1ST STATE BANCORP INC
Form 10-Q
August 14, 2002

U.S. 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, 2002

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

For the transition period from ______ to ______

Commission file number: 0-25859

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

VIRGINIA	56-2130744
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
445 S. MAIN STREET, BURLINGTON, NORTH CAROLINA	27215
(Address of Principal Executive Offices)	(Zip Code)

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

N/A
Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report

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

As of August 6, 2002, the issuer had 3,289,607 shares of common stock issued and outstanding.

1

CONTENTS

PAGE

PART I. FINANCIAL INFORMATION

PART II. OTHER INFORMATION

1ST STATE BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

JUNE 30, 2002 AND SEPTEMBER 30, 2001

(IN THOUSANDS)

	AT	AT

	JUNE 30, 2002 (Unaudited)	SEPTEMBER 2001
ASSETS		
Cash and cash equivalents	$ 19,939	25,981
Investment securities:		
Held to maturity (fair value of $10,356 and $12,495 at June 30, 2002 and September 30, 2001, respectively)	10,118	12,169
Available for sale (cost of $88,157 and $54,689 at June 30, 2002 and September 30, 2001, respectively)	88,941	55,527
Loans held for sale, at lower of cost or fair value	1,194	3,291
Loans receivable (net of allowance for loan losses of $3,700 and $3,612 at June 30, 2002 and September 30, 2001, respectively)	215,175	222,285
Real estate owned	2,226	1,981
Federal Home Loan Bank stock, at cost	1,750	1,650
Premises and equipment	8,074	8,414
Accrued interest receivable	2,171	2,542
Other assets	2,519	2,952
Total assets	$352,107	336,792
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Deposit accounts	259,247	248,370
Advances from Federal Home Loan Bank	20,000	20,000
Advance payments by borrowers for property taxes and insurance	655	82
Dividend payable	263	263
Other liabilities	5,278	4,433
Total liabilities	285,443	273,148
Stockholders' Equity:		
Preferred stock, $0.01 par value, 1,000,000 shares authorized; none issued	--	--
Common stock, $0.01 par value, 7,000,000 shares authorized; 3,289,607 shares issued and outstanding	33	33
Additional paid-in capital	35,610	35,588
Unallocated ESOP shares	(3,895)	(4,373)
Unearned compensation - management recognition plan	--	(518)
Deferred compensation	4,471	4,173
Treasury stock for deferred compensation	(4,471)	(4,173)
Retained income - substantially restricted	34,438	32,404
Accumulated other comprehensive income - net unrealized gain on investment securities available for sale	478	510
Total stockholders' equity	66,664	63,644
Total liabilities and stockholders' equity	$352,107	336,792

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, 2002 AND 2001

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(UNAUDITED)

	FOR THE THREE MONTHS END JUNE 30,	
	2002	2001
Interest income:		
Interest and fees on loans	$ 3,492	4,6
Interest and dividends on investments	1,413	1,1
Overnight deposits	50	2
Total interest income	4,955	6,0
Interest expense:		
Deposit accounts	1,475	2,7
Borrowings	281	2
Total interest expense	1,756	2,9
Net interest income	3,199	3,0
Provision for loan losses	60	
Net interest income after provision for loan losses	3,139	2,9
Other income:		
Service fees on loans sold	26	
Customer service fees	209	2
Commissions from sales of annuities and mutual funds	131	2
Mortgage banking income, net	155	3
Other	47	
Total other income	568	8
Operating expenses:		
Compensation and related benefits	1,512	1,6
Occupancy and equipment	315	3
Deposit insurance premiums	11	
Real estate operations, net	(24)	
Other expenses	365	4
Total operating expenses	2,179	2,4
Income before income taxes	1,528	1,3

Income taxes	542	4
Net income	$ 986	8
Earnings per share:		
Basic	$ 0.32	$ 0.
Diluted	$ 0.31	$ 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, 2002 AND 2001

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(UNAUDITED)

	FOR THE NINE MONTHS ENDE JUNE 30,	
	2002	200
Interest income:		
Interest and fees on loans	$ 10,891	14
Interest and dividends on investments	3,993	3
Overnight deposits	191	
Total interest income	15,075	18
Interest expense:		
Deposit accounts	5,248	8
Borrowings	843	
Total interest expense	6,091	9
Net interest income	8,984	9
Provision for loan losses	180	
Net interest income after provision for loan losses	8,804	9
Other income:		
Service fees on loans sold	72	
Customer service fees	675	
Commissions from sales of annuities and mutual funds	351	
Mortgage banking income, net	921	
Securities gains, net	47	
Other	153	
Total other income	2,219	1

Operating expenses:		
Compensation and related benefits	4,660	4
Occupancy and equipment	929	
Deposit insurance premiums	34	
Real estate operations, net	(56)	
Other expenses	1,119	1
Total operating expenses	6,686	6
Income before income taxes	4,337	3
Income taxes	1,582	1
Net income	$ 2,755	2
Earnings per share:		
Basic	$ 0.91	$ 0
Diluted	$ 0.87	$ 0

See accompanying notes to the consolidated financial statements

5

1ST STATE BANCORP, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
FOR THE NINE MONTHS ENDED JUNE 30, 2002 AND 2001 (UNAUDITED)
(IN THOUSANDS)

	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	UNEARNED ESOP SHARES	UNEARN COMPENSA MRP
Balance at September 30, 2000	$ 33	35,587	(4,950)	(1,2
Comprehensive income:				
Net income	--	--	--	
Other comprehensive income-unrealized gain on securities available-for-sale net of income taxes of $76	--	--	--	
Total comprehensive income				
Allocation of ESOP shares	--	(6)	409	
Deferred compensation	--	--	--	
Treasury stock held for deferred Compensation	--	--	--	
Vesting of MRP shares	--	--	--	5
Cash dividends declared	--	--	--	
Cash dividends on unallocated ESOP shares and unvested MRP shares	--	--	--	
Balance at June 30, 2001	$ 33	35,581	(4,541)	(7
Balance at September 30, 2001	$ 33	35,588	(4,373)	(5

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	--	--	--	
Treasury stock held for deferred Compensation	--	--	--	
Vesting of MRP shares	--	--	--	5
Cash dividends declared	--	--	--	
Cash dividends on unallocated ESOP shares and unvested MRP shares	--	--	--	
Balance at June 30, 2002	$ 33	35,610	(3,895)	

	TREASURY STOCK FOR DEFERRED COMPENSATION	RETAINED INCOME	OTHER COMPREHENSIV INCOME (LOSS
Balance at September 30, 2000	(2,679)	29,999	(164)
Comprehensive income:			
Net income	--	2,569	--
Other comprehensive income-unrealized gain on securities available-for-sale net of income taxes of $76	--	--	122
Total comprehensive income			
Allocation of ESOP shares	--	--	--
Deferred compensation	--	--	--
Treasury stock held for deferred Compensation	(1,346)	--	--
Vesting of MRP shares	--	--	--
Cash dividends declared	--	(789)	--
Cash dividends on unallocated ESOP shares and unvested MRP shares	--	64	--
Balance at June 30, 2001	(4,025)	31,843	(42)
Balance at September 30, 2001	(4,173)	32,404	510
Comprehensive income:			
Net income	--	2,755	--
Other comprehensive loss-unrealized loss on securities available-for-sale net of income taxes of $22	--	--	(32)
Total comprehensive income			
Allocation of ESOP shares	--	--	--
Deferred compensation	--	--	--
Treasury stock held for deferred Compensation	(298)	--	--

Vesting of MRP shares	--	--	--
Cash dividends declared	--	(790)	--
Cash dividends on unallocated ESOP shares and unvested MRP shares	--	69	--
Balance at June 30, 2002	(4,471)	34,438	478

See accompanying notes to the consolidated financial statements.

1ST STATE BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED JUNE 30, 2002 AND 2001

(UNAUDITED)

(IN THOUSANDS)

	FOR THE NINE MONTHS JUNE 30,
	2002
Cash flows from operating activities:	
Net income	$ 2,755
Adjustment to reconcile net income to net cash provided by operating activities:	
Provision for loan losses	180
Depreciation	474
Deferred tax expense (benefit)	495
Amortization of premiums and discounts, net	(23)
Deferred compensation	236
Release of ESOP shares	500
Vesting of MRP shares and dividends on unvested MRP shares	712
Loan origination fees and unearned discounts deferred, net of current amortization	(63)
Gain on sale of other real estate	(4)
Securities gains, net	(47)
Net loss on sale of loans	227
Proceeds from loans held for sale	49,134
Originations of loans held for sale	(47,264)
Decrease (increase) in other assets	(41)
Decrease in accrued interest receivable	371
Increase (decrease) in other liabilities	117
Net cash provided by operating activities	7,759
Cash flows used in investing activities:	
Purchase of FHLB stock	(100)
Purchase of investment securities held to maturity	(3,958)
Purchase of investment securities available for sale	(78,127)

Proceeds from sales of investment securities available for sale	1,811	
Proceeds from maturities of investment securities available for sale	42,923	
Proceeds from maturities of investment securities held to maturity	6,004	
Net decrease (increase) in loans receivable	6,646	
Proceeds from disposal of real estate acquired in settlement of loans	107	
Purchases of premises and equipment	(134)	
Net cash used in investing activities	(24,828)	(

7

1ST STATE BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED

FOR THE NINE MONTHS ENDED JUNE 30, 2002 AND 2001

(UNAUDITED)

(IN THOUSANDS)

	FOR THE NINE MONTHS EN JUNE 30,	
	2002	200
Cash flows from financing activities:		
Net increase in deposits	$ 10,877	$ 4,4
Advances from the Federal Home Loan Bank	29,000	5,0
Repayments of advances from Federal Home Loan Bank	(29,000)	(5,0
Return of capital dividend payment	--	(17,0
Purchase of treasury stock for deferred compensation	298	1,3
Dividends paid on common stock	(721)	(7
Increase in advance payments by borrowers for property taxes and insurance	573	5
Net cash provided by (used in) financing activities	11,027	(11,4
Net decrease in cash and cash equivalents	(6,042)	(9,7
Cash and cash equivalents at beginning of period	25,981	33,1
Cash and cash equivalents at end of period	$ 19,939	$ 23,3
Payments are shown below for the following:		
Interest	$ 6,085	$ 9,4

Income taxes	$ 1,534	$ 1,1
Noncash investing and financing activities:		
Deferred compensation to be settled in Company's stock	$ 298	$ 1,3
Unrealized gains (losses) on investment securities available for sale	$ (54)	$ 1
Cash dividends declared but not paid	$ 244	$ 2
Cash dividends on unallocated ESOP shares	$ 69	$
Transfer from loans held for sale to loans receivable	$ --	$ 6
Transfer from loans to real estate acquired in settlement of loans	$ 347	$ 1,9

See accompanying notes to consolidated financial statements.

1ST STATE BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2002 (UNAUDITED) AND SEPTEMBER 30, 2001

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, 2001, which is derived from the September 30, 2001 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, 2002 are not necessarily indicative of the results of operations that may be expected for the year ended September 30, 2002. 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, 2001 consolidated financial statements have been reclassified to conform with the presentation adopted in 2002. 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 denominators of 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, 2002 and 2001. A reconciliation of the denominators of the basic and diluted earnings per share computations is as follows:

	THREE MONTHS ENDED JUNE 30, 2002	THREE MONTHS ENDED JUNE 30, 2001
Average shares issued and outstanding	3,289,607	3,289,607
Less: Unvested MRP shares	(31,038)	(72,862)
Less: Unallocated ESOP shares	(216,108)	(184,207)
Average basic shares for earnings per share	3,042,461	3,032,538
Add: Unvested MRP shares	31,038	72,862
Add: Potential common stock pursuant to stock option plan	90,660	86,684
Average dilutive shares for earnings per share	3,164,159	3,192,084

	NINE MONTHS ENDED JUNE 30, 2002	NINE MONTHS ENDED JUNE 30, 2001
Average shares issued and outstanding	3,289,607	3,289,607
Less: Unvested MRP shares	(38,464)	(80,472)
Less: Unallocated ESOP shares	(224,280)	(191,252)

Average basic shares for earnings per share	3,026,863	3,017,883
Add: Unvested MRP shares	38,464	80,472
Add: Potential common stock pursuant to stock option plan	88,561	72,147
Average dilutive shares for earnings per share	3,153,888	3,170,502

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

The Company sponsors an employee stock ownership plan (the "ESOP") whereby an aggregate number of shares amounting to 253,050 or 8% of the stock issued in 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. In connection with the special cash dividend, the ESOP received $1,043,000 on its unallocated shares of the Company's stock. The ESOP purchased an additional 51,374 shares with this dividend. During the three and nine months ended June 30, 2002 and 2001, 7,179 and 7,045 and 24,382 and 21,134 shares of stock were committed to be released and approximately $172,000 and $135,000 and $500,000 and $403,000 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 2001 Annual Report on Form 10-K for a discussion of the Company's accounting policy with respect to this deferred compensation plan and the related treasury stock purchased by the Company to fund this obligation.

The expense related to this plan for the three and nine months ended June 30, 2002 and 2001 was $72,000 and $68,000 and $236,000 and $203,000, respectively. This expense is included in compensation expense.

NOTE 6. MANAGEMENT RECOGNITION PLAN

The Company has a Management Recognition Plan ("MRP") which serves as a means of providing existing directors and officers of the Bank with an ownership interest in the company. On June 6, 2000, restricted stock awards of 126,482 shares were granted. The shares awarded under the MRP were issued from authorized but unissued shares of common stock at no cost to the recipients. The shares vest at a rate of 33 1/3% per year with a one-third immediate vest on the date of the grant. Compensation expense of $192,000 and $260,000 and $712,000 and $787,000 associated with the MRP was recorded during the three and nine months ended June 30, 2002 and 2001, 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 stock. 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.

NOTE 8. NEW ACCOUNTING PRONOUNCEMENT

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 141 (Statement 141), "Business Combinations", and Statement of Financial Accounting Standards No. 142 (Statement 142), "Goodwill and Other Intangible Assets". Statement 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. Statement 141 also specifies criteria which must be met for intangible assets acquired in a purchase method business combination to be recognized and reported apart from goodwill. Statement 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of Statement 142. Statement 142 also requires that identifiable intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with Statement 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of". The adoption of SFAS No. 141 and SFAS No. 142 did not have a material effect on the Company's consolidated financial statements other than providing enhanced disclosures for mortgage servicing rights. As of January 1, 2002, the Company had no goodwill and had no intangible assets related to deposit and branch purchase acquisitions.

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, 2002 and September 30, 2001, MSRs totaled $352,000 and $209,000, respectively, and no valuation allowance was required.

Amortization expense totaled $43,000 and $56,000 for the nine months ended June 30, 2002 and 2001, respectively.

The estimated amortization expense for the mortgage servicing rights for the years ended September 30, 2002, 2003, 2004, 2005 and 2006 and thereafter is as follows:

	Estimated Amortization Expense
2002	$ 43,000
2003	38,000

2004	38,000
2005	38,000
2006	38,000
2007 and thereafter	14,000
	$209,000

The estimation of future amortization expense presented above is based on assumptions (such as estimates of prepayments of loans) subject to change in future periods. Accordingly, the amortization expense in future periods may be different from the amounts disclosed above to the extent that any of these assumptions are modified due to a change in the underlying estimations.

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. As a result, portions of this discussion (as of dates and for periods prior to April 23, 1999) relate to the financial condition and results of operations of 1st State Bank.

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. 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. The primary manner in which the economy impacts our business is our credit risk. Most of our customers are small businesses in our immediate market area that are more vulnerable to recent declines in the local economy than larger, more diversified companies whose revenues are supported by customers in a variety of locations. Our customer base includes textile companies that are continuing to feel the negative impact of the NAFTA legislation and the downturn in our local and regional economy. Such changes may impact future operations and earnings.

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.

Beginning in the late 1980's, 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.

COMPARISON OF FINANCIAL CONDITION AT JUNE 30, 2002 AND SEPTEMBER 30, 2001

Total assets increased by $15.3 million or 4.5% from $336.8 million at September 30, 2001 to $352.1 million at June 30, 2002. Increases in investment securities were partially offset by decreases in cash and loans receivable, net. Asset growth was primarily funded by increases in deposits.

Cash and cash equivalents decreased $6.1 million, or 23.5% from $26.0 million at September 30, 2001 to $19.9 million at June 30, 2002. Because of the relatively low interest rates on overnight funds, we invested excess cash in short term government agency securities to increase our yield on these funds.

Investment securities available for sale increased $33.4 million from $55.5 million at September 30, 2001 to $88.9 million at June 30, 2002. As market interest rates fell during the nine months ended June 30, 2002, many of the Company's callable investment securities were called by the issuers. During the nine months ended June 30, 2002, we received $44.7 million in proceeds from sales, maturities and issuer calls of investment securities available for sale. We reinvested $78.1 in investment securities available for sale during this time period.

Loans receivable, net decreased by $7.1 million, or 3.2%, from $222.3 million at September 30, 2001 to $215.2 million at June 30, 2002, and loans held for sale decreased $2.1 million from $3.3 million at September 30, 2001 to $1.2 million at June 30, 2002. During the nine months ended June 30, 2002, our mortgage originations, sales and prepayments were at record levels. The attractive mortgage rate environment encouraged many borrowers to take advantage of this opportunity to refinance their existing mortgage loans at lower interest rates. We sold these longer term, lower rate mortgage loans to limit our interest rate risk. The decrease in the loans held for sale resulted from timing differences in the funding of loan sales. We sold $49.3 million in fixed rate mortgage loans during the nine months ended June 30, 2002 compared to $37.5 million for the nine months ended June 30, 2001. We continue to emphasize commercial, commercial real estate, consumer loans and equity lines of credit that carry variable rates and/or short term maturities. At June 30, 2002, commercial, construction and commercial real estate loans totaled $118.2 million and account for 53.9% of gross loans compared to $110.6 million and 48.9% at September 30, 2001. One to four family residential loans at June 30, 2002 totaled $72.6 million or 33.2% of gross loans compared to $86.9 million or 38.5% at September 30, 2001.

Deposits increased $10.8 million from $248.4 million at September 30, 2001 to $259.2 million at June 30, 2002. Certificates of deposit at June 30, 2002 totaled $160.8 million or 62.0% of total deposits. At September 30, 2001, certificates of deposit totaled $159.7 million or 64.3% of total deposits. We continue to emphasize transaction accounts, which generally carry lower interest rates than certificates of deposit. Transaction accounts increased $7.2 million or 11.5% from $62.6 million at September 30, 2001 to $69.8 million at June 30, 2002.

Stockholders' equity increased by $3.1 million from $63.6 million at September 30, 2001 to $66.7 million at June 30, 2002 as a result of net income of $2.8 million, release of ESOP shares of $500,000, and vesting of MRP shares of $518,000. These increases were offset by cash dividends declared of $721,000 and a decrease in unrealized losses on available for sale securities of $32,000.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED JUNE 30, 2002 AND 2001

Net Income. We recorded net income of $986,000 for the quarter ended June 30, 2002, as compared to $893,000 for the quarter ended June 30, 2001, representing an increase of $93,000, or 10.4%. For the three months ended June 30, 2002 basic and diluted earnings per share were $0.32 and $0.31, respectively. The Company reported basic and diluted earnings per share for the quarter ended June 30, 2001 of $0.29 and $0.28 per share, respectively. The increase in net income resulted primarily from increased net interest income and decreased operating expenses which were offset partially by decreased other income and increased income taxes.

Net Interest Income. Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, for the three months ended June 30, 2002 was $3.2 million, an increase of $160,000 compared to the same quarter in the prior year. This increase reflects a $1.1 million decrease in interest income that was more than offset by the $1.2 million decrease in total interest expense. The average net interest margin decreased 13 basis points from 3.76% for the three months ended June 30, 2001 to 3.89% for the quarter ended June 30, 2002.

13

Interest Income. The decrease in interest income for the three months ended June 30, 2002 resulted from an increase of $6.4 million in average interest-earning assets compared to the same quarter in the prior year which was more than offset by a decrease in yield on interest-earning assets of 1.46% from 7.48% for the three months ended June 30, 2001 to 6.02% for the three months ended June 30, 2002. The increased volume of average interest-earning assets increased interest income by approximately $120,000 and the decreased yield decreased interest income by approximately $1.2 million. Average loans outstanding decreased $13.9 million coupled with a decrease in average interest-bearing overnight funds of $7.5 million were offset by an increase in average investment securities of $27.9 million. We experienced unusually heavy mortgage loan prepayments during the nine months ended June 30, 2002 as borrowers took advantage of the attractive mortgage rates and refinanced their existing mortgage loans. During this time we invested the loan prepayments and excess overnight funds into investment securities.

Interest Expense. Interest expense decreased in the three months ended June 30, 2002 which resulted from an increase in average interest-bearing liabilities of $2.4 million and a decrease in the cost of interest-bearing liabilities of 1.89% from 4.50% for the three months ended June 30, 2001 to 2.61% for the three months ended June 30, 2002. Average deposits increased by $805,000 while average FHLB advances increased $1.6 million for the three months ended June 30, 2002 compared to the same quarter in the prior year. The increase in average interest-bearing liabilities increased interest expense by approximately $27,000 while the decrease in the average cost of interest-bearing liabilities decreased interest expense by approximately $1.3 million.

14

The following table presents average balances and average rates earned/paid by the Company for the quarter ended June 30, 2002 compared to the quarter ended June 30, 2001.

	THREE MONTHS ENDED JUNE 30, 2002			DOLLARS IN THOUSANDS
	AVERAGE BALANCE	INTEREST	YIELD/ COST	AVERAGE BALANCE
Assets:				
Loans receivable (1)	$214,339	$3,492	6.52%	$228,239
Investment securities (2)	101,822	1,413	5.55	73,962
Interest-bearing overnight deposits	13,174	50	1.51	20,710
Total interest-earning assets (4)	329,335	4,955	6.02	322,911
Non interest-earning assets	22,601			23,327
Total assets	$351,936			$346,238
Liabilities and stockholders' equity:				
Interest bearing checking	32,836	38	0.47	30,265
Money market investment accounts	26,232	83	1.26	21,186
Passbook and statement savings	28,457	102	1.44	26,486
Certificates of deposit	159,727	1,252	3.14	168,510
FHLB advances	21,593	281	5.20	20,000
Total interest-bearing liabilities	268,845	1,756	2.61	266,447
Non interest-bearing liabilities	17,450			18,040
Total liabilities	286,295			284,487
Stockholders' equity	65,641			61,751
Total liabilities and stockholders' equity	$351,936			$346,238

Net interest income	$3,199	
	======	
Interest rate spread		3.41%
Net interest margin (3)		3.89%
Ratio of average interest-earning assets		122.50%

Provision for Loan Losses. The provision for loan losses is charged to earnings to maintain the total allowance for loan losses at a level considered adequate to absorb estimated probable losses inherent in the loan portfolio based on existing loan levels and types of loans outstanding, nonperforming loans, prior loan loss experience, general economic conditions and other factors. Provisions for loan losses totaled $60,000 for both the three months ended June 30, 2002 and 2001. The provision for loan losses was impacted by the continued shift in the portfolio to commercial loans which require a larger allocation of allowance for loan losses. The effects of this continued shift in the portfolio were offset to a certain degree in 2002 by a decrease in total loans. See also "Asset Quality."

Other Income. Other income decreased $292,000, or 34.0%, from $860,000 for the quarter ended June 30, 2001 to $568,000 for the quarter ended June 30, 2002. Mortgage banking income, net decreased $183,000 from $338,000 for the quarter ended June 30, 2001 to $155,000 for the quarter ended June 30, 2002. The decrease in mortgage banking income resulted from a decreased volume of loan originations and sales. During the quarter ended June 30, 2002, we sold fixed-rate mortgage loans held for sale of $7.2 million compared with sales of $19.8 million in the prior year. Commissions from sales of annuities and mutual funds decreased $109,000 from $240,000 for the quarter ended June 30, 2001 to $131,000 for the quarter ended June 30, 2002. The decrease is the result of decreased sales of

annuity and mutual funds. Sales of annuity and mutual funds totaled $3.0 million for the quarter ended June 30, 2002 compared with sales of $4.9 million for the quarter ended June 30, 2001.

Operating Expenses. Total operating expenses were $2.2 million for the quarters ended June 30, 2002, a decrease of $270,000 from the $2.4 million for the quarter ended June 30, 2001. Compensation and related benefits expense decreased $104,000, or 6.4% from $1.6 million for the quarter ended June 30, 2001 to $1.5 million for the quarter ended June 30, 2002. Of this decrease $68,000 was related to lower MRP expense in the quarter ended June 30, 2002 as the final vesting date for the MRPs was June 6, 2002. Also contributing to lower compensation expense was a decrease in incentives paid related to the lower volume of mortgage originations and decreased annuity and mutual fund sales during the quarter ended June 30, 2002 as compared with the quarter ended June 30, 2001. During the quarter ended June 30, 2002, the Company recognized net income from real estate operations of $24,000 compared to the net losses from real estate operations of $30,000 that were expensed during the quarter ended June 30, 2001. Other operating expenses were $365,000 for the quarter ended June 30, 2002, a decrease of $90,000 from the $455,000 for the quarter ended June 30, 2001. Expenses for the quarter ended June 30, 2001 included expenses necessary for the installation of the Bank's check imaging system.

Income Tax Expense. Income tax expense increased $45,000 from tax expense of $497,000 for the quarter ended June 30, 2001 to $542,000 for the quarter ended June 30, 2002. The increase resulted from a $138,000 increase in income before income taxes. The effective tax rates were 35.5% and 35.8% for the quarters ended June 30, 2002 and 2001, respectively.

COMPARISON OF OPERATING RESULTS FOR THE NINE MONTHS ENDED JUNE 30, 2002 AND 2001

Net Income. We recorded net income of $2.8 million for the nine months ended June 30, 2002, an increase of $186,000 over the $2.6 million reported in the nine months ended June 30, 2001. For the nine months ended June 30, 2002, basic and diluted earnings per share were $0.91 and $0.87, respectively. The Company reported basic and diluted earnings per share for the nine months ended June 30, 2001 of $0.85 and $0.81, respectively. The increase in net income resulted primarily from increased other income and decreased operating expenses which was partially offset by decreased net interest income and increased income taxes. The decline in the net interest income resulted primarily from the interest rate cuts by the Federal Reserve during calendar 2001. The rate cuts caused a greater reduction in the interest income than in interest expense for the nine months ended June 30, 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 $236,000 or 2.6% for the nine months ended June 30, 2002, compared to the same nine months in the prior year. This decrease reflects a $3.7 million decrease in interest income that was partially offset by the $3.5 million decrease in total interest expense. The average net interest margin decreased 14 basis points from 3.81% for the nine months ended June 30, 2001 to 3.67% for the nine months ended June 30, 2002.

Interest Income. The decrease in interest income for the nine months ended June 30, 2002 was due to a decrease in yield on interest-earning assets of 1.62% from 7.77% for the nine months ended June 30, 2001 to 6.15% for the nine months ended June 30, 2002 that was partially offset by an increase of $4.3 million in average interest-earning assets compared to the same period in the prior year. The increased volume of average interest-earning assets increased interest income by approximately $250,000 and the decreased yield decreased interest income by approximately $4.0 million. Average investment securities increased interest-earning assets by $18.6 million for the nine months compared to the prior year. These increases were offset in part by a decrease in average loans outstanding of $12.7 million and a decrease in interest-bearing overnight deposits of $1.6 million. We experienced unusually heavy mortgage loan prepayments during the nine months ended June 30, 2002 as borrowers took advantage of the attractive mortgage rates and refinanced their existing mortgage loans. During this time we invested the loan prepayments into investment securities.

Interest Expense. Interest expense decreased in the nine months ended June 30, 2002 due to a decrease in average interest-bearing liabilities of $1.8 million and a decrease in the cost of interest-bearing liabilities of 1.71% from 4.76% for the nine months ended June 30, 2001 to 3.05% for the nine months ended June 30, 2002. Average deposits decreased by $2.8 million while average FHLB advances increased $1.0 million for the nine months ended June 30, 2002 compared to the same nine months in the prior year. The decrease in average interest-bearing liabilities decreased interest expense by approximately $64,000 and the decrease in the average cost of interest-bearing liabilities decreased

interest expense by approximately $3.4 million.

The following table presents average balances and average rates earned/paid by the Company for the nine months ended June 30, 2002 compared to the nine months ended June 30, 2001.

	NINE MONTHS ENDED JUNE 30, 2002			
			DOLLARS IN THOUSANDS	
	AVERAGE BALANCE	INTEREST	YIELD/ COST	AVERAGE BALANCE
Assets:				
Loans receivable (5)	$217,934	$10,891	6.66%	$230,603
Investment securities (6)	94,589	3,993	5.63	76,001
Interest-bearing overnight deposits	14,097	191	1.81	15,722
Total interest-earning assets (8)	326,620	15,075	6.15	322,326
Non interest-earning assets	22,270			23,755
Total assets	$348,890			$346,081
Liabilities and stockholders' equity				
Interest bearing checking	31,658	115	0.48	30,172
Money market investment accounts	27,504	288	1.39	20,507
Passbook and statement savings	27,232	316	1.55	26,694
Certificates of deposit	157,852	4,530	3.83	169,661
FHLB advances	21,697	842	5.18	20,699
Total interest-earning liabilities	265,943	6,091	3.05	267,733
Non interest-earning liabilities	18,176			17,675
Total liabilities	284,120			285,408
Stockholders' equity	64,771			60,673
Total liabilities and stockholders' equity	$348,890			$346,081
Net interest income		$8,984		
Interest rate spread			3.10%	
Net interest margin (7)			3.67%	
Ratio of average interest-earning assets			122.82%	

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, 2002 and 2001. The provision for loan losses was impacted by the continued shift in the portfolio to commercial loans which require a larger allocation of allowance for loan losses. The effects of this continued shift in the portfolio were offset to a certain degree in 2002 by a decrease in total loans. See also "Asset Quality."

Other Income. Other income increased $376,000, or 20.4%, from $1.8 million for the nine months ended June 30, 2001 to $2.2 million for the nine months ended June 30, 2002. Mortgage banking income, net increased $263,000 from $658,000 for the nine months ended June 30, 2001 to $921,000 for the nine months ended June 30, 2002. During the nine months ended June 30, 2002, we sold fixed-rate mortgage loans held for sale of $49.3 million compared with sales of $37.5 million during the nine months ended June 30, 2001. Customer service fees increased $153,000, or 29.3% from $522,000 for the nine months ended June 30, 2001 to $675,000 for the nine months ended June 30, 2002. This increase results primarily from growth in the number of transaction accounts and increased service charges. Gains on sales of investment securities of $47,000 were recognized during the nine months ended June 30, 2002 that were not present in the prior year. Commissions from the sales of annuities and mutual funds decreased $108,000 from $459,000 for the nine months ended June 30, 2001 to $351,000 for the nine months ended June 30, 2002. This decrease was the result of diminished sales of annuities and mutual funds. Sales of these non-insured products were $6.5 million for the nine months ended June 30, 2002, a decrease of $1.5 million from the $8.0 million sold in the same period in the prior year.

Operating Expenses. Total operating expenses were $6.7 million for the nine months ended June 30, 2002, a decrease of $212,000, or 3.1% over the $6.9 million recorded for the nine months ended June 30, 2001. Compensation and related benefits expense increased $71,000 from $4.6 million for the nine months ended June 30, 2001 to $4.7 million for the nine months ended June 30, 2002. This increase resulted from increased salary and benefit costs as well as an increase in number of employees. The Company recognized income from real estate operations of $56,000 during the nine months ended June 30, 2002 compared to expenses of $36,000 in the same period in the prior year. Other operating expenses decreased $173,000 from $1.3 million for the nine months ended June 30, 2001 to $1.1 million for the nine months ended June 30, 2002.

Income Tax Expense. Income tax expense increased $166,000 from tax expense of $1.4 million for the nine months ended June 30, 2001 to $1.6 million for the nine months ended June 30, 2002. The increase resulted from a $352,000 increase in income before income taxes. The effective tax rates were 36.5% and 35.5% for the nine months ended June 30, 2002 and 2001, respectively. The increase in the effective tax rate was primarily due to an increase in non-deductible expenses over the prior period.

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 amounts represent credit and interest rate risk are summarized as follows:

	June 30, 2002	September 30, 2001
	(dollars in thousands)	
Commitments to originate new loans	5,537	9,119
Commitments to originate new loans held for sale	--	241
Unfunded commitments to extend credit under existing equity line and commercial lines of credit	70,316	56,907
Commercial letters of credit	425	256
Commitments to sell loans held for sale	1,143	2,157

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, 2002, the aggregate fair value of these commitments exceeded the book value of the loans to be sold.

CONTRACTUAL OBLIGATIONS

As of June 30, 2002

	Payments due by period (Dollars in thousands)			
	Less than 1 year	1-3 years	4-5 years	Over 5
Deposits	$ 230,914	19,986	8,347	
Long-term borrowings	--	--	--	20,
Lease obligations	19	56	42	
Total contractual cash obligations	$ 230,933	20,042	8,389	20,

CRITICAL ACCOUNTING POLICIES

The Company's significant accounting policies are set forth in note 1 of the consolidated financial statements as of September 30, 2001 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.

ASSET QUALITY

At June 30, 2002, the Company had approximately $6.0 million in non-performing assets (nonaccrual loans and real estate owned) or 1.69% of total assets. At September 30, 2001, non-performing assets were $2.9 million or 0.85% of total assets. At June 30, 2002 and September 30, 2001, impaired loans totaled $3.7 million and $2.5 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, 2002 result from two unrelated commercial loan customers, both of which have loans secured by commercial real estate and business assets in Alamance County. At September 30, 2001, the impaired loans resulted from real estate loans secured by commercial real estate in Alamance County owned by two unrelated commercial loan customers. At June 30, 2002, $3.3 million of the impaired loans are on non-accrual status, and their related reserve for loan losses totaled $160,000. At September 30, 2001, $433,000 of impaired loans was on nonaccrual status, and their related reserve for losses totaled $45,000. There was no impact on the provision as management had already anticipated the loans' performance in setting the allowance for loan losses in previous periods. The average carrying value of impaired loans was $3.7 million and $3.8 million during the three and nine months ended June 30, 2002, respectively. Interest income of $50,000 and $146,000 has been recorded on impaired loans in the three and nine months ended June 30, 2002, respectively. The Bank's net chargeoffs for the three and nine months ended June 30, 2002 were $0 and $91,000, respectively. The Bank's allowance for loan losses was $3.7 million at June 30, 2002 and $3.6 million at September 30, 2001. As a result of our continued shift toward commercial, construction, consumer and home equity loans, the recent decrease in residential mortgage loans, the 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 1.69% at June 30, 2002 compared to 1.60% at September 30, 2001.

The following table presents an analysis of our nonperforming assets:

	At June 30, 2002	At September 30, 2001
Nonperforming loans:		
Nonaccrual loans	$3,728	$ 878
Loans 90 days past due and accruing	--	--
Restructured loans	--	--
Total nonperforming loans	3,728	878
Other real estate	2,226	1,981
Total nonperforming assets	$5,954	$ 2,859
Nonperforming loans to loans receivable, net	1.73%	0.39%
Nonperforming assets as a percentage of loans and other real estate owned	2.74%	1.27%
Nonperforming assets to total assets	1.69%	0.85%

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, 2002, we had $5.6 million in classified assets consisting of $3.4 million in substandard and loss loans and $2.2 million in real estate owned. At September 30, 2001, we had $3.6 million in substandard assets consisting of $1.6 million in loans and $2.0 million in real estate owned.

In addition to regulatory classifications, we also classify as "special mention" and "watch" assets that are currently performing in accordance with their contractual terms but may become classified or nonperforming assets in the future. At June 30, 2002, we have identified approximately $2.3 million in assets classified as special mention and $31.3 million as watch.

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, 2002, 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, 2002, cash and cash equivalents totaled $19.9 million. We have other sources of liquidity should we need additional funds. During the three and nine months ended June 30, 2002, we sold loans totaling $7.2 million and $49.3 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 $90 million at June 30, 2002.

We anticipate that we will have sufficient funds available to meet our current commitments. At June 30, 2002, we had $5.5 million in commitments to originate new loans, $70.3 million in unfunded commitments to extend credit under existing equity lines and commercial lines of credit and $425,000 in standby letters of credit. At June 30, 2002, certificates of deposit, which are scheduled to mature within one year, totaled $132.5 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, 2002 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, 2002, 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 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, 2002 was 18.9%. The Company's capital level is sufficient to support future growth.

The Company has declared cash dividends per common share of $0.08 for each of the quarters in fiscal 2002 and fiscal 2001. The Company's ability to pay dividends is dependent upon earnings. The Company's dividend payout ratio for the three months ended June 30, 2002, September 30, 2001 and June 30, 2001 was 25.8%, 32.0% and 28.6%, respectively.

ACCOUNTING ISSUES

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 141 (Statement 141), "Business Combinations", and Statement of Financial Accounting Standards No. 142 (Statement 142), "Goodwill and Other Intangible Assets". Statement 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. Statement 141 also specifies criteria which must be met for intangible assets acquired in a purchase method business combination to be recognized and reported apart from goodwill. Statement 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of Statement 142. Statement 142 also requires that identifiable intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with Statement 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of". The adoption of SFAS No. 141 and SFAS No. 142 did not have a material effect on the Company's consolidated financial statements other than providing enhanced disclosures for mortgage servicing rights. For the periods presented herein, the Company had no goodwill and had no intangible assets related to deposit and branch purchase acquisitions.

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 FASB 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. By broadening the presentation of discontinued operations to include more disposal transactions, the FASB has enhanced management's ability to provide information that helps financial statement users to assess the effects of disposal

transactions on the ongoing operations of an entity. 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 is not expected to have a material impact on the Company's consolidated financial statements.

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146 (Statement 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 FASB Statement 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. The impact of adoption on the Company is not known at this time.

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, 2001. The Company does not believe that any material adverse changes in market risk exposures occurred since September 30, 2001.

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.

99 Certification

(b.) Reports on Form 8-K. During the quarter ended June 30, 2002, the registrant did not file any current reports on Form 8-K.

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.

/s/ James C. McGill

Date: August 14, 2002

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

/s/ A. Christine Baker

Date: August 14, 2002

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