

CORNERSTONE BANCORP INC
Form 10QSB
August 13, 2003
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United States Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-QSB

(Mark One)

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

For the quarterly period ended June 30, 2003

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

For the transition period from to

Commission file number: 0-25465

CORNERSTONE BANCORP, INC./CT

(Exact Name of small business issuer as specified in its charter)

Connecticut

06-1524044

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

550 Summer St., Stamford, Connecticut 06901

(Address of principal executive offices)

(203) 356-0111

(Issuer's telephone number)

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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.

YesNo

The number of shares outstanding of the issuer's common stock as of July 23, 2003 was 1,227,021.

Transitional Small Business Disclosure Format (check one):

YesNo

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CORNERSTONE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CONDITION
(In thousands, except per share data)
(unaudited)

| | June 30, 2003 | December 31, 2002 |
|--|-------------------|----------------------|
| Assets | | |
| Cash and cash equivalents: | | |
| Cash and due from banks | \$ 11,554 | \$ 11,304 |
| Federal funds sold | 53,000 | 22,900 |
| Total cash and cash equivalents | 64,554 | 34,204 |
| Securities, including collateral of \$6,573 at June 30, 2003 and \$5,815 at December 31, 2002 for borrowings under securities repurchase agreements: | | |
| Available for sale, at fair value | 8,658 | 11,392 |
| Held to maturity, at amortized cost (fair value of \$30,001 at June 30, 2003 and \$27,811 at December 31, 2002) | 29,062 | 26,758 |
| Total securities | 37,720 | 38,150 |
| Loans held for sale | 2,193 | 7,244 |
| Loans, net of allowance for loan losses of \$2,424 at June 30, 2003 and \$2,234 at December 31, 2002 | 116,961 | 121,475 |
| Accrued interest receivable | 946 | 1,081 |
| Federal Home Loan Bank stock, at cost | 613 | 521 |
| Premises and equipment, net | 2,932 | 2,962 |
| Bank-owned life insurance | 5,280 | 5,113 |
| Deferred income taxes | 795 | 781 |
| Other assets | 666 | 523 |
| Total assets | \$ 232,660 | \$ 212,054 |
| Liabilities and Stockholders Equity | | |
| Liabilities: | | |
| Deposits: | | |
| Demand (non-interest bearing) | \$ 48,031 | \$ 46,610 |
| Money market demand and NOW | 38,853 | 32,805 |
| Regular, club and money market savings | 37,618 | 34,106 |
| Time | 80,310 | 69,500 |
| Total deposits | 204,812 | 183,021 |
| Borrowings under securities repurchase agreements | 6,018 | 5,723 |
| Accrued interest payable | 114 | 126 |
| Securities purchased, not yet settled | | 2,529 |
| Other liabilities | 1,742 | 1,317 |
| Total liabilities | 212,686 | 192,716 |

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| | | |
|---|-------------------|-------------------|
| Stockholders' equity: | | |
| Common stock, par value \$0.01 per share. Authorized 5,000,000 shares; issued 1,287,123 shares at June 30, 2003 and 1,279,365 shares at December 31, 2002 | 13 | 13 |
| Additional paid-in capital | 14,123 | 13,954 |
| Retained earnings | 6,759 | 6,205 |
| Treasury stock, at cost (61,411 shares at June 30, 2003 and 71,461 shares at December 31, 2002) | (643) | (749) |
| Unearned restricted stock awards | (354) | (183) |
| Accumulated other comprehensive income, net of taxes | 76 | 98 |
| Total stockholders' equity | 19,974 | 19,338 |
| Total liabilities and stockholders' equity | \$ 232,660 | \$ 212,054 |

See accompanying notes to unaudited consolidated financial statements.

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CORNERSTONE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE THREE MONTHS ENDED JUNE 30, 2003 AND 2002
(In thousands, except per share data)
(unaudited)

| | Three Months Ended June 30, | |
|--|--------------------------------|---------------|
| | 2003 | 2002 |
| Interest income: | | |
| Loans | \$ 2,189 | \$ 2,244 |
| Securities | 432 | 496 |
| Federal funds sold | 135 | 49 |
| Total interest income | 2,756 | 2,789 |
| Interest expense: | | |
| Deposits | 754 | 731 |
| Borrowings | 21 | 17 |
| Total interest expense | 775 | 748 |
| Net interest income | 1,981 | 2,041 |
| Provision for loan losses | 70 | 64 |
| Net interest income after provision for loan losses | 1,911 | 1,977 |
| Non-interest income: | | |
| Deposit service charges | 113 | 123 |
| Gain on sale of loans and loan servicing, net | 406 | 149 |
| Bank-owned life insurance | 49 | 42 |
| Other | 99 | 210 |
| Total non-interest income | 667 | 524 |
| Non-interest expense: | | |
| Salaries and employee benefits | 1,030 | 967 |
| Occupancy | 180 | 194 |
| Furniture and equipment | 101 | 96 |
| Data processing | 140 | 140 |
| Professional fees | 83 | 99 |
| Advertising and promotion | 41 | 64 |
| Other | 325 | 221 |
| Total non-interest expense | 1,900 | 1,781 |
| Income before income tax expense | 678 | 720 |
| Income tax expense | 261 | 288 |
| Net income | \$ 417 | \$ 432 |
| Earnings per common share (Note B): | | |

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| | | | | |
|--|----|-----------|----|-----------|
| Basic | \$ | 0.35 | \$ | 0.36 |
| Diluted | | 0.33 | | 0.35 |
| <hr/> | | | | |
| Weighted average common shares (Note B): | | | | |
| Basic | | 1,200,335 | | 1,189,057 |
| Diluted | | 1,249,422 | | 1,228,268 |

See accompanying notes to unaudited consolidated financial statements.

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CORNERSTONE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE SIX MONTHS ENDED JUNE 30, 2003 AND 2002
(In thousands, except per share data)
(unaudited)

| | Six Months Ended June 30, | |
|--|------------------------------|---------------|
| | 2003 | 2002 |
| Interest income: | | |
| Loans | \$ 4,515 | \$ 4,560 |
| Securities | 859 | 1,050 |
| Federal funds sold | 233 | 99 |
| Total interest income | 5,607 | 5,709 |
| Interest expense: | | |
| Deposits | 1,497 | 1,536 |
| Borrowings | 40 | 35 |
| Total interest expense | 1,537 | 1,571 |
| Net interest income | 4,070 | 4,138 |
| Provision for loan losses | 175 | 112 |
| Net interest income after provision for loan losses | 3,895 | 4,026 |
| Non-interest income: | | |
| Deposit service charges | 231 | 246 |
| Gain on sale of loans and loan servicing, net | 573 | 225 |
| Bank-owned life insurance | 101 | 42 |
| Other | 346 | 350 |
| Total non-interest income | 1,251 | 863 |
| Non-interest expense: | | |
| Salaries and employee benefits | 2,133 | 1,866 |
| Occupancy | 364 | 378 |
| Furniture and equipment | 203 | 186 |
| Data processing | 283 | 278 |
| Professional fees | 176 | 171 |
| Advertising and promotion | 87 | 106 |
| Other | 563 | 414 |
| Total non-interest expense | 3,809 | 3,399 |
| Income before income tax expense | 1,337 | 1,490 |
| Income tax expense | 508 | 596 |
| Net income | \$ 829 | \$ 894 |
| Earnings per common share (Note B): | | |

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| | | | | |
|---------|----|------|----|------|
| Basic | \$ | 0.69 | \$ | 0.75 |
| Diluted | | 0.67 | | 0.73 |

Weighted average common shares (Note B):

| | | |
|---------|-----------|-----------|
| Basic | 1,198,627 | 1,187,774 |
| Diluted | 1,245,126 | 1,219,999 |

See accompanying notes to unaudited consolidated financial statements.

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CORNERSTONE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
FOR THE SIX MONTHS ENDED JUNE 30, 2003 AND 2002
(In thousands, except per share data)
(unaudited)

| | Common Stock | Additional Paid-in Capital | Retained Earnings | Treasury Stock | Restricted Stock | Accumulated Other Comprehensive Income (Loss) | Total Stockholders Equity |
|------------------------------------|-----------------|----------------------------------|----------------------|-------------------|---------------------|--|---------------------------------|
| Balances at January 1, 2003 | \$ 13 | \$ 13,954 | \$ 6,205 | \$ (749) | \$ (183) | \$ 98 | \$ 19,338 |
| Net income | | | 829 | | | | 829 |
| Other comprehensive loss | | | | | | (22) | (22) |
| Total comprehensive income | | | | | | | 807 |
| Cash dividends (\$0.225 per share) | | | (275) | | | | (275) |
| Shares issued in connection with: | | | | | | | |
| Restricted stock awards | | 65 | | 106 | (171) | | |
| Stock option exercises | | 51 | | | | | 51 |
| Dividend Reinvestment Plan | | 53 | | | | | 53 |
| Balances at June 30, 2003 | \$ 13 | \$ 14,213 | \$ 6,759 | \$ (643) | \$ (354) | \$ 76 | \$ 19,974 |
| Balances at January 1, 2002 | \$ 12 | \$ 11,816 | \$ 6,848 | \$ (880) | | \$ 145 | \$ 17,941 |
| Net income | | | 894 | | | | 894 |
| Other comprehensive loss | | | | | | (30) | (30) |
| Total comprehensive income | | | | | | | 864 |
| Cash dividends (\$0.225 per share) | | | (249) | | | | (249) |
| Shares issued in connection with: | | | | | | | |
| Stock dividend | 1 | 1,932 | (1,933) | | | | |
| Restricted stock awards | | 52 | | 131 | (183) | | |
| Stock option exercises | | 27 | | | | | 27 |
| Dividend Reinvestment Plan | | 61 | | | | | 61 |
| Directors Compensation Plan | | 10 | | | | | 10 |
| Balances at June 30, 2002 | \$ 13 | \$ 13,898 | \$ 5,560 | \$ (749) | \$ (183) | \$ 115 | \$ 18,654 |

See accompanying notes to unaudited consolidated financial statements.

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**CORNERSTONE BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX MONTHS ENDED JUNE 30, 2003 AND 2002**

(In thousands)

(unaudited)

| | Six Months Ended June 30, | |
|---|------------------------------|------------------|
| | 2003 | 2002 |
| Operating activities: | | |
| Net income | \$ 829 | \$ 894 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 300 | 289 |
| Provision for loan losses | 175 | 112 |
| Originations of loans held for sale | (12,376) | (1,426) |
| Proceeds from sales of loans held for sale | 17,819 | 1,624 |
| Decrease in accrued interest receivable | 135 | 3 |
| Increase in other assets | (143) | (303) |
| Decrease in accrued interest payable | (12) | (48) |
| Increase in other liabilities | 425 | 303 |
| Income on bank-owned life insurance | (101) | (42) |
| Other adjustments, net | (14) | 55 |
| Net cash provided by operating activities | 7,037 | 1,461 |
| Investing activities: | | |
| Proceeds from maturities and calls of securities available for sale | 2,669 | 2,000 |
| Proceeds from maturities and calls of securities held to maturity | 5,610 | 5,309 |
| Purchases of securities held to maturity | (7,990) | |
| Purchases of securities available for sale | (2,529) | |
| Net receipts (disbursements) for loan originations and principal repayments, other than loans held for sale | 3,959 | (13,787) |
| Purchases of bank-owned life insurance | (66) | (3,982) |
| Purchases of Federal Home Loan Bank stock | (92) | (55) |
| Purchases of premises and equipment | (165) | (175) |
| Net cash provided by (used in) investing activities | 1,396 | (10,690) |
| Financing activities: | | |
| Net increase in deposits | 21,791 | 16,358 |
| Net increase (decrease) in borrowings under securities repurchase agreements | 295 | (2,113) |
| Dividends paid on common stock | (273) | (244) |
| Proceeds from issuance of common stock | 104 | 88 |
| Net cash provided by financing activities | 21,917 | 14,089 |
| Net increase in cash and cash equivalents | 30,350 | 4,860 |
| Cash and cash equivalents at beginning of period | 34,204 | 24,299 |
| Cash and cash equivalents at end of period | \$ 64,554 | \$ 29,159 |
| Supplemental information: | | |
| Interest payments | \$ 1,549 | \$ 1,619 |
| Income tax payments | 532 | 594 |

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Decrease in liability for securities purchased, not yet settled

2,529

See accompanying notes to unaudited consolidated financial statements.

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CORNERSTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (UNAUDITED)

(dollars in thousands)

NOTE A - BASIS OF FINANCIAL STATEMENT PRESENTATION

The accompanying unaudited interim consolidated financial statements include the accounts of Cornerstone Bancorp, Inc., its subsidiary Cornerstone Bank (the Bank) and the Bank's subsidiary Cornerstone Business Credit, Inc. (CBC), collectively the Company. The interim consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial statements and the instructions to Form 10-QSB, and, accordingly, do not include all of the information and footnotes required by generally accepted accounting principles for a complete set of financial statements. While management believes that the disclosures presented are adequate so as not to make the information misleading, it is suggested that these interim consolidated financial statements be read in conjunction with the annual consolidated financial statements and notes included in the Form 10-KSB/A, Amendment Number One for the year ended December 31, 2002. The interim results of operations for the period ended June 30, 2003 are not necessarily indicative of the results to be expected for the year ending December 31, 2003 or for any other interim period.

In the opinion of management, the accompanying unaudited consolidated financial statements reflect all adjustments, consisting only of normal recurring accruals, necessary to present fairly the financial position, results of operations, changes in stockholders' equity and cash flows at the dates and for the periods presented. In preparing the interim consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the statement of condition and revenues and expenses for the period. Actual results could differ significantly from those estimates, as a result of changing conditions and future events. An estimate that is particularly critical and susceptible to significant near-term change is the allowance for loan losses.

Prior period amounts are reclassified, whenever necessary, to conform to the current period presentation.

NOTE B - EARNINGS PER SHARE

Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common stockholders (net income less dividends on preferred stock, if any) by the weighted average number of common shares outstanding during the period. For this purpose, unvested shares of restricted stock are not considered to be outstanding. Diluted EPS is computed in a similar manner, except that the weighted average number of common shares is increased (using the treasury stock method) by additional common shares that would have been outstanding if all potentially dilutive securities (such as stock options and unvested restricted stock awards) were exercised or vested during the period. For the three month and six month periods ended June 30, 2003 and 2002, the number of shares for diluted EPS exceeded the number of shares for basic EPS due to the dilutive effect of outstanding stock options and unvested restricted stock. For purposes of computing basic EPS, net income applicable to common stock equaled net income for these periods.

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NOTE C STOCK-BASED COMPENSATION

The Company accounts for stock-based compensation in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Accordingly, compensation expense is not recognized for fixed stock options if the exercise price of the option equals the fair value of the underlying stock at the grant date. The fair value of restricted stock awards, measured at the grant date, is recognized as unearned compensation (a component of stockholders' equity) and amortized to compensation expense over the vesting period.

Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, encourages the use of a fair-value-based method of accounting for employee stock compensation plans, but permits the continued use of the intrinsic-value-based method of accounting prescribed by APB Opinion No. 25. Under SFAS No. 123, the grant-date fair value of options is recognized as compensation expense over the vesting period (if any). The Company has elected to continue to apply APB Opinion No. 25 and disclose the pro forma information required by SFAS No. 123. Had stock-based compensation expense been recognized in accordance with SFAS No. 123, the Company's net income and earnings per common share would have been adjusted to the following pro forma amounts:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--|---------------|--|---------------|
| | 2003 | 2002 | 2003 | 2002 |
| | (In thousands, except per share data) | | (In thousands, except per share data) | |
| Net income, as reported | \$ 417 | \$ 432 | \$ 829 | \$ 894 |
| Add restricted stock expense included in reported net income, net of related tax effects | 11 | 6 | 22 | 11 |
| Deduct restricted stock and stock option expense determined under the fair-value-based method, net of related tax effects | (16) | (12) | (27) | (34) |
| Pro forma net income | \$ 412 | \$ 426 | \$ 824 | \$ 871 |
| Basic earnings per common share: | | | | |
| As reported | \$ 0.35 | \$ 0.36 | \$ 0.69 | \$ 0.75 |
| Pro forma | 0.34 | 0.36 | 0.69 | 0.73 |
| Diluted earnings per common share: | | | | |
| As reported | \$ 0.33 | \$ 0.35 | \$ 0.67 | \$ 0.73 |
| Pro forma | 0.33 | 0.35 | 0.66 | 0.71 |

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NOTE D COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) includes net income or loss, and any changes in stockholders' equity from non-owner sources that are not recognized in the income statement (such as changes in net unrealized gains and losses on securities available for sale). Other comprehensive loss reported in the statements of stockholders' equity for the six months ended June 30, 2003 and 2002 represents the change during those periods in the after-tax net unrealized gain on securities available for sale.

NOTE E STANDBY LETTERS OF CREDIT

The Company had outstanding letters of credit of \$1,102 and \$1,650 at June 30, 2003 and December 31, 2002, respectively. Substantially all of the Company's outstanding standby letters of credit are performance standby letters of credit within the scope of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). These are irrevocable undertakings by the Company, as guarantor, to make payments in the event a specified third party fails to perform under a non-financial contractual obligation. Most of the Company's performance standby letters of credit arise in connection with lending relationships and have terms of one year or less. The maximum potential future payments the Company could be required to make equals the contract amount of the standby letters of credit referred to above. FIN 45 also requires the recognition, at fair value, of a liability by a guarantor at the inception of certain guarantees issued or modified after December 31, 2002. The Company's recognized liability for performance standby letters of credit was insignificant at June 30, 2003.

NOTE F RECENT ACCOUNTING STANDARDS

SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, was issued in April 2003 to clarify the application of certain aspects of the accounting for these instruments and activities. The provisions of SFAS No. 149, which are generally effective for transactions after June 30, 2003, are not expected to have a significant effect on the Company's consolidated financial statements.

SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, was issued in May 2003. Under the Statement, certain freestanding financial instruments that embody obligations for the issuer and that are now classified in equity, must be classified as liabilities (or as assets in some circumstances). Generally, SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and is otherwise effective at the beginning of the first interim period beginning after June 15, 2003. Adoption of this standard is not expected to have a significant effect on the Company's consolidated financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations **(dollars in thousands)**

FORWARD-LOOKING STATEMENTS

The statements contained in this report that are not historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the

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Securities Exchange Act of 1934, as amended. Examples of such forward-looking statements include, without limitation, statements regarding expectations for earnings, credit quality, and other financial and business matters. When used in this report, the words anticipate, plan, believe, estimate, expect and similar expressions as they relate to the Company or its management are intended to identify forward-looking statements. All forward-looking statements involve risks and uncertainties. Actual results may differ materially from those discussed in, or implied by, the forward-looking statements as a result of certain factors, including but not limited to, competitive pressures on loan and deposit product pricing; other actions of competitors; changes in economic conditions; technological changes; the extent and timing of actions of the Federal Reserve Board, including changes in monetary policies and interest rates; customer deposit disintermediation; changes in customers' acceptance of the Bank's products and services; and the extent and timing of legislative and regulatory actions and reforms.

The forward-looking statements contained in this report speak only as of the date on which such statements are made.

FINANCIAL CONDITION**General**

Total assets increased to \$232,660 at June 30, 2003 from \$212,054 at December 31, 2002, an increase of \$20,606 (or 10%). Increases in cash and cash equivalents of \$30,350 and held to maturity securities of \$2,304 were funded by an increase in deposits of \$21,791 and decreases in net loans of \$4,514 and loans held for sale of \$5,051.

Loans

The net loan portfolio (excluding loans held for sale) decreased to \$116,961 at June 30, 2003 from \$121,475 at December 31, 2002, a decrease of \$4,514. The decreases in residential real estate and construction loans in the first six months of 2003 resulted from refinance activity, principal repayments and scheduled payoffs by consumers and commercial customers exceeding new loan originations for the period. These decreases were partially offset by increases in non-residential and commercial loans.

Major classifications of loans at June 30, 2003 and December 31, 2002 were as follows:

| | June 30, 2003 | December 31, 2002 | Dollar Change | Percent Change |
|-------------------------------|--------------------------|----------------------------------|--------------------------|---------------------------|
| Loans secured by real estate: | | | | |
| Residential | \$ 38,388 | \$ 46,085 | \$ (7,697) | (17)% |
| Nonresidential | 52,645 | 49,977 | 2,668 | 5 |
| Construction | 11,225 | 11,429 | (204) | (2) |
| Commercial loans | 14,876 | 14,024 | 852 | 6 |
| Consumer and other loans | 2,287 | 2,259 | 28 | 1 |
| | <hr/> | <hr/> | <hr/> | |
| Total loans | 119,421 | 123,774 | (4,353) | (4) |
| Allowance for loan losses | (2,424) | (2,234) | 190 | 9 |
| Deferred loan fees, net | (36) | (65) | 29 | (45) |
| | <hr/> | <hr/> | <hr/> | |
| Total loans, net | \$ 116,961 | \$ 121,475 | \$ (4,514) | (4)% |

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Residential mortgage loans held for sale at June 30, 2003 and December 31, 2002 were \$1,703 and \$7,057, respectively. Small Business Administration (SBA) loans held for sale at June 30, 2003 and December 31, 2002 were \$490 and \$187, respectively.

Non-performing Loans and the Allowance for Loan Losses

It is the Bank's policy to manage its loan portfolio to facilitate early recognition of problem loans. The Bank commences internal collection efforts once a loan payment is more than 15 days past due. The Bank's data processing system generates delinquency reports on all of the Bank's loans weekly, and management reviews the loan portfolio to determine if past due loans should be placed on non-accrual status. Unless the customer is working with the Bank toward repayment, once a loan payment is 90 days past due, the Bank generally initiates appropriate collection or legal action.

The following table summarizes, by type of loan, the recorded investment in non-performing loans at June 30, 2003 and December 31, 2002. Amounts are shown for (i) loans that were past due 90 days or more, segregated between those on non-accrual status and those that were still accruing interest, and (ii) loans that were current or past due less than 90 days for which interest payments were being applied to reduce principal balances.

| | <u>June 30, 2003</u> | <u>December 31, 2002</u> |
|--|----------------------|--------------------------|
| Loans on non-accrual status: | | |
| Loans secured by residential real estate | \$ 652 | \$ |
| Loans secured by commercial real estate | 149 | 149 |
| | <u>801</u> | <u>149</u> |
| Loans on accrual status: | | |
| Loans secured by real estate | 144 | 1,480 |
| Commercial loans | 21 | 122 |
| Consumer and other loans | 10 | 7 |
| | <u>175</u> | <u>1,609</u> |
| Total loans past due 90 days or more | <u>976</u> | <u>1,758</u> |
| Loans current or past due less than 90 days for which interest payments were being applied to reduce principal balances: | | |
| Loans secured by real estate | | 11 |
| Commercial loans | 277 | |
| | <u>277</u> | <u>11</u> |
| Total non-performing loans | <u>\$ 1,253</u> | <u>\$ 1,769</u> |
| Ratio of total non-performing loans to total loans outstanding | <u>1.05%</u> | <u>1.43%</u> |

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During the six months ended June 30, 2003, loans past due greater than 90 days and secured by real estate decreased by \$684. Repayments of approximately \$1,292 on loans past due 90 days or more in accrual status at December 31, 2002 were received in January 2003 and were partially offset by the addition of a \$642 loan to another borrower which became more than 90 days delinquent in the first quarter of 2003.

During the six months ended June 30, 2003, approximately \$26 in collected interest on a former non-accrual loan was applied to income due to the payoff of the loan. During the six months ended June 30, 2002, the Bank recovered all principal and other amounts due on four non-accrual loans to one borrower. This recovery resulted in additional loan interest income of \$175 (a recovery of interest previously applied to reduce principal on the aforementioned loans) and an additional \$8 in late charge income.

The following table sets forth changes in the allowance for loan losses for the periods indicated.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--------------------------------|--------------------------------|----------|------------------------------|----------|
| | 2003 | 2002 | 2003 | 2002 |
| Balance at beginning of period | \$ 2,347 | \$ 1,883 | \$ 2,234 | \$ 1,848 |
| Provision for loan losses | 70 | 64 | 175 | 112 |
| Loan charge-offs | (2) | | (2) | (14) |
| Recoveries | 9 | 2 | 17 | 3 |
| Balance at end of period | \$ 2,424 | \$ 1,949 | \$ 2,424 | \$ 1,949 |

The ratios of the allowance for loan losses to total loans and to non-performing loans were 2.03% and 193% respectively, at June 30, 2003, compared to 1.81% and 126%, respectively, at December 31, 2002.

In addition to non-performing loans, the Company had non-performing assets at June 30, 2003 and December 31, 2002, in the form of repossessed aircraft with a carrying amount of \$81 (included in other assets in the consolidated statements of condition). Total non-performing assets of \$1,334 represented 0.57% of total assets at June 30, 2003, compared to \$1,850 or 0.87% of total assets at December 31, 2002.

Securities

Total securities decreased to \$37,720 at June 30, 2003 from \$38,150 at December 31, 2002, a decrease of \$430 (or 1%). The decrease in the securities portfolio was primarily due to maturities and principal paydowns totaling \$8,279, partially offset by purchases of \$7,990 in securities held to maturity.

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The following table sets forth the amortized cost and estimated fair value of the securities portfolio at the dates indicated.

| | June 30, 2003 | | December 31, 2002 | |
|----------------------------|------------------|----------------------|-------------------|----------------------|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Available for sale | | | | |
| U.S. Agency securities | \$ 6,559 | \$ 6,665 | \$ 9,082 | \$ 9,242 |
| Mortgage-backed securities | 1,977 | 1,993 | 2,152 | 2,150 |
| | <u>\$ 8,536</u> | <u>\$ 8,658</u> | <u>\$ 11,234</u> | <u>\$ 11,392</u> |
| Held to maturity | | | | |
| U.S. Agency securities | \$ 22,138 | \$ 22,943 | \$ 20,746 | \$ 21,657 |
| Mortgage-backed securities | 3,859 | 3,947 | 5,937 | 6,079 |
| Municipal bonds | 2,990 | 3,036 | | |
| Other | 75 | 75 | 75 | 75 |
| | <u>\$ 29,062</u> | <u>\$ 30,001</u> | <u>\$ 26,758</u> | <u>\$ 27,811</u> |
| Total | <u>\$ 37,598</u> | <u>\$ 38,659</u> | <u>\$ 37,992</u> | <u>\$ 39,203</u> |

Deposits

Deposits are the primary source of funds for the Company. Deposits are obtained from individuals, partnerships, small and medium size businesses and professionals in the Company's market area. The Company does not accept brokered deposits.

The following table indicates the composition of deposits at the dates indicated.

| | June 30, 2003 | December 31, 2002 | Dollar Change | Percent Change |
|--|-------------------|-------------------|------------------|----------------|
| Demand (non-interest bearing) | \$ 48,031 | \$ 46,610 | \$ 1,421 | 3% |
| Money market demand and NOW | 38,853 | 32,805 | 6,048 | 18 |
| Regular, club and money market savings | 37,618 | 34,106 | 3,512 | 10 |
| Time | 80,310 | 69,500 | 10,810 | 16 |
| Total | <u>\$ 204,812</u> | <u>\$ 183,021</u> | <u>\$ 21,791</u> | <u>12%</u> |

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The increase in money market demand and NOW accounts was primarily due to larger balances held in attorney-related accounts. The increase in regular, club and money market savings was primarily due to an increase in customer deposit balances. The increase in demand deposits was primarily related to an increase of \$2.6 million in internal Bank demand deposit account balances at June 30, 2003 which are used to fund loan disbursements and customer purchases of official checks. This increase was partially offset by a decrease of \$2.1 million in the balance of one demand deposit account. During the first six months of 2003, increases in time deposits were primarily attributable to continued growth in 12-17 month and 18-23 month certificates of deposit of \$12,753 and \$6,119, respectively. This growth was partially offset by decreases of \$5,233 in 91-180 day certificates of deposit, \$1,433 in 24-30 month certificates of deposit, \$998 in 36-47 month certificates of deposit and \$397 in 60 month certificates of deposit. The \$10.8 million (or 16%) overall increase in time deposits reflects the competitive rates offered by the Bank during 2002 and 2003, as well as national economic uncertainty, particularly in the equity markets, which prompted customers to seek bank deposits as an alternative to investing in the equity markets. Certificates of deposit in denominations of \$100 or more were \$20,161 at June 30, 2003 compared to \$18,415 at December 31, 2002, an increase of \$1,746 (or 9%).

Liquidity and Capital Resources

At June 30, 2003, total short-term investments, which are made up of federal funds sold, available for sale securities and held to maturity securities maturing in three months or less, totaled \$62,664. The primary liquidity of the Company is measured by the ratio of net cash, short-term investments, and other marketable securities (non-U.S. agency securities) to deposits and short-term liabilities. The primary liquidity ratio at June 30, 2003 was 31.89%, compared to 17.89% at December 31, 2002. The Bank also calculates a secondary liquidity ratio which contemplates the maturity of held to maturity securities beyond three months. The Bank's secondary liquidity ratio at June 30, 2003 was 46.48%, compared to 34.92% at December 31, 2002. The increases in primary and secondary liquidity ratios in 2003 are primarily a result of the Bank's increased federal fund position at June 30, 2003 as compared to December 31, 2002. These increases were partially offset by an increase in deposits and short-term liabilities at June 30, 2003 compared to December 31, 2002. The Company's internal guideline is to generally maintain a primary liquidity ratio of 10 to 15% and a secondary liquidity ratio of 20% or more, although a higher primary ratio may be maintained from time to time depending on cash flow patterns and loan demand.

Net cash provided by operating activities was \$7,037 for the six months ended June 30, 2003 as compared to \$1,461 for the six months ended June 30, 2002, reflecting the higher net cash inflows from loans held for sale in the first six months of 2003. Compared to the first six months of 2002, cash used in investing activities decreased \$12,086, primarily due to the effect of net loan receipts of \$3,959 during the six months ended June 30, 2003 as compared to net loan disbursements of \$13,787 during the six months ended June 30, 2002. The increase in net cash provided by financing activities of \$7,828 for the six months ended June 30, 2003, primarily resulted from an increase in cash provided by deposits. Cash and cash equivalents increased \$30,350 for the six months ended June 30, 2003, compared to \$4,860 in the first six months of 2002.

At June 30, 2003, the Company had outstanding loan commitments under unused lines of credit approximating \$13,037 and outstanding letters of credit approximating \$1,102.

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At June 30, 2003 and December 31, 2002, the Company's consolidated leverage capital ratio was 8.8% and 9.2%, respectively. At June 30, 2003 and December 31, 2002, the Company's consolidated Tier 1 risk-based capital ratio was 13.7% and 13.0%, respectively. The Company's consolidated total risk-based capital ratio at June 30, 2003 and December 31, 2002 was 14.9% and 14.2%, respectively. The Bank's regulatory capital ratios at these dates were substantially the same as the consolidated ratios, and the Bank was classified as a well-capitalized institution for regulatory purposes.

RESULTS OF OPERATIONS

General

The Company's results of operations depend primarily on its net interest income, which is the difference between the interest income on earning assets, such as loans and securities, and the interest expense paid on deposits and borrowings. Results of operations are also affected by non-interest income and expense, the provision for loan losses and income tax expense. Non-interest income includes banking service fees and charges, income on bank-owned life insurance, and gains and losses on sales of securities available for sale and loans held for sale. The Company's non-interest expense consists primarily of salaries and employee benefits, occupancy and equipment expenses, data processing expenses and professional fees. Results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government policies and actions of regulatory authorities.

Critical Accounting Policies

In the course of the Company's normal business activity, management must select and apply many accounting policies and methodologies that lead to the financial results presented in the consolidated financial statements of the Company. Some of these policies are more critical than others. Management considers the accounting policy relating to the allowance for loan losses to be a critical accounting policy because of the uncertainty and subjectivity inherent in estimating the levels of allowance needed to cover probable credit losses within the loan portfolio and the material effect that these estimates can have on the Company's results of operations. While management uses the best available information to determine the allowance for loan losses, future adjustments to the allowance may be necessary based on a variety of factors, including changes in economic and real estate market conditions, particularly in Southwestern Fairfield County, Connecticut.

All accounting policies are important and readers of this report should review these policies, as included in Note 1 to the Consolidated Financial Statements in the 2002 Annual Report on Form 10-KSB/A, Amendment Number One, to gain a greater understanding of how the Company's financial performance is reported.

Comparative Analysis of Operating Results for the Three Months Ended June 30, 2003 and June 30, 2002

Net Income. Net income was \$417 for the three months ended June 30, 2003 compared to \$432 for the three months ended June 30, 2002, a decrease of \$15 (or 3%). Diluted earnings per common share were \$0.33 for the three months ended June 30, 2003 and \$0.35 for the three months ended June 30, 2002 based on weighted average common shares of 1,249,422 and 1,228,268, respectively. The annualized

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return on average common stockholders' equity was 8.46% and 9.37% for the three months ended June 30, 2003 and 2002, respectively. The annualized return on average assets was 0.73% for the three months ended June 30, 2003 and 0.93% for the three months ended June 30, 2002.

The lower net income for the three months ended June 30, 2003 was attributable to increased non-interest expense and a reduction in total interest income, which were partially offset by increased non-interest income, and reductions in total interest expense and income tax expense.

Net Interest Income. Net interest income is the difference between the interest income the Company earns on its loans, securities and other earning assets, and the interest cost of deposits and other interest-bearing liabilities necessary to fund these earning assets. It is the primary component of the Company's earnings.

Net interest income was \$1,981 for the three months ended June 30, 2003, a decrease of \$60 from the \$2,041 reported for the three months ended June 30, 2002. The average yield on interest-earning assets decreased 127 basis points for the quarter ended June 30, 2003 compared to June 30, 2002, while the average rate paid on interest-bearing liabilities decreased 38 basis points. Declining interest rates during 2002 which continued in 2003 directly impacted the yields on the Company's variable rate loans tied to the prime rate and on federal funds sold, and indirectly impacted the yields on other interest-earning assets as a result of the general decline in market interest rates. The increased volume of loans and federal funds offset the general decline in market rates. These declining market rates also contributed to the decline in the average rate paid on time certificates of deposit which was only partially offset by the increased volume of deposits. These changes resulted in an 88 basis point decrease in the net interest margin to 3.34% for the quarter ended June 30, 2003 compared to 4.22% for the quarter ended June 30, 2002.

Interest Income. Average earning assets for the three months ended June 30, 2003 were \$207,458 compared to \$168,823 for the three months ended June 30, 2002, an increase of \$38,635 (or 23%). Total interest income, which is a function of the volume of interest-earning assets and their related rates, was \$2,756 for the three months ended June 30, 2003 compared to \$2,789 for the three months ended June 30, 2002, representing a decrease of \$33 (or 1%).

Loans represent the largest component of interest-earning assets. Interest income on loans was \$2,189 for the three months ended June 30, 2003 compared to \$2,244 for the three months ended June 30, 2002, a decrease of \$55 (or 2%). Average loan volume increased during the quarter ended June 30, 2003 compared to June 30, 2002 but was substantially offset by declining yields on the Company's loan portfolio. Average loans outstanding in the three months ended June 30, 2003 were \$119,518 compared to \$116,865 during the three months ended June 30, 2002, an increase of \$2,653 (or 2%). The average yield on loans declined 35 basis points to 7.35% for the quarter ended June 30, 2003 from 7.70% for the quarter ended June 30, 2002.

Average investments in securities and federal funds sold were \$87,940 for the three months ended June 30, 2003 compared to \$51,958 for the three months ended June 30, 2002, an increase of \$35,982 (or 69%). Related income increased to \$567 for the three months ended June 30, 2003 from \$545 for the three months ended June 30, 2002, an increase of \$22 (or 4%). Average investments in securities, not including federal funds sold, increased by \$2,160 (or 5%) during the six months ended June 30, 2003. The decrease in income from securities was due to a decrease in the yield on new securities purchased,

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which was partially offset by the increase in the volume of securities. Average federal funds sold increased by \$33,822 (or 288%). The increase in federal funds is primarily due to management's review of the appropriate level of funds necessary to meet liquidity needs as well as the continued decline in the loan portfolio. The declines in the yield on the Company's investment securities and federal funds sold to 4.21% and 1.19%, respectively, in the second quarter of 2003 from 4.95% and 1.68%, respectively, in the year-ago quarter were partially offset by the increased volume of federal funds sold.

Interest Expense. Interest expense was \$775 for the three months ended June 30, 2003 compared to \$748 for the three months ended June 30, 2002, a 4% increase. Interest expense is a function of the volume of interest-bearing liabilities and their related rates. Average interest-bearing liabilities during the three months ended June 30, 2003 were \$154,078 compared to \$124,977 during the three months ended June 30, 2002, an increase of \$29,101 (or 23%). The decrease in market interest rates resulted in a decline in the average rate paid on interest-bearing liabilities of 38 basis points to 2.02% for the quarter ended June 30, 2003 compared to 2.40% the quarter ended June 30, 2002. This decrease in rate was partially offset by additional interest expense due to the increase in the volume of deposits.

Provision for Loan Losses. The periodic provision for loan losses represents the amount necessary to adjust the allowance for loan losses to management's estimate of probable credit losses inherent in the existing loan portfolio at the reporting date. Management's determination of the allowance for loan losses is based on the results of continuing reviews of individual loans and borrower relationships, particularly in the commercial and commercial real estate loan portfolios. A review of the quality of the loan portfolio is conducted internally by management on a quarterly basis, using a consistently-applied methodology, and the results are presented to the Board of Directors for approval. The evaluation covers individual borrowers whose aggregate loans are greater than \$100, as well as all adversely-classified loans. Management also considers factors such as the borrower's financial condition, historical and expected ability to make loan payments and underlying collateral values. The determination of the allowance for loan losses also considers the level of past due loans, the Bank's historical loan loss experience, changes in loan portfolio mix, geographic and borrower concentrations and current economic conditions. The allowance for loan losses is also reduced by charge-offs and increased by recoveries. The provision for loan losses was \$70 for the three months ended June 30, 2003 and \$64 for the three months ended June 30, 2002, reflecting management's assessment of credit risk in the portfolio, particularly the continued concern related to the economy. Net loan recoveries were \$7 in the quarter ended June 30, 2003 compared to net loan recoveries of \$2 in the second quarter last year.

At June 30, 2003, the Company had \$1,253 of non-performing loans, including \$801 of non-accrual loans and \$175 of accruing loans greater than 90 days past due. Loans less than 90 days past due for which interest payments were being applied to reduce principal balances were \$277 at June 30, 2003. At December 31, 2002, the Company had \$1,769 of non-performing loans, including \$149 of non-accrual loans and \$1,609 of accruing loans greater than 90 days past due. Loans less than 90 days past due for which interest payments were being applied to reduce principal balances were \$11 at December 31, 2002.

Non-interest Income. Non-interest income was \$667 for the three months ended June 30, 2003 compared to \$524 for the three months ended June 30, 2002, an increase of \$143 (or 27%). The \$257 increase in the net gain on sale of loans and loan servicing for the three months ended June 30, 2003 compared to June 30, 2002 relates to the increased volume of sales of (i) participating interests in Small

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Business Administration loans and (ii) newly-originated residential mortgage loans and the related servicing rights.

Non-interest Expense. Total non-interest expense was \$1,900 for the three months ended June 30, 2003 and \$1,781 for the three months ended June 30, 2002, an increase of \$119 (or 7%).

The following table summarizes the dollar amounts for each category of non-interest expense, and the dollar and percent changes:

| Category | Three Months Ended June 30, | | Increase (Decrease) 2003 vs 2002 | |
|-----------------------------------|--------------------------------|-----------------|-------------------------------------|-----------|
| | 2003 | 2002 | \$ Change | % Change |
| Salaries and employee benefits | \$ 1,030 | \$ 967 | \$ 63 | 7% |
| Occupancy | 180 | 194 | (14) | (7) |
| Furniture and equipment | 101 | 96 | 5 | 5 |
| Data processing | 140 | 140 | | |
| Professional fees | 83 | 99 | (16) | (16) |
| Advertising and promotion | 41 | 64 | (23) | (36) |
| Other | 325 | 221 | 104 | 47 |
| Total non-interest expense | \$ 1,900 | \$ 1,781 | \$ 119 | 7% |

The increase in salaries and employee benefits includes the addition of two employees, salary increases for existing staff and executive bonus increases. The decrease in occupancy expense is primarily due to the reduction in rent expense resulting from the closure of the West Broad Street office in November 2002. Increased other non-interest expense primarily relates to increased SBA related fees, donations and insurance expense.

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The following table summarizes dollar amounts for each category of non-interest expense as a percentage of total operating income (interest income plus non-interest income). Operating income increased by \$110 (or 3%) in the second quarter of 2003 compared to the same period in 2002.

| Category | Three Months Ended June 30, | |
|-----------------------------------|--------------------------------|---------------|
| | 2003 | 2002 |
| Salaries and employee benefits | 30.09% | 29.19% |
| Occupancy | 5.26 | 5.86 |
| Furniture and equipment | 2.95 | 2.90 |
| Data processing | 4.09 | 4.23 |
| Professional fees | 2.42 | 2.99 |
| Advertising and promotion | 1.20 | 1.93 |
| Other | 9.50 | 6.67 |
| Total non-interest expense | 55.51% | 53.76% |

Income Taxes. The provision for income taxes decreased to \$261 for the three months ended June 30, 2003 from \$288 for the three months ended June 30, 2002, primarily reflecting the decrease in pre-tax income.

Comparative Analysis of Operating Results for the Six Months Ended June 30, 2003 and June 30, 2002

Net Income. Net income was \$829 for the six months ended June 30, 2003 compared to \$894 for the six months ended June 30, 2002, a decrease of \$65 (or 7%). Diluted earnings per common share were \$0.67 for the six months ended June 30, 2003 and \$0.73 for the six months ended June 30, 2002 based on weighted average common shares of 1,245,126 and 1,219,999, respectively. The annualized return on average common stockholders' equity was 8.52% and 9.80% for the six months ended June 30, 2003 and 2002, respectively. The annualized return on average assets was 0.75% for the six months ended June 30, 2003 and 0.98% for the six months ended June 30, 2002.

The lower net income for the six months ended June 30, 2003 was attributable to increased non-interest expense, reduced net interest income and an increase in the provision for loan losses. These factors were partially offset by increased non-interest income and, to a lesser extent, a decrease in income tax expense. During the first quarter of 2002, the Bank recognized interest income of \$175 due to the recovery of interest previously applied against principal on four non-accrual loans to one borrower. Similar recoveries of non-accrual interest were \$26 in the first half of 2003. These factors impacted the reduction in net interest income for the six months ended June 30, 2003 compared to June 30, 2002.

Net Interest Income. Net interest income was \$4,070 for the six months ended June 30, 2003, a decrease of \$68 from the \$4,138 reported for the six months ended June 30, 2002. During the six months ended June 30, 2002, the Bank recognized interest income of \$175 due to the recovery of interest previously applied against principal on four non-accrual loans to one borrower. Similar recoveries of non-accrual interest were \$26 in the current six-month period. Accordingly, factors other than recoveries of non-accrual interest resulted in a net increase of \$81 in net interest income during the first half of 2003, as the effect of higher earning assets more than offset the narrower net interest margin.

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The average yield on interest-earning assets decreased 127 basis points to 5.60% for the six months ended June 30, 2003 compared to 6.87% for June 30, 2002, while the average rate paid on interest-bearing liabilities decreased 44 basis points to 2.08% from 2.52%. Declining interest rates during 2002 which continued in 2003 directly impacted the yields on the Company's variable rate loans tied to the prime rate and on federal funds sold, and indirectly impacted the yields on other interest-earning assets as a result of the general decline in market interest rates. The previously-described recoveries of interest on non-accrual loans were also a primary factor in the higher yields in the first six months of 2002. The increased volume of loans and federal funds partially offset the general decline in market rates. These declining market rates also contributed to the decline in the average rate paid on interest-bearing liabilities which was only partially offset by the increased volume of deposits. These changes resulted in an 84 basis point decrease in the net interest margin to 3.51% for the six months ended June 30, 2003 compared to 4.35% for the six months ended June 30, 2002.

Interest Income. Average earning assets for the six months ended June 30, 2003 were \$202,488 compared to \$167,498 for the six months ended June 30, 2002, an increase of \$34,990 (or 21%). Total interest income, which is a function of the volume of interest-earning assets and their related rates, was \$5,607 for the six months ended June 30, 2003 compared to \$5,709 for the six months ended June 30, 2002, representing a decrease of \$102 (or 2%).

Loans represent the largest component of interest-earning assets. Average loans outstanding in the six months ended June 30, 2003 were \$122,280 compared to \$113,341 during the six months ended June 30, 2002, an increase of \$8,939 (or 8%). Interest income on loans was \$4,515 for the six months ended June 30, 2003 compared to \$4,560 for the six months ended June 30, 2002, a decrease of \$45 (or 1%). Average loan volume increased during the six months ended June 30, 2003 compared to June 30, 2002 but was substantially offset by declining yields on the Company's loan portfolio (7.45% in the first half of 2003 compared to 8.11% for the same period in 2002). Loan income for the six months ended June 30, 2002 also reflects the aforementioned recovery of \$175 in interest on non-accrual loans for the six months ended June 30, 2002, compared to a recovery of only \$26 for the six months ended June 30, 2003.

Average investments in securities and federal funds sold were \$80,208 for the six months ended June 30, 2003 compared to \$54,156 for the six months ended June 30, 2002, an increase of \$26,052 (or 48%). Related income decreased to \$1,092 for the six months ended June 30, 2003 from \$1,149 for the six months ended June 30, 2002, a decrease of \$57 (or 5%). Average investments in securities, not including federal funds sold, decreased by \$1,535 (or 4%) during the six months ended June 30, 2003. The decrease in income from securities was due to a decrease in the yield on new securities purchased, as well as the volume of securities, as maturing investments were re-deployed into the loan portfolio during 2002. Average federal funds sold increased by \$27,587 (or 229%). The increase in federal funds is primarily due to management's review of the appropriate level of funds necessary to meet liquidity needs. The declines in the yield on the Company's investment securities and federal funds sold to 4.34% and 1.19%, respectively, in the first six months of 2003 from 5.03% and 1.65%, respectively, in the year-ago period were partially offset by the increased volume of federal funds sold.

Interest Expense. Interest expense was \$1,537 for the six months ended June 30, 2003 compared to \$1,571 for the six months ended June 30, 2002, a 2% decrease. Interest expense is a function of the volume of interest-bearing liabilities and their related rates. Average interest-bearing liabilities during the six months ended June 30, 2003 were \$148,624 compared to \$125,528 during the six months ended

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June 30, 2002, an increase of \$23,096 (or 18%). The decrease in market interest rates resulted in a decline in the average rate paid on interest-bearing liabilities of 44 basis points to 2.08% for the six months ended June 30, 2003 compared to 2.52% for the six months ended June 30, 2002. This decrease in rate was partially offset by additional interest expense due to the increase in the volume of deposits.

Provision for Loan Losses. The provision for loan losses was \$175 for the six months ended June 30, 2003 and \$112 for the six months ended June 30, 2002. The increase in 2003 reflects management's current assessment of credit risk in the portfolio, particularly the continued concern related to the economy. Net loan recoveries were \$15 in the six months ended June 30, 2003 compared to net loan charge-offs of \$11 in the first half of last year.

Non-interest Income. Non-interest income was \$1,251 for the six months ended June 30, 2003 compared to \$863 for the six months ended June 30, 2002, an increase of \$388 (or 45%). The \$348 increase in the net gain on sale of loans and loan servicing for the six months ended June 30, 2003 compared to June 30, 2002 relates to the increased volume of sales of (i) participating interests in SBA loans and (ii) newly-originated residential mortgage loans and the related servicing rights. Income on bank-owned life insurance increased by \$59 compared to the first half of 2002, due to a significant purchase made at the end of the first quarter of 2002.

Non-interest Expense. Total non-interest expense was \$3,809 for the six months ended June 30, 2003 and \$3,399 for the six months ended June 30, 2002, an increase of \$410 (or 12%).

The following table summarizes the dollar amounts for each category of non-interest expense, and the dollar and percent changes:

| Category | Six Months Ended June 30, | | Increase (Decrease) 2003 vs 2002 | |
|-----------------------------------|------------------------------|-----------------|-------------------------------------|------------|
| | 2003 | 2002 | \$ Change | % Change |
| Salaries and employee benefits | \$ 2,133 | \$ 1,866 | \$ 267 | 14% |
| Occupancy | 364 | 378 | (14) | (4) |
| Furniture and equipment | 203 | 186 | 17 | 9 |
| Data processing | 283 | 278 | 5 | 2 |
| Professional fees | 176 | 171 | 5 | 3 |
| Advertising and promotion | 87 | 106 | (19) | (18) |
| Other | 563 | 414 | 149 | 36 |
| Total non-interest expense | \$ 3,809 | \$ 3,399 | \$ 410 | 12% |

The increase in salaries and employee benefits includes the addition of two employees, salary increases for existing staff, executive bonus increases and increased group insurance premiums. The decrease in occupancy expense is primarily due to the reduction in rent expense resulting from the closure of the West Broad street office in November 2002. Increased furniture and equipment expense is primarily due to increased depreciation resulting from the purchase of new bank-owned vehicles in 2002. Increased other non-interest expense primarily relates to increased SBA related fees, donations and insurance expense.

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The following table summarizes dollar amounts for each category of non-interest expense as a percentage of total operating income (interest income plus non-interest income). Operating income increased by \$286 (or 4%) in the first half of 2003 compared to the same period in 2002.

| Category | Six Months Ended June 30, | |
|-----------------------------------|------------------------------|---------------|
| | 2003 | 2002 |
| Salaries and employee benefits | 31.10% | 28.39% |
| Occupancy | 5.31 | 5.75 |
| Furniture and equipment | 2.96 | 2.83 |
| Data processing | 4.13 | 4.23 |
| Professional fees | 2.57 | 2.60 |
| Advertising and promotion | 1.27 | 1.62 |
| Other | 8.20 | 6.30 |
| Total non-interest expense | 55.54% | 51.72% |

Income Taxes. The provision for income taxes decreased to \$508 for the six months ended June 30, 2003 from \$596 for the six months ended June 30, 2002. This reflects the decrease in pre-tax income, as well as a lower effective tax rate in 2003 attributable to factors such as the increase in non-taxable income on bank-owned life insurance.

Item 3. Controls and Procedures

An evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of June 30, 2003 was conducted under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were adequate and designed to ensure that information required to be disclosed by the Company in this report is recorded, processed, summarized and reported in a timely manner, including that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

During the quarter ended June 30, 2003, there were no significant changes in internal controls or in other factors that could significantly affect internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses in internal controls.

Reference is made to the Certifications of the Chief Executive Officer and Chief Financial Officer about these and other matters included as Exhibits to this report.

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PART II - Other Information

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

The Annual Meeting of Shareholders of the Bancorp was held on May 21, 2003. At the Annual Meeting, the shareholders elected Stanley A. Levine, Ronald C. Miller, Martin Prince and Joseph D. Waxberg to the Board of Directors of the Company. There were 837,764 votes for and 11,731 votes withheld for Mr. Levine; and 831,750 votes for and 18,925 votes withheld for Mr. Miller; 838,600 votes for and 11,895 votes withheld for Mr. Prince, and 839,084 votes for and 11,411 votes withheld for Mr. Waxberg. All four were elected for terms which expire at the 2006 Annual Meeting of Shareholders. James P. Jakubek, Joseph A. Maida, Melvin L. Maisel, Norman H. Reader and Paul H. Reader are currently serving terms on the Board of Directors which expire at the 2004 Annual Meeting of Shareholders. Joseph Field, J. James Gordon, Donald Sappern and Merrill Forgotson are currently serving terms on the Board of Directors which expire at the 2005 Annual Meeting of Shareholders.

The shareholders also ratified the appointment by the Board of Directors of KPMG LLP as the Company's independent auditors for the fiscal year ending December 31, 2003. There were 846,130 votes for, 700 votes against and 3,663 abstentions with respect to such ratification.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

31.1-Rule 13a-14(a)/15d-14(a) Certification.

31.2-Rule 13a-14(a)/15d-14(a) Certification.

32.1-Section 1350 Certifications.

(b) Reports on Form 8-K

The Company filed the following reports on Form 8-K during the quarter ended June 30, 2003:

1. Form 8-K filed on April 30, 2003 reporting earnings for the calendar quarter ended March 31, 2003.
2. Form 8-K filed on June 4, 2003 reporting cash dividend.

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SIGNATURES

In accordance with the requirements of the Exchange Act, the Registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized

Date: August 13, 2003

CORNERSTONE BANCORP, INC.
(Registrant)

/s/ MERRILL J. FORGOTSON

Merrill J. Forgotsen
President and Chief Executive Officer

Date: August 13, 2003

/s/ ERNEST J. VERRICO

Ernest J. Verrico
Vice President and Chief Financial
Officer

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