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1ST STATE BANCORP INC
Form 10-Q
August 14, 2001

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2001

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)

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

N/A

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

As of July 31, 2001, the issuer had 3,289,607 shares of common stock issued and outstanding.

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1ST STATE BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

JUNE 30, 2001 AND SEPTEMBER 30, 2000

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(IN THOUSANDS)

| | AT JUNE 30, 2001 | |
|--|------------------------|--|
| | (Unaudited) | |
| ASSETS | | |
| Cash and cash equivalents | \$ 23,371 | |
| Investment securities: | | |
| Held to maturity (fair value of \$25,852 and \$65,173 at June 30, 2001 and September 30, 2000, respectively) | 25,660 | |
| Available for sale (cost of \$54,399 and \$10,019 at June 30, 2001 and September 30, 2000, respectively) | 54,330 | |
| Loans held for sale, at lower of cost or fair value | 3,251 | |
| Loans receivable (net of allowance for loan losses of \$3,553 and \$3,536 at June 30, 2001 and September 30, 2000, respectively) | 222,493 | |
| Real estate owned | 1,981 | |
| Federal Home Loan Bank stock, at cost | 1,650 | |
| Premises and equipment | 8,552 | |
| Accrued interest receivable | 2,231 | |
| Other assets | 3,221 | |
| | \$346,740 | |
| | ===== | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities: | | |
| Deposit accounts | 258,843 | |
| Advances from Federal Home Loan Bank | 20,000 | |
| Advance payments by borrowers for property taxes and insurance | 684 | |
| Dividend payable | 263 | |
| Other liabilities | 4,789 | |
| | 284,579 | |
| | ----- | |
| 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; 3,289,607 shares issued and outstanding | 33 | |
| Additional paid-in capital | 35,581 | |
| Unearned ESOP shares | (4,541) | |
| Unearned compensation - management recognition plan | (713) | |
| Deferred compensation | 4,025 | |
| Treasury stock for deferred compensation | (4,025) | |
| Retained income - substantially restricted | 31,843 | |
| Accumulated other comprehensive loss - net unrealized loss on investment securities available for sale | (42) | |
| | 62,161 | |
| | ----- | |
| Total liabilities and stockholders' equity | \$346,740 | |
| | ===== | |

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See accompanying notes to the consolidated financial statements.

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1ST STATE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE THREE MONTHS ENDED JUNE 30, 2001 AND 2000
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(UNAUDITED)

| | FOR THE THREE MONTHS ENDED JUNE 30, | |
|--|--|-------|
| | 2001 | 2000 |
| Interest income: | | |
| Interest and fees on loans | \$ 4,625 | 4,725 |
| Interest and dividends on investments | 1,182 | 1,385 |
| Overnight deposits | 230 | 175 |
| Total interest income | 6,037 | 6,285 |
| Interest expense: | | |
| Deposit accounts | 2,725 | 2,565 |
| Borrowings | 273 | 395 |
| Total interest expense | 2,998 | 2,960 |
| Net interest income | 3,039 | 3,325 |
| Provision for loan losses | 60 | 65 |
| Net interest income after provision for loan losses | 2,979 | 3,260 |
| Other income: | | |
| Service fees on loans sold | 21 | 25 |
| Customer service fees | 204 | 145 |
| Commissions from sales of annuities and mutual funds | 240 | 125 |
| Mortgage banking income, net | 338 | 85 |
| Other | 57 | 55 |
| Total other income | 860 | 435 |
| Operating expenses: | | |
| Compensation and related benefits | 1,616 | 2,075 |
| Occupancy and equipment | 336 | 265 |
| Deposit insurance premiums | 12 | 15 |
| Real estate operations, net | 30 | (145) |
| Other expenses | 455 | 405 |
| Total operating expenses | 2,449 | 2,600 |

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| | | |
|----------------------------|---------|--------|
| Income before income taxes | 1,390 | 1,08 |
| Income taxes | 497 | 38 |
| Net income | \$ 893 | 70 |
| Earnings per share: | | |
| Basic | \$ 0.29 | \$ 0.2 |
| Diluted | \$ 0.28 | \$ 0.2 |

See accompanying notes to the consolidated financial statements.

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1ST STATE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE NINE MONTHS ENDED JUNE 30, 2001 AND 2000
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(UNAUDITED)

| | FOR THE NINE MONTHS END JUNE 30, | |
|--|-------------------------------------|-------|
| | 2001 | 2000 |
| | ----- | ----- |
| Interest income: | | |
| Interest and fees on loans | \$ 14,642 | 13, |
| Interest and dividends on investments | 3,517 | 4, |
| Overnight deposits | 629 | |
| Total interest income | 18,788 | 18, |
| Interest expense: | | |
| Deposit accounts | 8,715 | 7, |
| Borrowings | 853 | 1, |
| Total interest expense | 9,568 | 8, |
| Net interest income | 9,220 | 9, |
| Provision for loan losses | 180 | |
| Net interest income after provision for loan losses | 9,040 | 9, |
| Other income: | | |
| Service fees on loans sold | 63 | |
| Customer service fees | 522 | |
| Commissions from sales of annuities and mutual funds | 459 | |
| Mortgage banking income, net | 658 | |
| Other | 141 | |
| Total other income | 1,843 | |
| Operating expenses: | | |

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| | | |
|-----------------------------------|----------|-------|
| Compensation and related benefits | 4,589 | 4, |
| Occupancy and equipment | 944 | |
| Deposit insurance premiums | 37 | |
| Real estate operations, net | 36 | (|
| Other expenses | 1,292 | 1, |
| | ----- | ----- |
| Total operating expenses | 6,898 | 6, |
| | ----- | ----- |
| Income before income taxes | 3,985 | 4, |
| Income taxes | 1,416 | 1, |
| | ----- | ----- |
| Net income | \$ 2,569 | 2, |
| | ===== | ===== |
| Earnings per share: | | |
| Basic | \$ 0.85 | \$ 0 |
| Diluted | \$ 0.81 | \$ 0 |

See accompanying notes to the consolidated financial statements

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1ST STATE BANCORP, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
FOR THE NINE MONTHS ENDED JUNE 30, 2001 AND 2000 (UNAUDITED)
(IN THOUSANDS)

| | COMMON STOCK ----- | ADDITIONAL PAID-IN CAPITAL ----- | UNEARNED ESOP SHARES ----- | UNEARNED COMPENSA MRP ----- |
|---|--------------------------|---|-------------------------------------|--------------------------------------|
| Balance at September 30, 1999 | \$ 32 | 49,216 | (4,470) | |
| Comprehensive income: | | | | |
| Net income | -- | -- | -- | |
| Other comprehensive income-unrealized loss on securities available-for-sale net of income taxes of \$61 | -- | -- | -- | |
| Total comprehensive income | | | | |
| Shares issued for MRP | 1 | 2,331 | -- | (2, |
| Release of ESOP shares | -- | (11) | 423 | |
| Deferred compensation | -- | -- | -- | |
| Treasury stock held for deferred compensation | -- | -- | -- | |
| Vesting of MRP shares | -- | -- | -- | |
| Cash dividend declared | -- | -- | -- | |
| Cash dividend on unallocated ESOP shares | -- | -- | -- | |
| | ----- | ----- | ----- | ----- |
| Balance at June 30, 2000 | \$ 33 | 51,536 | (4,047) | (1, |
| | ===== | ===== | ===== | ===== |
| Balance at September 30, 2000 | \$ 33 | 35,587 | (4,950) | (1, |

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| | | | | |
|---|-------|--|-----------------|---|
| Comprehensive income: | | | | |
| Net income | -- | -- | -- | -- |
| Other comprehensive income-unrealized gain on securities available-for-sale net of income taxes of \$76 | -- | -- | -- | -- |
| Total comprehensive income | | | | |
| Release of ESOP shares | -- | (6) | 409 | -- |
| Deferred compensation | -- | -- | -- | -- |
| Treasury stock held for deferred compensation | -- | -- | -- | -- |
| MRP share amortization | -- | -- | -- | -- |
| Cash dividend declared | -- | -- | -- | -- |
| Cash dividend on unallocated ESOP shares | -- | -- | -- | -- |
| Balance at June 30, 2001 | \$ 33 | 35,581 | (4,541) | (10,000) |
| | ===== | ===== | ===== | ===== |
| | | TREASURY STOCK FOR DEFERRED COMPENSATION | RETAINED INCOME | ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) |
| | | ----- | ----- | ----- |
| Balance at September 30, 1999 | | (2,373) | 26,960 | (12,000) |
| Comprehensive income: | | | | |
| Net income | -- | -- | 2,914 | -- |
| Other comprehensive income-unrealized loss on securities available-for-sale net of income taxes of \$61 | -- | -- | -- | (10,000) |
| Total comprehensive income | | | | |
| Shares issued for MRP | -- | -- | -- | -- |
| Release of ESOP shares | -- | -- | -- | -- |
| Deferred compensation | -- | -- | -- | -- |
| Treasury stock held for deferred compensation | (230) | -- | -- | -- |
| Vesting of MRP shares | -- | -- | -- | -- |
| Cash dividend declared | -- | -- | (769) | -- |
| Cash dividend on unallocated ESOP shares | -- | -- | 62 | -- |
| Balance at June 30, 2000 | | (2,603) | 29,167 | (22,000) |
| | ===== | ===== | ===== | ===== |
| Balance at September 30, 2000 | | (2,679) | 29,999 | (16,000) |
| Comprehensive income: | | | | |
| Net income | -- | -- | 2,569 | -- |
| Other comprehensive income-unrealized gain on securities available-for-sale net of income taxes of \$76 | -- | -- | -- | 1,000 |
| Total comprehensive income | | | | |
| Release of ESOP shares | -- | -- | -- | -- |

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| | | | |
|---|---------|--------|---------|
| Deferred compensation | -- | -- | -- |
| Treasury stock held for deferred compensation | (1,346) | -- | -- |
| MRP share amortization | -- | -- | -- |
| Cash dividend declared | -- | (789) | -- |
| Cash dividend on unallocated ESOP shares | -- | 64 | -- |
| | ----- | ----- | ----- |
| Balance at June 30, 2001 | (4,025) | 31,843 | (4,025) |
| | ===== | ===== | ===== |

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, 2001 AND 2000
(UNAUDITED)
(IN THOUSANDS)

| | FOR THE NINE MONTHS ENDED JUNE 30 |
|--|---|
| | 2001 |
| | ----- |
| Cash flows from operating activities: | |
| Net income | \$ 2,569 |
| Adjustment to reconcile net income to net cash provided by operating activities: | |
| Provision for loan losses | 180 |
| Depreciation | 469 |
| Deferred income tax | (101) |
| Gain on sale of real estate owned | -- |
| Amortization of premiums and discounts, net | (18) |
| Release of ESOP shares | 403 |
| Vesting of MRP shares | 583 |
| Loan origination fees and unearned discounts deferred, net of current amortization | 6 |
| Net loss on sale of loans | 205 |
| Proceeds from loans held for sale | 37,260 |
| Originations of loans held for sale | (35,183) |
| Decrease (increase) in other assets | 356 |
| Decrease in accrued interest receivable | 422 |
| Increase (decrease) in other liabilities | 297 |
| | ----- |
| Net cash provided by operating activities | 7,448 |
| | ----- |
| Cash flows provided by (used in) investing activities: | |
| Purchase of FHLB stock | -- |
| Redemption of FHLB stock | -- |
| Purchases of investment securities held to maturity | (661) |

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| | |
|--|----------|
| Purchase of investment securities available for sale | (50,528) |
| Proceeds from maturities of investment securities available for sale | 6,148 |
| Proceeds from maturities of investment securities held to maturity | 42,251 |
| Proceeds from sale of real estate owned | -- |
| Net increase in loans receivable | (1,065) |
| Purchases of premises and equipment | (568) |
| | ----- |
| Net cash used in investing activities | (4,423) |
| | ----- |

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1ST STATE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED
FOR THE NINE MONTHS ENDED JUNE 30, 2001 AND 2000
(UNAUDITED)
(IN THOUSANDS)

| | FOR THE NINE MO JUNE 30 |
|--|----------------------------|
| | ----- 2001 ----- |
| Cash flows from financing activities: | |
| Net increase in deposits | \$ 4,438 |
| Advances from the Federal Home Loan Bank | 5,000 |
| Repayments of advances from Federal Home Loan Bank | (5,000) |
| Return of capital dividend payment | (17,007) |
| Dividends paid on common stock | (725) |
| Increase in advance payments by borrowers for property taxes and insurance | 533 |
| | ----- |
| Net cash (used in) provided by financing activities | (12,761) |
| | ----- |
| Net (decrease) increase in cash and cash equivalents | (9,736) |
| Cash and cash equivalents at beginning of period | 33,107 |
| | ----- |
| Cash and cash equivalents at end of period | \$ 23,371 |
| | ===== |
| Payments are shown below for the following: | |
| Interest | \$ 9,446 |
| | ===== |
| Income taxes | \$ 1,100 |
| | ===== |
| Noncash investing and financing activities: | |
| Deferred compensation to be settled in Company's stock | \$ 1,346 |
| | ===== |

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| | |
|---|-------------------|
| Unrealized gains (losses) on investment securities available for sale | \$ 198 ===== |
| Cash dividends declared but not paid | \$ 244 ===== |
| Cash dividends on unallocated ESOP shares, used to repay the Company's loan to ESOP, and on unallocated MRP shares | \$ 64 ===== |
| Transfer from loans held for sale to loans receivable | \$ 686 ===== |
| Transfer of land from other assets to premises and equipment | \$ -- ===== |
| Transfer from loans to real estate acquired in settlement of loans | \$ 1,981 ===== |

See accompanying notes to consolidated financial statements.

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1ST STATE BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2001 (UNAUDITED) AND SEPTEMBER 30, 2000

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, 2000, which is derived from the September 30, 2000 audited consolidated financial statements) have been prepared in accordance with generally accepted accounting principles for interim financial information 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 generally accepted accounting principles 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, 2001 are not necessarily indicative of the results of operations that may be expected for the year ended September 30, 2001. The preparation of consolidated financial statements in accordance with generally accepted accounting principles requires management to make certain estimates. These amounts may be revised in

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future periods because of changes in the facts and circumstances underlying their estimation.

NOTE 3. EARNINGS PER SHARE

The Company's basic earnings per share were computed by dividing net income by the weighted average shares outstanding, excluding ESOP and MRP benefit plan shares not committed to be released or granted. Diluted earnings per share includes the potentially dilutive effects of the Company's benefit plans. A reconciliation of the denominators of the basic and diluted EPS computations is as follows:

| | Three Months June 30, 2001 |
|---|----------------------------------|
| | ----- |
| Average shares issued and outstanding | 3,163,125 |
| Add: weighted average vested MRP shares issued | 53,620 |
| Less: weighted average unallocated ESOP shares | (184,207) |
| | ----- |
| Average shares for basic earnings per share | 3,032,538 |
| Add: weighted average unvested MRP shares | 72,862 |
| Add: potential common stock pursuant to stock option plan (See Note 7) | 86,684 |
| | ----- |
| Average shares for diluted earnings per share | 3,192,084 |
| | ===== |

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| | Nine Months E June 30, 2001 |
|---|-----------------------------------|
| | ----- |
| Average shares issued and outstanding | 3,163,125 |
| Add: weighted average vested MRP shares issued | 46,010 |
| Less: weighted average unallocated ESOP shares | (191,252) |
| | ----- |
| Average shares for basic earnings per share | 3,017,883 |
| Add: weighted average unvested MRP shares | 80,472 |
| Add: potential common stock pursuant to stock option plan (See Note 7) | 72,147 |
| | ----- |
| Average shares for diluted earnings per share | 3,170,502 |
| | ===== |

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

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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, 2001, 7,045 and 21,134 shares of stock were committed to be released and approximately \$143,000 and \$403,000 of compensation expense was recognized, respectively. Compensation expense related to the ESOP for the three and nine months ended June 30, 2000 was \$135,000 and \$411,000, respectively.

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. 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 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 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 Conversion, so the Company purchases its common stock to fund this obligation as additional amounts are deferred. Refer to the Company's notes to consolidated financial statements, incorporated by reference in the Company's 2000 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, 2001 was \$68,000 and \$203,000, respectively. This expense is included in compensation expense.

NOTE 6. MANAGEMENT RECOGNITION PLAN

The Company has a Management Recognition Plan ("MRP") which serves as a means of providing existing directors and officers of the Bank with an ownership interest in the Company. On June 6, 2000, restricted stock awards of 126,482 shares were granted. The shares awarded under the MRP were issued from authorized but unissued shares of common stock at no cost to the recipients. The shares vest at a rate of 33 1/3% per year with a one-third immediate vest on the date of the grant and annually thereafter. Compensation expense of \$260,000 and \$787,000 associated with the MRP was recorded during the three and nine months ended June 30, 2001. Compensation expense of \$842,000 associated with the MRP was recorded in the three and nine months ended June 30, 2000.

NOTE 7. 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 in fiscal year 2000. The exercise price per share is equal to the fair market value per share on the date of the grant of the stock.

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NOTE 8. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

In June 1998 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Certain Hedging Activities." In June 1999 the FASB issued SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities, an Amendment of SFAS 133." SFAS No. 133 and SFAS No. 138 require that all derivative instruments be recorded on the balance sheet at their respective fair values. Changes in the fair values of those derivatives will be reported in earnings or other comprehensive income depending on the use of the derivative and whether the derivative qualifies for hedge accounting. SFAS No. 133 and SFAS No. 138 are effective for all fiscal quarters of all fiscal years beginning after June 30, 2000; the Company adopted SFAS No. 133, as amended by SFAS No. 138, on October 1, 2000.

On October 1, 2000 and June 30, 2001, the Company had no embedded derivative instruments requiring separate accounting treatment and had identified fixed rate conforming loan commitments as its only freestanding derivative instrument. The Company does not currently engage in hedging activities. The commitments to originate fixed rate conforming loans totaled \$2,265,000 and \$1,114,000 at June 30, 2001 and October 1, 2000, respectively. The fair value of these commitments was immaterial on these dates and therefore the adoption of SFAS 133 on October 1, 2000 as well as the impact of applying SFAS 133 at June 30, 2001 was not material to the Company's consolidated financial statements.

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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.

COMPARISON OF FINANCIAL CONDITION AT JUNE 30, 2001 AND SEPTEMBER 30, 2000

Total assets decreased by \$8.8 million or 2.5% from \$355.5 million at September 30, 2000 to \$346.7 million at June 30, 2001. The decrease was primarily the result of the \$17.0 million return of capital dividend which was

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paid to stockholders on October 2, 2000 which was partially offset by asset growth of \$8.2 million during the nine months ended June 30, 2001.

Investment securities available for sale increased \$44.5 million from \$9.8 million at September 30, 2000 to \$54.3 million at June 30, 2001. Investment securities held to maturity decreased \$41.5 million from \$67.2 million at September 30, 2000 to \$25.7 million at June 30, 2001. As market interest rates fell during the nine months ended June 30, 2001, many of the Company's callable investment securities were called by the issuers. The majority of these investments had been classified as held to maturity at the time of purchase. Most of the investments purchased during the nine months ended June 30, 2001 have been classified as available for sale to give the Company more flexibility in the future.

Loans receivable, net decreased by \$1.1 million, or 0.5%, from \$223.6 million at September 30, 2000 to \$222.5 million at June 30, 2001. Loans held for sale also decreased \$2.2 million from \$5.5 million at September 30, 2000 to \$3.3 million at June 30, 2001. With the lower interest rate environment, we have continued to sell most of the long term fixed rate mortgage loans that we originate. We sold \$37.5 million in fixed rate mortgage loans during the nine months ended June 30, 2001 compared to \$14.7 million for the nine months ended June 30, 2000. We continue to emphasize commercial, commercial real estate, consumer loans and equity lines of credit that carry variable rates and/or short term maturities. At June 30, 2001, commercial loans totaled \$53.5 million and account for 23.7% of gross loans compared to \$42.9 million and 18.9% at September 30, 2000. One to four family residential loans at June 30, 2001 totaled \$89.8 million or 39.7% of gross loans compared to \$97.6 million or 43.0% at September 30, 2000.

Deposits increased \$4.4 million from \$254.4 million at September 30, 2000 to \$258.8 million at June 30, 2001. Certificates of deposit at June 30, 2001 totaled \$166.5 million or 64.3% of total deposits. At September 30, 2000, certificates of deposit totaled \$168.3 million or 66.2% of total deposits. We continue to emphasize transaction accounts, which carry lower interest rates than certificates of deposit. Transaction accounts increased \$6.1 million during the nine months ended June 30, 2001 which were offset by certificate of deposit runoff of \$1.7 million.

Stockholders' equity increased by \$3.0 million from \$59.2 million at September 30, 2000 to \$62.2 million at June 30, 2001 as a result of net income of \$2.6 million, release of ESOP shares of \$403,000, vesting of MRP shares of \$583,000, and an increase in unrealized gains on available for sale securities of \$122,000. These increases were offset by dividends declared of \$725,000.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED JUNE 30, 2001 AND 2000

Net Income. We recorded net income of \$893,000 for the quarter ended June 30, 2001, as compared to \$707,000 for the quarter ended June 30, 2000, representing an increase of \$186,000, or 26.3%. For the three months ended June 30, 2001 basic and diluted earnings per share were \$0.29 and \$0.28, respectively. The Company reported basic and diluted earnings per share for the quarter ended June 30, 2000 of \$0.24 per share. The increase in net income resulted primarily from increased other income and decreased operating expenses that were offset partially by decreased net interest income and increased income taxes. The decline in net interest income resulted from the decrease in average earning assets that resulted from the special return of capital dividend of \$17.0 million, which was paid on October 2, 2000 and decreased net interest margins. The return of capital dividend decreased the ratio of average interest-earning assets to average interest-bearing liabilities from 127.1% for the three months ended June 30, 2000 to 121.2% for the three months ended June 30, 2001.

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Net Interest Income. Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, decreased by \$286,000 or 8.6% for the three months ended June 30, 2001, compared to the same quarter in the prior year. This decrease reflects a \$243,000 decrease in interest income and \$43,000 increase in total interest expense. The average

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net interest margin decreased 35 basis points from 4.11% for the three months ended June 30, 2000 to 3.76% for the quarter ended June 30, 2001.

Interest Income. The decrease in interest income for the three months ended June 30, 2001 was due to a decrease of \$805,000 in average interest-earning assets compared to the same quarter in the prior year and a decrease in yield on interest-earning assets of 0.28% from 7.76% for the three months ended June 30, 2000 to 7.48% for the three months ended June 30, 2001. The decreased volume of average interest-earning assets decreased interest income by approximately \$16,000 and the decreased yield decreased interest income by approximately \$227,000. An increase in average loans outstanding of \$5.6 million coupled with an increase in average interest-bearing overnight funds of \$9.6 million increased interest-earning assets for the quarter compared to the prior year. These increases were offset by a decrease in average investments of \$15.9 million. Average investments decreased to provide cash to pay the special return of capital dividend.

Interest Expense. Interest expense increased in the three months ended June 30, 2001 due to an increase in average interest-bearing liabilities of \$11.7 million which was partially offset by a decrease in the cost of interest-bearing liabilities of 14 basis points from 4.64% for the three months ended June 30, 2000 to 4.50% for the three months ended June 30, 2001. Average deposits increased by \$18.8 million while average FHLB advances decreased \$7.1 million for the three months ended June 30, 2001 compared to the same quarter in the prior year. The increase in average interest-bearing liabilities increased interest expense by approximately \$136,000 while the decrease in the average cost of interest-bearing liabilities decreased interest expense by approximately \$94,000.

The following table presents average balances and average rates earned/paid by the Company for the quarter ended June 30, 2001 compared to the quarter ended June 30, 2000.

| | THREE MONTHS ENDED JUNE 30, 2001 | | | THREE MONTHS ENDED JUNE 30, 2000 |
|-------------------------------------|-------------------------------------|-------------------|---|-------------------------------------|
| | AVERAGE BALANCE ----- | INTEREST ----- | DOLLARS IN THOUSANDS YIELD/ COST ----- | |
| Assets: | | | | |
| Loans receivable (1) | 228,239 | 4,625 | 8.11% | 222,67 |
| Investment securities (2) | 73,962 | 1,182 | 6.39 | 89,89 |
| Interest-bearing overnight deposits | 20,710 | 230 | 4.45 | 11,15 |
| | ----- | ----- | ----- | ----- |
| Total interest-earning assets | 322,911 | 6,037 | 7.48 | 323,72 |
| Non interest-earning assets | 23,327 | | | 16,57 |
| | ----- | | | ----- |
| Total assets | 346,238 | | | 340,29 |

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| | | | | |
|--|---------|-------|---------|--------|
| Liabilities and stockholders' equity: | | | | |
| Deposits | 246,447 | 2,725 | 4.42% | 227,60 |
| FHLB advances | 20,000 | 273 | 5.45 | 27,12 |
| | ----- | ----- | | ----- |
| Total interest-earning liabilities | 266,447 | 2,998 | 4.50 | 254,72 |
| Non interest-earning liabilities | 18,040 | | | 12,44 |
| | ----- | | | ----- |
| Total liabilities | 284,487 | | | 267,16 |
| Stockholders' equity | 61,751 | | | 73,12 |
| | ----- | | | ----- |
| Total liabilities and stockholders' equity | 346,238 | | | 340,29 |
| | | | | |
| Net interest income | | 3,039 | | |
| Interest rate spread | | | 2.98% | |
| Net interest margin (3) | | | 3.76% | |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 121.19% | |

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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. Provisions for loan losses totaled \$60,000 for both the three months ended June 30, 2001 and 2000. See further discussion at "Asset Quality".

Other Income. Other income increased \$429,000, or 99.5%, from \$431,000 for the quarter ended June 30, 2000 to \$860,000 for the quarter ended June 30, 2001. Mortgage banking income, net, increased \$258,000 from \$80,000 for the quarter ended June 30, 2000 to \$338,000 for the quarter ended June 30, 2001. During the quarter ended June 30, 2001, we sold fixed-rate mortgage loans held for sale of \$19.8 million. Of this total \$17.6 million was sold on a servicing released basis and the Company recognized income of \$277,000 on these loans. During the quarter ended June 30, 2001 we sold fixed rate mortgages held for sale of \$2.2 million for which we retained the servicing of these loans. These loan sales generated income of \$61,000. During the quarter ended June 30, 2000, we sold fixed-rate mortgage loans held for sale of \$5.1 million on a servicing released basis and recognized income of \$61,000 from these loans. During the quarter ended June 30, 2000, the Company was able to record a nominal recovery of \$20,000 on its lower of cost or fair value on loans held for sale. Customer service fees increased \$55,000, or 36.9% from \$149,000 for the quarter ended June 30, 2000 to \$204,000 for the quarter ended June 30, 2001. This increase results primarily from growth in the number of transaction accounts and increases in the Bank's service charges. In addition, during the quarter ended June 30, 2001, commissions from sales of annuities and mutual funds increased \$112,000 or 87.5% from \$128,000 for the quarter ended June 30, 2000 to \$240,000 for the quarter ended June 30, 2001. This increase resulted primarily from increased sales volumes. Sales of annuity and mutual funds totaled \$4.9 million for the quarter ended June 30, 2001 as compared with \$2.4 million for the previous year.

Operating Expenses. Total operating expenses were \$2.5 million for the quarter ended June 30, 2001, a decrease of \$160,000, or 6.13% over the \$2.6 million recorded for the three months ended June 30, 2000. Compensation and related benefits expense decreased \$500,000, or 23.8% from \$2.1 million for the quarter ended June 30, 2000 to \$1.6 million for the quarter ended June 30, 2001. This decrease was primarily the result of the MRP expense of \$842,000 for the

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quarter ended June 30, 2000. This expense included \$777,000 from the immediate 1/3 vest of the shares granted under the MRP that was implemented on June 6, 2000. MRP expense for the quarter ended June 30, 2001 was \$260,000. Occupancy and equipment expense increased \$73,000 or 27.8% from \$263,000 for the quarter ended June 30, 2000 to \$336,000 for the quarter ended June 30, 2001. Most of this increase was depreciation expense from the new branch and the check imaging hardware and software, which were not present in the same quarter in the prior year. Expenses incurred in operating real estate owned were \$30,000 for the three months ended June 30, 2001 compared to a net gain on sale of real estate owned of \$149,000 for the three months ended June 30, 2000. The increases in other categories of operating expenses generally are attributable to the growth of the Company including the operating expenses associated with the Bank's seventh branch, which opened on September 27, 2000. We expect that other operating expenses will continue to increase in subsequent periods as a result of increased cost associated with operating a public company.

Income Tax Expense. Income tax expense increased \$117,000 from tax expense of \$380,000 for the quarter ended June 30, 2000 to \$497,000 for the quarter ended June 30, 2001. The increase resulted from a \$303,000 increase in income before income taxes. The effective tax rates were 35.8% and 35.0% for the quarters ended June 30, 2001 and 2000, respectively.

COMPARISON OF OPERATING RESULTS FOR THE NINE MONTHS ENDED JUNE 30, 2001 AND 2000

Net Income. We recorded net income of \$2.6 million for the nine months ended June 30, 2001, as compared to \$2.9 million for the nine months ended June 30, 2000, representing a decrease of \$300,000, or 10.3%. For the nine months ended June 30, 2001 basic and diluted earnings per share were \$0.85 and \$0.81, respectively. The Company reported basic and diluted earnings per share for the nine months ended June 30, 2000 of \$0.99 and \$0.98 per share, respectively. The decrease in net income resulted primarily from decreased net interest income and increased operating expenses that were offset partially by increased other income and decreased income taxes. The decline in net interest income resulted from (i) the decrease in average earning assets that resulted from the special return on capital dividend of \$17.0 million, which was paid on October 2, 2000 and (ii) decreased net interest margins. The return of capital dividend decreased the ratio of average interest-earning assets to average interest-bearing liabilities from 126.8% for the nine months ended June 30, 2000 to 120.4% for the nine months ended June 30, 2001.

Net Interest Income. Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, decreased by \$558,000 or 5.7% for the nine months ended June 30, 2001, compared to the same nine months in the prior year. This decrease reflects a \$564,000 increase in interest income that was more than offset by the \$1.1 million increase in total interest expense. The average net interest margin decreased 27 basis points from 4.08% for the nine months ended June 30, 2000 to 3.81% for the nine months ended June 30, 2001.

Interest Income. The increase in interest income for the nine months ended June 30, 2001 was due to an increase of \$2.9 million in average interest-earning assets compared to the same nine months in the prior year and an increase in yield on interest-earning assets of 16 basis points from 7.61% for the nine months ended June 30, 2000 to 7.77% for the nine months ended June 30, 2001. The increased volume of average interest-earning assets increased interest income by approximately \$168,000 and the increased yield increased interest income by approximately \$396,000. An increase in average loans outstanding of \$13.7 million

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coupled with an increase in average interest-bearing overnight funds of \$7.1 million increased interest-earning assets for the nine months compared to the prior year. These increases were offset in part by a decrease in average investments of \$17.9 million. Average investments decreased to provide cash to pay the special return of capital dividend.

Interest Expense. Interest expense increased in the nine months ended June 30, 2001 due to an increase in average interest-bearing liabilities of \$15.8 million and an increase in the cost of interest-bearing liabilities of 29 basis points from 4.47% for the nine months ended June 30, 2000 to 4.76% for the nine months ended June 30, 2001. Average deposits increased by \$21.4 million while average FHLB advances decreased \$5.6 million for the nine months ended June 30, 2001 compared to the same nine months in the prior year. The increase in average interest-bearing liabilities increased interest expense by approximately \$529,000 while the increase in the average cost of interest-bearing liabilities increased interest expense by approximately \$593,000.

The following table presents average balances and average rates earned/paid by the Company for the nine months ended June 30, 2001 compared to the nine months ended June 30, 2000.

| | NINE MONTHS ENDED JUNE 30, 2001 | | | NIN |
|--|------------------------------------|----------|--|--------------------|
| | AVERAGE BALANCE | INTEREST | DOLLARS IN THOUSANDS YIELD/ COST | AVERAGE BALANCE |
| Assets: | | | | |
| Loans receivable (1) | 230,603 | 14,642 | 8.47% | 216,8 |
| Investment securities (2) | 76,001 | 3,517 | 6.17 | 93,8 |
| Interest-bearing overnight deposits | 15,722 | 629 | 5.33 | 8,6 |
| | 322,326 | 18,788 | 7.77 | 319,3 |
| Total interest-earning assets | | | | |
| Non interest-earning assets | 23,755 | | | 20,9 |
| | 346,081 | | | 340,2 |
| Liabilities and stockholders' equity: | | | | |
| Deposits | 247,034 | 8,715 | 4.70% | 225,6 |
| FHLB advances | 20,699 | 853 | 5.49 | 26,3 |
| | 267,733 | 9,568 | 4.76 | 251,9 |
| Total interest-earning liabilities | | | | |
| Non interest-earning liabilities | 17,675 | | | 15,2 |
| | 285,408 | | | 267,1 |
| Total liabilities | | | | |
| Stockholders' equity | 60,673 | | | 73,1 |
| | 346,081 | | | 340,2 |
| Total liabilities and stockholders' equity | | | | |
| Net interest income | | | | |
| Interest rate spread | | 9,220 | | |
| Net interest margin (3) | | | 3.01% | |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 3.81% | |
| | | | | 120.39% |

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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. Provisions for loan losses totaled \$180,000 for both the nine months ended June 30, 2001 and 2000. During the fiscal 2001 we foreclosed on a \$2.1 million loan resulting in an increase to real estate owned. The fair value of the collateral for the loan, less costs to sell, was determined to be approximately \$125,000 less than the balance of the loan, thus we charged \$125,000 to the allowance for loan losses during the quarter ended June 30, 2001. See further discussion at "Asset Quality".

Other Income. Other income increased \$800,000, or 80.0%, from \$1.0 million for the nine months ended June 30, 2000 to \$1.8 million for the nine months ended June 30, 2001. Mortgage banking income, net increased \$636,000 from \$22,000 for the nine months ended June 30, 2000 to income of \$658,000 for the nine months ended June 30, 2001. During the nine months ended June 30, 2001, we sold fixed-rate mortgage loans held for sale of \$37.5 million and recognized income of \$638,000 on the sale as well as a recovery of \$20,000 from previous lower of cost or fair value adjustments on loans held for sale. During the nine months ended June 30, 2000, we sold fixed-rate mortgage loans held for sale of \$14.7 million and recognized income of \$179,000 from the sale of these loans; however, the increase in interest rates during this nine months required a \$157,000 charge to earnings to record the loans held for sale at the lower of cost or fair value. Customer service fees increased \$91,000, or 21.1% from \$431,000 for the nine months ended June 30, 2000 to \$522,000 for the nine months ended June 30, 2001. This increase results primarily from growth in the number of transaction accounts and increased service charges. In addition, during the nine months ended June 30, 2001, commissions from sales of annuities and mutual funds increased \$136,000 or 42.1% from \$323,000 for the nine months ended June 30, 2000 to \$459,000 for the nine months ended June 30, 2001. The increase resulted from an increase in sales volume. Sales of annuity and mutual funds were \$8.0 million for the nine months ended June 30, 2001 compared with \$5.6 million in the same period of the prior year.

Operating Expenses. Total operating expenses were \$6.9 million for the nine months ended June 30, 2001, an increase of \$800,000, or 13.1% over the \$6.1 million recorded for the nine months ended June 30, 2000. Compensation and related benefits expense increased \$200,000, or 4.5% from \$4.4 million for the nine months ended June 30, 2000 to \$4.6 million for the nine months ended June 30, 2001. This increase was primarily the result of increases in salaries and benefits as well as additional employees. Occupancy and equipment expense increased \$180,000 or 23.6% from \$764,000 for the nine months ended June 30, 2000 to \$944,000 for the nine months ended June 30, 2001. Most of this increase was depreciation expense from the new branch and the check imaging hardware and software, which were not present in the same nine months in the prior year. Expenses incurred in operating the real estate owned were \$36,000 for the nine months ended June 30, 2001 compared to a net gain on sale of real estate owned of \$149,000 for the nine months ended June 30, 2000. The increases in other categories of operating expenses generally are attributable to the growth of the Company including the operating expenses associated with the Bank's seventh branch, which opened on September 27, 2000. We expect that other operating expenses will continue to increase in subsequent periods as a result of increased cost associated with operating a public company.

Income Tax Expense. Income tax expense decreased \$200,000 from tax expense of \$1.6 million for the nine months ended June 30, 2000 to \$1.4 million for the nine months ended June 30, 2001. The decrease resulted from a \$494,000 decrease

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in income before income taxes. The effective tax rates were 35.5% and 34.9% for the nine months ended June 30, 2001 and 2000, respectively. The higher effective tax rate results from the losses at the holding company level for which no state tax benefit is received.

ASSET QUALITY

At June 30, 2001, the Company's non-performing assets (nonaccrual loans and real estate owned) were \$3.1 million or 0.89% of total assets. At September 30, 2000, non-performing assets consisted entirely of loans, which were approximately \$2.9 million or 0.82% of total assets. At June 30, 2001, impaired loans totaled \$2.5 million as defined by Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan," compared to \$2.6 million at September 30, 2000. The impaired loans at June 30, 2001 result from two borrowers and are collateralized primarily by real estate in Alamance County. Impaired loans totaling \$434,000 are on non-accrual status. Interest income of \$57,000 has been recorded on impaired loans in the three and nine months ended June 30, 2001. The related reserve for loan losses on these loans totaled \$45,000. The average carrying value of impaired loans was \$1.0 million and \$1.5 million during the three and nine months ended June 30, 2001, respectively. All amounts received on non-accrual impaired loans have been recorded as a reduction of the principal balance of the loan. At June 30, 2001 real estate owned totaled \$2.0 million, compared to zero at September 30, 2000. The increase is attributable to foreclosing on two loans secured by real estate during the current fiscal year. Within real estate owned is a 53 unit apartment complex in Burlington, N. C. with a carrying value of \$1.9 million. We have engaged a management company to rent and operate the complex while we own it. The Company is undertaking steps to liquidate the real estate owned properties. The Bank's net chargeoffs for the nine months ended June 30, 2001 and 2000 were \$163,000 and \$160,000, respectively. The allowance for loan losses was \$3.6 million or 1.57% of outstanding loans at June 30, 2001. This compares to 1.56% at September 30, 2000 and 1.54% at June 30, 2000.

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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, 2001, we had \$ 3.9 million in classified assets consisting of \$1.9 million in substandard loans and \$2.0 million 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, 2001, we have identified approximately \$3.1 million in assets classified as special mention and \$34.1 million as watch. Included in the watch asset total are five loans with an aggregate outstanding balance of \$4.4 million at June 30, 2001 to a company affiliated with one of our directors. In addition, the director has the ability to borrow an additional \$77,000 from us under a line of credit. All the loans are secured by a first lien on all company assets, including accounts receivable, inventory, equipment, furniture and real property occupied by the borrower. In addition, the director has personally guaranteed repayment of the loans. At June 30, 2001, such loans were current with respect to their payment terms and were performing in accordance with the related loan agreements. Based on an analysis of the borrower's current financial statements received in July 2001, management has concerns that the borrower may have difficulty in complying with the present loan repayment terms on an ongoing basis. Accordingly, this loan may become a nonperforming asset in future periods. Management will continue to closely monitor the performance of

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these loans in future periods.

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, 2001, 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, 2001, cash and cash equivalents totaled \$23.4 million. We have other sources of liquidity should we need additional funds. During the nine months ended June 30, 2001 and 2000, we sold loans totaling \$37.5 million and \$14.7 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 \$57.6 million at June 30, 2001.

We anticipate that we will have sufficient funds available to meet our current commitments. At June 30, 2001, we had \$7.4 million in commitments to originate new loans, \$62.6 million in unfunded commitments to extend credit under existing equity lines and commercial lines of credit and \$256,000 in standby letters of credit. At June 30, 2001, certificates of deposit, which are scheduled to mature within one year, totaled \$139.4 million. We believe that a significant portion of such deposits will remain with us.

The 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, 2001 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, 2001, the Company was in compliance with the capital requirements of the Federal Reserve.

ACCOUNTING ISSUES

In June 1998 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Certain Hedging Activities." In June 2000 the FASB issued SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities, an Amendment of SFAS 133." SFAS No. 133 and SFAS No. 138 require that all derivative instruments be recorded on the balance sheet at their respective fair values. Changes in the fair values of those derivatives will be reported in earnings or other comprehensive income depending on the use of the derivative and whether the derivative qualifies for hedge accounting. SFAS No. 133 and SFAS No. 138 are effective for all fiscal quarters of all

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fiscal years beginning after June 30, 2000; the Company adopted SFAS No. 133, as amended by SFAS No. 138, on October 1, 2000.

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On October 1, 2000 and June 30, 2001, the Company had no embedded derivative instruments requiring separate accounting treatment and had identified fixed rate conforming loan commitments as its only freestanding derivative instrument. The Company does not currently engage in hedging activities. The commitments to originate fixed rate conforming loans totaled \$2,265,000 and \$1,114,000 at June 30, 2001 and October 1, 2000, respectively. The fair value of these commitments was less than \$ 10,000 on these dates and therefore the adoption of SFAS 133 on October 1, 2000 as well as the impact of applying SFAS 133 at June 30, 2001 was not material to the Company's consolidated financial statements.

The FASB has issued Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" ("SFAS 140"). This statement replaces SFAS No. 125 ("Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities") and revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but it carries over most of the provisions of SFAS No. 125 without consideration. SFAS No. 140 provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities, based on application of a financial components approach that focuses on control. SFAS No. 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 2001. Adoption of SFAS No. 140 is not expected to have a material impact on the Company's consolidated financial statements.

The FASB has issued Statements of Accounting Standards No. 141, "Business Combinations" ("SFAS 141") and No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142").

SFAS 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 as well as all purchase method business combinations completed after June 30, 2001. SFAS 141 requires that intangible assets that meet certain criteria be recognized as assets apart from goodwill. SFAS 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets. SFAS 142 addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. SFAS 142 also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. SFAS 142 is required to be applied starting with fiscal years beginning after December 15, 2001 and early application is permitted for entities with fiscal years beginning after March 31, 2001, under certain conditions. Impairment losses for goodwill and intangible assets with indefinite useful lives that arise due to the initial application of SFAS 142 (resulting from a transitional impairment test) are to be reported as the cumulative effect of a change in accounting principle. Adoption of SFAS 141 and SFAS 142 are not expected to have a material impact on the Company's 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

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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, 2000. The Company does not believe that any material adverse changes in market risk exposures occurred since September 30, 2000.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None

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. None.

(b.) Reports on Form 8-K. During the quarter ended June 30, 2001,

the registrant did not file any current reports on Form 8-K.

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SIGNATURES

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

1ST STATE BANCORP, INC.

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Date: August 13, 2001

/s/ James C. McGill

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

Date: August 13, 2001

/s/ A. Christine Baker

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