

FLAG FINANCIAL CORP
Form 10-Q
May 10, 2005

**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 March 31, 2005**

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
(State of incorporation)

58-2094179
(I.R.S. Employer Identification No.)

3475 Piedmont Road N.E. Suite 550
Atlanta, Georgia 30305
(Address of principal executive offices)

(404) 760-7700
(Registrant's 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 x No o

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

Common stock, par value \$1 per share: 8,531,086 shares outstanding as of May 6, 2005

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Part I. Financial Information**Item 1. Financial Statements****FLAG FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS***(in thousands, except share data)*

	March 31, 2005 (Unaudited)	December 31, 2004 (Audited)	March 31, 2004 (Unaudited)
Assets			
Cash and due from banks	\$ 17,748	\$ 13,345	\$ 14,519
Federal funds sold	27,990	13,574	-
Other interest-bearing deposits in banks	13,564	13,397	12,329
Total cash and cash equivalents	59,302	40,316	26,848
Other interest-bearing deposits in banks	5,386	5,473	2,576
Investment securities available-for-sale	98,027	111,390	120,815
Other investments	13,403	13,161	14,694
Mortgage loans held-for-sale	7,271	10,688	4,998
Loans, net	606,253	596,101	470,986
Premises and equipment, net	13,657	14,458	14,477
Other assets	37,116	36,750	29,429
Total assets	\$ 840,415	\$ 828,337	\$ 684,823
Liabilities and Stockholders' Equity			
Deposits:			
Noninterest-bearing deposits	\$ 53,122	\$ 48,812	\$ 42,499
Interest-bearing demand deposits	331,261	347,940	280,079
Savings	22,132	20,940	22,371
Time	306,845	289,155	203,518
Total deposits	713,360	706,847	548,467
Advances from Federal Home Loan Bank	25,000	25,000	53,000
Federal funds purchased and repurchase agreements	2,166	2,295	9,362
Other borrowings	4,500	4,300	1,600
Junior subordinated debentures	14,433	14,433	-
Other liabilities	10,659	6,260	5,771
Total liabilities	770,118	759,135	618,200
Preferred stock (10,000,000 shares authorized, none issued and outstanding)	-	-	-
Common stock (\$1 par value, 20,000,000 shares authorized,			

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10,079,647, 10,053,572 and 9,775,099

shares issued at

March 31, 2005, December 31, 2004 and

March 31, 2004, respectively)

	10,080	10,054	9,775
Additional paid-in capital	28,152	27,954	24,557
Retained earnings	45,958	44,642	40,878
Accumulated other comprehensive (loss) income	(389)	56	990
Less: Treasury stock at cost; 1,551,186 shares at March 31, 2005 and December 31, 2004 and 1,246,961 shares at March 31, 2004	(13,504)	(13,504)	(9,577)
Total stockholders' equity	70,297	69,202	66,623
Total liabilities and stockholders' equity	\$ 840,415	\$ 828,337	\$ 684,823

See accompanying notes to consolidated financial statements

FLAG FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF EARNINGS

(in thousands, except per share data)

	Three Months Ended	
	March 31,	
	2005	2004
	<i>(Unaudited)</i>	
Interest income:		
Interest and fees on loans	\$ 11,411	\$ 8,119
Interest on investment securities	1,075	1,455
Interest on federal funds sold and other interest-bearing deposits	301	100
Total interest income	12,787	9,674
Interest expense:		
Interest on deposits:		
Demand	1,662	1,050
Savings	31	34
Time	2,131	1,238
Interest on other borrowings	384	219
Total interest expense	4,208	2,541
Net interest income before provision for loan losses	8,579	7,133
Provision for loan losses	375	720
Net interest income after provision for loan losses	8,204	6,413
Noninterest income:		
Service charges on deposit accounts	749	892
Mortgage banking activities	580	530
Insurance commissions and brokerage fees	74	113
Gain on sale of branch	-	3,000
Gain on sales of investment securities available-for-sale	123	7
Gain (loss) on sales of other real estate owned	91	(3)
Other	985	153
Total noninterest income	2,602	4,692
Noninterest expense:		
Salaries and employee benefits	4,993	4,790
Occupancy	956	910
Professional fees	549	300
Postage, printing and supplies	246	235
Communications	513	584
Other	860	1,169
Total noninterest expense	8,117	7,988
Earnings before provision for income taxes	2,689	3,117
Provision for income taxes	862	1,021
Net earnings	\$ 1,827	\$ 2,096
Basic earnings per share	\$ 0.21	\$ 0.25
Diluted earnings per share	\$ 0.20	\$ 0.23

See accompanying notes to consolidated financial statements

FLAG FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

	Three Months Ended	
	March 31,	2004
	2005	2004
	<i>(Unaudited)</i>	
Net earnings	\$ 1,827	\$ 2,096
Other comprehensive loss, net of tax:		
Unrealized losses on investment securities available-for-sale:		
Unrealized losses arising during the period, net of tax of \$225 and \$133, respectively	(369)	(217)
Less: Reclassification adjustment for gains included in net earnings, net of tax of \$47 and \$2, respectively	(76)	(5)
Other comprehensive loss	(445)	(222)
Comprehensive income	\$ 1,382	\$ 1,874

See accompanying notes to consolidated financial statements

FLAG FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASHFLOW

(in thousands)

	Three Months Ended	
	March 31,	
	2005	2004
	<i>(Unaudited)</i>	
Cash flows from operating activities:		
Net earnings	\$ 1,827	\$ 2,096
Adjustment to reconcile net earnings to net cash provided by operating activities:		
Depreciation, amortization and accretion	594	864
Provision for loan losses	375	720
Gain on sale of branch office	-	(3,000)
Gain on sales of investment securities available-for-sale	(123)	(7)
Gain on sales of loans	(362)	(336)
(Gain) loss on disposals of premises and equipment	(25)	25
(Gain) loss on sales of other real estate owned	(91)	3
Change in:		
Mortgage loans held-for-sale	3,779	(427)
Other assets and liabilities	4,166	521
Net cash provided by operating activities	10,140	459
Cash flows from investing activities (net of effect of branch sale):		
Cash paid in branch sale	-	(14,141)
Net change in other interest-bearing deposits	87	99
Proceeds from sales, calls and maturities of investment securities available-for-sale	63,195	18,346
Purchases of investment securities available-for-sale	(50,586)	(17,306)
Purchases of other investments	(242)	-
Proceeds from sale of other investments	-	250
Net change in loans	(10,527)	(11,301)
Proceeds from sales of other real estate owned	265	11
Proceeds from sales of premises and equipment	881	1
Purchases of premises and equipment	(466)	(175)
Purchases of cash surrender value life insurance	(50)	(37)
Net cash provided by (used in) investing activities	2,557	(24,253)
Cash flows from financing activities:		
Net change in deposits	6,513	13,652
Change in federal funds purchased and repurchase agreements	(129)	5,264
Change in other borrowings	200	500
Payments of FHLB advances	-	(5,000)
Proceeds from exercise of stock options	223	-
Cash dividends paid	(518)	(512)
Net cash provided by financing activities	6,289	13,904
Net change in cash and cash equivalents	18,986	(9,890)

Cash and cash equivalents at beginning of period	40,316		36,738
Cash and cash equivalents at end of period	\$ 59,302	\$	26,848

See accompanying notes to consolidated financial statements

Flag Financial Corporation and Subsidiary
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 Financial Corporation (“Flag” or the “Company”) and its wholly owned subsidiary, Flag Bank (the “Bank”). All significant intercompany 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 related notes included in Flag’s annual report on Form 10-K for the year ended December 31, 2004.

Note 2. Recent Accounting Pronouncements

As permitted by SFAS No. 123, *Accounting for Stock-Based Compensation*, Flag currently accounts for share-based payments to employees using APB opinion No. 25’s intrinsic value method and, as such, generally recognizes no compensation expense for employee stock options. The impact of adoption of SFAS No. 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had we adopted SFAS No.123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income earnings per share in Note 4 to our consolidated financial statements. SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in the periods after adoption. While the company cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized in prior periods for such excess tax deductions were insignificant. SFAS No. 123(R) is effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. On April 14, 2005, the Securities and Exchange Commission (the “SEC”) announced a new rule that amends the compliance dates for SFAS No. 123(R). The SEC’s new rule allows companies to implement SFAS No. 123(R) at the beginning of their next fiscal year, instead of the next reporting period, that begins after June 15, 2005. Flag will adopt the standard in the first quarter of 2006.

Note 3. Net Earnings Per Common 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 amounts):

	Three Months Ended	
	March 31,	
	2005	2004
Basic earnings per share:		
Net earnings	\$ 1,827	\$ 2,096
Weighted average common shares outstanding	8,515	8,528

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Basic earnings per share	\$	0.21	\$	0.25
Diluted earnings per share:				
Net earnings	\$	1,827	\$	2,096
Effect of dilutive stock options and warrants		753		566
Diluted earnings per share	\$	0.20	\$	0.23

Flag Financial Corporation and Subsidiary
Notes to Consolidated Financial Statements

Note 4. Stock-based Compensation

Flag currently accounts for stock-based compensation to employees and non-employee members of the Board 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 SFAS No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation (in thousands, except per share amounts):

	Three Months Ended	
	March 31,	
	2005	2004
Net earnings as reported	\$ 1,827	\$ 2,096
Deduct: Total stock-based employee compensation expense determined under fair-value based method for all awards, net of tax	(44)	(28)
Pro forma net earnings	\$ 1,783	\$ 2,068
Basic earnings per share:		
As reported	\$ 0.21	\$ 0.25
Pro forma	0.21	0.24
Diluted earnings per share:		
As reported	\$ 0.20	\$ 0.23
Pro forma	0.19	0.23

During the first three months of 2005, Flag issued 70,000 options with a weighted average grant date fair value of \$3.92 each. The fair value of each option was estimated on the date of grant using the Black-Scholes options-pricing model with the following weighted average assumptions: dividend yield of 1.80%, volatility of 0.2225, risk free interest rate of 4.24% and an expected life of 7 years.

Note 5. Loans

Flag engages in a full complement of lending activities, including permanent residential mortgage loans, permanent residential construction loans, commercial mortgage loans, commercial business loans, financial loans and consumer installment loans. Flag generally concentrates lending efforts on real estate related loans. As of March 31, 2005, Flag's loan portfolio consisted of 58.7% real estate mortgage loans, including 1-4 family residential loans, multi-family loans and commercial real estate loans, 29.1% real estate construction loans, 9.6% commercial and financial loans, and 2.6% 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 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.

Flag Financial Corporation and Subsidiary
Notes to Consolidated Financial Statements

Note 5. Loans (continued)

Loans are reported at outstanding unpaid balances and unamortized premiums or discounts on purchased loans. Balances within the major loans receivable categories are represented in the following table (in thousands):

	March 31,	% of	December	% of	March 31,	% of
	2005	Total	31,	Total	2004	Total
		Loans	2004	Loans		Loans
Commercial/financial/agricultural	\$ 59,183	9.6%	\$ 57,231	9.5%	\$ 50,900	10.7%
Real estate - construction	178,892	29.1%	176,111	29.1%	121,051	25.3%
Real estate - mortgage	360,939	58.7%	355,575	58.8%	291,211	60.9%
Installment loans to individuals	16,083	2.6%	15,644	2.6%	14,582	3.1%
Lease financings	18	-	142	-	294	-
Total loans	615,115	100.0%	604,703	100.0%	478,038	100.0%
Less: Allowance for loan losses	8,862		8,602		7,052	
Total net loans	\$606,253		\$596,101		\$470,986	

Note 6. Stock Repurchase Program

In March 2004, Flag's Board of Directors authorized a stock repurchase program covering an amount equal to 10% of the outstanding shares of Flag's common stock. As of March 31, 2005, the Company has repurchased approximately 304,000 shares of the approximately 853,000 shares authorized to be purchased, at an average price of \$12.91. See Item 2. "Changes in Securities" for additional information about Flag's share repurchases.

Flag Financial Corporation and Subsidiary

Item 2. Management's Discussion and Analysis of Financial Condition

The Company's net income for the quarter ended March 31, 2005, was \$1.8 million, or \$0.20 per diluted share, compared with net income of \$2.1 million, or \$0.23 per diluted share, for the same quarter last year. Net interest income grew 20.3% to \$8.6 million during the first quarter of 2005 compared to \$7.1 million in the first quarter of 2004. This improvement in net interest income over the first quarter of 2004 resulted from a 24.3% growth in average loans outstanding as well as an increase in Flag's yield on loans of 95 basis points to 7.67% from 6.72%. Growth in loans outstanding comes as Flag continues to develop a stronger presence in metro Atlanta and through its Atlanta based lending lines of business.

Nonperforming assets were 0.80% percent of total assets at March 31, 2005, compared to 0.99% at March 31, 2004. Net charge-offs were 0.08% of average loans outstanding for the quarter ended March 31, 2005, compared to 0.29% for the quarter ended March 31, 2004. The allowance for loan losses at March 31, 2005 was 1.44% of total loans outstanding, compared to 1.42% at December 31, 2004 and 1.48% at March 31, 2004.

During the first quarter of 2004, Flag sold its Thomaston, Georgia, branch to another Georgia based bank. Flag recorded an after-tax gain of approximately \$1.47 million, which included \$635,000 in expenses related directly to the sale of the branch. Included in the sale was approximately \$1.7 million of premises and equipment, \$16.7 million in loans and \$35.8 million in deposits.

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 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. As a result, our estimate of the allowance for loan losses affects our earnings directly.

Flag Financial Corporation and Subsidiary
Management's Discussion and Analysis of Financial Condition

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 specific 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, we consider 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 test 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, input from our independent loan reviewer, and reviews that may have been conducted by bank regulatory agencies as part of their usual examination process.

See "Provision and Allowance for Loan Losses" for additional information.

Flag Financial Corporation and Subsidiary
 Management's Discussion and Analysis of Financial Condition

Summary Financial Data

The following table presents summary financial data for the previous five quarters (in thousands, except per share data):

<i>(unaudited)</i>	2005			2004	First
	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	Quarter
INCOME SUMMARY					
Interest income	\$ 12,787	\$ 12,063	\$ 10,813		