FLAG FINANCIAL CORP
Form 10-Q
August 09, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

[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 0-24532

FLAG FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Georgia | 58-2094179 |
| (State of incorporation) | (I.R.S. Employer Identification No.) |
| 3475 Piedmont Road N.E. Suite 550<br>Atlanta, Georgia | 30305 |
| (Address of principal executive offices) | (Zip Code) |

(404) 760-7700

(Telephone Number)

Indicate by check mark whether the registrant has (1) 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 XX NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES XX NO

Common stock, par value $1 per share: 8,259,663 shares
Outstanding as of August 4, 2004

**Flag Financial Corporation and Subsidiaries**

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**Flag Financial Corporation and Subsidiaries**
**Consolidated Balance Sheets**
*(in thousands)*

| | (UNAUDITED) June 30, 2004 | (AUDITED) December 31, 2003 | (UNAUDITED) June 30, 2003 |
|---|---|---|---|
| **ASSETS** | | | |
| Cash and due from banks | $ 16,953 | 17,454 | 20,055 |
| Interest-bearing deposits in banks | 14,377 | 12,183 | 9,286 |
| Federal funds sold | 29,158 | 7,100 | 16,128 |
| Total cash and cash equivalents | 60,488 | 36,737 | 45,469 |
| Interest-bearing deposits | 2,576 | 2,675 | 8,051 |
| Investment securities available-for-sale | 97,339 | 122,565 | 108,871 |
| Other investments | 13,861 | 14,944 | 14,345 |
| Mortgage loans held-for-sale | 5,964 | 4,234 | 14,024 |
| Loans, net | 522,849 | 477,095 | 387,074 |
| Premises and equipment, net | 14,142 | 16,497 | 17,027 |
| Other assets | 32,152 | 29,110 | 28,565 |
| Total assets | $ 749,371 | 703,857 | 623,426 |
| **LIABILITIES** | | | |
| Non interest-bearing deposits | $ 42,136 | 51,087 | 40,905 |
| Interest-bearing demand deposits | 318,263 | 282,261 | 216,272 |
| Savings | 22,294 | 23,898 | 25,322 |
| Time | 227,943 | 213,324 | 214,223 |
| Total deposits | 610,636 | 570,570 | 496,722 |
| Advances from Federal Home Loan Bank | 53,000 | 58,000 | 53,000 |
| Federal funds purchased and other borrowings | 2,256 | 5,197 | 3,776 |
| Subordinated debt | 14,000 | - | - |
| Accrued interest payable and other liabilities | 5,087 | 4,830 | 6,273 |
| Total liabilities | 684,979 | 638,597 | 559,771 |
| **STOCKHOLDERS' EQUITY** | | | |

| | | | |
|---|---|---|---|
| Preferred stock (10,000,000 shares authorized, none issued and outstanding) | - | - | - |
| Common stock ($1 par value, 20,000,000 shares authorized, 9,810,099, 9,775,099 and 9,736,433 shares issued at June 30, 2004, December 31, 2003 and June 30, 2003, respectively | $ 9,810 | 9,775 | 9,736 |
| Additional paid-in capital | 24,795 | 24,557 | 24,316 |
| Retained earnings | 42,296 | 39,294 | 37,240 |
| Accumulated other comprehensive income | 35 | 1,211 | 1,940 |
| Less: Treasury stock at cost; 1,477,386 shares at June 30, 2004, 1,246,961 shares at December 31, 2003 and 1,246,961 shares at June 30, 2003, respectively | (12,544) | (9,577) | (9,577) |
| Total stockholders' equity | 64,392 | 65,260 | 63,655 |
| Total liabilities and stockholders' equity | $ 749,371 | 703,857 | 623,426 |

**See Accompanying Notes to Unaudited Consolidated Financial Statements.**

## Consolidated Statements of Earnings

| *(in thousands, except per share data)* | (UNAUDITED) Three Months Ended June 30, 2004 | Three Months Ended June 30, 2003 | Six Months Ended June 30, 2004 | Six Months Ended June 30, 2003 |
|---|---|---|---|---|
| **Interest Income** | | | | |
| Interest and fees on loans | $ 8,680 | 7,220 | 16,798 | 14,440 |
| Interest on investment securities | 1,292 | 1,325 | 2,748 | 2,988 |
| Interest on federal funds sold and interest-bearing deposits | 99 | 180 | 199 | 379 |
| Total interest income | 10,071 | 8,725 | 19,745 | 17,807 |
| **Interest Expense** | | | | |
| Interest on deposits: | | | | |
| Demand | 1,183 | 781 | 2,233 | 1,525 |
| Savings | 32 | 36 | 67 | 75 |
| Time | 1,183 | 1,587 | 2,421 | 3,435 |
| Interest on other borrowings | 314 | 202 | 533 | 415 |
| Total interest expense | 2,712 | 2,606 | 5,254 | 5,450 |
| Net interest income before provision for loan losses | 7,359 | 6,119 | 14,491 | 12,357 |
| **Provision for Loan Losses** | 375 | 315 | 1,095 | 571 |
| Net interest income after provision for loan losses | 6,984 | 5,804 | 13,396 | 11,786 |
| **Other Income** | | | | |
| Fees and service charges on deposit accounts | 958 | 818 | 1,850 | 1,721 |
| Mortgage banking activities | 595 | 1,483 | 1,125 | 2,343 |
| Insurance commissions and brokerage fees | 163 | 163 | 276 | 376 |
| Gain on sale of branch | - | - | 3,000 | - |
| Gain (Loss) on sale of investment securities | 685 | (80) | 693 | 7 |
| Other income | 190 | 1,153 | 339 | 1,543 |
| Total other income | 2,591 | 3,537 | 7,283 | 5,990 |
| **Other Expenses** | | | | |
| Salaries and employee benefits | 4,077 | 4,267 | 8,867 | 8,079 |
| Occupancy | 863 | 915 | 1,773 | 1,697 |
| Professional fees | 282 | 164 | 582 | 441 |
| Postage, printing and supplies | 214 | 276 | 449 | 529 |
| Amortization of intangibles | 23 | 23 | 45 | 38 |

| | | | | |
|---|---|---|---|---|
| Communications and data | 530 | 692 | 1,114 | 1,206 |
| Other operating | 745 | 746 | 1,891 | 1,382 |
| Total other expenses | 6,734 | 7,083 | 14,721 | 13,372 |
| Earnings before provision for income taxes | 2,841 | 2,258 | 5,958 | 4,404 |
| Provision for income taxes | 920 | 736 | 1,941 | 1,375 |
| Net earnings | $ 1,921 | 1,522 | 4,017 | 3,029 |
| Basic earnings per share | $ 0.23 | 0.18 | 0.47 | 0.36 |
| Diluted earnings per share | $ 0.21 | 0.17 | 0.44 | 0.34 |

**See Accompanying Notes to Unaudited Consolidated Financial Statements.**

### Consolidated Statements of Comprehensive Income

| | (UNAUDITED) | | | |
|---|---|---|---|---|
| *(in thousands)* | **Three Months Ended June 30,** | | **Six Months Ended June 30,** | |
| | **2004** | **2003** | **2004** | **2003** |
| Net earnings | $ 1,921 | 1,522 | 4,017 | 3,029 |
| Other comprehensive loss, net of tax: | | | | |
| Unrealized (losses) gains on investment securities available-for-sale: | | | | |
| Unrealized (losses) gains arising during the period, net of tax of $583, $76, $458 and $12, respectively | (950) | (123) | (746) | 20 |
| Reclassification adjustment for (gains) losses included in net earnings net of tax of $3, $30, $263 and $3, respectively | (5) | 49 | (430) | (4) |
| Unrealized gain on cash flow hedges, net of tax of $46 | - | - | - | (75) |
| Other comprehensive loss | (955) | (74) | (1,176) | (59) |
| Comprehensive income | $ 966 | 1,448 | 2,841 | 2,970 |

**See Accompanying Notes to Unaudited Consolidated Financial Statements.**

## Consolidated Statements of Cash Flows

| *(in thousands)* | (UNAUDITED) Six Months Ended June 30, 2004 | 2003 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | |
| Net earnings | $ 4,017 | $ 3,029 |
| Adjustment to reconcile net earnings to net | | |
| cash (used in) provided by operating activities: | | |
| Depreciation, amortization and accretion | 1,642 | 1,733 |
| Provision for loan losses | 1,095 | 571 |
| Gain on sale of branch office | (3,000) | |
| Gain on sale of available-for-sale securities | (693) | (7) |
| Gain on sale of loans | (651) | (1,311) |
| Loss (gain) on sale, write-down of fixed assets | 33 | (922) |
| Gain on sale of other real estate | (35) | (85) |
| Change in: | | |
| Mortgage loans held-for-sale | (1,079) | (107) |
| Other | (2,677) | 1,209 |
| Net cash (used in) provided by operating activities | (1,348) | 4,110 |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | |
| Cash paid in branch sale | (14,141) | - |
| Net change in interest-bearing deposits | 99 | 4,360 |
| Proceeds from sales and maturities of investment | | |
| securities available-for-sale | 47,027 | 52,930 |
| Purchases of investment securities available-for-sale | (24,332) | (23,517) |
| Purchases of other investments | - | (7,550) |
| Proceeds from sales of other investments | 1,760 | - |
| Net change in loans | (63,538) | (12,861) |
| Proceeds from sale of other real estate | 442 | 1,538 |
| Proceeds from sale of premises and equipment | - | 4,324 |
| Purchases of premises and equipment | (315) | (458) |
| Purchases of cash surrender value life insurance | (74) | (86) |
| Net cash (used in) provided by investing activities | (53,072) | 18,680 |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** | | |
| Net change in deposits | 75,822 | (13,008) |
| Change in federal funds purchased | (1,842) | 691 |
| Change in other borrowed funds | (1,100) | 1,750 |
| Payments of FHLB advances | (5,000) | (5,000) |
| Proceeds from issuance of subordinated debt | 14,000 | - |

| | | |
|---|---|---|
| Purchase of treasury stock | (2,967) | - |
| Proceeds from exercise of stock options | 273 | 800 |
| Proceeds from issuance of stock | - | 138 |
| Proceeds from issuance of warrants | - | 12 |
| Cash dividends paid | (1,015) | (1,014) |
| Net cash provided by (used in) financing activities | 78,171 | (15,631) |
| Net change in cash and cash equivalents | 23,751 | 7,159 |
| **Cash and cash equivalents at beginning of period** | 36,737 | 38,310 |
| **Cash and cash equivalents at end of period** | $ 60,488 | $ 45,469 |

**See Accompanying Notes to Unaudited Consolidated Financial Statements.**

**Notes to Consolidated Financial Statements**

The accompanying consolidated financial statements have not been audited. The results of operations are not necessarily indicative of the results of operations for the full year or any other interim periods.

**Note 1. Basis of Presentation**
The consolidated financial statements include the accounts of Flag and its wholly owned subsidiaries, Flag Bank (Atlanta, Georgia) and Flag Financial Corporation Statutory Trust. All significant inter-company accounts and transactions have been eliminated in consolidation.

The consolidated financial information furnished herein represents all adjustments that are, in the opinion of management, necessary to present a fair statement of the results of operations, and financial position for the periods covered herein and are normal and recurring in nature. For further information, refer to the consolidated financial statements and footnotes included in Flag s annual report on Form 10-K for the year ended December 31, 2003.

**Note 2. Earnings Per Share**
Net earnings per common share are based on the weighted average number of common shares outstanding during each period. The calculation of basic and diluted earnings per share is as follows:

| *(in thousands, except per share data)* | | **Three Months Ended June 30, 2004** | **Three Months Ended June 30, 2003** | **Six Months Ended June 30, 2004** | **Six Months Ended June 30, 2003** |
|---|---|---|---|---|---|
| Basic earnings per share: | | | | | |
| Net earnings | $ | 1,921 | 1,522 | 4,017 | 3,029 |
| Weighted average common shares outstanding | | 8,457,214 | 8,470,308 | 8,492,676 | 8,433,462 |
| Per share amount | $ | 0.23 | 0.18 | 0.47 | 0.36 |
| | | | | | |
| Diluted earnings per share: | | | | | |
| Net earnings | $ | 1,921 | 1,522 | 4,017 | 3,029 |
| Effect of stock options and warrants | | 533,490 | 659,958 | 542,955 | 560,805 |
| Diluted earnings per share | $ | 0.21 | 0.17 | 0.44 | 0.34 |

**Note 3. Stock-based Compensation**
Flag sponsors stock-based compensation plans. Flag accounts for these plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net earnings, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net earnings and earnings per share if Flag had applied the fair value recognition provisions of Statement of Financing Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

| *(in thousands, except per share data)* | | Three months ended June 30, 2004 | Three months ended June 30, 2003 | Six months ended June 30, 2004 | Six months ended June 30, 2003 |
|---|---|---|---|---|---|
| Net earnings as reported | $ | 1,921 | 1,522 | 4,017 | 3,029 |
| Compensation expense determined by fair value method | $ | (28) | (77) | (55) | (153) |
| Pro forma net earnings | $ | 1,893 | 1,445 | 3,962 | 2,876 |
| Basic earnings per share: | | | | | |

| | | | | |
|---|---|---|---|---|
| As reported | $ .23 | .18 | .47 | .36 |
| Pro forma | $ .22 | .17 | .47 | .34 |
| Diluted earnings per share: | | | | |
| As reported | $ .21 | .17 | .44 | .34 |
| Pro forma | $ .21 | .16 | .44 | .32 |

**Notes to Consolidated Financial Statements**

During the first six months of 2004, Flag issued 85,500 options with estimated value of $3.55 each. The fair value of each option is estimated on the date of grant using the Black-Scholes options-pricing model with the following assumptions: dividend yield of 1.80%; volatility of .2941; risk free interest rate of 4.15%; and an expected life of five years.

**Note 4. Loans**

Flag engages in a full complement of lending activities, including real estate-related, commercial and financial loans and consumer installment loans. Flag generally concentrates lending efforts on real estate related loans. As of June 30, 2004, Flag s loan portfolio consisted of 85.7% real estate-related loans, 11.6% commercial and financial loans, and 2.7% consumer installment loans. While risk of loss is primarily tied to the credit quality of the various borrowers, risk of loss may also increase due to factors beyond the Flag s control, such as local, regional and/or national economic downturns. General conditions in the real estate market may also impact the relative risk in the real estate portfolio. Of the target areas of lending activities, commercial and financial loans are generally considered to have a greater risk of loss than real estate loans or consumer installment loans.

Loans are stated at unpaid balances, net of unearned income and deferred loan fees. Balances within the major loans receivable categories are represented in the following table:

| *(in thousands)* | **June 30, 2004** | **December 31, 2003** | **June 30, 2003** |
|---|---|---|---|
| Commercial/financial/agricultural | $ 61,429 | $ 50,435 | $ 56,956 |
| Real estate Construction | 130,609 | 100,108 | 77,927 |
| Real estate Mortgage | 323,902 | 315,610 | 244,589 |
| Installment loans to individuals | 14,183 | 17,287 | 13,589 |
| Lease financing | 215 | 340 | 454 |
| Total loans | $ 530,338 | $ 483,780 | $ 393,515 |
| Less: Allowance for loan losses | 7,489 | 6,685 | 6,441 |
| Total net loans | $ 522,849 | $ 477,095 | $ 387,074 |

**Item 2. Management s Discussion and Analysis of**
**Financial Condition and Results of Operations**

**Overview**
Flag ended the second quarter of 2004 with strong balance sheet growth. Total assets grew to approximately $749.4 million, an increase of 20.2% from June 30, 2003. Loans outstanding (excluding loans held for sale) increased 34.8% to $530.3 million at June 30, 2004 when compared to June 30, 2003. Total deposits grew to $610.6 million, an increase of $113.9 million or 22.9% from balances at June 30, 2003.

During the first six months of 2004, Flag has increased total assets by $45.5 million from $703.9 million at December 31, 2003. Loans outstanding and total deposits have increased $46.6 million and $40.1 million, respectively, over the same period. These increases in significant sections of the balance sheet come despite the first quarter 2004 divestiture of Flag s Thomaston, Georgia branch that included total assets, loans outstanding and total deposits of $38 million, $17 million and $36 million, respectively.

Return on average equity for the three months ended June 30, 2004 was 11.59% on average shareholders equity of $66.3 million. This compares to 9.65% on average equity of $62.8 million for the same period in 2003. Return on average assets for the three months ended June 30, 2004 was 1.07%. This compares to 0.97% for the same period in 2003.

For the six month periods ended June 30, 2004 and 2003, Flag s return on average shareholders equity was 12.14% and 9.73%, respectively. Flag s return on average assets for the same periods was 1.13% and 0.96%, respectively.

**Forward-Looking Statements**
The following discussion and comments contain "forward-looking statements" relating to, without limitation, future economic performance, plans and objectives of management for future operations, and projections of revenues and other financial items that are based on the beliefs of our management, as well as assumptions made by and information currently available to our management. The words expect , estimate , anticipate , and believe , as well as similar expressions, are intended to identify forward-looking statements. Our actual results may differ materially from the results discussed in the forward-looking statements, and our operating performance each quarter is subject to various risks and uncertainties. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to, (i) the strength of the U.S. economy as well as the strength of the local economies in which operations are conducted; (ii) the effects of changing interest rates which could lower margins; (iii) inflation, interest rate, market and monetary fluctuations; (iv) unanticipated regulatory proceedings or legal actions, or changes in accounting policies and practices as adopted by the Financial Accounting Standards Board; (v) issues involved in the integration of any acquisitions; and (vi) the timely development of products and services that position Flag to succeed in an increasingly competitive industry. If we are unsuccessful in managing the risks relating to these factors, together with other risks incident to the operation of our business, our financial condition, results of operations and cash flows could be adversely affected. Forward-looking statements speak only as of the date on which they are made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made to reflect the occurrence of unanticipated events.

**Critical Accounting Policies**
The accounting principles we follow and our methods of applying these principles conform with accounting principles generally accepted in the United States and with general practices within the banking industry. In connection with the application of those principles, we have made judgments, estimates and assumptions which, in the case of the determining our allowance for loan losses (ALL), have been critical to the determination of our financial position and results of operations. Management assesses the adequacy of the ALL regularly during the year, and formally prior to the end of each calendar quarter. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance.

This estimation process can affect our estimated loan loss expense for a given period. Generally, the allowance for loan losses increases as the outstanding balance of loans or the level of classified or impaired loans increases. Loans or portions of loans that are deemed uncollectible are charged against and reduce the allowance. The allowance is replenished by means of a provision for loan losses that is charged as an expense against income. As a result, our estimate of the allowance for loan losses affects our earnings directly.

The ALL consists of two portions (1) allocated amounts representing the potential exposures on specifically identified credits and other exposures readily predictable by historical or comparative experience; and (2) an unallocated amount representative of inherent loss which is not readily identifiable. Even though the ALL is composed of two components, the entire ALL is available to absorb any credit losses. Allocated amounts are used on loans where management has determined that there is an increased probability or severity of loss than on the loan portfolio as a whole. We base the allocation for these unique loans primarily on risk rating grades assigned to each of these loans as a result of our loan management and review processes. We then assign each risk-rating grade a loss ratio, which is determined based on the experience of management, discussions with banking regulators and our independent loan review process. We estimate losses on impaired loans based on estimated cash flows discounted at the loan's original effective interest rate or based on the underlying collateral value. To the extent that management does not believe that a certain loan's risk is appropriately represented by the risk rating grades, a specific review of the credit is performed which would result in a less subjective allocation for that particular loan.

Unallocated amounts are particularly subjective and do not lend themselves to exact mathematical calculation. The unallocated amount represents estimated inherent credit losses which may exist, but have not yet been identified, as of the balance sheet date. In estimating the unallocated amount, such matters as changes in the local or national economy, the depth or experience in the lending staff, any concentrations of credit in any particular industry group, and new banking laws or regulations. After we assess applicable factors, we evaluate the aggregate unallocated amount based on our management's experience. We then estimate the resulting ALL balance by comparing the balance in the ALL to historical trends and peer information. Our management then evaluates the result of the procedures performed, including the result of our testing, and concludes on the appropriateness of the balance of the ALL in its entirety.

The audit committee of our board of directors reviews the assessment prior to the filing of quarterly and annual financial information. In assessing the adequacy of the ALL, we also rely on an ongoing independent loan review process. We undertake this process both to ascertain whether there are loans in the portfolio whose credit quality has weakened over time and to assist in our overall evaluation of the risk characteristics of the entire loan portfolio. Our loan review process includes the judgment of management, the input from our independent loan reviewer, and reviews that may have been conducted by bank regulatory agencies as part of their usual examination process.

**Summary Financial Data**

The following table presents summary financial data for the previous five quarters.

| *(in thousands, except per share data)* *(unaudited)* | | Second Quarter 2004 | First Quarter 2004 | Fourth Quarter 2003 | Third Quarter 2003 | Second Quarter 2003 |
|---|---|---|---|---|---|---|
| **INCOME SUMMARY** | | | | | | |
| Interest income | $ | 10,071 | 9,674 | 9,461 | 9,267 | 8,726 |
| Interest expense | | 2,712 | 2,541 | 2,608 | 2,490 | 2,606 |
| Net interest income | | 7,359 | 7,133 | 6,853 | 6,777 | 6,119 |
| Provision for loan losses | | 375 | 720 | 375 | 375 | 315 |
| Other income | | 2,591 | 4,692 | 2,042 | 2,332 | 3,537 |
| Other expenses | | 6,734 | 7,988 | 6,327 | 6,503 | 7,083 |
| Earnings before taxes | | 2,841 | 3,117 | 2,193 | 2,231 | 2,258 |
| Income taxes | | 920 | 1,021 | 664 | 685 | 736 |
| Earnings | $ | 1,921 | 2,096 | 1,530 | 1,546 | 1,522 |
| **PERFORMANCE RATIOS** | | | | | | |
| Earnings per common share: | | | | | | |
| Basic | $ | 0.23 | 0.25 | 0.18 | 0.18 | 0.18 |
| Diluted | | 0.21 | 0.23 | 0.17 | 0.17 | 0.17 |
| Return on average equity | | 11.59% | 12.68% | 9.30% | 9.70% | 9.65% |
| Return on average assets | | 1.07% | 1.19% | 0.89% | 0.98% | 0.97% |
| Net interest margin | | 4.46% | 4.40% | 4.31% | 4.67% | 4.35% |
| Yield on Earning Assets | | 6.11% | 5.96% | 5.94 % | 5.94% | 6.13 % |
| Cost of Funds | | 1.73% | 1.59% | 1.68% | 1.77% | 1.85% |
| Efficiency ratio | | 67.39% | 67.33% | 71.13% | 71.82% | 73.22% |
| Net overhead ratio | | 2.32% | 1.87% | 2.50% | 2.65% | 2.27% |
| Dividend payout ratio | | 26.63% | 24.42% | 33.45% | 33.02% | 33.47% |
| **ASSET QUALITY** | | | | | | |
| Allowance for loan losses | $ | 7,489 | 7,052 | 6,685 | 6,787 | 6,441 |
| Non-performing assets | | 5,853 | 6,785 | 7,426 | 7,658 | 9,412 |
| Allowance for loan losses to loans | | 1.41% | 1.48% | 1.38% | 1.56% | 1.64% |

| | | | | | |
|---|---|---|---|---|---|
| Non-performing assets to total assets | 0.78% | 0.99% | 1.06% | 1.17% | 1.50% |
| Net charge-offs to average loans | -0.05% | 0.29% | 0.42% | 0.03% | 0.29% |
| | | | | | |
| **AVERAGE BALANCES** | | | | | |
| Loans | $ 503,045 | 485,528 | 459,405 | 406,258 | 381,158 |
| Earning assets | 663,258 | 652,312 | 631,399 | 575,304 | 564,457 |
| Total assets | 715,212 | 706,763 | 686,422 | 628,899 | 626,368 |
| Deposits | 572,871 | 577,212 | 551,658 | 499,710 | 500,347 |
| Stockholders equity | 66,311 | 66,093 | 65,005 | 63,798 | 62,800 |
| Common shares outstanding: | | | | | |
| Basic | 8,457,214 | 8,528,138 | 8,515,858 | 8,500,030 | 8,470,308 |
| Diluted | 8,990,704 | 9,094,604 | 9,120,823 | 9,164,931 | 9,130,266 |
| | | | | | |
| **AT PERIOD END** | | | | | |
| Loans | $ 530,338 | 478,038 | 483,780 | 435,079 | 393,515 |
| Earning assets | 693,613 | 633,450 | 647,482 | 598,201 | 564,220 |
| Total assets | 749,371 | 684,823 | 703,857 | 654,652 | 623,426 |
| Deposits | 610,636 | 548,467 | 570,570 | 511,591 | 496,722 |
| Stockholders equity | 64,392 | 66,623 | 65,260 | 64,195 | 63,655 |
| Common shares outstanding | 8,333 | 8,528 | 8,528 | 8,510 | 8,489 |

**Management s Discussion and Analysis of**
**Financial Condition and Results of Operations**

**Overview of Financial Condition**

Total assets were $749.4 million at June 30, 2004, an increase of $45.5 million or 6.5% from December 31, 2003. Earning assets totaled $693.6 million or 92.6% of total assets at June 30, 2004 compared to $647.5 million or 92.0% of total assets at December 31, 2003. Stockholders equity increased $1.3 million or 2.0% to $64.4 million at June 30, 2004. Much of the growth discussed in this filing stems from Flag s Metro Atlanta expansion strategy. This initiative has focused on developing or hiring highly qualified teams of lenders, private bankers and treasury sales officers and has resulted in a very healthy pace of loan and demand deposit growth.

**Loans**

Gross loans outstanding (excluding mortgage loans held for sale) at June 30, 2004 totaled $530.3 million, an increase of $46.6 million over December 31, 2003 balances. Mortgage loans held-for-sale increased from $4.2 million at December 31, 2003 to $6.0 million at June 30, 200