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1ST STATE BANCORP INC
Form 10-K
December 23, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO SECTIONS 13 or 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

(Mark One)

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

For the fiscal year ended September 30, 2004

OR

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

For the transition period from _____ to _____

Commission File No. 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

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common stock, par value \$.01 per share

(Title of Class)

Indicate by check mark whether the registrant: (1) has filed all reports
required by Section 13 or 15(d) of the Securities Exchange Act of 1934 during
the preceding 12 months (or such shorter period that the registrant was required
to file such reports), and (2) has been subject to such filing requirements for

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the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The aggregate market value of the 1,511,144 shares of common stock held by non-affiliates was approximately \$44.6 million computed by reference to the closing sale price for the registrant's common stock on March 31, 2004 as reported on The Nasdaq National Market. For purposes of this calculation, it is assumed that directors, executive officers and beneficial owners of more than 5% of the registrant's outstanding voting stock are affiliates.

Number of shares of Common Stock outstanding as of December 17, 2004:
2,956,373

DOCUMENTS INCORPORATED BY REFERENCE

The following lists the documents incorporated by reference and the Part of the Form 10-K into which the document is incorporated:

1. Portions of the Annual Report to Stockholders for the fiscal year ended September 30, 2004. (Parts II and IV)

2. Portions of Proxy Statement for 2005 Annual Meeting of Stockholders. (Part III)

PART I

Item 1. Business

General

1st State Bancorp, Inc. We organized 1st State Bancorp, Inc. (the "Company") in November 1998 to be the holding company for 1st State Bank, Burlington, North Carolina (the "Bank"), following the Bank's conversion from mutual to stock form (the "Stock Conversion"), and then as a bank holding company of 1st State Bank following its conversion from a North Carolina chartered savings bank to a North Carolina commercial bank (the "Bank Conversion"). 1st State Bancorp acquired all the outstanding stock of 1st State Bank in connection with the Stock Conversion on April 23, 1999. Prior to that time, the Company did not own assets or conduct operations. 1st State Bancorp is primarily engaged in the business of directing, planning and coordinating the business activities of 1st State Bank. In the future, 1st State Bancorp may conduct operations or acquire or organize other operating subsidiaries, including other financial institutions, though we have no current plans in this regard. Currently, 1st State Bancorp does not maintain offices separate from those of 1st State Bank nor employ any persons other than its officers who are not separately compensated for their service.

1st State Bank. Founded in 1914, 1st State Bank is a community and customer-oriented North Carolina chartered commercial bank headquartered in Burlington, North Carolina. We have seven full service offices located in north central North Carolina on the Interstate 85 corridor between the Piedmont Triad

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and Research Triangle Park. We conduct most of our business in Alamance County, North Carolina.

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 the interest we pay on deposits and borrowed funds. We also earn income from miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds.

Market Area

We conduct most of our business in Alamance County in north central North Carolina, located on the Interstate 85 corridor between the Piedmont Triad and Research Triangle. Historically, the Alamance County economy has been heavily dependent on the textile industry. During the past 20 years, the economy has diversified to some extent, with increasing employment in the areas of insurance, banking, manufacturing and services. Nevertheless, the economy in Alamance County continues to be heavily dependent on the textile industry. Major employers in the area include LabCorp, Burlington Industries, Alamance - Burlington Schools, Glen Raven Mills. Great American Knitting, Culp, Elon University and Alamance Health Services.

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Lending Activities

Loan Portfolio Composition. At September 30, 2004, our gross loan portfolio totaled \$235.7 million and represented 62.4% of total assets. The following table sets forth information relating to the composition of our loan portfolio by type of loan at the dates indicated. At September 30, 2004, we had no concentrations of loans exceeding 10% of gross loans other than as disclosed below. Excluded from this table are mortgage loans held for sale, which are presented separately on our consolidated balance sheets and in "Selected Consolidated Financial Information and Other Data" in the Annual Report to Stockholders for the fiscal year ended September 30, 2004 (the "Annual Report").

| | At September 30, | | | | |
|---------------------------------|------------------------|--------|-----------|--------|-----------|
| | 2004 | | 2003 | | 2002 |
| | Amount | % | Amount | % | Amount |
| | (Dollars in thousands) | | | | |
| Real estate loans: | | | | | |
| Single-family residential | \$ 43,757 | 18.00% | \$ 49,343 | 21.04% | \$ 66,708 |
| Commercial | 63,402 | 26.07 | 63,538 | 27.09 | 34,431 |
| Home equity | 37,016 | 15.22 | 29,188 | 12.44 | 24,878 |
| Construction | 24,728 | 10.17 | 16,736 | 7.14 | 33,080 |
| Total real estate loans | 168,903 | 69.46 | 158,805 | 67.71 | 159,097 |
| Commercial | 69,649 | 28.64 | 70,054 | 29.87 | 72,061 |
| Consumer | 4,620 | 1.90 | 5,684 | 2.42 | 7,117 |

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| | | | | | |
|---------------------------------|------------|---------|------------|---------|------------|
| | 243,172 | 100.00% | \$ 234,543 | 100.00% | \$ 238,275 |
| | ===== | ===== | ===== | ===== | ===== |
| Less: | | | | | |
| Construction loans in process . | (7,436) | | (4,870) | | (14,273) |
| Deferred fees and discounts ... | (17) | | (92) | | (223) |
| Allowance for loan losses | (3,956) | | (3,856) | | (3,732) |
| | ----- | | ----- | | ----- |
| Total | \$ 231,763 | | \$ 225,725 | | \$ 220,047 |
| | ===== | | ===== | | ===== |

At September 30,

| | 2001 | | 2000 | |
|---------------------------------|------------------------|---------|------------|---------|
| | Amount | % | Amount | % |
| | ----- | ----- | ----- | ----- |
| | (Dollars in thousands) | | | |
| Real estate loans: | | | | |
| Single-family residential | \$ 86,886 | 37.33% | \$ 97,989 | 41.27% |
| Commercial | 40,957 | 17.60 | 46,525 | 19.59 |
| Home equity | 22,167 | 9.52 | 21,225 | 8.94 |
| Construction | 19,230 | 8.26 | 21,991 | 9.26 |
| | ----- | ----- | ----- | ----- |
| Total real estate loans | 169,240 | 72.71 | 187,730 | 79.06 |
| Commercial | 56,938 | 24.46 | 42,949 | 18.09 |
| Consumer | 6,583 | 2.83 | 6,782 | 2.85 |
| | ----- | ----- | ----- | ----- |
| | \$ 232,761 | 100.00% | \$ 237,461 | 100.00% |
| | ===== | ===== | ===== | ===== |
| Less: | | | | |
| Construction loans in process . | (6,573) | | (9,972) | |
| Deferred fees and discounts ... | (291) | | (358) | |
| Allowance for loan losses | (3,612) | | (3,536) | |
| | ----- | | ----- | |
| Total | \$ 222,285 | | \$ 223,595 | |
| | ===== | | ===== | |

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Loan Maturity Schedule. The following table sets forth certain information at September 30, 2004 regarding the dollar amount of loans maturing in our portfolio based on their contractual terms to maturity, including scheduled repayments of principal. Demand loans, loans having no stated schedule of repayments, such as lines of credit, and overdrafts are reported as due in one year or less. The table does not include any estimate of prepayments which significantly shorten the average life of mortgage loans and may cause our repayment experience to differ from that shown below.

| Due During the Year Ending September 30, 2005 | Due After 1 Through 5 Years After September 30, 2004 | Due After 5 Years After September 30, |
|---|---|---|
| ----- | ----- | ----- |

(In thousands)

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| | | | |
|-------------------------------|----------|----------|-----------|
| Real estate loans: | | | |
| Single-family residential ... | \$ 2,359 | \$ 5,993 | \$ 35,400 |
| Commercial | 9,600 | 24,133 | 29,660 |
| Home equity | 2,159 | 2,999 | 31,850 |
| Construction | 13,616 | 3,676 | |
| Commercial | 51,295 | 14,104 | 4,250 |
| Consumer | 2,486 | 2,111 | 2,000 |
| | ----- | ----- | ----- |
| Total | \$81,515 | \$53,016 | \$101,200 |
| | ===== | ===== | ===== |

The following table sets forth at September 30, 2004, the dollar amount of all loans due one year or more after September 30, 2004 which have predetermined interest rates and have floating or adjustable interest rates.

| | Predetermined Rate | Floating or Adjustable Rates | Total |
|-------------------------------|-----------------------|---------------------------------|-----------|
| | ----- | ----- | ----- |
| | (In thousands) | | |
| Real estate loans: | | | |
| Single-family residential ... | \$16,188 | \$ 25,210 | \$ 41,398 |
| Commercial | 11,849 | 41,953 | 53,802 |
| Home equity | 32 | 34,825 | 34,857 |
| Construction | 769 | 2,907 | 3,676 |
| Commercial | 2,965 | 15,389 | 18,354 |
| Consumer | 1,939 | 195 | 2,134 |
| | ----- | ----- | ----- |
| Total | \$33,742 | \$120,479 | \$154,221 |
| | ===== | ===== | ===== |

Scheduled contractual principal repayments of loans do not reflect the actual life of the loans. The average life of loans can be substantially less than their contractual terms because of prepayments. In addition, due-on-sale clauses on loans generally give us the right to declare a loan immediately due and payable in the event that, among other things, the borrower sells the real property subject to the mortgage and the loan is not repaid. The average life of mortgage loans tends to increase when current mortgage loan market rates are substantially higher than rates on existing mortgage loans and, conversely, decrease when current mortgage loan market rates are substantially lower than rates on existing mortgage loans.

Originations, Purchases and Sales of Loans. We generally have authority to originate and purchase loans secured by real estate located throughout the United States. Consistent with our emphasis on being a community-oriented financial institution, we concentrate our lending activities in Alamance County.

The following table sets forth certain information with respect to our loan origination, purchase and sale activity for the periods indicated.

| | Year Ended September 30, | | |
|--|--------------------------|-------|-------|
| | ----- | ----- | ----- |
| | 2004 | 2003 | 2002 |
| | ----- | ----- | ----- |
| | (In thousands) | | |

Loans originated:
Real estate loans:

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| | | | |
|---------------------------------|-----------|-----------|-----------|
| Single-family residential | \$ 30,549 | \$100,076 | \$ 69,434 |
| Commercial | 7,511 | 16,505 | 17,613 |
| Home equity | 18,692 | 20,469 | 15,989 |
| Construction | 18,029 | 9,808 | 23,565 |
| | ----- | ----- | ----- |
| Total real estate loans | 74,781 | 146,858 | 126,601 |
| Commercial | 33,601 | 33,830 | 26,398 |
| Consumer | 3,867 | 5,730 | 7,310 |
| | ----- | ----- | ----- |
| Total loans originated | \$112,249 | \$186,418 | \$160,309 |
| | ===== | ===== | ===== |
| Loans purchased: | | | |
| Real estate loans | \$ 230 | \$ 50 | \$ 100 |
| Other loans | -- | -- | -- |
| | ----- | ----- | ----- |
| Total loans purchased | \$ 230 | \$ 50 | \$ 100 |
| | ===== | ===== | ===== |
| Loans sold (1) | \$ 27,116 | \$103,739 | \$ 62,712 |
| | ===== | ===== | ===== |

(1) All loans sold were whole loans.

We obtain our loan originations from a number of sources, including referrals from depositors, borrowers and realtors, repeat customers, advertising and calling officers, as well as walk-in customers. We also advertise in local media and participate in various community organizations and events. Real estate loans are originated by our loan officers. All of our loan officers are salaried and are eligible to receive commissions for loans originated. We accept loan applications at our offices and do not originate loans on an indirect basis such as through arrangements with automobile dealers. In all cases, we have final approval of the application. Historically, we have purchased limited quantities of loans. During the years ended September 30, 2004, 2003 and 2002, virtually all loans purchased were small participation interests in multi-family residential real estate loans to finance low income housing.

In recent years, and particularly during the years ended September 30, 2004 and 2003, we have sold the majority of fixed-rate, single-family mortgage loans that we originated. During the years ended September 30, 2004, 2003 and 2002, we sold \$27.1 million, \$103.7 million and \$62.7 million, respectively, of such loans. Typically, in the current low interest rate environment, we have been selling fixed-rate, single-family mortgage loans with terms of 15 years or more, except in cases where the interest rate is sufficient to compensate us for the risk of retaining a long-term, fixed-rate loan in our portfolio. Most loans have been sold to private purchasers with servicing released. In addition, we sell a smaller amount of loans in the secondary market to the Federal Home Loan Mortgage Corporation. We retain servicing on loans sold to the Federal Home Loan Mortgage Corporation.

Loan Underwriting Policies. We have established written, nondiscriminatory underwriting standards and loan origination procedures. We obtain detailed loan applications to determine the borrower's ability to repay, and verify the more significant items on these applications through the use of credit reports, financial statements and confirmations. Individual officers have been granted authority by the board of directors to approve mortgage, consumer and commercial loans up to varying specified dollar amounts, depending upon the type of loan. A loan committee consisting of our President, Executive Vice President, Chief Financial Officer, senior credit officer and head of mortgage lending has authority to approve any loan in an amount exceeding individual lending authorities where our total loans to that borrower would not exceed \$350,000. Our executive committee, which consists of the

Chairman of the Board, the President, two additional board members that serve on a permanent basis and one board member selected on a rotating basis that serves for a three-month period, has authority to approve any loan where our total loans to that borrower would not exceed \$1.0 million. Loans above that amount may not be made unless approved by the full board of directors. These authorities are based on aggregate borrowings of an individual or entity. On a monthly basis, the executive committee reviews the actions taken by the loan committee and the full board of directors reviews the actions taken by the executive committee.

Applications for single-family real estate loans are underwritten and closed in accordance with the standards of Federal Home Loan Mortgage Corporation. Generally, upon receipt of a loan application from a prospective borrower, we order a credit report and verifications to confirm specific information relating to the loan applicant's employment, income and credit standing. If a proposed loan is to be secured by a mortgage on real estate, we usually obtain an appraisal of the real estate from an appraiser approved by us and licensed by the State of North Carolina. Except when we become aware of a particular risk of environmental contamination, we generally do not obtain a formal environmental report on real estate at the time a loan is made.

Our policy is to record a lien on the real estate securing a loan and to obtain title insurance which insures that the property is free of prior encumbrances and other possible title defects. Borrowers must also obtain hazard insurance policies prior to closing and, when the property is in a flood plain as designated by the Department of Housing and Urban Development, pay flood insurance policy premiums.

On single-family residential mortgage loans, we make a loan commitment of between 30 and 60 days for each loan approved. If the borrower desires a longer commitment, we may extend the commitment for good cause. We guarantee the interest rate for the commitment period.

We are permitted to lend up to 95% of the lesser of the appraised value or the purchase price of the real property securing a mortgage loan. However, if the amount of a residential loan originated or refinanced exceeds 80% of the appraised value, our policy generally is to obtain private mortgage insurance at the borrower's expense on that portion of the principal amount of the loan that exceeds 80% of the appraised value of the property. We will make a single-family residential mortgage loan with up to a 95% loan-to-value ratio if the required private mortgage insurance is obtained. We generally limit the loan-to-value ratio on commercial real estate mortgage loans to 80%, although the loan-to-value ratio on commercial real estate loans in limited circumstances has been as high as 90%. We limit the loan-to-value ratio on multi-family residential real estate loans to 80%.

Under applicable law, with certain limited exceptions, loans and extensions of credit by a financial institution to a person outstanding at one time and not fully secured by collateral having a market value at least equal to the amount of the loan or extension of credit shall not exceed 15% of net worth plus the general loan loss reserve. Loans and extensions of credit fully secured by readily marketable collateral may comprise an additional 10% of net worth. Applicable law additionally authorizes financial institutions to make loans to one borrower, for any purpose:

- o in an amount not to exceed \$500,000;

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- o in an amount not to exceed the lesser of \$30,000,000 or 30% of net worth to develop residential housing, provided (a) the purchase price of each single-family dwelling in the development does not exceed \$500,000, and (b) the aggregate amount of loans made under this authority does not exceed 150% of net worth; or
- o loans to finance the sale of real property in satisfaction of debts previously contracted in good faith, not to exceed 50% of net worth.

Under these limits, our loans to one borrower were limited to \$9.7 million at September 30, 2004. At that date, we had no lending relationships in excess of the loans-to-one-borrower limit. At September 30, 2004, our ten largest lending relationships ranged in size from \$3.6 million to \$9.3 million.

Single-Family Residential Real Estate Lending. We historically have been and continue to be an originator of single-family residential real estate loans in our market area. At September 30, 2004, single-family residential mortgage loans, excluding home equity loans, totaled \$43.8 million, or 18.0% of our gross loan portfolio.

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We originate fixed-rate mortgage loans at competitive interest rates. At September 30, 2004, \$16.2 million, or 6.7%, of our gross loan portfolio was comprised of fixed-rate single-family mortgage loans. Generally, in the current interest rate environment, we have been retaining fixed-rate mortgages with maturities of ten years or less while fixed-rate loans with longer maturities may be retained in the portfolio or sold in the secondary market.

We also offer adjustable-rate residential mortgage loans. The adjustable-rate loans we currently offer have interest rates which adjust every one, three or five years from the closing date of the loan or on an annual basis commencing after an initial fixed-rate period of three or five years in accordance with a designated index, plus a stipulated margin. The primary index we utilize is the weekly average yield on the one year U.S. Treasury securities adjusted to a constant comparable maturity equal to the loan adjustment period, as made available by the Federal Reserve Board (the "Treasury Rate"). The maximum adjustment on the bulk of our loans is 2% per adjustment period with a maximum aggregate adjustment of 6% over the life of the loan. We offer adjustable-rate mortgage loans that provide for initial rates of interest slightly below the rates that would prevail when the index used for repricing is applied, i.e., "teaser" rates. All of our adjustable-rate loans require that any payment adjustment resulting from a change in the interest rate of an adjustable-rate loan be sufficient to result in full amortization of the loan by the end of the loan term and, thus, do not permit any of the increased payment to be added to the principal amount of the loan, or so-called negative amortization. At September 30, 2004, \$25.2 million, or 57.5%, of our single-family residential mortgage loans were adjustable-rate loans.

The retention of adjustable-rate loans in our portfolio helps reduce our exposure to increases or decreases in prevailing market interest rates. However, there are unquantifiable credit risks resulting from potential increases in costs to borrowers in the event of upward repricing of adjustable-rate loans. It is possible that during periods of rising interest rates, the risk of default on adjustable-rate loans may increase due to increases in interest costs to borrowers. Further, although adjustable-rate loans allow us to increase the sensitivity of our interest-earning assets to changes in interest rates, the extent of this interest sensitivity is limited by the initial fixed-rate period before the first adjustment and the lifetime interest rate adjustment limitations. Accordingly, yields on our adjustable-rate loans may not fully

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adjust to compensate for increases in our cost of funds.

Commercial Real Estate Lending. Our commercial real estate loan portfolio includes loans secured by small office buildings, commercial and industrial buildings and small apartment buildings. These loans generally range in size from \$100,000 to \$4.2 million. At September 30, 2004, our commercial real estate loans totaled \$63.4 million, which amounted to 26.1%, of our gross loan portfolio. We originate commercial real estate loans for terms of up to 15 years and with interest rates that adjust daily based on our prime rate plus a negotiated margin typically up to 1% or that carry predetermined rates fixed for one, three or five years.

Commercial real estate lending entails significant additional risks as compared with single-family residential property lending. Commercial real estate loans typically involve larger loan balances to single borrowers or groups of related borrowers. The payment experience on such loans typically is dependent on the successful operation of the real estate project, retail establishment, apartment building or business. These risks can be significantly affected by supply and demand conditions in the market for office, retail and residential space, and, as such, may be subject to a greater extent to adverse conditions in the economy generally. To minimize these risks, we generally originate loans secured by collateral located in our market area or to borrowers with which we have prior experience or who are otherwise known to us. It has been our policy to obtain annual financial statements of the business of the borrower or the project for which commercial real estate loans are made. In addition, in the case of commercial mortgage loans made to a partnership or a corporation, we seek, whenever possible, to obtain personal guarantees and annual financial statements of the principals of the partnership or corporation.

Home Equity Loans. At September 30, 2004, we had approximately \$37.0 million in home equity line of credit loans, representing approximately 15.2% of our gross loan portfolio. Our home equity lines of credit generally have adjustable interest rates tied to our prime interest rate plus a margin. Home equity lines of credit must be repaid in 15 years or less and require monthly interest payments. Home equity lines of credit generally are secured by subordinate liens against residential real property. We require that fire and extended coverage casualty insurance and, if appropriate, flood insurance, be maintained in an amount at least sufficient to cover the loan. Home equity loans generally are limited so that the amount of such loans, along with any senior indebtedness, does not exceed 80% of the value of the real estate security. We have promoted home equity loans to our customers over the past few years and have seen growth in the outstanding balances of this category of loans.

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Construction Lending. We offer residential and commercial construction loans, with a significant portion of such loans originated to date being for the construction of owner-occupied, single-family dwellings in our market area. Residential construction loans are offered primarily to individuals building their primary or secondary residence, as well as to selected local developers to build single-family dwellings. In addition, on occasion, we make loans to selected local developers to acquire and develop land for sale to builders who will construct single-family residences in our market area. At September 30, 2004, \$24.7 million, or 10.2%, of our gross loan portfolio consisted of construction loans.

Generally, we originate loans to owner/occupants for the construction of owner-occupied, single-family residential properties in connection with the permanent loan on the property, and these loans have a construction term of six to 12 months. Interest rates on residential construction loans made to the

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owner/occupant have interest rates during the construction period equal to our prime rate. Upon completion of construction, the loan is converted into a one-year adjustable-rate loan, and the owner may lock in a fixed-rate loan at any time during the one-year period, or for a fee the borrower may lock in a market rate fixed-rate loan upon completion of the house.

We make construction loans to builders on either a pre-sold or speculative basis. However, we limit the number of outstanding loans on unsold homes under construction to individual builders, with the amount dependent on the financial strength of the builder, the present exposure of the builder, the location of the property and prior sales of homes in the development. At September 30, 2004, we have had speculative construction loans totaling \$10.1 million, or 4.2% of our gross loan portfolio. At September 30, 2004, the largest exposure to one borrower for speculative construction was \$1.5 million. Our residential construction loans to builders generally have adjustable interests rates set at our prime rate plus a margin typically up to 1% and adjust with changes in the prime rate, and are made for terms of up to 24 months.

Interest rates on commercial construction loans are based on the prime rate plus a negotiated margin typically up to 1%, adjustable, and are made for terms of up to 24 months, with construction terms generally not exceeding 12 months.

We make loans for the acquisition and development of land at a rate that adjusts daily, based on our prime rate plus a negotiated margin, for terms of up to three years. Interest only is paid during the term of the loan, and the principal balance of the loan is paid down as developed lots are sold to builders. At September 30, 2004, \$4.5 million of our gross loan portfolio consisted of acquisition and development loans. We had 11 such loans and all of these loans were performing in accordance with their terms at such date.

Prior to making a commitment to fund a construction loan, we require an appraisal of the property by appraisers approved by our board of directors. We also review and inspect each project at the commencement of construction and periodically during the term of the construction loan. We may charge a construction fee and/or an inspection fee on construction loans. Advances are made on a percentage of completion basis.

We consider construction financing generally to involve a higher degree of risk of loss than long-term financing on improved, occupied real estate. Risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property's value at completion of construction or development and the estimated cost, including interest, of construction. During the construction phase, a number of factors could result in delays and cost overruns. If the estimate of construction costs proves to be inaccurate and the borrower is unable to meet our requirements of putting up additional funds to cover extra costs or change orders, then we will demand that the loan be paid off and, if necessary, institute foreclosure proceedings or refinance the loan. If the estimate of value proves to be inaccurate, the collateral may not have sufficient value to assure full repayment. We have sought to minimize this risk by limiting construction lending to borrowers based in Alamance County who satisfy all credit requirements and whose loans satisfy all other underwriting standards which would apply to our permanent mortgage loan financing for the subject property. On loans to builders, we work only with selected builders with whom we have experience and carefully monitor the creditworthiness of the builders.

Commercial Lending. We originate commercial loans to small and medium-sized businesses in our market area. Our commercial borrowers are generally small businesses engaged in manufacturing, distribution or retailing, or professionals in healthcare, accounting and law. Commercial loans generally are made to finance the purchase of inventory, new or used equipment or

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commercial vehicles and for short-term working capital. Such loans generally

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are secured by equipment and inventory, and, if possible, cross-collateralized by a real estate mortgage, although commercial loans are sometimes granted on an unsecured basis. Commercial loans generally are made for terms of five years or less, depending on the purpose of the loan and the collateral, with loans to finance operating expenses made for one year or less, with interest rates that adjust at least annually at a rate equal to our prime rate plus a margin typically up to 2%. Generally, we make commercial loans in amounts ranging between \$50,000 and \$1.0 million. At September 30, 2004, commercial loans totaled \$69.6 million, or 28.6%, of our gross loan portfolio.

We underwrite commercial loans on the basis of the borrower's cash flow and ability to service the debt from earnings rather than on the basis of underlying collateral value, and we seek to structure such loans to have more than one source of repayment. The borrower is required to provide us with sufficient information to allow us to make our lending determination. In most instances, this information consists of at least two years of financial statements, a statement of projected cash flows, current financial information on any guarantor and any additional information on the collateral. For loans with maturities exceeding one year, we require that borrowers and guarantors provide updated financial information at least annually throughout the term of the loan.

Our commercial loans may be structured as term loans or as lines of credit. Commercial term loans are generally made to finance the purchase of assets and have maturities of five years or less. Commercial lines of credit are typically made for the purpose of providing working capital and are usually reviewed on an annual basis but may be called on demand. We also offer standby letters of credit for commercial borrowers. Standby letters of credit are written for a maximum term of one year.

Commercial loans are often larger and may involve greater risk than other types of lending. Because payments on commercial loans are often dependent on successful operation of the business involved, repayment of such loans may be subject to a greater extent to adverse conditions in the economy. We seek to minimize these risks through our underwriting guidelines, which require that the loan be supported by adequate cash flow of the borrower, profitability of the business, collateral and personal guarantees of the individuals in the business. In addition, we limit this type of lending to our market area and to borrowers with which we have prior experience or who are otherwise well known to us.

Consumer Lending. Our consumer loans include automobile loans, savings account loans, unsecured lines of credit and miscellaneous other consumer loans, including unsecured loans. At September 30, 2004, our consumer loans totaled \$4.6 million, or 1.9%, of our gross loan portfolio.

We generally underwrite automobile loans in amounts up to 80% of the lesser of the purchase price of the automobile or, with respect to used automobiles, the value as published by the National Automobile Dealers Association. The terms of most such loans do not exceed 60 months. We require that the vehicles be insured and that we be listed as loss payee on the insurance policy.

We make savings account loans for up to 90% of the depositor's savings account balance. The interest rate is normally 2.5% above the annual percentage yield paid on the savings account. The account must be pledged as collateral to secure the loan. Interest generally is paid on a monthly basis.

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Consumer lending affords us the opportunity to earn yields higher than those obtainable on single-family residential lending. However, consumer loans entail greater risk than do residential mortgage loans, particularly in the case of loans which are unsecured, as is the case with lines of credit, or secured by rapidly depreciable assets such as automobiles. Repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by events such as job loss, divorce, illness or personal bankruptcy. Further, the application of various state and federal laws, including federal and state bankruptcy and insolvency law, may limit the amount which may be recovered. In underwriting consumer loans, we consider the borrower's credit history, an analysis of the borrower's income and ability to repay the loan, and the value of the collateral.

Loan Fees and Servicing. We receive fees in connection with late payments and for miscellaneous services related to our loans and deposits. We also charge fees in connection with certain real estate loan

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originations. These fees can consist of origination, discount, application, construction and/or commitment fees, depending on the type of loan. Loan origination fees collected in excess of certain direct loan origination costs are deferred, and the net fee or cost is recognized over the contractual life of the related loans as an adjustment of the loan yield. In recent years, the net deferred loan origination fees have decreased as the result of a decrease in the underlying loans through refinancings, payoffs, sales and ongoing amortization. During this same time period, our net deferred loan origination costs have increased as a result of growth in commercial and home equity lines. We generally do not service loans for others except for mortgage loans we originate and sell with servicing retained. Mortgage servicing rights were \$493,000 and \$547,000 at September 30, 2004 and 2003, respectively. See Note 1 of Notes to Consolidated Financial Statements.

Nonperforming Loans and Other Problem Assets. We continually monitor our loan portfolio to anticipate and address potential and actual delinquencies. When a borrower fails to make a payment on a loan, we take immediate steps to have the delinquency cured and the loan restored to current status. Loans which are delinquent more than 15 days incur a late fee of 4% of the monthly payment of principal and interest due. As a matter of policy, we will contact the borrower after the loan has been delinquent 15 days. If payment is not promptly received, we contact the borrower again, and we try to formulate an affirmative plan to cure the delinquency. Generally, after any loan is delinquent 45 days or more, we send a default letter to the borrower. If the default is not cured after 30 days, we commence formal legal proceedings to collect amounts owed.

Generally we charge off, or reserve through an allowance for uncollected interest account, interest on loans, including impaired loans, that are contractually 90 days or more past due. The allowance for uncollected interest is established by a charge to interest income equal to all interest previously accrued. In certain circumstances, interest on loans that are contractually 90 days or more past due is not charged off or reserved through an allowance for uncollected interest account when we believe that the loan is both well secured and in the process of collection. If amounts are received on loans for which the accrual of interest has been discontinued, we decide whether payments received should be recorded as a reduction of the principal balance or as interest income

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depending on our analysis of the collectibility of principal. The loan is returned to accrual status when we believe the borrower has demonstrated the ability to make periodic interest and principal payments on a timely basis.

We classify real estate acquired as a result of foreclosure as real estate acquired in settlement of loans until such time as it is sold and is recorded at the lower of the estimated fair value of the underlying real estate, less costs to sell the property, or the carrying amount of the loan. Subsequent costs directly related to development and improvement of property are capitalized, whereas costs related to holding the property are expensed. We charge any required write-down of the loan to its fair value less estimated selling costs upon foreclosure against the allowance for loan losses. See Note 1 of Notes to Consolidated Financial Statements.

The following table sets forth information with respect to our nonperforming assets at the dates indicated. At the dates shown, we had no restructured loans within the meaning of Statement of Financial Accounting Standards No. 114, as amended.

| | At September 30 | | |
|--|------------------------|------------|------------|
| | 2004 | 2003 | 2002 |
| | (Dollars in thousands) | | |
| Loans accounted for on a nonaccrual basis (1) | \$ 3,962 | \$ 4,153 | \$ 4,204 |
| Accruing loans which are contractually past due | | | |
| 90 days or more | \$ -- | \$ -- | \$ -- |
| Total nonperforming loans | \$ 3,962 | \$ 4,153 | \$ 4,204 |
| Total loans | \$ 235,719 | \$ 229,581 | \$ 223,779 |
| Non-performing loans as a percentage of total loans .. | 1.68% | 1.81% | 1.88% |
| Other nonperforming assets (2) | \$ 17 | \$ 95 | \$ 183 |
| Loans modified in troubled debt restructuring | \$ -- | \$ -- | \$ -- |

(1) Payments received on a nonaccrual loan are either applied to the outstanding principal balance or recorded as interest income, depending on management's assessment of the collectibility of the loan.

(2) Other nonperforming assets consist of property acquired through foreclosure or repossession.

During the year ended September 30, 2004, gross interest income of \$223,000 would have been recorded on loans accounted for on a nonaccrual basis if the loans had been current throughout the year. Interest on such loans

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included in income during the year ended September 30, 2004 amounted to \$208,000.

At September 30, 2004, there were no loans which are not currently classified as nonaccrual, 90 days past due or restructured, but where known information about possible credit problems of borrowers 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 "-- Classified Assets" for information regarding classified assets.

At September 30, 2004, we had \$4.0 million of nonaccrual loans, which consisted of two one-to four- family mortgage loans, one construction loan, 12 commercial and commercial real estate loans and three consumer loans. At September 30, 2004, real estate owned totaled \$17,000. Real estate owned consists of one residential lot in Graham, North Carolina. This lot has been sold and is expected to close during the quarter ended December 31, 2004.

At September 30, 2004, we had impaired loans with two unrelated borrowers of \$3.6 million of which all were on nonaccrual status. The related allowance for loan losses on these loans was \$300,000. The average carrying value of impaired loans was \$3.7 million for the year ended September 30, 2004. These loans are primarily secured by business assets and real estate properties in Alamance County.

Classified Assets. Regulations require that we classify our assets on a regular basis. In addition, in connection with examinations of insured institutions, examiners have authority to identify problem assets and if appropriate, classify them in their reports of examination. There are three regulatory classifications for problem assets: "substandard," "doubtful" and "loss." Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, questionable, and there is a high possibility of loss. An asset classified as loss is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. Assets classified as substandard or doubtful require a financial institution to establish general allowances for loan losses. If an asset or portion thereof is classified as loss, a financial institution must either establish a specific allowance for loan losses in the amount of the portion of the asset classified loss, or charge off such amount. 1st State Bank regularly reviews its assets to determine whether any assets require classification or re-classification. At September 30, 2004, we had \$4.7 million in classified assets, consisting of \$4.7 million in substandard loans and \$17,000 in other 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 be classified or become nonperforming assets in the future. At September 30, 2004, we have identified approximately \$5.3 million in assets classified as special mention and \$24.8 million as watch.

Allowance for Loan Losses. We maintain the allowance for loan losses at a level we believe to be adequate to absorb probable losses in the portfolio. Our determination of the adequacy of the allowance is based on an evaluation of the portfolio, past loss experience, current economic conditions, volume, growth and composition of the portfolio, and other relevant factors. The allowance is increased by provisions for loan losses which are charged against income.

Although we believe we use the best information available to make

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determinations with respect to the allowance for loan losses and believe such allowances are adequate, future adjustments may be necessary if economic conditions differ substantially from the economic conditions in the assumptions used in making the initial determinations. We anticipate that our allowance for loan losses will increase in the future as we implement the board of directors' strategy of continuing existing lines of business while gradually expanding commercial and consumer lending, which loans generally entail greater risks than single-family residential mortgage loans.

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 prior loss experience, volume and type of

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lending we conduct, industry standards and past due loans in our loan portfolio. 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. 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 \$240,000, charge-offs were \$141,000 and recoveries were \$1,000 for the year ended September 30, 2004 compared with a provision of \$240,000, charge-offs of \$117,000 and recoveries of \$1,000 for the year ended September 30, 2003.

The allowance for loan losses was \$4.0 million at September 30, 2004 and \$3.9 million at September 30, 2003, which we think is adequate to absorb probable losses in the loan portfolio. As a result of our continued shift toward higher risk commercial, consumer and home equity loans as well as the sluggish local and regional economy, the ratio of the allowance for loan losses to total loans, net of loans in process and deferred loan fees was 1.68% at September 30, 2004 unchanged from September 30, 2003. While management uses the best information available to make evaluations, future adjustments to the allowance may be necessary based on changes in economic and other conditions. Additionally, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the recognition of adjustments to the allowance for loan losses based on their judgments of information available to them at the time of their examinations.

Banking regulatory agencies, including the FDIC, have adopted a policy statement regarding maintenance of an adequate allowance for loan and lease losses and an effective loan review system. This policy includes an arithmetic formula for checking the reasonableness of an institution's allowance for loan loss estimate compared to the average loss experience of the industry as a whole. Examiners will generally review an institution's allowance for loan losses and compare it against the sum of:

- o 50% of the portfolio that is classified doubtful;
- o 15% of the portfolio that is classified as substandard; and
- o for the portions of the portfolio that have not been classified, including those loans designated as special mention, estimated credit losses over the upcoming 12 months given the facts and circumstances as of the evaluation date.

This amount is considered neither a "floor" nor a "safe harbor" of the level of

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allowance for loan losses an institution should maintain, but examiners will view a shortfall relative to the amount as an indication that they should review management's policy on allocating these allowances to determine whether it is reasonable based on all relevant factors.

We have our own allowance for loan loss model which is similar to the FDIC model, but uses different factors and assumptions to arrive at an estimate of the allowance for loan losses under accounting principles generally accepted in the United States of America. Our model indicated that the allowance for loan losses was adequate at September 30, 2004.

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

| | Year Ended September 30, | | | |
|--|--------------------------|-----------|-----------|-----------|
| | 2004 | 2003 | 2002 | 2001 |
| | (Dollars in thousands) | | | |
| Balance at beginning of period | \$ 3,856 | \$ 3,732 | \$ 3,612 | \$ 3,536 |
| Loans charged off: | | | | |
| Commercial real estate | -- | -- | -- | 125 |
| 1-4 family residential | 122 | -- | 85 | 19 |
| Commercial | -- | 96 | -- | -- |
| Consumer | 19 | 21 | 36 | 24 |
| Total | 141 | 117 | 121 | 168 |
| Recoveries | 1 | 1 | 1 | 4 |
| Net loans charged off | 140 | 116 | 120 | 164 |
| Provision for loan losses | 240 | 240 | 240 | 240 |
| Balance at end of period | \$ 3,956 | \$ 3,856 | \$ 3,732 | \$ 3,612 |
| Average loans outstanding | \$229,225 | \$227,951 | \$219,071 | \$229,058 |
| Ratio of net loans charged off to average loans outstanding during the period | 0.0611% | 0.0509% | 0.0548% | 0.0716% |

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The following table allocates the allowance for loan losses by loan category at the dates indicated. The allocation of the allowance to each

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category is not necessarily indicative of future losses and does not restrict the use of the allowance to absorb losses in any category.

| | At September 30, | | | | |
|------------------------------------|------------------|--|----------------|--|------------------------|
| | 2004 | | 2003 | | |
| | Amount | Percent of Loans in Category to Total Loans | Amount | Percent of Loans in Category to Total Loans | |
| | | | | | (Dollars in thousands) |
| Real estate mortgage: | | | | | |
| Single-family residential | \$ 217 | 18.00% | \$ 222 | 21.04% | \$ |
| Commercial | 1,118 | 26.07 | 1,084 | 27.09 | 1, |
| Home equity | 201 | 15.22 | 182 | 12.44 | |
| Construction | 449 | 10.17 | 240 | 7.14 | |
| Commercial | 1,858 | 28.64 | 1,987 | 29.87 | 1, |
| Consumer | 113 | 1.90 | 141 | 2.42 | |
| Total allowance for loan losses .. | <u>\$3,956</u> | <u>100.00%</u> | <u>\$3,856</u> | <u>100.00%</u> | <u>\$3,</u> |

| | At September 30, | | | | |
|------------------------------------|------------------|--|----------------|--|------------------------|
| | 2001 | | 2000 | | |
| | Amount | Percent of Loans in Category to Total Loans | Amount | Percent of Loans in Category to Total Loans | |
| | | | | | (Dollars in thousands) |
| Real estate mortgage: | | | | | |
| Single-family residential | \$ 253 | 37.33% | \$ 320 | 41.27% | |
| Commercial | 932 | 17.60 | 1,084 | 19.59 | |
| Home equity | 131 | 9.52 | 179 | 8.94 | |
| Construction | 231 | 8.26 | 213 | 9.26 | |
| Commercial | 1,970 | 24.46 | 1,616 | 18.09 | |
| Consumer | 95 | 2.83 | 124 | 2.85 | |
| Total allowance for loan losses .. | <u>\$3,612</u> | <u>100.00%</u> | <u>\$3,536</u> | <u>100.00%</u> | |

Investment Activities

General. Interest income from investment securities generally provides our second largest source of income after interest on loans. Our board of directors has authorized investment in U.S. Government and agency securities, state government obligations, municipal securities, obligations of the Federal Home Loan Bank, and mortgage-backed securities issued by the Federal National

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Mortgage Association, the Government National Mortgage Association and the Federal Home Loan Mortgage Corporation. Our objective is to use these investments to reduce interest rate risk, enhance yields on assets and provide liquidity. At September 30, 2004, the amortized cost of our investment securities portfolio amounted to \$120.3 million, which included \$116.3 million of U.S. Government and agency securities, \$4.0 million of North Carolina municipal bonds, and \$7,000 of collateralized mortgage obligations ("CMOs"). At that date, we had an unrealized loss of \$402,000, net of deferred taxes, with respect to our investment securities classified as "available for sale." Additions to the investment portfolio depend to a large extent on the availability of investable funds that are not otherwise needed to satisfy loan demand. If loan demand is not present, the Company may invest in securities to produce interest income.

The board of directors has established an investment policy that sets forth investment and aggregate investment limitations and credit quality parameters of each class of investment security. Securities purchases are subject to the oversight of our Executive Committee. The President has authority to make specific investment decisions within the parameters determined by the board of directors.

We had securities with an aggregate cost of \$97.4 million and an approximate fair value of \$96.7 million at September 30, 2004 classified as available for sale. The impact on our financial statements was an after-tax decrease in stockholders' equity of approximately \$402,000 as of September 30, 2004. The net unrealized losses at September 30, 2003 in our portfolio of investment securities were due to increases in interest rates and a steepening of the yield curve after we bought the securities. Upon acquisition, we classify securities as to our intent. Securities designated as "held to maturity" are those assets which we have the ability and intent to hold to maturity. The held to maturity investment portfolio is not used for speculative purposes and is carried at amortized cost. Securities designated as "available for sale" are those assets which we may not hold to maturity and thus are carried at fair value with unrealized gains or losses, net of tax effect, recognized in stockholders' equity.

At September 30, 2004, we had \$97.4 million of U.S. Government and agency securities classified as available for sale, which carry unrealized after-tax losses of \$402,000, and \$22.9 million of investment securities classified as held to maturity. We attempt to maintain a high degree of liquidity in our investment securities portfolio by choosing those securities that are readily marketable. As of September 30, 2004, the estimated weighted average life of our U.S. Government and agency securities classified as available for sale was approximately 6.1 years, and the average yield on our portfolio of U.S. Government and agency securities classified as available for sale was 4.11%. In addition, at September 30, 2004, we had \$2.3 million of FHLB of Atlanta stock.

See Notes 1 and 3 of the Notes to Consolidated Financial Statements for a description of our accounting policies.

The following table sets forth the carrying value of our investment securities portfolio at the dates indicated.

| | At September 30, | | |
|---|------------------|----------|----------|
| | 2004 | 2003 | 2002 |
| | (In thousands) | | |
| Securities available for sale: | | | |
| U.S. Government and agency securities | \$96,693 | \$91,709 | \$78,572 |
| Total | \$96,693 | \$91,709 | \$78,572 |

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| | ===== | ===== | ===== |
|---|----------|----------|----------|
| Securities held to maturity: | | | |
| U.S. Government and agency securities | \$18,959 | \$16,408 | \$ 8,430 |
| Municipal bonds | 3,953 | 3,044 | 2,670 |
| CMOs | 7 | 10 | 14 |
| | ----- | ----- | ----- |
| Total | \$22,919 | \$19,462 | \$11,114 |
| | ===== | ===== | ===== |

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The following table sets forth the scheduled maturities, carrying values, amortized cost and average yields for our investment securities at September 30, 2004.

| | One Year or Less | | One to Five Years | | F |
|---|------------------|---------------|----------------------------|---------------|-------|
| | Carrying Value | Average Yield | Carrying Value | Average Yield | |
| | ----- | ----- | ----- | ----- | ----- |
| | | | (Dollars in thousands) | | |
| Securities available for sale: | | | | | |
| U.S. Government and agency securities | \$ -- | --% | \$26,806 | 3.46% | \$6 |
| | ===== | ===== | ===== | ===== | ===== |
| Securities held to maturity: | | | | | |
| U.S. Government and agency securities | -- | -- | 2,992 | 3.42 | 1 |
| CMOs | -- | -- | -- | -- | -- |
| Municipal bonds (1) | 250 | 4.84 | 1,385 | 5.29 | -- |
| | ----- | ----- | ----- | ----- | ----- |
| Total | \$ 250 | 4.84% | \$ 4,377 | 4.01% | \$1 |
| | ===== | ===== | ===== | ===== | ===== |
| | | | Total Investment Portfolio | | |
| | Carrying Value | Average Yield | Carrying Value | Market Value | A |
| | ----- | ----- | ----- | ----- | ----- |
| | | | (Dollars in thousands) | | |
| Securities available for sale: | | | | | |
| U.S. Government and agency securities | \$ 3,002 | 5.48% | \$96,693 | \$96,693 | == |
| | ===== | ===== | ===== | ===== | ===== |
| Securities held to maturity: | | | | | |
| U.S. Government and agency securities | 4,994 | 4.00 | 18,959 | 18,902 | -- |
| CMOs | 7 | 2.43 | 7 | 7 | -- |
| Municipal bonds (1) | 283 | 6.15 | 3,953 | 3,975 | -- |
| | ----- | ----- | ----- | ----- | ----- |
| Total | \$ 5,284 | 4.11% | \$22,919 | \$22,884 | == |
| | ===== | ===== | ===== | ===== | ===== |

- (1) Yields on tax-exempt municipal bonds have been adjusted to a tax equivalent basis.

Deposit Activity and Other Sources of Funds

General. Deposits are our primary source of funds for lending, investment activities and general operational purposes. In addition to deposits, we derive funds from loan principal and interest repayments, maturities of investment securities and interest payments thereon. Although loan repayments are a relatively stable source of funds, deposit inflows and outflows are significantly influenced by general interest rates and money market conditions. Borrowings may be used on a short-term basis to compensate for reductions in the availability of funds, or on a longer term basis for general operational purposes. We have access to FHLB of Atlanta advances as a source of borrowings.

Deposits. We attract deposits principally from within Alamance County by offering a variety of deposit instruments, including checking accounts, money market accounts, passbook and statement savings accounts, Individual Retirement Accounts and certificates of deposit which range in maturity from seven days to five years. Deposit terms vary according to the minimum balance required, the length of time the funds must remain on deposit and the interest rate. Maturities, terms, service fees and withdrawal penalties for our deposit accounts are established by us on a periodic basis. We review our deposit pricing on a weekly basis. In determining the characteristics of our deposit accounts, we consider the rates offered by competing institutions, lending and liquidity requirements, growth goals and applicable regulations. We believe we price our deposits comparably to rates offered by our competitors. We do not accept brokered deposits.

We compete for deposits with other institutions in our market area by offering competitively priced deposit instruments that are tailored to the needs of our customers. Additionally, we seek to meet customers' needs by providing convenient customer service to the community, efficient staff and convenient hours of service. Substantially all of our depositors are North Carolina residents. To provide additional convenience, we participate in the STAR and CIRBUS Automatic Teller Machine networks at locations throughout the world, through which customers can gain access to their accounts at any time. To better serve our customers, we have installed automatic teller machines at six office locations.

Our deposits at September 30, 2004 consisted of the various types of programs described below.

| Weighted Average Interest Rate | Minimum Term | Category | Minimum Amount | Bala Tho |
|---|-----------------|----------|-------------------|-------------|
| ---- | ---- | ----- | ----- | ---- |

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| | | | | |
|-------|---------------|---|---------|------|
| 0.00% | None | Noninterest bearing accounts | \$ 100 | \$ 1 |
| 0.24 | None | Checking accounts | 300 | 3 |
| 0.61 | None | Passbook and statement savings accounts | 100 | 3 |
| 0.84 | None | Money market accounts | 1,000 | 1 |
| | | Certificates of Deposit | | |
| | | ----- | | |
| 1.51 | 3 months | Fixed-term, fixed-rate | 500 | |
| 1.32 | 6 months | Fixed-term, fixed-rate | 500 | |
| 1.02 | 7 months (1) | Fixed-term, fixed-rate | 5,000 | 5 |
| 1.49 | 9 months | Fixed-term, fixed-rate | 500 | |
| 1.10 | 10 months | Fixed-term, fixed-rate | 5,000 | |
| 1.30 | 12 months | Fixed-term, fixed-rate | 500 | 2 |
| 1.70 | 15 months | Fixed-term, fixed-rate | 5,000 | 1 |
| 1.29 | 18 months | Floating rate individual retirement account | 50 | |
| 1.69 | 18 months | Fixed-term, fixed-rate | 500 | |
| 1.64 | 20 months | Fixed-term, fixed-rate | 500 | |
| 1.95 | 21 months | Fixed-term, fixed-rate | 10,000 | |
| 1.93 | 24 months | Fixed-term, fixed-rate | 500 | |
| 2.54 | 30 months | Fixed-term, fixed-rate | 500 | |
| 2.91 | 36 months | Fixed-term, fixed-rate | 500 | |
| 3.66 | 48 months | Fixed-term, fixed-rate | 500 | |
| 4.18 | 60 months | Fixed-term, fixed-rate | 500 | 2 |
| 1.92 | 7 to 365 days | Fixed-term, fixed-rate | 100,000 | 2 |
| 1.29 | | | | \$26 |
| | | | | === |

- (1) These certificates of deposit do not carry a penalty for early withdrawal. As a result, we believe that should interest rates increase materially after September 30, 2004, borrowers may withdraw funds invested in these certificates prior to maturity, causing our cost of funds to increase.

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The following table sets forth the distribution of our deposit accounts at the dates indicated and the change in dollar amount of deposits in the various types of accounts we offer between the dates indicated.

| | Balance at September 30, 2004 | % of Deposits | Increase (Decrease) | Balance at September 2003 |
|---|-------------------------------------|------------------|------------------------|---------------------------------|
| | ----- | ----- | ----- | ----- |
| | (Dollars in thousands) | | | |
| Noninterest bearing accounts | \$ 17,417 | 6.6% | \$ 3,838 | \$ 13,57 |
| Interest bearing checking accounts | 35,299 | 13.5 | (169) | 35,46 |
| Money market accounts | 19,475 | 7.4 | 979 | 18,49 |
| Passbook and statement savings accounts . | 30,263 | 11.5 | (271) | 30,53 |
| Certificates of deposit | 160,280 | 61.0 | (4,355) | 164,63 |
| | ----- | ----- | ----- | ----- |
| | \$ 262,734 | 100.0% | \$ 22 | \$ 262,71 |
| | ===== | ===== | ===== | ===== |

Balance at

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| | September 30, 2002 | % of Deposits |
|---|------------------------|------------------|
| | ----- | ----- |
| | (Dollars in thousands) | |
| Noninterest bearing accounts | \$ 13,527 | 5.2% |
| Interest bearing checking accounts | 32,432 | 12.4 |
| Money market accounts | 21,360 | 8.2 |
| Passbook and statement savings accounts . | 29,228 | 11.2 |
| Certificates of deposit | 164,120 | 63.0 |
| | ----- | ----- |
| | \$ 260,667 | 100.0% |
| | ===== | ===== |

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The following table sets forth the average balances and average interest rates based on daily balances for various types of deposits at the dates indicated for each category of deposits presented.

| | Year Ended September | | | |
|---|-----------------------|-----------------|--------------------|---------|
| | 2004 | | 2003 | |
| | Average Balance | Average Rate | Average Balance | Av R |
| | ----- | ----- | ----- | ----- |
| | (Dollars in thousand) | | | |
| Noninterest bearing accounts | \$ 15,596 | 0.00% | \$ 13,508 | 0 |
| Interest bearing checking accounts | 36,087 | 0.21 | 33,894 | 0 |
| Money market accounts | 19,951 | 0.70 | 22,042 | 0 |
| Passbook and statement savings accounts ... | 30,534 | 0.61 | 30,024 | 0 |
| Certificates of deposit | 159,246 | 1.91 | 156,116 | 2 |
| | ----- | | ----- | |
| Total | \$261,414 | 1.32 | \$255,584 | 1 |
| | ===== | | ===== | |

The following table sets forth our time deposits classified by rates at the dates indicated.

| | At September 30, | | |
|--------------------|------------------|-----------|-----------|
| | 2004 | 2003 | 2002 |
| | ----- | ----- | ----- |
| | (In thousands) | | |
| Rate | | | |
| ----- | | | |
| 0.00 - 1.99% | \$113,018 | \$110,007 | \$ 16,772 |
| 2.00 - 3.99% | 36,106 | 37,615 | 118,554 |
| 4.00 - 5.99% | 9,024 | 13,160 | 23,125 |
| 6.00 - 7.99% | 2,132 | 3,853 | 5,525 |
| 8.00 - 9.99% | -- | -- | 144 |
| | ----- | ----- | ----- |
| | \$160,280 | \$164,635 | \$164,120 |
| | ===== | ===== | ===== |

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The following table sets forth the amount and maturities of our time deposits at September 30, 2004.

| Rate | Amount Due | | | | |
|------------------|-----------------------|-----------|-----------|-----------|----------------|
| | Less Than One Year | 1-2 Years | 2-3 Years | 3 Years | After Total |
| | (In thousands) | | | | |
| 0.00 - 1.99% ... | 107,277 | 5,349 | 392 | -- | 113,018 |
| 2.00 - 3.99% ... | 16,616 | 6,516 | 2,416 | 10,558 | 36,106 |
| 4.00 - 5.99% ... | 1,551 | 2,671 | 4,446 | 356 | 9,024 |
| 6.00 - 7.99% ... | 1,239 | 893 | -- | -- | 2,132 |
| | \$126,683 | \$ 15,429 | \$ 7,254 | \$ 10,914 | \$160,280 |

The following table indicates the amount of our certificates of deposit of \$100,000 or more by time remaining until maturity as of September 30, 2004. At that date, such deposits represented 23.2% of total deposits and had a weighted average rate of 1.88%.

| Maturity Period | Certificates of Deposit |
|-------------------------------------|----------------------------|
| | (In thousands) |
| Three months or less | \$29,825 |
| Over three through six months | 11,844 |
| Over six through 12 months | 10,598 |
| Over 12 months | 8,684 |
| Total | \$60,951 |

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We estimate that more than \$34.7 million of certificates of deposit in amounts of \$100,000 or more maturing within one year of September 30, 2004 were held by our retail and commercial customers, while the remainder of such deposits were from schools, municipalities and other public entities and were obtained through competitive rate bidding. We believe certificates of deposit held by our retail and commercial customers are more likely to be renewed upon maturity than certificates of deposit obtained through competitive bidding.

The following table sets forth our savings activities for the periods indicated.

| Year Ended September 30, | | |
|--------------------------|------|------|
| 2004 | 2003 | 2002 |
| (In thousands) | | |

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| | | | |
|--|------------|------------|----------|
| Net increase (decrease) before interest credited ... | \$ (2,665) | \$ (1,636) | \$ 6,729 |
| Interest credited | 2,687 | 3,681 | 5,568 |
| | ----- | ----- | ----- |
| Net increase in deposits | \$ 22 | \$ 2,045 | \$12,297 |
| | ===== | ===== | ===== |

Borrowings. Savings deposits historically have been the primary source of funds for our lending, investments and general operating activities. We are authorized, however, to use advances from the FHLB of Atlanta to supplement our supply of lendable funds and to meet deposit withdrawal requirements. The FHLB of Atlanta functions as a central reserve bank providing credit for member financial institutions. As a member of the FHLB system, we are required to own stock in the FHLB of Atlanta and are authorized to apply for advances. Advances are obtained pursuant to several different programs, each of which has its own interest rate and range of maturities. We have a blanket agreement for advances with the FHLB under which we may borrow up to 16% of assets subject to normal collateral and underwriting requirements. Advances from the FHLB of Atlanta are secured by our stock in the FHLB of Atlanta and other eligible assets. During the year ended September 30, 2004, we used short-term advances to fund LIBOR-based loans as part of our asset liability strategy.

The following table sets forth certain information regarding our borrowings at the dates and for the periods indicated:

| | At or for the Year Ended September 30, | | |
|--|---|----------|----------|
| | 2004 | 2003 | 2002 |
| | ----- | ----- | ----- |
| | (Dollars in thousands) | | |
| Amounts outstanding at end of period: | | | |
| FHLB advances | \$44,000 | \$31,500 | \$20,000 |
| Weighted average rate paid on: | | | |
| FHLB advances | 3.62% | 3.90% | 5.39% |
| | | | |
| | For the Year Ended September 30, | | |
| | 2004 | 2003 | 2002 |
| | ----- | ----- | ----- |
| | (Dollars in thousands) | | |
| Maximum amount of borrowings outstanding at any month end: | | | |
| FHLB advances | \$48,500 | \$39,500 | \$35,000 |
| Average amounts outstanding: | | | |
| FHLB advances | \$37,692 | \$23,115 | \$21,811 |
| Approximate weighted average rate paid on (1): | | | |
| FHLB advances | 3.56% | 4.84% | 5.05% |

(1) Based on month-end balances.

Subsidiary Activities

In prior years, we had one subsidiary, First Capital Services, Inc., a North Carolina corporation ("First Capital"), that engaged in sales of annuities, mutual funds and insurance products on an agency basis. In September 1997, that corporation transferred its assets and liabilities to a newly formed North Carolina limited liability company, First Capital Services Company, LLC (the "LLC"), and the corporation was dissolved. 1st State Bank is the sole member of the LLC, and since the transfer of assets and liabilities, the LLC has conducted the activities previously conducted by First Capital. We earned \$153,000, \$258,000 and \$258,000 on a pre-tax basis from the activities of the LLC during the years ended September 30, 2004, 2003 and 2002, respectively.

Competition

We face strong competition in originating real estate, commercial business and consumer loans and in attracting deposits. We compete for real estate and other loans principally on the basis of interest rates, the types of loans we originate, the deposit products we offer and the quality of services we provide to our customers. We also compete by offering products which are tailored to the local community. Our competition in originating real estate loans comes primarily from savings institutions, commercial banks, mortgage bankers and mortgage brokers. Commercial banks, credit unions and finance companies provide vigorous competition in consumer lending. Competition may increase as a result of the continuing reduction of restrictions on the interstate operations of financial institutions.

We attract our deposits through our branch offices primarily from the local communities. Consequently, competition for deposits is principally from savings institutions, commercial banks, credit unions and brokers in our primary market area. We compete for deposits and loans by offering what we believe to be a variety of deposit accounts at competitive rates, convenient business hours, a commitment to outstanding customer service and a well-trained staff. We believe we have developed strong relationships with local realtors and the community in general.

We consider our primary market area for gathering deposits and originating loans to be Alamance County in north central North Carolina, which is the county in which our offices are located. Based on data provided by a private marketing firm, we estimate that at June 30, 2004, we had 13.2% of deposits held by all banks and savings institutions in our market area.

Employees

As of September 30, 2004, we had 72 full-time and 7 part-time employees, none of whom were represented by a collective bargaining agreement. We believe that our relationship with our employees is good.

Depository Institution Regulation

General. We are a North Carolina chartered commercial bank and a member of the FHLB of Atlanta, and our deposits are insured by the FDIC through the Savings Association Insurance Fund administered by the FDIC. 1st State Bank is subject to supervision, examination and regulation by the North Carolina Banking Commission and the FDIC and to North Carolina and federal statutory and regulatory provisions governing such matters as capital standards, mergers, subsidiary investments and establishment of branch offices. We are also subject to the FDIC's authority to conduct special examinations. 1st State Bank is required to file reports with the North Carolina Banking Commission and the FDIC

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concerning its activities and financial condition and is required to obtain regulatory approvals prior to entering into certain transactions, including mergers with, or acquisitions of, other depository institutions.

As a federally insured depository institution, 1st State Bank is subject to various regulations promulgated by the Federal Reserve Board, including Regulation B (Equal Credit Opportunity), Regulation D (Reserve Requirements), Regulation E (Electronic Fund Transfers), Regulation Z (Truth in Lending), Regulation CC (Availability of Funds and Collection of Checks) and Regulation DD (Truth in Savings).

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The system of regulation and supervision applicable to us establishes a comprehensive framework for our operations and is intended primarily for the protection of the FDIC and our depositors. Changes in the regulatory framework could have a material effect on us and our operations.

Financial Modernization Legislation. On November 12, 1999, legislation was enacted which has had a far-reaching impact on the financial services industry. The Gramm-Leach-Bliley ("G-L-B") Act authorizes affiliations between banking, securities and insurance firms and authorizes bank holding companies and national banks to engage in a variety of new financial activities. Among the new activities that are permitted to bank holding companies are securities and insurance brokerage, securities underwriting, insurance underwriting and merchant banking. The Federal Reserve Board, in consultation with the Secretary of the Treasury, may approve additional financial activities. The G-L-B Act, however, prohibits future acquisitions of existing unitary savings and loan holding companies by firms which are engaged in commercial activities and limits the permissible activities of unitary holding companies formed after May 4, 1999.

The G-L-B Act imposes new requirements on financial institutions with respect to customer privacy. The G-L-B Act generally prohibits disclosure of customer information to non-affiliated third parties unless the customer has been given the opportunity to object and has not objected to such disclosure. Financial institutions are further required to disclose their privacy policies to customers annually. Financial institutions, however, will be required to comply with state law if it is more protective of customer privacy than the G-L-B Act. The privacy provisions became effective in July 2001.

The G-L-B Act contains significant revisions to the Federal Home Loan Bank ("FHLB") System. The G-L-B Act imposes new capital requirements on the FHLBs and authorizes them to issue two classes of stock with differing dividend rates and redemption requirements. The G-L-B Act deletes the current requirement that the FHLBs annually contribute \$300 million to pay interest on certain government obligations in favor of a 20% of net earnings formula. The G-L-B Act expands the permissible uses of FHLB advances by community financial institutions (under \$500 million in assets) to include funding loans to small businesses, small farms and small agri-businesses.

The G-L-B Act contains a variety of other provisions including a prohibition against ATM surcharges unless the customer has first been provided notice of the imposition and amount of the fee. The G-L-B Act reduces the frequency of Community Reinvestment Act examinations for smaller institutions and imposes certain reporting requirements on depository institutions that make payments to non-governmental entities in connection with the Community Reinvestment Act. The G-L-B Act also eliminated the Savings Association Insurance Fund special reserve.

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Capital Requirements. The Federal Reserve Board and the FDIC have established guidelines with respect to the maintenance of appropriate levels of capital by bank holding companies with consolidated assets of \$150 million or more and state non-member banks, respectively. The regulations impose two sets of capital adequacy requirements: minimum leverage rules, which require bank holding companies and state non-member banks to maintain a specified minimum ratio of capital to total assets, and risk-based capital rules, which require the maintenance of specified minimum ratios of capital to "risk-weighted" assets. The regulations of the FDIC and the Federal Reserve Board require bank holding companies and state non-member banks, respectively, to maintain a minimum leverage ratio of "Tier 1 capital" to total assets of 3%. Although setting a minimum 3% leverage ratio, the capital regulations state that only the strongest bank holding companies and banks, with composite examination ratings of 1 under the rating system used by the federal bank regulators, would be permitted to operate at or near such minimum level of capital. All other bank holding companies and banks are expected to maintain a leverage ratio of Tier 1 capital to total assets of not less than 4%. Tier 1 capital is the sum of common stockholders' equity, certain perpetual preferred stock, which must be noncumulative with respect to banks, including any related surplus, and minority interests in consolidated subsidiaries; minus all intangible assets other than certain purchased mortgage servicing rights and purchased credit card receivables, identified losses and investments in certain subsidiaries.

As a Savings Association Insurance Fund of the FDIC-insured, state-chartered bank, we must also deduct from Tier 1 capital an amount equal to our investments in, and extensions of credit to, subsidiaries engaged in activities that are not permissible for national banks, other than debt and equity investments in subsidiaries engaged in activities undertaken as agent for customers or in mortgage banking activities or in subsidiary depository

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institutions or their holding companies. Any bank or bank holding companies experiencing or anticipating significant growth would be expected to maintain capital well above the minimum levels. In addition, the Federal Reserve Board has indicated that whenever appropriate, and in particular when a bank holding company is undertaking expansion, seeking to engage in new activities or otherwise facing unusual or abnormal risks, it will consider, on a case-by-case basis, the level of an organization's ratio of tangible Tier 1 capital to total assets in making an overall assessment of capital.

In addition to the leverage ratio, the regulations of the Federal Reserve Board and the FDIC require bank holding companies and state-chartered nonmember banks to maintain a minimum ratio of qualifying total capital to risk-weighted assets of at least 8% of which at least 4% must be Tier 1 capital. Qualifying total capital consists of Tier 1 capital plus Tier 2 or "supplementary" capital items which include allowances for loan losses in an amount of up to 1.25% of risk-weighted assets, cumulative preferred stock and preferred stock with a maturity of 20 years or more, certain other capital instruments and up to 45% of unrealized gains on equity securities. The includable amount of Tier 2 capital cannot exceed the institution's Tier 1 capital. Qualifying total capital is further reduced by the amount of the bank's investments in banking and finance subsidiaries that are not consolidated for regulatory capital purposes, reciprocal cross-holdings of capital securities issued by other banks and certain other deductions. The risk-based capital regulations assign balance sheet assets and the credit equivalent amounts of certain off-balance sheet items to one of four broad risk weight categories. The aggregate dollar amount of each category is multiplied by the risk weight assigned to that category based principally on the degree of credit risk associated with the obligor. The sum of these weighted values equals the bank holding company or the bank's

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risk-weighted assets.

The federal bank regulators, including the Federal Reserve Board and the FDIC, have revised their risk-based capital requirements to ensure that such requirements provide for explicit consideration of interest rate risk. Under the rule, a bank's interest rate risk exposure would be quantified using either the measurement system set forth in the rule or the bank's internal model for measuring such exposure, if such model is determined to be adequate by the bank's examiner. If the dollar amount of a bank's interest rate risk exposure, as measured under either measurement system, exceeds 1% of the bank's total assets, the bank would be required under the rule to hold additional capital equal to the dollar amount of the excess. We believe that the interest rate risk component does not have a material effect on our capital. Further, the FDIC has adopted a regulation that provides that the FDIC may take into account whether a bank has significant risks from concentrations of credit or non-traditional activities in determining the adequacy of its capital. We have not been advised that we will be required to maintain any additional capital under this regulation. The interest rate risk component does not apply to bank holding companies on a consolidated basis.

In addition to FDIC regulatory capital requirements, the North Carolina Commissioner of Banks requires us to have adequate capitalization which is determined based upon each bank's particular set of circumstances. We are subject to the North Carolina Bank Commissioner's capital surplus regulation which requires commercial banks to maintain a capital surplus of at least 50% of common capital. Common capital is defined as the total of the par value of shares times the number of shares outstanding.

At September 30, 2004, we complied with each of the capital requirements of the FDIC and the North Carolina Banking Commission.

Prompt Corrective Regulatory Action. Under the Federal Deposit Insurance Corporation Improvement Act ("FDICIA"), the federal banking regulators are required to take prompt corrective action if an insured depository institution fails to satisfy certain minimum capital requirements. All institutions, regardless of their capital levels, are restricted from making any capital distribution or paying any management fees if the institution would thereafter fail to satisfy the minimum levels for any of its capital requirements. An institution that fails to meet the minimum level for any relevant capital measure (an "undercapitalized institution") may be: (i) subject to increased monitoring by the appropriate federal banking regulator; (ii) required to submit an acceptable capital restoration plan within 45 days; (iii) subject to asset growth limits; and (iv) required to obtain prior regulatory approval for acquisitions, branching and new lines of businesses. The capital restoration plan must include a guarantee by the institution's holding company that the institution will comply with the plan until it has been adequately capitalized on average for four consecutive quarters, under which the holding company would be liable up to the lesser of 5% of the institution's total assets or the amount necessary to bring the institution into capital compliance as of the date it failed to comply with its capital restoration plan. A "significantly undercapitalized"

institution, as well as any undercapitalized institution that does not submit an acceptable capital restoration plan, may be subject to regulatory demands for recapitalization, broader application of restrictions on transactions with affiliates, limitations on interest rates paid on deposits, asset growth and other activities, possible replacement of directors and officers, and restrictions on capital distributions by any bank holding company controlling

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the institution. Any company controlling the institution may also be required to divest the institution or the institution could be required to divest subsidiaries. The senior executive officers of a significantly undercapitalized institution may not receive bonuses or increases in compensation without prior approval and the institution is prohibited from making payments of principal or interest on its subordinated debt. In their discretion, the federal banking regulators may also impose the foregoing sanctions on an undercapitalized institution if the regulators determine that such actions are necessary to carry out the purposes of the prompt corrective provisions. If an institution's ratio of tangible capital to total assets falls below the "critical capital level" established by the appropriate federal banking regulator, the institution will be subject to conservatorship or receivership within specified time periods.

Under the implementing regulations, the federal banking regulators, including the FDIC, generally measure an institution's capital adequacy on the basis of its total risk-based capital ratio (the ratio of its total capital to risk-weighted assets), Tier 1 risk-based capital ratio (the ratio of its core capital to risk-weighted assets) and leverage ratio (the ratio of its core capital to adjusted total assets). The following table shows the capital ratios required for the various prompt corrective action categories.

| | Well Capitalized ----- | Adequately Capitalized ----- | Undercapitalized ----- | Signifi Underca ----- |
|------------------------------------|---------------------------|------------------------------------|---------------------------|-----------------------------|
| Total risk-based capital ratio | 10.0% or more | 8.0% or more | Less than 8.0% | Less t |
| Tier 1 risk-based capital ratio | 6.0% or more | 4.0% or more | Less than 4.0% | Less t |
| Leverage ratio | 5.0% or more | 4.0% or more* | Less than 4.0%* | Less t |

* 3.0% if institution has a composite 1 CAMELS rating.

A "critically undercapitalized" savings institution is defined as an institution that has a ratio of "tangible equity" to total assets of less than 2.0%. Tangible equity is defined as core capital plus cumulative perpetual preferred stock (and related surplus) less all intangibles other than qualifying supervisory goodwill and certain purchased mortgage servicing rights. The FDIC may reclassify a well capitalized savings institution as adequately capitalized and may require an adequately capitalized or undercapitalized institution to comply with the supervisory actions applicable to institutions in the next lower capital category (but may not reclassify a significantly undercapitalized institution as critically undercapitalized) if the FDIC determines, after notice and an opportunity for a hearing, that the institution is in an unsafe or unsound condition or that the institution has received and not corrected a less-than-satisfactory rating for any CAMELS rating category.

The Bank meets the definition of "well capitalized" under the FDIC's prompt corrective action regulations.

Safety and Soundness Guidelines. Under FDICIA, as amended by the Riegle Community Development and Regulatory Improvement Act of 1994 (the "CDRI Act"), each federal banking agency was required to establish safety and soundness standards for institutions under its authority. The interagency guidelines require depository institutions to maintain internal controls and information systems and internal audit systems that are appropriate for the size, nature and scope of the institution's business. The guidelines also establish certain basic standards for loan documentation, credit underwriting, interest rate risk

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exposure, and asset growth. The guidelines further provide that depository institutions should maintain safeguards to prevent the payment of compensation, fees and benefits that are excessive or that could lead to material financial loss, and should take into account factors such as comparable compensation practices at comparable institutions. If the appropriate federal banking agency determines that a depository institution is not in compliance with the safety and soundness guidelines, it may require the institution to submit an acceptable plan to achieve compliance with the guidelines. A depository institution must submit an acceptable compliance plan to its primary federal regulator within 30 days of receipt of a request for such a plan. Failure to submit or implement a compliance plan may subject the institution to regulatory sanctions. Management believes that 1st State Bank meets all the standards adopted in the interagency guidelines.

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Community Reinvestment Act. 1st State Bank, like other financial institutions, is subject to the Community Reinvestment Act ("CRA"). The purpose of the CRA is to encourage financial institutions to help meet the credit needs of their entire communities, including the needs of low and moderate-income neighborhoods.

The federal banking regulatory agencies have implemented an evaluation system that rates institutions based on their actual performance in meeting community credit needs. Under the regulations, a bank will first be evaluated and rated under three categories: a lending test, an investment test and a service test. For each of these three tests, the bank will be given a rating of either "outstanding," "high satisfactory," "low satisfactory," "needs to improve," or "substantial non-compliance." A set of criteria for each rating has been developed and is included in the regulation. If an institution disagrees with a particular rating, the institution has the burden of rebutting the presumption by clearly establishing that the quantitative measures do not accurately present its actual performance, or that demographics, competitive conditions or economic or legal limitations peculiar to its service area should be considered. The ratings received under the three tests will be used to determine the overall composite CRA rating. The composite ratings currently given are: "outstanding," "satisfactory," "needs to improve" or "substantial non-compliance."

During our last compliance examination, we received a "satisfactory" rating for CRA compliance.

Our CRA rating would be a factor considered by the Federal Reserve Board and the FDIC in considering applications to acquire branches or to acquire or combine with other financial institutions and take other actions and, if such rating was less than "satisfactory," could result in the denial of such applications.

Federal Home Loan Bank System. The FHLB System consists of 12 district FHLBs subject to supervision and regulation by the Federal Housing Finance Board ("FHFB"). The FHLBs provide a central credit facility primarily for member institutions. As a member of the FHLB of Atlanta, we are required to acquire and hold shares of capital stock in the FHLB of Atlanta in an amount at least equal to 1% of the aggregate unpaid principal of home mortgage loans, home purchase contracts, and similar obligations at the beginning of each year, or 1/20 of advances from the FHLB of Atlanta, whichever is greater. We were in compliance with this requirement with investment in FHLB of Atlanta stock at September 30, 2004 of \$2.3 million. The FHLB of Atlanta serves as a reserve or central bank for its member institutions within its assigned district. It is funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB

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System. It offers advances to members in accordance with policies and procedures established by the FHFB and the board of directors of the FHLB of Atlanta. Long-term advances may only be made for the purpose of providing funds for residential housing finance, small businesses, small farms and small agri-businesses. At September 30, 2004, we had \$44.0 million in advances outstanding from the FHLB of Atlanta.

Reserves. Under Federal Reserve Board regulations, we must maintain average daily reserves equal to 3% on transaction accounts over \$6.6 million up to \$45.4 million, plus 10% on the remainder. This percentage is subject to adjustment by the Federal Reserve Board. Because required reserves must be maintained in the form of vault cash or in a non-interest bearing account at a Federal Reserve Bank, the effect of the reserve requirement is to reduce the amount of the institution's interest-earning assets. As of September 30, 2004, we met our reserve requirements.

We are also subject to the reserve requirements of North Carolina commercial banks. North Carolina law requires state non-member banks to maintain, at all times, a reserve fund in an amount set by regulation of the North Carolina Banking Commission. As of September 30, 2004, we met our reserve requirements.

Deposit Insurance. We are required to pay assessments based on a percentage of insured deposits to the FDIC for insurance of our deposits by the Savings Association Insurance Fund of the FDIC. The FDIC is required to set semi-annual assessments for Savings Association Insurance Fund-insured institutions at a level necessary to maintain the designated reserve ratio of the Savings Association Insurance Fund at 1.25% of estimated insured deposits, or at a higher percentage of estimated insured deposits that the FDIC determines to be justified for that year by circumstances indicating a significant risk of substantial future losses to the Savings Association Insurance Fund. Under the FDIC's risk-based deposit insurance assessment system, the assessment rate for an insured depository institution depends on the assessment risk classification assigned to the institution by the FDIC, which is determined by the institution's capital level and supervisory evaluations. Based on the data reported to regulators

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for the date closest to the last day of the seventh month preceding the semi-annual assessment period, institutions are assigned to one of three capital groups --- well capitalized, adequately capitalized or undercapitalized -- using the same percentage criteria as in the prompt corrective action regulations. See "-- Prompt Corrective Regulatory Action" for definitions and percentage criteria for the capital group categories. Within each capital group, institutions are assigned to one of three subgroups on the basis of supervisory evaluations by the institution's primary supervisory authority and such other information as the FDIC determines to be relevant to the institution's financial condition and the risk posed to the deposit insurance fund. Subgroup A consists of financially sound institutions with only a few minor weaknesses. Subgroup B consists of institutions that demonstrate weaknesses which, if not corrected, could result in significant deterioration of the institution and increased risk of loss to the deposit insurance fund. Subgroup C consists of institutions that pose a substantial probability of loss to the deposit insurance fund unless effective corrective action is taken.

The assessment rate for SAIF members ranges from zero for well capitalized institutions in Subgroup A to 0.27% of deposits for undercapitalized institutions in Subgroup C. In addition, both Bank Insurance Fund of the FDIC and Savings Association Insurance Fund of the FDIC members are assessed an

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amount for interest payments on certain bonds issued by the Financing Corporation, an agency of the federal government to finance takeovers of insolvent thrifts.

Liquidity Requirements. FDIC policy requires that banks maintain an average daily balance of liquid assets in an amount which it deems adequate to protect safety and soundness of the bank. Liquid assets include cash, certain time deposits, bankers' acceptances and specified United States government, state, or federal agency obligations. The FDIC currently has no specific level which it requires.

North Carolina banks must maintain a reserve fund in an amount and/or ratio set by the North Carolina Banking Commission to account for the level of liquidity necessary to assure the safety and soundness of the State banking system. At September 30, 2004, our liquidity ratio exceeded the North Carolina regulations.

Dividend Restrictions. Under FDIC regulations, we are prohibited from making any capital distributions if after making the distribution, we would have:

- o a total risk-based capital ratio of less than 8%;
- o a Tier 1 risk-based capital ratio of less than 4%; or
- o a leverage ratio of less than 4%.

Our earnings appropriated to bad debt reserves and deducted for Federal income tax purposes are not available for payment of cash dividends or other distributions to stockholders without payment of taxes at the then current tax rate on the amount of earnings removed from the pre-1988 reserves for such distributions. We intend to make full use of this favorable tax treatment and do not contemplate use of any earnings in a manner which would create federal tax liabilities.

We may not pay dividends on our capital stock if our regulatory capital would thereby be reduced below the amount then required for the liquidation account established for the benefit of certain depositors at the time of the conversion.

1st State Bancorp is subject to limitations on dividends imposed by the Federal Reserve Board.

Transactions with Related Parties. Transactions between a state non-member bank and any affiliate are governed by Sections 23A and 23B of the Federal Reserve Act. An affiliate of a state non-member bank is any company or entity which controls, is controlled by or is under common control with the state non-member bank. In a holding company context, the parent holding company of a state non-member bank, such as 1st State Bancorp, and any companies which are controlled by the parent holding company are affiliates of the savings institution or state non-member bank. Generally, Sections 23A and 23B (i) limit the extent to which an institution or its subsidiaries may engage in "covered transactions" with any one affiliate to an amount equal to 10% of such institution's capital

stock and surplus, and contain an aggregate limit on all such transactions with all affiliates to an amount equal to 20% of such capital stock and surplus, and (ii) require that all such transactions be on terms substantially the same, or

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at least as favorable, to the institution or subsidiary as those provided to a non-affiliate. The term "covered transaction" includes the making of loans, purchase of assets, issuance of a guarantee and similar other types of transactions. In addition to the restrictions imposed by Sections 23A and 23B, no state non-member bank may (i) loan or otherwise extend credit to an affiliate, except for any affiliate which engages only in activities which are permissible for bank holding companies, or (ii) purchase or invest in any stocks, bonds, debentures, notes or similar obligations of any affiliate, except for affiliates which are subsidiaries of the state non-member bank.

Loans to Directors, Executive Officers and Principal Stockholders. State non-member banks also are subject to the restrictions contained in Section 22(h) of the Federal Reserve Act and the Federal Reserve Board's Regulation O thereunder on loans to executive officers, directors and principal stockholders. Under Section 22(h), loans to a director, executive officer and to a greater than 10% stockholder of a state non-member bank and certain affiliated interests of such persons, may not exceed, together with all other outstanding loans to such person and affiliated interests, the institution's loans-to-one-borrower limit (generally equal to 15% of the institution's unimpaired capital and surplus) and all loans to such persons may not exceed the institution's unimpaired capital and unimpaired surplus. Section 22(h) also prohibits loans, above amounts prescribed by the appropriate federal banking agency, to directors, executive officers and greater than 10% stockholders of a depository institution, and their respective affiliates, unless such loan is approved in advance by a majority of the board of directors of the institution with any "interested" director not participating in the voting. Regulation O prescribes the loan amount (which includes all other outstanding loans to such person) as to which such prior board of director approval is required as being the greater of \$25,000 or 5% of capital and surplus up to \$500,000. Further, Section 22(h) requires that loans to directors, executive officers and principal stockholders be made on terms substantially the same as offered in comparable transactions to other persons. Section 22(h) also generally prohibits a depository institution from paying the overdrafts of any of its executive officers or directors.

State non-member banks also are subject to the requirements and restrictions of Section 22(g) of the Federal Reserve Act on loans to executive officers. Section 22(g) of the Federal Reserve Act requires loans to executive officers of depository institutions not be made on terms more favorable than those afforded to other borrowers, requires approval by the board of directors of a depository institution for such extensions of credit to executive officers of the institution, and imposes reporting requirements for and additional restrictions on the type, amount and terms of credits to such officers. In addition, Section 106 of the Bank Holding Company Act of 1956, as amended prohibits extensions of credit to executive officers, directors, and greater than 10% stockholders of a depository institution by any other institution which has a correspondent banking relationship with the institution, unless such extension of credit is on substantially the same terms as those prevailing at the time for comparable transactions with other persons and does not involve more than the normal risk of repayment or present other unfavorable features.

Additionally, North Carolina statutes set forth restrictions on loans to executive officers of state-chartered banks, which provide that no bank may extend credit to any of its executive officers nor a firm or partnership of which such executive officers is a member, nor a company in which such executive officer owns a controlling interest, unless the extension of credit is made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions by the bank with persons who are not employed by the bank, and provided further that the extension of credit does not involve more than the normal risk of repayment.

Restrictions on Certain Activities. State-chartered banks with deposits insured by the FDIC are generally prohibited from engaging in activities and

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investments that are not permissible for a national bank. The foregoing limitation, however, does not prohibit FDIC-insured state banks from acquiring or retaining an equity investment in a subsidiary in which the bank is a majority owner. State chartered banks are also prohibited from engaging as a principal in any type of activity that is not permissible for a national bank. Further subsidiaries of state chartered, FDIC-insured state banks may not engage as a principal in any type of activity that is not permissible for a subsidiary of a national bank, unless in either case, the FDIC determines that the activity would pose no significant risk to the appropriate deposit insurance fund and the bank is, and continues to be, in compliance with applicable capital standards.

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The FDIC has adopted regulations to clarify the foregoing restrictions on activities of FDIC-insured state-chartered banks and their subsidiaries. Under the regulations, the term "activity" refers to the conduct of business by an insured state bank and includes acquiring or retaining any investment other than an equity investment as defined by regulation. An activity permissible for a national bank includes any activity expressly authorized for national banks by statute or recognized as permissible in regulations, official circulars, bulletins, orders or written interpretations issued by the Office of the Comptroller of the Currency. In its regulations, the FDIC indicates that it will not permit state banks to directly engage in commercial ventures or directly or indirectly engage in any insurance underwriting activity other than to the extent such activities are permissible for a national bank or a national bank subsidiary or except for certain other limited forms of insurance underwriting permitted under the regulations. FDIC regulations permit state banks that meet applicable minimum capital requirements to engage as principal in certain activities that are not permissible to national banks including guaranteeing obligations of others, activities which the Federal Reserve Board has found by regulation or order to be closely related to banking and certain securities activities conducted through subsidiaries.

Patriot Act. The Patriot Act is intended to strengthen U.S. law enforcement's and the intelligence communities' abilities to work cohesively to combat terrorism on a variety of fronts. The potential impact of the Patriot Act on financial institutions of all kinds is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws and imposes various regulations including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

Regulation of 1st State Bancorp, Inc.

General. 1st State Bancorp, as the sole shareholder of 1st State Bank, is a bank holding company and is registered as such with the Federal Reserve Board. Bank holding companies are subject to comprehensive regulation by the Federal Reserve Board under the Bank Holding Company Act of 1956, as amended (the "BHCA"), and the regulations of the Federal Reserve Board. As a bank holding company, 1st State Bancorp is required to file with the Federal Reserve Board annual reports and such additional information as the Federal Reserve Board may require, and is subject to regular examinations by the Federal Reserve Board. The Federal Reserve Board also has extensive enforcement authority over bank holding companies, including, among other things, the ability to assess civil money penalties, to issue cease and desist or removal orders and to require that a holding company divest of subsidiaries, including its bank subsidiaries. In general, enforcement actions may be initiated for violations of law and regulations and unsafe or unsound practices. 1st State Bancorp is also required to file certain reports with, and comply with the rules and regulations of the

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Securities and Exchange Commission under the federal securities laws.

Under the BHCA, a bank holding company must obtain Federal Reserve Board approval before:

- o acquiring, directly or indirectly, ownership or control of any voting shares of another bank or bank holding company if, after such acquisition, it would own or control more than 5% of such shares, unless it already owns or controls the majority of such shares;
- o acquiring all or substantially all of the assets of another bank or bank holding company; or
- o merging or consolidating with another bank holding company.

Satisfactory financial condition, particularly with respect to capital adequacy, and a satisfactory CRA rating generally are prerequisites to obtaining federal regulatory approval to make acquisitions.

The BHCA also prohibits a bank holding company, with certain exceptions, from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities which, by statute or by Federal Reserve Board regulation or order, have been identified as activities closely related to the business of banking or managing or controlling banks. The list of activities permitted by the Federal Reserve Board includes, among other things:

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- o operating a savings institution, mortgage company, finance company, credit card company or factoring company;
- o performing certain data processing operations;
- o providing certain investment and financial advice;
- o underwriting and acting as an insurance agent for certain types of credit-related insurance;
- o leasing property on a full-payout, non-operating basis;
- o selling money orders, travelers' checks and United States Savings Bonds;
- o real estate and personal property appraising;
- o providing tax planning and preparation services; and,
- o subject to certain limitations, providing securities brokerage services for customers.

Presently, we have no plans to engage in any of these activities.

Acquisition of Bank Holding Companies and Banks. Under the BHCA, any company must obtain approval of the Federal Reserve Board prior to acquiring control of 1st State Bancorp or 1st State Bank. For purposes of the BHCA, "control" is defined as ownership of more than 25% of any class of voting

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securities of 1st State Bancorp or 1st State Bank, the ability to control the election of a majority of the directors, or the exercise of a controlling influence over management or policies of 1st State Bancorp or 1st State Bank. In addition, the Change in Bank Control Act and the related regulations of the Federal Reserve Board require any person or persons acting in concert to file a written notice with the Federal Reserve Board before such person or persons may acquire control of 1st State Bancorp or 1st State Bank. The Change in Bank Control Act defines "control" as the power, directly or indirectly, to vote 25% or more of any voting securities or to direct the management or policies of a bank holding company or an insured bank.

Interstate Banking. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Riegle-Neal Act") was enacted to ease restrictions on interstate banking. Effective September 29, 1995, the Riegle-Neal Act allows the Federal Reserve Board to approve an application of an adequately capitalized and adequately managed bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than the holding company's home state, without regard to whether the transaction is prohibited by the laws of any state. The Federal Reserve Board may not approve the acquisition of a bank that has not been in existence for a minimum of five years, regardless of a longer minimum period specified by the law of the host state. The Riegle-Neal Act also prohibits the Federal Reserve Board from approving an application if the applicant and its depository institution affiliates control or would control more than 10% of the insured deposits in the United States or 30%, or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. The Riegle-Neal Act does not affect a state's authority to limit the percentage of total insured deposits in the state which may be held or controlled by a bank or bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% statewide concentration limit contained in the Riegle-Neal Act.

Additionally, the federal banking agencies are authorized to approve interstate merger transactions without regard to whether such transaction is prohibited by the law of any state, unless the home state of one of the banks has opted out of the Riegle-Neal Act by adopting a law, which applies equally to all out-of-state banks and expressly prohibits merger transactions involving out-of-state banks. Interstate acquisitions of branches will be permitted only if the law of the state in which the branch is located permits such acquisitions. Interstate mergers and branch acquisitions are subject to the nationwide and statewide insured deposit concentration amounts described above. North Carolina has enacted legislation permitting interstate banking transactions.

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The Riegle-Neal Act authorizes the FDIC to approve interstate branching de novo by state banks only in states which specifically allow for such branching. Pursuant to the Riegle-Neal Act, the appropriate federal banking agencies have adopted regulations which prohibit any out-of-state bank from using the interstate branching authority primarily for the purpose of deposit production. These regulations include guidelines to ensure that interstate branches operated by an out-of-state bank in a host state are reasonably helping to meet the credit needs of the communities which they serve.

Dividends. The Federal Reserve Board has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses the Federal Reserve Board's view that a bank holding company should pay cash dividends only to the extent that the company's net income for the past year is sufficient to cover both the cash dividends and a rate of earning retention that is consistent

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with the company's capital needs, asset quality and overall financial condition. The Federal Reserve Board also indicated that it would be inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends. Furthermore, under the prompt corrective action regulations adopted by the Federal Reserve Board, the Federal Reserve Board may prohibit a bank holding company from paying any dividends if the holding company's bank subsidiary is classified as "undercapitalized". For a definition of "undercapitalized" institution, see "-- Depository Institution Regulation -- Prompt Corrective Regulatory Action."

Bank holding companies are required to give the Federal Reserve Board prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the their consolidated net worth. The Federal Reserve Board may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation, Federal Reserve Board order, directive, or any condition imposed by, or written agreement with, the Federal Reserve Board. Bank holding companies whose capital ratios exceed the thresholds for well capitalized banks on a consolidated basis are exempt from the foregoing requirement if they were rated composite 1 or 2 in their most recent inspection and are not the subject of any unresolved supervisory issues.

Sarbanes-Oxley Act of 2002. On July 30, 2002, the Sarbanes-Oxley Act of 2002 ("SOX") was signed into law which mandated a variety of reforms intended to address corporate and accounting fraud. SOX contained provisions which amend the Securities Exchange Act of 1934, as amended (the "1934 Act") and provisions which directed the SEC to promulgate rules. The resultant law and regulations under the Act as of the time of this annual report is set forth in the following paragraphs. SOX provides for the establishment of a new Public Company Accounting Oversight Board ("PCAOB"), which will enforce auditing, quality control and independence standards for firms that audit Securities and Exchange Commission ("SEC")-reporting companies and will be funded by fees from all SEC-reporting companies. SOX imposed higher standards for auditor independence and restricts provision of consulting services by auditing firms to companies they audit. Any non-audit services being provided to an audit client will require preapproval by the Company's audit committee members. In addition, certain audit partners must be rotated periodically. SOX requires chief executive officers and chief financial officers, or their equivalent, to certify to the accuracy of periodic reports filed with the SEC, subject to civil and criminal penalties if they knowingly or willfully violate this certification requirement. In addition, under SOX, counsel will be required to report evidence of a material violation of the securities laws or a breach of fiduciary duty by a company to its chief executive officer or its chief legal officer, and, if such officer does not appropriately respond, to report such evidence to the audit committee or other similar committee of the board of directors or the board itself.

Longer prison terms will also be applied to corporate executives who violate federal securities laws, the period during which certain types of suits can be brought against a company or its officers has been extended, and bonuses issued to top executives prior to restatement of a company's financial statements are now subject to disgorgement if such restatement was due to corporate misconduct. Executives are also prohibited from trading during retirement plan "blackout" periods, and loans to company executives are restricted. In addition, a provision directs that civil penalties levied by the SEC as a result of any judicial or administrative action under the 1934 Act be deposited in a fund for the benefit of harmed investors. Directors and executive officers must also report most changes in their ownership of a company's securities within two business days of the change, and as of the end of June 2003, all ownership reports must be electronically filed.

SOX also increases the oversight and authority of audit committees of publicly traded companies. Audit committee members must be independent and are barred from accepting consulting, advisory or other compensatory fees from the issuer. In addition, all SEC-reporting companies must disclose whether at least one member of the committee is an audit committee "financial expert" (as such term is defined by the SEC rules) and if not, why not. Audit committees of publicly traded companies will have authority to retain their own counsel and other advisors funded by the company. Audit committees must establish procedures for the receipt, retention and treatment of complaints regarding accounting and auditing matters and procedures for confidential, anonymous submission of employee concerns regarding questionable accounting or auditing matters. It is the responsibility of the audit committee to hire, oversee and work on disagreements with the Company's independent auditor.

Beginning six months after the SEC determines that the PCAOB is able to carry out its functions, it will be unlawful for any person that is not a registered public accounting firm ("RPAF") to audit an SEC-reporting company. Under SOX, a RPAF is prohibited from performing statutorily mandated audit services for a company if such company's chief executive officer, chief financial officer, comptroller, chief accounting officer or any person serving in equivalent positions has been employed by such firm and participated in the audit of such company during the one-year period preceding the audit initiation date. SOX also prohibits any officer or director of a company or any other person acting under their direction from taking any action to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in the audit of the Company's financial statements for the purpose of rendering the financial statement's materially misleading. The SEC has prescribed rules requiring inclusion of an internal control report and assessment by management in the annual report to shareholders. SOX requires the RPAF that issues the audit report to attest to and report on management's assessment of the Company's internal controls. The Company will be required to include this internal control report with its September 30, 2005 consolidated financial statements. In addition, SOX requires that each financial report required to be prepared in accordance with (or reconciled to) generally accepted accounting principles and filed with the SEC reflect all material correcting adjustments that are identified by a RPAF in accordance with generally accepted accounting principles and the rules and regulations of the SEC.

Although the Company anticipates it will incur additional expense in complying with the provisions of the 1934 Act and the related rules, management does not expect that such compliance will have a material impact on the Company's financial condition or results of operations.

TAXATION

General

1st State Bancorp and 1st State Bank file a consolidated federal income tax return based on a fiscal year ending September 30. They file separate state returns.

Federal Income Taxation

Financial institutions such as 1st State Bank are subject to the provisions of the Internal Revenue Code in the same general manner as other corporations. Through tax years beginning before December 31, 1995, institutions such as 1st State Bank which met certain definitional tests and other conditions

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prescribed by the Internal Revenue Code benefitted from certain favorable provisions regarding their deductions from taxable income for annual additions to their bad debt reserve. For purposes of the bad debt reserve deduction, loans are separated into "qualifying real property loans," which generally are loans secured by interests in certain real property, and "nonqualifying loans", which are all other loans. The bad debt reserve deduction with respect to nonqualifying loans must be based on actual loss experience. The amount of the bad debt reserve deduction with respect to qualifying real property loans may be based upon actual loss experience (the "experience method") or a percentage of taxable income determined without regard to such deduction (the "percentage of taxable income method"). Under the experience method, the bad debt deduction for an addition to the reserve for qualifying real property loans was an amount determined under a formula based generally on the bad debts actually sustained by a savings institution over a period of years. Under the percentage of taxable income method, the bad debt reserve deduction for qualifying real property loans was computed as 8% of a savings institution's taxable income, with certain adjustments. We generally elected to use the method which has resulted in the greatest deductions for federal income tax purposes in any given year.

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Legislation that is effective for tax years beginning after December 31, 1995 requires institutions to recapture into taxable income over a six taxable year period the portion of the tax loan reserve that exceeds the pre-1988 tax loan loss reserve. As a result of changes in the law, institutions were required to change to either the reserve method or the specific charge-off method that applied to banks.

We are not required to provide a deferred tax liability for the tax effect of additions to the tax bad debt reserve through 1987, the base year. Retained income at September 30, 1998 includes approximately \$4.2 million for which no provision for federal income tax has been made. These amounts represent allocations of income to bad debt deductions for tax purposes only. Reduction of such amounts for purposes other than tax bad debt losses could create income for tax purposes in certain remote instances, which would be subject to the then current corporate income tax rate.

For additional information on our policies regarding tax and accounting matters, see our consolidated financial statements and related notes in the Annual Report filed as Exhibit 13 in this document.

State Income Taxation

Under North Carolina law, the corporate income tax currently is 6.90% of federal taxable income as computed under the Internal Revenue Code, subject to certain prescribed adjustments. An annual state franchise tax recorded in other expense, is imposed at a rate of .15% applied to the greatest of the institution's (i) capital stock, surplus and undivided profits, (ii) investment in tangible property in North Carolina, or (iii) fifty-five percent of appraised valuation of property in North Carolina.

For additional information regarding taxation, see Notes 1 and 11 of the Notes to the Consolidated Financial Statements, which you can find in the Annual Report.

Item 2. Properties

The following table sets forth the location and certain additional information regarding our offices at September 30, 2004.

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| | Year Opened | Owned or Leased | Book Value at September 30, 2004 (1) | Approximate Square Footage | Deposits September 2004 |
|--|----------------|--------------------|--|-------------------------------|-------------------------------|
| (Dollars in thousands) | | | | | |
| Main Office: 445 S. Main Street Burlington, NC 27215 | 1988 | Owned | \$3,365 | 33,700 | \$96 |
| Branch Offices: 2294 N. Church Street Burlington, NC 27215 | 1984 | Leased (2) | 221 | 2,600 | 23 |
| 503 Huffman Mill Road Burlington, NC 27215 | 1982 | Owned | 335 | 2,600 | 35 |
| 102 S. 5th Street Mebane, NC 27302 | 1973 | Owned | 416 | 2,300 | 37 |
| 211 N. Main Street Graham, NC 27253 | 1974 | Owned | 88 | 2,700 | 35 |

(table continued on next page)

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| | | | | | |
|---|------|-------|-------|-------|----|
| 3466 S. Church Street Burlington, NC 27215 | 1996 | Owned | 1,306 | 4,000 | 23 |
| 1203 S. Main Street Graham, NC 27253 | 2000 | Owned | 1,331 | 4,000 | 10 |

(1) Land and building only.

(2) Land is leased. Lease expires on July 5, 2009, with options to extend for three five-year periods.

The net book value of our investment in premises and equipment was \$7.9 million at September 30, 2004. See Note 7 of Notes to Consolidated Financial Statements elsewhere in this document.

Item 3. 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, 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.

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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 has 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. Since year end these loans have been paid off. Included in part of plaintiffs' complaint are allegations related to loans made by the Bank to the borrowers. The Bank will vigorously defend the lawsuit and seek its dismissal by the court. Management does not anticipate that this lawsuit will have a material adverse impact on the Company's financial condition or results of operations.

Item 4. Submission of Matters to Vote of Security Holders

Not applicable.

PART II

Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

(a) The information contained under the sections captioned "Market Information" in the Company's Annual Report to Stockholders for the Fiscal Year Ended September 30, 2004 (the "Annual Report") filed as Exhibit 13 hereto is incorporated herein by reference.

(b) Not applicable.

(c) During the last quarter covered by this Report, the Company did not repurchase any of its common stock.

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Item 6. Selected Financial Data

The information contained in the table captioned "Selected Consolidated Financial and Other Data" on page 2 in the Annual Report is incorporated herein by reference.

Item 7. Management's Discussion and Analysis of Financial Condition and Results

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of Operations

The information contained in the section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations" on pages 4 through 19 in the Annual Report is incorporated herein by reference.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

The information contained under the sections captioned "Market Risk" on pages 7 and 8 in the Annual Report is incorporated herein by reference.

Item 8. Financial Statements and Supplementary Data

The Consolidated Financial Statements, Notes to Consolidated Financial Statements, Independent Auditors' Report and Selected Financial Data contained on pages 20 through 55 in the Annual Report, which are listed under Item 15 herein, are incorporated herein by reference.

Item 9. Changes in and Disagreements With Accountants on Accounting and

Financial Disclosure

None.

Item 9A. Controls and Procedures

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

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

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Item 9B. Other Information

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Not Applicable

PART III

Item 10. Directors and Executive Officers of the Registrant

The information contained under the sections captioned "Proposal I -- Election of Directors" and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Company's definitive proxy statement for the Company's 2004 Annual Meeting of Stockholders (the "Proxy Statement") is incorporated herein by reference.

The Company has adopted a Code of Ethics that applies to the Company's chief executive officer, chief financial officer and all senior management, as well as directors, officers and employees.

Item 11. Executive Compensation

The information contained under the sections captioned "Proposal I -- Election of Directors -- Executive Compensation," in the Proxy Statement is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

- (a) Security Ownership of Certain Beneficial Owners. Information required by this item is incorporated herein by reference to the section captioned "Voting Securities and Security Ownership" in the Proxy Statement.
- (b) Security Ownership of Management. Information required by this item is incorporated herein by reference to the sections captioned "Voting Securities and Security Ownership" and "Proposal I -- Election of Directors" in the Proxy Statement.
- (c) Changes in Control. Management of the Company knows of no arrangements, including any pledge by any person of securities of the Company, the operation of which may at a subsequent date result in a change in control of the registrant.
- (d) Equity Compensation Plans. The following table sets forth certain information with respect to the Company's equity compensation plans as of September 30, 2004.

(a) (b)

| | |
|---|---|
| Number of securities to be issued upon exercise of outstanding options, warrants & rights | Weighted-average exercise price of outstanding options, warrants and rights |
|---|---|

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| | | |
|--|------------------|------------------|
| Equity compensation plans approved by security holders | 314,235 | \$14.71 |
| Equity compensation plans not approved by security holders | -- | -- |
| Total | 314,235 ===== | \$14.71 ===== |

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Item 13. Certain Relationships and Related Transactions

The information required by this item is incorporated herein by reference to the section captioned "Proposal I -- Election of Directors -- Transactions with Management" in the Proxy Statement.

Item 14. Principal Accountant Fees and Services

The information required by this item is incorporated herein by reference to the section captioned "Audit and Other Fees Paid to Independent Accountants" in the Proxy Statement.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) List of Documents Filed as Part of this Report

(1) Financial Statements. The following consolidated financial statements are incorporated by reference from Item 8 hereof (see Exhibit 13):

Independent Auditors' Report

Consolidated Balance Sheets as of September 30, 2004 and 2003

Consolidated Statements of Income for the Years Ended September 30, 2004, 2003 and 2002

Consolidated Statements of Stockholders' Equity and Comprehensive Income for the Years Ended September 30, 2004, 2003 and 2002

Consolidated Statements of Cash Flows for the Years Ended September 30, 2004, 2003 and 2002

Notes to Consolidated Financial Statements

(2) Financial Statement Schedules. All schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are omitted because of the absence of conditions under which they are required or because the required information is included in the consolidated financial statements and related notes thereto.

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(b) Exhibits. The following is a list of exhibits filed as part of this Annual Report on Form 10-K and is also the Exhibit Index.

| No. | Description |
|------|---|
| --- | ----- |
| 3.1 | Articles of Incorporation of 1st State Bancorp, Inc. (Incorporated herein by reference from Exhibit 3.1 to the Company's Registration Statement on Form S-1 (File No. 333-68091)) |
| 3.2 | Bylaws of 1st State Bancorp, Inc. (Incorporated herein by reference to the Company's Annual Report on Form 10-K for the Fiscal Year Ended September 30, 2000) |
| 4 | Form of Common Stock Certificate of 1st State Bancorp, Inc. (Incorporated herein by reference from Exhibit 4 to the Company's Registration Statement on Form 8-A) |
| 10.1 | 1st State Bancorp, Inc. 2000 Stock Option and Incentive Plan (Incorporated herein by reference to the Company's Annual Report on Form 10-K for the Fiscal Year Ended September 30, 2000) + |
| 10.2 | 1st State Bancorp, Inc. Management Recognition Plan (Incorporated herein by reference to the Company's Annual Report on Form 10-K for the Fiscal Year Ended September 30, 2000) + |
| 10.3 | Employment Agreements by and between 1st State Bank and James C. McGill, A. Christine Baker and Fairfax C. Reynolds (Incorporated herein by reference from Exhibit 10.3 to the Company's Registration Statement on Form S-1 (File No. 333-68091)) + |
| 10.4 | Form of Guaranty Agreement by and between 1st State Bancorp, Inc. and James C. McGill, A. Christine Baker and Fairfax C. Reynolds (Incorporated herein by reference from Exhibit 10.4 to the Company's Registration Statement on Form S-1 (File No. 333-68091)) + |
| 10.5 | 1st State Bank Deferred Compensation Plan (Incorporated herein by reference from Exhibit 10.5 to the Company's Registration Statement on Form S-1 (File No. 333-68091)) + |
| 13 | Annual Report to Stockholders |
| 14 | Code of Ethics for Directors, Officers and Employees (Incorporated herein by reference to the Company's Annual Report on Form 10-K for the Fiscal Year Ended September 30, 2003) |
| 21 | Subsidiaries of the Registrant |
| 23 | Consent of KPMG LLP |
| 31.1 | Rule 13a-14(a) Certification of Chief Executive Officer |

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

32 Certification pursuant to 18 U.S.C. Section 1350

+ Management contract or compensation plan or arrangement.

(b) Exhibits. The exhibits required by Item 601 of Regulation S-K are either filed as part of this Annual Report on Form 10-K or incorporated by reference herein.

(c) Financial Statements and Schedules Excluded from Annual Report. There are no other financial statements and financial statement schedules which were excluded from the Annual Report to Stockholders pursuant to Rule 14a-3(b) which are required to be included herein.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

December 21, 2004

By: /s/ James C. McGill

James C. McGill
President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

/s/ James C. McGill

December 21, 2004

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

/s/ A. Christine Baker

December 21, 2004

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

/s/ Richard C. Keziah

December 21, 2004

Richard C. Keziah
Director

/s/ James A. Barnwell, Jr.

December 21, 2004

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James A. Barnwell, Jr.
Chairman of the Board

/s/ Bernie C. Bean

December 21, 2004

Bernie C. Bean
Director

/s/ Ernest A. Koury, Jr.

December 21, 2004

Ernest A. Koury, Jr.
Director

/s/ James G. McClure

December 21, 2004

James G. McClure
Director

/s/ T. Scott Quakenbush

December 21, 2004

T. Scott Quakenbush
Director

/s/ Richard H. Shirley

December 21, 2004

Richard H. Shirley
Director

/s/ Virgil L. Stadler

December 21, 2004

Virgil L. Stadler
Director