1ST STATE BANCORP INC
Form 10-Q
August 14, 2003

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2003

[ ] 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

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

As of August 8, 2003, the issuer had 2,973,066 shares of common stock issued and outstanding.

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1st STATE BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS
JUNE 30, 2003 AND SEPTEMBER 30, 2002
(In Thousands, except share data)

	AT JUNE 30, 2003
	(Unaudited)
ASSETS	
Cash and cash equivalents	$ 32,058
Investment securities:	
Held to maturity (fair value of $15,527 and $11,558 at June 30, 2003 and September 30, 2002, respectively)	15,098
Available for sale (cost of $60,024 and $77,213 at June 30, 2003 and September 30, 2002, respectively)	60,739
Loans held for sale, at lower of cost or fair value	9,484
Loans receivable (net of allowance for loan losses of $3,902 and $3,732 at June 30, 2003 and September 30, 2002, respectively)	223,661
Real estate owned	80
Federal Home Loan Bank stock, at cost	1,000
Premises and equipment	8,448
Accrued interest receivable	1,549
Other assets	2,803
Total assets	$ 354,920
LIABILITIES AND STOCKHOLDERS' EQUITY	
Liabilities:	
Deposit accounts	260,211
Advances from Federal Home Loan Bank	20,000
Advance payments by borrowers for property taxes and insurance	336
Dividend payable	297
Other liabilities	10,953
Total liabilities	291,797
Stockholders' Equity:	
Preferred stock, $0.01 par value, 1,000,000 shares authorized; none issued	--
Common stock, $0.01 par value, 7,000,000 shares authorized; 2,975,600 and 3,008,682 shares issued and outstanding at June 30, 2003 and September 30, 2002, respectively	33
Additional paid-in capital	35,730
Unallocated ESOP shares	(3,291)
Deferred compensation payable in treasury stock	5,466
Treasury stock	(12,695)
Retained income - substantially restricted	37,445
Accumulated other comprehensive income - net unrealized gain on investment securities available for sale	435
Total stockholders' equity	63,123
Total liabilities and stockholders' equity	$ 354,920

See accompanying notes to the consolidated financial statements.

1st STATE BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME
FOR THE THREE MONTHS ENDED JUNE 30, 2003 AND 2002
(In Thousands, Except per Share Data)

(UNAUDITED)

	FOR THE THREE MONTHS EN JUNE 30,	
	2003	200
Interest income:		
Interest and fees on loans	$ 3,097	3,5
Interest and dividends on investments	982	1,4
Overnight deposits	43	
Total interest income	4,122	4,9
Interest expense:		
Deposit accounts	1,040	1,4
Borrowings	273	2
Total interest expense	1,313	1,7
Net interest income	2,809	3,2
Provision for loan losses	60	
Net interest income after provision for loan losses	2,749	3,1
Other income:		
Customer service fees	218	2
Commissions from sales of annuities and mutual funds	100	1
Mortgage banking income, net	457	1
Securities gains, net	103	
Other	65	
Total other income	943	5
Operating expenses:		
Compensation and related benefits	1,348	1,5
Occupancy and equipment	353	3
Real estate operations, net	(2)	(
Other expenses	443	3
Total operating expenses	2,142	2,1
Income before income taxes	1,550	1,5

Income taxes	562	5
Net income	$ 988	9
Earnings per share:		
Basic	$ 0.35	$ 0.
Diluted	$ 0.34	$ 0.

See accompanying notes to the consolidated financial statements.

1st STATE BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME
FOR THE NINE MONTHS ENDED JUNE 30, 2003 AND 2002
(In Thousands, Except per Share Data)

(UNAUDITED)

	FOR THE NINE MONTHS ENDE JUNE 30,	
	2003	2002
Interest income:		
Interest and fees on loans	$ 9,764	10,9
Interest and dividends on investments	3,194	3,9
Overnight deposits	128	1
Total interest income	13,086	15,1
Interest expense:		
Deposit accounts	3,500	5,2
Borrowings	825	8
Total interest expense	4,325	6,0
Net interest income	8,761	9,0
Provision for loan losses	180	1
Net interest income after provision for loan losses	8,581	8,8
Other income:		
Customer service fees	648	6
Commissions from sales of annuities and mutual funds	346	3
Mortgage banking income, net	1,350	9
Securities gains, net	103	
Other	183	1

Total other income	2,630	2,1
Operating expenses:		
Compensation and related benefits	4,149	4,6
Occupancy and equipment	1,088	9
Real estate operations, net	7	(
Other expenses	1,282	1,1
Total operating expenses	6,526	6,6
Income before income taxes	4,685	4,3
Income taxes	1,717	1,5
Net income	$ 2,968	2,7
Earnings per share:		
Basic	$ 1.06	$ 0.
Diluted	$ 1.01	$ 0.

See accompanying notes to the consolidated financial statements.

1st STATE BANCORP, INC. AND SUBSIDI
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COM
FOR THE NINE MONTHS ENDED JUNE 30, 2003 AND 2002
(In Thousands)

	Common stock	Additional paid-in capital	Unallocated ESOP shares	Unear Compens MRP
Balance at September 30, 2001	$33	35,588	(4,373)	(518
Comprehensive income:				
Net income	--	--	--	-
Other comprehensive loss-unrealized loss on securities available-for-sale net of income taxes of $22	--	--	--	-
Total comprehensive income				
Allocation of ESOP shares	--	22	478	-
Deferred compensation	--	--	--	-
Acquisition of treasury shares	--	--	--	-
Vesting of MRP shares	--	--	--	51
Cash dividends declared ($0.24 per share)	--	--	--	-

Cash dividends on unallocated ESOP shares and unvested MRP shares	--	--	--	-
Balance at June 30, 2002	$33	35,610	(3,895)	-
Balance at September 30, 2002	$33	35,623	(3,739)	-
Comprehensive income:				
Net income	--	--	--	-
Other comprehensive loss-unrealized loss on securities available-for-sale net of income taxes of $252	--	--	--	-
Total comprehensive income				
Allocation of ESOP shares	--	107	448	-
Acquisition of treasury shares	--	--	--	-
Cash dividends declared ($0.28 per share)	--	--	--	-
Cash dividends on unallocated ESOP shares	--	--	--	-
Balance at June 30, 2003	$33	35,730	(3,291)	-

	Treasury stock	Retained Income	Ac com inc
Balance at September 30, 2001	(4,173)	32,404	
Comprehensive income:			
Net income	--	2,755	
Other comprehensive loss-unrealized loss on securities available-for-sale net of income taxes of $22	--	--	
Total comprehensive income			
Allocation of ESOP shares	--	--	
Deferred compensation	--	--	
Acquisition of treasury shares	(298)	--	
Vesting of MRP shares	--	--	
Cash dividends declared ($0.24 per share)	--	(790)	
Cash dividends on unallocated ESOP shares and unvested MRP shares	--	69	
Balance at June 30, 2002	(4,471)	34,438	
Balance at September 30, 2002	(11,899)	35,258	
Comprehensive income:			

Net income	--	2,968
Other comprehensive loss-unrealized loss on securities available-for-sale net of income taxes of $252	--	--
Total comprehensive income		
Allocation of ESOP shares	--	--
Acquisition of treasury shares	(796)	--
Cash dividends declared ($0.28 per share)	--	(834)
Cash dividends on unallocated ESOP shares	--	53
Balance at June 30, 2003	(12,695)	37,445

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, 2003 AND 2002
(UNAUDITED)

(In Thousands)

	FOR THE NINE MONT JUNE 30, 2003
Cash flows from operating activities:	
Net income	$ 2,968
Adjustment to reconcile net income to net cash provided by operating activities:	
Provision for loan losses	180
Depreciation	557
Deferred tax expense	137
Amortization of premiums and discounts, net	(34)
Deferred compensation	180
Release of ESOP shares	555
Vesting of MRP shares and dividends on unvested MRP shares	--
Loan origination fees and unearned discounts deferred, net of current amortization	(66)
Loss (gain) on sale of other real estate	11
Securities gains, net	(103)
Net (gain) loss on sale of loans	(302)
Proceeds from loans held for sale	73,457
Originations of loans held for sale	(75,841)
Decrease (increase) in other assets	208
Decrease in accrued interest receivable	723
Increase in other liabilities	2,835
Net cash provided by operating activities	5,465

Cash flows provided by (used in) investing activities:	
Purchase of FHLB stock	(268)
Proceeds from redemption of FHLB stock	1,018
Purchases of investment securities held to maturity	(5,998)
Purchases of investment securities available for sale	(80,239)
Proceeds from sales of investment securities available for sale	1,103
Proceeds from maturities and issuer calls of investment securities available for sale	96,473
Proceeds from maturities and issuer calls of investment securities held to maturity	2,003
Net decrease (increase) in loans receivable	(3,728)
Proceeds from disposal of real estate acquired in settlement of loans	92
Purchases of premises and equipment	(1,033)
Net cash provided by (used in) investing activities	9,423

(Continued)

1st STATE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED

FOR THE NINE MONTHS ENDED JUNE 30, 2003 AND 2002

(UNAUDITED)
(In Thousands)

	FOR THE NINE MO JUNE 2003
Cash flows from financing activities:	
Net increase (decrease) in deposits	$ (456)
Advances from the Federal Home Loan Bank	13,000
Repayments of advances from the Federal Home Loan Bank	(13,000)
Purchase of treasury stock	(796)
Dividends paid on common stock	(725)
Increase in advance payments by borrowers for property taxes and insurance	282
Net cash provided by (used in) financing activities	(1,695)
Net increase (decrease) in cash and cash equivalents	13,193
Cash and cash equivalents at beginning of period	18,865
Cash and cash equivalents at end of period	$ 32,058

Payments are shown below for the following:	
Interest	$ 4,343
Income taxes	$ 1,133
Noncash investing and financing activities:	
Deferred compensation to be settled in Company's stock	$ --
Unrealized losses on investment securities available for sale	$ (644)
Cash dividends declared but not paid	$ 278
Cash dividends on unallocated ESOP shares	$ 53
Transfer from loans to real estate acquired in settlement of loans	$ --

See accompanying notes to consolidated financial statements.

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1st STATE BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2003 (UNAUDITED) AND SEPTEMBER 30, 2002

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, 2002, which is derived from the September 30, 2002 audited consolidated financial statements) have been prepared in accordance with accounting principles generally accepted in the United States of America 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 accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (none of which were other than normal recurring accruals) necessary for a fair presentation of the financial position and results of operations for the periods presented have been included.

The results of operations for the three and nine month periods ended June 30, 2003 are not necessarily indicative of the results of operations that may be expected for the year ended September 30, 2003. The preparation of consolidated financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make certain estimates. These amounts may be revised in future periods because of changes in the facts and circumstances underlying their estimation.

Certain amounts in the June 30, 2002 consolidated financial statements have been reclassified to conform with the presentation adopted in 2003. Such reclassifications did not change net income or stockholders' equity as previously reported.

NOTE 3. EARNINGS PER SHARE

For purposes of computing basic and diluted earnings per share, weighted average shares outstanding excludes unallocated ESOP shares that have not been committed to be released. The deferred compensation obligation discussed in note 5 that is fully funded with shares of the Company's common stock has no net impact on the Company's earnings per share computations. Diluted earnings per share includes the potentially dilutive effects of the Company's stock-based benefit plans. There were no antidilutive stock options for the three and nine months ended June 30, 2003 and 2002. A reconciliation of the denominators of the basic and diluted earnings per share computations is as follows:

	THREE MONTHS ENDED JUNE 30,	
	2003	200
Average shares issued and outstanding	2,976,652	3,289
Less: Unvested MRP shares	--	(31
Less: Unallocated ESOP shares	(176,174)	(216
Average basic shares for earnings per share	2,800,478	3,042
Add: Unvested MRP shares	--	31
Add: Potential common stock pursuant to stock option plan	123,595	90
Average dilutive shares for earnings per share	2,924,073	3,164

	NINE MONTHS ENDED JUNE 30,	
	2003	200
Average shares issued and outstanding	2,991,761	3,289

Less: Unvested MRP shares issued	--	(38
Less: Unallocated ESOP shares	(181,034)	(224
Average basic shares for earnings per share	2,810,727	3,026
Add: Unvested MRP shares	--	38
Add: Potential common stock pursuant to stock option plan	124,192	88
Average dilutive shares for earnings per share	2,934,919	3,153

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

The Company sponsors an employee stock ownership plan (the "ESOP") whereby an aggregate number of shares amounting to 253,050 or 8% of the stock issued in the conversion was purchased for future allocation to employees. The ESOP was funded by an 11 year term loan from the Company in the amount of $4,899,000. The loan is secured by the shares of stock purchased by the ESOP. During the three and nine months ended June 30, 2003 and 2002, 7,644 and 7,179 and 22,932 and 24,382 shares of stock were committed to be released and approximately $185,000 and $172,000 and $555,000 and $500,000 of compensation expense was recognized, 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. This plan generally provides for fixed payments beginning after the participant retires. Each participant is fully vested in his account balance under the plan. Directors may elect to defer their directors' fees and executive officers may elect to defer 25% of their salary and 100% of bonus compensation.

Prior to the 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. Refer to the Company's notes to consolidated financial statements, incorporated by reference in the Company's 2002 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.

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The expense related to this plan for the three and nine months ended June 30, 2003 and 2002 was $60,000 and $72,000 and $180,000 and $236,000, 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. The Company recorded no compensation expense associated with the MRP during the three and nine months ended June 30, 2003 as all shares became fully vested in June 2002. Compensation expense of $192,000 and $712,000 associated with the MRP was recorded during the three and nine months ended June 30, 2002, respectively.

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 option. Options granted under the Stock Option Plan are 100% vested on the date of the grant, and all options expire 10 years from the date of the grant. As a result of the one-time cash dividend of $5.17 paid on October 2, 2000, the exercise price for the options repriced from $18.44 to $14.71. No options were exercised or granted during the three and nine months ended June 31, 2003 and 2002. At June 30, 2003, 316,312 options are outstanding, all of which are exercisable.

In December 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure" (SFAS 148) an amendment of FASB Statement No. 123, "Accounting for Stock-Based Compensation" (SFAS 123), which provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require prominent disclosure in both annual and interim financial statements about the method of accounting for stock-based compensation and the effect of the method on reported results. The Company does not have any plans to change its method of accounting for stock-based employee compensation. There is no pro forma impact for any of the periods presented or for either of the two prior fiscal years.

NOTE 8. MORTGAGE SERVICING RIGHTS

The rights to service mortgage loans for others are included in other assets on the consolidated balance sheet. Mortgage servicing rights ("MSRs") are capitalized based on the allocated cost which is determined when the underlying loans are sold. MSRs are amortized over a period which approximates the life of the underlying loans as an adjustment of income. Impairment reviews of MSRs are performed on a quarterly basis. As of June 30, 2003 and September 30, 2002 MSRs totaled $526,000 and $370,000, respectively, and no valuation allowance was required.

Amortization expense totaled $126,000 and $43,000 for the nine months ended June 30, 2003 and 2002, respectively.

NOTE 9. STANDBY LETTERS OF CREDIT

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others", which addressed the disclosure to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. FIN 45 requires the guarantor to recognize a liability for the non-contingent component of the guarantee, such as the obligation to stand ready to perform in the event that specified triggering events or conditions occur. The initial measurement of this liability is the fair value of the guarantee at inception. The recognition of the liability is required even if it is not probable that payments will be required under the guarantee or if the guarantee was issued with a premium payment or as part of a transaction with multiple events. The initial recognition and measurement provisions are effective for all guarantees within the scope of FIN 45 issued or modified after December 31, 2002. The Company issues standby letters of credit whereby the Company guarantees performance if a specified triggering event or condition occurs (primarily nonperformance under construction contracts entered into by construction customers). The guarantees generally expire within one year and may be automatically renewed depending on the terms of the guarantee. The maximum potential amount of undiscounted future payments related to standby letters of credit at June 30, 2003 is $276,000. At June 30, 2003 the Company has recorded no liability for the current carrying amount of the obligation to perform as a guarantor and no contingent liability is considered necessary as such amounts are deemed immaterial. Substantially all standby letters of credit are secured by real estate and/or guaranteed by third parties in the event the Company had to advance funds to fulfill the guarantee.

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

FORWARD-LOOKING STATEMENTS

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

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

GENERAL

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

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

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

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

Over the years, we have sought to gradually increase the percentage of our assets invested in commercial real estate loans, commercial loans and consumer loans, which have shorter terms and adjust more frequently to changes in interest rates than single-family residential mortgage loans. These loans generally carry added risk when compared to a single family residential mortgage loan, so we have concurrently increased our allowance for loan losses as we have originated these loans.

CRITICAL ACCOUNTING POLICIES

The Company's significant accounting policies are set forth in note 1 of the consolidated financial statements as of September 30, 2002 which was filed on Form 10-K. Of these significant accounting policies, the Company considers its policy regarding the allowance for loan losses to be its most critical accounting policy, because it requires management's most subjective and complex judgments. In addition, changes in economic conditions can have a significant impact on the allowance for loan losses and therefore the provision for loan losses and results of operations. The Company has developed appropriate policies and procedures for assessing the adequacy of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. The Company's assessments may be impacted in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of information with respect to borrowers which is not known to management at the time of the issuance of the consolidated financial statements.

COMPARISON OF FINANCIAL CONDITION AT JUNE 30, 2003 AND SEPTEMBER 30, 2002

Total assets increased by $4.4 million or 1.3% from $350.5 million at September 30, 2002 to $354.9 million at June 30, 2003. As market rates remained low during the nine months ended June 30, 2003, many of the Company's callable investments were called by the issuers. The proceeds from investment maturities and calls totaled $98.5 million for the nine months ended June 30, 2003 compared with investment purchases of $86.2 million; therefore, total investment securities decreased from September 30, 2002. Cash and cash equivalents increased $13.2 million from $18.9 million at September 30, 2002 to $32.1 million at June 30, 2003 as a result of the decrease in investment securities. Loans receivable, net and loans held for sale increased by $3.7 million and $2.7 million, respectively. Deposits decreased by $456,000 from $260.7 million at September 30, 2002 to $260.2 million at June 30, 2003.

Investment securities available for sale decreased $17.9 million from $78.6 million at September 30, 2002 to $60.7 million at June 30, 2003. During the nine months ended June 30, 2003, we purchased $80.2 million of securities available for sale and received $96.5 million in proceeds from maturities and issuer calls of investment securities available for sale. Investment securities held to maturity increased from $11.1 million at September 30, 2002 to $15.1 million at June 30, 2003 as $6.0 million of investment securities held to maturity were purchased during this period, and $2.0 million were called by the issuers.

Loans held for sale increased by $2.7 million from $6.8 million at September 30, 2002 to $9.5 million at June 30, 2003. Loans receivable, net increased $3.7 million from $220.0 million at September 30, 2002 to $223.7 million at June 30, 2003. The increase in loans held for sale resulted from timing differences in the funding of loan sales. During the nine months ended June 30, 2003 our mortgage originations and prepayments continued at record levels. Mortgage rates declined to record low levels during this period, and many borrowers took advantage of this opportunity to refinance their existing mortgage loans. Mortgage loans secured by single family dwellings decreased by $16.8 million during this period as a result of the tremendous refinancing activity. During this same period, increases in commercial and home equity line loans more than offset this single family mortgage loan decrease.

Stockholders' equity increased by $1.5 million from $61.6 million at September 30, 2002 to $63.1 million at June 30, 2003 as a result of net income of $3.0 million and release of ESOP shares of $555,000. These increases were offset by cash dividends to stockholders declared of $781,000, purchases of treasury stock of $796,000 and a net decrease in unrealized gain on available for sale securities of $392,000.

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COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED JUNE 30, 2003 AND 2002

Net Income. We recorded net income of $988,000 for the quarter ended June 30, 2003, as compared to $986,000 for the quarter ended June 30, 2002, representing an increase of $2,000, or 0.2%. For the three months ended June 30, 2003, basic and diluted earnings per share were $0.35 and $0.34, respectively, compared to the basic and diluted earnings per share for the quarter ended June 30, 2002 of $0.32 and $0.31, respectively. 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 tax expense. The decrease in net interest income resulted from lower net interest margins. The average prime interest rate for the quarter ended June 30, 2003 was 4.24%, a decrease of 51 basis points from 4.75% which was the average prime for the quarter ended June 30, 2002. The repricing of certificates of deposits, savings and money market investment accounts decreased the Company's cost of funds to partially offset the decrease in asset yield which resulted from the lower prevailing interest rates during the quarter ended June 30, 2003. Basic and diluted earnings per share was favorably impacted by the Company's stock repurchase plan which was approved in August 2002.

Net Interest Income. Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, decreased by $400,000 or 12.7% for the three months ended June 30, 2003, compared to the same quarter in the prior year. This decrease results from a $843,000 decrease in interest income that was offset in part by the $443,000 decrease in total interest expense. The net interest income as a percentage of average earning assets decreased 44 basis points from 3.90% for the three months ended June 30, 2002 to 3.46% for the quarter ended June 30, 2003.

Interest Income. The decrease in interest income for the three months ended June 30, 2003 was the result of a decrease in yield on interest-earning assets of 95 basis points from 6.03% for the three months ended June 30, 2002 to 5.08% for the three months ended June 30, 2003 and a $5.0 million decrease in average interest earning assets. Average loans receivable increased $13.1 million from $214.3 million for the quarter ended June 30, 2002 to $227.4 million for the quarter ended June 30, 2003. Average investment securities decreased $19.6 million for the quarter compared to the prior year. Average interest-bearing overnight funds increased $1.6 million for the quarter compared to the prior year. The decrease in asset yield resulted from the lower rates prevailing in the marketplace. The decrease in average interest earning assets decreased interest income by approximately $53,000 and the decrease in the average yield on interest earning assets decreased interest income by approximately $790,000.

Interest Expense. Interest expense decreased in the three months ended June 30, 2003 due to a decrease in the cost of interest-bearing liabilities of 60 basis points from 2.61% for the three months ended June 30, 2002 to 2.01% for the three months ended June 30, 2003. Average interest-bearing deposits decreased by $6.5 million while average FHLB advances decreased $1.6 million for the three months ended June 30, 2003 compared to the same quarter in the prior year. The decrease in the average rate of interest-bearing liabilities decreased interest expense by approximately $385,000 and the decrease in the average interest-bearing liabilities decreased interest expense by approximately $58,000.

The following table presents average balances and average rates earned/paid by the Company for the quarter ended June 30, 2003 compared to the quarter ended June 30, 2002.

	THREE MONTHS ENDED JUNE 30, 2003	THREE MONTHS JUNE 30,

	DOLLARS IN THOUSANDS				
	AVERAGE BALANCE	INTEREST	AVERAGE YIELD/COST	AVERAGE BALANCE	INTEREST
Assets:					
Loans receivable (1)	$227,367	$3,097	5.45%	$214,339	$3,502
Investment securities (2)	82,245	982	4.78	101,822	1,413
Interest-bearing overnight deposits	14,687	43	1.16	13,174	50
Total interest-earning assets (4)	324,299	4,122	5.08	329,335	4,965
Non interest-earning assets	20,109			22,601	
Total assets	$344,408			$351,936	
Liabilities and stockholders' equity					
Interest-bearing checking	$34,322	27	0.31	$32,836	38
Money market investment accounts	23,876	55	0.92	26,232	83
Passbook and statement savings	30,823	65	0.85	28,457	102
Certificates of deposit	151,748	894	2.36	159,727	1,252
FHLB advances	20,000	272	5.45	21,593	281
Total interest-bearing liabilities	260,769	1,313	2.01	268,845	1,756
Non interest-bearing liabilities	20,797			17,450	
Total liabilities	281,566			286,295	
Stockholders' equity	62,842			65,641	
Total liabilities and stockholders' equity	$344,408			$351,936	
Net interest income		$2,809			$3,209
Interest rate spread			3.07%		
Net interest margin (3)			3.46%		
Ratio of average interest-earning assets to average interest-bearing liabilities			124.36%		

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

Provision for Loan Losses. We charge provisions for loan losses to earnings to maintain the total allowance for loan losses at a level we consider adequate to provide for probable loan losses, based on existing loan levels and types of loans outstanding, nonperforming loans, prior loss experience, general economic conditions and other factors. We estimate the allowance using an allowance for loan losses model which takes into consideration all of these factors. Our policies require the review of assets on a regular basis, and we assign risk grades to loans based on the relative risk of the credit, considering such factors as repayment experience, value of collateral, guarantors, etc. Our credit management systems have resulted in low loss experience; however, there can be no assurances that such experience will continue. We believe we use the best information available to make a determination with respect to the allowance for loan losses, recognizing that future adjustments may be necessary depending upon a change in economic conditions. The provision for loan losses was $60,000 and net charge-offs were $8,000 for the quarter ended June 30, 2003 compared with a provision of $60,000, and net charge-offs of $0 for the quarter ended June 30, 2002. Nonperforming loans were $4.5 million at June 30, 2003 and $4.2 million September 30, 2002. The

majority of the non-performing loans resulted from two unrelated, unique credits which are not necessarily indicative of the credit quality of the entire portfolio. There was no significant impact on the provision for the periods presented as a result of these loans as these loans are well secured by property and equipment. The provision for the quarter ended June 30, 2003 reflects the shift in the loan portfolio to commercial loans which receive higher allocations in the allowance for loan losses model. The Company made no significant changes to the allowance for loan losses methodology during the period which impacted the provision for loan losses.

During the quarters ended June 30, 2003 and 2002 commercial and home equity loans continued to increase as well as the percentages of these loans to the total portfolio. Although these loans normally have a relatively short maturity management believes that there is greater risk inherent in these loans than the typical one-to-four family residential mortgage loan. Therefore, management assigns these types of loans a higher risk weighting in the analysis of the loan loss reserve. The commercial loans that have been originated are loans made to businesses to either produce a product, sell a product or provide a service. Many of these loans are asset-based loans which are loans where repayment is based primarily on the cash flow from operations and secondarily on, the liquidation of assets such as inventory and accounts receivable.

Other Income. Other income increased $385,000, or 69%, from $558,000 for the quarter ended June 30, 2002 to $943,000 for the quarter ended June 30, 2003. Commissions from sales of annuities and mutual funds decreased $31,000, or 23.7% from $131,000 for the quarter ended June 30, 2002 to $100,000 for the quarter ended June 30, 2003. This decrease results from lower sales of annuities and mutual funds. Mortgage banking income, net increased $286,000 from $171,000 for the quarter ended June 30, 2002 to $457,000 for the quarter ended June 30, 2003 as a result of higher loan sales. Proceeds from the sale of mortgage loans totaled $24.7 million for the quarter ended June 30, 2003 as compared to $7.2 million for the quarter ended June 30, 2002. The increased loan activity resulted from heavy mortgage loan refinancing activity which resulted from the attractive mortgage loan rates available in the marketplace. The Company recorded gains on the sale of investments of $103,000 for the quarter ended June 30, 2003 which were not present in the prior quarter.

Operating Expenses. Total operating expenses were $2.1 million for the quarter ended June 30, 2003 and $2.2 million for the quarter ended June 30, 2002. Compensation and related benefits expense decreased $200,000 from $1.5 million for the quarter ended June 30, 2002 to $1.3 million for the quarter ended June 30, 2003. Compensation and related benefits expense for the quarter ended June 30, 2002 included $192,000 of expense related to the vesting of the restricted stock awards which was not present in 2003 as the final vesting date for the restricted stock awards was June 6, 2002. Occupancy and equipment expense increased $38,000, or 12.1% from $315,000 for the quarter ended June 30, 2002 to $353,000 for the quarter ended June 30, 2003. This increase was primarily the result of increased depreciation on new equipment. During the quarter ended June 30, 2003, the rent receipts on real estate owned properties exceeded operating expenses by $2,000, compared with $24,000 in the prior year.

Income Tax Expense. Income tax expense increased $20,000 from tax expense of $542,000 for the quarter ended June 30, 2002 to $562,000 for the quarter ended June 30, 2003. The effective tax rates were 36.3% and 35.5% for the quarters ended June 30, 2003 and 2002, respectively. The increase in the effective rate was primarily due to an increase in non-deductible expenses over the prior period.

COMPARISON OF OPERATING RESULTS FOR THE NINE MONTHS ENDED JUNE 30, 2003 AND 2002

Net Income. We recorded net income of $3.0 million for the nine months ended June 30, 2003, an increase of $200,000, or 7.1% over the $2.8 million reported in the nine months ended June 30, 2002. For the nine months ended June 30, 2003, basic and diluted earnings per share were $1.06 and $1.01, respectively. The Company reported basic and diluted earnings per share for the nine months ended June 30, 2002 of $0.91 and $0.87,

respectively. The increase in net income resulted primarily from increased other income and decreased operating expenses. These increases in income were partially offset by decreased net interest income and increased income taxes. The decrease in the net interest income resulted from lower net interest margins. The average prime interest rate for the nine months ended June 30, 2003 was 4.32%, a decrease of 57 basis points from 4.89%, which was the average prime for the nine months ended June 30, 2002. The rate decrease caused a greater reduction in the average rate paid on interest-bearing liabilities than the average yield on earning assets. Basic and diluted earnings per share was favorably impacted by the Company's stock repurchase plan which was approved in August 2002.

Net Interest Income. Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, decreased by $266,000 or 2.9% for the nine months ended June 30, 2003, compared to the same nine months in the prior year. This increase reflects a $2.0 million decrease in interest income that was partially offset by the $1.8 million decrease in total interest expense. The average net interest margin decreased 10 basis points from 3.69% for the nine months ended June 30, 2002 to 3.59% for the nine months ended June 30, 2003.

Interest Income. The decrease in interest income for the nine months ended June 30, 2003 was due to a decrease in the yield on interest-earning assets of 80 basis points from 6.17% for the nine months ended June 30, 2002 to 5.37% for the nine months ended June 30, 2003 as well as a decrease of $1.5 million in average interest-earning assets compared to the same period in the prior year. The decreased volume of average interest-earning assets decreased interest income by approximately $69,000 and the decreased yield decreased interest income by approximately $2.0 million. Average loans receivable increased $9.8 million for the nine months ended June 30, 2003 compared with the prior year. This increase was offset in part by a decrease in average investment securities of $11.2 million and a decrease of $9,000 in average interest bearing overnight funds.

Interest Expense. Interest expense decreased in the nine months ended June 30, 2003 due to a decrease in average interest-bearing liabilities of $3.4 million and a decrease in the cost of interest-bearing liabilities of 85 basis points from 3.05% for the nine months ended June 30, 2002 to 2.20% for the nine months ended June 30, 2003. Average deposits decreased by $2.4 million and average FHLB advances decreased $1.0 million for the nine months ended June 30, 2003 compared to the same nine months in the prior year. The decrease in average interest-bearing liabilities decreased interest expense by approximately $79,000 and the decrease in the average cost of interest-bearing liabilities decreased interest expense by approximately $1.7 million.

The following table presents average balances and average rates earned/paid by the Company for the nine months ended June 30, 2003 compared to the nine months ended June 30, 2002.

	NINE MONTHS ENDED JUNE 30, 2003			
				DOLLARS IN THOUSANDS
	AVERAGE BALANCE	INTEREST	AVERAGE YIELD/COST	AVERAGE BALANCE
Assets:				
Loans receivable (5)	$227,694	$9,764	5.72%	$217,934
Investment securities (6)	83,352	3,194	5.11	94,589
Interest-bearing overnight deposits	14,088	128	1.21	14,097
Total interest-earning assets (8)	325,134	13,086	5.37	326,620
Non interest-earning assets	20,094			22,270
Total assets	$345,228			$348,890
Liabilities and stockholders' equity				
Interest-bearing checking	$33,686	101	0.40	$ 31,658
Money market investment accounts	22,649	167	0.98	27,504
Passbook and statement savings	29,784	227	1.01	27,232
Certificates of deposit	155,675	3,005	2.57	157,852
FHLB advances	20,718	825	5.31	21,697
Total interest-earning liabilities	262,512	4,325	2.20	265,943
Non interest-earning liabilities	20,517			18,176
Total liabilities	283,029			284,119
Stockholders' equity	62,199			64,771
Total liabilities and stockholders' equity	$345,228			$348,890
Net interest income		$8,761		
Interest rate spread			3.17%	
Net interest margin (7)			3.59%	
Ratio of average interest-earning assets to average interest-bearing liabilities			123.85%	

(5) Includes nonaccrual loans and loans held for sale, net of discounts and allowance for loan losses.
(6) Includes FHLB of Atlanta stock.
(7) Represents net interest income divided by the average balance of

interest-earning assets.

(8) Due to immateriality, the interest income and yields related to certain tax exempt assets have not been adjusted to reflect a fully taxable equivalent yield.

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, 2003 and 2002. The provision for loan losses in both periods was impacted by the continued shift in the portfolio to commercial loans which require a larger allocation of allowance for loan losses.

Other Income. Other income increased $400,000, 18.2%, from $2.2 million for the nine months ended June 30, 2002 to $2.6 million for the nine months ended June 30, 2003. Mortgage banking income, net increased $400,000 from $950,000 for the nine months ended June 30, 2002 to $1.4 million for the nine months ended June 30, 2003. During the nine months ended June 30, 2003, we sold fixed-rate mortgage loans held for sale of $73.5 million compared with loan sales of $49.1 million for the nine months ended June 30, 2002. Gains on sales of

investment securities of $103,000 were recognized during the nine months ended June 30, 2003 while gains on sales of investment securities of $47,000 were recognized during the nine months ended June 30, 2002. The non-interest income recognized in fiscal 2003 was positively impacted by the relatively low interest rates which increased the mortgage banking income and gains on investments over the prior year.

Operating Expenses. Total operating expenses were $6.5 million for the nine months ended June 30, 2003, a decrease of $200,000, or 3.0% from the $6.7 million recorded for the nine months ended June 30, 2002. Compensation and related benefits expense decreased $500,000, or 10.6% from $4.7 million for the nine months ended June 30, 2002 to $4.2 million for the nine months ended June 30, 2003. Compensation and related benefits for the nine months ended June 30, 2002 included $712,000 of expense related to the vesting of restricted stock awards which was not present in 2003 as the final vesting date for the restricted stock awards was June 6, 2002. Partially offsetting this decrease was increased personnel expense related to the increased number of employees and increased salary and benefit costs. The Company recognized income from real estate operations of $56,000 during the nine months ended June 30, 2002 compared to expenses of $7,000 in the nine months ended June 30, 2003.

Income Tax Expense. Income tax expense increased $100,000 from tax expense of $1.6 million for the nine months ended June 30, 2002 to $1.7 million for the nine months ended June 30, 2003. The increase resulted from a $348,000 increase in income before income taxes. The effective tax rates were 36.7% and 36.5% for the nine months ended June 30, 2003 and 2002, respectively.

COMMITMENTS, CONTINGENCIES AND OFF-BALANCE SHEET RISK

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

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

	June 30, 2003	September
	(dollars in thousands)	
Commitments to originate new loans	$ 1,421	$
Commitments to originate new loans held for sale	881	
Unfunded commitments to extend credit under existing equity line and commercial lines of credit	56,060	
Commercial letters of credit	276	
Commitments to sell loans held for sale	20,169	

The Company does not have any special purpose entities or other similar forms of off-balance sheet financing arrangements.

Commitments to originate new loans or to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Loan commitments generally expire within 30 to 45 days. Most equity line commitments are for a term of 15 years, and commercial lines of credit are generally renewable on an annual basis. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amounts of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the borrower.

Commitments to sell loans held for sale are agreements to sell loans to a third party at an agreed upon price. At June 30, 2003, the agreed-upon price of these commitments exceeded the book value of the loans to be sold. The fair value of these commitments at June 30, 2003 was not considered material.

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CONTRACTUAL OBLIGATIONS

As of June 30, 2003

Payments due by period

(Dollars in thousands)

	Less than 1 year	1-3 years	4-5 years
Deposits	$ 229,410	20,883	9,918
Long-term borrowings	--	--	20,000
Lease obligations	19	56	42
Total contractual cash			

obligations	$ 229,429	20,939	29,960

ASSET QUALITY

At June 30, 2003, we had approximately $4.6 million in non-performing assets (nonaccrual loans and real estate owned) or 1.30% of total assets. At September 30, 2002, non-performing assets were $4.4 million or 1.25% of total assets. At June 30, 2003 and September 30, 2002, impaired loans totaled $3.8 million and $3.7 million, respectively, as defined by Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan." The impaired loans at June 30, 2003 result from three unrelated commercial loan customers, all of which have loans secured by commercial real estate and business assets in Alamance County. At June 30, 2003, the entire $3.8 million of the impaired loans were on non-accrual status, and their related reserve for loan losses totaled $210,000. The average carrying value of impaired loans was $3.8 million and $3.7 million during the three and nine months ended June 30, 2003, respectively. Interest income of $42,000 and $159,000 has been recorded on impaired loans on a cash basis in the three and nine months ended June 30, 2003, respectively. The Bank's net charge-offs for the three and nine months ended June 30, 2003 were $8,000 and $10,000, respectively. The Bank's allowance for loan losses was $3.9 million at June 30, 2003 compared with $3.7 million at September 30, 2002 and $3.7 million at June 30, 2002. As a result of our continued , gradual shift toward commercial, construction, consumer and home equity loans, the recent decrease in residential mortgage loans, the modest increase in non-performing loans as a percentage of total loans as well as the continued decline in the local and regional economy, the ratio of the allowance for loan losses to total loans, net of loans in process and deferred loan fees increased to 1.71% at June 30, 2003 compared to 1.67% at September 30, 2002.

The following table presents an analysis of our nonperforming assets:

		(Dollars in thousands)
	At June 30, 2003	At September 30, 2002
Nonperforming loans:		
Nonaccrual loans	$4,501	$ 4,204
Loans 90 days past due and accruing	--	--
Restructured loans	--	--
Total nonperforming loans	4,501	4,204
Other real estate	80	183
Total nonperforming assets	$4,581	$ 4,387
Nonperforming loans to loans receivable, net	2.01%	1.91%
Nonperforming assets as a percentage of loans and other real estate owned	2.05%	1.99%
Nonperforming assets to total assets	1.29%	1.25%

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, 2003, we had $5.0 million in classified assets consisting of $4.9 million in substandard and loss loans and $80,000 in real estate owned. At September 30, 2002, we had $5.1 million in substandard assets consisting of $4.9 million in loans and $183,000 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, 2003, we have identified approximately $1.1 million in assets classified as special mention and $36.5 million as watch. Included in the watch asset total are six loans with an aggregate outstanding balance of $4.5 million at June 30, 2003 to entities affiliated with one of our directors. In addition, the director has the ability to borrow an additional $403,000 from us under line of credits. 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, 2003, 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 2003, management has concerns that the borrower may have difficulty in complying with the present loan repayment terms on an ongoing basis. Accordingly, these loans may become a nonperforming asset in future periods. Management will continue to closely monitor the performance of 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, 2003, 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, 2003, cash and cash equivalents totaled $32.0 million. We have other sources of liquidity should we need additional funds. During the three and nine months ended June 30, 2003, we sold loans totaling $24.7 million and $73.5 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 $70.2 million at June 30, 2003.

We anticipate that we will have sufficient funds available to meet our current commitments. At June 30, 2003, we had $2.3 million in commitments to originate new loans, $53.9 million in unfunded commitments to extend credit under existing equity lines and commercial lines of credit and $276,000 in standby letters of credit. At June 30, 2003, certificates of deposit, which are scheduled to mature within one year, totaled $125.3 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, 2003 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, 2003, the Company was in compliance with the capital requirements of the Federal Reserve.

On October 2, 2000, the Company paid a one-time special cash distribution of $5.17 per share to its stockholders. The distribution was made to manage the Company's capital and enhance shareholder value. Returning capital to the stockholders reduced the Company's equity to asset ratio from 21.2% to 17.2%. The Company's equity to asset ratio at June 30, 2003 was 17.8%. The Company's capital level is sufficient to support future growth.

The Company has declared cash dividends per common share of $0.10, $0.08 and $0.08 for each of the three months ended June 30, 2003, September 30, 2002 and June 30, 2002, respectively. The Company's ability to pay dividends is dependent upon earnings. The Company's dividend payout ratio for the three months ended June 30, 2003, September 30, 2002 and June 30, 2002 was 29.4%, 26.4% and 25.8%, respectively.

ACCOUNTING MATTERS

On October 3, 2001, the FASB issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS No. 144), which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. While SFAS No. 144 supercedes SFAS No. 121 ("Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of"), it retains many of the fundamental provisions of SFAS No. 121. SFAS No. 144 also supersedes the accounting and reporting provisions of Accounting Principles Board Opinion No. 30 (Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions) for the disposal of a segment of a business. However, it retains the requirement in Opinion No. 30 to report separately discontinued operations and extends the reporting to a component of an entity that either has been disposed of (by sale, abandonment, or in a distribution to owners) or is classified as held for sale. The provisions of SFAS No. 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. Adoption of SFAS No. 144 on October 1, 2002 did not have a material impact on the Company's consolidated financial statements.

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146 (SFAS No. 146), "Accounting for Costs Associated with Exit or Disposal Activities," which addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." This Statement applies to costs associated with an exit activity that does not involve an entity newly acquired in a business combination or with a disposal activity covered by SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Those costs include, but are not limited to, the following: a) termination benefits provided to current employees that are involuntarily terminated under the terms of a benefit arrangement that, in substance, is not an ongoing benefit arrangement or an individual deferred compensation contract (hereinafter referred to as one-time termination benefits), b) costs to terminate a contract that is not a capital lease and c) costs to consolidate facilities or relocate employees. This Statement does not apply to costs associated with the retirement of a long-lived asset covered by FASB Statement No. 143, "Accounting for Asset Retirement Obligations." A liability for a cost associated with an exit or disposal activity shall be recognized and measured initially at its fair value in the period in which the liability is incurred. A liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability is met. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. This statement will impact the Company to the extent it engages in exit or disposal activities in future periods.

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others", which addresses the disclosure to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. FIN 45 requires the guarantor to recognize a liability for the non-contingent component of the guarantee, such as the obligation to stand ready to perform in the event that specified triggering events or conditions occur. The

initial measurement of this liability is the fair value of the guarantee at inception. The recognition of the liability is required even if it is not probable that payments will be required under the guarantee or if the guarantee was issued with a premium payment or as part of a transaction with multiple events. The disclosure requirements are effective for interim and annual financial statements ending after December 15, 2002. The initial recognition and measurement provisions are effective for all guarantees within the scope of FIN 45 issued or modified after December 31, 2002. The Company issues standby letters of credit whereby the Company guarantees performance if a specified triggering event or condition occurs (primarily nonperformance under construction contracts entered into by construction customers.) The guarantees generally expire within one year and may be automatically renewed depending on the terms of the guarantee. The maximum potential amount of undiscounted future payments related to standby letters of credit at June 30, 2003 is $276,000. At June 30, 2003, the Company has recorded no liability for the current carrying amount of the obligation to perform as a guarantor and no contingent liability is considered necessary, as such amounts are deemed immaterial. Substantially all standby letters of credit are secured by real estate and/or guaranteed by third parties in the event the Company had to advance funds to fulfill the guarantee.

In December 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure' (SFAS 148) an amendment of FASB Statement No. 123, Accounting for Stock-Based Compensation (SFAS 123), which provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition provisions of the statement are effective for financial statements for fiscal years ending after December 15, 2002 while the disclosure requirements are effective for interim periods beginning after December 15, 2002, with early application encouraged. The adoption of SFAS 148 have resulted in enhanced disclosures for the Company's stock-based employee compensation plan effective January 1, 2003.

In April 2003, the FASB issued Statement of Financial Accounting Standards No. 149 (SFAS No. 149), "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," which amends and clarifies financial accounting and reporting for derivative instruments and for hedging activities under Statement of Financial Accounting Standards No. 133 (SFAS No. 133). This statement clarifies when a contract with an initial net investment meets the characteristic of a derivative, clarifies when a derivative instrument contains a financing component, amends the definition of an underlying to conform it to language used in Financial Accounting Standards Board Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others", and amends certain other existing pronouncements. This Statement requires that contracts with comparable characteristics be accounted for similarly. This Statement is effective for most contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. For contracts with forward purchases or sales of TBA-type securities or other securities that do not yet exist, this Statement is effective for both existing contracts and new contracts entered into after June 30, 2003. All provisions of this Statement should be applied prospectively. Adoption of SFAS No. 149 on July 1, 2003 did not have a material effect on the Company's consolidated financial statements.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150 (SFAS No. 150), "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity", which establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. It is to be implemented by reporting the cumulative effect of a change in accounting principle for financial instruments created before the issuance date of the Statement and still existing at the beginning of the interim period of adoption. Adoption of SFAS No. 150 on July 1, 2003 did not have a material effect 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 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, 2002. The Company does not believe that any material adverse changes in market risk exposures occurred since September 30, 2002.

ITEM 4. CONTROLS AND PROCEDURES

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

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

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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.

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

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

32 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b.) Reports on Form 8-K.

The Registrant filed the following Current Reports on Form 8-K during the quarter ended June 30, 2003:

DATE OF REPORT	ITEM(S) REPORTED	FINANCIAL STATEMENTS FILED
January 28, 2003	7, 12	N/A

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.

Date: August 14, 2003

/s/James C. McGill

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

Date: August 14, 2003

/s/A. Christine Baker

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