1ST STATE BANCORP INC
Form 10-Q
August 11, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 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, 2005

OR

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

For the transition period from ____________ to ___________

Commission file number: 0-25859

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)

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

Not Applicable
(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 1, 2005, the issuer had 2,898,637 shares of common stock issued and outstanding.

CONTENTS

1st State Bancorp, Inc. and Subsidiary
Consolidated Balance Sheets

June 30, 2005 and September 30, 2004
(In Thousands, except share data)

	At June 30, 2005 (Unaudited)	At September 30, 2004
ASSETS		
Cash and cash equivalents	$ 8,949	$ 9,854
Investment securities:		
Held to maturity (fair value of $24,130 and $22,884 at June 30, 2005 and September 30, 2004, respectively)	24,251	22,919
Available for sale (cost of $88,445 and $97,386 at June 30, 2005 and September 30, 2004, respectively)	87,540	96,693
Loans held for sale, at lower of cost or fair value	1,390	930
Loans receivable (net of allowance for loan losses of $4,191 and $3,956 at June 30, 2005 and September 30, 2004, respectively)	234,396	231,763
Real estate owned	301	17
Federal Home Loan Bank stock, at cost	2,000	2,325
Premises and equipment	7,567	7,884
Accrued interest receivable	2,452	2,124
Other assets	4,241	3,205
Total assets	$ 373,087	$ 377,714
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Deposit accounts	274,367	262,734
Advances from Federal Home Loan Bank	28,000	44,000
Advance payments by borrowers for property taxes and insurance	273	39
Dividend payable	287	296
Other liabilities	4,040	4,731
Total liabilities	306,967	311,800
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; 2,898,637 and 2,962,323 shares issued and outstanding at June 30, 2005 and September 30, 2004, respectively	33	33
Additional paid-in capital	36,316	36,038
Unallocated ESOP shares	(2,154)	(2,571)
Deferred compensation payable in treasury stock	6,700	6,440
Treasury stock	(16,324)	(14,086)
Retained income - substantially restricted	42,100	40,462
Accumulated other comprehensive loss - net unrealized loss on investment securities available for sale	(551)	(402)
Total stockholders' equity	66,120	65,914
Total liabilities and stockholders' equity	$ 373,087	$ 377,714

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, 2005 and 2004
(In Thousands, Except per Share Data)

(Unaudited)

	For the Three Months Ended June 30, 2005	2004
Interest income:		
Interest and fees on loans	$ 3,605	$ 2,812
Interest and dividends on investments	1,151	1,288
Overnight deposits	29	6
Total interest income	4,785	4,106
Interest expense:		
Deposit accounts	1,311	824
Borrowings	298	346
Total interest expense	1,609	1,170
Net interest income	3,176	2,936
Provision for loan losses	500	60
Net interest income after provision for loan losses	2,676	2,876
Other income:		
Customer service fees	245	253
Commissions from sales of annuities and mutual funds	105	99
Mortgage banking income, net	102	126
Other	72	208
Total other income	524	686
Operating expenses:		
Compensation and related benefits	1,290	1,351
Occupancy and equipment	364	351
Real estate operations, net	7	(4)
Other expenses	398	375
Total operating expenses	2,059	2,073
Income before income taxes	1,141	1,489

Income taxes	403	516
Net income	$ 738	$ 973
Net income per share:		
Basic	$ 0.27	$ 0.35
Diluted	$ 0.25	$ 0.33

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, 2005 and 2004
(In Thousands, Except per Share Data)

(Unaudited)

	For the Nine Months Ended June 30,	
	2005	2004
Interest income:		
Interest and fees on loans	$ 10,066	$ 8,495
Interest and dividends on investments	3,500	3,588
Overnight deposits	68	24
Total interest income	13,634	12,107
Interest expense:		
Deposit accounts	3,380	2,629
Borrowings	957	965
Total interest expense	4,337	3,594
Net interest income	9,297	8,513
Provision for loan losses	890	180
Net interest income after provision for loan losses	8,407	8,333
Other income:		
Customer service fees	788	699
Commissions from sales of annuities and mutual funds	229	263
Mortgage banking income, net	314	337
Securities (losses) gains, net	(2)	185
Other	304	318
Total other income	1,633	1,802

Operating expenses:		
Compensation and related benefits	3,828	3,999
Occupancy and equipment	1,074	1,034
Real estate operations, net	(1)	(9)
Other expenses	1,302	1,208
Total operating expenses	6,203	6,232
Income before income taxes	3,837	3,903
Income taxes	1,363	1,393
Net income	$ 2,474	$ 2,510
Net income per share:		
Basic	$ 0.88	$ 0.89
Diluted	$ 0.84	$ 0.85

See accompanying notes to the consolidated financial statements.

1st State Bancorp, Inc. and Subsidiary
Consolidated Statements of Stockholders' Equity and Comprehensive
For the Six Months Ended June 30, 2005 and 2004 (Unaud
(In Thousands)

	Common stock	Additional paid-in capital	Unallocated ESOP Shares	Deferred compensation payable in treasury stock	Treasury stock	Re i
Balance at September 30, 2003	$ 33	35,778	(3,141)	5,466	(12,785)	
Comprehensive income:						
Net income	--	--	--	--	--	
Other comprehensive loss-unrealized loss on securities available-for-sale, net of income tax benefit of $587	--	--	--	--	--	
Total comprehensive income						
Allocation of ESOP shares	--	190	429	--	--	
Acquisition of treasury stock	--	--	--	--	(1,112)	
Deferred compensation	--	--	--	786	--	
Exercise of stock options	--	19	--	--	--	
Cash dividends declared ($0.30 per share)	--	--	--	--	--	
Cash dividends on unallocated ESOP shares	--	--	--	--	--	
Balance at June 30, 2004	$ 33	35,987	(2,712)	6,252	(13,897)	
Balance at September 30, 2004	$ 33	36,038	(2,571)	6,440	(14,086)	

Comprehensive income:					
Net income	--	--	--	--	--
Other comprehensive loss-unrealized loss on securities available-for-sale, net of income tax benefit of $63,000	--	--	--	--	--
Total comprehensive income					
Allocation of ESOP shares	--	198	417	--	--
Acquisition of treasury stock	--	--	--	--	(2,238)
Deferred compensation	--	--	--	260	--
Exercise of stock options	--	80	--	--	--
Cash dividends declared ($0.30 per share)	--	--	--	--	--
Cash dividends on unallocated ESOP shares	--	--	--	--	--
Balance at June 30, 2005	$ 33	36,316	(2,154)	6,700	(16,324)

See accompanying notes to the consolidated financial statements

4

1st State Bancorp, Inc. and Subsidiary
Consolidated Statements of Cash Flows
For the Nine Months Ended June 30, 2005 and 2004
(Unaudited)
(In Thousands)

	For the Nine Month June 30,	
	2005	200
Cash flows from operating activities:		
Net income	$ 2,474	$ 2,
Adjustment to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	890	
Depreciation	485	
Deferred tax benefit	(247)	(
Amortization of premiums and discounts, net	(24)	
Deferred compensation	180	
Release of ESOP shares	615	
Loan origination fees and unearned discounts deferred, net of current amortization	(45)	
Gain on sale of other real estate	(10)	
Loss (gain) on sale of investment securities available for sale	2	(
Net loss on sale of loans	26	
Proceeds from loans held for sale	17,470	21,
Originations of loans held for sale	(17,956)	(21,
Increase in other assets	(726)	(
Increase in accrued interest receivable	(328)	(
Decrease in other liabilities	(610)	

Net cash provided by operating activities	2,196	2,
Cash flows from investing activities:		
Proceeds from redemption of FHLB stock	5,463	2,
Purchases of FHLB stock	(5,138)	(3,
Purchases of investment securities held to maturity	(4,564)	(9,
Purchases of investment securities available for sale	--	(48,
Proceeds from sales of investment securities available for sale	1,944	10,
Proceeds from maturities and issuer calls of investment securities available for sale	7,000	30,
Proceeds from maturities and issuer calls of investment securities held to maturity	3,251	6,
Net increase in loans receivable	(3,767)	(4,
Purchase of and improvements to real estate acquired in settlement of loans	(12)	(
Purchases of premises and equipment net of disposals	(168)	(
Proceeds from disposal of real estate acquired in settlement of loans	17	
Net cash provided by (used in) investing activities	4,026	(16,

(Contin

1st State Bancorp, Inc. and Subsidiary
Consolidated Statements of Cash Flows - Continued
For the Nine Months Ended June 30, 2005 and 2004
(Unaudited)
(In Thousands)

	For the Nine Months Ende June 30,	
	2005	2004
Cash flows from financing activities:		
Net increase in deposits	$ 11,633	$ 1,126
Advances from the Federal Home Loan Bank	119,500	90,000
Repayments of advances from the Federal Home Loan Bank	(135,500)	(74,000)
Purchase of treasury stock	(2,238)	(1,112)
Exercise of stock options	80	19
Dividends paid on common stock	(836)	(841)
Increase in advance payments by borrowers for property taxes and insurance	234	231
Net cash used in financing activities	(7,127)	(15,423)
Net decrease in cash and cash equivalents	(905)	(1,376)
Cash and cash equivalents at beginning of period	9,854	9,359

Cash and cash equivalents at end of period	$ 8,949	$ 10,735
Payments are shown below for the following:		
Interest	$ 4,299	$ 3,566
Income taxes	$ 1,811	$ 1,397
Noncash investing and financing activities:		
Unrealized losses on investment securities available for sale	$ 212	$ 1,499
Cash dividends declared but not paid	$ 274	$ 280
Cash dividends on unallocated ESOP shares	$ 39	$ 48
Transfer from loans to real estate acquired in settlement of loans	$ 289	$ 182

See accompanying notes to the consolidated financial statements.

1st State Bancorp, Inc. and Subsidiary
Notes to Consolidated Financial Statements
June 30, 2005 (unaudited) and September 30, 2004

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, 2004, which is derived from the September 30, 2004 audited consolidated financial statements) have been prepared in accordance with accounting principles generally accepted in the United States of America 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, 2005 are not necessarily indicative of the results of operations that may be expected for the year ending September 30, 2005. 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.

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 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 include the potentially dilutive effects of the Company's stock-based benefit plans. There were no anti-dilutive stock options for the three and nine months ended June 30, 2005 and 2004. A reconciliation of the denominators of the basic and diluted earnings per share computations is as follows:

	Three Months Ended June 30,	
	2005	2004
Average shares issued and outstanding	2,898,955	2,962,323
Less: Unallocated ESOP shares	(113,607)	(142,207)
Average basic shares for earnings per share	2,785,348	2,820,116
Add: Potential common stock pursuant to stock option plan	158,593	145,534
Average dilutive shares for earnings per share	2,943,941	2,965,560

	Nine Months Ended June 30,	
	2005	2004
Average shares issued and outstanding	2,930,589	2,965,045
Less: Unallocated ESOP shares	(120,705)	(149,527)
Average basic shares for earnings per share	2,809,884	2,815,518
Add: Potential common stock pursuant to stock option plan	151,573	150,436
Average dilutive shares for earnings per share	2,961,457	2,965,954

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, 2005 and 2004, 7,098 and 7,280 and 21,294 and 21,920 shares of stock were committed to be released and approximately $215,000 and $199,000 and $615,000 and $619,000, respectively, of compensation expense was recognized.

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 Stock 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 Stock 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 Stock 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 2004 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 were $60,000 in each of the three months ended June 30, 2005 and 2004 and $180,000 in each of the nine months ended June 30, 2005 and 2004. This expense is included in compensation expense.

Note 6. 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. The exercise price per share is equal to the fair market value per share on the date of the grant. 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. There were 5,423 options exercised during each of the three and nine months ended June 30, 2005, respectively. No options were granted during the three and nine months ended June 30, 2005 and 2004. At June 30, 2005, 308,812 options are outstanding, all of which are exercisable.

Note 7. 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 that is determined when the underlying loans are sold. MSRs are amortized over a period that approximates the life of the underlying loan as an adjustment of servicing income. Impairment reviews of MSRs are performed on a quarterly basis. As of June 30, 2005 and September 30, 2004, MSRs totaled $464.000 and $493,000, respectively, and no valuation allowance was required.

Amortization expense totaled $75,000 and $85,000 for the nine months ended June 30, 2005 and 2004, respectively.

Note 8. Standby Letters of Credit and Loan Commitments

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 June 30, 2003. 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, 2005 is $2.1 million. At June 30, 2005, the Company has recorded no liability for the obligation to perform as a guarantor. In addition, no contingent liability is considered necessary as such amounts are not deemed probable. 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.

The Company originates certain fixed rate residential mortgage loans with the intention of selling these loans. At the time the Company enters into a commitment to originate a fixed rate residential mortgage loan with a potential borrower, we concurrently "lock in" the sale of the loan with a secondary market investor under a best efforts delivery mechanism. Between the time the Company commits to originate the loan and the time the closed loan is sold, the Company is subject to changes in market prices related to these commitments. The commitments to originate fixed rate residential mortgage loans and the forward sales commitments are freestanding derivative instruments. They do not qualify for hedge accounting treatment so their fair value adjustments are recorded through the income statement.

Note 9. Investments

The following table provides additional information regarding unrealized losses as of June 30, 2005, none of which relate to securities that are deemed to be other than temporarily impaired. The table is segregated into investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for more than 12 months.

	Less than 12 months		12 months or more		
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	F V
			(In thousands)		
Held to maturity:					
U.S. Government and agency securities	$ 4,555	(44)	10,896	(95)	
Municipal bonds	1,599	(24)	613	(20)	
Collateralized mortgage obligations	--	--	--	--	
Total	$ 6,154	(68)	11,509	(115)	
Available for sale:					
U.S. Government and agency securities	$ 13,689	(59)	60,115	(875)	

In the above table, all of the unrealized losses are the result of increases in the interest rates and not because of credit quality concerns. Therefore, the Company expects to collect the full par value of each bond upon maturity with no accounting loss.

Note 10. Recent Developments

On June 29, 2005, the Board of Directors of 1st State Bancorp, Inc. executed a definitive agreement to merge the company to Capital Bank Corporation, headquartered in Raleigh, N.C. This transaction is expected to close in January 2006, subject to approval of shareholders of both companies and regulators and other normal and customary closing conditions.

9

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 home equity lines of credit, 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.

Due to a general slowdown in the economy beginning in 2000, the Federal Reserve acted to provide a stimulus through a series of interest rate reductions that lowered the prime rate from 9.50% in January 2001 to 4.00% in June 2003. These reductions in prime tended to negatively impact the Company's net interest margin and net interest spread which resulted in lower net interest income for the Company. Beginning June 29, 2004, the Federal Reserve implemented a tightening policy that has resulted in nine one-quarter percent increases in the prime rate bringing it to 6.25% at July 1, 2005. These rate increases have helped to improve the yield on earning assets although the cost of funds has also increased primarily as a result of increase in short-term interest rates. The Company's balance sheet is currently asset sensitive, that is, rate sensitive assets

exceed rate sensitive liabilities. We expect an increase in net interest income during periods of rising interest rates and decreased net interest income during periods of falling interest rates.

Merger Agreement

On June 29, 2005, the Company entered into a definitive merger agreement with Capital Bank Corporation ("Capital") whereby the Company will be merged with and into Capital, with Capital being the surviving corporation. Capital is headquartered in Raleigh, N.C. and operates 21 branches with total assets of $917 million. Upon consummation of the transaction, which is expected to occur in January 2006, each share of the Company's common stock will receive approximately $37.15 (in cash and/or stock) subject to adjustment based on changes in the value of Capital Bank stock above or below certain levels . The merger is subject to approval of shareholders of both companies and regulators and other normal and customary closing conditions.

Critical Accounting Policies

The Company's significant accounting policies are set forth in Note 1 of the consolidated financial statements as of September 30, 2004, which was filed on the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2004. 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 that is not known to management at the time of the issuance of the consolidated financial statements.

Comparison of Financial Condition at June 30, 2005 and September 30, 2004

Total assets decreased $4.6 million from $377.7 million at September 30, 2004 to $373.1 million at June 30, 2005. During the nine months ended June 30, 2005, the Company's loan growth was more than offset by a decrease in investments. The Company shrank its investment portfolio by applying proceeds from investment calls to reduce overnight borrowings. The Company grew deposits by $11.7 million during the nine months ended June 30, 2005, the proceeds of which were also applied to reduce overnight borrowings. The Company was successful in attracting retail certificates of deposit as an alternative to short term borrowings from the FHLB of Atlanta as part of its asset liability strategy.

Investment securities available for sale decreased $9.2 million from $96.7 million at September 30, 2004 to $87.5 million at June 30, 2005. During the nine months ended June 30, 2005, we received $8.9 million in proceeds from maturities, sales and issuer calls of investment securities available for sale and did not purchase any investments available for sale. Interest rates increased during the nine months ended June 30, 2005 which caused the Company's gross unrealized loss on investment securities available for sale to increase from $693,000 at September 30, 2004 to $905,000 at June 30, 2005. Investment securities held to maturity increased $1.4 million from $22.9 million at September 30, 2004 to $24.3 million at June 30, 2005. During the nine months ended June 30, 2005, we purchased $4.6 million of securities and received $3.3 million in proceeds from maturities and issuer calls of investment securities held to maturity. As interest rates have increased, the Company has purchased fewer fixed-rate securities.

Loans held for sale increased to $1.4 million at June 30, 2005 from $930,000 at September 30, 2004. The increase in loans held for sale resulted from timing differences in the funding of loan sales. Loans receivable, net increased from $231.8 million at September 30, 2004 to $234.4 million at June 30, 2005. The Company's mortgage originations have been slower this year as refinance activity slowed down in response to higher mortgage interest rates. During this same period, the Company saw growth in commercial loans and equity lines.

Deposits increased $11.7 million to $274.4 million at June 30, 2005 from $262.7 million at September 30, 2004. The increase resulted from successful certificate of deposit campaigns.

Advances from the Federal Home Loan Bank of Atlanta decreased $16.0 million from $44.0 million at September 30, 2004 to $28.0 million at June 300, 2005. The Company used deposit proceeds and proceeds from investments calls and maturities to repay these borrowings.

Stockholders' equity increased by $200,000 from $65.9 million at September 30, 2004 to $66.1 million at June 30, 2005 as a result of net income of $2.5 million and the release of ESOP shares of $615,000 and $80,000 from the exercise of stock options. These increases were partially offset by cash dividends to stockholders declared of $836,000, purchases of treasury stock of $2.0 million, and an increase in the net unrealized loss on available for sale securities of $149,000. The increase in the net unrealized loss on available for sale securities was a result of increases in interest rates which caused bond prices to decrease.

Comparison of Operating Results for the Three Months Ended June 30, 2005 and 2004

Net Income. We recorded net income of $738,000 for the quarter ended June 30, 2005, as compared to $973,000 for the quarter ended June 30, 2004, representing a decrease of $235,000, or 24.2%. For the three months ended June 30, 2005, basic and diluted earnings per share were $0.27 and $0.25, respectively, compared to the basic and diluted earnings per share for the quarter ended June 30, 2004 of $0.35 and $0.33, respectively. The decrease in net income resulted primarily from increased provision for loan losses and decreased other income which was offset partially by increased net interest income and decreased income tax expense. The increase in net interest income resulted from growth in net interest-earning assets and higher net interest margins. The average prime interest rate for the quarter ended June 30, 2005 was 5.91%, an increase of 191 basis points from 4.00%, which was the average prime for the quarter ended June 30, 2004. The repricing of loans and investments increased the Company's average asset yield by 84 basis points whereas the average cost of funds increased 70 basis points during the quarter ended June 30, 2005.

Net Interest Income. Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, increased by $300,000 or 10.3% for the three months ended June 30, 2005, compared to the same quarter in the prior year. This increase results from a $700,000 increase in interest income that was partially offset by the $400,000 increase in total interest expense. The average net interest rate spread increased 14 basis points from 3.01% for the three months ended June 30, 2004 to 3.15% for the quarter ended June 30, 2005.

Interest Income. The increase in interest income for the three months ended June 30, 2005 was the result of an increase in yield on interest-earning assets of 84 basis points from 4.61% for the three months ended June 30, 2004 to 5.45% for the three months ended June 30, 2005 which was offset partially by the decrease of $5.4 million in average interest-earning assets compared to the same quarter in the prior year. Average loans receivable increased $3.1 million, average investment securities decreased $9.7 million, and average interest-bearing overnight funds increased $1.2 million. The increase in the average asset yield increased interest income by approximately $740,000 while the decrease in average interest-earning assets decreased interest income by approximately $62,000.

Interest Expense. Interest expense increased in the three months ended June 30, 2005 due to an increase in the cost of interest-bearing liabilities of 70 basis points from 1.60% for the three months ended June 30, 2004 to 2.30% for the three months ended June 30, 2005 which was offset partially by the decrease in average interest-bearing liabilities of $12.2 million. Average interest-bearing deposits increased by $8.6 million while average FHLB advances decreased $20.9 million for the three months ended June 30, 2005 compared to the same quarter in the prior year. The average cost of the FHLB advances increased 202 basis points to 5.16% for the three months ended June 30, 2005 from the 3.14% for the three months ended June 30, 2004. This increase reflects the increase in short term interest rates as well and the impact of lower volumes of short-term borrowings during the quarter ended June 30, 2005 compared to the same quarter in the prior year. Short-term borrowings averaged $3.1 million for the quarter ended June 30, 2005 compared to an average of $24.0 million for the quarter ended June 30, 2004. The cost of the short-term borrowings is less than the average cost of the $20 million long-term advance which was outstanding in both periods. The increase in average cost of interest-bearing liabilities increased interest expense by approximately $488,000 while the decrease in the average interest-bearing liabilities decreased interest expense by approximately $49,000.

The following table presents average balances and average rates earned/paid by the Company for the quarter ended June 30, 2005 compared to the quarter ended June 30, 2004.

	Three Months Ended June 30, 2005			Three Months June 30, 2
	(Dollars in Thousands)			
	Average		Average	Average

	Balance	Interest	Yield/Cost	Balance	Interest
Assets:					
Loans receivable (1)	$234,199	3,605	6.16%	$231,111	$ 2,812
Investment securities(2)	113,011	1,151	4.07	122,717	1,288
Interest-bearing overnight deposits	3,983	29	2.88	2,796	6
Total interest-earning assets (3) ..	351,193	4,785	5.45	356,624	4,106
Non interest-earning assets	20,494			20,466	
Total assets	$371,687			$377,090	
Liabilities and stockholders' equity					
Interest-bearing					
checking	35,073	26	0.29	36,805	19
Money market investment accounts	16,818	42	0.99	19,884	33
Passbook and statement savings	29,375	54	0.73	30,943	47
Certificates of deposit	175,835	1,189	2.71	160,827	725
FHLB advances	23,088	298	5.16	43,967	346
Total interest-bearing liabilities..	280,189	1,609	2.30	292,426	1,170

	Balance	Interest	Yield/Cost	Balance	Interest
Noninterest-bearing liabilities	25,729			21,411	
Total liabilities	305,918			313,837	
Stockholders' equity	65,769			63,253	
Total liabilities and stockholders' equity	371,687			$377,090	
Net interest income		$ 3,176			$ 2,936
Interest rate spread			3.15%		
Net interest margin (4)			3.62%		
Ratio of average interest-earning assets to average interest-bearing liabilities..			125.34%		

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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) 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.
(4) Represents net interest income divided by the average balance of interest-earning assets.

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 $42,000 for the three months ended June 30, 2004 compared with a provision of $500,000, and net charge-offs of $4,000 for the three months ended June 30, 2005. At June 30, 2005, the Company established a specific loan valuation reserve of $794,000 on a $3.5 million credit that has been identified as a potential loan problem. This specific reserve increased the provision for the quarter ended June 30, 2005. Nonperforming loans at June 30, 2005 and September 30, 2004 were $2.8 million and $4.0 million, respectively. Approximately $2.2 million of nonperforming loans at June 30, 2005 consist of one commercial relationship which is not necessarily indicative of the credit quality of the entire portfolio. See "-- Asset Quality" for further information.

Other Income. Other income decreased $162,000 from $686,000 for the three months ended June 30, 2004 to $524,000 for the three months ended June 30, 2005. Mortgage banking income, net decreased $25,000 from $126,000 for the three months ended June 30, 2004 to $101,000 for the three months ended June 30, 2005. The lower fee income reflects lower volumes of mortgage loan originations and sales. We sold loans totaling $6.0 million in the three months ended June 30, 2005 compared with sales of $7.5 million in the previous year for the comparable period. Given the current level of mortgage interest rates, the Company believes that mortgage banking income will continue to decrease in future quarters due to lower refinancing activity. The Company recorded a gain of $143,000 on the sale of real estate that had previously served as one of the Company's branch offices. This gain was included in other income for the quarter ended June 30, 2004. There was no such gain reported in the quarter ended June 30, 2005 and other income decreased to $72,000 from the $208,000 which was reported in the three months ended June 30, 2004.

Operating Expenses. Total operating expenses were $2.1 million for each of the three months ended June 30, 2005 and 2004. The Company has been able to control expenses during this period of slower asset growth and lower lending volumes.

Income Tax Expense. Income tax expense decreased $113,000 from tax expense of $516,000 for the three months ended June 30, 2004 to $403,000 for the three months ended June 30, 2005. The effective tax rates were 35.3% and 34.7% for the three months ended June 30, 2005 and 2004, respectively. The increase in the effective tax rate was primarily due to a relative decrease in tax-exempt income compared to the prior year.

Comparison of Operating Results for the Nine Months Ended June 30, 2005 and 2004

Net Income. We recorded net income of $2.5 million for each of the nine months ended June 30, 2005 and 2004. For the nine months ended June 30, 2005, basic and diluted earnings per share were $0.88 and $0.84, respectively. The Company reported basic and diluted earnings per share for the nine months ended June 30, 2004 of $0.89 and $0.85, respectively. Comparing the results for the nine months ended June 30, 2005 to the previous year, the Company had an increase in net interest income which was offset by increased provision for loan losses and a decrease in non-in other income. The increase in the net interest income resulted from improved net interest margins and increased net interest earning assets. The average prime interest rate for the nine months ended June 30, 2005 was 5.45%, an increase of 145 basis points from 4.00%, which was the average prime for the nine months ended June 30, 2004. The rate increase caused a greater increase in the average yield on earning assets than the average rate paid on interest-bearing liabilities.

Net Interest Income. Net interest income, the difference between interest earned on loans and investments and interest paid on interest-bearing liabilities, increased by $784,000 or 9.2% for the nine months ended June 30, 2005, compared to the same nine months in the prior year. This increase reflects a $1.5 million increase in interest income that was partially offset by the $743,000 increase in total interest expense. The average net interest rate spread increased 14 basis points from 2.97% for the nine months ended June 30, 2004 to 3.11% for the nine months ended June 30, 2005.

Interest Income. The increase in interest income for the nine months ended June 30, 2005 was due to a increase in yield on interest-earning assets of 49 basis points from 4.67% for the nine months ended June 30, 2004 to 5.16% for the nine months ended June 30, 2005 combined with an increase of $5.6 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 $200,000 and the increased yield increased interest income by approximately $1.3 million. Average loans receivable increased $4.9 million, average investment securities increased $576,000, and average interest-bearing overnight funds increased $196,000 compared with the prior year.

Interest Expense. Interest expense increased in the nine months ended June 30, 2005 due to an increase in the cost of interest-bearing liabilities of 35 basis points from 1.70% for the nine months ended June 30, 2004 to 2.05% for the nine months ended June 30, 2005. This was partially offset by the decrease in average interest-bearing liabilities of $342,000 compared to the prior year. Average deposits increased by $8.0 million and average FHLB advances decreased $8.3 million for the nine months ended June 30, 2005 compared to the same nine months in the prior year. The increase in the average cost of interest-bearing liabilities increased interest expense by approximately $882,000. The decrease in average interest-bearing liabilities decreased interest expense by approximately $138,000.

The following table presents average balances and average rates earned/paid by the Company for the nine months ended June 30, 2005 compared to the nine months ended June 30, 2004.

	Nine Months Ended June 30, 2005			Nine Months En June 30, 200	
	(Dollars in Thousands)				
	Average Balance	Interest	Average Yield/Cost	Average Balance	Interest
Assets:					
Loans receivable (1)	233,687	$ 10,066	5.74%	$228,827	$ 8,495
Investment securities (2)	114,056	3,500	4.09	113,480	3,588
Interest-bearing overnight deposits	3,752	68	1.23	3,556	24

Total interest-earning assets (3) .	351,495	13,634	5.16	345,863	12,107
Non interest-earning assets	20,527			20,896	
Total assets	$372,022			$366,759	
Liabilities and stockholders' equity:					
Interest-bearing checking	35,498	72	0.27	36,148	57
Money market investment accounts	16,800	125	0.99	19,565	98
Passbook and statement savings	29,701	156	0.70	30,377	139
Certificates of deposit	172,537	3,027	2.34	160,476	2,335
FHLB advances	27,571	957	4.63	35,883	965
Total interest-bearing liabilities	282,107	4,337	2.05	282,449	3,594
Noninterest-bearing liabilities	23,985			21,060	
Total liabilities	306,092			303,509	
Stockholders' equity	65,930			63,250	
Total liabilities and stockholders' equity	$372,022			$366,759	
Net interest income		$ 9,297			$ 8,513
Interest rate spread			3.11%		
Net interest margin (4)			3.51%		
Ratio of average interest-earning assets to average interest-bearing liabilities			124.60%		

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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) 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.

(4) Represents net interest income divided by the average balance of interest-earning assets.

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, non-performing loans, prior loan loss experience, general economic conditions and other factors. Provisions for loan losses totaled $890,000 and $180,000 for the nine months ended June 30, 2005 and 2004, respectively. The provision for loan losses was impacted by the increase the loan charge-offs and an increase in specific reserves for impaired loans. Net loan charge-offs for the nine months ended June 30, 2005 and 2004 were $655,000 and $126,000, respectively. The most significant chargeoff during the nine months ended June 30, 2005 totaled $620,000 related to one credit.

Other Income. Other income was $1.6 million and $1.8 million for the nine months ended June 30, 2005 and 2004, respectively. Customer fees increased $89,000 to $788,000 for the nine months ended June 30, 2005 compared with the $699,000 reported in the prior year. This increase was the result of increased deposit service charges and loan late charges compared with the prior year. Commissions from sales of annuities and mutual funds decreased $34,000 from $263,000 for the nine months ended June 30, 2004 to $229,000 for the nine months ended June 30, 2005. This decrease results from lower sales of annuities and mutual funds. The Company recorded gains on sales of investments of $185,000 in the nine months ended June 30, 2004 compared to a loss of $2,000 in the nine months ended June 30, 2005. Mortgage banking income, net decreased $23,000 from $337,000 for the nine months ended June 30, 2004 to $314,000 for the nine months ended June 30, 2005. The lower fee income reflects lower volumes of mortgage loan originations and sales. We sold loans totaling $18.0 million in the nine months ended June 30, 2005 compared with sales of $21.1 million in the previous year for the comparable period.

Operating Expenses. Total operating expenses were $6.2 million for each of the nine months ended June 30, 2005 and 2004, respectively. The Company has been able to control expenses during this period of slower asset growth.

Income Tax Expense. Income tax expense was $1.4 million for each of the nine months ended June 30, 2005 and 2004. The effective tax rates were 35.5% and 35.7% for the nine months ended June 30, 2005 and 2004, 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 amounts represent credit and interest rate risk are summarized as follows:

	June 30, 2005	September 30, 2004
	(In thousands)	
Commitments to originate new loans	$ 4,052	$ 2,177
Commitments to originate new loans held for sale	117	--
Unfunded commitments to extend credit under existing equity line and commercial lines of credit	65,554	55,357
Commercial letters of credit	2,150	2,055
Commitments to sell loans held for sale	1,344	2,174

Commitments to originate new loan include six unrelated commercial real estate loans totaling $3.7 million. 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 amount 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, 2005, the aggregate fair value of these commitments exceeded the book value of the loans to be sold.

Contractual Obligations

As of June 30, 2005:

	Payments Due by Period (Dollars in thousands)				
	Less than 1 year	1-3 years	4-5 years	Over 5 years	Total
Deposits	$238,425	$ 25,966	$ 9,976	$ --	$274,367
Advances from Federal Home Loan Bank	8,000	20,000	--	--	28,000
Lease obligations	20	42	42	5	109
Total contractual cash obligations	$246,445	$ 46,008	$ 10,018	$ 5	$302,476

Asset Quality

At June 30, 2005, the Company had approximately $3.1 million in nonperforming assets (nonaccrual loans and real estate owned) or 0.83% of total assets. At September 30, 2004, nonperforming assets were $4.0 million or 1.05% of total assets. At June 30, 2005 and September 30, 2004, impaired loans totaled $5.9 million (of which $2.4 were on nonaccrual status) and $3.8 million (all of which were on nonaccrual status), respectively, as defined by Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan." The most significant impaired loans at June 30, 2005 result from two unrelated commercial loans secured by commercial real estate and business assets in Alamance County. At June 30, 2005, the combined loan balances of these two relationships totaled $5.7 million. The average carrying value of impaired loans was $3.2 million during the nine months ended June 30, 2005. Interest income of $97,000 has been recorded on impaired loans in the nine months ended June 30, 2005. The Bank's net charge-offs for the nine months ended June 30, 2005 were $655,000. The Bank's allowance for loan losses was $4.2 million and $4.0 million at June 30, 2005 and September 30, 2004, respectively, and the ratio of the allowance for loan losses to total loans, net of loans in process and deferred loan fees was 1.76% and 1.68% at June 30, 2005 and September 30, 2004, respectively.

At June 30, 2005, the Company had one $3.5 million loan relationship which is not currently classified as nonaccrual, 90 days past due or restructured, but where known financial information about possible credit problems causes management to have serious concerns as to the ability of the borrowers to comply with present loan repayment terms and may result in disclosure as nonaccrual, 90 days past due or restructured. See "--Provision For Loan Losses" for information concerning the specific reserve on this loan.

The following table presents an analysis of our nonperforming assets:

	At June 30, 2005	At September 30, 2004	At June 30, 2004
Non-performing loans:	(Dollars in thousands)		
Nonaccrual loans	$ 2,370	$ 3,962	$ 4,007
Loans 90 days past due and accruing	430	--	--
Restructured loans	--	--	--
Total non-performing loans	2,800	3,962	4,007
Other real estate	301	26	17
Total non-performing assets	$ 3,101	$ 3,979	$ 4,033
Non-performing loans to loans receivable, net	1.17%	1.72%	1.74%
Non-performing assets as a percentage of loans and other real estate owned	1.30%	1.72%	1.75%
Non-performing assets to total assets	0.83%	1.05%	1.06%

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, 2005, we had $6.9 million in classified assets consisting of $6.6 million in substandard loans, $4,000 in loans classified as loss and $301,000 in real estate owned. At September 30, 2004, we had $4.7 million in classified assets consisting of $4.7 million in substandard loans and $17,000 in real estate owned. At June 30, 2004, we had $4.8 million in classified assets consisting of $4.8 million in substandard loans, $7,000 in loss loans and $26,000 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, 2005, we have identified approximately $923,000 in assets classified as special mention and $25.4 million as watch. At June 30, 2004, we had identified approximately $4.8 million in assets classified as special mention and $28.0 million as watch.

The following table sets forth an analysis of our allowance for loan losses for the periods indicated.

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2005	2004	2005	2004
	(Dollars in thousands)			

Balance at beginning period	$ 3,695	$ 3,892	$ 3,956	$ 3,856
Loans charged off	(5)	(42)	(657)	(126)
Recoveries	1	--	2	--
Net loans charged off	(4)	(42)	(655)	(126)
Provisions for losses	500	60	890	180
Balance at end of period	$ 4,191	$ 3,910	$ 4,191	$ 3,910
Average loans outstanding	$ 234,199	$ 231,111	$ 233,687	$ 228,827
Ratio of net loans charged off to average loans outstanding during the period	.0017%	.0182%	.2803%	.0551%

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, 2005, 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, 2005, cash and cash equivalents totaled $8.9 million. We have other sources of liquidity should we need additional funds. During the three and nine months ended June 30, 2005, we sold loans totaling $6.0 million and $17.9 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 $88.9 million at June 30, 2005.

We anticipate that we will have sufficient funds available to meet our current commitments. At June 30, 2005, we had $4.2 million in commitments to originate new loans, $65.6 million in unfunded commitments to extend credit under existing equity lines and commercial lines of credit and $2.2 million in standby letters of credit. At June 30, 2005, certificates of deposit, which are scheduled to mature within one year, totaled $142.4 million. We believe that a significant portion of such deposits will remain with us.

The Federal Deposit Insurance Corporation ("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, 2005 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, 2005, the Company was in compliance with the capital requirements of the Federal Reserve.

The Company's equity to asset ratio at June 30, 2005 was 17.7%. The Company's capital level is sufficient to support future growth.

The Company has declared cash dividends per common share of $0.10 for each of the three months ended June 30, 2005, September 30, 2004 and June 30, 2004. The Company's ability to pay dividends is dependent upon earnings. The Company's dividend payout ratio for the three months ended June 30, 2005, September 30, 2004 and June 30, 2004 was 40.0%, 31.3% and 30.3%, respectively.

Accounting Matters

In March 2004, the SEC released Staff Accounting Bulletin No. 105 - Application of Accounting Principles to Loan Commitments. This bulletin requires all registrants to begin accounting for their issued loan commitments (including interest rate lock commitments) subject to Statement 133 as written options. Treatment as a written option would require those loan commitments to be reported as liabilities until either they are exercised (and a loan is made) or they expire unexercised. Staff Accounting Bulletin No. 105 must be applied to loan commitments that are issued after June 30, 2004. The adoption of Staff Accounting Bulletin No. 105 did not have a material impact on the consolidated financial statements.

In January 2003, FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an interpretation of ARB No. 51", (Interpretation 46) was issued. Interpretation 46 addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. Interpretation 46 applies immediately to variable interests in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003), "Consolidation of Variable Interest Entities", which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, "Consolidation of Variable Interest Entities", which was issued in January 2003. The Company will be required to apply FIN 46R to variable interests in VIEs created after December 31, 2003. FASB deferred the effective date of FIN 46 to no later than the end of the first reporting period that ends after March 15, 2004. The application of this revised interpretation is not expected to have a material effect on the consolidated financial statements.

On September 30, 2004, the FASB issued FASB Staff Position ("FSP") Emerging Issues Task Force ("EITF") Issue No. 03-1-1 delaying the effective date of paragraphs 10-20 of EITF 03-1, "The meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments", which provides guidance for determining the meaning of "other-than-temporarily impaired" and its application to certain debt and equity securities within the scope of SFAS No.

115, "Accounting for Certain Investments in Debt and Equity Securities", and investments accounted for under the cost method. The guidance requires that investments which have declined in value due to credit concerns or solely due to changes in interest rates must be recorded as other than temporarily impaired unless the Company can demonstrate its intention to hold the security for a period of time sufficient to allow for a recovery of fair value up to or beyond the cost of the investment which might mean maturity. The delay of the effective date of EITF 03-1 will be superceded concurrent with the final issuance of proposed FSP Issue 03-1-a. Proposed FSP Issue 03-1-a is intended to provide implementation guidance with respect to all securities analyzed for impairment under paragraphs 10-20 of EITF 03-1. Management continues to closely monitor and evaluate how the provisions of EITF 03-1 and proposed Issue 03-1-a will affect the Company.

On December 16, 2004, the FASB issued SFAS No. 123R, "Share-Based Payment," which is an Amendment of FASB Statement Nos. 123 and 95. SFAS No. 123R changes, among other things, the manner in which share-based compensation, such as stock options, will be accounted for and will be effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. The cost of employee services received in exchange for equity instruments including options and restricted stock awards generally will be measured at fair value at the grant date. The grant date fair value will be estimated using option-pricing models adjusted for the unique characteristics of those options and instruments, unless observable market prices for the same or similar options are available. The cost will be recognized over the requisite service period, often the vesting period, and will be remeasured subsequently at each reporting date through settlement date.

The changes in accounting will replace existing requirements under SFAS No. 123, "Accounting for Stock-Based Compensation," and will eliminate the ability to account for share-based compensation transactions using ABP Opinion No. 25, "Accounting for Stock Issued to Employees," which does not require companies to expense options if the exercise price is equal to the trading price at the date of grant. The accounting for similar transactions involving parties other than employees or the accounting for employee stock ownership plans that are subject to American Institute of Certified Public Accountants ("AICPA") Statement of Position 93-6, "Employers' Accounting for Employee Stock Ownership Plans," would remain unchanged.

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, 2004. The Company does not believe that any material changes in market risk exposures have occurred since September 30, 2004.

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.

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

From time to time, we are a party to various legal proceedings incident to our business. There currently are no legal proceedings to which we are a party, or to which any of our property was subject, except as described in the following paragraph and none which are expected to result in a material loss. There are no pending regulatory proceedings to which we are a party or to which any of our properties is subject which are expected to result in a material loss.

A civil action was filed against 1st State Bank and Brokers, Incorporated by Michael Locklar in Davidson County Superior Court, in the State of North Carolina on May 16, 2003. Mr. Locklar has alleged in the action that 1st State Bank granted him an option to purchase certain real property located in Davidson County, North Carolina, which 1st State Bank wrongfully sold to Brokers, Incorporated for $150,000 in breach of the option granted to Mr. Locklar. Mr. Locklar is seeking to set aside the conveyance of property to Brokers, Incorporated and to purchase the property from 1st State Bank for the option price. Brokers, Incorporated has filed a cross-claim against 1st State Bank seeking indemnification in the form of return of the purchase price they paid for the property, damages and attorneys fees should Locklar be successful in setting aside the real estate conveyance. 1st State Bank intends to vigorously contest Mr. Locklar's allegations. Management does not anticipate that this lawsuit will have a material adverse impact on the Company's financial condition or results of operations.

The Bank had been named as a co-defendant in a lawsuit brought by minority stockholders of a corporation against the majority stockholders of the corporation. A director of the Company and the Bank, along with family members, is the majority stockholder of the corporation, which had previously had loans outstanding from the Bank. During the quarter ended December 31, 2004, these loans were paid off in full. The Bank settled this lawsuit in July 2005 for an immaterial amount.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) Not applicable.

(b) Not applicable.

(c) The following table sets forth information regarding the Company's repurchases of its common stock during the quarter ended June 30, 2005.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shar that May Yet B Purchased Unde the Plans or Programs
April 2005 Beginning date: April 1 Ending date: April 30	4,880	$29.10	4,880	227,123 (
May 2005 Beginning date: May 1 Ending date: May 31				
June 2005 Beginning date: June 1 Ending date: June 30				
Total	4,880	$29.10	4,880	

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(1) On November 17, 2004, the Company announced a 10% stock repurchase program to acquire up to 296,232 shares of the Company's stock over a period of 24 months. These share purchases were a part of this repurchase program.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

The following exhibits are filed herewith:

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

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

32 Section 1350 Certifications

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

1st STATE BANCORP, INC.

Date: August 11, 2005

/s/ James C. McGill

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

Date: August 11, 2005

/s/ A. Christine Baker

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