Ending Balance	$ (1,589)	$ (130,875)	$ (7,031)	$ (139,495)

	December 31, 2021			
	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Accumulated Other Comprehensive Income
Beginning Balance	$ —	$ 28,905	$ (6,325)	$ 22,580
Net unrealized gains (losses)	—	(15,933)	—	(15,933)
Less: net realized (gains) losses reclassified to earnings	—	3	—	3
Net change in pension plan benefits	—	—	305	305
Ending Balance	$ —	$ 12,975	$ (6,020)	$ 6,955

	December 31, 2020			
	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Accumulated Other Comprehensive Income
Beginning Balance	$ —	$ 7,838	$ (6,412)	$ 1,426
Net unrealized gains (losses)	—	22,603	—	22,603
Less: net realized (gains) losses reclassified to earnings	—	(1,536)	—	(1,536)
Net change in pension plan benefits	—		87	87
Ending Balance	$ —	$ 28,905	$ (6,325)	$ 22,580

Note 17— Accumulated Other Comprehensive Income (Loss) (continued)

The following table presents amounts reclassified out of each component of accumulated other comprehensive income (loss) for the years ending December 31, 2022, 2021, and 2020 (in thousands).

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified From Accumulated Other Comprehensive Income 2022	2021	2020	Affected Line Item in the Statements of Income
Cash flow hedges:				
Interest rate contracts	$ (167)	$ —	$ —	Interest income
Tax effect	35	—	—	Income tax expense (benefit)
Net of Tax	$ (132)	$ —	$ —	
Available-for-sale securities:				
Realized gains (losses) on securities	$ (454)	$ (4)	$ 1,944	Net gains/(losses) on securities
Tax effect	95	1	(408)	Income tax expense (benefit)
Net of Tax	$ (359)	$ (3)	$ 1,536	
Defined benefit pension plan:				
Amortization of actuarial gain / (loss)	$ 1,280	$ (386)	$ 110	Pension and other employee benefits
Tax effect	(269)	81	(23)	Income tax expense (benefit)
Net of Tax	$ 1,011	$ (305)	$ 87	
Total reclassifications, net of tax	$ 520	$ (308)	$ 1,623	Net income

Note: The Defined benefit pension plan items are included in the computation of net periodic pension cost. See Note 8 — Defined Benefit Pension Plan, for additional information.

Note 18— Parent Company Financial Information

The following tables summarize condensed financial statements for Burke and Herbert Financial Services Corp. for the periods indicated (in thousands):

Parent Company Only Condensed Balance Sheet

	2022
Assets	
Cash	$ 2,000
Investment in subsidiary	271,757
Other assets	209
Total Assets	$ 273,966
Liabilities	
Other liabilities	$ 513
Total Liabilities	513
Total Shareholders' Equity	273,453
Total Liabilities and Shareholders' Equity	$ 273,966

Note 18— Parent Company Financial Information (continued)

Parent Company Only Condensed Statement of Income

	2022
Income	
Dividends from bank subsidiary	$ 5,936
Total Income	5,936
Expense	
Salaries and employee benefit	426
Other operating expenses	568
Total Expense	994
Income (loss) before income tax benefit and equity in undistributed income of subsidiaries	4,942
Income tax benefit	209
Income (loss) before equity in undistributed income of subsidiaries	5,151
Equity in undistributed earnings of subsidiary	38,862
Net Income	$ 44,013

Parent Company Only Condensed Statement of Cash Flows

	2022
Cash Flows from Operating Activities	
Net income	$ 44,013
Adjustments to reconcile net income to net cash provided by operating activities:	
Equity in undistributed income of subsidiaries	(38,862)
Share based compensation	481
Deferred income taxes	(105)
Net change in other assets	513
Net change in other liabilities	(104)
Net cash flows provided by operating activities	5,936
Cash Flows from Investing Activities	—
Net cash (used in) provided by investing activities	—
Cash Flows from Financing Activities	
Dividends paid	(3,936)
Net cash (used in) financing activities	(3,936)
Increase in cash and cash equivalents	$ 2,000
Cash and cash equivalents	
Beginning of the year	$ —
End of the year	2,000

Note 19— Other Operating Expense

Other operating expense from the Statements of Income for years ended December 31, 2022, 2021 and 2020 is as follows (in thousands):

	2022	2021	2020
Directors' fees	$ 1,941	$ 1,093	$ 1,147
Consultant fees	1,708	1,548	1,064
Marketing expense	1,295	1,086	509
Historic tax credit amortization	2,526	2,717	2,718
Virginia franchise tax	2,492	2,366	2,249
(Recapture of) Provision for off-balance sheet exposure	—	—	(1,380)
Network expense	1,693	1,592	1,459
FDIC assessment	958	920	460
IT related	1,980	1,306	965
(Gain)/loss on sale of buildings	(4,533)	(1,063)	7
Legal expense	986	275	369
Audit expense	705	302	220
Other	5,668	5,627	5,963
Total	$ 17,419	$ 17,769	$ 15,750

Note 20— Qualified Affordable Housing Project and Historic Tax Investments

The Company invests in qualified affordable housing projects. At December 31, 2022 and 2021, the balance of the investment for qualified affordable housing projects was $23.5 million and $29.7 million, respectively. These balances are reflected in the other assets line on the Balance Sheets. Total unfunded commitments related to the investments in qualified affordable housing projects totaled $0.8 million and $1.6 million at December 31, 2022 and 2021, respectively. The Company expects to fulfill the majority of these commitments by 2024.

During the year ended December 31, 2022, 2021, and 2020, the Company recognized total amortization expense of $6.1 million, $6.8 million, and $7.1 million, respectively. In 2022, 2021, and 2020, $2.5 million, $2.7 million, and $2.7 million was included in non-interest expense on the Statements of Income related to historic tax credit investments that do not qualify for the proportional amortization method. The remainder of the amortization expense was recorded as income tax expense.

Note 21— Revenue from Contracts with Customers

All of the Company's revenue from contracts with customers in the scope of ASC 606 is recognized within non-interest income. ASC 606 is applicable to non-interest revenue streams, such as trust and wealth management income, deposit related fees, interchange fees, merchant income, and annuity and insurance commissions.

The following table presents the components of non-interest income for the years ended December 31, 2022, 2021, and 2020 (in thousands):

	2022	2021	2020
Service charges and fees (1)			
Debit card fees	$ 4,454	$ 4,413	$ 3,743
Deposit related fees	2,308	1,792	1,869
Other fees	93	123	88
Fiduciary and wealth management (1)			
Trust fees	3,176	3,297	3,067
Advisory fees	1,575	1,342	950
Other fees	558	523	434
Net gains (losses) on securities (2)	(454)	(4)	1,944
Income from life insurance (2)	2,656	2,325	2,303
Other non-interest income (1)			
FHLB dividend (2)	484	409	501
Merchant & credit card fees	801	730	576
Safety deposit fees	394	411	394
Servicing release premium	58	1,303	1,374
Wire fees	358	372	338
Other non-interest (3)	626	215	1,423
Total non-interest income	$ 17,087	$ 17,251	$ 19,004

(1) Income within the scope of ASC 606 - Revenue Recognition

(2) Income excluded from the scope of ASC 606 - Revenue Recognition

(3) Includes income that arises from the Company electing the FVO as stated that is not within the scope of ASC 606.

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

Income from fiduciary & wealth management activities

Fiduciary and wealth management income is primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Company's performance obligation is generally satisfied over time and the resulting fees are recognized monthly, based upon the month-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after month end through a direct charge to customers' accounts. The Company does not earn performance-based incentives. Optional services such as real estate sales and tax return preparation services are also available to existing trust and asset management customers. The Company's performance obligation for these transactional-based services is generally satisfied at a point in time (i.e., as incurred), and that allows the Company to recognize the related revenue associated with that transaction. Payment is received shortly after services are rendered.

Annuity and insurance income primarily consists of commissions received on annuity product sales. The Company acts as an intermediary between the Company's customer and the insurance carrier. The Company's performance obligation is generally satisfied upon the issuance of the annuity policy. Shortly after the policy is issued, the carrier remits the commission payment to the Company, and the Company recognizes the revenue. The Company does not earn a significant amount of trailer fees on annuity sales. The majority of the trailer fees relates to variable annuity

Note 21— Revenue from Contracts with Customers (continued)

products and are calculated based on a percentage of market value at period end. Revenue is not recognized until the annuity's market value can be determined.

Other non-interest income consists of other recurring revenue streams, such as commissions from sales of mutual funds and other investments, investment advisor fees from the Company's wealth management product, safety deposit box rental fees, and other miscellaneous revenue streams. Commissions from the sale of mutual funds and other investments are payable on the trade date and are received in the following month, which is when the Company has satisfied its performance obligation. The Company also receives periodic service fees (i.e., trailers) from mutual fund companies typically based on a percentage of net asset value. Trailer revenue is recorded over time, usually monthly or quarterly, as net asset value is determined. Investment advisor fees from the wealth management product are earned over time and based on an annual percentage rate of the net asset value. The investment advisor fees are charged to the customer's account in advance on the first month of the quarter, and the revenue is recognized over the following three-month period.

Service charges and fees

Service charges and fees on deposit accounts consist of monthly service fees, check orders, and other deposit account related fees. Check orders and other deposit account related fees are largely transactional based, and therefore, the Company's performance obligation is satisfied at a point in time, and the related revenue recognized. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers' accounts.

Fees, exchange, and other service charges are primarily comprised of debit and credit card income, ATM fees, merchant services income, and other service charges. Debit and credit card income is primarily comprised of interchange fees earned whenever the Company's debit and credit cards are processed through card payment networks such as Visa. Merchant services income mainly consists of fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. Other service charges include revenue from processing wire transfers, bill pay service, cashier's checks, and other services. The Company's performance obligation for fees, exchange, and other service charges are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month.

Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Company determined that since rentals and renewals occur fairly consistently over time, revenue is recognized on a basis consistent with the duration of the performance obligation.

Note 22— Share-Based Compensation

The Company has a share-based incentive plan described below that allows it to offer a variety of equity compensation awards subject to approval. Total compensation cost that has been charged against income for the awards granted was $2.0 million, $283 thousand and $146 thousand for 2022, 2021 and 2020, respectively. The total income tax benefit was $421 thousand, $59 thousand and $31 thousand for 2022, 2021 and 2020, respectively.

<u>2019 Stock Incentive Plan</u>

In 2019, the Company's Stock Incentive Plan ("2019 SIP") was approved by the Board of Directors. The 2019 SIP provides for the issuance of stock-based awards to directors and employees of the Company. The 2019 SIP authorized the issuance of 240,000 units to be issued and the Company has a practice of using shares held as treasury stock to satisfy these awards. Each unit represents a contingent right to receive one common share or an equivalent amount of cash, or a combination of the two, at the discretion of the Company. Currently, we have a sufficient number of treasury shares to satisfy outstanding equity awards.

Under the 2019 SIP, the Company has issued restricted stock units ("RSUs") that are both time-based and performance-based. Each RSU award will indicate the number of shares, the conditions (e.g., service, performance, and/or a combination), and the grant date. Compensation expense is recognized over the vesting period of the awards based on the fair value of the award at grant date. A total of 13,160, 106,040, and 4,160 shares were issued in 2022, 2021, and 2020, respectively.

Note 22— Share-Based Compensation continued

For time-based RSUs, the fair value was determined by using the closing stock price on the date prior to the grant date. These RSUs vest over three to five years.

In 2021, the Board of Directors approved performance-based RSUs that may be earned between a three to five year performance period. Whether units are earned at the end of the performance period will be determined based on the achievement of a market capitalization target over the performance period. If the condition is not achieved, the grant recipient will receive 50% of the units. If the condition is achieved, the grant recipient will receive a 100% of the units granted.

The fair value for performance-based RSUs was determined by using a Monte Carlo simulation analysis to estimate the market capitalization of the Company and whether the market capitalization met the required hurdle over a thirty-day trading period. The simulation analysis required the following inputs: (1) expected term, (2) expected volatility, (3) risk-free rate, and (4) dividend yield. The expected term was based on the stated performance period. Management used the expected volatility from a peer group. The risk-free interest rate is based on the U.S. Treasury yield curve over the performance period. The dividend yield assumption was based on historical and anticipated dividend payouts.

The following is a summary of the Company's RSUs:

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2022	112,880	$ 47.49
Granted	13,160	54.78
Vested	(2,000)	59.87
Forfeited	(1,600)	52.92
Nonvested at December 31, 2022	122,440	$ 48.00

As of December 31, 2022, there was $3.6 million of total unrecognized compensation costs related to nonvested shares granted under the 2019 SIP. The cost is expected to be recognized over a weighted average period of 1.95 years.

Note 23— Earnings Per Share

Basic earnings per share excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential impact of contingently issuable shares.

The following shows the weighted average number of shares used in computing earnings per share and the effect of weighted average number of shares dilutive potential Common Stock. Dilutive potential Common Stock has no effect on income available to common shareholders.

	2022	2021	2020
Net income (in thousands)	$ 44,013	$ 36,165	$ 26,499
Weighted average number of shares	7,425,088	7,424,405	7,453,651
Options effect of dilutive shares	42,629	5,659	809
Weighted average dilutive shares	7,467,717	7,430,064	7,454,460
Basic EPS	$ 5.93	$ 4.87	$ 3.56
Diluted EPS	5.89	4.87	3.55

Stock awards equivalent to zero, 462, and 5,727 shares of Common Stock were not considered in computing diluted earnings per common share for 2022, 2021, and 2020, respectively, because they were antidilutive.

INDEPENDENT AUDITOR'S REPORT

Shareholders and the Board of Directors
of Burke & Herbert Financial Services Corp.
Alexandria, Virginia

Report on the Audit of the Financial Statements

Opinion

We have audited the consolidated financial statements of Burke & Herbert Financial Services Corp., which comprise the consolidated balance sheets as of December 31, 2022 and 2021, and the related consolidated statements of income, comprehensive income (loss), changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of Burke & Herbert Financial Services Corp. 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 also have audited, in accordance with auditing standards generally accepted in the United States of America, Burke & Herbert Financial Services Corp.'s internal control over financial reporting as of December 31, 2022, based on criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) relevant to reporting objectives for the express purpose of meeting the regulatory requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and our report dated February 24, 2023 expressed an unmodified opinion.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of Burke & Herbert Financial Services Corp. 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.

Other Matter

The consolidated financial statements of Burke & Herbert Financial Services Corp. for the year ended December 31, 2020, were audited by other auditors, who expressed an unmodified opinion on those statements on March 8, 2021. As disclosed in Note 1 of the consolidated financial statements, a reorganization occurred during 2022 from Burke & Herbert Bank & Trust Company to Burke & Herbert Financial Services Corp.

Responsibilities of Management for the Financial Statements

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

In preparing the consolidated financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about Burke & Herbert Financial Services Corp.'s ability to continue as a going concern for one year from the date the consolidated financial statements are available to be issued.

Auditor's Responsibilities for the Audit of the Financial Statements

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

In performing an audit in accordance with GAAS, we:

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

CROWE LLP

Crowe LLP

Washington, D.C.
February 24, 2023