1ST STATE BANCORP INC
Form 10-Q
August 16, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

/X/ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2004

OR

/ / TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______ to ______

Commission file number: 0-25859

1st STATE BANCORP, INC.
(Exact Name of Registrant as Specified in Its Charter)

Virginia	56-2130744
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
445 S. Main Street, Burlington, North Carolina	27215
(Address of Principal Executive Offices)	(Zip Code)

(336) 227-8861
Registrant's Telephone Number, Including Area Code

Not Applicable
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

As of August 6, 2004, the issuer had 2,962,323 shares of common stock issued and outstanding.

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1st STATE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

JUNE 30, 2004 AND SEPTEMBER 30, 2003
(IN THOUSANDS, EXCEPT SHARE DATA)

	AT JUNE 30, 2004 (Unaudited)	SE
ASSETS		
Cash and cash equivalents	$ 10,735	
Investment securities:		
Held to maturity (fair value of $22,780 and $19,397 at June 30, 2004 and September 30, 2003, respectively)	23,228	
Available for sale (cost of $100,365 and $92,971 at June 30, 2004 and September 30, 2003, respectively)	97,604	
Loans held for sale, at lower of cost or fair value	1,222	
Loans receivable (net of allowance for loan losses of $3,910 and $3,856 at June 30, 2004 and September 30, 2003, respectively)	230,377	
Real estate owned	26	
Federal Home Loan Bank stock, at cost	2,425	
Premises and equipment	8,038	
Accrued interest receivable	2,229	
Other assets	4,501	
Total assets	$ 380,385	
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Deposit accounts	263,838	
Advances from Federal Home Loan Bank	47,500	
Advance payments by borrowers for property taxes and insurance	288	
Dividend payable	296	
Other liabilities	4,693	
Total liabilities	316,615	
Stockholders' Equity:		
Preferred stock, $0.01 par value, 1,000,000 shares authorized; none issued	--	
Common stock, $0.01 par value, 7,000,000 shares authorized; 2,962,323 and 2,971,977 shares issued and outstanding at June 30, 2004 and September 30, 2003, respectively	33	
Additional paid-in capital	35,987	
Unallocated ESOP shares	(2,712)	
Deferred compensation payable in treasury stock	6,252	
Treasury stock	(13,897)	
Retained income - substantially restricted	39,787	
Accumulated other comprehensive loss - net unrealized loss on investment securities available for sale	(1,680)	
Total stockholders' equity	63,770	
Total liabilities and stockholders' equity	$ 380,385	

See accompanying notes to the consolidated financial statements.

1st STATE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE THREE MONTHS ENDED JUNE 30, 2004 AND 2003
(IN THOUSANDS, EXCEPT PER SHARE DATA)

(UNAUDITED)

	FOR THE THREE MONTHS END JUNE 30,	
	2004	200
Interest income:		
Interest and fees on loans	$ 2,812	$ 3,0
Interest and dividends on investments	1,288	9
Overnight deposits	6	
Total interest income	4,106	4,1
Interest expense:		
Deposit accounts	824	1,0
Borrowings	346	2
Total interest expense	1,170	1,3
Net interest income	2,936	2,8
Provision for loan losses	60	
Net interest income after provision for loan losses	2,876	2,7
Other income:		
Customer service fees	253	2
Commissions from sales of annuities and mutual funds	99	1
Mortgage banking income, net	126	4
Securities gains, net	--	1
Other	208	
Total other income	686	9
Operating expenses:		
Compensation and related benefits	1,351	1,3
Occupancy and equipment	351	3
Real estate operations, net	(4)	
Other expenses	375	4
Total operating expenses	2,073	2,1

Income before income taxes	1,489	1,5
Income taxes	516	5
Net income	$ 973	$ 9
Earnings per share:		
Basic	$ 0.35	$ 0.
Diluted	$ 0.33	$ 0.

See accompanying notes to the consolidated financial statements.

1st STATE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE NINE MONTHS ENDED JUNE 30, 2004 AND 2003
(IN THOUSANDS, EXCEPT PER SHARE DATA)

(UNAUDITED)

	FOR THE NINE MONTHS ENDED JUNE 30,	
	2004	2003
Interest income:		
Interest and fees on loans	$ 8,495	$ 9,7
Interest and dividends on investments	3,588	3,1
Overnight deposits	24	1
Total interest income	12,107	13,0
Interest expense:		
Deposit accounts	2,629	3,5
Borrowings	965	8
Total interest expense	3,594	4,3
Net interest income	8,513	8,7
Provision for loan losses	180	1
Net interest income after provision for loan losses	8,333	8,5
Other income:		
Customer service fees	699	6
Commissions from sales of annuities and mutual funds	263	3
Mortgage banking income, net	337	1,2
Securities gains, net	185	1
Other	318	1

Total other income	1,802	2,5
Operating expenses:		
Compensation and related benefits	3,999	4,0
Occupancy and equipment	1,034	1,0
Real estate operations, net	(9)	
Other expenses	1,208	1,2
Total operating expenses	6,232	6,4
Income before income taxes	3,903	4,6
Income taxes	1,393	1,7
Net income	$ 2,510	$ 2,9
Earnings per share:		
Basic	$ 0.89	$ 1.
Diluted	$ 0.85	$ 1.

See accompanying notes to the consolidated financial statements.

1st STATE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF STOCKHOLDERS'
EQUITY AND COMPREHENSIVE INCOME
FOR THE NINE MONTHS ENDED JUNE 30, 2004 AND
2003 (UNAUDITED)
(IN THOUSANDS)

	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	UNALLOCATED ESOP SHARES	DEFERRED COMPENSATIO PAYABLE IN TREASURY STOCK
Balance at September 30, 2002	$ 33	35,623	(3,739)	5,466
Comprehensive income:				
Net income	--	--	--	--
Other comprehensive loss-unrealized loss on securities available-for-sale net of income tax benefit of $252	--	--	--	--
Total comprehensive income				
Allocation of ESOP shares	--	107	448	--
Acquisition of treasury stock	--	--	--	--
Cash dividends declared ($0.28 per share)	--	--	--	--
Cash dividends on unallocated ESOP shares	--	--	--	--

Balance at June 30, 2003	$ 33	35,730	(3,291)	5,466
Balance at September 30, 2003	$ 33	35,778	(3,141)	5,466
Comprehensive income:				
Net income	--	--	--	--
Other comprehensive loss-unrealized loss on securities available-for-sale net of income tax benefit of $587	--	--	--	--
Total comprehensive income				
Allocation of ESOP shares	--	190	429	--
Acquisition of treasury stock	--	--	--	--
Deferred compensation	--	--	--	786
Exercise of stock options	--	19	--	--
Cash dividends declared ($0.30 per share)	--	--	--	--
Cash dividends on unallocated ESOP shares	--	--	--	--
Balance at June 30, 2004	$ 33	35,987	(2,712)	6,252

	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	TOTAL STOCKHOLDERS' EQUITY
Balance at September 30, 2002	827	61,569
Comprehensive income:		
Net income	--	2,968
Other comprehensive loss-unrealized loss on securities available-for-sale net of income tax benefit of $252	(392)	(392)
Total comprehensive income		2,576
Allocation of ESOP shares	--	555
Acquisition of treasury stock	--	(796)
Cash dividends declared ($0.28 per share)	--	(834)
Cash dividends on unallocated ESOP shares	--	53
Balance at June 30, 2003	435	63,123
Balance at September 30, 2003	(768)	62,701
Comprehensive income:		
Net income	--	2,510
Other comprehensive loss-unrealized loss on securities available-for-sale net of income tax benefit of $587	(912)	(912)
Total comprehensive income		1,598
Allocation of ESOP shares	--	619
Acquisition of treasury stock	--	(1,112)
Deferred compensation	--	786
Exercise of stock options	--	19
Cash dividends declared ($0.30 per share)	--	(889)
Cash dividends on unallocated ESOP shares	--	48

Balance at June 30, 2004	(1,680)	63,770
	========	=======

See accompanying notes to the consolidated financial statements.

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1st STATE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED JUNE 30, 2004 AND 2003
(UNAUDITED)
(IN THOUSANDS)

	FOR THE NINE JUN
	2004
Cash flows from operating activities:	
Net income	$ 2,510
Adjustment to reconcile net income to net cash provided by operating activities:	
Provision for loan losses	180
Depreciation	514
Deferred tax expense (benefit)	(135)
Amortization of premiums and discounts, net	8
Deferred compensation	180
Release of ESOP shares	619
Loan origination fees and unearned discounts deferred, net of current amortization	(49)
Loss (gain) on sale of other real estate	(22)
Gain on sale of investment securities available for sale	(185)
Net (gain) loss on sale of loans	39
Proceeds from loans held for sale	21,072
Originations of loans held for sale	(21,688)
Decrease (increase) in other assets	(190)
Decrease (increase) in accrued interest receivable	(262)
Increase (decrease) in other liabilities	(74)
Net cash provided by operating activities	2,517
Cash flows provided by (used in) investing activities:	
Proceeds from redemption of FHLB stock	2,500
Purchases of FHLB stock	(3,250)
Purchases of investment securities held to maturity	(9,776)
Purchases of investment securities available for sale	(48,504)
Proceeds from sales of investment securities available for sale	10,993
Proceeds from maturities and issuer calls of investment securities available for sale	30,302
Proceeds from maturities and issuer calls of investment securities	

held to maturity	6,002
Net increase in loans receivable	(4,965)
Purchase of real estate acquired in settlement of loans	(255)
Proceeds from sales of REO	528
Purchases of premises and equipment net of disposals	(139)
Net cash provided by (used in) investing activities	(16,564)

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1st STATE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED
FOR THE NINE MONTHS ENDED JUNE 30, 2004 AND 2003
(UNAUDITED)
(IN THOUSANDS)

	FOR THE NINE JU
	2004
Cash flows from financing activities:	
Net increase (decrease) in deposits	$ 1,126
Advances from the Federal Home Loan Bank	90,000
Repayments of advances from the Federal Home Loan Bank	(74,000)
Purchase of treasury stock	(1,112)
Exercise of stock options	19
Dividends paid on common stock	(841)
Increase in advance payments by borrowers for property taxes and insurance	231
Net cash provided by (used in) financing activities	15,423
Net increase in cash and cash equivalents	1,376
Cash and cash equivalents at beginning of period	9,359
Cash and cash equivalents at end of period	$ 10,735
Payments are shown below for the following:	
Interest	$ 3,566
Income taxes	$ 1,397
Noncash investing and financing activities:	

Unrealized losses on investment securities available for sale	$ (1,499)
Cash dividends declared but not paid	$ 280
Cash dividends on unallocated ESOP shares	$ 48
Transfer from loans to real estate acquired in settlement of loans	$ 182

See accompanying notes to the consolidated financial statements.

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1st STATE BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2004 (UNAUDITED) AND SEPTEMBER 30, 2003

NOTE 1. NATURE OF BUSINESS

1st State Bancorp, Inc. (the "Company") was incorporated under the laws of the Commonwealth of Virginia for the purpose of becoming the holding company for 1st State Bank (the "Bank") in connection with the Bank's conversion from a North Carolina-chartered mutual savings bank to a North Carolina-chartered stock savings bank (the "Converted Bank") pursuant to its Plan of Conversion (the "Stock Conversion"). Upon completion of the Stock Conversion, the Converted Bank converted from a North Carolina-chartered stock savings bank to a North Carolina commercial bank (the "Bank Conversion"), retaining the name 1st State Bank (the "Commercial Bank"), and the Commercial Bank succeeded to all of the assets and liabilities of the Converted Bank. The Stock Conversion and the Bank Conversion were consummated on April 23, 1999. The common stock of the Company began trading on the Nasdaq National Market System under the symbol "FSBC" on April 26, 1999.

NOTE 2. BASIS OF PRESENTATION

The accompanying consolidated financial statements (which are unaudited, except for the consolidated balance sheet at September 30, 2003, which is derived from the September 30, 2003 audited consolidated financial statements) have been prepared in accordance with accounting principles generally accepted in the United States of America and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (none of which were other than normal recurring accruals) necessary for a fair presentation of the financial position and results of operations for the periods presented have been included.

The results of operations for the three and nine month periods ended June 30, 2004 are not necessarily indicative of the results of operations that may be expected for the year ending September 30, 2004. The preparation of consolidated financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make certain estimates. These amounts may be revised in future periods because of changes in the facts and circumstances underlying their estimation.

NOTE 3. EARNINGS PER SHARE

For purposes of computing basic and diluted earnings per share, weighted average shares outstanding excludes unallocated ESOP shares that have not been committed to be released. The deferred compensation obligation discussed in Note 5 that is funded with shares of the Company's common stock has no net impact on the Company's earnings per share computations. Diluted earnings per share include the potentially dilutive effects of the Company's stock-based benefit plans. There were no anti-dilutive stock options for the three and nine months ended June 30, 2004 and 2003. A reconciliation of the denominators of the basic and diluted earnings per share computations is as follows:

	THREE MONTHS ENDED JUNE 30,	
	2004	200
Average shares issued and outstanding	2,962,323	2,976
Less: Unallocated ESOP shares	(142,207)	(176
Average basic shares for earnings per share	2,820,116	2,800
Add: Potential common stock pursuant to stock option plan	145,534	123
Average dilutive shares for earnings per share	2,965,560	2,924

	NINE MONTHS ENDED JUNE 30,	
	2004	200
Average shares issued and outstanding	2,965,045	2,991
Less: Unallocated ESOP shares	(149,527)	(181
Average basic shares for earnings per share	2,815,518	2,810
Add: Potential common stock pursuant to stock option plan	150,436	124
Average dilutive shares for earnings per share	2,965,954	2,934

NOTE 4. EMPLOYEE STOCK OWNERSHIP PLAN ("ESOP")

The Company sponsors an employee stock ownership plan (the "ESOP") whereby an aggregate number of shares amounting to 253,050 or 8% of the stock issued in the conversion was purchased for future allocation to employees. The ESOP was funded by an 11-year term loan from the Company in the amount of $4,899,000. The loan is secured by the shares of stock purchased by the ESOP. During the three and nine months ended June 30, 2004 and 2003, 7,280 and 7,644 and 21,920 and 22,932 shares of stock were committed to be released and approximately $199,000

and $185,000 and $619,000 and $555,000, respectively, of compensation expense was recognized.

NOTE 5. DEFERRED COMPENSATION

Directors and certain executive officers participate in a deferred compensation plan, which was approved by the Board of Directors on September 24, 1997. This plan generally provides for fixed payments beginning after the participant retires. Each participant is fully vested in his account balance under the plan. Directors may elect to defer their directors' fees and executive officers may elect to defer 25% of their salary and 100% of bonus compensation.

Prior to the Stock Conversion, amounts deferred by each participant accumulated interest at a rate equal to the highest rate of interest paid on the Bank's one-year certificates of deposit. In connection with the Stock Conversion, participants in the plan were given the opportunity to prospectively elect to have their deferred compensation balance earn a rate of return equal to the total return of the Company's stock. All participants elected this option concurrent with the Stock Conversion, so the Company purchases its common stock to fund this obligation. Refer to the Company's notes to consolidated financial statements, incorporated by reference in the Company's 2003 Annual Report on Form 10-K for a discussion of the Company's accounting policy with respect to this deferred compensation plan and the related treasury stock purchased by the Company to fund this obligation.

The expense related to this plan for the three and nine months ended June 30, 2004 and 2003 was $60,000 and $60,000 and $180,000 and $180,000, respectively. This expense is included in compensation expense.

NOTE 6. STOCK OPTION AND INCENTIVE PLAN

On June 6, 2000, the Company's stockholders approved the 1st State Bancorp, Inc. 2000 Stock Option and Incentive Plan (the "Plan"). The purpose of this plan is to advance the interests of the Company through providing select key employees and directors of the Bank with the opportunity to acquire shares. By encouraging such stock ownership, the Company seeks to attract, retain and motivate the best available personnel for positions of substantial responsibility and to provide incentives to the key employees and directors. Under the Plan, the Company granted 316,312 options to purchase its $0.01 par value common stock. The exercise price per share is equal to the fair market value per share on the date of the grant. Options granted under the Stock Option Plan are 100% vested on the date of the grant, and all options expire 10 years from the date of the grant. As a result of the one-time cash dividend of $5.17 paid on October 2, 2000, the exercise price for the options repriced from $18.44 to $14.71. There were 2,077 options exercised during the nine months ended June 30, 2004. No options were granted during the three and nine months ended June 30, 2004 and 2003. At June 30, 314,235 options are outstanding, all of which are exercisable.

NOTE 7. MORTGAGE SERVICING RIGHTS

The rights to service mortgage loans for others are included in other assets on the consolidated balance sheet. Mortgage servicing rights ("MSRs") are capitalized based on the allocated cost that is determined when the underlying loans are sold. MSRs are amortized over a period that approximates the life of the underlying loan as an adjustment of servicing income. Impairment reviews of MSRs are performed on a quarterly basis. As of June 30, 2004 and September 30,

2003, MSRs totaled $508,000 and $547,000, respectively, and no valuation allowance was required.

Amortization expense totaled $85,000 and $126,000 for the nine months ended June 30, 2004 and 2003, respectively.

NOTE 8. STANDBY LETTERS OF CREDIT

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others", which addressed the disclosure to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. FIN 45 requires the guarantor to recognize a liability for the non-contingent component of the guarantee, such as the obligation to stand ready to perform in the event that specified triggering events or conditions occur. The initial measurement of this liability is the fair value of the guarantee at inception. The recognition of the liability is required even if it is not probable that payments will be required under the guarantee or if the guarantee was issued with a premium payment or as part of a transaction with multiple events. The initial recognition and measurement provisions are effective for all guarantees within the scope of FIN 45 issued or modified after June 30, 2003. The Company issues standby letters of credit whereby the Company guarantees performance if a specified triggering event or condition occurs (primarily nonperformance under construction contracts entered into by construction customers). The guarantees generally expire within one year and may be automatically renewed depending on the terms of the guarantee. The maximum potential amount of undiscounted future payments related to standby letters of credit at June 30, 2004 is $2.0 million. At June 30, 2004, the Company has recorded no liability for the obligation to perform as a guarantor. In addition, no contingent liability is considered necessary as such amounts are not deemed probable. Substantially all standby letters of credit are secured by real estate and/or guaranteed by third parties in the event the Company had to advance funds to fulfill the guarantee.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

When used in this Form 10-Q, the words or phrases "will likely result," "are expected to," "will continue," "is anticipated," "estimate," "project" or similar expressions are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements are subject to certain risks and uncertainties including changes in economic conditions in our market area, changes in policies by regulatory agencies, fluctuations in interest rates, demand for loans in our market area, and competition that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. We wish to caution you not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We wish to advise you that the factors listed above could affect our financial performance and could cause our actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods in any current statements.

We do not undertake, and specifically disclaim any obligation, to publicly release the result of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements

or to reflect the occurrence of anticipated or unanticipated events.

GENERAL

1st State Bancorp, Inc. was formed in November 1998 and became the holding company for 1st State Bank on April 23, 1999.

Our business consists principally of attracting deposits from the general public and investing these funds in loans secured by single-family residential and commercial real estate, secured and unsecured commercial loans and consumer loans. Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment securities portfolios and our cost of funds, which consists of interest paid on deposits and borrowed funds. Net interest income also is affected by the relative amounts of interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, any positive interest rate spread will generate net interest income. Our profitability is also affected by the level of other income and operating expenses. Other income consists of miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds. Operating expenses consist of compensation and benefits, occupancy related expenses, federal deposit insurance premiums, data processing, advertising and other expenses.

Our operations are influenced significantly by local economic conditions and by policies of financial institution regulatory authorities. Our cost of funds is influenced by interest rates on competing investments and by rates offered on similar investments by competing financial institutions in our market area, as well as general market interest rates. These factors can cause fluctuations in our net interest income and other income. Lending activities are affected by the demand for financing of real estate and other types of loans, which in turn is affected by the interest rates at which such financing may be offered. In addition, local economic conditions can impact the credit risk of our loan portfolio, in that local employers may be required to eliminate employment positions of many of our borrowers, and small businesses and other commercial borrowers may experience a downturn in their operating performance and become unable to make timely payments on their loans. Management evaluates these factors in estimating its allowance for loan losses, and changes in these economic conditions could result in increases or decreases to the provision for loan losses.

Our business emphasis has been to operate as a well capitalized, profitable and independent community-oriented financial institution dedicated to providing quality customer service. We are committed to meeting the financial needs of the communities in which we operate. We believe that we can be more effective in servicing our customers than many of our nonlocal competitors because of our ability to quickly and effectively provide senior management responses to customer needs and inquiries. Our ability to provide these services is enhanced by the stability of our senior management team.

Over the years, we have sought to gradually increase the percentage of our assets invested in commercial real estate loans, commercial loans and consumer loans, which have shorter terms and adjust more frequently to changes in interest rates than single-family residential mortgage loans. These loans

generally carry added risk when compared to a single-family residential mortgage loan, so we have concurrently increased our allowance for loan losses as we have originated these loans.

Due to a general slowdown in the economy beginning in 2000, the Federal Reserve acted to provide a stimulus through a series of interest rate reductions that lowered the prime rate from 9.50% in January 2001 to 4.00% in June 2003. These reductions in prime tended to negatively impact the Company's net interest margin and net interest spread which resulted in lower net interest income for the Company. The Company's asset growth has been slower as a result of heavy refinancing as customers have taken advantage of these attractive interest rates. The fee income associated with the heavy refinancing volume has replaced some of the lost net interest income. Now as the refinancing activity has slowed, the Company is looking to replace lost net interest income possibly with leverage strategies. During periods of slow loan demand, the Company purchases more investments, and the Company uses short-term borrowings as an alternative to deposits for funding certain assets. The Company's balance sheet is currently asset sensitive, that is, rate sensitive assets exceed rate sensitive liabilities. We expect an increase in net interest income during periods of rising interest rates and decreased net interest income during periods of falling interest rates.

CRITICAL ACCOUNTING POLICIES

The Company's significant accounting policies are set forth in Note 1 of the consolidated financial statements as of September 30, 2003, which was filed on the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2003. Of these significant accounting policies, the Company considers its policy regarding the allowance for loan losses to be its most critical accounting policy, because it requires management's most subjective and complex judgments. In addition, changes in economic conditions can have a significant impact on the allowance for loan losses and therefore the provision for loan losses and results of operations. The Company has developed appropriate policies and procedures for assessing the adequacy of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. The Company's assessments may be impacted in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of information with respect to borrowers that is not known to management at the time of the issuance of the consolidated financial statements.

COMPARISON OF FINANCIAL CONDITION AT JUNE 30, 2004 AND SEPTEMBER 30, 2003

Total assets increased $17.8 million from September 30, 2003 to June 30, 2004. Assets increased to $380.4 million at June 30, 2004 from $362.6 million at September 30, 2003. The Company grew both loans receivable, net and loans held for sale as well as investment securities. Asset growth was funded by increased borrowings from the Federal Home Loan Bank of Atlanta and to a lesser extent deposits.

Investment securities available for sale increased $5.9 million from $91.7 million at September 30, 2003 to $97.6 million at June 30, 2004. During the nine months ended June 30, 2004, we purchased $48.5 million of securities and received $41.3 million in proceeds from sales, maturities and issuer calls of investment securities available for sale. Interest rates increased during the nine months ended June 30, 2004 which caused the Company's gross unrealized loss on investment securities available for sale to increase from $1.3 million at September 30, 2003 to $2.8 million at June 30, 2004. Investment securities held to maturity increased $3.7 million from $19.5 million at September 30, 2003 to $23.2 million at June 30, 2004. During the nine months ended June 30, 2004, we

purchased $9.8 million of securities and received $6.0 million in proceeds from maturities and issuer calls of investment securities held to maturity.

Loans held for sale increased to $1.2 million at June 30, 2004 from $645,000 at September 30, 2003. Loans receivable, net increased from $225.7 million at September 30, 2003 to $230.4 million at June 30, 2004. The increase in loans held for sale resulted from timing differences in the funding of loan sales. During the nine months ended June 30, 2004, mortgage originations were considerably slower than in previous quarters as refinance activity slowed down in response to higher mortgage interest rates. During this same period, the Company saw growth in commercial loans and equity lines.

Stockholders' equity increased by $1.1 million from $62.7 million at September 30, 2003 to $63.8 million at June 30, 2004 as a result of net income of $2.5 million and the release of ESOP shares of $619,000. These increases were partially offset by cash dividends to stockholders declared of $841,000, purchases of treasury stock of $326,000, and an increase in the net unrealized loss on available for sale securities of $912,000. The increase in the net unrealized loss on available for sale securities was a result of increases in interest rates which caused bond prices to decrease.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED JUNE 30, 2004 AND 2003

NET INCOME. We recorded net income of $973,000 for the quarter ended June 30, 2004, as compared to $988,000 for the quarter ended June 30, 2003, representing a decrease of $15,000, or 1.5%. For the three months ended June 30, 2004, basic and diluted earnings per share were $0.35 and $0.33, respectively, compared to the basic and diluted earnings per share for the quarter ended June 30, 2003 of $0.35 and $0.34, respectively. The decrease in net income resulted primarily from decreased other income that was offset partially by increased net interest income, decreased operating expenses and decreased income tax expense. The increase in net interest income resulted from increased volumes which were offset partially by lower net interest margins. The average prime interest rate for the quarter ended June 30, 2004 was 4.00%, a decrease of 24 basis points from 4.24%, which was the average prime for the quarter ended June 30, 2003. The repricing of loans and investments decreased the Company's average asset yield by 47 basis points whereas the average cost of funds decreased only 41 basis points for the quarter ended June 30, 2004 compared to the prior year.

NET INTEREST INCOME. Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, increased by $127,000 or 4.5% for the three months ended June 30, 2004, compared to the same quarter in the prior year. This increase results from a $143,000 decrease in interest expense that was partially offset by a $16,000 decrease in total interest income. The average net interest rate spread decreased 6 basis points from 3.07% for the three months ended June 30, 2003 to 3.01% for the quarter ended June 30, 2004.

INTEREST INCOME. The decrease in interest income for the three months ended June 30, 2004 was the result of a decrease in yield on interest-earning assets of 47 basis points from 5.08% for the three months ended June 30, 2003 to 4.61% for the three months ended June 30, 2004. This decrease was partially offset by an increase of $32.3 million in average interest-earning assets compared to the same quarter in the prior year. Average investment securities increased $40.5 million, average interest-bearing overnight funds decreased $11.9 million and average loans receivable increased $3.7 million. The increase in average interest-earning assets increased interest income by approximately $499,000 and the decrease in the average asset yield decreased interest income by approximately $515,000.

INTEREST EXPENSE. Interest expense decreased in the three months ended June 30, 2004 due to a decrease in the cost of interest-bearing liabilities of 41 basis points from 2.01% for the three months ended June 30, 2003 to 1.60% for the three months ended June 30, 2004. This decrease was partially offset by an increase in average interest-bearing liabilities of $31.7 million. Average interest-bearing deposits increased by $7.7 million while average FHLB advances increased $24.0 million for the three months ended June 30, 2004 compared to the same quarter in the prior year. The increase in average interest-bearing liabilities increased interest expense by approximately $359,000 and the decrease in the average cost of interest-bearing liabilities decreased interest expense by approximately $502,000.

The following table presents average balances and average rates earned/paid by the Company for the quarter ended June 30, 2004 compared to the quarter ended June 30, 2003.

	THREE MONTHS ENDED JUNE 30, 2004			
			(DOLLARS IN THOUSA	
	AVERAGE BALANCE	INTEREST	AVERAGE YIELD/COST	AVER BALA
Assets:				
Loans receivable (1)........................	$ 231,111	$ 2,812	4.87%	$ 227
Investment securities (2)...................	122,717	1,288	4.20	82
Interest-bearing overnight deposits	2,796	6	0.93	14
Total interest-earning assets (3)..........	356,624	4,106	4.61	324
Noninterest-earning assets..................	20,466			20
Total assets.............................	$ 377,090			$ 344
Liabilities and stockholders' equity:				
Interest bearing checking...................	36,805	19	0.21	34
Money market investment accounts............	19,884	33	0.67	23
Passbook and statement savings..............	30,943	47	0.61	30
Certificates of deposit.....................	160,827	725	1.80	151
FHLB advances...............................	43,967	346	3.14	20
Total interest-bearing liabilities.........	292,426	1,170	1.60	260
Noninterest-bearing liabilities.............	21,411			20
Total liabilities........................	313,837			281
Stockholders' equity........................	63,253			62
Total liabilities and stockholders' equity	$ 377,090			$ 344
Net interest income.........................		$ 2,936		
Interest rate spread........................			3.01%	
Net interest margin (4).....................			3.29%	

Ratio of average interest-earning assets to Average interest-bearing liabilities........	121.95%

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(1) Includes nonaccrual loans and loans held for sale, net of discounts and allowance for loan losses.
(2) Includes FHLB of Atlanta stock.
(3) Due to immateriality, the interest income and yields related to certain tax exempt assets have not been adjusted to reflect a fully taxable equivalent yield.
(4) Represents net interest income divided by the average balance of interest-earning assets.

PROVISION FOR LOAN LOSSES. We charge provisions for loan losses to earnings to maintain the total allowance for loan losses at a level we consider adequate to provide for probable loan losses, based on existing loan levels and types of loans outstanding, nonperforming loans, prior loss experience, general economic conditions and other factors. We

estimate the allowance using an allowance for loan losses model which takes into considerations all of these factors. Our policies require the review of assets on a regular basis, and we assign risk grades to loans based on the relative risk of the credit, considering such factors as repayment experience, value of collateral, guarantors, etc. Our credit management systems have resulted in low loss experience; however, there can be no assurances that such experience will continue. We believe we use the best information available to make a determination with respect to the allowance for loan losses, recognizing that future adjustments may be necessary depending upon a change in economic conditions.

The provision for loan losses was $60,000 and net charge-offs were $42,000 for the three months ended June 30, 2004 compared with a provision of $60,000, and net charge-offs of $8,000 for the three months ended June 30, 2003. Nonperforming loans at June 30, 2004 and September 30, 2003 were $4.0 million and $4.2 million, respectively. The majority of the non-performing loans resulted from two unrelated, distinct credits which are not necessarily indicative of the credit quality of the entire portfolio. There was no significant impact on the provision as these loans are well secured by property and equipment.

OTHER INCOME. Other income decreased $222,000 from $908,000 for the three months ended June 30, 2003 to $686,000 for the three months ended June 30, 2004. Mortgage banking income, net decreased $296,000 from $422,000 for the three months ended June 30, 2003 to $126,000 for the three months ended June 30, 2004. This decrease results from a decrease in volume of mortgage loan originations and sales. We sold loans totaling $7.5 million in the three months ended June 30, 2004 compared with sales of $24.7 million in the previous year for the comparable period. The increase in mortgage interest rates slowed the volume of mortgage originations and sales. Given the current level of mortgage interest rates, the Company believes that mortgage banking income will continue to decrease in future quarters due to lower refinancing activity. The Company relocated its Mebane branch to a new location in September 2003. In June 2004, the Company sold the real estate that had previously served as the Bank's Mebane

office. A gain of $143,000 was recognized on this sale and is included in other income and accounts for the increase in other income for the current quarter compared to the previous year. Customer fees increased $35,000 or 16.1% to $253,000 for the quarter ended June 30, 2004 compared with the $218,000 reported in the prior year. This increase was the result of increased deposit service charges compared with the prior year. The Company recorded gains on sales of investments of $103,000 in the three months ended June 30, 2003 which were not present in the current year.

OPERATING EXPENSES. Total operating expenses were $2.1 million for each of the three months ended June 30, 2004 and 2003, respectively. The Company has been able to control expenses during this period of slower loan and deposit growth.

INCOME TAX EXPENSE. Income tax expense decreased $46,000 from tax expense of $562,000 for the three months ended June 30, 2003 to $516,000 for the three months ended June 30, 2004. The effective tax rates were 34.7% and 36.3% for the three months ended June 30, 2004 and 2003, respectively. The decrease in the effective tax rate was primarily due to an increase in the ratio of non-taxable income as a percentage of net income before taxes.

COMPARISON OF OPERATING RESULTS FOR THE NINE MONTHS ENDED JUNE 30, 2004 AND 2003

NET INCOME. We recorded net income of $2.5 million for the nine months ended June 30, 2004, a decrease of $500,000, or 16.7% over the $3.0 million reported in the nine months ended June 30, 2003. For the nine months ended June 30, 2004, basic and diluted earnings per share were $0.89 and $0.85, respectively. The Company reported basic and diluted earnings per share for the nine months ended June 30, 2003 of $1.06 and $1.01, respectively. The decrease in net income resulted primarily from decreased net interest income and decreased other income. These decreases in income were partially offset by decreased operating expenses and decreased income taxes. The decrease in the net interest income resulted from lower net interest margins. The average prime interest rate for the nine months ended June 30, 2004 was 4.00%, a decrease of 32 basis points from 4.32% which was the average prime for the nine months ended June 30, 2003. The rate decrease caused a greater reduction in the average yield on earning assets than the average rate paid on interest-bearing liabilities.

NET INTEREST INCOME. Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, decreased by $248,000 or 2.8% for the nine months ended June 30, 2004, compared to the same nine months in the prior year. This decrease reflects a $979,000 decrease in interest income that was partially offset by the $731,000 decrease in total interest expense. The average net interest rate spread decreased 20 basis points from 3.17% for the nine months ended June 30, 2003 to 2.97% for the nine months ended June 30, 2004.

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INTEREST INCOME. The decrease in interest income for the nine months ended June, 2004 was due to a decrease in yield on interest-earning assets of 70 basis points from 5.37% for the nine months ended June 30, 2003 to 4.67% for the nine months ended June 30, 2004 that was partially offset by an increase of $20.7 million in average interest-earning assets compared to the same period in the prior year. The increased volume of average interest-earning assets increased interest income by approximately $1.1 million and the decreased yield decreased interest income by approximately $2.1 million. Average investment securities increased $30.1 million and average loans receivable increased $1.1 million compared with the prior year. These increases were offset in part by a decrease

of $10.5 million in average interest bearing overnight funds.

INTEREST EXPENSE. Interest expense decreased in the nine months ended June 30, 2004 due to a decrease in the cost of interest-bearing liabilities of 50 basis points from 2.20% for the nine months ended June 30, 2003 to 1.70% for the nine months ended June 30, 2004 that was partially offset by an increase of $19.9 million in average interest-bearing liabilities. Average deposits increased by $4.8 million and average FHLB advances increased $15.2 million for the nine months ended June 30, 2004 compared to the same nine months in the prior year. The increase in average interest-bearing liabilities increased interest expense by approximately $673,000 and the decrease in the average cost of interest-bearing liabilities decreased interest expense by approximately $1.4 million.

The following table presents average balances and average rates earned/paid by the Company for the nine months ended June 30, 2004 compared to the nine months ended June 30, 2003.

	NINE MONTHS ENDED JUNE 30, 2004			
			(DOLLARS IN THOUSAN	
	AVERAGE BALANCE	INTEREST	AVERAGE YIELD/COST	AVERA BALAN
Assets:				
Loans receivable (5)........................	$ 228,827	$ 8,495	4.95%	$ 227,
Investment securities (6)...................	113,480	3,588	4.22	83,
Interest-bearing overnight deposits	3,556	24	0.89	14,
Total interest-earning assets (7)..........	345,863	12,107	4.67	325,
Noninterest-earning assets..................	20,896			20,
Total assets..............................	$ 366,759			$ 345,
Liabilities and stockholders' equity:				
Interest bearing checking...................	36,148	57	0.21	33,
Money market investment accounts............	19,565	98	0.67	22,
Passbook and statement savings..............	30,377	139	0.61	29,
Certificates of deposit.....................	160,476	2,335	1.94	155,
FHLB advances...............................	35,883	965	3.58	20,
Total interest-bearing liabilities.........	282,449	3,594	1.70	262,
Non interest-bearing liabilities............	21,060			20,
Total liabilities.........................	303,509			283,
Stockholders' equity........................	63,250			62,
Total liabilities and stockholders' equity	$ 366,759			$ 345,
Net interest income.........................		$ 8,513		
Interest rate spread........................			2.97%	
Net interest margin (8).....................			3.28%	
Ratio of average interest-earning assets to				

average interest-bearing liabilities........	122.45%
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(5) Includes nonaccrual loans and loans held for sale, net of discounts and allowance for loan losses.
(6) Includes FHLB of Atlanta stock.
(7) Due to immateriality, the interest income and yields related to certain tax exempt assets have not been adjusted to reflect a fully taxable equivalent yield.
(8) Represents net interest income divided by the average balance of interest-earning assets.

PROVISION FOR LOAN LOSSES. The provision for loan losses is charged to earnings to maintain the total allowance for loan losses at a level considered adequate to absorb estimated probable losses inherent in the loan portfolio based on existing loan levels and types of loans outstanding, nonperforming loans, prior loan loss experience, general economic conditions and other factors. The provision for loan losses was $180,000 and net charge-offs were $126,000 for the nine months ended June 30, 2004 compared with a provision of $180,000, and net charge-offs of $10,000 for the nine months ended June 30, 2003. The provision for loan losses was impacted by the continued shift in the portfolio to commercial loans which require a larger allocation of allowance for loan losses. The effects of this continued shift in the portfolio were offset to a certain degree in 2004 by a decrease in nonperforming loans. The Company has completed the foreclosure on some of the nonperforming loans and has sold the majority of its real estate owned.

OTHER INCOME. Other income decreased $700,000 from $2.5 million for the nine months ended June 30, 2003 to $1.8 million for the nine months ended June 30, 2004. Mortgage banking income, net decreased $922,000 from $1.3 million for the nine months ended June 30, 2003 to $337,000 for the nine months ended June 30, 2004. This decrease results from a decrease in volume of mortgage loan originations and sales. We sold loans totaling $21.7 million in the nine months ended June 30, 2004 compared with sales of $75.8 million in the previous year for the comparable period. The increase in mortgage interest rates slowed the volume of mortgage originations and sales. Given the current level of mortgage interest rates, the Company believes that mortgage banking income will continue to decrease in future quarters due to lower refinancing activity. Commissions from sales of annuities and mutual funds decreased $83,000 from $346,000 for the nine months ended June 30, 2003 to $263,000 for the nine months ended June 30, 2004. This decrease results from lower sales of annuities. Sales of annuities and mutual funds totaled $150,000 and $4.9 million and $1.9 million and $4.6 million for the nine months ended June 30, 2004 and 2003, respectively. The Company recorded gains on sales of investments of $185,000 in the nine months ended June 30, 2004 compared to gains of $103,000 in the prior year. Other income increased $135,000 from $183,000 for the nine months ended June 30, 2003 to $318,000 for the nine months ended June 30, 2004. The increase was the result of the $143,000 gain on the sale of the Mebane real estate in the current quarter.

OPERATING EXPENSES. Total operating expenses were $6.2 million and $6.4 million for the nine months ended June 30, 2004 and 2003, respectively. The Company has been able to control expenses during this period of slower loan and deposit growth.

INCOME TAX EXPENSE. Income tax expense decreased $300,000 from tax expense of $1.7 million for the nine months ended June 30, 2003 to $1.4 million for the nine months ended June 30, 2004. The effective tax rates were 35.7% and 36.7%

for the nine months ended June 30, 2004 and 2003, respectively. The decrease in the effective rate was primarily due to an increase in the ratio of non-taxable income as a percentage of net income before taxes.

COMMITMENTS, CONTINGENCIES AND OFF-BALANCE SHEET RISK

The Company is a party to financial instruments with off-balance sheet risk including commitments to extend credit under existing lines of credit and commitments to sell loans. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

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Off-balance sheet financial instruments whose contract amounts represent credit and interest rate risk are summarized as follows:

	JUNE 30, 2004	SEPTEMBER 30,
	(Dollars in thousands)	
Commitments to originate new loans	$ 4,563	$ 1,552
Commitments to originate new loans held for sale	--	278
Unfunded commitments to extend credit under existing equity line and commercial lines of credit	56,172	57,237
Commercial letters of credit	1,994	326
Commitments to sell loans held for sale	1,532	1,630

Commitments to originate new loan include two unrelated commercial real estate loans totaling $3.7 million. The Company does not have any special purpose entities or other similar forms of off-balance sheet financing arrangements.

Commitments to originate new loans or to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Loan commitments generally expire within 30 to 45 days. Most equity line commitments are for a term of 15 years, and commercial lines of credit are generally renewable on an annual basis. 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 Company evaluates each customer's creditworthiness on a case-by-case basis. The amounts of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the borrower.

Commitments to sell loans held for sale are agreements to sell loans to a third party at an agreed upon price. At June 30, 2004, the aggregate fair value of these commitments exceeded the book value of the loans to be sold.

CONTRACTUAL OBLIGATIONS

As of June 30, 2004:

PAYMENTS DUE BY PERIOD
(DOLLARS IN THOUSANDS)

	LESS THAN 1 YEAR	1-3 YEARS	4-5 YEARS	OVER 5 YE
Deposits	$ 228,919	$ 23,112	$ 11,807	$ --
Advances from FHLB	27,500	--	20,000	--
Lease obligations	18	41	42	26
Total contractual cash obligations	$ 256,437	$ 23,153	$ 31,849	$ 26

ASSET QUALITY

At June 30, 2004, the Company had approximately $4.0 million in nonperforming assets (nonaccrual loans and real estate owned) or 1.06% of total assets. At September 30, 2003, nonperforming assets were $4.2 million or 1.17% of total assets. At June 30, 2004 and September 30, 2003, impaired loans totaled $3.6 million and $3.8 million, respectively, as defined by Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan." The impaired loans at June 30, 2004 and September 30, 2003 result from two and three, respectively, unrelated commercial loan customers, each of which have loans secured by commercial real estate and business assets in Alamance County. At June 30, 2004, the entire $3.6 million of the impaired loans are on non-accrual status, and their related reserve for loan losses totaled $160,000. The average carrying value of impaired loans was $3.7 million during the nine months ended June 30, 2004. Interest income of $148,000 has been recorded on impaired loans in the nine months ended June 30, 2004. The Bank's net chargeoffs for the nine months ended June 30, 2004 were $126,000. The Bank's allowance for loan losses was $3.9 million at June 30, 2004 and September 30, 2003, and the

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ratio of the allowance for loan losses to total loans, net of loans in process and deferred loan fees was 1.67% and 1.68% at June 30, 2004 and September 30, 2003, respectively.

The following table presents an analysis of our nonperforming assets:

	AT JUNE 30, 2004	AT SEPTEMBER 30, 2003
Nonperforming loans:		
Nonaccrual loans	$ 4,007	$ 4,153
Loans 90 days past due and accruing	--	--
Restructured loans	--	--
Total nonperforming loans	4,007	4,153
Other real estate	26	95
Total nonperforming assets	$ 4,033	$ 4,248

Nonperforming loans to loans receivable, net	1.74%	1.84%
Nonperforming assets as a percentage of loans and other real estate owned	1.75%	1.88%
Nonperforming assets to total assets	1.06%	1.17%

Regulations require that we classify our assets on a regular basis. There are three classifications for problem assets: substandard, doubtful and loss. We regularly review our assets to determine whether any assets require classification or re-classification. At June 30, 2004, we had $4.8 million in classified assets consisting of $4.8 million in substandard loans, $7,000 in loss loans and $26,000 in real estate owned. At September 30, 2003, we had $4.9 million in substandard assets consisting of $4.8 million in loans and $95,000 in real estate owned. At June 30, 2003, we had $4.9 million in substandard and loss loans and $80,000 in real estate owned.

In addition to regulatory classifications, we also classify as "special mention" and "watch" assets that are currently performing in accordance with their contractual terms but may become classified or nonperforming assets in the future. At June 30, 2004, we have identified approximately $4.8 million in assets classified as special mention and $28.0 million as watch. At June 30, 2003, we had identified approximately $1.1 million in assets classified as special mention and $36.5 million as watch.

Included in the total of special mention assets are five loans with an aggregate outstanding balance of $4.0 million at June 30, 2004 to borrowers, of which one of our directors along with family members, is a majority stockholder. In addition, one of the borrowers has the ability to borrow an additional $124,000 from us under a line of credit. All the loans are secured by a first lien on all assets, including accounts receivable, inventory, equipment, furniture and real property occupied by the borrower. In addition, the director and his spouse have personally guaranteed repayment of the loans. At June 30, 2004, such loans were current with respect to their payment terms.

Subsequent to June 30, 2004, the borrowers sold a division and used the proceeds from such sale to repay a significant portion of the outstanding principal balance of such loans, reducing the aggregate outstanding balance of the loans to $580,000 at August 12, 2004. However, the minority stockholders of the borrower, Roger W. Overman, Jack D. Overman and Larry D. Overman, have brought a lawsuit in the Superior Court of Guilford County, North Carolina, against the majority stockholders, as well as others, including the Bank, seeking money damages. Included in part of plaintiffs' complaint are allegations related to loans made by the Bank to the borrowers. Although the time for the Bank to formally respond in court to the complaint has not yet arrived, the Bank's attorneys have asked that the plaintiffs' attorney drop the Bank as a party to the lawsuit. If the plaintiffs do not do so, the Bank will vigorously defend the lawsuit and seek its dismissal by the court. Management does not anticipate that this lawsuit will have a material adverse impact on the Company's financial condition or results of operations.

LIQUIDITY AND CAPITAL RESOURCES

The Bank must meet certain liquidity requirements established by the State of North Carolina Office of the Commissioner of Banks (the "Commissioner"). At June 30, 2004, the Bank's liquidity ratio exceeded such requirements. Liquidity generally refers to the Bank's ability to generate adequate amounts of funds to meet its cash needs. Adequate liquidity guarantees that sufficient funds are available to meet deposit withdrawals, fund loan commitments, maintain adequate reserve requirements, pay operating expenses, provide funds for debt service, pay dividends to stockholders and meet other general commitments.

Our primary sources of funds are deposits, principal and interest payments on loans, proceeds from the sale of loans, and to a lesser extent, advances from the FHLB of Atlanta. While maturities and scheduled amortization of loans are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and local competition.

Our most liquid assets are cash and cash equivalents. The levels of these assets are dependent on our operating, financing, lending and investing activities during any given period. At June 30, 2004, cash and cash equivalents totaled $10.7 million. We have other sources of liquidity should we need additional funds. During the three and nine months ended June 30, 2004, we sold loans totaling $7.5 million and $21.1 million, respectively. Additional sources of funds include FHLB of Atlanta advances. Other sources of liquidity include loans and investment securities designated as available for sale, which totaled $97.6 million at June 30, 2004.

We anticipate that we will have sufficient funds available to meet our current commitments. At June 30, 2004, we had $5.1 million in commitments to originate new loans, $56.2 million in unfunded commitments to extend credit under existing equity lines and commercial lines of credit and $2.0 million in standby letters of credit. At June 30, 2004, certificates of deposit, which are scheduled to mature within one year, totaled $124.9 million. We believe that a significant portion of such deposits will remain with us.

The Federal Deposit Insurance Corporation ("FDIC") requires the Bank to meet a minimum leverage capital requirement of Tier I capital to assets ratio of 4%. The FDIC also requires the Bank to meet a ratio of total capital to risk-weighted assets of 8%, of which 4% must be in the form of Tier I capital. The Commissioner requires the Bank at all times to maintain certain minimum capital levels. The Bank was in compliance with all capital requirements of the FDIC and the Commissioner at June 30, 2004 and is deemed to be "well capitalized."

The Federal Reserve also mandates capital requirements on all bank holding companies, including 1st State Bancorp, Inc. These capital requirements are similar to those imposed by the FDIC on the Bank. At June 30, 2004, the Company was in compliance with the capital requirements of the Federal Reserve.

The Company's equity to asset ratio at June 30, 2004 was 16.8%. The Company's capital level is sufficient to support future growth.

The Company has declared cash dividends per common share of $0.10 for each of the three months ended June 30, 2004, September 30, 2003 and June 30, 2003. The Company's ability to pay dividends is dependent upon earnings. The Company's dividend payout ratio for the three months ended June 30, 2004, September 30, 2003 and June 30, 2003 was 30.3%, 31.2% and 29.4%, respectively.

ACCOUNTING MATTERS

In March 2004, the SEC released Staff Accounting Bulletin No. 105 - Application of Accounting Principles to Loan Commitments. This bulletin requires all registrants to begin accounting for their issued loan commitments (including interest rate lock commitments) subject to Statement 133 as written options. Treatment as a written option would require those loan commitments to be reported as liabilities until either they are exercised (and a loan is made) or they expire unexercised. Staff Accounting Bulletin No. 105 must be applied to loan commitments that are issued after March 31, 2004. The adoption of Staff Accounting Bulletin No. 105 did not have a material impact on the consolidated

financial statements.

In January 2003, FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an interpretation of ARB No. 51", (Interpretation 46) was issued. Interpretation 46 addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. Interpretation 46 applies immediately to variable interests in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003), "Consolidation of Variable Interest Entities", which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, "Consolidation of Variable Interest Entities", which was issued in January 2003. The Company will be required to apply FIN 46R to variable interests in VIEs created after December 31, 2003. The application of this revised interpretation is not expected to have a material effect on the consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the possible chance of loss from unfavorable changes in market prices and rates. These changes may result in a reduction of current and future period net interest income, which is the favorable spread earned from the excess of interest income on interest-earning assets over interest expense on interest-bearing liabilities.

The Company considers interest rate risk to be its most significant market risk, which could potentially have the greatest impact on operating earnings. The structure of the Company's loan and deposit portfolios is such that a significant decline in interest rates may adversely impact net market values and net interest income.

The Company monitors whether material changes in market risk have occurred since September 30, 2003. The Company does not believe that any material adverse changes in market risk exposures have occurred since September 30, 2003.

ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, management of the Company carried out an evaluation, under the supervision and with the participation of the Company's principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures. Based on this evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. It should be noted that the design of the Company's disclosure controls and procedures is based in part upon certain reasonable assumptions about the likelihood of future events, and there can be no reasonable assurance that any design of disclosure controls and procedures will succeed in achieving its stated goals under all potential future conditions, regardless of how remote, but the Company's principal executive and financial officers have concluded that the Company's disclosure controls and procedures are, in fact, effective at a reasonable assurance level.

In addition, there have been no changes in the Company's internal control over financial reporting identified in connection with the evaluation described in the above paragraph that occurred during the Company's last fiscal quarter, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we are a party to various legal proceedings incident to our business. There currently are no legal proceedings to which we are a party, or to which any of our property was subject, except as described in the following paragraph, and none which are expected to result in a material loss. There are no pending regulatory proceedings to which we are a party or to which any of our properties is subject which are expected to result in a material loss.

A civil action was filed against 1st State Bank and Brokers, Incorporated by Michael Locklar in Davidson County Superior Court, in the State of North Carolina on May 16, 2003. Mr. Locklar has alleged in the action that 1st State Bank granted him an option to purchase certain real property located in Davidson County, North Carolina, which 1st State Bank wrongfully sold to Brokers, Incorporated for $150,000 in breach of the option granted to Mr. Locklar. Mr. Locklar is seeking to set aside the conveyance of property to Brokers, Incorporated and to purchase the property from 1st State Bank for the option price. Brokers, Incorporated has filed a cross-claim against 1st State Bank seeking indemnification in the form of return of the purchase price they paid for the property, damages and attorneys fees should Locklar be successful in setting aside the real estate conveyance. 1st State Bank intends to vigorously contest Mr. Locklar's allegations.

The Bank has been named as a defendant in a lawsuit brought by minority stockholders of a corporation against the majority stockholders of the corporation. A director of the Company and the Bank, along with family members, is the majority stockholder of the corporation, which has loans outstanding from the Bank. For further information regarding this lawsuit, see "Part I Financial Information -- Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Comparison of Operating Results for the Nine Months Ended June 30, 2004 and 2003 -- Asset Quality."

ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF SECURITIES

(a) Not applicable

(b) Not applicable

(c) Not applicable

(d) Not applicable

(e) The Company did not repurchase any of its Common Stock during the quarter ended June 30, 2004.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) EXHIBITS.

31.1 Rule 13a-14(a) Certification of Chief Executive Officer

31.2 Rule 13a-14(a) Certification of Chief Financial Officer

32 Section 1350 Certification

(b) REPORTS ON FORM 8-K.

The Registrant filed the following Current Reports on Form 8-K during the quarter ended June 30, 2004:

Date of Report	Item(s) Reported	Financial Statements Filed
April 26, 2004	7, 12	N/A

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

1st STATE BANCORP, INC.

Date: August 12, 2004

/s/ James C. McGill

James C. McGill
President and Chief Executive Officer
(Principal Executive Officer)

Date: August 12, 2004

/s/ A. Christine Baker

A. Christine Baker
Executive Vice President
Treasurer and Secretary
(Principal Financial and Accounting
Officer)