

THE UPSTATE NATIONAL BANK

ROCHESTER, NEW YORK

AUDITED FINANCIAL STATEMENTS

AND

INDEPENDENT AUDITOR'S REPORT

DECEMBER 31, 2022 AND 2021



BUSINESS
ADVISORS
AND CPAS

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BUSINESS
ADVISORS
AND CPAS

INDEPENDENT AUDITOR'S REPORT

Board of Directors
The Upstate National Bank

Opinion

We have audited the accompanying financial statements of The Upstate National Bank which comprise the balance sheets as of December 31, 2022 and 2021 and the related statements of income, comprehensive (loss) income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of The Upstate National Bank 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 United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of The Upstate National Bank, 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; this includes 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 Upstate National Bank's ability to continue as a going concern for one year after the date that the financial statements are available to be issued.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the 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, but not for the purpose of expressing an opinion on the effectiveness of The Upstate National Bank's internal control. Accordingly, no such opinion is expressed.
- 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 Upstate National Bank'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.

Mengel, Metzger, Baw & Co. LLP

Rochester, New York
March 3, 2023

THE UPSTATE NATIONAL BANK

BALANCE SHEETS

<u>ASSETS</u>	December 31,	
	<u>2022</u>	<u>2021</u>
Cash and due from banks	\$ 298,000	\$ 464,000
Interest bearing deposits with banks	22,622,000	5,251,000
Investment securities:		
Securities available for sale	30,803,000	29,472,000
Securities held to maturity	10,000	10,000
Restricted equity securities	<u>3,238,000</u>	<u>1,706,000</u>
INVESTMENT SECURITIES	34,051,000	31,188,000
Loans, net of allowance for loan losses of \$2,566,000 and \$2,165,000, respectively	247,809,000	208,104,000
Accrued interest receivable	976,000	760,000
Premises and equipment, net	230,000	230,000
Other assets	2,470,000	1,702,000
	<u>\$ 308,456,000</u>	<u>\$ 247,699,000</u>

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

<u>LIABILITIES AND SHAREHOLDERS' EQUITY</u>	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
Liabilities:		
Deposits:		
Non-interest bearing	\$ 25,648,000	\$ 17,297,000
Interest-bearing savings, NOW and money market deposits	61,438,000	104,170,000
Interest-bearing time deposits of \$250,000 or more	17,299,000	1,273,000
Interest-bearing other time deposits	<u>132,463,000</u>	<u>86,571,000</u>
TOTAL DEPOSITS	236,848,000	209,311,000
Federal Home Loan Bank advances	49,500,000	16,000,000
Accrued interest payable	399,000	47,000
Other liabilities	<u>699,000</u>	<u>731,000</u>
TOTAL LIABILITIES	287,446,000	226,089,000
Shareholders' equity:		
Series A:		
Redeemable convertible preferred stock, \$2.50 par value:		
Authorized - 3,880 shares		
Issued and outstanding - 2,825 shares	7,000	7,000
Common stock:		
\$.01 par value: Authorized -		
100,000,000 shares at December 31, 2022 and 2021		
Issued and outstanding - 26,068,848 shares at		
December 31, 2022 and 2021	262,000	262,000
Additional paid in capital	19,360,000	19,360,000
Retained earnings	5,116,000	2,110,000
Accumulated other comprehensive loss	(3,708,000)	(102,000)
Less treasury stock at cost - 39,520 common shares at	<u>(27,000)</u>	<u>(27,000)</u>
December 31, 2022 and 2021	<u>21,010,000</u>	<u>21,610,000</u>
	<u>\$ 308,456,000</u>	<u>\$ 247,699,000</u>

THE UPSTATE NATIONAL BANK

STATEMENTS OF INCOME

	Year ended December 31,	
	2022	2021
Interest income:		
Loans, including fees	\$ 10,310,000	\$ 8,641,000
Debt securities:		
U.S. obligations	627,000	383,000
Deposits with banks and other	252,000	92,000
Total interest income	11,189,000	9,116,000
Interest expense:		
Deposits	2,274,000	1,197,000
Borrowed funds	684,000	105,000
Total interest expense	2,958,000	1,302,000
NET INTEREST INCOME BEFORE PROVISION FOR LOAN LOSSES	8,231,000	7,814,000
Provision for loan losses	400,000	400,000
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	7,831,000	7,414,000
Non-interest income:		
Service charges	68,000	10,000
Other income	49,000	39,000
Total non-interest income	117,000	49,000
Non-interest expenses:		
Salaries and employee benefits	2,228,000	1,940,000
Occupancy expenses	179,000	164,000
Depreciation	53,000	55,000
Professional fees	620,000	576,000
Data processing fees	302,000	283,000
Other loan expense	50,000	39,000
Marketing and advertising	1,000	6,000
FDIC assessments	144,000	150,000
Other operating expenses	272,000	265,000
Total non-interest expenses	3,849,000	3,478,000
INCOME BEFORE INCOME TAXES	4,099,000	3,985,000
Expense for income taxes	(1,093,000)	(920,000)
NET INCOME	\$ 3,006,000	\$ 3,065,000
NET INCOME APPLICABLE TO COMMON SHAREHOLDERS	\$ 3,006,000	\$ 3,065,000
Earnings per common share:		
Basic	\$ 0.12	\$ 0.12
Diluted	\$ 0.12	\$ 0.12

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

THE UPSTATE NATIONAL BANK

STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

	<u>Year ended December 31,</u>	
	<u>2022</u>	<u>2021</u>
Net income	\$ 3,006,000	\$ 3,065,000
Other comprehensive loss:		
Change in net unrealized loss on available for sale securities	(4,484,000)	(780,000)
Tax effect	<u>878,000</u>	<u>28,000</u>
OTHER COMPREHENSIVE LOSS	<u>(3,606,000)</u>	<u>(752,000)</u>
COMPREHENSIVE (LOSS) INCOME	<u>\$ (600,000)</u>	<u>\$ 2,313,000</u>

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

THE UPSTATE NATIONAL BANK

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

YEARS ENDED DECEMBER 31, 2022 AND 2021

	Series A Redeemable Convertible Preferred Stock	Common Stock	Additional Paid-in Capital	(Accumulated (deficit) retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total
Balance at January 1, 2021	\$ 7,000	\$ 262,000	\$ 19,360,000	\$ (955,000)	\$ 650,000	\$ (27,000)	\$ 19,297,000
Net income	-	-	-	3,065,000	-	-	3,065,000
Other comprehensive loss	-	-	-	-	(780,000)	-	(780,000)
Tax effect	-	-	-	-	28,000	-	28,000
	BALANCE AT						
	DECEMBER 31, 2021						
	7,000	262,000	19,360,000	2,110,000	(102,000)	(27,000)	\$ 21,610,000
Net income	-	-	-	3,006,000	-	-	3,006,000
Other comprehensive loss	-	-	-	-	(4,484,000)	-	(4,484,000)
Tax effect	-	-	-	-	878,000	-	878,000
	BALANCE AT						
	DECEMBER 31, 2022						
	<u>\$ 7,000</u>	<u>\$ 262,000</u>	<u>\$ 19,360,000</u>	<u>\$ 5,116,000</u>	<u>\$ (3,708,000)</u>	<u>\$ (27,000)</u>	<u>\$ 21,010,000</u>

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

THE UPSTATE NATIONAL BANK

STATEMENTS OF CASH FLOWS

	<u>Year ended December 31,</u>	
	<u>2022</u>	<u>2021</u>
<u>CASH FLOWS - OPERATING ACTIVITIES</u>		
Net income	\$ 3,006,000	\$ 3,065,000
Adjustments to reconcile net income to net cash provided from operating activities:		
Provision for loan losses	400,000	400,000
Depreciation	53,000	55,000
Net amortization of securities	77,000	144,000
Amortization on loans, net	89,000	(112,000)
Deferred income tax expense	420,000	917,000
Changes in certain assets and liabilities affecting operations:		
Accrued interest receivable	(216,000)	37,000
Other assets	(234,000)	-
Accrued interest payable	352,000	(33,000)
Other liabilities	(32,000)	361,000
	<u>3,915,000</u>	<u>4,834,000</u>
NET CASH PROVIDED FROM OPERATING ACTIVITIES	3,915,000	4,834,000
<u>CASH FLOWS - INVESTING ACTIVITIES</u>		
Increase in loans, net	(40,194,000)	(33,238,000)
Proceeds from available for sale securities	6,290,000	6,453,000
Proceeds from restricted equity securities	561,000	1,489,000
Purchase of available for sale securities	(12,258,000)	(23,378,000)
Purchase of restricted equity securities	(2,093,000)	(1,882,000)
Purchases of premises and equipment	(53,000)	(6,000)
(Increase) decrease in interest bearing deposits with banks, net	(17,371,000)	5,480,000
	<u>(65,118,000)</u>	<u>(45,082,000)</u>
NET CASH USED FOR INVESTING ACTIVITIES	(65,118,000)	(45,082,000)
<u>CASH FLOWS - FINANCING ACTIVITIES</u>		
Net increase in deposits	27,537,000	35,281,000
Increase in Federal Home Loan Bank advances	33,500,000	5,000,000
	<u>61,037,000</u>	<u>40,281,000</u>
NET CASH PROVIDED FROM FINANCING ACTIVITIES	61,037,000	40,281,000
	(166,000)	33,000
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(166,000)	33,000
Cash and cash equivalents at beginning of year	464,000	431,000
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 298,000</u>	<u>\$ 464,000</u>

THE UPSTATE NATIONAL BANK
STATEMENTS OF CASH FLOWS, Cont'd

	<u>Year ended December 31,</u>	
	<u>2022</u>	<u>2021</u>
<u>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</u>		
Cash paid during the period for:		
Interest	<u>\$ 2,606,000</u>	<u>\$ 1,335,000</u>
Income taxes	<u>\$ 660,505</u>	<u>\$ 3,000</u>

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

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS

DECEMBER 31, 2022 AND 2021

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

The Upstate National Bank (the Bank), a national bank with offices in New York State, provides lending, deposit, and other financial services to consumers and businesses located within its service area.

Cash and cash equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash, due from banks, federal funds sold, and short-term investments, with original terms to maturity of 90 days or less.

Investment securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as “held to maturity” and recorded at amortized cost. Securities not classified as held to maturity are classified as “available for sale”. Unrealized holding losses and gains for debt securities are reported in other comprehensive income (loss), whereas unrealized holding gains and losses for equity securities are reported in net income. Restricted equity securities consist primarily of Federal Reserve Bank and Federal Home Loan Bank stock.

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

Loans

The Bank grants mortgage, commercial, and consumer loans to customers. A substantial portion of the loan portfolio is represented by residential and commercial mortgage loans throughout New York State. The ability of the Bank’s debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding principal balances adjusted for the allowance for loan losses and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees (net of certain direct origination costs), premiums, and discounts are deferred and recognized as an adjustment of the related loan yield using the interest method over the contractual life of the loan.

The accrual of interest on residential mortgage, commercial mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in the process of collection. Loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Cont'd

All interest income accrued but not collected for loans that are placed on nonaccrual or charged off is generally reversed against interest income. Interest received on nonaccrual loans, including impaired loans, generally is applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

Allowance for loan losses

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans, or portions of loans, which are determined to be uncollectible are charged against the allowance account and subsequent recoveries, if any, are credited to the account. The allowance for loan losses is based on management's ongoing assessment of the Bank's credit exposure, given its judgment about a number of relevant variables. These variables include prevailing and anticipated domestic economic conditions, assigned risk ratings, the diversification and size of the loan portfolio, the results of the most recent regulatory examinations available to the Bank, off-balance sheet credit risks, the nature and level of non-performing loans that have been identified as potential problems, the adequacy of collateral, past and expected loss experience and other factors deemed relevant by management. 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 impaired. For loans that are classified as impaired, an allowance is established when the discounted cash flow (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans that are not considered impaired, as well as smaller balance homogeneous consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these categories of loans, adjusted for qualitative risk factors.

Each of the qualitative risk factors is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information at the time of the evaluation.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Cont'd

An allowance for loan losses is established for an impaired loan if its carrying amount exceeds its estimated fair value. The estimated fair values of substantially all of the Bank's impaired loans are measured based on the estimated fair value of the loan's collateral.

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

Loans whose terms are modified are classified as troubled debt restructurings if the Bank grants such borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate or an extension of a loan's stated maturity date. Nonaccrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as troubled restructurings are designated as impaired.

The allowance calculation methodology includes further segregation of loan classes into risk rating categories. The borrower's overall financial condition, repayment sources, guarantors and value of collateral, if appropriate, are evaluated annually for commercial loans or when credit deficiencies arise, such as delinquent loan payments, for commercial and consumer loans.

Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans criticized special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledge, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, or the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loans losses. Loans not classified are rated pass.

Management believes the allowance for loan losses is adequate. While management uses available information in establishing the allowance for loan losses, future additions to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

Premises and equipment

Premises and equipment are stated at cost less accumulated depreciation. Major renewals and betterments are capitalized, while repairs and maintenance are charged to operations as incurred. Upon sale or retirement, the related cost and allowances for depreciation are removed from the accounts and the related gain or loss is reflected in operations. Depreciation is computed by the straight-line method over the estimated useful lives of the assets, which range from 3 to 40 years.

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Cont'd

Foreclosed real estate

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less costs to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of the property to the lower of its cost or fair value less costs to sell. There was no foreclosed real estate at December 31, 2022 or 2021.

Common stock

In 2018, the Board of Directors approved a proposal to amend the Certificate of Incorporation to increase the number of authorized shares of common stock from 50,000,000 shares to 100,000,000 shares. The amendment had no effect on the par value of the common stock.

Treasury stock

Treasury stock is recorded at cost.

Income taxes

Deferred tax assets and liabilities arise from temporary differences between the financial statement and tax basis of assets and liabilities, as measured by the enacted tax rates which are expected to be in effect when these differences reverse. Deferred tax expense (benefit) is a result of the changes in deferred tax assets and liabilities, except for the change in deferred taxes related to unrealized gains (losses) on debt securities available for sale which is reflected in other comprehensive income. The principal types of temporary differences between assets and liabilities for financial statement and tax return purposes are detailed in Note 8.

The Bank is taxed under the provisions of the Internal Revenue Code and applicable state tax laws. The Bank files tax returns in the U.S. federal jurisdiction and in New York State. With few exceptions, as of December 31, 2022, the Bank is no longer subject to U.S. federal or state income tax examinations by tax authorities for years ended before December 31, 2019. The tax returns for the years ended December 31, 2019 through 2022 are still subject to potential audit by the IRS and the taxing authorities in New York State. Management of the Bank believes it has no material uncertain tax positions and, accordingly, it has not recognized any liability for unrecognized tax benefits.

Off-balance sheet financial instruments

In the ordinary course of business, the Bank has originated off-balance sheet financial instruments consisting of commitments to extend credit, unused portions of consumer credit lines, commercial letters of credit, and municipal letters of credit. Such financial instruments are recorded in the financial statements when they are funded.

Use of estimates in the preparation of financial statements

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

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Cont'd

Comprehensive income (loss)

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) consists of the change in net unrealized gains (losses) on available for sale debt securities.

New accounting pronouncement – credit losses

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326). The ASU amends the guidance on the impairment of financial instruments. The ASU adds an impairment model known as the current expected credit loss (CECL) model that is based on expected losses rather than incurred losses. Under the new guidance, the Bank recognizes as an allowance its estimate of expected credit losses, which FASB believes will result in more timely recognition of losses when compared to the current model. For nonpublic business entities, the guidance in this ASU is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2022. The Bank has selected a vendor to assist in the implementation process. The model chosen utilizes a loss driver analysis which includes reasonable and supportable forecasts to estimate future losses. This analysis includes different methods which are used depending on the nature of the portfolio segment. The Bank is running its current incurred loss model and a CECL model concurrently. The Bank is in the process of updating its policies and internal controls accordingly. The Bank will recognize a one-time cumulative-effect adjustment to the allowance for loan losses upon adoption of CECL, effective January 1, 2023 if necessary.

Revenue recognition

The majority of the Bank's revenue-generating transactions are not subject to ASC 606, including revenue generated from financial instruments, such as loans and investment securities which are presented in the statements of income as components of net interest income. All of the Bank's revenue from contracts with customers in the scope of ASC 606 is recognized within non-interest income.

Other income and service charges: The Bank earns fees from its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as ATM users 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 Bank fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are recognized at the time the maintenance occurs. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance.

Subsequent events

The Bank has conducted an evaluation of potential subsequent events occurring after the balance sheet date through March 3, 2023, which is the date the financial statements are available to be issued. No subsequent events requiring disclosure were noted.

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

2. EARNINGS PER COMMON SHARE

Basic earnings per common share is computed by dividing net income applicable to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income by the weighted-average number of common shares and dilutive potential common shares outstanding during the period. Treasury shares are not deemed outstanding for earnings per share calculations.

The factors used in the calculation of basic earnings per share and diluted earnings per share for the years ended December 31, 2022 and 2021 are as follows:

	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
Net income	<u>\$ 3,006,000</u>	<u>\$ 3,065,000</u>
Basic weighted-average shares	26,068,848	26,068,848
Effect of dilutive securities:		
Convertible preferred stock - Series A	<u>14,125</u>	<u>14,125</u>
Dilutive potential common shares	<u>26,082,973</u>	<u>26,082,973</u>
Net earnings per share:		
Basic	<u>\$ 0.12</u>	<u>\$ 0.12</u>
Diluted	<u>\$ 0.12</u>	<u>\$ 0.12</u>

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

3. INVESTMENT SECURITIES

The amortized cost and fair value of investment securities with gross unrealized gains and losses are as follows:

	<u>Amortized cost</u>	<u>Gross unrealized gains</u>	<u>Gross unrealized losses</u>	<u>Fair value</u>
<u>December 31, 2022</u>				
Available for sale:				
Mortgage Backed Securities -				
Government issued or guaranteed	\$ 20,035,000	\$ 44,000	\$ 2,439,000	\$ 17,640,000
U.S. government agency securities	920,000	-	32,000	888,000
Municipal bonds	9,561,000	-	1,588,000	7,973,000
SBA loan backed securities	<u>4,976,000</u>	<u>-</u>	<u>674,000</u>	<u>4,302,000</u>
Total securities available for sale	<u>\$ 35,492,000</u>	<u>\$ 44,000</u>	<u>\$ 4,733,000</u>	<u>\$ 30,803,000</u>
Held to maturity:				
State and municipal securities	<u>\$ 10,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 10,000</u>
Total held to maturity securities	<u>\$ 10,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 10,000</u>
Restricted equity securities	<u>\$ 3,238,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,238,000</u>
<u>December 31, 2021</u>				
Available for sale:				
Mortgage Backed Securities -				
Government issued or guaranteed	\$ 17,129,000	\$ 144,000	\$ 278,000	\$ 16,995,000
Municipal bonds	7,611,000	36,000	-	7,647,000
SBA loan backed securities	<u>4,862,000</u>	<u>158,000</u>	<u>190,000</u>	<u>4,830,000</u>
Total securities available for sale	<u>\$ 29,602,000</u>	<u>\$ 338,000</u>	<u>\$ 468,000</u>	<u>\$ 29,472,000</u>
Held to maturity:				
State and municipal securities	<u>\$ 10,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 10,000</u>
Total held to maturity securities	<u>\$ 10,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 10,000</u>
Restricted equity securities	<u>\$ 1,706,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,706,000</u>

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

3. INVESTMENT SECURITIES, Cont'd

The above restricted equity securities primarily include non-marketable Federal Home Loan Bank New York (FHLBNY) stock and non-marketable Federal Reserve Bank (FRB) stock, both of which are required to be held for regulatory purposes and for borrowing availability. The required investment in FHLBNY stock is tied to the Banks's borrowing levels with the FHLB. Holdings of FHLBNY stock and FRB stock totaled \$2,569,000 and \$589,000 at December 31, 2022, respectively and \$1,037,000 and \$589,000 at December 31, 2021, respectively. The Bank has an investment in a banker's bank of \$80,000 at December 31, 2022 and 2021. These securities are carried at par, which is also cost.

Restricted equity securities are held as a long-term investment and value is determined based on the ultimate recoverability of the par value. Impairment of these investments is evaluated quarterly and is a matter of judgement that reflects management's view of the issuer's long-term performance, which includes factors such as the following: its operating performance; the severity and duration of declines in the fair value of its net assets related to its capital stock amount; its commitment to make payments required by law or regulation and the level of such payments in relation to its operating performance; and its liquidity and funding position. After evaluating these considerations, the Bank concluded that the par value of these investments will be recovered and, as such, has not recognized any impairment of its holdings of restricted equity securities during the current year.

Management evaluates securities for other than temporary impairment at least on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value.

Gross unrealized losses in securities available for sale at December 31, 2022 consist of securities in a continuous loss position of:

	<u>Amortized cost</u>	<u>Fair value</u>	<u>Gross unrealized losses</u>
12 months or more	\$ 16,743,000	\$ 13,715,000	\$ 3,028,000
Less than 12 months	13,406,000	11,701,000	1,705,000

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

3. INVESTMENT SECURITIES, Cont'd

The amortized cost and fair value of debt securities by contractual maturities at December 31, 2022 are as follows:

	<u>Available for sale</u>		<u>Held to maturity</u>	
	<u>Amortized cost</u>	<u>Fair value</u>	<u>Amortized cost</u>	<u>Fair value</u>
Due in one year or less	\$ 2,000	\$ 2,000	\$ -	\$ -
Due after year through five years	1,147,000	1,107,000	10,000	10,000
Due after five years through ten years	8,106,000	6,790,000	-	-
Due after ten years or more	<u>26,237,000</u>	<u>22,904,000</u>	<u>-</u>	<u>-</u>
	<u>\$ 35,492,000</u>	<u>\$ 30,803,000</u>	<u>\$ 10,000</u>	<u>\$ 10,000</u>

No securities were pledged at December 31, 2022 or 2021.

4. LOANS

Loans receivable, net are summarized as follows:

	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>90 Days or More Past Due (Still accruing interest)</u>	<u>90 Days or More Past Due (Nonaccrual)</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total</u>
<u>December 31, 2022</u>							
Construction and Land Development	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 6,399,000	\$ 6,399,000
Residential Mortgages	-	-	-	-	-	117,119,000	117,119,000
Multi - Family	-	-	-	-	-	47,197,000	47,197,000
Commercial Real Estate	-	-	-	-	-	73,822,000	73,822,000
Commercial and Industrial	-	-	-	-	-	5,831,000	5,831,000
Loans to Individuals	-	-	-	-	-	3,000	3,000
All Other Loans	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,000</u>	<u>4,000</u>
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 250,375,000</u>	<u>\$ 250,375,000</u>
						Allowance for loan losses	<u>(2,566,000)</u>
						Total loans receivable	<u>\$ 247,809,000</u>

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

4. LOANS, Cont'd

<u>December 31, 2021</u>	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>90 Days or More Past Due (Still accruing interest)</u>	<u>90 Days or More Past Due (Nonaccrual)</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total</u>
Construction and Land Development	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 4,939,000	\$ 4,939,000
Residential Mortgages	-	-	-	-	-	89,307,000	89,307,000
Multi - Family	-	-	-	-	-	38,474,000	38,474,000
Commercial Real Estate	-	-	-	-	-	68,869,000	68,869,000
Commercial and Industrial	-	-	174,000 *	-	174,000	8,424,000	8,598,000
Loans to Individuals	-	-	-	-	-	13,000	13,000
Municipals	-	-	-	-	-	61,000	61,000
All Other Loans	-	-	-	-	-	8,000	8,000
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 174,000</u>	<u>\$ -</u>	<u>\$ 174,000</u>	<u>\$ 210,095,000</u>	<u>\$ 210,269,000</u>
						Allowance for loan losses	<u>(2,165,000)</u>
						Total loans receivable	<u>\$ 208,104,000</u>

* Loan is well-secured and in the process of collection.

THE UPSTATE NATIONAL BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2022 AND 2021

4. LOANS, Cont'd

All loans 90 days or more past due shown in the tables, if any, above are in nonaccrual status. There were no loans in nonaccrual status for the years ended December 31, 2022 and 2021. The Bank had one loan 90 days or more delinquent and still accruing interest at December 31, 2021. There were no loans 90 days or more delinquent and still accruing interest at December 31, 2022.

Activity in the allowance for loan losses is summarized below:

	Construction and Land Development	Residential Mortgages	Multi- Family	Commercial Real Estate	Commercial and Industrial	Loans to Individuals	Municipals	All Other Loans	Unallocated	Total
2022:										
Beginning balance	\$ 31,000	\$ 86,000	\$ 79,000	\$ 409,000	\$ 505,000	\$ -	\$ 1,000	\$ 3,000	\$ 1,051,000	\$ 2,165,000
Provision for loan losses	-	-	-	-	-	-	-	-	400,000	400,000
Transfers	-	-	-	-	-	-	(1,000)	-	1,000	-
Charge-offs	-	-	-	-	1,000	-	-	-	-	1,000
Ending balance	<u>\$ 31,000</u>	<u>\$ 86,000</u>	<u>\$ 79,000</u>	<u>\$ 409,000</u>	<u>\$ 506,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,000</u>	<u>\$ 1,452,000</u>	<u>\$ 2,566,000</u>
2021:										
Beginning balance	\$ 31,000	\$ 86,000	\$ 79,000	\$ 422,000	\$ 505,000	\$ -	\$ 1,000	\$ 3,000	\$ 651,000	\$ 1,778,000
Provision for loan losses	-	-	-	-	-	-	-	-	400,000	400,000
Charge-offs	-	-	-	-	-	-	-	-	-	-
Recoveries	-	-	-	(13,000)	-	-	-	-	-	(13,000)
Ending balance	<u>\$ 31,000</u>	<u>\$ 86,000</u>	<u>\$ 79,000</u>	<u>\$ 409,000</u>	<u>\$ 505,000</u>	<u>\$ -</u>	<u>\$ 1,000</u>	<u>\$ 3,000</u>	<u>\$ 1,051,000</u>	<u>\$ 2,165,000</u>

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

4. LOANS, Cont'd

Information pertaining to the allocation and balance of the allowance for loan losses and loans receivable based on individual and collective impairment evaluation by loan portfolio class as of December 31, 2022 and 2021 follows:

	Allowance for Loan Loss			Loans Receivable		
	Balance	Balances related to loans individually evaluated for impairment	Balances related to loans collectively evaluated for impairment	Balance	Balance Individually evaluated for impairment	Balance Collectively evaluated for impairment
<u>December 31, 2022</u>						
Construction and Land Development	\$ 31,000	\$ -	\$ 31,000	\$ 6,399,000	\$ -	6,399,000
Residential Mortgages	86,000	-	86,000	117,119,000	-	117,119,000
Multi - Family	79,000	-	79,000	47,197,000	-	47,197,000
Commercial Real Estate	409,000	-	409,000	73,822,000	-	73,822,000
Commercial and Industrial	506,000	-	506,000	5,831,000	-	5,831,000
Loans to Individuals	-	-	-	3,000	-	3,000
All Other Loans	3,000	-	3,000	4,000	-	4,000
Unallocated	1,452,000	-	1,452,000	-	-	-
Total	<u>\$ 2,566,000</u>	<u>\$ -</u>	<u>\$ 2,566,000</u>	<u>\$ 250,375,000</u>	<u>\$ -</u>	<u>\$ 250,375,000</u>
<u>December 31, 2021</u>						
Construction and Land Development	\$ 31,000	\$ -	\$ 31,000	\$ 4,939,000	\$ -	4,939,000
Residential Mortgages	86,000	-	86,000	89,307,000	-	89,307,000
Multi - Family	79,000	-	79,000	38,474,000	-	38,474,000
Commercial Real Estate	409,000	-	409,000	68,869,000	-	68,869,000
Commercial and Industrial	505,000	-	505,000	8,598,000	174,000	8,424,000
Loans to Individuals	-	-	-	13,000	-	13,000
Municipals	1,000	-	1,000	61,000	-	61,000
All Other Loans	3,000	-	3,000	8,000	-	8,000
Unallocated	1,051,000	-	1,051,000	-	-	-
Total	<u>\$ 2,165,000</u>	<u>\$ -</u>	<u>\$ 2,165,000</u>	<u>\$ 210,269,000</u>	<u>\$ 174,000</u>	<u>\$ 210,095,000</u>

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

4. LOANS, Cont'd

The following is information pertaining to impaired loans at December 31, 2022 and 2021:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Interest Income Recognized</u>
2022:				
With no related allowance recorded:				
Commercial and Industrial	\$ -	\$ -	\$ -	\$ -
Total	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
2021:				
With no related allowance recorded:				
Commercial and Industrial	\$ 177,000	\$ 174,000	\$ -	\$ 6,000
Total	<u>\$ 177,000</u>	<u>\$ 174,000</u>	<u>\$ -</u>	<u>\$ 6,000</u>

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

4. LOANS, Cont'd

The following table presents the classes of the loan portfolio summarized by the pass rating and the classified ratings of special mention, substandard, and doubtful within the Bank's internal risk rating system as of December 31, 2022 and 2021:

	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
<u>December 31, 2022</u>					
Construction and Land Development	\$ 6,399,000	\$ -	\$ -	\$ -	\$ 6,399,000
Residential Mortgages	117,119,000	-	-	-	117,119,000
Multi - Family	47,197,000	-	-	-	47,197,000
Commercial Real Estate	73,098,000	724,000	-	-	73,822,000
Commercial and Industrial	5,831,000	-	-	-	5,831,000
Loans to Individuals	3,000	-	-	-	3,000
All Other Loans	<u>4,000</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,000</u>
	<u>\$ 249,651,000</u>	<u>\$ 724,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 250,375,000</u>
<u>December 31, 2021</u>					
Construction and Land Development	\$ 4,939,000	\$ -	\$ -	\$ -	\$ 4,939,000
Residential Mortgages	89,307,000	-	-	-	89,307,000
Multi - Family	38,258,000	-	216,000	-	38,474,000
Commercial Real Estate	68,737,000	132,000	-	-	68,869,000
Commercial and Industrial	8,598,000	-	-	-	8,598,000
Loans to Individuals	13,000	-	-	-	13,000
Municipals	61,000	-	-	-	61,000
All Other Loans	<u>8,000</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>8,000</u>
	<u>\$ 209,921,000</u>	<u>\$ 132,000</u>	<u>\$ 216,000</u>	<u>\$ -</u>	<u>\$ 210,269,000</u>

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

5. PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2022 and 2021 by major classification are summarized as follows:

	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
Buildings and improvements	\$ 594,000	\$ 594,000
Furniture, fixtures and equipment	399,000	346,000
Land	<u>91,000</u>	<u>91,000</u>
	1,084,000	1,031,000
Accumulated depreciation	<u>854,000</u>	<u>801,000</u>
Net book value	<u>\$ 230,000</u>	<u>\$ 230,000</u>

6. DEPOSITS

The aggregate amount of time deposits in denominations of \$250,000 or more at December 31, 2022 and 2021 was \$17,299,000 and \$1,273,000 respectively. Brokered deposits, including non-reciprocal CDARS and ICS deposits, totaled approximately \$49,500,000 and \$16,000,000 at December 31, 2022 and 2021, respectively.

At December 31, 2022, the scheduled maturities of time deposits are as follows:

2023	\$ 113,201,000
2024	11,207,000
2025	14,223,000
2026	888,000
2027	9,994,000
2028	<u>249,000</u>
	<u>\$ 149,762,000</u>

7. FEDERAL HOME LOAN BANK ADVANCES

The Bank pledges assets to the FHLB as collateral for the ability to borrow from the FHLB and for letters of credit to collateralize certain municipal deposits. At December 31, 2022, the Bank had pledged approximately \$220,422,000 of mortgage loans receivable. There was \$49,500,000 in advances from the FHLB at December 31, 2022. Total eligible collateral value at December 31, 2022 was approximately \$155,924,000. The Bank had the capacity to borrow an additional amount of approximately \$48,524,000 from the FHLB against this collateral at December 31, 2022. At December 31, 2021, the Bank had pledged approximately \$184,969,000 of mortgage loans receivable. There was \$16,000,000 in advances from the FHLB at December 31, 2021. Total eligible collateral value at December 31, 2021 was approximately \$134,512,000. The Bank had the capacity to borrow an additional amount of approximately \$36,712,000 from the FHLB against this collateral at December 31, 2021.

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

8. INCOME TAXES

The expense from income taxes for the years ended December 31, 2022 and 2021 is summarized as follows:

	<u>2022</u>	<u>2021</u>
Current:		
Federal	\$ 603,000	\$ -
State	70,000	3,000
Deferred	<u>420,000</u>	<u>917,000</u>
	<u>\$ 1,093,000</u>	<u>\$ 920,000</u>

State income tax expense consists of current state capital base taxes payable.

The Bank's 2022 and 2021 effective tax rates differ from the statutory U.S. Federal income tax rate due primarily to the effects of state taxes and certain nondeductible expenses for Federal tax purposes.

	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
Deferred tax assets:		
Federal net operating loss carryforwards	\$ -	\$ 389,000
State net operating loss carryforwards	673,000	825,000
Unrealized loss on securities held for sale	985,000	-
Allowance for loan losses	321,000	216,000
Other	<u>16,000</u>	<u>23,000</u>
Total deferred tax assets	1,995,000	1,453,000
Deferred tax liabilities:		
Other	<u>(42,000)</u>	<u>(35,000)</u>
Total deferred tax liabilities	<u>(42,000)</u>	<u>(35,000)</u>
Net deferred tax assets	<u>\$ 1,953,000</u>	<u>\$ 1,418,000</u>

At December 31, 2022, the Bank has no Federal net operating loss carryforwards remaining. The Bank has available for carryforward \$10,353,000 of New York State net operating loss carryforwards expiring at various dates through 2039.

Accounting principles generally accepted in the United States of America prescribe minimum recognition thresholds for evaluating uncertain income tax positions, and provide guidance on derecognition, measurement, classification, interest and penalties, and disclosure.

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

9. EMPLOYEE BENEFIT PLAN

The Bank has a salary savings profit sharing plan. The plan provides for matching contributions at a rate of 65% by the Bank up to 6% of each eligible employee's salary, for a maximum match of 3.9%. Expense for the plan, which is included in salaries and employee benefits, aggregated \$70,000 and \$68,000 for the years ended December 31, 2022 and 2021, respectively.

10. OFF-BALANCE SHEET ACTIVITIES

The Bank is a party to credit related 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, consumer lines of credit and commercial letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets.

The Bank's exposure to credit loss is represented by the contractual amount of these commitments. The Bank follows the same credit policies in making commitments as it does for on-balance sheet instruments.

At December 31, 2022 and 2021, commitments of \$23,150,000 and \$24,367,000, respectively, were outstanding whose contract amounts represent credit risk. Of these amounts, commitments to extend new money totaled \$8,102,000 and \$11,428,000 at December 31, 2022 and 2021, respectively. The unused portion of lines of credit and construction loans totaled \$15,000,000 and \$12,891,000 at December 31, 2022 and 2021, respectively. Conditional letters of credit totaled \$48,000 at December 31, 2022 and 2021.

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.

The commitments may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

Commercial and municipal letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary. Management believes that the proceeds through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding commitments. No liability was required to be recorded on the balance sheets as December 31, 2022 and 2021 under letters of credit.

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

11. REGULATORY CAPITAL

The Bank, as a national bank, is subject to the dividend restrictions set forth by The Office of the Comptroller of the Currency (OCC). Under such restrictions, the Bank may not, without prior approval of the OCC, declare dividends, either common or preferred, that would exceed its net profits for the current year combined with retained net profits (net profits minus dividends paid during that period) of the two prior years. There were no dividends declared or paid during 2022 or 2021.

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

In addition to setting minimum capital ratios, the requirements introduce a capital conservation buffer, which must be added to each of the minimum capital ratios and is designed to absorb losses during period of economic stress. The implementation of the capital conservation buffer began on January 1, 2016 and reached 2.5% on January 1, 2019. If the Bank fails to hold capital above minimum capital ratios, including the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain required amounts and ratios as set forth in the table below.

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

11. REGULATORY CAPITAL, Cont'd

As of December 31, 2022, the most recent notification categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, Common Equity Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following table:

	Actual		To be adequately capitalized under prompt corrective action provisions		To be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2022:						
Total capital (to risk-weighted assets)	\$ 25,318,000	12.39%	\$ 16,347,000	8.00%	\$ 20,434,000	10.00%
Tier 1 capital (to risk-weighted assets)	22,762,000	11.14%	12,260,000	6.00%	16,347,000	8.00%
Tier 1 capital (leveraged) (to adjusted total assets)	22,762,000	7.97%	11,421,000	4.00%	14,276,000	6.00%
Common Equity Tier 1 (to risk-weighted assets)	22,743,000	11.13%	9,195,000	4.50%	13,282,000	6.50%
As of December 31, 2021:						
Total capital (to risk-weighted assets)	\$ 22,418,000	13.19%	\$ 13,596,000	8.00%	\$ 16,996,000	10.00%
Tier 1 capital (to risk-weighted assets)	20,293,000	11.94%	10,197,000	6.00%	13,596,000	8.00%
Tier 1 capital (leveraged) (to adjusted total assets)	20,293,000	8.20%	9,895,000	4.00%	12,369,000	6.00%
Common Equity Tier 1 (to risk-weighted assets)	20,274,000	11.93%	7,648,000	4.50%	11,047,000	6.50%

THE UPSTATE NATIONAL BANK

NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

12. FAIR VALUE MEASUREMENTS

The definition of fair value is clarified by accounting principles generally accepted in the United States of America ("GAAP") to be the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. GAAP established a three-level hierarchy for fair value measurements based upon the inputs to the valuation of an asset or liability.

Level 1 - Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 - Valuation is determined from quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar instruments in markets that are not active or by model-based techniques in which all significant inputs are observable in the market.

Level 3 - Valuation is derived from model-based techniques in which at least one significant input is unobservable and based on the Bank's own estimates about the assumptions that market participants would use to value the asset or liability.

The asset's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at December 31, 2022 and 2021.

U.S. government agency securities, mortgage backed securities and SBA loan backed securities: Valued by reference to prices for similar securities or through model-based techniques in which all significant inputs are observable.

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Bank believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

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NOTES TO FINANCIAL STATEMENTS, Cont'd

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12. FAIR VALUE MEASUREMENTS, Cont'd

Fair values of assets measured on a recurring basis at December 31, 2022 and 2021 are as follows:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<u>December 31, 2022</u>				
Mortgage backed securities -				
Government issued or guaranteed	\$ -	\$ 17,640,000	\$ -	\$ 17,640,000
U.S. government agency securities	-	888,000	-	888,000
Municipal bonds	-	7,973,000	-	7,973,000
SBA loan backed securities	-	4,302,000	-	4,302,000
Total securities available for sale	<u>\$ -</u>	<u>\$ 30,803,000</u>	<u>\$ -</u>	<u>\$ 30,803,000</u>
 <u>December 31, 2021</u>				
Mortgage backed securities -				
Government issued or guaranteed	\$ -	\$ 16,995,000	\$ -	\$ 16,995,000
Municipal bonds	-	7,647,000	-	7,647,000
SBA loan backed securities	-	4,830,000	-	4,830,000
Total securities available for sale	<u>\$ -</u>	<u>\$ 29,472,000</u>	<u>\$ -</u>	<u>\$ 29,472,000</u>

13. RELATED PARTY TRANSACTIONS

The Bank has entered into transactions with its directors, significant shareholders and their affiliates (related parties). There were no loans to related parties at December 31, 2022 and 2021. The aggregate amount of deposits from such related parties at December 31, 2022 and 2021 were \$3,802,000 and \$3,421,000, respectively.

14. REDEEMABLE CONVERTIBLE PREFERRED STOCK

Holders of the Series A redeemable convertible preferred stock will be entitled to receive dividends as declared by the Board of Directors, if any, out of assets of the Bank legally available for payment. Any Series A redeemable convertible preferred stock dividends, if declared, will be at the rate of 5.5% per annum, based on a \$10 per share purchase price, or \$0.55 per share per annum. This rate can be changed by the Board of Directors at any time. No preferred stock dividends were paid in 2022 and 2021. The preferred stock is non-cumulative, however, dividends in any year must be paid on the Series A redeemable convertible preferred stock prior to any payment of dividends on the common stock.

Each share of the Series A redeemable convertible preferred stock is convertible into 5 shares of common stock at the option of the holder. There were no preferred stock transactions during 2022 and 2021.

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NOTES TO FINANCIAL STATEMENTS, Cont'd

DECEMBER 31, 2022 AND 2021

14. REDEEMABLE CONVERTIBLE PREFERRED STOCK, Cont'd

The holders of preferred stock will not have a vote in any matter, unless otherwise required by law.

In the event of a liquidation, dissolution or winding up of the Bank, each holder of preferred stock would be entitled to receive, after payment of all debts and liabilities of the Bank and prior to any liquidation rights of the holders of common stock, a pro rata portion of all assets of the Bank available for distribution to holders of preferred stock up to the amount of the preferred stock purchase price. Holders of preferred stock have no right to share in any other assets of the Bank upon liquidation.

Holders of shares of common stock are not entitled to preemptive rights with respect to any shares of preferred stock that may be issued. The shares of preferred stock will be redeemable at the option of the holder.

15. COMMITMENTS

The Bank has a master license maintenance and service agreement for data processing software which expires in March 2027. The agreement requires total monthly payments approximating \$19,000 per month.

Future minimum payments are as follows:

<u>Year</u>	<u>Amount</u>
2023	\$ 224,000
2024	224,000
2025	224,000
2026	224,000
Thereafter	<u>56,000</u>
	<u>\$ 952,000</u>

Data processing expense was approximately \$302,000 and \$283,000 for the years ended December 31, 2022 and 2021, respectively.

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NOTES TO FINANCIAL STATEMENTS, Cont'd
DECEMBER 31, 2022 AND 2021

16. COMPREHENSIVE INCOME (LOSS)

The following table displays the components of other comprehensive income (loss):

	<u>Unrealized gains (losses)</u>	<u>Accumulated other comprehensive income (loss)</u>
Balance at January 1, 2021	\$ 650,000	\$ 650,000
Net loss during 2021	(780,000)	(780,000)
Tax effect	<u>28,000</u>	<u>28,000</u>
Balance at December 31, 2021	(102,000)	(102,000)
Net loss during 2022	(4,484,000)	(4,484,000)
Tax effect	<u>878,000</u>	<u>878,000</u>
Balance at December 31, 2022	<u>\$ (3,708,000)</u>	<u>\$ (3,708,000)</u>