HARRODSBURG FIRST FINANCIAL BANCORP INC
Form 10KSB
December 23, 2003

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

(Mark One)

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

For the fiscal year ended September 30, 2003

- or -

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

For the transition period from ______ to ______

Commission Number: 0-26570

HARRODSBURG FIRST FINANCIAL BANCORP, INC.

(Exact name of Registrant as specified in its Charter)

Delaware	**61-1284899**
(State or other jurisdiction of incorporation)	**(I.R.S. Employer or Organization Identification No.)**
104 South Chiles Street, Harrodsburg, Kentucky	**40330-1620**
(Address of principal executive offices)	**Zip Code**

Registrant s telephone number, including area code:

(859) 734-5452

Securities registered pursuant to Section 12(b) of the Act: None

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

Common Stock, par value $.10 per share

(Title of Class)

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

State issuer s revenues for its most recent fiscal year: $9.6 million.

The aggregate market value of the voting stock held by non-affiliates of the Registrant, based on the closing price of the Registrant s Common Stock as quoted on the NASDAQ National Market on December 1, 2003, was approximately $16.9 million.

As of December 1, 2003 there were issued and outstanding 1,222,978 shares of the Registrant s Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE: NONE

PART I

Harrodsburg First Financial Bancorp, Inc. (the Company or Registrant) may from time to time make written or oral forward-looking statements, including statements contained in the Company s filings with the Securities and Exchange Commission (including this Annual Report on Form 10-KSB and the exhibits thereto), in its reports to Stockholders and in other communications by the Company, which are made in good faith by the Company pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995.

These forward-looking statements involve risks and uncertainties, such as statements of the Company s plans, objectives, expectations, estimates and intentions, that are subject to change based on various important factors (some of which are beyond the Company s control). The following factors, among others, could cause the Company s financial performance to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements: the strength of the United States economy in general and the strength of the local economies in which the Company conducts operations; the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System (FRB), inflation, interest rate, market and monetary fluctuations; the timely development of and acceptance of new products and services of the company and the perceived overall value of these products and services by users, including the features, pricing and quality compared to competitors products and services; the willingness of users to substitute competitors products and services for the Company s products and services; the success of the Company in gaining regulatory approval of its products and services, when required; the impact of changes in financial services laws and regulations (including laws concerning taxes, banking, securities and insurance); technological changes; acquisitions; changes in consumer spending and savings habits; and the success of the Company at managing the risks involved in the foregoing.

The Company cautions that the foregoing list of important factors is not exclusive. The Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the company.

Item 1. Business

General

The Registrant is a bank holding company that serves as the holding company for First Financial Bank (First Financial), a federally-chartered stock savings bank of which it is the sole shareholder, and for Citizens Financial Bank, Inc. (Citizens), a state-chartered commercial bank in which it holds a 55.80% interest at September 30, 2003. The Registrant completed its acquisition of Citizens on July 15, 2001. First Financial and Citizens are referred to herein as the Banks. The Company conducts no significant business or operations of its own other than holding all or a majority of the outstanding stock of the Banks, and owning 22.5% of Independence Bancorp, New Albany, Indiana. References to the Company or Registrant generally refers to the consolidated entity including the Banks, unless the context indicates otherwise.

On June 30, 2003, the Company completed its Dutch Tender Offer and repurchased approximately 111,000 of its shares for $16.50 a shares, or approximately $1.9 million.

First Financial is a federally chartered stock savings bank headquartered in Harrodsburg, Kentucky. It is subject to examination and comprehensive regulation by the Office of Thrift Supervision (OTS) and its deposits are federally insured by the Savings Association Insurance Fund (SAIF). First Financial is a member of and owns capital stock in the Federal Home Loan Bank (FHLB) in Cincinnati, which is one of the 12 regional banks in the FHLB System.

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First Financial operates a traditional savings bank business, attracting deposit accounts from the general public and using those deposits, together with other funds, primarily to originate and invest in loans secured by one- to four-family residential real estate, non-residential real estate, and commercial loans. To a lesser extent, First Financial also originates multi-family real estate loans and consumer loans.

Citizens, a newly organized de novo Kentucky-chartered commercial bank located in Glasgow, Kentucky, commenced operations on July 17, 2001. Citizens operates as a commercial bank, attracting deposit accounts from the general public and using these deposits, together with other funds primarily to originate residential and non-residential, commercial and consumer loans. It is subject to examination and regulation by the Federal Deposit Insurance Corporation (FDIC) and the Kentucky Department of Financial Institutions, and its deposits are insured by the Bank Insurance Fund (BIF). Citizens is a member of and owns capital stock in the FHLB in Cincinnati.

On September 16, 2003 (the Effective Date), in connection with a routine regulatory examination, Citizens entered into a memorandum of understanding between the Regional Director of the Federal Deposit Insurance Corporation, Chicago Region (the Regional Director) and the Commissioner of the Kentucky Department of Financial Institutions (the Commissioner). Pursuant to the understanding, Citizens may not increase its total assets by more than 5% during any consecutive three-month period without first providing at least 30 days advance written notice to the Regional Director and the Commissioner. Additionally, among other things, the understanding also required Citizens to revise certain of its loan policies and review procedures. The understanding will remain in place until terminated by the Regional Director and the Commissioner. See Loan Approval Authority and Underwriting and Management s Discussion and Analysis of Financial Condition and Results of Operation.

Competition

The competition for deposit products comes from other insured financial institutions such as commercial banks, thrift institutions, credit unions, and multi-state regional banks in the Registrant s market area of Mercer, Anderson and Barren Counties, Kentucky. Deposit competition also includes a number of insurance products sold by local agents and investment products such as mutual funds and other securities sold by local and regional brokers. Loan competition varies depending upon market conditions and comes from other insured financial institutions such as commercial banks, thrift institutions, credit unions, multi-state regional banks, and mortgage bankers.

Analysis of Loan Portfolio. The following table sets forth information concerning the composition of the Registrant s loan portfolio in dollar amounts and in percentages of the total loan portfolio (before deductions for loans in process, deferred loan origination fees and costs and allowance for loan losses) as of the dates indicated.

	At September 30,			
	2003		2002	
	Amount	Percent	Amount	Percent
	(Dollars in Thousands)			
Type of Loans:				
Real Estate:				
One-to four-family residential	$ 72,075	60.45%	$ 74,437	65.05%
Multi-family	2,220	1.86	2,419	2.12
Agricultural	14,317	12.07	7,283	6.36
Commercial	19,616	16.46	14,217	12.42
Construction	4,602	3.86	5,433	4.75
Consumer:				
Home equity	1,923	1.61	2,666	2.33
Other (1)	3,864	3.24	7,227	6.32
Savings account	533	0.45	741	0.65
Total loans receivable	119,150	100.00%	114,423	100.00%
Less:				
Deferred loan origination fees and costs, net	489		439	
Allowance for loan losses	1,006		632	
Loans receivable, net	$ 117,655		$ 113,352	

(1) Includes home improvement, personal loans, auto and commercial loans.

Loan Maturity Tables

The following table sets forth the maturity of the Banks loan portfolio at September 30, 2003. The table does not include prepayments or scheduled principal repayments. Prepayments and scheduled principal repayments on loans totaled approximately $39.1 million for the year ended September 30, 2003. Adjustable-rate mortgage loans are shown as maturing based on contractual maturities.

	Due within 1 year	Due after 1 through 5 years	Due after 5 years	Total
	(Dollars in Thousands)			
One- to four-family residential	$ 2,111	$ 5,596	$ 64,368	$ 72,075
Multi-family, agricultural and commercial	7,209	5,433	23,511	36,153
Construction	3,615	26	961	4,602
Consumer	2,614	3,663	43	6,320
Total	$ 15,549	$ 14,718	$ 88,883	$ 119,150

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The following table sets forth as of September 30, 2003 the dollar amount of all loans, which have fixed rates of interest and floating or adjustable interest rates. At September 30, 2003, of the total loan maturity due within one year of $15.5 million, Citizens loan maturity was approximately $7.9 million.

	Fixed Rates	Floating or Adjustable Rates	Total
		(Dollars in Thousands)	
One- to four-family residential	$ 16,310	$ 55,765	$ 72,075
Multi-family, agricultural and commercial	6,046	30,107	36,153
Construction	3,916	686	4,602
Consumer	5,129	1,191	6,320
Total	$ 31,401	$ 87,749	$ 119,150

One- to Four-Family Residential Loans. First Financial s primary lending activity consists of the origination of one- to four-family residential mortgage loans secured by property located in their primary market area. First Financial generally originates one- to four-family residential mortgage loans without private mortgage insurance in amounts up to 85% of the lesser of the appraised value or selling price of the mortgaged property. Loans in excess of 89.9% of the value of the mortgaged property typically require private mortgage insurance in the amount of 25% to 30% of the loan amount.

First Financial offers three types of residential adjustable rate mortgage loans, all of which use the index value of the National Monthly Median Cost of Funds Ratio to SAIF-Insured Institutions plus a set margin added to it. The interest rates on these loans have an initial adjustment period of between one and five years, and generally adjust annually thereafter, with a maximum adjustment of 2% per year and a maximum increase of 5% over the life of the loan. The index margin on a non owner-occupied one- to four-family property loan is 50 basis points higher than on an owner-occupied property loan. First Financial s adjustable-rate one-to- four family mortgage loans are for terms of up to 30 years, amortized on a monthly basis, with principal and interest due each month. Borrowers may refinance or prepay loans at their option without penalty. First Financial originates, to a limited extent, 10 year, 15 year, 25 and 30 year term fixed-rate mortgages on one- to four-family, owner-occupied homes with loan to value ratios of 85% or less.

Loan originations are generally obtained from existing and walk-in customers, members of the local community, and referrals from realtors, depositors and borrowers within the Bank s lending area. Mortgage loans originated and held by First Financial in its portfolio generally include due-on-sale clauses which provide First Financial with the contractual right to deem the loan immediately due and payable in the event that the borrower transfers ownership of the property without the Registrant s consent.

During periods of rising interest rates, the risk of default on adjustable-rate loans may increase due to increases in interest costs to borrowers. Further, adjustable-rate loans that provide for initial rates of interest below the fully indexed rates may be subject to increased risk of delinquency or default as the higher, fully indexed rate of interest subsequently replaces the lower, initial rate.

Construction Loans. The Banks engage in construction lending involving loans to qualified borrowers for construction of one- to four-family dwellings, multi-family residential units, commercial buildings and churches, with the intent of such loans converting to permanent financing upon completion of construction. All construction loans are secured by a first lien on the property under construction. Loan proceeds are disbursed in increments as construction progresses and as inspections warrant.

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Construction/permanent loans generally have adjustable or fixed interest rates and are underwritten in accordance with the same terms and requirements as permanent mortgages, except the loans generally provide for disbursement in stages during a construction period of up to twelve months, during which the borrower is not required to make monthly payments. If construction improvements are not completed at the end of six months, accrued interest must be paid to date. Accrued interest must be paid at completion of construction to the first day of the following month, and monthly payments start the first day of the following month if the loan is converted to permanent financing. Borrowers must satisfy all credit requirements that would apply to permanent mortgage loan financing for the subject property and must execute a construction loan agreement.

Construction financing generally is considered to involve a higher degree of risk of loss than long term financing on improved, occupied real estate. Risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property s value at completion of construction or development and the estimated cost (including interest) of construction. During the construction phase, a number of factors could result in delays and cost overruns. If the estimate of construction cost proves to be inaccurate, the Banks may be required to advance funds beyond the amount originally committed to permit completion of the development. The Banks have sought to minimize this risk by requiring precise construction cost estimates, specifications, and drawing plans from qualified borrowers in their market area.

Multi-Family and Commercial Real Estate Loans. In order to serve its community and enhance yields on its assets, the Banks originate loans secured by commercial real estate and multi-family properties. The multi-family and commercial real estate loans originated have generally been made to individuals, small businesses and partnerships. They have primarily been secured by first mortgages on apartment buildings, office buildings, churches and other properties. The Banks benefit from originating such loans due to higher adjustable interest rates. Adjustable-rate loans for this type of lending have a margin that is 50 basis points higher than the margin added to single-family owner-occupied property loan. First Financial s multi-family residential and commercial real estate loans are adjustable-rate loans with terms of 30 years or less, with loan-to-value ratios not exceeding 80%. Citizens multi-family residential and commercial real estate loans are adjustable rate loans with a maximum maturity of twenty years, and loan- to-value ratios not exceeding 85%. As of September 30, 2003, loans on multi-family residential and commercial real estate properties constituted approximately $36.1 million, or 30% of the Banks total loan portfolio.

Multi-family and commercial real estate lending entails significant additional risks as compared to one- to four-family residential lending. For example, such loans typically involve large loans to single borrowers or related borrowers, the payment experience on such loans is typically dependent on the successful operation of the project, and these risks can be significantly affected by the supply and demand conditions in the market for commercial property and multi-family residential units.

Loans secured by commercial real estate generally involve a greater degree of risk than residential mortgage loans and carry larger loan balances. This increased credit risk is a result of several factors, including the concentration of principal in a limited number of loans and borrowers, the effects of general economic conditions on income producing properties, and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of loans secured by commercial real estate is typically dependent upon the successful operation of the related real estate project. If the cash flow from the project is reduced, the borrower s ability to repay the loan may be impaired. To minimize these risks, the Banks generally limits loans of this type to its market area and to borrowers with which it has substantial experience or who are otherwise well known to them. The Banks underwriting procedures require verification of the borrower s credit history, income, financial statements, banking relationships, credit references, and income projections for the property. It is their current practice to obtain personal guarantees from all principals obtaining this type of loan. For the small total dollar amount of loans secured by church real estate that are originated by the Banks, repayment is dependent upon the continuing financial support of the church s members. The Banks also obtain appraisals on each property. All appraisals on commercial and multi-family real estate are reviewed by the Banks management.

Agricultural Loans. The Banks engage in lending on improved farm land with no dwelling, building lots and building acreage sites. The Banks benefit from originating such loans due to higher origination fees and adjustable interest rates. These properties must have good road access. The loan to value ratio for this type of loan is generally 75% or less with a maximum loan term of 15 years for First Financial and 20 years for Citizens. An adjustable- rate loan for this type of lending has a margin that is 50 basis points higher than the margin added to one- to four-family owner-occupied property loans.

The Banks also engage in loans for improved farm land with dwellings. The-loan-to-value ratio for this type of loan is generally 85% or less with a maximum term of 30 years for First Financial and 20 years for Citizens. These loans can be set up with payment of interest collected semi-annually and principal yearly as well as monthly principal and interest payments.

Consumer Lending. The Banks originate consumer loans on either a secured or unsecured basis. These loans generally require a pre-existing relationship with the Banks. The Banks generally make certificate of deposit loans for terms of up to six months in amounts up to the face amount of the certificate. The interest rate charged on these loans is up to 2% higher than the rate paid on the certificate, and interest is billed on a quarterly basis. These loans are payable on demand and the account must be assigned to the Banks as collateral for the loan.

Consumer loans may entail greater risk than residential loans, particularly in the case of consumer loans that are unsecured or secured by assets that depreciate rapidly. Repossessed collateral for a defaulted consumer loan may not be sufficient for repayment of the outstanding loan, and the remaining deficiency may not be collectible.

Loan Approval Authority and Underwriting. First Financial has established various lending limits for its officers and maintains a loan committee. The loan committee consists of Arthur L. Freeman, Chairman of the Board and Chief Executive Officer, Jack D. Hood, Treasurer and Chief Financial Officer, and Wickliffe T. Asbury, Executive Vice President, Charles W. Graves, Jr., Senior Vice President, and Vice Presidents Gay Gaines and James Baxter. Messrs. Freeman, Graves, Hood, and Asbury, each have the authority to approve secured loan applications up to $300,000 and unsecured loans of up to $30,000. Messrs. Baxter and Gaines, each have the authority to approve secured loan applications up to $200,000 and unsecured loans of $20,000. Any two officers may join together to approve loans, but only to the limit of the higher authority of the two officers. The loan committee approves loans that exceed the limits established for individual officers and may approve secured loans of up to $500,000 and unsecured loans of $50,000. The Board of Directors must approve all loans that exceed the lending limit of the loan committee.

For all loans originated by First Financial, upon receipt of a completed loan application from a prospective borrower, a credit report is generally ordered, income and certain other information is verified and, if necessary, additional financial information is requested. An appraisal of the real estate intended to be used as security for the proposed loan is obtained. All appraisals are reviewed by officers of First Financial designated by the Board of Directors. An independent appraiser designated and approved by the Board of Directors of First Financial is utilized for all real estate mortgage loans. For construction/permanent loans, the funds advanced during the construction phase are held in a loan-in- process account and disbursed based upon various stages of completion in accordance with the results of inspection reports that are based upon physical inspection of the construction by an independent contractor hired by First Financial or in some cases by an officer of the Bank. For real estate loans First Financial will require either title insurance or a title opinion. Borrowers must also obtain fire and casualty, hazard or flood insurance (for loans on property located in a flood zone, flood insurance is required) prior to the closing of the loan.

Citizens has established various lending limits for its officers and maintains an officers loan committee. The officers loan committee consists of Terry Bunnell, President, Larry Ramey, Chief Operating Officer, and Vice Presidents, Nancy Hale, Jeff Constant and Jennie Wilson. In connection with the memorandum of understanding between the Regional Director and the Commissioner, the lending limits for Citizen s officers have been revised. Mr. Bunnell has the authority to approve secured loans up to $250,000 and unsecured loans up to $25,000. Mr. Ramey has the authority to approve secured loans up to $200,000 and unsecured loans up to $20,000. Ms. Hale and Mr. Constant each have the authority to approve secured loans up to $100,000 and unsecured loans up to $10,000. Ms. Wilson has the authority to approve secured loans up to $20,000 and unsecured loans up to $5,000.

Officers may not join authorities to approve loans but officers may have an officer with higher authority approve loans up to the limit of that officer. The loan committee approves loans exceeding officer limits up to the loan committee limit of $250,000 for secured loans and $25,000 for unsecured loans. The loan committee consists of officers Bunnell, Constant, Ramey, Hale and Wilson. The Board loan committee consists of Terry Bunnell, Larry Ramey, Henry H. Dickinson, Chairman of the Board, Thomas K. Lyons, Samuel D. Dickinson, Philip J. Rutledge and Arthur Freeman and approves loans in excess of $250,000 for secured loan and in excess of $25,000 for unsecured loans.

The Board of Directors approves all insider loans and other loans as presented by the Board loan committee for full board approval.

For all loans originated by Citizens, upon receipt of a completed loan application from a prospective borrower, a credit report is generally ordered, income and certain other information is verified and, if necessary additional financial information is requested. An appraisal of the real estate intended to be used as security for the proposed loan is obtained as required by regulations. For loans for which appraisals are not required, written evaluations of the real estate collateral are prepared. Officers of Citizens review all appraisals or written evaluations prepared. Independent appraisers as approved by the Board of Directors are utilized. For construction/permanent loans a line of credit is established and advances are drawn against the line based upon various stages of completion in accordance with the results of inspection reports based on physical inspection of the construction by an independent contractor or bank officer. For real estate loans Citizens requires either title insurance or a title opinion. Borrowers must also obtain fire and casualty, hazard or flood insurance if in a flood zone prior to closing the loan.

Loan Commitments. First Financial issues written commitments to prospective borrowers on all approved real estate loans. Generally, the commitment requires acceptance within 20 days of the date of issuance. At September 30, 2003, First Financial had approximately $0.9 million of commitments to cover originations, undisbursed funds for loans-in-process and unused lines of credit.

Citizens issues written commitments to prospective borrowers on all approved real estate loans. Generally, the commitment requires acceptance within 20 days of the date of issuance. At September 30, 2003, Citizens had approximately $2.9 million of commitments to cover unused lines of credit.

Non-Performing and Problem Assets

Loan Delinquencies. First Financial monitors delinquencies on all types of loans closely. If such loans later become delinquent, First Financial contacts and works with the borrower to resolve the delinquency before initiating foreclosure proceedings. First Financial s collection procedures provide that when a mortgage loan is 10 days past due, a notice of nonpayment is sent. Delinquent notices are sent if the loan becomes delinquent for more than 30 days. If payment is still delinquent after 60 days, the customer will receive a letter and/or telephone call and may receive a visit from a representative of the Registrant. If the delinquency continues, similar subsequent efforts are made to eliminate the delinquency. If the loan continues in a delinquent status for 90 days past due and no repayment plan is in effect, management will generally initiate legal proceedings.

Loans are reviewed on a monthly basis by management and are generally placed on a non-accrual status when the loan becomes more than 90 days delinquent and, in the opinion of management, the collection of additional interest is doubtful. Interest accrued and unpaid at the time a loan is placed on non- accrual status is charged against interest income. Subsequent interest payments, if any, are either applied to the outstanding principal balance or recorded as interest income, depending on the assessment of the ultimate collectibility of the loan.

Citizens monitors delinquencies on all types of loans closely. If such loans later become delinquent, Citizens contacts and works with the borrower to resolve the delinquency before initiation of foreclosure proceedings. Citizens collection procedures provide that when a mortgage loan is 15 days past due (10 days for other loans), a notice of nonpayment is sent. Delinquent notices are sent if the loan becomes delinquent for more than 30 days. At 30 days past due, the customer also receives a letter, phone call or officer visit to discuss the loan status. If the delinquency continues, similar subsequent efforts are made to eliminate the delinquency. If the loan continues in a delinquent status for up to 90 days past due and no repayment plan is in effect, management will generally initiate legal proceedings.

Loans are reviewed on a monthly basis by management and will be placed on non-accrual status when the loan becomes more than 90 days past due and, in the opinion of management, the collection of additional interest is doubtful. Interest accrued and unpaid at the time a loan is placed on non-accrual status is charged against interest income. Subsequent interest payments, if any, are either applied to principal then to interest that would have been contractually accrued.

Non-Performing Assets. The following table sets forth information regarding non-accrual loans, real estate owned and certain other repossessed assets and loans. As of the dates indicated, the Registrant had no loans categorized as troubled debt restructuring within the meaning of Statement of Financial Accounting Standards (SFAS) 15 and no impaired loans within the meaning of meaning of SFAS 114, as amended by SFAS 118.

	At September 30,	
	2003	2002
	(In Thousands)	
Loans accounted for on a non-accrual basis:		
Total	$ 425	$ 41
Accruing loans which are contractually past due 90 days or more:		
Mortgage loans:		
Permanent loans secured by 1 to 4 family dwelling units	189	217
All other mortgage loans	7	5
Non-mortgage loans:		
Commercial	85	
Consumer	129	112
Total	410	334
Total non-accrual loan	835	375
Real estate owned		233
Total non-performing assets	$ 835	$ 608
Total non-performing loans to net loans	.71%	.33%
Total non-performing loans to total assets	.48%	.25%
Total non-performing assets to total assets	.48%	.40%

Classified Assets. Federal regulations provide for a classification system for problem assets of insured institutions that covers all problem assets. Under this classification system, problem assets of insured institutions are classified as substandard, doubtful, or loss. An asset is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified substandard, with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets may be designated special mention because of potential weakness that do not currently warrant classification in one of the aforementioned categories.

When an insured institution classifies problem assets as either substandard or doubtful, it may establish general allowances for loan losses in an amount deemed prudent by management. General allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been allocated to particular problem assets. When an insured institution classifies problem assets as loss, it is required either to establish a specific allowance for losses equal to 100% of that portion of the asset so classified or to charge off such amount. First Financial and Citizens determination as to the classification of its assets and the amount of its valuation allowances is subject to review by the OTS and the FDIC, respectively, which may order the establishment of additional general or specific loss allowances. A portion of general loss allowances established to cover possible losses related to assets classified as substandard or doubtful may be included in determining an institution s regulatory capital, while specific valuation allowances for loan losses generally do not qualify as regulatory capital.

The following table sets forth the Registrant s classified assets in accordance with its classification system:

	At September 30, 2003
	(In Thousands)
Special Mention	$ 12
Substandard	2,465
Doubtful	1
Loss	1
Total	$ 2,479

Allowance for Loan Losses. It is management s policy to provide for losses on loans in its loan portfolio. A provision for loan losses is charged to operations based on management s evaluation of the losses that may be incurred in the Registrant s loan portfolio. Such evaluation, which includes a review of all loans of which full collectibility of interest and principal may not be reasonably assured, considers the Registrant s past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral, current economic conditions, and the relationship of the allowance for loan losses to outstanding loans.

The following table sets forth information with respect to the Registrant s allowance for loan losses at the dates and for the periods indicated:

	At or for the Year Ended September 30,	
	2003	2002
	(Dollars In Thousands)	
Total Loans Outstanding	$ 119,150	$ 115,977
Average Loans Outstanding	$ 116,664	$ 109,011
Allowance balances (at beginning of period)	$ 632	$ 411
Provision (credit):		
Residential	428	241
Consumer		
Net Charge-offs (recoveries):		
Residential	54	20
Consumer		
Allowance balance (at end of period)	$ 1,006	$ 632
Allowance for loan losses as a percent of total loans outstanding	.84%	.54%