

HARBOR BANKSHARES CORP
Form 10KSB
March 24, 2004
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-KSB

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

Commission File Number : 0-20990

HARBOR BANKSHARES CORPORATION

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

52-1786341
(IRS Employer Identification No.)

25 West Fayette Street

Baltimore, Maryland
(Address of principal executive officer)

21201
(Zip Code)

Registrant's telephone number, including area code: (410) 528-1800

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

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

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Common Stock, par value \$0.01 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 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-K or any amendment to this Form 10-KSB.

Issuer's revenues for its most recent fiscal year: \$ 14,392,435

As of March 5, 2004, the registrant had 704,176 shares of Common Stock issued and outstanding, including 33,795 non-voting shares. The aggregate market value of shares held by nonaffiliates on such date was \$7,603,578 based on the average of the bid and asked price of \$20.00 per share of the Registrant's Common Stock on that date. For purposes of this calculation, it is assumed that the 424,998 shares held by directors and executive officers of the Registrant, are shares held by affiliates.

Documents Incorporated by Reference: Portions of the Registrant's Annual Report to Stockholders for the year ended December 31, 2003 and Registrant's 2004 Proxy Statement are incorporated by reference into Parts I and II.

Transitional small business disclosure format (check one): Yes No

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HARBOR BANKSHARES CORPORATION

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

SECURITIES AND EXCHANGE COMMISSION

FORM 10-KSB

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Portions of the Registrant's Annual Report to Stockholders for the year ended December 31, 2003 and the Registrant's 2004 Proxy Statement are incorporated by reference into Parts I and II.

PART I

Forward Looking Statements

Item 1. Description of Business, Item 3. Legal Proceedings, Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations, and other portions of this annual report on Form 10-KSB include forward-looking statements such as: statements of Harbor Bancshares Corporation's goals, intentions, and expectations; estimates of risks and of future costs and benefits; assessments of loan quality, probable loan losses, liquidity, off-balance sheet arrangements, and interest rate risk; and statements of its ability to achieve financial and other goals. These forward-looking statements are subject to significant uncertainties because they are based upon: the amount and timing of future changes in interest rates and other economic conditions; future laws, regulations and accounting principles; and a variety of other matters. Because of these uncertainties, the actual future results may be materially different from the results indicated by these forward-looking statements. In addition, Harbor Bankshares Corporation's past growth and performance do not necessarily indicate its future results.

Item 1. Description of Business

Harbor Bankshares Corporation

Harbor Bankshares Corporation (the Corporation) is a bank holding company with one bank subsidiary and two other Community Development financial subsidiaries, one for profit, The Harbor Bank of Baltimore LLC and a non-profit, The Harbor Bank CDC. Both were established during 2002. The Corporation has no investment in either subsidiary as of December 31, 2003. The Corporation was organized under the laws of the State of Maryland in 1992. On November 2, 1992, Harbor Bankshares Corporation acquired all outstanding stock of The Harbor Bank of Maryland (the Bank), headquartered in Baltimore, Maryland.

The Harbor Bank of Maryland

The Harbor Bank of Maryland is a state chartered institution in the State of Maryland. The deposits of the Bank are insured by the Federal Deposit Insurance Corporation.

The Harbor Bank of Maryland is a commercial bank headquartered in Baltimore, Maryland. The Bank conducts a general commercial and retail business. The Bank was opened on September 13, 1982 and was incorporated under the laws of the State of Maryland. During the second and third quarters of 1994, the Corporation, through its subsidiary, The Harbor Bank of Maryland acquired three (3) branch locations from the

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Resolution Trust Corporation; two (2) located in Baltimore City, and one (1) located in Riverdale, Prince George's County. A new branch location was opened during December 1995 in Baltimore County, expanding the market area of the Bank. During May 1997, The Harbor Bank of Maryland opened a *de novo* branch location in the East side of Baltimore City, and on January 19, 1999, a *de novo* branch was opened in the West side of the City, this branch location was closed during March 2002. During September 2000, a branch located in Baltimore City was also closed. The closing of both facilities have helped the profitability of the Bank.

In April, 2002, the Bank purchased a branch location from another financial institution in Baltimore County in order to increase its market share. The purchase included \$18.8 million in deposits. The Bank had a location near the purchased facility and both were merged into the acquired office in order to reduce the overhead cost of running both branches.

Harbor Financial Services, a company dealing with the sale of mutual funds, stocks, insurance, etc., was established as a subsidiary of the Bank during May 1997, in order to compete with that expanding market. This subsidiary had a loss of \$11 thousand for the year ended December 31, 2003.

The Bank conducts general banking business in six (6) locations and serves primarily the Baltimore Metropolitan area. It offers checking, savings and time deposits, commercial, real estate, personal, home improvement, automobile and other

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installment loans, credit cards and term loans. The Bank is also a member of a local and national ATM network. The retail nature of the Bank allows for full diversification of deposits and borrowers so it is not dependent upon a single or a few customers.

Competition

The Corporation's subsidiary, The Harbor Bank of Maryland, competes with virtually all banks and savings institutions, which offer services in its market area. The Bank directly competes with branches of most of the State's largest banks, each of which has greater financial and other resources to conduct large advertising campaigns and to allocate their investment assets to regions of higher yield and demand. To attract business in this competitive environment, the Bank relies heavily on local promotional activities and personal contact by its officers and directors and by its ability to provide personalized services.

Supervision and Regulation

Harbor Bankshares Corporation is a registered bank holding company subject to regulation and examination by the board of governors of the Federal Reserve System under the Bank Holding Company Act of 1956 (the Act). The Corporation is required to file with the board of governors quarterly and annual reports and any additional information that may be required according to the Act. The Act also requires every bank holding company to obtain the prior approval of the Federal Reserve Board before acquiring direct or indirect ownership or control of more than 5% of the voting shares of any bank that is not already majority owned. The Act also prohibits a bank holding company, with certain exceptions, from engaging in or acquiring direct or indirect control of more than 5% of the voting shares of any company engaged in non-banking activities. One of the principal exceptions to these provisions is for engaging or acquiring shares of a company engaged in activities found by the Federal Reserve Board to be so closely related to banking or managing banks to be a proper incident thereto.

The Harbor Bank of Maryland is a state chartered institution insured by the Federal Deposit Insurance Corporation (FDIC) and subject to federal and state laws applicable to commercial banks. The Bank is examined regularly by FDIC and the State of Maryland Banking Commissioner's office.

In accordance with Federal Reserve regulation, the Bank is limited as to the amount it may loan affiliates, including the Corporation, unless such loans are collateralized by specific obligations. Additionally, banking law limits the amount of dividends that a bank can pay without prior approval from bank regulators.

Governmental Monetary Policies and Economic Controls

The earnings and growth of the banking industry and ultimately of The Harbor Bank of Maryland, Harbor Bankshares Corporation's sole subsidiary, are affected by the credit policies of monetary authorities including the Federal Reserve System. An important function of the Federal Reserve System is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the Federal Reserve to implement these objectives are open market operations in U.S. Government securities, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans and investments and deposits, and may also affect interest rates charged on loans or paid for deposits. The monetary policies of the Federal Reserve authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future.

In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the Federal Reserve System, no prediction can be made as to possible future changes in interest rates, deposit levels, and loan demand, or their effect on the business and earnings of the Corporation and its subsidiary.

Employees

At December 31, 2003, Harbor Bankshares Corporation and its subsidiaries employed 78 individuals, of which 27 were officers and 51 were full-time employees.

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Executive Officers

Information concerning executive officers of the Corporation is listed below:

<u>Executive Officers</u>	<u>Age</u>	<u>Position</u>
Joseph Haskins, Jr.	56	Chairman, President and Chief Executive Officer of the Bank and Corporation
John Paterakis	75	Chairman of the Executive Committee of the Corporation and the Bank
Teodoro J. Hernandez	58	Treasurer of the Corporation and Senior Vice President and Cashier of the Bank

Tabular Information

Exhibit A, B, C and D to the Registrant's Annual Report to Shareholders for the year ended December 31, 2003 (the Annual Report) are incorporated herein by reference. The information in this description of business should be read in conjunction with the information provided in the Management's Discussion and Analysis of Financial Condition and Operations, which is incorporated herein from the Annual Report.

Investment Securities (*dollars in thousands*)

Maturity Distribution of Investment Securities (*dollars in thousands*)

	U.S.			
	<u>Treasuries</u>	<u>U.S. Agencies</u>	<u>Other Securities</u>	<u>TOTAL</u>
Maturing Within One Year	\$ 2,018	\$ 11,190	\$ 507	\$ 13,715
Maturing After One But Within Five Years		21,852		21,852
Maturing After Five But Within Ten Years		1,966		1,966
Maturing After Ten Years		343	42	385
TOTAL	\$ 2,018	\$ 35,351	\$ 549	\$ 37,918

Table of ContentsWeighted Average Interest Rates of Investment Securities at December 31, 2003

	<u>U.S. Treasury</u>	<u>U.S. Government Agencies</u>	<u>Other Securities</u>	<u>TOTAL</u>
Maturing Within One Year	3.25%	3.31%	2.87%	3.14%
Maturing After One But Within Five Years		3.57%		3.57%
Maturing After Five But Within Ten Years		3.34%		3.34%
Maturing After Ten Years		6.19%	7.25%	6.35%
TOTAL	3.25%	3.41%	3.35%	3.34%

Carrying amount and the market value of Investment Securities at 2003 , 2002 AND 2001 (dollars in thousands)

	<u>2003</u>		<u>2002</u>		<u>2001</u>	
	<u>Amortized Cost</u>	<u>Market</u>	<u>Amortized Cost</u>	<u>Market</u>	<u>Amortized Cost</u>	<u>Market</u>
U.S. Treasuries, Government Agencies and						
Mortgage Backed Securities	\$ 37,258	\$ 37,369	\$ 54,370	\$ 55,254	\$ 50,879	\$ 50,501
Other Securities	548	549	554	561	558	553
TOTAL	\$ 37,806	\$ 37,918	\$ 54,924	\$ 55,815	\$ 51,437	\$ 51,054

Table of ContentsLoan DistributionFive-Year Loan Distribution at December 31 (dollars in thousands)

	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
Commercial Loans	\$ 55,184	\$ 30,964	\$ 23,126	\$ 33,515	\$ 31,801
Real Estate Loans	87,228	78,856	71,962	70,596	67,117
Consumer Loans	8,806	11,751	11,718	8,286	3,583
TOTAL	\$ 151,218	\$ 121,571	\$ 106,806	\$ 112,397	\$ 102,501

Five-Year Loan Distribution at December 31 (expressed as percentages)

	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
Commercial Loans	36.49%	25.47%	21.65%	29.82%	31.03%
Real Estate Loans	57.69%	64.86%	67.38%	62.80%	65.47%
Consumer Loans	5.82%	9.67%	10.97%	7.38%	3.50%
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%

Maturity and Repricing of Loans and December 31, 2003 (dollars in thousands)

	<u>Commercial Loans</u>	<u>Real Estate Loans</u>	<u>Consumer Loans</u>	<u>TOTAL</u>
Within One Year	\$ 32,734	\$ 5,444	\$ 1,513	\$ 39,691
After One Year But Within Five Years	17,679	27,595	5,521	\$ 50,795
After Five Years	4,771	54,189	1,772	\$ 60,732
TOTAL	\$ 55,184	\$ 87,228	\$ 8,806	\$ 151,218

Loans Classified by Sensitivity to Changes in Interest Rates (dollars in thousands)

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	Fixed Interest	Adjustable Interest	
	Rate Loans	Rate Loans	TOTAL
	<hr/>	<hr/>	<hr/>
Within One Year	\$ 9,111	\$ 38,882	\$ 47,993
After One But Within Five Years	50,762	595	51,357
After Five Years	51,868		51,868
	<hr/>	<hr/>	<hr/>
TOTAL	\$ 111,741	\$ 39,477	\$ 151,218
	<hr/>	<hr/>	<hr/>

Asset Quality

One of the Corporation's main objectives has been and continues to be the achievement of a high level of asset quality. We maintain a large portion of loans secured by residential one-to four- family properties and commercial properties. As of December 31, 2003, those loans totaled \$78 million or 51.32 percent of total outstanding loans. We set sound credit standards for new loan originations, and follow careful loan administration procedures. We strengthened our focus on credit risk by having independent reviews of all major credit with detailed reports to management.

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Delinquent Loans and Foreclosed Assets: The Corporation policies require that management continuously monitor the status of the loan portfolio and report to the Board of Directors on a monthly basis. These reports include information on delinquent loans and foreclosed real estate, and actions and plans to cure the delinquent status of the loans and to dispose of the foreclosed properties.

Interest on Non-accrual Loans. (dollars in thousands)

	<u>2003</u>	<u>2002</u>
Interest Income that Would Have Been Recorded Under Original Terms	\$ 30	\$ 57
Interest Income Recorded during the Period	\$	\$

It is the policy of the Corporation to place a loan on non-accrual status whenever there is substantial doubt about the ability of a borrower to pay principal or interest on any outstanding credit. Management considers such factors as payment history, the nature of the collateral securing the loan, and the overall economic situation of the borrower when making a non-accrual decision. Non-accrual loans are closely monitored by management. A non-accruing loan is restored to accrual status when principal and interest payments have been brought current or it becomes well-secured or is in the process of collection and the prospects of future contractual payments are no longer in doubt.

We generally stop accruing income when interest or principal payments are between 90 and 120 days in arrears. We may stop accruing income on such loans earlier than 90 days when we consider the timely collectibility of interest or principal payment to be doubtful.

When we designate non-accrual loans, we reverse all outstanding interest that we had previously credited. If we receive a payment on a non-accrual loan, we may recognize a portion of that payment as interest income if we determine that the ultimate collectibility of principal is no longer in doubt. However, such loans may remain in non-accrual status.

Impaired Loans

At December 31, 2003, the Corporation had \$1,184 thousand of impaired loans for which the borrowers were experiencing financial difficulties. Those loans are subject to constant management attention and their classification is reviewed monthly. Impaired loans are individually assessed to determine whether the carrying value exceeds the fair value of the collateral.

Foreclosed Real Estate

Foreclosed real estate consists of property we have acquired through foreclosed or deed in lieu of foreclosure. Foreclosed real estate properties are initially recorded at the lower of the recorded investment in the loan or fair value. At December 31, 2003, 2002 and 2001, respectively, we had \$0, \$70 thousand and \$14 thousand in foreclosed real estate.

Potential Nonperforming Loans

Those performing loans considered potential nonperforming loans, loans which are not included in the past due, nonaccrual or restructured categories, but for which known information about possible credit problems cause management to be uncertain as to the ability of the borrowers to comply with the present loan repayment terms over the next six months, amounted to approximately \$3,502 thousand at December 31, 2003, compared to \$3,270 thousand at December 31, 2002, and \$2,215 thousand at December 31, 2001. These loans are subject to continuing management attention and are considered by management in determining the level of the allowance for loan losses.

Table of Contents**Allowance for Loan Losses**

The Corporation's allowance for loan loss methodology is a loan classification-based system, based on the required reserve on a percentage of the loan balance for each type of loan and classification level. Watch, special mention, substandard and doubtful loans are reserved at 5.0%, 10.0%, 20.0% and 50.0%, respectively. Reserve percentages are based on each individual lending program, its loss history and underwriting characteristics including loan to value, credit score, debt coverage, collateral, and capacity to service debt. This analysis is used to validate the loan loss reserve matrix as well as assist in establishing overall lending direction. The \$439, thousand, or 41.8%, increase in the allowance in 2003 was primarily the result of substantial loan growth, particularly in categories that have historically higher risk, such as commercial and commercial real estate Loans, and a decline in the percentage of the portfolio represented by historically lower risk residential real estate loans. During 2003, there were no changes in estimation methods or assumptions that affected the methodology for assessing the appropriateness of the allowance.

While management considers the Corporation's allowance for loan losses to be adequate based on information currently available, future adjustments to the allowance may be necessary due to changes in economic conditions, management's assumptions as to future delinquencies or loss rates, and management's intent with regard to asset disposition options. In addition, the Corporation's allowance for loan losses is periodically reviewed by the bank regulatory agencies as an integral part of their examination process. Based on their review, the agencies may require the Corporation to adjust the allowance.

Maturities of Time Certificates of Deposit of \$100,000 or More Outstanding at December 31, 2002 and 2001

(dollars in thousands)

	<u>2003</u>	<u>2002</u>
Three months or less	\$ 9,013	\$ 7,993
Three to six months	5,678	2,871
Six to twelve months	5,233	10,909
Over twelve months	5,170	4,069
TOTAL	\$ 25,094	\$ 25,842

Long And Short Term Borrowings

Long term borrowings for the year 2003 and 2002 consist of a note payable due July 1, 2012 at a fixed rate of 7.0% with interest payments only from August 2001 to August 2002 and equal principal and interest payments from August 2002 to July 1, 2012. This note was paid during October, 2003. On October 9, 2003, Harbor Bankshares Corporation issued a Floating Rate Junior Subordinated Debt Securities due 2033 in the amount of \$7.2 million. The Debt Security was issued by the corporation pursuant to an Indenture, dated as of October 9, 2003, between the Corporation and Wilmington Trust Company. The Capital Securities will be issued by Harbor Bankshares Corporation Capital Trust pursuant to a Purchase Agreement dated September 18, 2003, among the Corporation, the Trust and Citigroup Global Markets Inc. Upon receipt of the funds, the corporation paid off its long-term debt to N.C.I.F. in the amount of \$1.8 million and placed the remaining funds in its subsidiary, The Harbor Bank of Maryland, increasing the Bank's Tier One capital. This capital infusion will allow the Bank to increase its lending limit and allow for future growth.

Table of Contents**Borrowings for the Years Ended December 31, 2003 and 2002***(dollars in thousands)*

	<u>2003</u>	<u>2002</u>
Amount outstanding at period-end:		
Long-term debt	\$ 0	\$ 1,943
Subordinated Debt Securities	7,217	0
Average outstanding:		
Long-term debt	\$ 1,310	\$ 1,986
Subordinated Debt Securities	1,611	0
Weighted average interest rate during the period:		
Long-term debt	7.00%	7.00%
Subordinated Debt Securities	4.40%	0

Off-Balance Sheet Arrangements

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds collateral supporting those commitments for which collateral is deemed necessary. County National Bank has not been required to perform on any financial guarantees and has not incurred any losses on its commitments. The issuance of letters of credit is not a significant activity of the Bank.

Commitments to extend credit are agreements to lend funds to customers as long as there are no violations of any condition established in the loan contracts. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on credit evaluation by management. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment as well as income producing properties. We believe that we have adequate resources to fund all loan commitments.

The Bank has entered into leases for its branch and office space, most of which contain renewal options.

For additional information regarding off-balance sheet arrangements, please see Notes 7 and 20 to the Consolidated Financial Statements and the discussion of the Debt Security in Long and Short Term Borrowings, above.

Critical Accounting Policies

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The Corporation's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used

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to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

The most significant accounting policies followed by the Corporation are presented in Note 2 to the consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions and estimates underlying those amounts, management has identified the determination of the allowance for loan losses as the accounting area that requires the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available.

The Corporation believes it has developed appropriate policies and procedures for assessing the adequacy of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. The Corporation's assessments may be affected in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of information with respect to borrowers which is not known to management at the time of the issuance of the consolidated financial statements. For additional discussion concerning the Corporation's allowance for loan losses and related matters, see Provision for Loan Losses and Asset Quality above and Note 2 to the Consolidated Financial Statements.

Item 2. Description of Properties

The Corporation's Headquarters is located at 25 West Fayette Street, Baltimore, Maryland 21201. This location is approximately 60,000 square feet and was bought by the Corporation during September, 2003 for \$2.9 million.

The Bank also maintains another five(5) branch offices, four (4) are leased; two (2) located in Baltimore City, one (1) located in Prince George's County, Maryland and one (1) located in Baltimore County, Maryland. The Bank owns another branch facility in Baltimore City. This office was purchased during December 1998.

Item 3. Legal Proceedings

In the normal course of business, the Corporation is at all times subject to various pending and threatened legal actions. The relief or damages sought in some of these actions may be substantial. After reviewing pending and threatened actions with counsel, management considers that the outcome of such actions will not have a material adverse effect on the Corporation's financial position; however, the Corporation is not able to predict whether the outcome of such actions may or may not have a material adverse effect on results of operations in a particular future period as the timing and amount of any resolution of such actions and relationship to the future results of operations are not known.

In 1999, the Bank entered into an agreement with an unaffiliated company that operated and serviced automated teller machines (ATMs). This agreement called for the Bank to provide cash for use in certain ATMs not located on Bank premises. The Bank has discovered that it has a significant cash shortage in connection with this arrangement. The investigation of the cash shortage is ongoing and the Bank is vigorously pursuing recovery. The Bank cannot yet reasonably estimate the amount of loss it may incur as a result of this cash shortage. Therefore, no accrual for any potential loss has been reflected in the accompanying financial statements. The maximum exposure to the Bank is estimated at approximately \$1.1 million, without consideration of any related tax benefit.

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

None

Table of Contents**PART II****Item 5. Market for Registrant's Common Equity and Related Stockholder Matters**

Information listed under, "Stockholder Information" in the Annual Report to Stockholders for the year ended December 31, 2003 is incorporated herein by reference with respect to prices for the Registrant's common stock and the dividends paid thereon. The number of Stockholders of Record as of December 31, 2003 was 685.

The following table presents disclosure regarding equity compensation plans in existence at December 31, 2003, consisting only of the stock option plan arrangements described further under the caption "Stock Options" in Note 14 to the consolidated financial statements.

Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans excluding securities reflected in column (a) (c)
Equity compensation plans approved by security holders			
Equity compensation plans not approved by security holders	151,843	\$15.49	75,043
Total	151,843	\$15.49	75,043

Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations

Information required by this item is incorporated by reference from information appearing under the caption, "Corporate Financial Review" appearing on pages 1 through 9 of the Management Discussion and Analysis section of the Registrant's Annual Report to Shareholders for the year ended December 31, 2003, and from pages 8 through 23 of this Form 10-KSB.

Contractual Obligations

Payments due by period for the Company's contractual obligations (other than deposit liabilities with no stated maturity) at December 31, 2003 are presented below:

Total

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	<u>Within One Year</u>	<u>After One but Within Three Years</u>	<u>After Three but Within Five Years</u>	<u>After Five Years</u>	<u> </u>
Time Deposits	\$ 39,874,000	\$ 13,957,000	\$ 2,388,000	\$	\$ 56,219,000
Junior subordinated debentures				\$ 7,217,000	\$ 7,217,000
Operating Lease obligations	\$ 250,784	\$ 319,675	\$ 97,839		\$ 668,298
Purchase obligations					
Total contractual obligations	\$ 40,124,784	\$ 14,276,675	\$ 2,485,839	\$ 7,217,000	\$ 64,104,298

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Item 7. Financial Statements

Information required by Item 7 is incorporated by reference from information appearing on pages 1 through 26 in the Audited Consolidated Financial Statements section of the Registrant's Annual Report to Shareholders for the year ended December 31, 2003.

Item 8. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure

None

Item 8A. Controls and Procedures

The Corporation's management, under the supervision and with the participation of its Chief Executive Officer and the Chief Financial Officer, evaluated as of the last day of the period covered by this report, the effectiveness of the design and operation of the Corporation's disclosure controls and procedures, as defined in Rule 13a-15 under the Securities Exchange Act of 1934. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Corporation's disclosure controls and procedures were adequate. There were no significant changes in the Corporation's internal controls over financial reporting (as defined in Rule 13a-15 under the Securities Act of 1934) during the quarter ended December 31, 2003, that have materially effected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

PART III

Item 9. Directors and Executive Officers of the Registrant

Information required by this item is incorporated by reference from information appearing under the caption, Election of Directors on pages 2 to 6 of the Registrant's 2004 Proxy statement and page 4 of this report under the caption of Executive Officers of the Registrant.

Item 10. Executive Compensation

Information required by this item is incorporated by reference from information appearing under the captions Code of Ethics and Business Conduct on page 9 and Executive Compensation on pages 11 through 14 of the Registrant's 2004 Proxy Statement.

Item 11. Security ownership of certain beneficial owners and management

Information required by Item 11 is incorporated by reference from information appearing on pages 2 to 6 of the Registrant's 2004 Proxy Statement, under the caption of Election of Directors of the Registrant.

Item 12. Certain relationships and related transactions

The information required by Item 12 is incorporated by reference from Note 6 on page 16 in the Audited Consolidated Financial Statements section of the Registrant's Annual Report to Shareholders.

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Item 13. Exhibits and Reports on Form 8-K

(a) Exhibits

(1) The following consolidated financial statements of the Registrant and its subsidiaries, included in the Annual Report to Stockholders for the year ended December 31, 2003, are incorporated herein by reference in Item 8:

Consolidated Balance Sheets As of December 31, 2003 and 2002

Consolidated Statements of Income Years ended December 31, 2003 and 2002

Consolidated Statements of Changes in Stockholders' Equity Years ended December 31, 2003 and 2002

Consolidated Statements of Cash Flows Years ended December 31, 2003 and 2002

Notes to Consolidated Financial Statements

Report of Stegman & Company, Independent Auditors

All other schedules to the consolidated financial statements required by Article 9 of Regulation S-X and all other schedules to the financial statements of the Registrant required by Article 5 of Regulation S-X are not required under the related instructions or are inapplicable and, therefore, have been omitted.

(a) Exhibits. The following is a list of exhibits filed as part of this Annual Report on Form 10-KSB.

<u>No.</u>	<u>Exhibit</u>
3.1	Articles of Incorporation of Harbor Bankshares Corporation (incorporated by reference to Exhibit 3(a) to Registration Statement on Form S-4 filed July 17, 1992.
3.2	Bylaws of Harbor Bankshares Corporation (incorporated by reference to Exhibit 3(b) to Registration Statement on Form S-4 filed July 17, 1992.
10.1*	Harbor Bankshares Corporation Stock Option Plan (incorporated by reference to Exhibit 10(b) to Registration Statement on Form S-4 filed July 17, 1992.
10.2*	

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Employment Agreement by and between Joseph Haskins, Jr., Harbor Bankshares Corporation, and the Harbor Bank of Maryland effective January 1, 2000.

13	Portions of the Annual Report to Shareholders for the Year Ended December 31, 2003
23	Independent Auditors' Consent
31(a), (b)	Rule 13a-14(a)/15d-14(a) Certifications
32(a), (b)	18 U.S.C. Section 1350 Certifications

* Management contract or compensatory plan or arrangement.

(b) Reports on Form 8-K.

None.

Item 14. Principal Accountant Fees and Services

Information required by this item is incorporated by reference from information appearing under the caption "Company's Independent Public Accountants" on pages 10 and 11 of the Registrant's 2004 Proxy Statement.

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SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HARBOR BANKSHARES CORPORATION

By: /s/ Joseph Haskins, Jr.

Title: Chairman of the Board, President, and Chief
Executive Officer

Date: March 23, 2004

In accordance with Section 13 or 15(d) of the Exchange Act, this report has been signed by the following persons on behalf of the Registrant, and in the capacities, and on the dates indicated:

By: /s/ Joseph Haskins, Jr.

Title: Chairman of the Board, President, and Chief
Executive Officer

Date: March 23, 2004

By: /s/ Teodoro J. Hernandez

Title: Treasurer

Date: March 23, 2004

By: /s/ George F. Vaeth, Jr.

Title: Director

Date: March 23, 2004

By: /s/ Sachindler Gupta

Title: Director

Date: March 23, 2004

By: /s/ Stanley W. Tucker

Title: Director

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Date: March 23, 2004

By: /s/ James Scott, Jr.

Title: Director

Date: March 23, 2004

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HARBOR BANKSHARES CORPORATION

AND SUBSIDIARIES

REPORT ON AUDITS OF
FINANCIAL STATEMENTS

FOR THE YEARS ENDED
DECEMBER 31, 2003 AND 2002

No extracts from this report may be published without our written consent.

Stegman & Company

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INDEPENDENT AUDITORS REPORT

The Board of Directors and Stockholders

of Harbor Bankshares Corporation

Baltimore, Maryland

We have audited the accompanying consolidated balance sheets of Harbor Bankshares Corporation and subsidiaries as of December 31, 2003 and 2002 and the related consolidated statements of income, changes in stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the management of Harbor Bankshares Corporation. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Harbor Bankshares Corporation and subsidiaries as of December 31, 2003 and 2002 and the results of their operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Baltimore, Maryland

January 17, 2004

Table of Contents**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES**

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2003 AND 2002

ASSETS

	<u>2003</u>	<u>2002</u>
Cash and due from banks	\$ 6,982,136	\$ 7,273,439
Federal funds sold	8,159,452	12,653,002
Interest bearing deposits in other banks	1,900,000	2,300,000
Investment securities:		
Held to maturity - at amortized cost (fair value of \$2,129,594 in 2003 and \$2,188,910 in 2002)	2,048,807	2,057,205
Available for sale - at fair value	35,788,476	53,626,729
Total investment securities	37,837,283	55,683,934
Loans	151,217,707	121,571,331
Allowance for loan losses	(1,488,212)	(1,048,671)
Net loans	149,729,495	120,522,660
Premises and equipment, net	3,735,628	985,018
Federal Home Loan Bank of Atlanta stock - at cost	461,000	600,000
Goodwill	2,506,226	2,506,226
Other intangible assets	623,587	716,336
Bank-owned life insurance	3,858,625	3,679,501
Other assets	3,753,328	3,313,803
TOTAL ASSETS	\$ 219,546,760	\$ 210,233,919

See accompanying notes.

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LIABILITIES AND STOCKHOLDERS EQUITY

	<u>2003</u>	<u>2002</u>
LIABILITIES:		
Deposits:		
Noninterest bearing demand	\$ 32,481,912	\$ 27,419,881
Interest bearing transaction accounts	21,873,356	21,845,806
Savings	85,327,769	88,910,645
Time, \$100,000 or more	25,093,981	25,842,052
Other time	31,124,406	29,275,363
	<u>195,901,424</u>	<u>193,293,747</u>
Total deposits		
Accrued interest payable	233,765	319,508
Junior subordinated debentures	7,217,000	
Long-term debt		1,943,334
Other liabilities	919,803	527,997
	<u>204,271,992</u>	<u>196,084,586</u>
Total liabilities		
STOCKHOLDERS EQUITY:		
Common stock (par value \$0.01):		
Authorized 10,000,000 shares; issued 704,176 and 735,813, including 33,795 common nonvoting at December 31, 2003 and 2002, respectively	7,041	7,357
Additional paid-in capital	7,210,178	7,204,280
Retained earnings	8,036,714	6,435,464
Accumulated other comprehensive income	20,835	502,232
	<u>15,274,768</u>	<u>14,149,333</u>
Total stockholders equity		
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	<u>\$ 219,546,760</u>	<u>\$ 210,223,919</u>

Table of Contents**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES**

CONSOLIDATED STATEMENTS OF INCOME

FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002

	<u>2003</u>	<u>2002</u>
INTEREST INCOME:		
Interest and fees on loans	\$ 10,243,769	\$ 9,123,522
Interest on investments - taxable	1,457,451	2,153,695
Interest on deposits in other banks	68,131	63,279
Interest on federal funds sold	97,368	274,015
Other interest income	19,399	32,584
	<u> </u>	<u> </u>
Total interest income	11,886,118	11,647,095
	<u> </u>	<u> </u>
INTEREST EXPENSE:		
Interest bearing transaction accounts	37,887	61,834
Savings	696,201	1,144,913
Time, \$100,000 or more	661,839	914,422
Other time	840,168	1,140,035
Notes payable	103,892	141,213
Interest on junior subordinated debentures	70,560	
	<u> </u>	<u> </u>
Total interest expense	2,410,547	3,402,417
	<u> </u>	<u> </u>
NET INTEREST INCOME	9,475,571	8,244,678
PROVISION FOR LOAN LOSSES	755,000	340,000
	<u> </u>	<u> </u>
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	8,720,571	7,904,678
	<u> </u>	<u> </u>
NONINTEREST INCOME:		
Service charges on deposit accounts	854,745	910,473
Other service charges	490,462	592,361
Gain on sale of securities	225,327	226,355
Gain on sales of loans	50,824	54,015
Awards and grants	663,818	214,483
Loan servicing fees	16,287	25,865
Other income	204,854	197,203
	<u> </u>	<u> </u>
Total noninterest income	2,506,317	2,220,755
	<u> </u>	<u> </u>
NONINTEREST EXPENSES:		
Salaries and employee benefits	4,368,415	4,229,792
Occupancy expense of premises	720,155	785,212
Equipment expense	385,641	477,673
Data processing fees	972,730	975,914
Professional fees	174,165	207,787
Amortization of intangible assets	80,460	46,615

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Other expenses	1,908,774	1,852,527
	<u> </u>	<u> </u>
Total noninterest expense	8,610,340	8,575,520
	<u> </u>	<u> </u>
INCOME BEFORE INCOME TAXES	2,616,548	1,549,913
APPLICABLE INCOME TAXES	831,220	472,621
	<u> </u>	<u> </u>
NET INCOME	\$ 1,785,328	\$ 1,077,292
	<u> </u>	<u> </u>
BASIC EARNINGS PER SHARE	\$ 2.46	\$ 1.47
	<u> </u>	<u> </u>
DILUTED EARNINGS PER SHARE	\$ 2.36	\$ 1.43
	<u> </u>	<u> </u>

See accompanying notes.

Table of Contents**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES**

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002

	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total Stockholders Equity</u>
Balance at January 1, 2002	\$ 7,219	\$ 6,986,078	\$ 5,538,547	\$ (290,465)	\$ 12,241,379
Comprehensive income:					
Net income			1,077,292		1,077,292
Unrealized gains on securities available-for-sale, net of taxes				792,697	792,697
Total comprehensive income					1,869,989
Stock dividend	98	176,482	(176,580)		
Payment of cash dividends			(3,795)		(3,795)
Common stock issued as compensation	40	41,720			41,760
Balance at December 31, 2002	7,357	7,204,280	6,435,464	502,232	14,149,333
Comprehensive income:					
Net income			1,785,328		1,785,328
Unrealized losses on securities available-for-sale, net of taxes				(481,397)	(481,397)
Total comprehensive income					1,304,013
Retirement of stock	(321)	321			
Payment of cash dividends			(184,078)		(184,078)
Stock options exercised	5	5,577			5,582
Balance at December 31, 2003	\$ 7,041	\$ 7,210,178	\$ 8,036,714	\$ 20,835	\$ 15,274,768

See accompanying notes.

Table of Contents**HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES**

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002

	<u>2003</u>	<u>2002</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 1,785,328	\$ 1,077,292
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	401,080	487,150
Provision for loan losses	755,000	340,000
Common stock issued as compensation		41,760
Deferred income taxes	17,457	88,805
Increase in cash surrender value of life insurance	(179,124)	(179,166)
Gains on sales of loans	(50,824)	(54,015)
Gain on sale securities	(225,327)	(226,355)
Origination of loans held for sale	(4,477,099)	(4,045,571)
Proceeds from sales of loans held for sale	4,527,923	4,099,586
Decrease in accrued interest receivable and other assets	(147,674)	(1,238,048)
Increase in accrued interest payable and other liabilities	306,063	32,734
	<u>2,712,803</u>	<u>424,172</u>
Net cash provided by operating activities		
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net decrease (increase) in deposits at other banks	400,000	(1,138,483)
Purchases of investment securities available for sale	(29,812,604)	(45,411,260)
Proceeds from sales, maturities and principal payments of investment securities available-for-sale	18,659,255	15,342,008
Proceeds from called securities available-for-sale	29,000,000	26,850,003
Net increase in loans	(29,938,130)	(14,901,929)
Proceeds from sales of other real estate owned	69,727	
Purchase of other real estate owned		(55,727)
Purchases of premises and equipment - net	(3,151,690)	(429,944)
	<u>(14,773,442)</u>	<u>(19,745,332)</u>
Net cash used in investing activities		
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	2,607,677	21,762,559
Proceeds from sale of common stock	5,582	
Cash dividends paid	(184,078)	(3,795)
Repayment of long-term debt	(1,943,395)	(56,666)
Proceeds from junior subordinated debentures	6,790,000	
	<u>7,275,786</u>	<u>21,702,098</u>
Net cash provided by financing activities		
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(4,784,853)	2,380,938
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	19,926,441	17,545,503
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 15,141,588	\$ 19,926,441



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Harbor Bankshares Corporation

Consolidated Statements of Cash Flows (Continued)

For the Years Ended December 31, 2003 and 2002

	<u>2003</u>	<u>2002</u>
Supplemental disclosure of cash flows information:		
Cash paid for income taxes	\$ 675,000	\$ 495,107
Cash paid for interest	\$ 2,321,838	\$ 3,621,292

See accompanying notes.

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HARBOR BANKSHARES CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002

1. NATURE OF OPERATIONS

Harbor Bankshares Corporation (the Corporation) is a bank holding company organized under the laws of the State of Maryland in 1992. The Corporation owns all of the outstanding stock of the Harbor Bank of Maryland (the Bank) which owns all of the outstanding stock of the Bank's subsidiary, Harbor Financial Services.

The Bank is a commercial bank headquartered in Baltimore, Maryland. The deposits of the Bank are insured by the Federal Deposit Insurance Corporation. The Bank conducts general banking business in six locations and primarily serves the Baltimore, Maryland metropolitan area. The Bank also has a branch in Riverdale, Prince George's County, Maryland. It offers checking, savings and time deposits, commercial real estate, personal, home improvement, automobile, and other installment and term loans. The Bank is also a member of a local and national ATM network. The retail nature of the Bank allows for diversification of depositors and borrowers so it is not dependent upon a single or a few customers.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies of the Corporation and its subsidiary conform to accounting principles generally accepted in the United States of America and to general practice within the banking industry. Certain reclassifications have been made to amounts previously reported to conform to the classifications made in 2003. The following is a summary of the more significant accounting policies:

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, the Corporation considers all highly liquid debt instruments with original maturities of three months or less and money market funds to be cash equivalents.

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Investment Securities

Debt securities that the Corporation has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Debt and equity securities are classified as trading securities if bought and held principally for the purpose of selling them in the near term. Trading securities are reported at estimated fair value, with unrealized gains and losses included in earnings. Debt securities not classified as held to maturity and debt and equity securities not classified as trading securities are considered available for sale and are reported at estimated fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity, net of tax effects, in accumulated other comprehensive income.

The Corporation designates securities into one of the three categories at the time of purchase. If a decline in value of an individual security classified as held to maturity or available for sale is judged to be other than temporary, the cost basis of that security is reduced to its fair value and the amount of the write-down is reflected in earnings. Estimated fair value is determined based on bid prices published in financial newspapers or bid quotations received from securities dealers. Gains or losses on the sales of investments are calculated using a specific identification basis and are determined on a trade-date basis. Premiums and discounts on investment and mortgage-backed securities are amortized over the term of the security using methods that approximate the interest method.

Loans

Loans are stated at their principal balance outstanding net of any deferred fees and costs. Interest income on loans is accrued at the contractual rate based on the principal outstanding. The Corporation places loans, on non-accrual when any portion of the principal or interest is ninety days past due and collateral is insufficient to discharge the debt in full. Interest accrual may also be discontinued earlier if, in management's opinion, collection is unlikely.

Loans are considered impaired when, based on current information, it is probable that the Corporation will not collect all principal and interest payments according to contractual terms. Generally, loans are considered impaired once principal or interest payments become ninety days or more past due and they are placed on non-accrual. Management also considers the financial condition of the borrower, cash flows of the loan and the value of the related collateral. Impaired loans do not include large groups of smaller balance homogeneous credits such as residential real estate and consumer installment loans, which are evaluated collectively for impairment. Loans specifically reviewed for impairment are not considered impaired during periods of minimal delay in payment (ninety days or less) provided eventual collection of all amounts due is expected. The impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if repayment is expected to be provided by the collateral. Generally, the Corporation's impairment on such loans is measured by reference to the fair value of the collateral. Income on impaired loans is recognized on the cash basis and is first applied against the principal balance outstanding.

Discounts and premiums on purchased loans are amortized to income using the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments.

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Allowance for Loan Losses

The allowance for loan losses represents an amount which, in management's judgment, will be adequate to absorb probable losses on existing loans that may become uncollectible. The allowance for loan losses consists of an allocated component and an unallocated component. The components of the allowance for loan losses represent an estimation done pursuant to either Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*, or SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*. The adequacy of the allowance for loan losses is determined through careful and continuous review and evaluation of the loan portfolio and involves the balancing of a number of factors as outlined below to establish a prudent level. Loans deemed uncollectible are charged against, while recoveries are credited to, the allowance. Management adjusts the level of the allowance through the provision for loan losses, which is recorded as a current period operating expense. The Corporation's methodology for assessing the appropriateness of the allowance consists of several key elements, which include the formula allowance, specific allowances and the unallocated allowance.

The allowance formula is calculated by applying loss factors to corresponding categories of outstanding loans. Loss factors are based on the Corporation's historical loss experience. The use of these loss factors is intended to reduce the difference between estimated losses inherent in the portfolio and observed losses.

Specific allowances are established in cases where management has identified significant conditions or circumstances related to a loan that management believes indicate the probability that a loss may be incurred in an amount different from the amount determined by application of the formula allowance. For other problem graded credits, allowances are established according to the application of credit risk factors. These factors are set by management to reflect its assessment of the relative level of risk inherent in each grade.

The unallocated allowance is based upon management's evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. Such conditions include general economic and business conditions affecting key lending areas, credit quality trends (including trends in delinquencies and nonperforming loans expected to result from existing conditions), loan volumes and concentrations, specific industry conditions within portfolio categories, recent loss experience in particular loan categories, duration of the current business cycle, bank regulatory examination results, findings of internal loan examiners, and management's judgment with respect to various other conditions including loan administration and management and the quality of risk identification systems. Executive management reviews these conditions quarterly.

Management believes that the allowance for loan losses is adequate. However, the determination of the allowance requires significant judgment, and estimates of probable losses inherent in the loan portfolio can vary significantly from the amounts actually observed. While management uses available information to recognize probable losses, future additions to the allowance may be necessary based on changes in the loans comprising the loan portfolio and changes in the financial condition of borrowers, such as may result from changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's loan portfolio and allowance for loan losses. Such review may result in recognition of additions to the allowance based on their judgments of information available to them at the time of their examination.

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Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation and amortization computed using the straight-line method. Premises and equipment are depreciated over the useful lives of the assets, except for leasehold improvements which are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. Useful lives range from three to seven years for furniture, fixtures and equipment and forty years for buildings. The costs of major renewals and betterments are capitalized, while the costs of ordinary maintenance and repairs are expensed as incurred.

Federal Home Loan Bank of Atlanta Stock

The Bank, as a member of the Federal Home Loan Bank System, is required to maintain an investment in capital stock of the Federal Home Loan Bank of Atlanta (FHLB) in varying amounts based on balances of outstanding home loans and on amounts borrowed from the FHLB. Because no ready market exists for this stock and it has no quoted market value, the Bank's investment in this stock is carried at cost.

Other Real Estate Owned (OREO)

OREO comprises properties acquired in partial or total satisfaction of problem loans. The properties are recorded at the lower of cost or fair value at the date acquired. Losses arising at the time of acquisition of such properties are charged against the allowance for loan losses. Subsequent write-downs that may be required are added to a valuation reserve. Gains and losses realized from the sale of OREO, as well as valuation adjustments, are included in noninterest income. Expenses of operation are included in noninterest expense. OREO of \$-0- and \$69,700 as of December 31, 2003 and 2002, respectively, was included in other assets.

Goodwill

Goodwill represents the excess of the cost of assets acquired in business combinations accounted for under the purchase method over the fair value of the net assets at dates of acquisition and is annually tested for impairment.

Core Deposit Intangibles

Upon acquiring the branches of another financial institution, the Bank engages an independent third party of experts to analyze and prepare a core deposit study. This study reflects the cumulative present value benefit of acquiring deposits versus an alternative source of funding. Based upon this analysis, the amount of the premium related to the core deposits of the business purchased is calculated along with the estimated life of the acquired deposits. The core deposit intangible is then amortized to expense over an approximate life of 9 years.

Loan Servicing

The cost of mortgage servicing rights is amortized in proportion to, and over the period of, estimated net servicing revenue. Impairment of mortgage servicing rights is assessed based on the fair value of those rights. Fair values are estimated using discounted cash flows based on a current market interest rate. The amount of impairment recognized is the amount by which the capitalized mortgage servicing rights exceed their fair value.

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When participating interests in loans sold have an average contractual interest rate, adjusted for normal servicing fees, that differs from the agreed yield to the purchaser, gains or losses are recognized equal to the present value of such differential over the estimated remaining life of such loans. The resulting excess servicing receivable or deferred servicing revenue is amortized over the estimated life using a method approximating the interest method.

Quoted market prices are not available for the excess servicing receivables. Thus, the excess servicing receivables and the amortization thereon are periodically evaluated in relation to estimated future servicing revenue, taking into consideration changes in interest rates, current repayment rates, and expected future cash flows. The Corporation evaluates the carrying value of the excess servicing receivables by estimating the future servicing income of the excess servicing receivables based on management's best estimate of remaining loan lives and discounted at the original discount rate.

Bank-Owned Life Insurance

The Bank is the beneficiary of insurance policies on the lives of certain officers of the Bank. The Bank has recognized the amount that could be realized under the insurance policies as an asset in the consolidated balance sheets.

Income Taxes

Income tax expense is based on the results of operations, adjusted for permanent differences between items of income or expense reported in the financial statements and those reported for tax purposes. Under the liability method, deferred income taxes are determined based on the differences between the financial statement carrying amounts and the income tax basis of assets and liabilities and are measured at the enacted tax rates that will be in effect when these differences reverse.

Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted-average number of shares outstanding during the period. Diluted earnings per share is determined using the weighted-average number of shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents, consisting of shares that might be issued upon exercise of common stock options.

Stock Based Compensation

The Corporation's stock-based compensation plan is accounted for based on the intrinsic value method set forth in Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Compensation expense for stock options is generally not recognized if the exercise price of the option equals or exceeds the fair market value of the stock on the date of grant.

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The table on the following page illustrates the effect on net income and earnings per share if the Corporation had applied the fair value recognition provisions of SFAS 123 to all stock option awards.

	For the Year Ended	
	2003	2002
Net income, as reported	\$ 1,785,328	\$ 1,077,292
Less: total option expense determined under fair value method for all option awards, net of related tax effects	(33,760)	(21,202)
Pro forma net income	<u>\$ 1,751,568</u>	<u>\$ 1,056,090</u>
Pro forma net income per share:		
Basic - as reported	<u>\$ 2.46</u>	<u>\$ 1.47</u>
Basic - pro forma	<u>\$ 2.42</u>	<u>\$ 1.44</u>
Diluted - as reported	<u>\$ 2.36</u>	<u>\$ 1.43</u>
Diluted - pro forma	<u>\$ 2.31</u>	<u>\$ 1.40</u>

The fair values of stock options granted were estimated at the date of grant using the Black-Scholes option pricing model. The Black-Scholes option pricing model was originally developed for use in estimating the fair value of traded options, which have different characteristics from the Corporation's employee stock options. The model is also sensitive to changes in assumptions, which can materially affect the fair value estimate. The following weighted-average assumptions were used to determine the fair value of options granted on the Corporation's common stock:

	For the Year Ended	
	2003	2002
Risk-free interest rate	4.81%	4.87%
Expected volatility	20%	20%
Expected life (in years)	10	10
Expected dividend yield	0%	0%

Advertising

Advertising costs are expensed as incurred. Advertising expense was \$344,498 and \$286,855 for the years ended December 31, 2003 and 2002, respectively.

Awards and Grants

Income from awards and grants represents awards from the Community Development Financial Institution Fund and is recognized when a definitive commitment from the federal government agency is received.

Business Segments

The Corporation has determined that its current business and operations consist of one business segment.

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3. RECENT ACCOUNTING PRONOUNCEMENTS

In April 2003, the Financial Accounting Standards Board (FASB) issued and the Corporation adopted SFAS No. 149, *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities*. This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The adoption of SFAS No. 149 did not have a material impact on the Corporation's financial statements.

In November 2002, the FASB issued and the Corporation adopted Interpretation No. 45 (FIN 45), *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This interpretation expands the disclosures to be made by a guarantor in its financial statements about its obligations under certain guarantees and requires the guarantor to recognize a liability for the fair value of an obligation assumed under a guarantee. The adoption of FIN 45 did not have a material impact on the Corporation's financial statements.

In January 2003, the FASB issued and the Corporation adopted Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities*. This interpretation provides new accounting guidance on how to identify a variable interest entity (VIE) and determine when the assets, liabilities, non-controlling interest and results of operation of a VIE need to be included in a Corporation's consolidated financial statements. The adoption of FIN 46 did not have a material impact on the Corporation's financial statements.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. Some of the provisions of this Statement are consistent with the current definition of liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements*. The remaining provisions of this Statement are consistent with the Board's proposal to revise that definition to encompass certain obligations that a reporting entity can or must settle by issuing its own equity shares, depending on the nature of the relationship established between the holder and the issuer. While the Board still plans to revise that definition through an amendment to Concepts Statement 6, the Board decided to defer issuing that amendment until it has concluded its deliberations on the next phase of this project. That next phase will deal with certain compound financial instruments including puttable shares, convertible bonds, and dual-indexed financial instruments. These provisions of SFAS No. 150 are effective for financial statements for fiscal years ending after June 15, 2003. The application of SFAS No. 150 did not have a material impact on the Corporation's operations.

4. RESTRICTIONS ON CASH AND DUE FROM BANKS

The Bank is required by the Federal Reserve to maintain a reserve balance based principally on deposit liabilities. The balance maintained is included in cash and due from banks. The reserve balances kept at the Federal Reserve Bank as of December 31, 2003 were \$447,000.

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5. INVESTMENT SECURITIES

The amortized cost and estimated fair values of investments securities are as follows:

Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
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