SLADES FERRY BANCORP
Form 10-Q
May 12, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period quarter ended March 31, 2005

Commission file number 000-23904

SLADE'S FERRY BANCORP.

(Exact name of registrant as specified in its character)

Massachusetts	04-3061936
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
100 Slade's Ferry Avenue Somerset, Massachusetts	02726
(Address of principal executive offices)	(Zip code)

(508)-675-2121

(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 reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes No X

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date:

Common stock ($0.01 par value) 4,114,646 shares as of April 30, 2005.

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PART I

ITEM 1

FINANCIAL STATEMENTS

SLADE'S FERRY BANCORP. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)	March 31, 2005	December 31, 20
	(Unaudited)	
Assets		
Cash and due from banks	$ 19,901	$ 15,984
Interest-bearing demand deposits with other banks	550	410
Federal Home Loan Bank overnight deposit	-	5,000

Federal funds sold	7,100	13,800
Cash and cash equivalents	27,551	35,194
Interest-bearing time deposits with other bank	100	100
Investments in available-for-sale securities (at fair value)	80,896	83,882
Investments in held-to-maturity securities (fair values of $35,883 at March 31, 2005 and $38,112 at December 31, 2004)	35,964	37,773
Federal Home Loan Bank stock	5,905	4,650
Loans, net of allowance for loan losses of $4,176 at March 31, 2005 and $4,101 at December 31, 2004	379,452	362,265
Premises and equipment	5,427	5,527
Goodwill	2,173	2,173
Accrued interest receivable	2,055	1,969
Cash surrender value of life insurance	11,563	11,548
Deferred taxes	1,321	880
Other assets	3,428	3,871
Total assets	$555,835	$549,832
Liabilities and Stockholders' Equity		
Deposits:		
Noninterest-bearing	$ 76,602	$ 80,232
Interest-bearing	308,936	319,673
Total deposits	385,538	399,905
Federal Home Loan Bank advances	110,180	90,286
Subordinated debentures	10,310	10,310
Other liabilities	2,211	2,296
Total liabilities	508,239	502,797
Stockholders' equity:		
Common stock, par value $0.01 per share; authorized 10,000,000 shares; issued and outstanding 4,094,333 shares on March 31, 2005 and 4,068,423 shares on December 31, 2004	41	41
Paid-in capital	30,381	29,976
Retained earnings	17,590	16,893
Accumulated other comprehensive income (loss)	(416)	125
Total stockholders' equity	47,596	47,035
Total liabilities and stockholders' equity	$555,835	$549,832

The accompanying notes are an integral part of these consolidated financial statements.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

(Dollars in Thousands, except per share data)	Three Months Ended March 31, 2005	2004
Interest and dividend income:		
Interest and fees on loans	$ 5,266	$ 4,892
Interest and dividends on securities	1,322	529
Interest on federal funds sold	65	58
Other interest	4	1
Total interest and dividend income	6,657	5,480
Interest expense:		
Interest on deposits	1,159	1,122
Interest on Federal Home Loan Bank advances	911	595
Interest on subordinated debentures	136	16
Total interest expense	2,206	1,733
Net interest and dividend income	4,451	3,747
Provision for loan losses	50	246
Net interest and dividend income after provision for loan losses	4,401	3,501
Noninterest income:		
Service charges on deposit accounts	98	145
Overdraft service charges	110	123
Gain on sale of property and equipment	40	-
Gain on sales and calls of available-for-sale securities, net	2	35
Increase in cash surrender value of life insurance policies	147	138
Other income	172	122
Total noninterest income	569	563
Noninterest expense:		
Salaries and employee benefits	2,033	1,968
Occupancy expense	239	231
Equipment expense	170	147
Professional fees	307	227
Marketing expense	99	57
Other expense	525	480
Total noninterest expense	3,373	3,110
Income before income taxes	1,597	954
Income taxes	532	308
Net income	$ 1,065	$ 646
Earnings per common share - basic	$ 0.26	$ 0.16
Earnings per common share - diluted	$ 0.26	$ 0.16
Weighted average common shares outstanding - basic	4,076,707	4,012,654
Weighted average common shares outstanding - diluted	4,113,256	4,069,855
Dividends declared per share	$ 0.09	$ 0.09

The accompanying notes are an integral part of these consolidated financial statements.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
THREE MONTHS ENDED MARCH 31, 2005 AND DECEMBER 31, 2004
(Unaudited)

(Dollars in Thousands, except per share data)	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)
Balance, December 31, 2004	$41	$29,976	$16,893	$ 125
Comprehensive income:				
Net income	-	-	1,065	-
Net unrealized losses on securities available-for-sale, net of tax and reclassification adjustment	-	-	-	(541)
Comprehensive income	-	-	-	-
Issuance of common stock from dividend reinvestment plan	-	142	-	-
Stock issuance relating to optional cash contribution plan	-	12	-	-
Stock options exercised	-	196	-	-
Tax benefit of stock options exercised	-	55	-	-
Dividends declared ($.09 per share)	-	-	(368)	-
Balance, March 31, 2005	$41	$30,381	$17,590	$(416)

The accompanying notes are an integral part of these consolidated financial statements.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(Dollars in Thousands)	Three Months Ended March 31, 2005	2004

Cash flows from operating activities:		
Net income	$ 1,065	$ 646
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization, net of accretion of securities	59	44
Gain on sales and calls of available-for-sale securities, net	(2)	(35)
Change in unearned income	37	83
Provision for loan losses	50	246
Deferred tax (benefit) expense	244	(21)
Depreciation and amortization	184	166
Gain on sale of property and equipment	(40)	-
Increase in cash surrender value of life insurance policies	(147)	(138)
Increase in interest receivable	(86)	(6)
(Increase) decrease in other assets	443	(404)
Decrease in other liabilities	(85)	(165)
Net cash provided by operating activities	1,722	416
Cash flows from investing activities:		
Decrease in interest-bearing time deposits with other banks	-	100
Purchases of available-for-sale securities	(767)	(852)
Proceeds from sales of available-for-sale securities	892	-
Proceeds from maturities of available-for-sale securities	1,670	5,535
Proceeds from maturities of held-to-maturity securities	1,772	1,367
Purchases of Federal Home Loan Bank stock	(1,255)	-
Loan originations and principal collections, net	(17,299)	(17,656)
Recoveries of loans previously charged off	25	49
Purchase of premises and equipment	(696)	(118)
Proceeds from sale of banking premises	652	-
Proceeds from sale of property and equipment	-	(25)
Redemption of life insurance policy	132	-
Net cash used in investing activities	(14,874)	(11,600)

The accompanying notes are an integral part of these consolidated financial statements.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(Continued)

	Three Months Ended March 31,	
(Dollars in Thousands)	2005	2004
Cash flows from financing activities:		
Net increase in demand deposits, NOW and savings accounts	$ 807	$ 33,774
Net increase (decrease) in time deposits	(15,174)	33,357
Short-term advances from Federal Home Loan Bank, net	-	(4,300)
Long-term advances from Federal Home Loan Bank	20,000	-

Payments on Federal Home Loan Bank long-term advances	(106)	(85)
Proceeds from issuance of common stock	154	201
Stock options exercised	196	327
Retirement of shares of common stock	-	(32)
Dividends declared	(368)	(360)
Proceeds from issuance of subordinated debentures	-	10,310
Net cash provided by financing activities	5,509	73,192
Net increase (decrease) in cash and cash equivalents	(7,643)	62,008
Cash and cash equivalents at beginning of period	35,194	22,706
Cash and cash equivalents at end of period	$ 27,551	$ 84,714
Supplemental disclosures:		
Interest paid	$ 2,132	$ 1,683
Income taxes paid	$ 555	$ 101

The accompanying notes are an integral part of these consolidated financial statements.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
March 31, 2005

Note A - Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and the instructions to Form 10-Q and, accordingly, do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of the management of Slade's Ferry Bancorp. (the "Company"), all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

The year-end consolidated financial data was derived from audited financial statements, but does not include all disclosures required by GAAP. This form 10-Q should be read in conjunction with the Company's Annual Report filed on Form 10-K for the year ended December 31, 2004.

Note B - Accounting Policies

The accounting principles followed by Slade's Ferry Bancorp. and subsidiary and the methods of applying these principles which materially affect the determination of financial position, results of operations, or changes in financial position are consistent with those used for the year ended December 31, 2004.

The consolidated financial statements of Slade's Ferry Bancorp. include its wholly-owned subsidiary, Slade's Ferry Trust Company, and its subsidiaries, Slade's Ferry Realty Trust, Slade's Ferry Securities Corporation, Slade's Ferry Securities Corporation II and Slade's Ferry Loan Company. Slade's Ferry Loan Company is currently in the process of dissolution. All significant intercompany balances have been eliminated.

Slade's Ferry Statutory Trust I, a subsidiary of the Company, was formed to sell capital securities to the public through a third party trust pool. In accordance with Financial Accounting Standards Board ("FASB") Interpretation No. 46R, "Consolidation of Variable Interest Entities" ("FIN 46R"), the subsidiary has not been included in the consolidated financial statements.

Note C - Stock Based Compensation

The Company has a stock-based employee compensation plan. The Company accounts for the plan under the recognition and measurement principles of Accounting Principle Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations. No stock-based employee compensation cost is reflected in net income (except for appreciation from options surrendered), as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards ("SFAS") Statement No. 123, "Accounting for Stock-Based Compensation," to stock-based employee compensation.

	Three Months Ended March 31,	
(Dollars in Thousands, except per share data)	2005	2004
Net income, as reported	$1,065	$ 646
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	-	-
Pro forma net income	$1,065	$ 646
Earnings per share:		
Basic - as reported	$ 0.26	$0.16
Basic - pro forma	$ 0.26	$0.16
Diluted - as reported	$ 0.26	$0.16
Diluted - pro forma	$ 0.26	$0.16

Note D - Pension Benefits

The following summarizes the net periodic benefit cost for the three months ended March 31:

(Dollars in Thousands)	2005	2004
Service cost	$ 1	$ 3
Interest cost	26	25
Expected return on plan assets	(41)	(11)
Amortization of transition obligation	2	2
Prior service cost recognized	1	1
Recognized net actuarial (gain) loss	21	(56)
Net periodic benefit cost (income)	$ 10	$(36)

The Company previously disclosed in its consolidated financial statements for the year ended December 31, 2004 that it expects to make no contributions to the plan in 2005.

Note E - Impact of New Accounting Standards

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"). This Statement revises FASB Statement No. 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and its related implementation guidance. SFAS 123R requires that the cost resulting from all share-based payment transactions be recognized in the financial statements. It establishes fair value as the measurement objective in accounting for share-based payment arrangements and requires all entities to apply a fair-value based measurement method in accounting for share-based payment transactions with employees except for equity instruments held by employee share ownership plans. This Statement was originally to be effective for the Company as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. On April 14, 2005, the Securities and Exchange Commission adopted a rule which allows companies to adopt SFAS 123R at the beginning of their next fiscal year. Accordingly, the Company will adopt SFAS 123R effective January 1, 2006. The Company does not believe the adoption of this Statement will have a material impact on the Company's financial position or results of operations.

ITEM 2

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Slade's Ferry Bancorp, a Massachusetts corporation, is a bank holding company headquartered in Somerset, Massachusetts with consolidated assets of $555.8 million, consolidated net loans and leases of $379.5 million, consolidated deposits of $385.5 million and consolidated shareholders' equity of $47.7 million as of March 31, 2005. We conduct our business principally through our wholly-owned subsidiary, Slade's Ferry Trust Company (referred to herein as the "Bank"), a Massachusetts-chartered trust company.

Our common stock is quoted on the Nasdaq Small Cap Market under the symbol "SFBC."

Forward-looking Statements

This Form 10-Q contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including statements regarding the strength of the company's capital and asset quality. Such statements may be identified by words such as "believes," "will," "expects," "project," "may," "could," "developments," "strategic," "launching," "opportunities," "anticipates," "estimates," "intends," "plans," "targets" and similar expressions. These statements are based upon the current beliefs and expectations of Slade's Ferry Bancorp's management and are subject to significant risks and uncertainties. Actual results may differ materially from those set forth in the forward-looking statements as a result of numerous factors.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in our forward-looking statements:

(1) enactment of adverse government regulation;
(2) competitive pressures among depository and other financial institutions may increase significantly and have an effect on pricing, spending, third-party relationships and revenues;
(3) the strength of the United States economy in general and specifically the strength of the New England economies may be different than expected, resulting in, among other things, a deterioration in overall credit quality and borrowers' ability to service and repay loans, or a reduced demand for credit, including the resultant effect on the Bank's loan portfolio, levels of charge-offs and non-performing loans and allowance for loan losses;
(4) changes in the interest rate environment may reduce interest margins and adversely impact net interest income; and
(5) changes in assumptions used in making such forward-looking statements.

Should one or more of these risks materialize or should underlying beliefs or assumptions prove incorrect, Slade's Ferry Bancorp's actual results could differ materially from those discussed.

All subsequent written and oral forward-looking statements attributable to Slade's Ferry Bancorp or any person acting on its behalf are expressly qualified in their entirety by the cautionary statements set forth above. Slade's Ferry Bancorp does not intend or undertake any obligation to update any forward-looking statement to reflect circumstances or events that occur after the date the forward-looking statements are made.

As used throughout this report, the terms "we," "our," "us," or the "Company" refer to Slade's Ferry Bancorp and its consolidated subsidiaries.

Critical Accounting Policies

Our significant accounting policies are incorporated by reference from Note 2 to our Consolidated Financial Statements filed within Form 10-K for the year ended December 31, 2004. In preparing financial information, management is required to make significant judgements, estimates, and assumptions that impact the reported amounts of certain assets, liabilities, revenues and expenses. The accounting principles we follow and the methods of applying these principles conform to accounting principles generally accepted in the United States, and general banking practices. We consider the following to be our critical accounting policies: allowance for loan losses; goodwill and other intangible assets other than temporary impairment of investments; and deferred taxes.

Allowance for loan losses. The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon our periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

Other than temporary impairment. We record a writedown impairment charge when we believe an investment experiences a decrease in value that is other than temporary. In making a decision whether an investment is permanently impaired, we review current and forecasted information about the underlying investment that is available, applicable industry data, and analyst reports. When an investment is deemed to be permanently impaired, it is written down to current fair market value. Future adverse changes in economic and market conditions, deterioration in credit quality, and continued poor financial results of underlying investments or other factors could result in further losses that may not be reflected in an investment's current book value that could result in future writedown charges due to impairment.

Deferred tax estimates. We use the asset and liability method for accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective tax basis. We also assess the probability that deferred tax assets will be recovered from future taxable income, and establish a valuation allowance for any assets determined not likely to be recovered. Our management exercises judgement in evaluating the amount and timing of recognition of the resulting deferred tax assets and liabilities, including projections of future taxable income. These judgements are estimates and assumptions and are reviewed on a continuing basis.

Comparison of Financial Condition at March 31, 2005 and December 31, 2004

General

Total assets increased by $6.0 million, or 1.1%, from $549.8 million at December 31, 2004 to $555.8 million at March 31, 2005. The increase is the result of growth in the loan portfolio, which increased by $17.2 million or 4.7%, from $362.3 million (net of allowance for loan losses) to $379.5 million. The increase in loans was partially offset by decreases in cash equivalents totaling $7.6 million and decreases in securities portfolios totaling $3.8 million. During the first quarter of 2005, deposits decreased by $14.4 million, or 3.6%, from $399.9 million to $385.5 million. This decrease is predominantly the result of planned run-off of certificate

of deposit "specials" which matured in January of 2005. The decrease in deposits was offset by an increase in Federal Home Loan Bank advances totaling $19.9 million.

Cash and Cash Equivalents

Cash and cash equivalents decreased by $7.6 million, from $35.2 million reported at year-end 2004 to $27.6 million at March 31, 2005. The decrease partially funded the run-off of special-rate certificates of deposit that matured in January 2005.

Investment Portfolio

Total investments, excluding Federal Home Loan Bank stock, decreased by $4.8 million from $121.7 million reported at December 31, 2004 to $116.9 million at March 31, 2005. The decrease in investments, coupled with the decrease in federal funds sold, partially funded the planned run-off of premium-rate certificates of deposit that matured in January 2005. We chose not to offer a premium-rate certificate in January 2005. Contingent upon our funding needs, additional premium-rate certificates may be offered in the future. The main objective of the investment policy is to provide adequate liquidity to meet reasonable declines in deposits and any anticipated increases in the loan portfolio, to provide safety of principal and interest, to generate earnings adequate to provide a stable income, and to fit within our overall asset/liability management objectives. We do not purchase free standing derivative instruments, such as swaps, options or futures.

We utilize both a "held-to-maturity" portfolio and an "available-for-sale" portfolio, as defined in Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities", to manage investments. Our investment policy requires Board approval before a trading account can be established. The held-to-maturity portfolio was originally established for holding high-yielding municipal securities. During 2004, certain mortgage-backed securities designated as collateral for FHLB advances were also designated as held-to-maturity. Management has the ability and intent to hold these securities to their contractual maturity. We primarily utilize U.S. Government agency securities and agency-insured mortgage-backed securities as investment vehicles. High-quality corporate bonds and municipal securities are purchased when an exceptional opportunity to enhance investment yields arises. Purchases of these investments are limited to securities that carry a rating of "Baa1" (Moody's) or "BBB+" (Standard and Poor's), in order to control credit risk within the investment portfolio. Among other investment criteria, it is management's goal to maintain a total portfolio duration of less than five years. At March 31, 2005, the portfolio duration was estimated at 2.65 years.

The following table presents the amortized cost, unrealized gains and losses, and fair value of our portfolio of Investment Securities Held-to-Maturity at March 31, 2005:

(Dollars in Thousands)	Amortized Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Fair
Debt securities issued by states of the United States and political subdivisions of the states	$ 8,251	$222	$ 6	$
Federal agency mortgage-backed securities	27,713	-	297	2
Total	$35,964	$222	$303	$3

Securities in the Available-for-Sale portfolio are securities that we intend to hold for an indefinite period of time, but not necessarily to maturity. These securities may be sold in response to interest rate changes, liquidity needs or other factors. Any unrealized gain or loss, net of taxes, for the Available-for-Sale securities is reflected in stockholders' equity.

The Available-for-Sale portfolio consists primarily of Federal agency obligations, agency-insured mortgage-backed securities, and high-quality corporate bonds. We also have a portfolio of common and preferred marketable equity securities. The equity securities carry a greater level of risk as they are subject to market fluctuations. These securities are constantly monitored and evaluated to determine their suitability for sale, retention in the portfolio, or possible write-downs due to impairment issues. We minimize risk by limiting the total amount invested in marketable equity securities. At March 31, 2005, the amount invested in marketable equity securities was 4.4% of the total market value of the investment portfolio distributed over various industry sectors.

The following table presents the amortized cost, unrealized gains and losses, and fair value of our portfolio of Investment Securities Available-for-Sale at March 31, 2005:

(Dollars in Thousands)	Amortized Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses
Debt securities issued by the U.S. Treasury and other U.S. Government corporations and agencies	$41,423	$ 5	$ 651
Federal agency mortgage-backed securities	26,385	238	153
Corporate debt securities	9,089	29	231
Mutual funds	1,215	1	-
Marketable equity securities	3,736	153	343

Total	$81,848	$426	$1,378

Loans

The loan portfolio consists of loans originated primarily in our market area. There are no foreign loans outstanding. The interest rates we charge on loans are affected principally by the demand for such loans, the supply of money available for lending purposes and the rates offered by its competitors. Total net loans increased from 65.9% of total assets at December 31, 2004, to 68.3% of total assets at March 31, 2005.

The following table shows the amount of loans by category at March 31, 2005 and December 31, 2004.

(Dollars In Thousands)	March 31, 2005	December 31, 2004	Pe Increas
Commercial, financial and agricultural	$ 30,113	$ 26,606	
Real estate - construction and land development	22,535	24,240	
Real estate - residential	101,084	97,496	
Real estate - commercial	205,423	192,822	
Home equity lines of credit	22,556	23,131	
Consumer	2,393	2,510	
Total loans	384,104	366,805	
Allowance for loan losses	(4,176)	(4,101)	
Unearned income	(476)	(439)	
Net loans, carrying amount	$379,452	$362,265	

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The increases in the loan portfolio are the result of the normal origination process. We have been successful in both retention of existing loans and the origination of new loans, particularly commercial and commercial real estate loans.

The following table presents information with respect to nonaccrual and past due loans during the periods indicated.

Information With Respect to Nonaccrual and Past Due Loans
at March 31, 2005 and December 31, 2004

(Dollars in Thousands)	At March 31, 2005	At Decembe 2004

Non-accrual loans	$ 484	$ 50
Interest income that would have been recorded during the period under original terms	8	6
Interest income recorded during the period	8	4
Loans 90 days or more past due and still accruing real estate acquired by foreclosure or substantively repossessed	-	
Percentage of nonaccrual loans to total gross loans	0.13%	.01
Percentage of nonaccrual loans, restructured loans, and real estate acquired by foreclosure or substantively repossessed to total assets	0.09%	0.1
Percentage of allowance for loan losses to nonaccrual loans	862.81%	810.4

The $484,000 in non-accrual loans as of March 31, 2005 consists mainly of $379,000 of real estate mortgages and $106,000 attributed to commercial loans. There were no restructured loans included in nonaccrual loans for the first three months of 2005.

We stop accruing interest on a loan once it becomes past due 90 days unless there is adequate collateral and the financial condition of the borrower is sufficient. When a loan is placed on nonaccrual status, all previously accrued but unpaid interest is reversed and charged against current income. Interest is thereafter recognized only when payments are received and the loan is no longer past due.

Loans in the nonaccrual category will remain in that category until the possibility of collection no longer exists, the loan is paid off, or the loan becomes current. When a loan is determined to be uncollectible, it is then charged off against the allowance for loan losses.

Statement of Financial Accounting Standards No. 114 "Accounting by Creditors for Impairment of a Loan" ("SFAS No. 114") applies to all loans except large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, loans measured at fair value or at the lower of cost or fair value. SFAS No. 114 requires that impaired loans be valued at the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the market value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, we do not separately identify individual consumer and residential loans for impairment disclosures. A loan is considered impaired when, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement.

At March 31, 2005 there were $64,300 of loans which we have determined to be impaired, with a related allowance for credit losses of $3,200.

Analysis of Allowance for Loan Losses

The table below illustrates the changes in the Allowance for Loan Losses for the periods indicated.

(Dollars in Thousands)	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Balance at beginning of period	$4,101	$4,154
Charge-offs:		
Commercial	-	-
Real estate - construction	-	-
Real estate - mortgage	-	-
Installment/Consumer	-	(4)
Total charge-offs	-	(4)
Recoveries:		
Commercial	8	21
Real estate - construction	-	-
Real estate - mortgage	16	24
Installment/Consumer	1	4
Total recoveries	25	49
Net charge-offs	25	45
Provision charged to operations	50	246
Balance at end of period	$4,176	$4,445
Allowance for Loan Losses as a percent of loans	1.09%	1.26%
Ratio of net recoveries (charge-offs) to average loans outstanding	0.12%	0.00%

We maintain an allowance for possible losses that are inherent in the loan portfolio. The allowance for loan losses is increased by provisions charged to operations based on the estimated loan loss exposure inherent in the portfolio. Management uses a methodology to systematically measure the amount of estimated loan loss exposure inherent in the portfolio for purposes of establishing a sufficient allowance for loan losses. The methodology includes three elements: an analysis of individual loans deemed to be impaired in accordance with the terms of Statement of Financial Accounting Standard No. 114, "Accounting by Creditors for Impairment of a Loan", general loss allocations for various loan types based on loss experience factors and other qualitative factors, and an unallocated allowance which is maintained based on management's assessment of many factors including the risk characteristics of the portfolio, concentrations of credit, economic conditions that may effect borrowers' ability to pay, and trends in loan delinquencies and charge-offs. Realized losses, net of recoveries, are charged directly to the allowance. While management uses the currently available information in establishing the allowance for loan losses, adjustments to the allowance may be necessary if

future economic conditions differ from the assumptions used in making the evaluation. In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses.

During 2004 and going forward, we have placed increased emphasis on the origination of residential real estate loans. Accordingly, as the composition of the loan portfolio gradually changes and diversifies from higher credit risk weighted loans, such as commercial real estate and commercial, financial and agricultural, to residential and home equity loans, a lower overall reserve allowance rate will be required. We also continued to take positive steps in reducing the overall level of risk in the loan portfolio by further enhancing and strengthening our underwriting guidelines, and by selling impaired real estate loans totaling $8.4 million in August 2004. We realized a gain of $198,000 on this sale. As a result, the allowance for loan losses remained relatively constant, increasing from $4,101,000, or 1.11% of total gross loans at December 31, 2004 to $4,176,000, or 1.09% of total gross loans at March 31, 2005. After thorough review and analysis of the adequacy of the loan loss allowance, we recorded a provision for loan losses of $50,000 for the three months ended March 31,2005, compared to a provision of $246,000 recorded for the three months ended March 31, 2004. The decreased provision is primarily the result of the enhanced credit quality achieved with the actions taken in 2004. Loans charged off were $0 in the three months ended March 31, 2005 compared with $4,000 for the three months ended March 31, 2004. We realized recoveries of previously charged-off loans totaling $25,000 for the three months ended March 31, 2005 compared with recoveries totaling $49,000 for the three months ended March 31, 2004. Management believes that the Allowance for Loan Losses of $4,176,000 at March 31, 2005 is adequate to cover potential losses in the loan portfolio, based on current information available to management.

This table shows an allocation of the allowance for loan losses as of the end of each of the periods indicated.

	March 31, 2005		December 31, 2004	
(Dollars in Thousands)	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans
Commercial (4)	$ 491(1)	7.84%	$ 743(1)	7.26%
Real estate Construction	211	5.87%	236	6.62%
Real estate - residential	430	32.19%	421	32.87%
Real estate - commercial	2,994	53.48%	2,568	52.57%
Consumer (2)	50(3)	0.62%	133(3)	0.68%

$4,176	100.00%	$4,101	100.00%
======	======	======	======