

Southern Financial Corporation

Report on Consolidated Financial Statements

For the years ended December 31, 2022 and 2021

Southern Financial Corporation

Contents

Page

Independent Auditor's Report	2-3
---	------------

Financial Statements

Consolidated Statements of Financial Condition.....	4
Consolidated Statements of Income.....	5
Consolidated Statements of Comprehensive Income (Loss)	6
Consolidated Statements of Changes in Shareholders' Equity.....	7
Consolidated Statements of Cash Flows.....	8-9
Notes to Consolidated Financial Statements.....	10-43

Independent Auditor's Report

The Board of Directors
Southern Financial Corporation and Subsidiary
Spartanburg, South Carolina

Opinion

We have audited the consolidated financial statements of Southern Financial Corporation and Subsidiary (the "Company"), which comprise the consolidated statements of financial condition as of December 31, 2022 and 2021, the related consolidated statements of income, comprehensive income (loss), changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements (collectively, the "financial statements").

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

Basis for Opinion

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

Responsibilities of Management for the Financial Statements

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

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

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the 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 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 financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances.
- 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 financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the Company's ability to continue as a going concern for a reasonable period of time.

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



Greenville, South Carolina
March 30, 2023

Southern Financial Corporation

Consolidated Statements of Financial Condition

As of December 31, 2022 and 2021

	2022	2021
Assets		
Cash and due from banks	\$ 4,332,774	\$ 2,724,196
Federal funds sold	6,790,606	7,267,267
Total cash and cash equivalents	11,123,380	9,991,463
Certificates of deposit with other banks	-	648,000
Securities available-for-sale	48,119,875	27,788,697
Restricted equity securities	72,500	46,500
Loans receivable, net of allowance for loan losses net of \$1,526,226 and \$961,926, respectively	150,590,078	99,268,073
Accrued interest receivable	689,021	399,291
Premises and equipment	7,547,195	3,151,005
Foreclosed real estate	273,328	553,984
Bank owned life insurance	4,207,886	2,106,557
Deferred tax assets, net of deferred tax liabilities	1,378,682	176,870
Other assets	402,239	493,433
Total assets	<u>\$ 224,404,184</u>	<u>\$ 144,623,873</u>
Liabilities		
Deposits:		
Noninterest-bearing	\$ 29,624,217	\$ 26,789,963
Interest-bearing	169,705,108	98,725,065
Total deposits	199,329,325	125,515,028
Subordinated debt	4,890,338	4,861,095
Accrued expenses and other liabilities	755,038	343,936
Borrower's escrow payable	160,086	187,384
Total liabilities	<u>\$ 205,134,787</u>	<u>\$ 130,907,443</u>
Shareholders' Equity		
Preferred stock - \$0.01 par value, authorized 1,000,000 shares, 2,250 shares issued and outstanding at December 31, 2022; no shares issued and outstanding at December 31, 2021;	\$ 23	\$ -
Common stock - \$0.01 par value, authorized 10,000,000 shares, 2,797,490 and 2,050,395 shares issued and outstanding at December 31, 2022 and 2021, respectively	27,975	20,504
Additional paid-in capital	14,473,787	5,689,795
Retained earnings	8,427,787	8,177,845
Accumulated other comprehensive loss	(3,660,175)	(171,714)
Total shareholders' equity	19,269,397	13,716,430
Total liabilities and shareholders' equity	<u>\$ 224,404,184</u>	<u>\$ 144,623,873</u>

See Notes to Consolidated Financial Statements

Southern Financial Corporation

Consolidated Statements of Income

For the years ended December 31, 2022 and 2021

	2022	2021
Interest income		
Loans, including fees	\$ 6,978,515	\$ 4,451,468
Securities available-for-sale	953,383	418,011
Federal funds sold	201,301	10,143
Other bank deposits	18,969	38,671
Dividends	2,611	2,144
Total interest income	8,154,779	4,920,437
Interest expense		
Deposits	1,282,392	509,794
Borrowings	272,998	52,964
Total interest expense	1,555,390	562,758
Net interest income	6,599,389	4,357,679
Provision for loan losses	600,000	300,000
Net interest income after provision for loan losses	5,999,389	4,057,679
Noninterest income		
Customer service fees	228,439	213,859
Mortgage banking income	94,611	10,155
Increase in cash surrender value of bank owned life insurance	101,329	48,563
Net gain (loss) on investment securities transactions	(60)	4,764
Other	32,017	34,344
Total noninterest income	456,336	311,685
Noninterest expenses		
Salaries and employee benefits	3,820,237	2,357,567
Occupancy expenses	696,015	566,298
Data processing	366,328	332,034
Legal and accounting fees	300,873	250,250
Advertising	177,067	38,904
Loss on sale and other expenses of foreclosed real estate	138,441	62,440
Deposit insurance premiums	104,414	50,765
Other	544,860	391,043
Total noninterest expenses	6,148,235	4,049,301
Income before income taxes	307,490	320,063
Provision expense (benefit) for income taxes	57,548	(33,016)
Net income per common share	\$ 249,942	\$ 353,079
Earnings per common share		
Basic	\$ 0.11	\$ 0.19
Diluted	\$ 0.10	\$ 0.19
Weighted average common shares outstanding		
Basic	2,256,711	1,810,822
Diluted	2,484,813	1,810,822

See Notes to Consolidated Financial Statements

Southern Financial Corporation

Consolidated Statements of Comprehensive Income (Loss)

For the years ended December 31, 2022 and 2021

	2022	2021
Net income	\$ 249,942	\$ 353,079
Other comprehensive income (loss):		
Investment securities available for sale		
Unrealized holding losses on securities		
available-for-sale arising during the period, net	(4,640,513)	(357,203)
Reclassification adjustment for gains/(losses) included in net income	(60)	4,764
Related income tax impact	1,152,112	100,972
Other comprehensive loss	(3,488,461)	(251,467)
Comprehensive income (loss)	\$ (3,238,519)	\$ 101,612

See Notes to Consolidated Financial Statements

Southern Financial Corporation
Consolidated Statements of Changes in Shareholders' Equity
For the years ended December 31, 2022 and 2021

	Preferred Stock		Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
	Shares	Amount	Shares	Amount				
Balance, December 31, 2020	250	\$ 250,000	26,108	\$ 261,080	\$ 524,204	\$ 7,824,766	\$ 79,753	\$ 8,939,803
Net income	-	-	-	-	-	353,079	-	353,079
Sale of 2,081 shares of common stock as part of redemption and reissuance program	-	-	2,081	20,810	882,299	-	-	903,109
Redemption of preferred stock	(250)	(250,000)	-	-	-	-	-	(250,000)
Change to \$0.01 Par Value as part of SC Domestication effective April 1, 2021	-	-	-	(281,608)	281,608	-	-	-
55 to 1 Stock Split effective May 1, 2021	-	-	1,522,206	15,222	(15,222)	-	-	-
Sale of 500,000 shares of common stock	-	-	500,000	5,000	3,988,093	-	-	3,993,093
Stock Based Compensation	-	-	-	-	28,813	-	-	28,813
Other comprehensive loss	-	-	-	-	-	-	(251,467)	(251,467)
Balance, December 31, 2021	-	-	2,050,395	20,504	5,689,795	8,177,845	(171,714)	13,716,430
Net income	-	-	-	-	-	249,942	-	249,942
Sale of 747,095 shares of common stock	-	-	747,095	7,471	6,689,440	-	-	6,696,911
Sale of 2,250 shares of preferred stock	2,250	23	-	-	2,015,962	-	-	2,015,985
Stock Based Compensation	-	-	-	-	78,590	-	-	78,590
Other comprehensive loss	-	-	-	-	-	-	(3,488,461)	(3,488,461)
Balance, December 31, 2022	<u>2,250</u>	<u>\$ 23</u>	<u>2,797,490</u>	<u>\$ 27,975</u>	<u>\$ 14,473,787</u>	<u>\$ 8,427,787</u>	<u>\$ (3,660,175)</u>	<u>\$ 19,269,397</u>

See Notes to Consolidated Financial Statements

Southern Financial Corporation

Consolidated Statements of Cash Flows

For the years ended December 31, 2022 and 2021

	2022	2021
Cash flows from operating activities		
Net income	\$ 249,942	\$ 353,079
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	600,000	300,000
Depreciation	225,341	106,101
Net amortization of investment securities	54,248	64,495
Amortization of debt issuance costs	29,243	5,568
Loss on sale of foreclosed real estate	30,976	11,051
Net loss (gain) on investment securities transactions	60	(4,764)
Write-down of foreclosed real estate	98,800	2,887
Increase in cash surrender value of BOLI	(101,329)	(48,563)
Deferred tax benefit	(51,999)	(14,443)
Stock based compensation	78,590	28,813
Decrease (increase) in operating assets:		
Accrued interest receivable	(289,730)	(75,050)
Other assets	(100,501)	(59,767)
Increase (decrease) in operating liabilities:		
Accrued interest payable	128,921	(12,511)
Accrued expenses and other liabilities	459,783	41,269
Net cash provided by operating activities	<u>1,412,345</u>	<u>698,165</u>
Cash flows from investing activities		
Proceeds from sales, calls and maturities of investment securities:		
Available-for-sale	220,000	7,875,000
Purchases of investment securities:		
Available-for-sale	(27,502,663)	(19,547,010)
Proceeds from principal paydowns of available-for-sale securities	2,256,664	326,731
Redemption (purchase) of FHLB Stock	(26,000)	24,900
Redemption of certificate of deposits with other banks	648,000	4,324,000
Net increase in loans	(51,973,811)	(43,907,445)
Proceeds from sale of foreclosed real estate	191,720	718,658
Purchase of bank owned life insurance	(2,000,000)	(1,500,000)
Purchases of property and equipment	(4,621,531)	(1,772,285)
Net cash used for investing activities	<u>(82,807,621)</u>	<u>(53,457,451)</u>

See Notes to Consolidated Financial Statements

Southern Financial Corporation**Consolidated Statements of Cash Flows****For the years ended December 31, 2022 and 2021**

	2022	2021
<i>Cash flows from financing activities</i>		
Net increase in demand deposits, NOW accounts, money market deposit accounts and savings accounts	10,109,489	16,992,802
Net increase in time deposits	63,704,808	25,196,026
Net proceeds from issuance of subordinated debt	-	4,855,527
Issuance (redemption) of preferred stock	2,015,985	(250,000)
Net proceeds from issuance of common stock	6,696,911	4,896,202
Net cash provided by financing activities	<u>82,527,193</u>	<u>51,690,557</u>
Net (decrease) increase in cash and cash equivalents	1,131,917	(1,068,729)
<i>Cash and cash equivalents, beginning of year</i>	<u>9,991,463</u>	<u>11,060,192</u>
<i>Cash and cash equivalents, end of year</i>	<u><u>\$ 11,123,380</u></u>	<u><u>\$ 9,991,463</u></u>
<i>Cash paid during the year for</i>		
Interest	\$ 1,426,469	\$ 575,269
Income taxes, net of refunds	(205,385)	86,857
<i>Noncash investing and financing activities</i>		
Change in unrealized loss on securities available for sale	\$ (4,640,513)	\$ (352,439)
Transfers of loans to foreclosed real estate	\$ 40,840	\$ 902,047
Loans charged off	<u>\$ 46,666</u>	<u>\$ 82,211</u>

See Notes to Consolidated Financial Statements

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 1. Significant Accounting Policies

The accounting and reporting policies of Southern Financial Corporation (the “Company”) are in accordance with generally accepted accounting principles and conform to general practices within the banking industry. The more significant policies are briefly summarized below:

Principles of consolidation:

The accompanying consolidated financial statements present the accounts of the Company, a one-bank holding company, and its wholly-owned subsidiary, Southern Bank (the Bank), Sardis, Georgia. Southern Financial Corporation was formerly known as Sardis Bancshares, Inc., with a name change taking place effective April 1, 2021. Material inter-company transactions have been eliminated in consolidation.

Nature of operations:

The Bank operates under a State of Georgia charter and provides full banking services. The Bank is a member of the Federal Deposit Insurance Corporation and is therefore subject to regulation of that agency and the Georgia Department of Banking and Finance. The area served by the Bank is principally Burke, Jenkins, Screven, Richmond, and Glascock counties with services provided by four full-service offices in the cities of Sardis, Waynesboro, Hephzibah and Gibson. During 2022, the Bank expanded into the upstate of South Carolina, by opening a full-service branch in Greenville. The bank has already received approval from the FDIC for full-service branches in Spartanburg and Aiken.

Use of estimates:

In preparing financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, and the valuation of deferred tax assets.

Risk and uncertainties:

In the normal course of its business, the Company encounters two significant types of risks: economic and regulatory. There are three main components of economic risk: interest rate risk, credit risk and market risk. The Company is subject to interest rate risk to the degree that its interest-bearing liabilities mature or reprice at different speeds, or on different bases, than its interest-earning assets. Credit risk is the risk of default on the Company’s loan and investment portfolios that result from a borrower’s inability or unwillingness to make contractually required payments. Market risk reflects changes in the value of collateral underlying securities, loans receivable and the valuation of real estate held by the Company.

The Company is subject to the regulations of various governmental agencies (regulatory risk). These regulations can change significantly from period to period. The Company also undergoes periodic examinations by the regulatory agencies, which may subject it to further changes with respect to asset valuations, amounts of required loss allowances and operating restrictions from the regulators’ judgments based on information available to them at the time of their examination.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 1. Significant Accounting Policies, Continued

Revenue from contracts with customers:

The Company's revenue from contracts with customers with the scope of Accounting Standards Codification Topic 606 ("ASC 606") is comprised of the following items for the years ended December 31, 2022 and 2021:

	<u>2022</u>	<u>2021</u>
Service charges on deposit accounts	\$ 143,054	\$ 115,158
Interchange income	85,385	98,701
Net losses on sales of foreclosed real estate	(30,976)	(11,051)

Service charges on deposit accounts: The Company earns fees from its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as ATM use fees, stop payment charges, statement rendering and ACH fees, are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposit accounts are withdrawn from the customer's account balance.

Interchange income: The Company earns interchange fees from cardholder transactions conducted through the Visa/Mastercard or other payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

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

Cash and cash equivalents:

For purposes of the presentation in the consolidated statement of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption "Cash and due from banks" and "Federal funds sold."

Securities available-for-sale:

Debt securities are classified as "available-for-sale" and are reflected at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 1. Significant Accounting Policies, Continued

Securities available-for-sale, continued:

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities unless they are callable. On callable securities, the premium or discount is amortized to the earliest call date in accordance with ASU 2017-08. Declines in value of available-for-sale securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. During 2022 and 2021, no such events occurred. Gains and losses on the sale of available-for-sale securities are determined using the specific identification method.

Restricted equity securities:

Restricted equity securities consist of investments in the stock of the Federal Home Loan Bank of Atlanta ("FHLB"), which is carried at cost. The Company is a member of the FHLB. As a requirement of membership, the Company invests in stock of the FHLB. FHLB stock is carried at cost and evaluated periodically for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

Loans receivable:

The Bank grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is secured by real estate loans in the Bank's primary trade areas of Southeast Georgia and Upstate South Carolina. The ability of the Bank's debtors to honor their contracts is dependent upon the real estate and general economic conditions of these areas.

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

Interest on commercial, real estate and loans to individuals is computed on a daily basis based on the principal amount outstanding. The accrual of interest on mortgages and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well secured and in the process of collection. Loans to individuals are typically charged-off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on non-accrual or are charged-off is reversed against interest income. The interest on these loans is accounted for on the cash basis until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 1. Significant Accounting Policies, Continued

Allowance for loan losses:

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

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

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard, or weak pass. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable loss. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 1. Significant Accounting Policies, Continued

Off-balance sheet related financial instruments:

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

All derivative financial instruments held by the Bank are held for purposes other than trading. The principal form of derivative instruments held are in the form of indexed securities held as a part of the securities portfolio. None are deemed to be “hedges” as defined under the provisions of FASB Codification Section 815, Derivatives and Hedging.

Foreclosed real estate:

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less estimated selling costs at the date of foreclosure establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in the Consolidated Statements of Income. The historical average holding period for such properties is eighteen months.

Premises and equipment:

Land is carried at cost. Bank premises, furniture and equipment are carried at cost, less accumulated depreciation and amortization. The provision for depreciation is computed principally on the straight-line method over the estimated useful lives of the assets, which range as follows: buildings - 20 to 45 years; equipment - 3 to 10 years. Costs of major additions and improvements are capitalized. Expenditures for maintenance and repairs are charged to operations as incurred. Gains or losses from the disposition of property are reflected in operations, and the asset accounts and related allowances for depreciation are reduced.

Bank owned life insurance:

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

Deferred tax assets, net of deferred tax liabilities:

Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 1. Significant Accounting Policies, Continued

Deferred tax assets, net of deferred tax liabilities, continued:

The Company and the Bank file consolidated income tax returns. The Bank provides for income taxes on a separate return basis, and remits to the Company amounts determined to be currently payable. Management reviews all tax positions when preparing tax provisions and evaluating reasonableness of tax liabilities and assets in the financial statements. All provisions, liabilities and assets were reviewed for prior periods with open statutes of limitations to determine if they were adequate as required by FASB Codification Section 740, Income Taxes. Management did not identify any uncertain positions that would give rise to additional liabilities, penalties or interest. Therefore, no additional liabilities or assets were recorded in the financial statements for uncertain tax positions, nor for interest or penalties.

Subordinated debt:

On October 21, 2021, the Company issued \$5,000,000 in subordinated debt that matures on October 21, 2031. The cost to issue this debt was approximately \$145,000 and is being amortized over five years because the debt is fully redeemable on October 21, 2026.

Authorized shares:

Effective April 1, 2021, the Company domesticated to South Carolina and changed its name to Southern Financial Corporation. In connection with the move and name change, the Articles of Incorporation were amended to make certain changes, including increasing the authorized number of common and preferred shares to 10,000,000 and 1,000,000, respectively, and changing the par value of each share type to \$0.01 per share.

Stock split:

Effective May 1, 2021, the Company issued a 55 to 1 stock split to shareholders of record as of that date. The number of shares outstanding before the split was 28,189 with 1,550,395 outstanding shares after the split.

Private placements:

As part of a plan to expand its operations into the upstate region of South Carolina, the Company has completed several private placement offerings.

The first one was completed on June 30, 2021. The private placement was for a total of 500,000 shares of the Company's common stock to accredited investors at \$8 per share. This transaction resulted in proceeds to the Company of \$3,993,092 net of fees of \$6,908.

The Company completed another private placement on September 15, 2022, for a total of 747,095 shares of the Company's common stock to accredited investors at \$9 per share. This transaction resulted in proceeds to the Company of \$6,696,911 net of fees of \$26,942.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 1. Significant Accounting Policies, Continued

Preferred Stock:

On September 16, 2022, the Company amended its Articles of Incorporation to provide for the issuance of Series A {Non-Voting} Convertible Perpetual Preferred Stock of up to 5,000 shares. Each share of Series A Preferred Stock is convertible to 100 shares of Common Stock at the option of the holder provided the holder does not own more than 9.99% of common stock after the conversion. On September 28, 2022, the Company completed its first preferred stock offering by selling 2,250 shares to accredited investors at \$900 per share. This transaction resulted in proceeds to the Company of \$2,015,985 net of fees of \$9,015.

Stock-based compensation:

Included in salaries and employee benefits is the compensation cost related to common stock options which totaled \$78,590 and \$28,813 for the years ended December 31, 2022 and 2021, respectively. Compensation cost is recognized when these awards are issued to employees and directors, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options. The calculated weighted-average grant date fair values used for calculating compensation expense were \$2.22 and \$2.07 per share for 2022 and 2021, respectively. Compensation cost is recognized over the required service period, generally defined as the vesting period. The Company's accounting policy is to recognize compensation cost net of estimated forfeitures.

Advertising costs:

The Company follows the practice of expensing advertising costs as they are incurred. These amounts are disclosed as a separate line item on the Consolidated Statements of Income.

Net income per share of common stock:

Basic earnings per common share is net income divided by the weighted average number of shares of common stock outstanding during the period. All shares issuable to participants in the Company's deferred compensation plan are considered to be participating securities for purposes of calculating basic earnings per share. Diluted earnings per common share includes the dilutive effect of additional potential shares of common stock issuable under stock options and securities convertible to common stock. Basic and diluted earnings per share have been restated for all stock splits through the date of issuance of the financial statements.

Comprehensive income (loss):

Comprehensive income (loss) consists of net income for the current period and other comprehensive income (loss), defined as income, expenses, gains and losses that bypass the consolidated statements of income and are reported directly in a separate consolidated statement of comprehensive income (loss). In this statement, the Company reports items of other comprehensive income (loss) according to their nature. Total comprehensive income (loss) is also reported in the consolidated statements of changes in shareholders' equity. The accumulated balance of accumulated other comprehensive income (loss) is shown separately in the shareholders' equity section of the consolidated statements of financial condition. At December 31, 2022 and 2021, the only component of accumulated other comprehensive income (loss) was unrealized losses on available-for-sale investment securities.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 1. Significant Accounting Policies, Continued

Recently issued accounting pronouncements:

The following is a summary of recent authoritative pronouncements that affect accounting, reporting, and disclosure of financial information by the Company:

On December 21, 2022, the Financial Accounting Standards Board ("FASB") issued FASB Accounting Standards Update ("ASU") Update 2022-06—*Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848*. The objective of the guidance in Topic 848 was to provide relief during the temporary transition from the London Interbank Offered Rate (LIBOR), so FASB had included a sunset provision within Topic 848 based on expectations of when the LIBOR would cease being published. In 2021, the UK Financial Conduct Authority (FCA) delayed the intended cessation date of certain tenors of USD LIBOR to June 30, 2023. To ensure the relief in Topic 848 covers the period during which a significant number of modifications may take place, the ASU defers the sunset date of Topic 848 from December 31, 2022, to December 31, 2024, after which entities will no longer be permitted to apply the relief in Topic 848. The company does not expect the adoption of this standard to have a material impact on its financial position, results of operations or cash flows. On December 16, 2022, the Federal Reserve adopted the final rule that implements Adjustable Interest Rate (LIBOR) Act by identifying benchmark rates based on Secured Overnight Financing Rate (SOFR) that will replace LIBOR in certain financial contracts after June 30, 2022.

In June 2022, the FASB issued ASU Update 2022-03—*Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance. The company does not expect the adoption of this standard to have a material impact on its financial position, results of operations or cash flows as we currently do not invest in any equity securities subject to contractual sale restrictions.

In March 2022, the FASB issued ASU No. 2022-02, ASU 2022-02—*Financial Instruments—Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*. The amendments in this Update eliminate the accounting guidance for TDRs by creditors in Subtopic 310-40, Receivables—Troubled Debt Restructurings by Creditors, while enhancing disclosure requirements for certain loan refinancings and restructurings by creditors when a borrower is experiencing financial difficulty to bring TDR accounting and disclosures in line with Topic 326. For vintage disclosures, the amendments in this Update require that an entity disclose current-period gross write-offs by year of origination for financing receivables and net investments in leases within the scope of Subtopic 326-20, Financial Instruments—Credit Losses—Measured at Amortized Cost. The vintage disclosure amendment is only applicable to public companies. The Company does not expect adoption of this standard, which will be January 1, 2023, to have a material impact on its financial position, results of operations or cash flows.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 1. Significant Accounting Policies, Continued

Recently issued accounting pronouncements, continued:

In June 2016, the FASB issued ASU No. 2016-13: *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. This guidance changes the accounting for credit losses and modifies the impairment model for certain debt securities. The guidance requires a financial asset (including trade receivables) measured at amortized cost basis to be presented at the net amount expected to be collected. Thus, the income statement will reflect the measurement of credit losses for newly recognized financial assets as well as the expected increases or decreases of expected credit losses that have taken place during the period. The amendments are effective for the Company for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. The Company adopted this standard on January 1, 2023 and recorded a \$402,750 negative adjustment to retained earnings, net of tax, for the cumulative effect of change in accounting principle.

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

Reclassification of prior year amounts:

Certain amounts presented in the prior year data have been reclassified to be consistent with the current year's presentation. These reclassifications had no material effect on previously reported results of operations or shareholders' equity.

Subsequent events:

In relation to current economic conditions, management has evaluated deposit relationships with the Bank and has not identified any significant concentrations. In addition, there has been no significant deposit deterioration through the date the financial statements were issued.

The Company has disclosed its investment portfolio position in Note 2. There has been no significant deterioration in the investment portfolio through the date the consolidated financial statements were issued.

Management has reviewed events occurring through March 30, 2023, the date the consolidated financial statements were available to be issued and has not identified any other subsequent events that have occurred requiring accrual or disclosure.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 2. Securities Available-for-Sale

Debt and equity securities have been classified in the consolidated statements of financial condition according to management's intent. The carrying amounts of securities and their approximate fair values at December 31, 2022 and 2021 follow:

	December 31, 2022			
	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Agency securities	\$ 8,525,821	\$ -	\$ 1,358,863	\$ 7,166,958
U.S. Treasury securities	1,036,198	-	131,100	905,098
State and municipal securities	2,539,165	586	76,317	2,463,434
State and municipal securities - taxable	5,733,065	-	1,110,467	4,622,598
Mortgage-backed securities	29,421,739	24,440	1,885,681	27,560,498
Corporate securities	5,735,020	-	333,731	5,401,289
	<u>\$ 52,991,008</u>	<u>\$ 25,026</u>	<u>\$ 4,896,159</u>	<u>\$ 48,119,875</u>
	December 31, 2021			
	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Agency securities	\$ 7,232,781	\$ 1,922	\$ 180,384	\$ 7,054,319
U.S. Treasury securities	1,042,279	-	1,439	1,040,840
State and municipal securities	2,585,839	99,995	-	2,685,834
State and municipal securities - taxable	3,147,614	14,615	14,299	3,147,930
Mortgage-backed securities	11,260,804	-	172,358	11,088,446
Corporate securities	2,750,000	30,918	9,590	2,771,328
	<u>\$ 28,019,317</u>	<u>\$ 147,450</u>	<u>\$ 378,070</u>	<u>\$ 27,788,697</u>

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 2. Securities Available-for-Sale, Continued

Unrealized losses and estimated fair value, aggregated by investment category and length of time that individual investment securities available for sale have been in continuous unrealized loss position, as of December 31, 2022 and 2021 are summarized as follows:

	<u>2022</u>		<u>2021</u>	
	<u>Estimated Fair Value</u>	<u>Unrealized Losses</u>	<u>Estimated Fair Value</u>	<u>Unrealized Losses</u>
Unrealized loss for less than 12 months:				
U.S. Agency securities	\$ 1,450,437	\$ 41,480	\$ 2,842,230	\$ 57,770
U.S. Treasuries	-	-	1,040,840	1,439
State and municipal securities	2,263,237	76,317	-	-
State and municipal securities - taxable	898,235	86,334	1,852,115	14,299
Mortgage-backed securities	16,404,889	442,417	11,088,446	172,358
Corporate securities	<u>2,095,499</u>	<u>139,522</u>	<u>990,410</u>	<u>9,590</u>
	<u>23,112,297</u>	<u>786,070</u>	<u>17,814,041</u>	<u>255,456</u>
Unrealized loss for greater than 12 months:				
U.S. Agency securities	5,716,521	1,317,383	3,527,386	122,614
U.S. Treasuries	905,098	131,100	-	-
State and municipal securities - taxable	3,724,364	1,024,133	-	-
Mortgage-backed securities	8,280,940	1,443,263	-	-
Corporate securities	<u>1,555,790</u>	<u>194,210</u>	<u>-</u>	<u>-</u>
	<u>20,182,713</u>	<u>4,110,089</u>	<u>3,527,386</u>	<u>122,614</u>
	<u>\$ 43,295,010</u>	<u>\$ 4,896,159</u>	<u>\$ 21,341,427</u>	<u>\$ 378,070</u>

At December 31, 2022 and 2021, the unrealized losses on debt securities arose due to changing interest rates and market conditions and are considered to be temporary because of acceptable investment grades where the repayment sources of principal and interest are largely backed by the U.S. Government.

At December 31, 2022 and 2021, securities with a carrying value of \$ 14,962,011 and \$15,425,948, respectively, were pledged to secure public deposits and for other purposes as required or permitted by law.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 2. Securities Available-for-Sale, Continued

The amortized cost and fair value of debt securities by contractual maturity at December 31, 2022 follow:

	<u>Available-for-sale securities</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in one year or less	\$ 199,780	\$ 200,367
Due from one to five years	23,307,183	22,690,759
Due in five to ten years	25,311,671	22,019,005
Due after ten years	4,172,374	3,209,744
	<u>\$ 52,991,008</u>	<u>\$ 48,119,875</u>

There were no sales of investment securities during 2022 or 2021. Proceeds from calls and maturities of available-for-sale securities totaled \$220,000 and \$7,875,000 during 2022 and 2021 resulting in realized losses of \$60 in 2022, and realized gains of \$4,764 in 2021.

Note 3. Loans and Allowance for Loan Losses

Major classifications of the loan portfolio are summarized as of the dates indicated as follows:

	<u>2022</u>	<u>2021</u>
Construction, Land and Land Development	\$ 20,930,399	\$ 5,862,430
Farmland	840,384	952,852
Residential Real Estate	39,274,834	34,734,593
Multi-family Real Estate	2,656,837	206,165
Commercial real estate	62,529,756	43,091,112
Loans to Farmers	33,974	16,807
Commercial	17,170,755	10,175,754
Individuals	8,663,158	5,174,386
Overdrafts	16,207	15,900
Total loans	<u>\$ 152,116,304</u>	<u>\$ 100,229,999</u>

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 3. Loans and Allowance for Loan Losses, Continued

An analysis of the changes in the allowance for loan losses follows:

	Construction and Land Development		Farmland		Residential Real Estate	
	2022	2021	2022	2021	2022	2021
Available for loan losses:						
Beginning balance	\$ 43,968	\$ 20,474	\$ 7,568	\$ 50,399	\$ 278,023	\$ 47,590
Chargeoffs	-	-	-	-	(390)	-
Recoveries	-	-	-	-	3,484	-
Provisions	113,010	23,494	(896)	(42,831)	101,388	230,433
Total	<u>\$ 156,978</u>	<u>\$ 43,968</u>	<u>\$ 6,672</u>	<u>\$ 7,568</u>	<u>\$ 382,505</u>	<u>\$ 278,023</u>
	Multi-Family Real Estate		Commercial Real Estate		Loans to Farmers	
	2022	2021	2022	2021	2022	2021
Beginning balance	\$ 4,144	\$ 51,062	\$ 417,986	\$ 45,674	\$ 126	\$ -
Chargeoffs	-	-	-	(2,293)	-	(2,107)
Recoveries	-	-	11	1,394	-	145
Provisions	39,775	(46,918)	94,616	373,211	129	2,088
Total	<u>\$ 43,919</u>	<u>\$ 4,144</u>	<u>\$ 512,613</u>	<u>\$ 417,986</u>	<u>\$ 255</u>	<u>\$ 126</u>
	Commercial		Individuals			
	2022	2021	2022	2021		
Beginning balance	\$ 94,662	\$ 11,636	\$ 83,789	\$ 122,782		
Chargeoffs	(14,300)	(20,262)	(31,976)	(57,549)		
Recoveries	-	-	7,471	27,525		
Provisions	68,769	103,288	82,302	(8,969)		
Total	<u>\$ 149,131</u>	<u>\$ 94,662</u>	<u>\$ 141,586</u>	<u>\$ 83,789</u>		
	Overdrafts		Unallocated		Totals	
	2022	2021	2022	2021	2022	2021
Beginning balance	\$ -	\$ -	\$ 31,660	\$ 365,456	\$ 961,926	\$ 715,073
Chargeoffs	-	-	-	-	(46,666)	(82,211)
Recoveries	-	-	-	-	10,966	29,064
Provisions	-	-	100,907	(333,796)	600,000	300,000
Total	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 132,567</u>	<u>\$ 31,660</u>	<u>\$ 1,526,226</u>	<u>\$ 961,926</u>

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 3. Loans and Allowance for Loan Losses, Continued

The components of loans in the consolidated statements of financial condition were as follows:

	Construction and Land Development		Farmland		Residential Real Estate	
	2022	2021	2022	2021	2022	2021
Loans:						
Total ending balance	\$ 20,930,399	\$ 5,862,430	\$ 840,384	\$ 952,852	\$ 39,274,834	\$ 34,734,593
Less ending balance: individually evaluated for impairment	-	-	-	-	873,495	189,440
Ending balance: collectively evaluated for impairment	<u>\$ 20,930,399</u>	<u>\$ 5,862,430</u>	<u>\$ 840,384</u>	<u>\$ 952,852</u>	<u>\$ 38,401,339</u>	<u>\$ 34,545,153</u>
	Multi-Family Real Estate		Commercial Real Estate		Loans to Farmers	
	2022	2021	2022	2021	2022	2021
Total ending balance	\$ 2,656,837	\$ 206,165	\$ 62,529,756	\$ 43,091,112	\$ 33,974	\$ 16,807
Less ending balance: individually evaluated for impairment	-	-	-	-	-	-
Ending balance: collectively evaluated for impairment	<u>\$ 2,656,837</u>	<u>\$ 206,165</u>	<u>\$ 62,529,756</u>	<u>\$ 43,091,112</u>	<u>\$ 33,974</u>	<u>\$ 16,807</u>
	Commercial		Individuals			
	2022	2021	2022	2021		
Total ending balance	\$ 17,170,755	\$ 10,175,754	\$ 8,663,158	\$ 5,174,386		
Less ending balance: individually evaluated for impairment	-	-	64,601	41,155		
Ending balance: collectively evaluated for impairment	<u>\$ 17,170,755</u>	<u>\$ 10,175,754</u>	<u>\$ 8,598,557</u>	<u>\$ 5,133,231</u>		
	Overdrafts		Totals			
	2022	2021	2022	2021		
Total ending balance	\$ 16,207	\$ 15,900	\$152,116,304	\$100,229,999		
Less ending balance: individually evaluated for impairment	-	-	938,096	230,595		
Ending balance: collectively evaluated for impairment	<u>\$ 16,207</u>	<u>\$ 15,900</u>	<u>\$151,178,208</u>	<u>\$ 99,999,404</u>		

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 3. Loans and Allowance for Loan Losses, Continued

Scheduled maturities of loans at December 31, 2022 are as follows:

	<u>Within one year</u>	<u>Greater than one year through five years</u>	<u>Greater than five years</u>	<u>Total</u>
Variable rate loans	\$ 37,652,245	\$ -	\$ -	\$ 37,652,245
Fixed rate loans	<u>11,400,826</u>	<u>87,112,561</u>	<u>15,950,672</u>	<u>114,464,059</u>
	<u>\$ 49,053,071</u>	<u>\$ 87,112,561</u>	<u>\$ 15,950,672</u>	<u>\$152,116,304</u>

Scheduled maturities of loans at December 31, 2021 are as follows:

	<u>Within One year</u>	<u>Greater than one year through five years</u>	<u>Greater than five years</u>	<u>Total</u>
Variable rate loans	\$ 8,226,574	\$ -	\$ -	\$ 8,226,574
Fixed rate loans	<u>3,051,113</u>	<u>64,161,436</u>	<u>24,790,876</u>	<u>92,003,425</u>
	<u>\$ 11,277,687</u>	<u>\$ 64,161,436</u>	<u>\$ 24,790,876</u>	<u>\$100,229,999</u>

The Company was a participating lender in the Small Business Administration Paycheck Protection Program ("PPP"). PPP Loans are forgivable in whole or in part if the proceeds are used for payroll and other permitted purposes in accordance with the requirements of the PPP. During the years ended December 31, 2022, and 2021, the Company originated PPP loans with an aggregate balance of approximately \$0 and \$513,000, respectively. As of December 31, 2022 and 2021, the remaining balance of PPP loans originated in previous years amounted to approximately \$0 and \$36,000, respectively.

Risk ratings:

The Company categorizes loans receivable 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 information, and current industry and economic trends among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a continual basis. The Company uses the following nine definitions for its risk ratings:

- Virtually No Risk, Minimal Credit Risk, Satisfactory Credit Risk and Acceptable Credit Risk – Loans in these four categories are considered to have a low probability of default and do not meet the criteria of the risk categories below. In prior years, these loans were listed as "unclassified" in the footnotes to the Company's financial statements. For this year's presentation, the Company will combine these categories into one line called Acceptable Credit Risk.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 3. Loans and Allowance for Loan Losses, Continued

Risk ratings, continued:

- Weak Pass - This grade is given to loans that show signs of weakness in either adequate sources of repayment or collateral but have demonstrated mitigating factors that minimize the risk of delinquency or loss. Payments have generally been made as agreed with only minor and isolated delinquencies. In prior years, this category was called "watch."
- Special Mention – Loans with underwriting guideline tolerances or exceptions and with no mitigating factors. Loans where adverse economic conditions that develop after the loan origination that do not jeopardize liquidation of the debt but do substantially increase the level of risk may also warrant this rating. The Company currently has no loans in this category on December 31, 2022. This risk category was not implemented until 2022, so there are no loans in this category on December 31, 2021.
- Substandard - A Substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as Substandard must have a well-defined weakness (or weaknesses) that jeopardize the liquidation of the debt; they are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Loans consistently not meeting the repayment schedule are downgraded to this classification.
- Doubtful - Loans classified Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full based on currently existing facts, conditions, and values highly questionable and improbable. The ability of the borrower to service the debt is extremely weak, overdue status is constant, the debt has been placed on non-accrual status, and no definite repayment schedule exists. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off. The Company has no loans in this category on December 31, 2022, or 2021.
- Loss – loans categorized as Loss have the same characteristics as Doubtful; however, probability of loss is certain. Loans classified as Loss are generally charged off within 30 days of receiving this risk rating. The Company has no loans in this category on December 31, 2022 or 2021.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 3. Loans and Allowance for Loan Losses, Continued

The following table illustrates the outstanding balances in loan receivables by risk category at December 31, 2022 and 2021:

	Construction and Land Development		Farmland		Residential Real Estate	
	2022	2021	2022	2021	2022	2021
Acceptable credit risk	\$ 20,930,399	\$ 5,862,430	\$ 840,384	\$ 952,852	\$ 37,927,157	\$ 34,277,945
Weak Pass	-	-	-	-	176,534	244,159
Special Mention	-	-	-	-	-	-
Substandard	-	-	-	-	1,171,143	212,489
Doubtful	-	-	-	-	-	-
Loss	-	-	-	-	-	-
Total	<u>\$ 20,930,399</u>	<u>\$ 5,862,430</u>	<u>\$ 840,384</u>	<u>\$ 952,852</u>	<u>\$ 39,274,834</u>	<u>\$ 34,734,593</u>
	Multi-Family Real Estate		Commercial Real Estate		Loans to Farmers	
	2022	2021	2022	2021	2022	2021
Acceptable credit risk	\$ 2,656,837	\$ 206,165	\$ 61,672,346	\$ 43,020,113	\$ 17,970	\$ 16,807
Weak Pass	-	-	857,410	-	16,004	-
Special Mention	-	-	-	-	-	-
Substandard	-	-	-	70,999	-	-
Doubtful	-	-	-	-	-	-
Loss	-	-	-	-	-	-
Total	<u>\$ 2,656,837</u>	<u>\$ 206,165</u>	<u>\$ 62,529,756</u>	<u>\$ 43,091,112</u>	<u>\$ 33,974</u>	<u>\$ 16,807</u>
	Commercial		Individuals			
	2022	2021	2022	2021		
Acceptable credit risk	\$ 15,534,608	\$ 10,175,754	\$ 8,516,985	\$ 5,056,195		
Weak Pass	1,153,830	-	62,771	79,538		
Special Mention	-	-	-	-		
Substandard	482,317	-	83,402	38,653		
Doubtful	-	-	-	-		
Loss	-	-	-	-		
Total	<u>\$ 17,170,755</u>	<u>\$ 10,175,754</u>	<u>\$ 8,663,158</u>	<u>\$ 5,174,386</u>		
	Overdrafts		Totals			
	2022	2021	2022	2021		
Acceptable credit risk	\$ 16,207	\$ 15,900	\$148,112,893	\$ 99,584,161		
Weak Pass	-	-	2,266,549	323,697		
Special Mention	-	-	-	-		
Substandard	-	-	1,736,862	322,141		
Doubtful	-	-	-	-		
Loss	-	-	-	-		
Total	<u>\$ 16,207</u>	<u>\$ 15,900</u>	<u>\$152,116,304</u>	<u>\$100,229,999</u>		

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 3. Loans and Allowance for Loan Losses, Continued

The following table presents the amortized cost basis in loans by aging category and accrual status as of December 31, 2022 and 2021:

<u>As of December 31, 2022</u>	<u>Current</u>	<u>30-89 days</u>	<u>Greater than or Equal to 90 days</u>	<u>Nonaccrual</u>	<u>Total Loans</u>
Construction, Land and Land Development	\$ 20,871,826	\$ 58,573	\$ -	\$ -	\$ 20,930,399
Farmland	840,384	-	-	-	840,384
Residential Real Estate	37,666,020	735,319	873,495	873,495	39,274,834
Multi-Family Real Estate	2,656,837	-	-	-	2,656,837
Commercial Real Estate	61,983,206	546,550	-	-	62,529,756
Loans to Farmers	33,974	-	-	-	33,974
Commercial	17,031,677	139,078	-	-	17,170,755
Individuals	8,423,600	174,957	64,601	64,601	8,663,158
Overdrafts	16,207	-	-	-	16,207
Ending Balance	<u>\$ 149,523,731</u>	<u>\$ 1,654,477</u>	<u>\$ 938,096</u>	<u>\$ 938,096</u>	<u>\$ 152,116,304</u>

<u>As of December 31, 2022</u>	<u>Current</u>	<u>30-89 days</u>	<u>Greater than or Equal to 90 days</u>	<u>Nonaccrual</u>	<u>Total Loans</u>
Construction, Land and Land Development	\$ 5,862,430	\$ -	\$ -	\$ -	\$ 5,862,430
Farmland	952,852	-	-	-	952,852
Residential Real Estate	33,627,230	917,923	189,440	189,440	34,734,593
Multi-Family Real Estate	206,165	-	-	-	206,165
Commercial Real Estate	42,730,274	360,838	-	-	43,091,112
Loans to Farmers	16,807	-	-	-	16,807
Commercial	10,174,308	1,446	-	-	10,175,754
Individuals	4,961,587	171,644	4,155	4,155	5,174,386
Overdrafts	15,900	-	-	-	15,900
Ending Balance	<u>\$ 98,547,553</u>	<u>\$ 1,451,851</u>	<u>\$ 230,595</u>	<u>\$ 230,595</u>	<u>\$ 100,229,999</u>

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 3. Loans and Allowance for Loan Losses, Continued

Accounting policies for determination of which loans are assessed for impairment can be found in the Note 1, Significant Accounting Policies. Further, factors considered in determining whether the loan is impaired are also detailed in the Significant Accounting Policies. Interest on impaired loans is recorded in income under the same provisions as for non-accrual loans, on the cash basis as collected.

Impaired loans at December 31, 2022:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<u>With no related allowance recorded:</u>					
Construction, Land and Land Development	\$ -	\$ -	\$ -	\$ -	\$ -
Farmland	-	-	-	-	-
Residential Real Estate	-	-	-	-	-
Multi-family Real Estate	-	-	-	-	-
Commercial Real Estate	-	-	-	-	-
Loans to Farmers	-	-	-	-	-
Commercial	-	-	-	-	-
Individuals	-	-	-	-	-
Overdrafts	-	-	-	-	-
Subtotal	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
<u>With allowance recorded:</u>					
Construction, Land and Land Development	\$ -	\$ -	\$ -	\$ -	\$ -
Farmland	-	-	-	-	-
Residential Real Estate	873,495	886,066	87,349	872,852	-
Multi-family Real Estate	-	-	-	-	-
Commercial Real Estate	-	-	-	-	-
Loans to Farmers	-	-	-	-	-
Commercial	-	-	-	-	-
Individuals	64,601	69,734	46,255	62,952	-
Overdrafts	-	-	-	-	-
Subtotal	<u>\$ 938,096</u>	<u>\$ 955,800</u>	<u>\$ 133,604</u>	<u>\$ 935,804</u>	<u>\$ -</u>
<u>Total impaired loans:</u>					
Construction, Land and Land Development	\$ -	\$ -	\$ -	\$ -	\$ -
Farmland	-	-	-	-	-
Residential Real Estate	873,495	886,066	87,349	872,852	-
Multi-family Real Estate	-	-	-	-	-
Commercial Real Estate	-	-	-	-	-
Loans to Farmers	-	-	-	-	-
Commercial	-	-	-	-	-
Individuals	64,601	69,734	46,255	62,952	-
Overdrafts	-	-	-	-	-
Totals	<u>\$ 938,096</u>	<u>\$ 955,800</u>	<u>\$ 133,604</u>	<u>\$ 935,804</u>	<u>\$ -</u>

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 3. Loans and Allowance for Loan Losses, Continued

Impaired Loans at December 31, 2021:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
<u>With no related allowance recorded:</u>					
Construction, Land and Land Development	\$ -	\$ -	\$ -	\$ -	\$ -
Farmland	-	-	-	-	-
Residential Real Estate	-	-	-	-	-
Multi-family Real Estate	-	-	-	-	-
Commercial Real Estate	-	-	-	-	-
Loans to Farmers	-	-	-	-	-
Commercial	-	-	-	-	-
Individuals	-	-	-	-	-
Overdrafts	-	-	-	-	-
Subtotal	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
<u>With allowance recorded:</u>					
Construction, Land and Land Development	\$ -	\$ -	\$ -	\$ -	\$ -
Farmland	-	-	-	-	-
Residential Real Estate	189,440	221,387	18,944	199,401	12,185
Multi-family Real Estate	-	-	-	-	-
Commercial Real Estate	-	-	-	-	-
Loans to Farmers	-	-	-	-	-
Commercial	-	-	-	-	-
Individuals	41,155	42,882	20,578	45,068	1,727
Overdrafts	-	-	-	-	-
Subtotal	<u>\$ 230,595</u>	<u>\$ 264,269</u>	<u>\$ 39,522</u>	<u>\$ 244,469</u>	<u>\$ 13,912</u>
<u>Total Impaired Loans:</u>					
Construction, Land and Land Development	\$ -	\$ -	\$ -	\$ -	\$ -
Farmland	-	-	-	-	-
Residential Real Estate	189,440	221,387	18,944	199,401	12,185
Multi-family Real Estate	-	-	-	-	-
Commercial Real Estate	-	-	-	-	-
Loans to Farmers	-	-	-	-	-
Commercial	-	-	-	-	-
Individuals	41,155	42,882	20,578	45,068	1,727
Overdrafts	-	-	-	-	-
Totals	<u>\$ 230,595</u>	<u>\$ 264,269</u>	<u>\$ 39,522</u>	<u>\$ 244,469</u>	<u>\$ 13,912</u>

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 3. Loans and Allowance for Loan Losses, Continued

Troubled debt restructurings are loans which have been restructured from their original contractual terms and include concessions that would not otherwise have been granted if not for the financial difficulty of the borrower. Concessions can relate to the contractual interest rate, maturity date, or payment structure of the note. The purpose of a troubled debt restructuring is to facilitate the ultimate repayment of the loan.

At December 31, 2022 and 2021, the Company had no loans that were considered troubled debt restructurings and no loans were modified during the years ended December 31, 2022 and 2021 that were considered to be troubled debt restructurings.

Note 4. Premises and Equipment

Components of premises and equipment included in the consolidated statements of financial condition at December 31, 2022 and 2021 were as follows:

	<u>2022</u>	<u>2021</u>
Land	\$ 2,999,065	\$ 1,000,065
Bank premises	4,362,563	2,402,332
Furniture and equipment	1,219,211	564,941
Fixed assets in process	<u>596,415</u>	<u>588,385</u>
Total cost	9,177,254	4,555,723
Less: accumulated depreciation	<u>1,630,059</u>	<u>1,404,718</u>
	<u>\$ 7,547,195</u>	<u>\$ 3,151,005</u>

Charges to operations for the years ended December 31, 2022 and 2021 for depreciation of property and equipment aggregated to \$225,341 and \$106,101, respectively. During 2022, there were no disposals of assets. During 2021, the Company disposed of \$929,055 of fully depreciated assets no longer in use. No gain or loss was recognized with this disposition.

The Company had no material equipment leases as of December 31, 2022 or 2021. The Company owns all land and buildings.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 5. Foreclosed Real Estate

Activity in foreclosed real estate was as follows:

	<u>2022</u>	<u>2021</u>
Balance net of valuation allowance, beginning of year	\$ 553,984	\$ 384,533
Foreclosures	40,840	902,047
Sales	(191,720)	(718,658)
Write downs	(98,800)	(2,887)
Loss on disposition	(30,976)	(11,051)
Balance, net of valuation allowance, end of year	<u>\$ 273,328</u>	<u>\$ 553,984</u>

The valuation allowance balance was \$98,800 and \$200,000 at December 31, 2022 and 2021, respectively. Expenses applicable to foreclosed assets include the following:

	<u>2022</u>	<u>2021</u>
Net loss on sales of foreclosed real estate	\$ 30,976	\$ 11,051
Adjustments to valuation allowance	98,800	-
Operating expenses - net	8,665	51,389
	<u>\$ 138,441</u>	<u>\$ 62,440</u>

There were no repossessed automobiles or trucks that are held for resale at December 31, 2022 or 2021.

Note 6. Deposits

The following table illustrates the breakdown of deposits by type and non-interest bearing totals and interest bearing totals:

	<u>December 31, 2022</u>		<u>December 31, 2021</u>	
	<u>Non-interest Bearing</u>	<u>Interest Bearing</u>	<u>Non-interest Bearing</u>	<u>Interest Bearing</u>
Deposits:				
Demand deposits and NOW accounts	\$ 29,624,217	\$ 17,524,480	\$ 26,789,963	\$ 14,548,282
Savings and money market accounts	-	32,702,920	-	28,403,883
Certificates of deposits and IRA's	-	119,477,708	-	55,772,900
Totals	<u>\$ 29,624,217</u>	<u>\$ 169,705,108</u>	<u>\$ 26,789,963</u>	<u>\$ 98,725,065</u>

The aggregate amount of time deposits exceeding \$250,000 at December 31, 2022 and 2021 was \$24,157,675 and \$5,503,678, respectively. At December 31, 2022, the scheduled maturities of time deposits are as follows:

	<u>CD's \$250,000 or less</u>	<u>CD's Over \$250,000</u>	<u>Total</u>
2023	\$ 37,806,699	\$ 12,259,285	\$ 50,065,984
2024-2025	37,984,939	5,319,028	43,303,967
After 2025	19,528,395	6,579,362	26,107,757
Total	<u>\$ 95,320,033</u>	<u>\$ 24,157,675</u>	<u>\$ 119,477,708</u>

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 7. Federal Home Loan Bank Advances and other Lines of Credit

The Bank has a line of credit established with the Federal Home Loan Bank of Atlanta in the amount of 25% of total assets. Residential and commercial mortgage loans can be pledged to secure the line. At December 31, 2022 and 2021, there was no outstanding balance on the line of credit.

The Bank also maintains lines of credit for Fed Fund Purchases in the amount of \$4,000,000 with First National Bankers Bank, \$1,600,000 with South State Bank, \$5,000,000 with The Independent Bankers Bank and \$5,000,000 with United Bankers Bank. At December 31, 2022 and 2021, no amounts were outstanding on these lines of credit.

Note 8. Subordinated Debt

On October 21, 2021, the Company issued \$5,000,000 of subordinated debentures with a maturity of October 21, 2031. The Company may redeem the subordinated debentures, in whole or in part, in a principal amount with integral multiples of \$1,000, on or after October 21, 2026, at 100% of the principal amount, plus accrued and unpaid interest. The subordinated debentures are also redeemable in whole or in part from time to time, upon the occurrence of specific events defined within the subordinated debentures.

The subordinated debentures may be included in Tier 2 capital (with certain limitations applicable) under current regulatory guidelines and interpretations. The subordinated debentures have a fixed rate of 4.875% until October 21, 2026. After that date, the debentures have a variable rate of interest equal to the three month Secured Overnight Financing Rate (SOFR) plus 3.93%. At December 31, 2022, and 2021, the Company had \$109,662 and \$138,905 of capitalized expenses related to the debt issuance costs that are being amortized over 5 years.

Note 9. Financial Instruments with Off Balance Sheet Risk

The Bank is a party to financial instruments with off balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit and have been issued for purposes other than trading. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in those particular financial instruments.

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

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

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 9. Financial Instruments with Off Balance Sheet Risk, Continued

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. All letters of credit are due within one year of the original commitment date. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

The notional value of commitments to make loans and standby letters of credit were as follows:

	<u>2022</u>	<u>2021</u>
Financial instruments whose contract amounts represent credit risk at December 31:		
Commitments to extend credit	\$ 18,362,871	\$ 10,823,581
Standby letters of credit	\$ 20,000	\$ 39,029

Note 10. Market and Concentration of Credit Risks

Most of the Bank's business activity is with customers located in the Bank's market area, Southeastern Georgia and the upstate of South Carolina. Investment in state and municipal securities primarily are with governmental entities within Georgia. The concentrations by type of loan are set forth in Note 3.

The distribution of commitments to extend credit approximated the distribution of loans outstanding. Standby letters of credit were granted primarily to commercial borrowers.

The contractual amounts of credit-related financial instruments, such as commitments to extend credit and letters of credit, represent the amounts of potential accounting loss should the contract be fully drawn upon, the customer defaults, and the value of any existing collateral becomes worthless.

The Bank maintains cash balances and Federal Funds balances with five financial institutions. Accounts at each institution are insured by the Federal Deposit Insurance Corporation up to \$250,000. Uninsured balances aggregate \$8,890,027 at December 31, 2022 and \$7,718,744 at December 31, 2021.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 11. Federal and State Income Taxes

The Company and the subsidiary Bank file consolidated federal income tax returns on a calendar-year basis. The Bank uses the experience method to determine bad debt deductions which differs from the provision used for financial reporting. The tax years 2019, 2020, and 2021 are subject to examination and adjustment by taxing authorities. The statute of limitations expires three years from filing dates, including extensions.

The consolidated provision for income taxes consisted of the following for the years ended December 31:

	2022	2021
Current tax provision:		
Federal	\$ 103,525	\$ (391)
State	3,783	(18,182)
Total current	<u>107,308</u>	<u>(18,573)</u>
Deferred:		
Federal	(19,702)	(14,443)
State	<u>(11,314)</u>	<u>-</u>
Total deferred	<u>(31,016)</u>	<u>(14,443)</u>
Change in valuation allowance	<u>(18,744)</u>	<u>-</u>
Total provision	<u>\$ 57,548</u>	<u>\$ (33,016)</u>

The reasons for the differences between the statutory federal income tax rates and the effective tax rates are summarized as follows:

	2022	2021
Statutory rates	21.00%	21.00%
Increase (decrease) resulting from:		
State income taxes, net of federal benefits	(1.93)%	(4.49)%
Effect of tax-exempt income	(3.50)%	(3.85)%
Disallowed interest	0.23%	0.16%
Cash surrender value of bank-owned life insurance	(6.92)%	(3.19)%
Tax benefit from NOL carryback claim	-	(24.75)%
Expiration of tax credits	7.02%	-
Adjust deferred taxes to actual	1.69%	2.38%
Change in valuation allowance	(6.10)%	-
Stock options	3.42%	-
Nondeductible dues	1.31%	-
Other	<u>2.48%</u>	<u>2.41%</u>
	<u>18.70%</u>	<u>(10.32)%</u>

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 11. Federal and State Income Taxes, Continued

Deferred tax assets and liabilities included in other assets at December 31 consist of the following:

	<u>2022</u>	<u>2021</u>
Deferred tax assets:		
Allowance for loan losses	\$ 298,248	\$ 177,193
Foreclosed real estate	44,729	54,216
Deferred compensation	14,064	2,947
NOL and credits	156,921	143,000
Stock options	9,179	2,239
Net unrealized loss on available for sale securities	<u>1,210,958</u>	<u>58,906</u>
Deferred tax asset	1,734,099	438,501
Valuation allowance	<u>(142,111)</u>	<u>(160,855)</u>
Deferred tax asset, net of valuation allowance	1,591,988	277,646
Deferred tax liabilities:		
Accumulated depreciation	<u>213,306</u>	<u>100,776</u>
Deferred tax liability	<u>213,306</u>	<u>100,776</u>
Net deferred tax asset	<u>\$ 1,378,682</u>	<u>\$ 176,870</u>

Deferred tax assets represent the future tax benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. As of December 31, 2022, management has determined it is likely the majority of the deferred tax asset from continuing operations will be realized. The valuation allowance of \$142,111 relates to the Company's state operating loss and credit carryforwards for which realizability is uncertain.

Note 12. Related Parties

The Bank has engaged in transactions with its directors, significant shareholders, and their affiliates (related parties). The amount of loans to such related parties at December 31, 2022 and 2021 is as follows.

	<u>2022</u>	<u>2021</u>
Balance, beginning of year	\$ 2,339,475	\$ -
New loans originated	413,084	2,397,322
Repayments	<u>(138,111)</u>	<u>(57,847)</u>
Balance, end of year	<u>\$ 2,614,448</u>	<u>\$ 2,339,475</u>

These totals exclude loans made in the ordinary course of business to other companies with which the Bank has no relationship other than the association of one of its directors in the capacity of officer or director. These loan transactions were made on substantially the same terms as those prevailing at the time for comparable loans to other persons. They did not involve more than the normal risk of collectability or present other unfavorable features.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 13. Commitments and Contingencies

The aggregate balances of deposits of related parties held by the Bank at December 31, 2022 and 2021 was \$6,484,272 and \$1,526,345, respectively. These deposit transactions were made on substantially the same terms as those prevailing at the time for comparable deposits of other persons.

In the ordinary course of business, the Bank has various outstanding commitments and contingent liabilities that are not reflected in the accompanying consolidated financial statements. None are expected to have a material adverse effect on the consolidated financial condition of the Bank.

Note 14. Restrictions on Retained Earnings

The approval of the Georgia Department of Banking and Finance is required before the Bank's dividends in a given year may exceed fifty percent of its net profit (as defined) for the preceding year or if the ratio of equity capital to adjusted total assets is less than six percent. During 2022, the Bank paid dividends of \$0 to the Holding Company. At December 31, 2022, approximately \$253,000 were available for dividend distributions without prior regulatory approval. There were no appropriations of, or restrictions on, retained earnings at December 31, 2022.

Note 15. Pension and Profit-Sharing Plans

The Bank maintains a defined contribution profit-sharing plan under the provisions of Section 401(k) of the Internal Revenue Code. As of January 1, 2022, the plan was amended to qualify as a Safe Harbor plan. As such, the plan now covers all the Bank's employees and contributions by the Company are mandatory. The plan continues to allow for voluntary employee pre-tax deferrals. The company matches 100% on the first 3% contributed by the employee and 50% on the next 2% contributed by the employee. The employee is immediately 100% vested in the employer match under the Safe Harbor provisions. The Bank contributed \$42,882 to the plan for the year ended December 31, 2022.

The plan in effect in 2021, covered substantially all the Bank's employees and allowed for voluntary employee pre-tax deferrals. Contributions to that plan were not mandatory and were set annually by the Board of Directors. The Bank contributed \$3,981 to the plan for the year ended December 31, 2021.

Note 16. Stock-Based Compensation

The Company's 2021 Equity Incentive Plan (stock option plan or the Plan), which is director and shareholder-approved, permits the grant of share options to its employees and directors for up to 10% of shares of common stock outstanding, which equates to 279,749 shares at December 31, 2022. Option awards are generally granted with an exercise price equal to the market price of the Company's common stock at the date of grant; those option awards have vesting periods ranging from 3 to 5 years and have 10-year contractual terms.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses the assumptions in the table below. Due to the limited trading in the Company's stock, expected volatilities are based on historical volatilities of a custom peer group of bank holding companies similar in size and scope to our Company. Likewise, the expected term of options granted is based on management's experience at similar institutions and represents the period that options granted are expected to be outstanding, which considers that the options are not transferrable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 16. Stock-Based Compensation, Continued

The fair value of options granted was determined using the following weighted-average assumptions as of grant date:

	<u>2022</u>
Risk-free interest rate	1.31%
Expected term	6 years
Expected stock price volatility	24.28%
Dividend yield	-%

A summary of the activity in the stock option plan for 2022 follows:

	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term (Years)</u>
Outstanding at beginning of year	91,250	\$ 8.00	9.5
Granted	47,800	8.05	9.1
Exercised	-	-	-
Forfeited or expired	(2,500)	8.00	8.5
Outstanding at end of year	<u>136,550</u>	<u>8.02</u>	<u>8.7</u>
Exercisable at end of year	<u>28,417</u>	<u>\$ 8.00</u>	<u>9.0</u>

As of December 31, 2022, there was \$158,087 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over a weighted-average period of 3.69 years.

Note 17. Earnings Per share

	<u>2022</u>	<u>2021</u>
Net Income	\$ 249,942	\$ 353,079
Net income per common share:		
Basic	0.11	0.19
Diluted	0.10	0.19
Weighted Average common shares:		
Basic	2,256,711	1,810,822
Effect of dilutive securities:		
Stock Options	3,102	-
Convertible Preferred Stock	225,000	-
Diluted	<u>\$ 2,484,813</u>	<u>\$ 1,810,822</u>

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 18. Regulatory 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. The net unrealized gain or loss on available for sale securities is included in computing regulatory capital. Management believes as of December 31, 2022, the Company and 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. At year end 2022 and 2021, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institution's category.

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

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

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

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 18. Regulatory Matters, Continued

The leverage capital guidelines presently only apply on a consolidated basis to any bank holding company with consolidated assets of \$3 billion or more, unless the holding company is engaged in certain activities as defined by the Federal Reserve Board. The Company does not anticipate that it would be subject to the consolidated leverage capital measures. However, as a holding company with less than \$3 billion of assets, the Company would be subject to the Federal Reserve Board's Small Bank Holding Company Policy Statement.

Actual and required capital amounts and ratios are presented in the table.

	Amount		To Be Well Capitalized Under Prompt Corrective Action Regulations (CBLR Framework)	
	Amount	Ratio	Amount	Ratio
As of December 31, 2022:				
Tier 1 Capital (to Average Assets)				
Consolidated	\$ 22,929,571	12.72%	N/A	N/A
Southern Bank	\$ 25,836,704	13.89%	\$ 16,744,742	≥ 9.0%

	Amount		To Be Well Capitalized Under Prompt Corrective Action Regulations (CBLR Framework)	
	Amount	Ratio	Amount	Ratio
As of December 31, 2021:				
Tier 1 Capital (to Average Assets)				
Consolidated	\$ 13,888,144	11.84%	N/A	N/A
Southern Bank	\$ 17,831,227	15.20%	\$ 9,969,242	≥ 8.50%

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 19. Fair Value Measurements

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

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

Generally accepted accounting principles related to fair-value measurements and disclosures establishes three levels of inputs that may be used to measure fair value:

- Level 1: Valuation is based on quoted prices in active markets for identical assets or liabilities.
- Level 2: Valuation is based on 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 for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted prices that are traded less frequently than exchange-traded instruments and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.
- Level 3: Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

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

Securities available-for-sale: Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include highly liquid government securities and certain other products. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flows. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy.

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 19. Fair Value Measurements, Continued

Impaired loans: A loan is considered to be impaired when it is probable that the Company or the Bank will be unable to collect all principal or interest payments due in accordance with the contractual terms of the loan agreement. Individually identified impaired loans are measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of

the collateral if the loan is collateral dependent. If the recorded investment in the impaired loan exceeds the measure of fair value, a valuation allowance may be established as a component of the allowance for loan losses. Impaired loans are classified within Level 3 of the hierarchy.

Foreclosed real estate: Foreclosed properties are adjusted to fair value upon transfer of the loans to foreclosed real estate. Subsequently, foreclosed real estate is carried at the lower of carrying value or fair value minus selling costs. When the fair value of the property is based on an observable market price or a current appraised value, the foreclosed real estate is recorded as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the property requires reduction for estimated selling costs or is further impaired below the appraised value and there is no observable market price, the foreclosed real estate is recorded as a nonrecurring Level 3 measurement.

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

		December 31, 2022			
		Level 1	Level 2	Level 3	Total
Recurring fair value measurements					
Securities available-for-sale	\$	-	\$ 48,119,875	\$ -	\$ 48,119,875
	\$	-	\$ 48,119,875	\$ -	\$ 48,119,875
Nonrecurring fair value measurements					
Impaired loans	\$	-	\$ -	\$ 938,096	\$ 938,096
Foreclosed real estate		-	-	273,328	273,328
	\$	-	\$ -	\$ 1,211,424	\$ 1,211,424
		December 31, 2021			
		Level 1	Level 2	Level 3	Total
Recurring fair value measurements					
Securities available-for-sale	\$	-	\$ 27,788,697	\$ -	\$ 27,788,697
	\$	-	\$ 27,788,697	\$ -	\$ 27,778,697
Nonrecurring fair value measurements					
Impaired loans	\$	-	\$ -	\$ 230,595	\$ 230,595
Foreclosed real estate		-	-	553,984	553,984
	\$	-	\$ -	\$ 784,579	\$ 784,579

Southern Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2022 and 2021

Note 20. Condensed Financial Information of Parent Corporation

Condensed Balance Sheets

	<u>2022</u>	<u>2021</u>
Assets		
Cash	\$ 1,944,133	\$ 931,087
Investment in bank subsidiary	22,176,528	17,659,513
Due from bank subsidiary	72,220	20,043
Other Assets	<u>15,250</u>	<u>14,278</u>
Total assets	<u>\$ 24,208,131</u>	<u>\$ 18,624,921</u>
Liabilities and Shareholders' Equity		
Liabilities		
Subordinated debt	4,890,338	4,861,095
Accrued interest payable	47,396	47,396
Other accrued liabilities	<u>1,000</u>	<u>-</u>
Total liabilities	<u>4,938,734</u>	<u>4,908,491</u>
Shareholders' Equity		
Preferred stock	23	-
Common stock	27,975	20,504
Additional paid-in capital	14,473,787	5,689,795
Retained earnings	8,427,787	8,177,845
Accumulated other comprehensive loss	<u>(3,660,175)</u>	<u>(171,714)</u>
Total shareholders' equity	<u>19,269,397</u>	<u>13,716,430</u>
Total liabilities and shareholders' equity	<u>\$ 24,208,131</u>	<u>\$ 18,624,921</u>

Condensed Statements of Income

	<u>2022</u>	<u>2021</u>
Operating Income		
Interest expense	\$ (272,993)	\$ (52,964)
Other operating expenses, net of income tax benefit	<u>17,459</u>	<u>(3,415)</u>
Loss before equity in undistributed net income of subsidiary	(255,534)	(56,379)
Equity in undistributed net income of bank subsidiary	<u>505,476</u>	<u>409,458</u>
Net Income	<u>\$ 249,942</u>	<u>\$ 353,079</u>

Southern Financial Corporation**Notes to Consolidated Financial Statements****December 31, 2022 and 2021**

Note 20. Condensed Financial Information of Parent Corporation, Continued**Condensed Statements of Cash Flows**

	<u>2022</u>	<u>2021</u>
Cash Flow from Operating Activities:		
Net income	\$ 249,942	\$ 353,079
Adjustments to reconcile net income to net cash used by operating activities:		
Subsidiary's undistributed income	(505,476)	(409,458)
Amortization of debt issuance costs	29,243	5,568
Stock based compensation	78,590	8,770
Increase in other assets	(972)	(11,295)
Increase in due from subsidiary	(52,177)	-
increase in other liabilities	1,000	-
Increase in accrued interest payable	-	47,396
Net cash used for operating activities	<u>(199,850)</u>	<u>(5,940)</u>
 Cash Flow from Investing Activities:		
Additional investment in bank subsidiary	<u>(7,500,000)</u>	<u>(8,600,000)</u>
Net cash used for investing activities	<u>(7,500,000)</u>	<u>(8,600,000)</u>
 Cash Flow from Financing Activities:		
Net proceeds from the issuance common stock	6,696,911	4,896,202
Issuance (redemption) of preferred stock	2,015,985	(250,000)
Net proceeds from issuance of subordinated debt	<u>-</u>	<u>4,855,527</u>
Net cash provided by financing activities	<u>8,712,896</u>	<u>9,501,729</u>
Net increase in cash and cash equivalents	1,013,046	895,789
 Cash and equivalents, beginning of year	<u>931,087</u>	<u>35,298</u>
Cash and equivalents, end of year	<u>\$ 1,944,133</u>	<u>\$ 931,087</u>
 Supplemental Disclosure of Cash Flow Information		
Cash paid during the year for:		
Income taxes, net of refunds	<u>\$ (205,385)</u>	<u>\$ 86,857</u>