UNITED BANCORPORATION OF ALABAMA INC
Form 10-Q
November 15, 2004

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2004

Commission file number 2-78572

UNITED BANCORPORATION OF ALABAMA, INC.

(Exact name of registrant as specified in its charter)

Delaware	63-0833573
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
200 East Nashville Avenue, Atmore, Alabama	36502
(Address of principal executive offices)	(Zip Code)

(251) 368-2525
(Registrant s telephone number, including area code)

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of November 6, 2004.

Class A Common Stock	2,217,330 Shares*
Class B Common Stock	-0- Shares

*Reflects two-for-one stock split effective June 30, 2004.

UNITED BANCORPORATION OF ALABAMA, INC.

FORM 10-Q

For the Quarter Ended September 30, 2004

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PART I-FINANCIAL INFORMATION
United Bancorporation of Alabama, Inc.
and Subsidiary

Item 1. Financial Statements

Condensed Consolidated
Balance Sheets

	September 2004 Unaudited	December 31, 2003 Audited
Assets:		
Cash and due from banks	$ 11,193,274	$ 9,901,225
Federal funds sold	2,759,721	14,546,400
Cash and cash equivalents	13,952,995	24,447,625
Securities available for sale (amortized cost of $53,979,888 and $52,908,801 respectively)	54,521,034	53,666,589
Loans	198,697,663	164,147,155
Allowance for loan losses	2,432,707	2,116,060
Net loans	196,264,956	162,031,095
Premises and equipment, net	7,311,131	7,581,389
Interest receivable and other assets	9,051,592	7,393,911
Total assets	281,101,708	255,120,609
Liabilities and Stockholders Equity:		
Deposits:		
Non-interest bearing	49,566,659	42,687,610
Interest bearing	175,250,798	156,717,972
Total deposits	224,817,457	199,405,582
Securities sold under agreements to repurchase	15,270,522	13,495,670
Other borrowed funds	9,030,276	10,909,975
Accrued expenses and other liabilities	1,658,956	2,216,445
Note payable to Trust	4,124,000	4,124,000
Total liabilities	254,901,211	230,151,672
Stockholders equity:		

Class A common stock. Authorized 5,000,000 shares of $.01 par value; 2,363,762* and 1,181,881 shares issued respectively	23,651	11,819
Class B common stock of $.01 par value. Authorized 250,000 shares; -0- shares issued and outstanding.	0	0
Preferred stock of $.01 par value. Authorized 250,000 shares; -0- shares issued and outstanding.	0	0
Additional Paid in Capital	5,444,550	5,418,175
Accumulated other comprehensive income, net of tax	394,702	454,671
Retained earnings	21,176,612	19,925,926
	27,039,515	25,810,591
Less: 146,432* and 74,483 treasury shares, at cost, respectively	839,018	841,654
Total stockholders equity	26,200,497	24,968,937
Total liabilities and stockholders equity	$281,101,708	$255,120,609

* Reflects two-for-one stock split effective June 30, 2004.

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United Bancorporation of Alabama, Inc.
And Subsidiary

Condensed Consolidated Statements of Earnings and Comprehensive Income
(Unaudited)

	Three Months Ended September		Nine Months Ended September	
	2004	**2003**	**2004**	**2003**
Interest income:				
Interest and fees on loans	$3,093,692	$2,831,461	$ 8,684,682	$8,419,148
Interest on investment securities available for sale:				
Taxable	325,431	195,871	928,299	768,308
Nontaxable	250,335	241,953	757,785	709,104
Total investment income	575,766	437,824	1,686,084	1,477,412
Other interest income	10,745	29,074	61,518	79,949
Total interest income	3,680,203	3,298,359	10,432,284	9,976,509
Interest expense:				
Interest on deposits	763,359	730,805	2,143,897	2,395,707
Interest on other borrowed funds	146,300	143,693	429,338	449,405
Total interest expense	909,659	874,498	2,573,235	2,845,112
Net interest income	2,770,544	2,423,861	7,859,049	7,131,397
Provision for loan losses	180,000	186,000	540,000	534,704
Net interest income after provision for loan losses	2,590,544	2,237,861	7,319,049	6,596,693
Noninterest income:				
Service charge on deposits	581,286	550,920	1,756,406	1,544,586
Commission on credit life	2,713	14,031	38,413	47,606
Investment securities gains, net	167,610	71,464	170,898	363,672
Other	124,587	178,965	455,232	606,908
Total noninterest income	876,196	815,380	2,420,949	2,562,772
Noninterest expense:				
Salaries and benefits	1,521,987	1,343,601	4,303,403	3,961,687
Net occupancy expense	480,365	424,736	1,395,783	1,240,354

Other	600,417	574,816	1,972,095	1,782,497
Total noninterest expense	2,602,769	2,343,153	7,671,281	6,984,538
Earnings before income tax expense	863,971	710,088	2,068,716	2,174,927
Income tax expense	229,403	182,995	485,812	590,468
Net earnings	$ 634,568	$ 527,093	$ 1,582,904	$1,584,459
Basic earnings per share	$ 0.29	$ 0.24	$ 0.71	$ 0.73
Diluted earnings per share	$ 0.29	$ 0.24	$ 0.71	$ 0.72
Basic weighted average shares outstanding*	2,217,330	2,173,796	2,215,599	2,173,730
Diluted weighted average shares outstanding*	2,219,679	2,188,112	2,217,948	2,189,078
Cash dividend per share*	$	$	$ 0.15	$ 0.125
Statement of Comprehensive Income				
Net Income	634,568	527,093	$ 1,582,904	$1,584,458
Other Comprehensive Income, net of tax:				
Unrealized holding gain arising during the period	641,019	(611,123)	(59,969)	(310,411)
Less: Reclassification adjustment for gains included in net income.	100,566	42,878	102,539	218,203
Comprehensive income	$1,175,021	$ (126,908)	$ 1,420,396	$1,055,844

* Reflects two-for-one stock split effective June 30, 2004.

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United Bancorporation of Alabama, Inc.
and Subsidiary

Condensed Consolidated Statements of Cash Flows
For the Nine Months Ended September 30, 2004 and 2003
(Unaudited)

	2004	2003
Operating Activities		
Net Income	$ 1,582,904	1,584,458
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities		
Provision for Loan Losses	540,000	534,704
Depreciation on Premises and Equipment	605,991	561,884
Accretion of Investment Securities Available for Sale	128,766	203,880
Gain on Sale of Investment Securities Available for Sale	(170,898)	(363,672)
Gain on Sale of Other Real Estate	(897)	
Gain on Disposal of Premises and Equipment	(4,850)	(13,400)
Increase in Interest Receivable and Other Assets	(1,431,783)	(2,798,253)
Decrease in Accrued Expenses and Other Liabilities	(517,509)	(97,585)
Net Cash Provided (Used) by Operating Activities	731,724	(387,984)
Investing Activities		
Proceeds From Sales of Investment Securities Available for Sale	4,340,737	8,913,246
Proceeds From Maturities of Investment Securities Available for Sale	8,211,599	14,543,007
Purchases of Investment Securities Available for Sale	(13,464,598)	(19,156,035)
Net Increase in Loans	(35,003,862)	(8,813,630)
Purchases of Premises and Equipment	(335,733)	(1,516,907)
Proceeds From Sales of Premises and Equipment	4,850	13,400
Proceeds From Sales of Other Real Estate	5,000	
Net Cash Used by Investing Activities	(36,242,007)	(6,016,919)
Financing Activities		
Net Increase in Deposits	25,411,875	12,150,678
Net Increase in securities sold under agreement to repurchase	1,774,852	8,110,633
Cash Dividends	(332,219)	(271,725)
Net Tranactions on Treasury Stock	2,636	4,712
Proceeds from sale of common stock	38,207	
Decrease in Other Borrowed Funds	(1,879,698)	(1,986,716)
Net Cash Provided by Financing Activities	25,015,653	18,007,582
Increase (Decrease) in Cash and Cash Equivalents	(10,494,630)	11,602,679

Cash and Cash Equivalents at Beginning of Period	24,447,625	9,087,315
Cash and Cash Equivalents at End of Period	$ 13,952,995	20,689,994
Supplemental disclosures		
Cash paid during the year for:		
Interest	$ 2,607,522	$ 3,001,483
Income Taxes	$ 370,000	$ 563,000
Noncash transactions		
Transfer of loans to other real estate through foreclosure	$ 230,001	$ 920,000

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UNITED BANCORPORATION OF ALABAMA, INC.
AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements

NOTE 1 General

This report includes interim consolidated financial statements of United Bancorporation of Alabama, Inc. (the Corporation or the Company) and its wholly-owned subsidiary, United Bank (the Bank). The interim consolidated financial statements in this report have not been audited. In the opinion of management, all adjustments necessary to present fairly the financial position and the results of operations for the interim periods have been made. All such adjustments are of a normal recurring nature. The results of operations are not necessarily indicative of the results of operations for the full year or any other interim periods. For further information, refer to the consolidated financial statements and footnotes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2003.

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NOTE 2 Net Earnings per Share

Basic net earnings per share were computed by dividing net earnings by the weighted average number of shares of common stock outstanding during the three and nine-month periods ended September 30, 2004 and 2003. Common stock outstanding consists of issued shares less treasury stock. Diluted net earnings per share for the three and nine-month periods ended September 30, 2004 and 2003 were computed by dividing net earnings by the weighted average number of shares of common stock and the dilutive effects of the shares subject to options awarded under the Company s Stock Option Plan, based on the treasury stock method using an average fair market value of the stock during the respective periods. The earnings per share amounts and average common shares and potential common stock outstanding have been adjusted to reflect the two-for-one stock split effected as a 100% stock dividend as of June 30, 2004. Presented below is a summary of the components used to calculate diluted earnings per share for the three and nine months ended September 30, 2004 and 2003:

	2004	**2003**	**2004**	**2003**
Diluted earnings per share	$ 0.29	$ 0.24	$ 0.71	$ 0.72
Weighted average common shares outstanding	2,217,330	2,173,796	2,215,599	2,217,948
Effect of the assumed exercise of stock options based on the treasury stock method using average market price	2,349		2,349	
Total weighted average common shares and potential common stock outstanding*	2,219,679	2,173,796	2,217,948	2,217,948

*24,288 and 28,960 shares subject to outstanding options for the three and nine months ended September 30, 2004 and 2003, respectively, were not included in the calculation of diluted earnings per share, as the exercise price of these options was in excess of average market price.

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NOTE 3 Allowance for Loan Losses

The following table summarizes the activity in the allowance for loan losses for the nine month periods ended September 30 ($ in thousands):

	2004	**2003**
Balance at beginning of year	2,117	2,117
Provision charged to expense	540	535
Less loans charged off	282	308
Recoveries	59	61
Balance at end of period	2,434	2,405

At September 30, 2004 and 2003, the amounts of nonaccrual loans were $1,056,162 and $2,265,047, respectively.

NOTE 4 Operating Segments

Statement of Financial Accounting Standard 131 (SFAS 131), *Disclosures about Segments of an Enterprise and Related Information,* establishes standards for the disclosure made by public business enterprises to report information about operating segments in annual financial statements and requires those enterprises to report selected information about operating segments in interim financial reports issued to shareholders. It also establishes standards for related disclosures about products and services, geographic areas, and major customers. The Corporation operates in only one segment commercial banking.

NOTE 5 New Accounting Standards

In December 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46 (revised December 2003) (FIN 46R), *Consolidation of Variable Interest Entities*, which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces No. 46, *Consolidation of Variable Interest Entities*, which was issued in January 2003. The Company will be required to apply FIN 46R to all entities subject to this interpretation no later than the end of the first reporting period that ends after December 15, 2004. This interpretation must be applied to those entities that are considered to be special purpose entities no later than as of the end of the first reporting period that ended after December 15, 2003.

For any variable interest entities (VIEs) that must be consolidated under FIN No. 46R that were created before January 1, 2004, the assets, liabilities, and noncontrolling interests of the VIE initially would be measured at their carrying amounts with any difference between the net amount added to the balance sheet and any previously recognized interest being recognized as the cumulative effect of an accounting change. If determining the carrying amounts is not practicable, fair value at the date FIN No. 46R first applies may be used to measure the assets, liabilities and noncontrolling interest of the VIE.

The Company has applied FIN No. 46R in accounting for United Bancorp Capital Trust I (Trust), established on June 27, 2002. Accordingly, the accompanying balance sheet includes, in other assets, the Company s investment in the Trust of $124,000 and also includes, in Note payable to Trust , the balance owed the Trust of $4,124,000. Except as related to the Trust, the application of this interpretation is not expected to have a material effect on the Company s consolidated financial statements.

In May 2003, the FASB issued FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. The provisions of this statement are effective for financial instruments entered into or modified after May 31, 2003, and otherwise are effective at the beginning of the first interim period beginning after June 15, 2003. It is implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before May 15, 2003 and still existing at the beginning of the interim period of adoption. The adoption of this new standard did not have an impact on the consolidated financial position or results of operations of the Company.

In October 2003, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position (SOP) 03-3, which addresses accounting for differences between contractual cash flows expected to be collected from an investor s initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes such loans acquired in purchase business combinations and applies to all nongovernmental entities, including not-for-profit organizations. This SOP does not apply to loans originated by the entity. This SOP limits the yield that may be accreted (accretable yield) to the excess of the investor s estimate of undiscounted expected principal, interest, and other cash flows (cash flows expected at acquisition to be collected) over the investor s initial investment in the loan. This SOP requires that the excess of contractual cash flows over cash flows expected to be collected (nonaccretable difference) not be recognized as an adjustment of yield, loss accrual, or valuation allowance. This SOP prohibits investors from displaying accretable yield and nonaccretable difference in the balance sheet. Subsequent increases in cash flows expected to be collected generally would be recognized prospectively through adjustment of the loan s yield over its remaining life. Decreases in cash flows expected to be collected would be recognized as impairment. This SOP prohibits carrying over or creation of valuation allowances in the initial accounting of all loans acquired in a transfer that are within the scope of this SOP. The prohibition of the valuation allowance carryover applies to the purchase of an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination. This SOP is effective for loans acquired in fiscal years beginning after December 15, 2004. Management is currently assessing the potential impact of this SOP to the Consolidated Financial Statements.

In March 2004, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) 105, which summarizes the views of the staff regarding the application of generally accepted accounting principles to loan commitments accounted for as derivative instruments. The SAB requires that the fair value measurement of a loan commitment that is accounted for as a derivative includes only differences between the guaranteed interest rate in the loan commitment and a market interest rate, excluding any expected future cash flows related to the customer relationship or loan servicing. This SAB is effective for loan commitments entered into after March 31, 2004. The Company adopted SAB 105 on April 1, 2004, and the effect was not material.

In November 2003, the Emerging Issues Task Force (EITF) issued issue summary 03-1 (EITF 03-1), *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.* EITF 03-01 addressed an entity s treatment of the impairment of securities when such impairment is considered other than temporary. The preliminary summary required disclosures only related to other than temporary impairment. In March 2004, the EITF continued its discussion and reached a consensus on the procedures for recognizing an impairment of securities considered other than temporarily impaired. The guidance in EITF 03-1 was intended to be effective for reporting periods beginning after June 15, 2004. However, in September 2004, the FASB issued FSP EITF 03-1-1, which deferred the effective date for the measurement and recognition provisions of EITF 03-1 until further implementation guidance could be established. Management does not believe the provision of this standard, as currently written, will have a material impact on consolidated financial position or the results of future operations.

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NOTE 6 Stock Based Compensation

The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations, in accounting for its fixed plan stock options. As such, compensation expense is recorded if the current market price on the date of grant of the underlying stock exceeds the exercise price.

Statement of Financial Accounting Standard (SFAS) No. 123 prescribes the recognition of compensation expense based on the fair value of options on the grant date and allows companies to apply APB No. 25 as long as certain pro forma disclosures are made assuming hypothetical fair value method application.

Had compensation expense for the Company s stock options been recognized based on the fair value on the grant date under the methodology prescribed by SFAS No. 123, the Company s net earnings and earnings per share for the three and nine months ended September 30, 2004 and 2003 would have been impacted as shown in the following table:

	For the three months ended September 30		For the nine months ended September 30	
	2004	**2003**	**2004**	**2003**
Reported net earnings	$634,568	$527,093	$1,582,904	$1,584,459
Compensation expense, net of taxes	5,020	6,572	15,059	19,715
Pro forma net earnings	629,548	520,521	1,567,845	1,564,744
Reported basic earnings per share*	$ 0.29	$ 0.24	$ 0.71	$ 0.73
Pro forma basic earnings per share*	$ 0.28	$ 0.24	$ 0.71	$ 0.72
Reported diluted earnings per share*	$ 0.29	$ 0.24	$ 0.71	$ 0.73
Pro forma diluted earnings per share*	$ 0.28	$ 0.24	$ 0.71	$ 0.72

*Reflects two-for-one stock split effective June 30, 2004.

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

Critical Accounting Estimates

The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, which require management to make estimates and assumptions. Management believes that its determination of the allowance for loan losses is a critical accounting policy and involves a higher degree of judgment and complexity than the Bank s other significant accounting policies. Further, these estimates can be materially impacted by changes in market conditions or the actual or perceived financial condition of the Bank s borrowers, subjecting the Bank to significant volatility of earnings.

The allowance for loan losses is regularly evaluated by management and reviewed by the Board of Directors for accuracy by taking into consideration factors such as changes in the nature and volume of the loan portfolio; trends in actual and forecasted portfolio credit quality, including delinquency, charge-off and bankruptcy rates; and current economic conditions that may affect a borrower s ability to pay. The use of different estimates or assumptions could produce different provisions for loan losses. The allowance for credit losses is established through the provision for loan losses, which is a charge against earnings.

Results of Operations

The following financial review is presented to provide an analysis of the results of operations of United Bancorporation of Alabama, Inc. (the Corporation) and its principal subsidiary for the three and nine months ended September 30, 2004, and 2003, compared. This review should be used in conjunction with the condensed consolidated financial statements included in the Form 10-Q.

Nine Months ended September 30, 2004 and 2003, Compared

Summary

Net income for the nine months ended September 30, 2004, decreased by $1,555 for no material change, as compared to the same period in 2003.

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Net Interest Income

Total interest income increased $455,775, or 4.57%, for the first nine months of 2004 as compared to the same period in 2003. Average interest-earning assets were $249,337,898 for the first nine months of 2004, as compared to $224,071,347 for the same period in 2003, an increase of $25,266,551, or 11.28%. A substantial portion of the increase is due to increases in deposits by two existing Bank customers. The average rate earned on interest earning assets in 2004 was 5.33% as compared to 5.73% in 2003, reflecting the continuing impact of the decrease in rates by the Federal Reserve Board during previous years. The Federal Reserve Board has raised rates three times since June of 2004, but the interest earning assets yields have still not risen to the rates of a year ago.

Total interest expense decreased by $271,877, or 9.56%, in 2004, when compared to the same period in 2003. Average interest bearing liabilities increased to $199,980,397 in 2004 from $177,572,799 in 2003, an increase of $22,407,598, or 12.62%. The average rate paid fell to 1.72% in 2004 as compared to 2.14% in 2003.

This decrease in interest expense can be attributed primarily to higher interest rates paid in 2003 on slower repricing deposits, compared to lower rates paid on deposits which have repriced in 2004 at the current lower interest rates. The Bank expects the cost of deposits to rise over the next three months, due to the rise in rates caused by the Federal Reserve Board.

Net interest margin decreased to 4.21% for the first nine months of 2004 as compared to 4.26% for the same period in 2003. This decrease is the result of the interest earning assets repricing faster than the interest bearing liabilities funding the Bank s investment and loan portfolios.

Noninterest Income

Total noninterest income decreased $141,823 or 5.53% for the first nine months of 2004. Service charges on deposits increased $211,820, or 13.71%, for the first nine months of 2004. This increase is primarily due to an increase in insufficient fund charges on checks, which increased $169,686 or 15.27%. Gains on sale of investments decreased by $192,774 in 2004, compared to 2003, when management elected to capture gains on securities given management s assessment of a high probability that these interest bearing securities would be called at par in future periods. Management has sold additional investments in the third quarter of 2004 to help fund loans. Commissions on credit life insurance decreased $9,193 in 2004, or 19.31%, as compared to 2003. Other income decreased during the first nine months of 2004 by $151,676 or 24.99%. This decrease is partially attributed to a decrease of $87,517 in mortgage origination fees in 2004, and a decrease in gain on the sale of other real estate owned of $26,672 in 2004.

Noninterest Expense

Total noninterest expense increased $686,743, or 9.83% during the first nine months of 2004 as compared to 2003. Salaries and benefits increased $341,716 or 8.63% in the first nine months of

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2004 primarily due to the addition of two new branches in Summerdale, Alabama and Jay, Florida, increased health insurance cost, and an increase in 401(k) plan contributions. Occupancy expense increased $155,429 or 12.53% as the Bank continued expansion into new markets. Other expenses increased $189,598, or 10.64%, during the first nine months of 2004. This increase is due in part to increases in professional fees as the Bank implements requirements of the Sarbanes-Oxley Act of 2002, increased expense for supplies, as well as increased marketing expenses incurred to promote the celebration of the Bank s 100th anniversary.

Provision for Loan Losses

The provision for loan losses totaled $540,000 for the first nine months of 2004 as compared to $534,704 for the same period in 2003. This slight increase is due to the growth in the loan portfolio. See further discussion under Allowance for Loan Losses below.

Income Taxes

Earnings before taxes for the first nine months of 2004 were $2,068,717 as compared to $2,174,927 for the first nine months of 2003, a decrease of $106,210, or 4.88%. Income tax expense for the first nine months of 2004 decreased by $104,655, to $485,813 or by 17.72%, when compared to $590,468 the same period in 2003. The effective tax rate decreased to 23.48% from 27.15%. This decrease is due to increases in nontaxable income as the Bank reduced its income tax expense.

Three Months Ended September 30, 2004, and 2003, Compared

Summary

Net income for the three months ended September 30, 2004 increased $107,475, or 20.39%.

Net Interest Income

Total interest income increased $381,844, or 11.58%, in the third quarter of 2004 as compared to 2003. Average interest-earning assets were $254,687,856 for the third three months of 2004, as compared to $230,403,104 for the same period in 2003, an increase of $24,284,752, or 10.54%. A substantial portion of the increase is due to increases in deposits by two existing Bank customers. The average rate earned during the third quarter of 2004 was 5.53% as compared to 5.48% in 2003, reflecting the continuing impact of the decrease in rates by the Federal Reserve Board during previous years.

Total interest expense increased by $35,161 or 4.02% in the third quarter of 2004, when compared to the same period in 2003. Average interest bearing liabilities increased to $205,207,911 in 2004 from $183,568,909 in 2003, an increase of $21,639,002, or 11.79%. The average rate paid fell to 1.77% in 2004 as compared to 1.91% in 2003.

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The net interest margin increased to 4.33% for the third quarter of 2004, as compared to 4.17% for the same period in 2003. This was due to interest rates being higher during the third quarter of 2004 than in the third quarter of 2003, because the increase in interest rates by the Federal Reserve Board did not occur until the end of June 2004.

Provision for Loan Losses

The provision for loan losses totaled $180,000 for the third quarter of 2004 as compared to $186,000 for the same period in 2003. The provision reflected both the growth and improvement in credit quality in the loan portfolio. See further discussion under Allowance for Loan Losses below.

Noninterest Income

Total noninterest income increased $60,816 or 7.46% for the third quarter of 2004. Service charges on deposits increased $30,366, or 5.51%, for the third quarter of 2004 as compared to 2003. This increase is primarily due to an increase in insufficient fund charges on checks, which increased $15,994. Gains on sale of investments increased by $96,146 in the third quarter of 2004 as compared to 2003, because management sold investments in the third quarter of 2004 to help fund loans. Commissions on credit life insurance decreased $11,318, or 80.66% for the third quarter of 2004. Other income decreased during the third quarter of 2004 by $54,378 or 30.38% as compared to 2003. The majority of this decrease is from the decrease in mortgage origination fees of $49,797 from the 2003 third quarter compared to the 2004 period.

Noninterest Expense

Total noninterest expense increased $259,616, or 11.08%, during the third quarter of 2004 compared to the same quarter of 2003. Salaries and benefits increased $178,386, or 13.28%, in the third quarter 2004. This increase is primarily due to the expansion of the bank into new markets. Occupancy expense increased $55,629, or 13.10%, in the third quarter of 2004, also largely associated with branch expansion. Other expenses increased $25,601 or 4.45% during the third quarter of 2004 as compared to 2003, reflecting overall increases in general operating expenses due to the continued expansion.

Income Taxes

Earnings before taxes for the third quarter of 2004 were $863,971 as compared to $710,088 in the third quarter of 2003, an increase of $153,883 or 21.67%. Income tax expense for the third quarter increased $46,408 to $229,403, or by 25.36%, when compared to $182,995 for the same period in 2003. The effective tax rate increased to 26.55% from 25.77%.

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Financial Condition and Liquidity

Total assets on September 30, 2004 increased $25,981,099 or 10.18% from December 31, 2003. Average total assets for the first nine months of 2004 were $280,923,815. The ratio of loans (net of allowance) to deposits plus repurchase agreements on September 30, 2004 was 81.74% as compared to 76.11% on December 31, 2003.

Cash and Cash Equivalents

Federal Funds Sold and interest bearing balances in other banks as of September 30, 2004 decreased to $2,759,721, or by 81.03%, from December 31, 2003. This decrease is attributed to the increase in loans and the increase in investment securities available for sale.

Loans

Net loans increased by $34,233,861 or 21.13% at September 30, 2004, from December 31, 2003. Agricultural lending and commercial real estate loans contributed the majority of this loan growth. Agricultural loans are normally originated in the winter and spring of the year with funding taking place through the fall.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level which, in management s opinion, is appropriate to provide for estimated losses in the portfolio at the balance sheet date. Factors considered in determining the adequacy of the allowance include historical loan loss experience, the amount of past due loans, loans classified from the most recent regulatory examinations and internal reviews, general economic conditions and the current portfolio mix. The amount charged to operating expenses is that amount necessary to maintain the allowance for loan losses at a level indicative of the associated risk, as determined by management, of the current portfolio.

The allowance for loan losses consists of two portions: the classified portion and the nonclassified portion. The classified portion is based on identified problem loans and is calculated based on an assessment of credit risk related to those loans. Specific loss estimate amounts are included in the allowance based on assigned loan classifications as follows: monitor (5%), substandard (15%), doubtful (50%), loss (100%) and specific reserves based on identifiable losses. Any loan categorized loss is charged off in the period in which the loan is so categorized.

The nonclassified portion of the allowance is for inherent losses which probably exist as of the evaluation date even though they may not have been identified by the more specific processes for the classified portion of the allowance. This is due to the risk of error and inherent imprecision in the process. This portion of the allowance is particularly subjective and requires judgments based upon qualitative factors which do not lend themselves to exact mathematical calculations. Some of the factors considered are changes in credit concentrations, loan mix, historical loss experience, non-accrual and delinquent loans and the general economic environment in the

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Corporation s markets. However, unfavorable changes in the factors used by management to determine the adequacy of the allowance, including increased loan delinquencies and subsequent charge-offs, or the availability of new information, could require additional provisions, in excess of normal provisions, to the allowance for loan losses in future periods.

While the total allowance is described as consisting of a classified and a nonclassified portion, these terms are primarily used to describe a process. Both portions are available to support inherent losses in the loan portfolio. Management realizes that general economic trends greatly affect loan losses, and no assurances can be made that future charges to the allowance for loan losses will not be significant in relation to the amount provided during a particular period, or that future evaluations of the loan portfolio based on conditions then prevailing will not require sizable charges to income. Management does, however, consider the allowance for loan losses to be appropriate for the reported periods.

The allowance for possible loan losses represents 1.22% of gross loans at September 30, 2004, as compared to 1.29% at year-end 2003. This decrease was due to a combination of improved credit quality of the loan portfolio, partially offset by the growth in the agricultural portion of the portfolio.

Loans on which the accrual of interest had been discontinued has decreased to $1,056,162 at September 30, 2004, as compared to $2,265,047 at December 31, 2003. This decrease is due primarily to several unrelated commercial and some residential property loans either refinancing, paying off or being foreclosed on. Net charged-off loans for the first nine months of 2004 were $223,000, as compared to $247,000 for the same period in 2003.

Non-performing Assets: The following table sets forth the Corporation s non-performing assets at September 30, 2004 and December 31, 2003. Under the Corporation s nonaccrual policy, a loan is placed on nonaccrual status when collectibility of principal and interest is in doubt or when principal and interest is 90 days or more past due except for credit cards, which continue to accrue interest after ninety days.

The amount of impaired loans determined under SFAS No. 114 and 118 has been considered in the summary of non-performing assets below. These credits were considered in determining the adequacy of the allowance for loan losses and are regularly monitored for changes within a particular industry or general economic trends, which could cause the borrowers financial difficulties. At September 30, 2004 the Bank had $689,924 in impaired loans, compared to $100,318 at December 31, 2003, reflecting an increase in specific reserves on classified loans.

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Description			September 30 2004	December 31, 2003
			(Dollars in Thousands)	
	A	Loans accounted for on a nonaccrual basis	$ 1,056	$ 2,265
	B	Loans which are contractually past due ninety days or more as to interest or principal payments (excluding balan FONT-SIZE: 10pt; FONT-FAMILY: times new roman">Cash and cash equivalents	$ 6,864	$ 6,279
Restricted cash	643		771	
Accounts receivable, net of doubtful accounts	4,797		3,240	
Inventories	4,236		3,495	
Prepaid expenses and other current assets	417		507	
Total current assets	16,957		14,292	
Property, plant and equipment, (net)	2,411		2,051	
Intangible assets, (net)	-		8	
Investments in equity investees	31		1	
Total assets	$ 19,399		$ 16,352	
Current liabilities:				
Accounts payable	$ 3,581		$ 2,389	
Short-term borrowings	280		793	
Long-term loans-current portion	253		-	
Obligations under capital leases – current portion	41		251	
Accrual expenses and other liabilities	2,057		1,056	
Income tax payable	71		-	
Total current liabilities	6,283		4,489	
Obligations under capital leases-net of current portion	3		44	
Deferred income taxes	173		147	
Long-term loans – net of current portion	375		-	
Total liabilities	6,834		4,680	
Shareholders' equity:				
Common shares, $0.01 par value	38		38	
Additional paid-in capital	11,335		11,289	
Retained earnings	1,206		461	
Accumulated other comprehensive loss	-		(13)	
	(14)		(53)	

Treasury shares, at cost – 37,800 shares and 5,049 shares as of March 31, 2010; and 2011 respectively		
Total Highway Holdings Limited shareholders' equity	12,565	11,722
Non-controlling interest	-	(50)
Total Equity	12,565	11,672
Total liabilities and shareholders' equity	$ 19,399	$ 16,352