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PFS BANCORP INC
Form ARS
April 08, 2005

[PFS Bancorp Logo]

PFS BANCORP, INC.

2004 ANNUAL REPORT

TO SHAREHOLDERS

TABLE OF CONTENTS

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President's Letter to Shareholders.....

Business of PFS Bancorp, Inc.....

Market Price of PFS Bancorp Common Shares and Related Shareholder Matters.....

Selected Consolidated Financial and Other Data.....

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

Report of Independent Registered Public Accounting Firm.....

Consolidated Statements of Financial Condition.....

Consolidated Statements of Earnings.....

Consolidated Statements of Comprehensive Income.....

Consolidated Statements of Shareholders' Equity.....

Consolidated Statements of Cash Flows.....

Notes to Consolidated Financial Statements.....

Directors and Executive Officers.....

Banking Locations and Shareholder Information.....

President's Letter

Dear Shareholders, Customers, and Employees:

As we look back on 2004 and PFS Bancorp's performance, we are sure it will be viewed as a time of challenge and growth. The challenge came in the form of historically low interest rates on loans and continued pressure on our interest rate spread. Our deposits are made up of numerous products with different durations which are used primarily to fund our loan portfolio of largely adjustable rate loan products. Historically, this mix has worked well for PFS ,

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however, with respect to 2004, we focused on loan growth to drive our increase in net interest income. This growth came primarily in both the commercial and residential mortgage areas and is reflected in the results of this report.

We were pleased to reward our shareholders for their faith in PFS Bancorp with not only regular dividends of 7.5 cents per share for the first three quarters of 2004 but a special dividend of \$5.00 per share for the fourth quarter of 2004. Shareholders' equity at December 31, 2004 remained a solid \$20.5 million or 15.8% of total assets, a decrease of \$6.4 million or 23.7% from the December 31, 2003 level. Apparently, the investment community appreciates our efforts to date. At December 31, 2004, our share price was \$17.67, representing a net gain of 15.4% from the December 31, 2003 closing price, adjusted for the \$5.00 per share special dividend.

Our assets at December 31, 2004 totaled \$129.8 million representing an increase of \$11.5 million, or 9.7% compared to the December 31, 2003 level. The loan portfolio experienced total growth of \$14.4 million or 14.3% to a record high of \$114.7 million. We are further encouraged by the composition of our loan portfolio as \$99.9 million, or 84.4% of the portfolio, consists of adjustable-rate loans. We are looking forward to continuing this trend in 2005.

Net earnings for the year ended December 31, 2004 totaled \$897,000, an increase of \$70,000, or 8.5%, compared to the \$827,000 for the year ended December 31, 2003. In 2004, diluted earnings per share amounted to \$.64, compared to \$.60 in 2003. The slight increase in net earnings can be attributed to the increases in net interest income and other income.

As we continue to grow, we pledge to do our best to maintain your trust. This pledge has been carried forward since the establishment of Peoples Federal Savings Bank in 1887. We have a long and proud legacy to live up to. Our goal has always been to maintain a stable and secure financial institution that provides quality service to our customers while offering competitive rates on our loans and deposits. The key to meeting that goal is, as it always has been, our employees, who have over 400 years of combined banking experience. We are encouraged by our progress to date and look forward to building on our successes.

I wish to thank our directors, officers and employees for their support and their continued service and dedication to PFS Bancorp and the Bank. We have made many changes in the past four years and I feel we have just begun to see the potential of PFS. I would also like to thank you as investors for your overwhelming support and confidence in our stock.

Sincerely,

/s/ Mel E. Green

Mel E. Green
President and Chief Executive Officer

1

PFS Bancorp, Inc.

BUSINESS OF PFS BANCORP, INC.

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PFS Bancorp, Inc., an Indiana corporation ("PFS Bancorp" or the "Corporation"), is a unitary savings and loan holding company which owns all of

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the outstanding common shares of Peoples Federal Savings Bank ("Peoples" or the "Bank"), a federally chartered savings bank.

Founded in 1887, Peoples is a community and customer oriented stock savings bank organized under the laws of the United States. Peoples conducts business out of its main office located in Aurora, Indiana and two branch offices in Rising Sun and Vevay, Indiana. Peoples' business consists principally of attracting deposits from the general public and using those funds to originate loans secured by one-to-four-family residential real estate, multi-family real estate and non-residential real estate, as well as consumer loans. Peoples' profitability depends primarily on its net interest income, which is the difference between the income it receives on loans and other assets and its cost of funds, which consists of the interest paid on deposits and borrowings. At December 31, 2004, PFS Bancorp had total assets of \$129.8 million, deposits of \$86.9 million and total shareholders' equity of \$20.5 million.

PFS Bancorp is subject to regulation, supervision and examination by the Office of Thrift Supervision of the U.S. Department of Treasury (the "OTS"), as its primary federal regulator, and the Federal Deposit Insurance Corporation (the "FDIC"), which administers the Savings Association Insurance Fund. The FDIC insures deposits in Peoples up to applicable limits.

MARKET PRICE OF PFS BANCORP COMMON SHARES AND RELATED SHAREHOLDER MATTERS

PFS Bancorp's common shares have been listed on the Nasdaq National Market ("Nasdaq") since October 2001, under the symbol "PBNC." Presented below are the high and low trading prices for PFS Bancorp's common shares as well as related dividends for the two year period from January 1, 2003 to December 31, 2004. Such prices do not include retail financial markups, markdowns or commissions. Information relating to prices has been obtained from Nasdaq.

| Quarter ended: | High | Low | Dividends |
|-------------------------|---------|---------|-----------|
| 2004 | | | |
| December 31, 2004..... | \$24.26 | \$15.07 | \$ 5.000 |
| September 30, 2004..... | 22.80 | 20.50 | .075 |
| June 30, 2004..... | 20.50 | 19.06 | .075 |
| March 31, 2004..... | 20.79 | 19.50 | .075 |
| 2003 | | | |
| December 31, 2003..... | \$20.50 | \$17.75 | \$.075 |
| September 30, 2003..... | 18.00 | 16.88 | .075 |
| June 30, 2003..... | 17.80 | 15.88 | .075 |
| March 31, 2003..... | 16.46 | 15.18 | .075 |

As of March 24, 2005, PFS Bancorp had 1,473,728 common shares outstanding held of record by approximately 321 shareholders. The number of shareholders does not reflect the number of persons or entities who may hold stock in nominee or "street" name through brokerage firms or others.

PFS Bancorp, Inc.

SELECTED CONSOLIDATED FINANCIAL AND OTHER DATA

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The following selected consolidated financial and other data does not purport to be complete and is qualified in its entirety by reference to the more detailed financial information, including the audited Consolidated Financial Statements and related notes, appearing elsewhere herein.

| | At December 31, | |
|---|------------------------|-----------|
| | 2004 | 2003 |
| | (Dollars In Thousands) | |
| Selected Balance Sheet Data: | | |
| Total assets | \$129,754 | \$118,273 |
| Cash and cash equivalents(1) | 7,484 | 5,187 |
| Investment securities available for sale | 5,014 | 10,016 |
| Investment securities held to maturity | 143 | 152 |
| Loans receivable-net | 114,673 | 100,293 |
| Deposits | 86,939 | 88,328 |
| FHLB advances and other borrowings | 21,000 | 2,000 |
| Shareholders' equity | 20,529 | 26,922 |
| Full service offices | 3 | 3 |

| | Year ended December 31, | |
|--|---------------------------------------|----------|
| | 2004 | 2003 |
| | (In thousands, except per share data) | |
| Selected Operating Data: | | |
| Total interest income | \$ 5,677 | \$ 5,747 |
| Total interest expense | 1,704 | 1,922 |
| | ----- | ----- |
| Net interest income | 3,973 | 3,825 |
| Provision for losses on loans | 96 | 52 |
| | ----- | ----- |
| Net interest income after provision for losses on loans | 3,877 | 3,773 |
| Total other income | 503 | 398 |
| Total general, administrative and other expense | 2,882 | 2,780 |
| | ----- | ----- |
| Earnings before income taxes | 1,498 | 1,391 |
| Income taxes | 601 | 564 |
| | ----- | ----- |
| Net earnings | \$ 897 | \$ 827 |
| | ===== | ===== |
| Earnings per share | | |
| Basic | \$.65 | \$.60 |
| | ===== | ===== |
| Diluted | \$.64 | \$.60 |
| | ===== | ===== |

Footnotes on following page.

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PFS Bancorp, Inc.

SELECTED CONSOLIDATED FINANCIAL AND OTHER DATA

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| | At or for the year ended December 31, | |
|--|--|--------|
| Selected Operating Ratios(2): | 2004 | 2003 |
| Performance Ratios: | | |
| Return on average assets | .72% | .70% |
| Return on average equity | 3.60 | 3.09 |
| Equity to assets at end of period | 15.82 | 22.76 |
| Interest rate spread(3) | 2.78 | 2.67 |
| Net interest margin(3) | 3.24 | 3.28 |
| Average interest-earning assets to average interest-bearing liabilities | 132.88 | 136.92 |
| Net interest income after provision for losses on loans to total general, administrative and other expense | 134.52 | 135.72 |
| Total general, administrative and other expense to average total assets | 2.31 | 2.34 |
| Dividend payout ratio(4) | 803.85 | 50.00 |
| Asset Quality Ratios: | | |
| Non-performing and impaired loans to total loans at end of period(5) | .71% | 1.48% |
| Non-performing and impaired assets to total assets at end of period(5) | .63 | 1.40 |
| Allowance for loan losses to total loans at end of period | .73 | .77 |
| Allowance for loan losses to total non-performing and impaired loans at end of period(5) | 102.08 | 51.96 |
| Capital Ratios(6): | | |
| Tangible capital ratio | 16.9% | 18.2% |
| Core capital ratio | 16.9 | 18.2 |
| Risk-based capital ratio | 28.7 | 31.2 |

- (1) Consists of cash and short-term interest-bearing deposits in other financial institutions.
- (2) With the exception of end of period ratios, all ratios are based on average monthly balances during the periods.
- (3) Interest rate spread represents the difference between the weighted-average yield on interest-earning assets and the weighted-average rate on interest-bearing liabilities. Net interest margin represents net interest income as a percentage of average interest-earning assets.
- (4) The Corporation paid a \$5.00 per share special dividend in 2004.
- (5) Non-performing loans consist of non-accrual loans and non-performing assets consist of non-performing loans and real estate acquired by foreclosure or deed-in-lieu thereof.
- (6) Consists of regulatory ratios for Peoples Federal Savings Bank

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PFS Bancorp, Inc.

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

General

PFS Bancorp's profitability depends primarily on its net interest income, which is the difference between interest and dividend income on interest-earning assets, principally loans, investment securities and interest-earning deposits in other financial institutions, and interest expense on interest-bearing deposits and borrowings, primarily from the Federal Home Loan Bank of Indianapolis. Net interest income is dependent upon the level of interest rates and the extent to which such rates are changing. PFS Bancorp's profitability also depends, to a lesser extent, on the level of other income, the provision for losses on loans, general, administrative and other expenses and federal income taxes.

Historically, Peoples' business has consisted primarily of originating single-family real estate loans secured by property in its market area and funded by deposits. Typically, single-family loans involve a lower degree of risk and carry a lower yield than commercial, nonresidential real estate, construction and consumer loans. In recent years, Peoples has increased its investment in commercial and nonresidential real estate loans, as well as utilizing Federal Home Loan Bank advances as a funding source for new loans.

PFS Bancorp's operations and profitability are subject to changes in interest rates, applicable statutes and regulations and general economic conditions, as well as other factors beyond management's control.

Forward-Looking Statements Are Subject to Change

Certain statements are made in this document as to what management expects may happen in the future. These statements usually contain the words "believe," "estimate," "project," "expect," "anticipate," "intend" or similar expressions. Because these statements look to the future, they are based on management's current expectations and beliefs. Actual results or events may differ materially from those reflected in the forward-looking statements. Management's current expectations and beliefs as to future events are subject to change at any time, and no assurances can be provided that the future events will actually occur.

Critical Accounting Policies

Certain of the Corporation's accounting policies are important to the portrayal of the Corporation's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances that could affect these judgments include, but without limitation, changes in interest rates, changes in the performance of the economy or changes in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses. If management were to underestimate the allowance for loan losses, earnings could be reduced in the future as a result of greater than expected net loan losses. Overestimations of the required allowance could result in future increases in income, as loan loss recoveries increase or provisions for losses on loans decrease.

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PFS Bancorp, Inc.

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

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The following tables present for the periods indicated the total dollar amount of interest income from average interest-earning assets and the resultant yields, as well as interest expense on average interest-bearing liabilities, expressed both in dollars and rates, and the net interest margin. All average balances are based on daily balances for 2004 and monthly balances for 2003. Management does not believe that the monthly averages differ significantly from the daily average balances.

| | At December 31, 2004 | | | 2004 | Year e |
|--|----------------------|----------------|--------------------|-------------------|-------------------|
| | Balance | Yield/ Rate | Average Balance | Interest | Aver Yie Ra |
| | | | | (Dollars In thous | |
| Interest-earning assets: | | | | | |
| Loans receivable, net(1) | \$114,673 | 5.00% | \$108,861 | \$5,325 | 4 |
| Investment securities (2) | 6,132 | 3.43 | 9,494 | 293 | 3 |
| Deposits in other financial institutions(3) | 6,489 | 2.05 | 4,398 | 59 | 1 |
| | ----- | ----- | ----- | ----- | ----- |
| Total interest-earning assets | 127,294 | 4.77 | 122,753 | 5,677 | 4 |
| Non-interest-earning assets | 2,460 | | 1,774 | | |
| | ----- | | ----- | | |
| Total assets | \$129,754 | | \$124,527 | | |
| | ===== | | ===== | | |
| Interest-bearing liabilities: | | | | | |
| Deposits | \$ 82,881 | 1.95 | \$ 80,830 | 1,422 | 1 |
| FHLB advances | 17,500 | 2.89 | 10,899 | 249 | 2 |
| Note payable | 3,500 | 5.28 | 650 | 33 | 5 |
| | ----- | ----- | ----- | ----- | ----- |
| Total interest-bearing liabilities | 103,881 | 2.22 | 92,379 | 1,704 | 1 |
| | | ----- | | | |
| Non-interest-bearing liabilities | 5,344 | | 7,264 | | |
| | ----- | | ----- | | |
| Total liabilities | 109,225 | | 99,643 | | |
| Total equity(4) | 20,529 | | 24,884 | | |
| | ----- | | ----- | | |
| Total liabilities and equity | \$129,754 | | \$124,527 | | |
| | ===== | | ===== | | |
| Net interest-earning assets | \$ 23,413 | | \$ 30,374 | | |
| | ===== | | ===== | | |
| Net interest income | | | | \$3,973 | |
| | | | | ===== | |
| Interest rate spread | | 2.55% | | | 2 |
| | | ===== | | | ===== |
| Net interest margin | | | | | 3 |
| | | | | | ===== |
| Average interest-earning assets to average interest bearing liabilities | | | | | 132 |
| | | | | | ===== |

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- (1) Includes nonaccruing loans. Interest income on loans receivable includes amortized loan fees.
 - (2) Includes Federal Home Loan Bank stock.
 - (3) Includes interest-bearing demand deposits and other interest-bearing deposits.
 - (4) Includes accumulated other comprehensive income.

6

PFS Bancorp, Inc.

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

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Rate/Volume Analysis

The following table shows the extent to which changes in interest rates and changes in volume of interest-related assets and liabilities affected PFS Bancorp's interest income and expense during the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (i) changes in volume (change in volume multiplied by prior year rate), and (ii) changes in rate (change in rate multiplied by prior year volume). The combined effect of changes in both rate and volume has been allocated proportionately to the change due to rate and the change due to volume.

| | Year ended December 31, vs December 31, 2003 | |
|--|---|--------------------------|
| | Increase (Decrease) Due to Yield/Rate | Volume (In Thousands) |
| Interest-earning assets: | | |
| Loans receivable, net | \$(552) | \$ 608 |
| Investment securities | 5 | (114) |
| Deposits in other financial institutions | 9 | (26) |
| | ----- | ----- |
| Total | (538) | 468 |
| Interest-bearing liabilities: | | |
| Deposits | (408) | (89) |
| Borrowings | 1 | 278 |
| | ----- | ----- |
| Total | (407) | 189 |
| | ----- | ----- |
| Increase (decrease) in net interest income | \$(131) | \$ 279 |
| | ===== | ===== |

7

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PFS Bancorp, Inc.

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

Changes in Financial Condition From December 31, 2004 to December 31, 2003

Total assets amounted to \$129.8 million at December 31, 2004, an increase of \$11.5 million, or 9.7%, compared to December 31, 2003. The increase in assets consisted primarily of a \$14.4 million, or 14.3%, increase in loans receivable, which was principally funded by additional advances from the Federal Home Loan Bank, which increased by \$15.5 million. A special dividend of \$5.00 per share or \$7.4 million was paid to shareholders of record at the close of business on October 18, 2004. The Corporation borrowed \$3.5 million to finance the dividend payment.

Investment securities totaled \$5.2 million at December 31, 2004, a decrease of \$5.0 million, or 49.3%, from December 31, 2003 levels. The decrease resulted primarily from maturities and sales of \$23.1 million and \$713,000, respectively, which were partially offset by purchases totaling \$18.7 million during the year. The average yield on investment securities was 3.09% for 2004.

Loans receivable increased by \$14.4 million, or 14.3%, during the year ended December 31, 2004, to a total of \$114.7 million. Loan disbursements amounted to \$46.3 million and were partially offset by principal payments of \$31.8 million. During the year ended December 31, 2004, loan originations were comprised of \$26.2 million in loans secured by one- to four-family residential real estate, \$1.1 million in loans secured by multifamily residential real estate, \$11.6 million in loans secured by commercial and nonresidential real estate and \$7.4 million in consumer and other loans.

The allowance for loan losses totaled \$833,000 and \$771,000 at December 31, 2004 and 2003, respectively. Nonperforming and impaired loans totaled \$816,000 and \$1.5 million at December 31, 2004 and 2003, respectively. The allowance for loan losses represented 102.1% and 52.0% of nonperforming and impaired loans as of December 31, 2004 and 2003, respectively. The allowance represented approximately .73% and .77% of the total loan portfolio at December 31, 2004 and 2003, respectively. At December 31, 2004, nonperforming and impaired loans were comprised of \$280,000 in loans secured by one- to four-family residential real estate, \$514,000 in loans secured by nonresidential real estate and \$22,000 in commercial, consumer and other loans. Although management believes that its allowance for loan losses at December 31, 2004, was sufficient to cover known and inherent losses in the portfolio based upon the available facts and circumstances, there can be no assurance that additions to such allowance will not be necessary in future periods, which could adversely affect the Corporation's results of operations.

Deposits totaled \$86.9 million at December 31, 2004, a decrease of \$1.4 million, or 1.6% from December 31, 2003 levels. The decline was due primarily to planned withdrawals from one municipality's savings account. Excluding this one account, deposits would have increased \$4.0 million, or 4.6%. While management generally strives to maintain a moderate level of growth in deposits through marketing and pricing strategies, the current low interest rate environment presented an impediment to increasing deposits as depositors sought higher-yielding alternative investments.

Shareholders' equity amounted to \$20.5 million at December 31, 2004, a decrease of \$6.4 million, or 23.7%, from December 31, 2003 levels. The decrease resulted primarily from the payment of dividends of \$7.7 million which included

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a special dividend of \$5.00 per share, or \$7.4 million, in October 2004. The decrease was partially offset by net earnings of \$897,000, a \$140,000 increase in unrealized gains on securities designated as available for sale, and an increase of \$270,000 attributable to the amortization effects of a distribution of shares in connection with the Company's Recognition and Retention Plan and the Employee Stock Ownership Plan.

8

PFS Bancorp, Inc.

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

Comparison of Operating Results for the Years Ended December 31, 2004 and 2003

General. Net earnings amounted to \$897,000 for the year ended December 31, 2004, compared to \$827,000 for the year ended December 31, 2003. The increase in earnings of \$70,000, or 8.5%, was due primarily to a \$148,000, or 3.9%, increase in net interest income and a \$105,000, or 26.4%, increase in other income, which were partially offset by a \$44,000, or 84.6%, increase in the provision for losses on loans, a \$102,000, or 3.7%, increase in general, administrative and other expense, and a \$37,000, or 6.6%, increase in income taxes.

Net Interest Income. Total interest income amounted to \$5.7 million for the year ended December 31, 2004, a decrease of \$70,000, or 1.2%, for the year ended December 31, 2003. Interest income on loans totaled \$5.3 million during the 2004 period, an increase of \$56,000, or 1.1%, from the 2003 period. The increase was primarily due to a \$11.8 million, or 12.2%, increase in the average balance of loans outstanding year to year, which was partially offset by a 54 basis point decrease in the weighted-average yield year to year, to 4.89% for the year ended December 31, 2004. The decrease in the average yield was due to the downward repricing of our adjustable rate mortgage loans. The increase in the average balance was due primarily to increased origination activity.

Interest income on investment securities decreased by \$109,000, or 27.1%, for the year ended December 31, 2004, compared to the year ended December 31, 2003. This decline was due primarily to a \$3.7 million, or 27.9%, decrease in the average balance outstanding, which was partially offset by a 4 basis point increase in the weighted-average yield to 3.09% for the year ended December 31, 2004. Interest income on other interest-bearing deposits decreased by \$17,000, or 22.4%, during the year ended December 31, 2004, compared to 2003, due primarily to a \$2.0 million, or 30.9%, decrease in the average balance outstanding for the year. The decline in the average balance of investment securities and interest-bearing deposits was primarily due to the use of such funds to fund loan growth.

Interest expense decreased by \$218,000, or 11.3%, to \$1.7 million for the year ended December 31, 2004, compared to \$1.9 million for the year ended December 31, 2003. Interest expense on deposits decreased by \$497,000, or 25.9%, due primarily to a decrease in the average rate paid from 2.26% for the year ended December 31, 2003 to 1.76% for the year ended December 31, 2004, coupled with a \$4.1 million, or 4.8%, decrease in the average balance of interest-bearing deposits outstanding year to year. The decrease in the rate paid generally reflects a decline in market rates in the overall economy. Interest expense on borrowings increased by \$279,000 to \$282,000 for the year ended December 31, 2004 compared to the \$3,000 borrowing cost recorded in 2003. This increase in interest expense on borrowings was due to an increase in the average balance of borrowings during 2004, which, as stated previously, was

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utilized to fund loan growth.

As a result of the foregoing changes in interest income and interest expense, net interest income increased by \$148,000, or 3.9%, to \$4.0 million for the year ended December 31, 2004, compared to \$3.8 million for the year ended December 31, 2003. The interest rate spread increased from 2.67% for the year ended December 31, 2003 to 2.78% for the year ended December 31, 2004, while the net interest margin decreased from 3.28% in 2003 to 3.24% in 2004. The ratio of average interest-earning assets to average interest-bearing liabilities decreased from 136.92% to 132.88% year to year.

9

PFS Bancorp, Inc.

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

=====

Comparison of Operating Results for the Years Ended December 31, 2004 and 2003
(continued)

Provision for Losses on Loans. As a result of an analysis of historical experience, the volume and type of lending conducted by the Bank, the status of past due principal and interest payments, general market conditions, particularly as such conditions relate to the Bank's market area, and other factors related to the collectibility of the Bank's loan portfolio, management elected to record a provision for losses on loans totaling \$96,000 for the year ended December 31, 2004 compared to the \$52,000 provision for the year ended December 31, 2003. The current year provision was predicated primarily upon the growth in the loan portfolio, including an increase in loans secured by both residential and nonresidential real estate correlated to the level of loan charge-offs during 2004. There can be no assurance that the loan loss allowance will be sufficient to cover losses on nonperforming assets in the future.

Other Income. Other income amounted to \$503,000 for the year ended December 31, 2004, an increase of \$105,000, or 26.4%, compared to \$398,000 for the year ended December 31, 2003. The increase was primarily due to a \$66,000, or 24.6%, increase in service charge fees which includes returned check fees and ATM fees. In addition, there was a \$28,000 loss resulting from the sale of investment securities in 2003, as compared to a \$6,000 gain in 2004.

General, Administrative and Other Expense. General, administrative and other expense increased by \$102,000, or 3.7%, to \$2.9 million for the year ended December 31, 2004. Employee compensation and benefits increased by \$157,000, or 10.1%, due primarily to normal merit increases coupled with an increase in benefit expenses. The increase in benefit costs was due to the increased market value of the Corporation's common stock, coupled with increased costs related to the defined benefit retirement plan. Data processing expense increased by \$16,000, or 7.0%, and other operating expense increased by \$44,000, or 8.8%, due primarily to check processing costs related to Check 21 and loan processing expenses, which were partially offset by a \$55,000, or 14.5%, decrease in occupancy and equipment expense and a \$59,000 decrease in the provision for losses on real estate acquired through foreclosure. The decline in occupancy and equipment expense reflects a reduction in real estate taxes and a decrease in depreciation expense.

Income Tax. The provision for income taxes totaled \$601,000 for the year ended December 31, 2004, an increase of \$37,000, or 6.6%, from the \$564,000 recorded for the year ended December 31, 2003. The increase in income taxes was

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due primarily to an \$107,000, or 7.7%, increase in pre-tax earnings. The Company's effective tax rates were 40.1% and 40.5% for the years ended December 31, 2004 and 2003, respectively.

10

PFS Bancorp, Inc.

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

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Exposure to Changes in Interest Rates

Our ability to maintain net interest income depends upon our ability to earn a higher yield on assets than the rates we pay on our deposits and borrowings. Our interest-earning assets consist primarily of long-term residential mortgage loans which have adjustable rates of interest. Our ability to maintain a positive spread between the interest earned on assets and the interest paid on deposits and borrowings can be adversely affected when market rates of interest rise since our adjustable-rate loans typically do not adjust as rapidly as our liabilities.

Quantitative Analysis. The OTS provides a quarterly report on the potential impact of interest rate changes upon the market value of portfolio equity. Management reviews the quarterly reports from the OTS which show the impact of changing interest rates on net portfolio value. The report is based on financial data provided by management of Peoples. Net portfolio value is the difference between incoming and outgoing discounted cash flows from assets, liabilities, and off-balance sheet contracts.

Qualitative Analysis. Our ability to maintain a positive "spread" between the interest earned on assets and the interest paid on deposits and borrowings is affected by changes in interest rates. Our fixed-rate loans help our profitability if interest rates are stable or declining since these loans have yields that exceed the cost of funds. At December 31, 2004, \$18.4 million, or 16.6%, of the total loan portfolio consisted of fixed-rate loans. If interest rates increase, however, we would have to pay more on our deposits and new borrowings, which would adversely affect our interest rate spread. In order to counter the potential effects of dramatic increases in market rates of interest, we have focused primarily on marketing adjustable-rate mortgage loans as well as shorter term commercial real estate and consumer loans. At December 31, 2004, \$96.3 million, or 84.0% of the total loan portfolio, consisted of adjustable-rate loans.

Although the interest rate sensitivity gap is a useful measurement and contributes toward effective asset and liability management, it is difficult to predict the effect of changing interest rates based solely on that measure. As a result, management also regularly reviews interest rate risk by forecasting the impact of alternative interest rate environments on net interest income and net portfolio value, which is defined as the net present value of a savings institution's existing assets, liabilities and off-balance sheet instruments, and evaluating such impacts against the maximum potential changes in net interest income and net portfolio value.

11

PFS Bancorp, Inc.

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

The following tables present Peoples' net portfolio value as of December 31, 2004 and 2003.

| December 31, 2004 Net Portfolio Value | | | | |
|---|------------------|--|---------------------|-----------------------------|
| Change in interest rates (basis points) | Estimated NPV | Estimated NPV as a percentage of assets (Dollars in thousands) | Amount of change | Change percent of ass |
| +300 | \$21,729 | 17.14% | \$ (4,661) | (262) |
| +200 | 23,748 | 18.34 | (2,642) | (142) |
| +100 | 25,440 | 19.30 | (950) | (47) |
| 0 | 26,390 | 19.77 | -- | -- |
| -100 | 26,357 | 19.63 | (33) | (13) |

| December 31, 2003 Net Portfolio Value | | | | |
|---|------------------|--|---------------------|-----------------------------|
| Change in interest rates (basis points) | Estimated NPV | Estimated NPV as a percentage of assets (Dollars in thousands) | Amount of change | Change percent of ass |
| +300 | \$21,223 | 18.69% | \$ (3,196) | (203) |
| +200 | 22,864 | 19.79 | (1,555) | (93) |
| +100 | 24,006 | 20.51 | (413) | (21) |
| 0 | 24,419 | 20.72 | -- | -- |
| -100 | 24,407 | 20.63 | (12) | (9) |

Net portfolio values are not provided for a decline of 200 or 300 basis points as the cost of funds would approximate zero at those levels.

12

PFS Bancorp, Inc.

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

Liquidity and Capital Resources

Peoples maintains cash and liquid investments in corporate debt securities, municipal obligations and other securities to meet loan commitments and other funding needs.

The following table sets forth information regarding Peoples' obligations

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and commitments to make future payments under contract as of December 31, 2004.

| | Less than 1 year | 1-3 years | 3-5 years | Payments due by period More than 5 years (In thousands) |
|--|------------------------|--------------|--------------|---|
| Contractual obligations: | | | | |
| Advances from the Federal Home Loan Bank | \$ 8,000 | \$ 6,500 | \$ 3,000 | \$ -- |
| Note payable | -- | 3,500 | -- | -- |
| Certificates of deposit | 41,349 | 12,622 | 1,183 | 177 |
| Amount of commitments expiration per period | | | | |
| Commitments to originate loans: | | | | |
| One- to four-family residential loans | 1,219 | -- | -- | -- |
| Nonresidential real estate loans | 36 | -- | -- | -- |
| Undisbursed loans in process | 2,746 | -- | -- | -- |
| Commercial lines of credit | 4,543 | -- | -- | -- |
| Home equity | 2,122 | -- | -- | -- |
| Letters of credit | 45 | 252 | -- | -- |
| | ----- | ----- | ----- | ----- |
| Total contractual obligations | \$60,060 | \$22,874 | \$ 4,183 | \$ 177 |
| | ===== | ===== | ===== | ===== |

Peoples anticipates that it will have sufficient funds available to meet its current loan commitments. Based upon historical deposit flow data, Peoples' competitive pricing in its market and management's experience, management believes that a significant portion of maturing certificates of deposit will remain with Peoples.

Liquidity management is both a daily and long-term function of Peoples' management strategy. In the event that Peoples should require funds beyond its ability to generate them internally, additional funds are available through the use of FHLB advances, and also may be available through sales of securities, although no sales of securities are planned.

Peoples is required to maintain regulatory capital sufficient to meet tangible, core and risk-based capital ratios of at least 1.5%, 4.0% and 8.0%, respectively. At December 31, 2004, Peoples more than exceeded each of its capital requirements, with tangible, core and risk-based capital ratios of 16.9%, 16.9% and 28.7%, respectively.

Impact of Inflation and Changing Prices

The consolidated financial statements and related financial data presented herein regarding PFS Bancorp have been prepared in accordance with accounting principles generally accepted in the United States of America, which generally require the measurement of financial position and operating results in terms of historical dollars, without considering changes in relative purchasing power over time due to inflation. Unlike most industrial companies, virtually all of PFS Bancorp's assets and liabilities are monetary in nature. As a result, interest rates generally have a more significant impact on PFS Bancorp's performance than does the effect of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services, since such prices are affected by inflation to a larger extent than interest rates.

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13

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors
PFS Bancorp, Inc.

We have audited the accompanying consolidated statements of financial condition of PFS Bancorp, Inc. as of December 31, 2004 and 2003, and the related consolidated statements of earnings, comprehensive income, shareholders' equity and cash flows for each of the years ended December 31, 2004 and 2003. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Corporation is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 financial statements referred to above present fairly, in all material respects, the consolidated financial position of PFS Bancorp, Inc. as of December 31, 2004 and 2003, and the results of its operations and its cash flows for each of the years ended December 31, 2004 and 2003, in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP

Cincinnati, Ohio
March 11, 2005

14

17

PFS BANCORP, INC.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

December 31, 2004 and 2003
(In thousands, except share data)

| ASSETS | 2004 |
|-------------------------|--------|
| Cash and due from banks | \$ 995 |

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| | |
|---|------------|
| Interest-bearing deposits in other financial institutions | 6,489 |
| | ----- |
| Cash and cash equivalents | 7,484 |
| Investment securities designated as available for sale - at market | 5,014 |
| Investment securities held to maturity - at amortized cost, which approximates market | 143 |
| Loans receivable - net | 114,673 |
| Office premises and equipment - at depreciated cost | 940 |
| Real estate acquired through foreclosure | -- |
| Federal Home Loan Bank stock - at cost | 975 |
| Accrued interest receivable | 441 |
| Prepaid expenses and other assets | 64 |
| Prepaid income taxes | 20 |
| Deferred income taxes | -- |
| | ----- |
| Total assets | \$ 129,754 |
| | ===== |
| LIABILITIES AND SHAREHOLDERS' EQUITY | |
| Deposits \$ | 86,939 |
| Advances from the Federal Home Loan Bank | 17,500 |
| Note payable | 3,500 |
| Advances by borrowers for taxes and insurance | 201 |
| Accrued interest payable | 11 |
| Other liabilities | 1,061 |
| Deferred income taxes | 13 |
| | ----- |
| Total liabilities | 109,225 |
| Commitments | -- |
| Shareholders' equity | |
| Preferred stock, 5,000,000 shares authorized, \$.01 par value; no shares issued | -- |
| Common stock - 10,000,000 shares authorized, \$.01 par value; 1,551,293 shares issued | 16 |
| Additional paid-in capital | 15,106 |
| Retained earnings - restricted | 7,298 |
| Less 77,565 shares of treasury stock - at cost | (1,282) |
| Shares acquired by stock benefit plans | (1,608) |
| Accumulated other comprehensive income - unrealized gains on securities designated as available for sale, net of related tax effects | 999 |
| | ----- |
| Total shareholders' equity | 20,529 |
| | ----- |
| Total liabilities and shareholders' equity | \$ 129,754 |
| | ===== |

The accompanying notes are an integral part of these statements.

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CONSOLIDATED STATEMENTS OF EARNINGS

For the years ended December 31, 2004 and 2003
(In thousands, except share data)

| | 2004 | 2003 |
|--|----------|----------|
| Interest income | | |
| Loans | \$ 5,325 | \$ 5,269 |
| Investment securities | 293 | 402 |
| Interest-bearing deposits and other | 59 | 76 |
| | ----- | ----- |
| Total interest income | 5,677 | 5,747 |
| Interest expense | | |
| Deposits | 1,422 | 1,919 |
| Borrowings | 282 | 3 |
| | ----- | ----- |
| Total interest expense | 1,704 | 1,922 |
| | ----- | ----- |
| Net interest income | 3,973 | 3,825 |
| Provision for losses on loans | 96 | 52 |
| | ----- | ----- |
| Net interest income after provision for losses on loans | 3,877 | 3,773 |
| Other income (loss) | | |
| Gain (loss) on sale of real estate acquired through foreclosure | (1) | 10 |
| Gain (loss) on sale of investment securities | 6 | (28) |
| Service charges | 334 | 268 |
| Other operating | 164 | 148 |
| | ----- | ----- |
| Total other income | 503 | 398 |
| General, administrative and other expense | | |
| Employee compensation and benefits | 1,716 | 1,559 |
| Occupancy and equipment | 325 | 380 |
| Data processing | 245 | 229 |
| Federal deposit insurance premiums | 50 | 51 |
| Provision for losses on real estate acquired through foreclosure | -- | 59 |
| Other operating | 546 | 502 |
| | ----- | ----- |
| Total general, administrative and other expense | 2,882 | 2,780 |
| | ----- | ----- |
| Earnings before income taxes | 1,498 | 1,391 |
| Income taxes | | |
| Current | 568 | 528 |
| Deferred | 33 | 36 |
| | ----- | ----- |
| Total income taxes | 601 | 564 |
| | ----- | ----- |
| NET EARNINGS | \$ 897 | \$ 827 |
| | ===== | ===== |

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| EARNINGS PER SHARE | | | |
|--------------------|--|--------|--------|
| Basic | | \$.65 | \$.60 |
| | | ===== | ===== |
| Diluted | | \$.64 | \$.60 |
| | | ===== | ===== |

The accompanying notes are an integral part of these statements.

16

PFS BANCORP, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the years ended December 31, 2004 and 2003
(In thousands)

| | |
|--|----------|
| | 2004 |
| Net earnings | \$ 897 |
| Other comprehensive income (loss), net of tax: | |
| Unrealized holding gains (losses) on securities during the year, net of taxes (benefits) of \$72 and (\$21) for the years ended December 31, 2004 and 2003, respectively | 144 |
| Reclassification adjustment for realized (gains) losses included in earnings, net of taxes (benefits) of \$2 and \$(10) for the years ended December 31, 2004 and 2003, respectively | (4) |
| | ----- |
| Comprehensive income | \$ 1,037 |
| | ===== |
| Accumulated comprehensive income | \$ 999 |
| | ===== |

The accompanying notes are an integral part of these statements.

17

PFS BANCORP, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

For the years ended December 31, 2004 and 2003
(In thousands, except share data)

Additional

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| | Common stock | paid-in capital | Retained earnings | T |
|---|-----------------|--------------------|----------------------|----|
| Balance at January 1, 2003 | \$ 16 | \$ 14,971 | \$ 13,723 | \$ |
| Amortization of expense related to stock benefit plan | -- | 58 | -- | |
| Purchase of treasury shares | -- | -- | -- | |
| Net earnings for the year ended December 31, 2003 | -- | -- | 827 | |
| Cash dividends of \$.30 per share | -- | -- | (449) | |
| Unrealized losses on securities designated as available for sale, net of related tax effects | -- | -- | -- | |
| | ----- | ----- | ----- | |
| Balance at December 31, 2003 | 16 | 15,029 | 14,101 | |
| Amortization of expense related to stock benefit plan | -- | 77 | -- | |
| Net earnings for the year ended December 31, 2004 | -- | -- | 897 | |
| Cash dividends of \$5.225 per share | -- | -- | (7,700) | |
| Unrealized gains on securities designated as available for sale, net of related tax effects | -- | -- | -- | |
| | ----- | ----- | ----- | |
| Balance at December 31, 2004 | \$ 16 | \$ 15,106 | \$ 7,298 | \$ |
| | ===== | ===== | ===== | = |

| | Shares acquired by stock benefit plans | Unrealized gains (losses) on securities designated as available for sale |
|---|---|--|
| Balance at January 1, 2003 | \$ (1,994) | \$ 881 |
| Amortization of expense related to stock benefit plan | 193 | -- |
| Purchase of treasury shares | -- | -- |
| Net earnings for the year ended December 31, 2003 | -- | -- |
| Cash dividends of \$.30 per share | -- | -- |
| Unrealized losses on securities designated as available for sale, net of related tax effects | -- | (22) |
| | ----- | ----- |
| Balance at December 31, 2003 | (1,801) | 859 |
| Amortization of expense related to stock benefit plan | 193 | -- |
| Net earnings for the year ended December 31, 2004 | -- | -- |
| Cash dividends of \$5.225 per share | -- | -- |
| Unrealized gains on securities designated as available for sale, net of related tax effects | -- | 140 |
| | ----- | ----- |
| Balance at December 31, 2004 | \$ (1,608) | \$ 999 |
| | ===== | ===== |

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For the years ended December 31, 2004 and 2003
(In thousands)

| | 2004 | 2003 |
|---|----------|----------|
| Cash flows from operating activities: | | |
| Net earnings for the year | \$ 897 | \$ 827 |
| Adjustments to reconcile net earnings to net cash provided by (used in) operating activities: | | |
| Amortization of premium on investment securities | 54 | 80 |
| Amortization of deferred loan origination fees | (42) | (61) |
| Amortization expense of stock benefit plans | 270 | 251 |
| (Gain) loss on sale of real estate acquired through foreclosure | 1 | (10) |
| Dividends on Federal Home Loan Bank stock | (35) | (28) |
| (Gain) loss on sale of investment securities | (6) | 28 |
| Depreciation | 160 | 189 |
| Provision for losses on loans | 96 | 52 |
| Provision for losses on real estate acquired through foreclosure | -- | 59 |
| Deferred compensation liability | 42 | 52 |
| Increase (decrease) in cash due to changes in: | | |
| Accrued interest receivable | (46) | 51 |
| Prepaid expenses and other assets | 62 | 50 |
| Other liabilities | 136 | 13 |
| Accrued interest payable | (1) | (14) |
| Income taxes | | |
| Current | (65) | (50) |
| Deferred | 33 | (25) |
| | ----- | ----- |
| Net cash provided by operating activities | 1,556 | 1,464 |
| Cash flows provided by (used in) investing activities: | | |
| Proceeds from maturities of investment securities | 23,103 | 31,937 |
| Proceeds from sale of investment securities | 713 | 3,001 |
| Principal repayments on investment securities | 9 | 9 |
| Purchase of investment securities designated as available for sale | (18,650) | (29,953) |
| Loan principal repayments | 31,779 | 35,516 |
| Loan disbursements | (46,263) | (40,145) |
| Purchase of office premises and equipment | (35) | (84) |
| Proceeds from sale of real estate acquired through foreclosure | 218 | 57 |
| Purchase of Federal Home Loan Bank stock | (182) | -- |
| | ----- | ----- |
| Net cash provided by (used in) investing activities | (9,308) | 338 |
| Cash flows provided by (used in) financing activities: | | |
| Net decrease in deposits | (1,389) | (1,092) |
| Proceeds from note payable | 3,500 | -- |
| Proceeds from Federal Home Loan Bank advances | 23,500 | 4,500 |
| Repayment of Federal Home Loan Bank advances | (8,000) | (3,500) |
| Advances by borrowers for taxes and insurance | 138 | (17) |
| Dividends paid on common stock | (7,700) | (449) |
| Purchase of treasury shares | -- | (1,282) |
| | ----- | ----- |
| Net cash provided by (used in) financing activities | 10,049 | (1,840) |
| | ----- | ----- |
| Net increase (decrease) in cash and cash equivalents | 2,297 | (38) |
| Cash and cash equivalents at beginning of year | 5,187 | 5,225 |
| | ----- | ----- |

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| | | |
|--|----------|----------|
| Cash and cash equivalents at end of year | \$ 7,484 | \$ 5,187 |
| | ===== | ===== |

19

PFS BANCORP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

For the years ended December 31, 2004 and 2003
(In thousands)

| | 2004 | 2003 |
|---|----------|----------|
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the year for: | | |
| Income taxes | \$ 633 | \$ 697 |
| | ===== | ===== |
| Interest on deposits and borrowings | \$ 1,705 | \$ 1,936 |
| | ===== | ===== |
| Supplemental disclosure of noncash investing activities: | | |
| Unrealized gains (losses) on securities designated as available for sale, net of related tax effects | \$ 140 | \$ (22) |
| | ===== | ===== |
| Transfers from loans to real estate acquired through foreclosure | \$ 50 | \$ 47 |
| | ===== | ===== |

The accompanying notes are an integral part of these statements.

20

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2004 and 2003

NOTE A - SUMMARY OF ACCOUNTING POLICIES

In 2001, the Board of Directors of Peoples Federal Savings Bank ("Peoples" or the "Savings Bank") adopted an overall plan of conversion and reorganization (the "Plan") whereby the Savings Bank would convert to the stock form of ownership, followed by the issuance of all the Savings Bank's outstanding stock to a newly formed holding company, PFS Bancorp, Inc. (the "Corporation"). The conversion to the stock form of ownership was completed in October 2001, culminating in the Corporation's issuance of 1,551,293 common shares.

The Savings Bank conducts a general banking business in southeastern

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Indiana which primarily consists of attracting deposits from the general public and applying those funds to the origination of loans for residential, consumer, and nonresidential purposes. Peoples' profitability is significantly dependent on its net interest income, which is the difference between interest income generated from interest-earning assets (i.e. loans and investments) and the interest expense paid on interest-bearing liabilities (i.e. deposits and borrowed funds). Net interest income is affected by the relative amount of interest-earning assets and interest-bearing liabilities and the interest received or paid on these balances. The level of interest rates paid or received by Peoples can be significantly influenced by a number of environmental factors, such as governmental monetary policy, that are outside of management's control.

The financial information presented herein has been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") and general accounting practices within the financial services industry. In preparing financial statements in accordance with U.S. GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from such estimates.

The following is a summary of significant accounting policies which have been consistently applied in the preparation of the accompanying consolidated financial statements.

1. Principles of Consolidation

The consolidated financial statements include the accounts of the Corporation and its subsidiary, Peoples. All significant intercompany balances and transactions have been eliminated.

2. Investment Securities

The Corporation accounts for investment securities in accordance with Statement of Financial Accounting Standards ("SFAS") No. 115 "Accounting for Certain Investments in Debt and Equity Securities." SFAS No. 115 requires that investments in debt and equity securities be categorized as held-to-maturity, trading, or available for sale. Securities classified as held-to-maturity are to be carried at cost only if the Corporation has the positive intent and ability to hold these securities to maturity. Securities designated as available for sale are carried at fair value with resulting unrealized gains or losses recorded to shareholders' equity.

Realized gains and losses on sales of securities are recognized using the specific identification method.

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3. Loans Receivable

Loans receivable are stated at the principal amount outstanding, adjusted for deferred loan origination fees and the allowance for loan losses. Interest is accrued as earned unless the collectibility of the loan is in doubt. Interest on loans that are contractually past due is charged off, or an allowance is established based on management's periodic evaluation. The allowance is established by a charge to interest income equal to all interest previously accrued, and income is subsequently recognized only to the extent that cash payments are received until, in management's judgment, the borrower's ability to make periodic interest and principal payments has returned to normal, in which case the loan is returned to accrual status. If the ultimate collectibility of the loan is in doubt, in whole or in part, all payments received on nonaccrual loans are applied to reduce principal until such doubt is eliminated.

4. Loan Origination Fees

The Savings Bank accounts for loan origination fees in accordance with SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases." Pursuant to the provisions of SFAS No. 91, origination fees received from loans, net of direct origination costs, are deferred and amortized to interest income using the level-yield method, giving effect to actual loan prepayments. Additionally, SFAS No. 91 generally limits the definition of loan origination costs to the direct costs attributable to originating a loan, i.e., principally actual personnel costs. Fees received for loan commitments that are expected to be drawn upon, based on the Savings Bank's experience with similar commitments, are deferred and amortized over the life of the related loan using the interest method.

5. Allowance for Loan Losses

It is the Savings Bank's policy to provide valuation allowances for estimated losses on loans based on past loss experience, trends in the level of delinquent and problem loans, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral and current and anticipated economic conditions in the primary lending area. When the collection of a loan becomes doubtful, or otherwise troubled, the Savings Bank records a charge-off equal to the difference between the fair value of the property securing the loan and the loan's carrying value. Major loans and major lending areas are reviewed periodically to determine potential problems at an early date. The allowance for loan losses is increased by charges to earnings and decreased by charge-offs (net of recoveries).

The Savings Bank accounts for impaired loans in accordance with SFAS No. 114, "Accounting by Creditors for Impairment of a Loan," which requires that impaired loans be measured based upon the present value of expected future cash flows discounted at the loan's effective interest rate or, as an alternative, at the loan's observable market price or fair value of the collateral. The Savings Bank's current procedures for evaluating impaired loans result in carrying such loans at the lower of cost or fair value.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE A - SUMMARY OF ACCOUNTING POLICIES (continued)

5. Allowance for Loan Losses (continued)

A loan is defined under SFAS No. 114 as impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. In applying the provisions of SFAS No. 114, the Savings Bank considers its investment in one- to four-family residential loans and consumer installment loans to be homogeneous and therefore excluded from separate identification for evaluation of impairment. With respect to the Savings Bank's investment in multi-family and nonresidential loans, and its evaluation of impairment thereof, such loans are collateral dependent, and as a result, are carried as a practical expedient at the lower of cost or fair value.

It is the Savings Bank's policy to charge off unsecured credits that are more than ninety days delinquent. Similarly, collateral dependent loans which are more than ninety days delinquent are considered to constitute more than a minimum delay in repayment and are evaluated for impairment under SFAS No. 114 at that time.

The Savings Bank's impaired loan information was as follows at December 31:

| | 2004 | 2003 |
|--|----------------|-------|
| | (In thousands) | |
| Impaired loans with related allowance | \$ -- | \$ -- |
| Impaired loans with no related allowance | 514 | 514 |
| | ---- | ---- |
| Total impaired loans | \$514 | \$514 |
| | ==== | ==== |
| | | |
| Average balance of impaired loans | \$514 | \$517 |
| Interest income recognized on impaired loans | \$ 19 | \$ 25 |

6. Office Premises and Equipment

Office premises and equipment are carried at cost and include expenditures which extend the useful lives of existing assets. Maintenance, repairs and minor renewals are expensed as incurred. For financial reporting, depreciation and amortization are provided primarily using the straight-line and declining balance methods over the useful lives of the assets, generally estimated to be thirty years for the building and building improvements and five to seven years for furniture and equipment. An accelerated depreciation method is used for tax reporting purposes.

7. Real Estate Acquired through Foreclosure

Real estate acquired through foreclosure is carried at the lower of the loan's unpaid principal balance (cost) or fair value less estimated selling expenses at the date of acquisition. Real estate loss provisions

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are recorded if the properties' fair value subsequently declines below the value determined at the recording date. In determining the lower of cost or fair value at acquisition, costs relating to development and improvement of property are capitalized. Costs relating to holding real estate acquired through foreclosure, net of rental income, are charged against earnings as incurred.

23

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE A - SUMMARY OF ACCOUNTING POLICIES (continued)

8. Income Taxes

The Corporation accounts for income taxes in accordance with the provisions of SFAS No. 109, "Accounting for Income Taxes." Pursuant to the provisions of SFAS No. 109, a deferred tax liability or deferred tax asset is computed by applying the current statutory tax rates to net taxable or deductible differences between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future periods. Deferred tax assets are recorded only to the extent that the amount of net deductible temporary differences or carryforward attributes may be utilized against current period earnings, carried back against prior years' earnings, offset against taxable temporary differences reversing in future periods, or utilized to the extent of management's estimate of future taxable income. A valuation allowance is provided for deferred tax assets to the extent that the value of net deductible temporary differences and carryforward attributes exceeds management's estimates of taxes payable on future taxable income. Deferred tax liabilities are provided on the total amount of net temporary differences taxable in the future.

The Corporation's principal temporary differences between pretax financial income and taxable income result primarily from the different methods of accounting for deferred loan origination fees and costs, deferred compensation, charitable contributions carryforwards and the general loan loss allowance. Additionally, a temporary difference is recognized for depreciation utilizing accelerated methods for federal income tax purposes.

9. Earnings Per Share

Basic earnings per share is computed based upon the weighted-average common shares outstanding during the period, less shares in the ESOP that are unallocated and not committed to be released. Weighted-average common shares deemed outstanding gives effect to 75,597 and 86,632 unallocated ESOP shares as of December 31, 2004 and 2003, respectively.

Diluted earnings per share is computed by taking into consideration common shares outstanding and the dilutive effect of additional potential common shares issuable under the Company's stock option plan. The computations are as follows:

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| | For the year ended December 31, | |
|---|------------------------------------|-----------|
| | 2004 | 2003 |
| Weighted-average common shares outstanding (basic) | 1,387,129 | 1,390,238 |
| Dilutive effect of assumed exercise of stock options | 12,401 | 37 |
| | ----- | ----- |
| Weighted-average common shares outstanding (diluted) | 1,399,530 | 1,390,275 |
| | ===== | ===== |

24

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE A - SUMMARY OF ACCOUNTING POLICIES (continued)

10. Benefit Plans

The Corporation has an Employee Stock Ownership Plan ("ESOP") that provides retirement benefits for substantially all employees who have completed one year of service and have attained the age of 21. The Corporation accounts for the ESOP in accordance with Statement of Position ("SOP") 93-6, "Employers' Accounting for Employee Stock Ownership Plans." SOP 93-6 requires that compensation expense recorded by employers equal the fair value of ESOP shares allocated to participants during a given year. Expense related to the ESOP totaled approximately \$239,000 and \$210,000 for the years ended December 31, 2004 and 2003, respectively.

The Corporation also has a Recognition and Retention Plan ("RRP"). Subsequent to the offering of common shares by the Corporation, the RRP purchased 60,835 shares of the Corporation's common stock in the open market. During 2002, 21,294 shares were awarded to members of the Board of Directors and certain members of management. Common stock awarded under the RRP vests ratably over a five year period, commencing with the date of the award. A provision of \$71,000 related to the RRP was charged to operations for each of the years ended December 31, 2004 and 2003.

The Savings Bank funds its defined benefit pension plan through participation in the Pentegra Defined Benefit Plan (the "Plan"). The Savings Bank is required to fund pension costs accrued. The Savings Bank made a \$47,000 and \$6,000 contribution in 2004 and 2003, respectively, due to the Plan's funding requirements. The provision for pension expense is computed by the Plan's actuaries utilizing the projected unit credit cost method and assuming a 8.25% return on Plan assets. The Savings Bank is not required to disclose separate actuarial information due to the Plan's classification as a multi-employer pension plan.

The Savings Bank has a 401(k) savings plan for its employees. All employees are eligible and receive matching contributions from the Savings Bank at a predetermined rate. Expense recognized in connection with the 401(k) savings plan totaled approximately \$11,000 for each of the years ended December 31, 2004 and 2003.

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The Savings Bank has a nonqualified Executive Officers and Directors Deferred Compensation Plan (the "Compensation Plan"), which provides for the payment of benefits to its directors and certain officers upon termination of service with the Savings Bank, with full vesting in the Compensation Plan after ten years of service. The deferred compensation unfunded liability reflects the current value of the plan obligation based on a present value of providing a sum certain of \$17,800 per year to each participant for ten years after retirement. The present value was determined using an interest rate of 7.5% and considering the time to retirement for each participant. The Savings Bank recorded expense totaling \$42,000 and \$52,000 for the Compensation Plan during the years ended December 31, 2004 and 2003, respectively.

25

PFS Bancorp, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE A - SUMMARY OF ACCOUNTING POLICIES (continued)

11. Stock Option Plan

In 2002, the Board of Directors adopted the PFS Bancorp, Inc. 2002 Stock Option Plan (the "Plan") that provides for the issuance of 152,088 shares of authorized, but unissued shares of common stock at fair value at the date of grant. Stock options were granted in June 2003 for 79,316 (adjusted) shares at an exercise price equal to fair value of \$13.22 (adjusted for the \$5.00 special dividend in 2004). The Plan provides that one-fifth of the options granted become exercisable on each of the first five anniversaries of the date of grant and each option has an exercise period of ten years from the grant date.

The Corporation accounts for the Plan in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," which contains a fair value-based method for valuing stock-based compensation that entities may use, which measures compensation cost at the grant date based on the fair value of the award. Compensation is then recognized over the service period, which is usually the vesting period. Alternatively, SFAS No. 123 permits entities to continue to account for stock options and similar equity instruments under Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." Entities that continue to account for stock options using APB Opinion No. 25 are required to make pro forma disclosures of net earnings and earnings per share, as if the fair value-based method of accounting defined in SFAS No. 123 had been applied.

The Corporation applies APB Opinion No. 25 and related Interpretations in accounting for the Plan. Accordingly, no compensation cost had been recognized for the Plan. Had compensation cost for the Plan been determined based on the fair value at the grant date for awards under the Plan consistent with the accounting method utilized in SFAS No. 123, the Corporation's net earnings and earnings per share would have been reported as the pro forma amounts indicated below:

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| | | Year ended December 31, | |
|-----------------------------|--------------------------------------|----------------------------|--------|
| | | 2004 | 2003 |
| Net earnings (In thousands) | As reported | \$ 897 | \$ 827 |
| | Stock-based compensation, net of tax | (36) | (14) |
| | Pro-forma | \$ 861 | \$ 813 |
| | | ===== | ===== |
| Earnings per share Basic | As reported | \$.65 | \$.60 |
| | Stock-based compensation, net of tax | (.03) | (.02) |
| | Pro-forma | \$.62 | \$.58 |
| | | ===== | ===== |
| Diluted | As reported | \$.64 | \$.60 |
| | Stock-based compensation, net of tax | (.03) | (.02) |
| | Pro-forma | \$.61 | \$.58 |
| | | ===== | ===== |

26

PFS Bancorp, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE A - SUMMARY OF ACCOUNTING POLICIES (continued)

11. Stock Option Plan (continued)

The fair value of each option grant is estimated on the date of grant using the modified Black-Scholes options-pricing model with the following assumptions used for grants during 2003: dividend yield of 1.7%; expected volatility of 15.8%; a risk-free interest rate of 3.4%; and an expected life of ten years for all grants.

A summary of the status of the Plan as of and for the year ended December 31 is presented below:

| | 2004 | | 2003 | |
|----------------------------------|--------|---|--------|---|
| | Shares | Weighted- average exercise price | Shares | Weighted- average exercise price |
| Outstanding at beginning of year | 79,316 | \$13.22 | -- | \$ |
| Granted | -- | -- | 79,316 | 13 |

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| | | | | |
|--|--------|---------|--------|---------|
| Exercised | -- | -- | -- | --- |
| Forfeited | -- | -- | -- | --- |
| | ----- | ----- | ----- | ----- |
| Outstanding at end of year | 79,316 | \$13.22 | 79,316 | \$13.22 |
| | ===== | ===== | ===== | ===== |
| Options exercisable at year-end | 15,863 | \$13.22 | -- | \$ |
| | ===== | ===== | ===== | ===== |
| Weighted-average fair value of options granted during the year | | N/A | | \$ 3 |
| | | ===== | | ===== |

The following information applies to options outstanding at December 31, 2004:

| | |
|---|------------|
| Number outstanding | 79,316 |
| Range of exercise prices | \$13.22 |
| Weighted-average exercise price | \$13.22 |
| Weighted-average remaining contractual life | 8.50 years |

12. Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks and interest-bearing deposits in other financial institutions with original terms to maturity of less than ninety days.

27

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE A - SUMMARY OF ACCOUNTING POLICIES (continued)

13. Fair Value of Financial Instruments

SFAS No. 107, "Disclosures About Fair Value of Financial Instruments," requires disclosure of the fair value of financial instruments, both assets and liabilities, whether or not recognized in the statements of financial condition, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. SFAS No. 107 excludes certain financial instruments and all non-financial instruments from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Corporation.

The following methods and assumptions were used by the Corporation in estimating its fair value disclosures for financial instruments. The use of different market assumptions and/or estimation methodologies may have a

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material effect on the estimated fair value amounts.

Cash and cash equivalents: The carrying amounts presented in the consolidated statements of financial condition for cash and cash equivalents are deemed to approximate fair value.

Investment securities: Fair values for investment securities are based on quoted market prices and dealer quotes.

Loans receivable: The loan portfolio has been segregated into categories with similar characteristics, such as one- to four-family residential, multi-family residential and nonresidential real estate. These categories were further delineated into fixed-rate and adjustable-rate loans. The fair values for the resultant categories were computed via discounted cash flow analysis, using current interest rates offered for loans with similar terms to borrowers of similar credit quality. For loans on deposit accounts, and consumer and other loans, fair values were deemed to equal the historic carrying values.

Federal Home Loan Bank stock: The carrying amount presented in the consolidated statements of financial condition is deemed to approximate fair value.

Deposits: The fair values of deposits with no stated maturity, such as NOW accounts, passbook accounts and money market passbook accounts are deemed to approximate the amount payable on demand as of December 31, 2004 and 2003. The fair values for fixed-rate certificates of deposit are based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

Advances from the Federal Home Loan Bank and Note Payable: The fair value of these borrowings is estimated using the rates currently offered for similar borrowings of similar remaining maturities or, when available, quoted market prices.

28

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE A - SUMMARY OF ACCOUNTING POLICIES (continued)

13. Fair Value of Financial Instruments (continued)

Advances by borrowers for taxes and insurance: The carrying amount of advances by borrowers for taxes and insurance is deemed to approximate fair value.

Commitments to extend credit: For fixed-rate and adjustable-rate loan commitments, the fair value estimate considers the difference between current levels of interest rates and committed rates. The fair value of outstanding loan

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commitments at December 31, 2004 and 2003, was not material.

Based on the foregoing methods and assumptions, the carrying value and fair value of the Corporation's financial instruments are as follows at December 31:

| | | 2004 | |
|--|-------------------|---------------|----|
| | Carrying value | Fair value | C |
| | | (In thousand) | |
| Financial assets | | | |
| Cash and cash equivalents | \$ 7,484 | \$ 7,484 | \$ |
| Investment securities designated as available for sale | 5,014 | 5,014 | |
| Investment securities held to maturity | 143 | 143 | |
| Loans receivable - net | 114,673 | 113,531 | |
| Federal Home Loan Bank stock | 975 | 975 | |
| | ----- | ----- | |
| | \$128,289 | \$127,147 | \$ |
| | ===== | ===== | = |
| Financial liabilities | | | |
| Deposits | \$ 86,939 | \$ 86,945 | \$ |
| Advances from the Federal Home Loan Bank | 17,500 | 17,479 | |
| Note payable | 3,500 | 3,500 | |
| Advances by borrowers for taxes and insurance | 201 | 201 | |
| | ----- | ----- | |
| | \$108,140 | \$108,125 | \$ |
| | ===== | ===== | = |

14. Advertising

Advertising costs are expensed when incurred. The Corporation's advertising expense totaled \$36,000 and \$31,000 for the years ended December 31, 2004 and 2003, respectively.

15. Reclassifications

Certain prior year amounts have been reclassified to conform to the 2004 consolidated financial statement presentation.

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE A - SUMMARY OF ACCOUNTING POLICIES (continued)

16. Effects of Recent Accounting Pronouncements

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In December 2004, the Financial Accounting Standards Board ("FASB") issued a revision to SFAS No. 123 which establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, primarily on accounting for transactions in which an entity obtains employee services in share-based transactions. This Statement, SFAS No. 123 (R) "Share Based Payment", requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award, with limited exceptions. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award - the requisite service period. No compensation cost is recognized for equity instruments for which employees do not render the requisite service. Employee share purchase plans will not result in recognition of compensation cost if certain conditions are met.

Initially, the cost of employee services received in exchange for an award of liability instruments will be measured based on current fair value; the fair value of that award will be remeasured subsequently at each reporting date through the settlement date. Changes in fair value during the requisite service period will be recognized as compensation cost over that period. The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models adjusted for the unique characteristics of those instruments (unless observable market prices for the same or similar instruments are available). If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.

Excess tax benefits, as defined by SFAS No. 123(R) will be recognized as an addition to additional paid-in capital. Cash retained as a result of those excess tax benefits will be presented in the consolidated statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost will be recognized as income tax expense unless there are excess tax benefits from previous awards remaining in additional paid in capital to which it can be offset.

Compensation cost is required to be recognized in the beginning of the first interim or annual period that begins after December 15, 2005, or January 1, 2006 as to the Corporation. The Corporation anticipates the annual compensation expense under SFAS No. 123 will approximate the amount disclosed in Note A-11 above.

30

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE B - INVESTMENT SECURITIES

The amortized cost, gross unrealized gains, gross unrealized losses and estimated fair value of investment securities at December 31, 2004 and 2003, are as follows:

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| | | 2004 | |
|--|-------------------|--|-------------------------------|
| | Amortized cost | Gross unrealized gains (In thousands) | Gross unrealized losses |
| Held to maturity: | | | |
| Municipal obligations | \$ 143 ===== | \$ -- ===== | \$ -- ===== |
| Available for sale: | | | |
| Corporate debt securities | \$ 2,980 | \$ 27 | \$ 8 |
| U. S. Government agency securities | 500 | -- | 12 |
| FHLMC stock | 20 ----- | 1,507 ----- | -- ----- |
| Total investment securities available for sale | \$ 3,500 ===== | \$ 1,534 ===== | \$ 20 ===== |

| | | 2003 | |
|--|-------------------|--|-------------------------------|
| | Amortized cost | Gross unrealized gains (In thousands) | Gross unrealized losses |
| Held to maturity: | | | |
| Municipal obligations | \$ 152 ===== | \$ -- ===== | \$ -- ===== |
| Available for sale: | | | |
| Corporate debt securities | \$ 8,194 | \$ 135 | \$ 4 |
| U. S. Government agency securities | 500 | -- | 17 |
| FHLMC stock | 20 ----- | 1,188 ----- | -- ----- |
| Total investment securities available for sale | \$ 8,714 ===== | \$ 1,323 ===== | \$ 21 ===== |

31

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE B - INVESTMENT SECURITIES (continued)

The amortized cost and estimated fair value of corporate debt and U. S. Government agency securities, by contractual terms to maturity, are shown below at December 31, 2004 and 2003.

| | 2004 | Estimated fair | 2003 | Estim |
|--|-----------|-------------------|-----------|-------|
| | Amortized | | Amortized | |

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| | cost | value | cost | v |
|-------------------------------------|---------|---------|---------|-----|
| Due within one year | \$1,971 | \$1,981 | \$5,188 | \$5 |
| Due after one through three years | 509 | 524 | 2,506 | 2 |
| Due after three through five years | 500 | 494 | 500 | |
| Due after five through ten years | 250 | 245 | 250 | |
| Due after ten through fifteen years | 250 | 243 | 250 | |
| | ----- | ----- | ----- | |
| | \$3,480 | \$3,487 | \$8,694 | \$8 |
| | ===== | ===== | ===== | == |

Municipal obligations are scheduled to mature ratably over the next 11 years.

Proceeds from sales of investment securities totaled \$713,000 during the year ended December 31, 2004, resulting in gross realized gains of \$6,000.

Proceeds from sales of investment securities totaled \$3.0 million during the year ended December 31, 2003, resulting in gross realized losses of \$28,000.

The table below indicates the length of time individual securities have been in a continuous unrealized loss position at December 31, 2004:

| Description of securities | Less than 12 months | | | 12 months or longer | | |
|--------------------------------------|-----------------------|------------|-------------------|-----------------------|------------|-------------------|
| | Number of investments | Fair value | Unrealized losses | Number of investments | Fair value | Unrealized losses |
| Corporate debt and agency securities | 3 | \$ 705 | \$ 5 | 3 | \$ 736 | \$ 15 |
| | ===== | ===== | ===== | ===== | ===== | ===== |

(Dollars in thousands)

Management has the intent and ability to hold these securities for the foreseeable future. The decline in the fair value is primarily due to an increase in market interest rates. The fair values are expected to recover as securities approach maturity dates.

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE C - LOANS RECEIVABLE

The composition of the loan portfolio at December 31 was as follows:

| | 2004 | 2003 |
|---|----------------|-----------|
| | (In thousands) | |
| One- to four-family residential real estate | \$ 84,432 | \$ 76,330 |
| Multi-family residential real estate | 2,158 | 2,168 |

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| | | |
|-------------------------------------|-----------|-----------|
| Construction | 7,709 | 3,908 |
| Nonresidential real estate and land | 16,659 | 14,142 |
| Commercial | 4,590 | 3,282 |
| Consumer and other loans | 2,802 | 2,676 |
| | ----- | ----- |
| | 118,350 | 102,506 |
| Less: | | |
| Undisbursed loans in process | 2,746 | 1,361 |
| Deferred loan origination fees | 98 | 81 |
| Allowance for loan losses | 833 | 771 |
| | ----- | ----- |
| | \$114,673 | \$100,293 |
| | ===== | ===== |

As depicted above, the Savings Bank's lending efforts have historically focused on one- to four-family and multi-family residential real estate loans, which comprise approximately \$86.6 million, or 76%, of the total loan portfolio at December 31, 2004, and \$78.5 million, or 78%, of the total loan portfolio at December 31, 2003. Customarily, such loans have been underwritten on the basis of no more than an 80% loan-to-value ratio, which has historically provided the Savings Bank with adequate collateral coverage in the event of default. Nevertheless, the Savings Bank, as with any lending institution, is subject to the risk that residential real estate values could deteriorate in its primary lending area of southeastern Indiana, thereby impairing collateral values. However, management is of the belief that real estate values in the Savings Bank's primary lending area are presently stable.

In the ordinary course of business, the Savings Bank has granted loans to some of its executive officers, directors, and their related interests. In the opinion of management, such loans are within applicable regulatory lending limitations and do not involve more than the normal risk of collectibility. The aggregate dollar amount of these loans was approximately \$102,000 and \$146,000 at December 31, 2004 and 2003, respectively.

33

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE D - ALLOWANCE FOR LOAN LOSSES

The activity in the allowance for loan losses for the years ended December 31 is summarized as follows:

| | 2004 | 2003 |
|-------------------------------|----------------|-------|
| | (In thousands) | |
| Beginning balance | \$771 | \$764 |
| Provision for losses on loans | 96 | 52 |
| Charge-off of loans | (39) | (47) |
| Recoveries | 5 | 2 |
| | ---- | ---- |
| Ending balance | \$833 | \$771 |

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As of December 31, 2004, the Savings Bank's allowance for loan losses was solely general in nature, and is includible as a component of regulatory risk-based capital.

At December 31, 2004 and 2003, the Savings Bank's nonperforming and impaired loans totaled approximately \$816,000 and \$1.5 million, respectively. Interest income which would have been recognized if such loans had performed pursuant to contractual terms totaled approximately \$21,000 and \$30,000 for the years ended December 31, 2004 and 2003, respectively.

NOTE E - OFFICE PREMISES AND EQUIPMENT

Office premises and equipment are comprised of the following at December 31:

| | 2004 | 2003 |
|--|----------------|---------|
| | (In thousands) | |
| Land and improvements | \$ 107 | \$ 107 |
| Buildings and improvements | 1,303 | 1,299 |
| Furniture and equipment | 953 | 974 |
| Automobiles | 19 | 19 |
| | ----- | ----- |
| | 2,382 | 2,399 |
| Less accumulated depreciation and amortization | 1,442 | 1,334 |
| | ----- | ----- |
| | \$ 940 | \$1,065 |
| | ===== | ===== |

34

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE F - DEPOSITS

Deposits consist of the following major classifications at December 31:

| Deposit type and weighted- average interest rate (In thousands) | 2004 | 2003 |
|---|----------|----------|
| Non-interest bearing accounts | \$ 4,058 | \$ 5,178 |
| NOW accounts | | |
| 2004 - 0.77% | 7,993 | |
| 2003 - 0.46% | | 7,525 |
| Savings accounts | | |
| 2004 - 0.50% | 9,616 | |
| 2003 - 0.50% | | 9,604 |
| Super Savers | | |
| 2004 - 0.75% | 9,941 | |
| 2003 - 0.75% | | 13,888 |
| | ----- | ----- |
| Total demand, transaction and | | |

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| | | |
|-------------------------------|----------|----------|
| passbook deposits | 31,608 | 36,195 |
| Certificates of deposit | | |
| Original maturities of: | | |
| Less than 12 months | | |
| 2004 - 1.54% | 2,914 | |
| 2003 - 1.28% | | 3,616 |
| 12 months to 24 months | | |
| 2004 - 2.35% | 27,628 | |
| 2003 - 2.15% | | 23,653 |
| 24 months to 36 months | | |
| 2004 - 3.24% | 9,624 | |
| 2003 - 3.55% | | 9,540 |
| More than 36 months | | |
| 2004 - 4.09% | 2,565 | |
| 2003 - 4.16% | | 1,716 |
| Individual retirement | | |
| 2004 - 2.62% | 8,385 | |
| 2003 - 3.21% | | 8,384 |
| Jumbo | | |
| 2004 - 2.38% | 4,215 | |
| 2003 - 2.31% | | 5,224 |
| | ----- | ----- |
| Total certificates of deposit | 55,331 | 52,133 |
| | ----- | ----- |
| Total deposits | \$86,939 | \$88,328 |
| | ===== | ===== |

At December 31, 2004 and 2003, the Savings Bank had certificate of deposit accounts with balances in excess of \$100,000 totaling approximately \$17.2 million and \$13.8 million, respectively.

35

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE F - DEPOSITS (continued)

Interest expense on deposits for the years ended December 31 is summarized as follows:

| | 2004 | 2003 |
|-------------------------------|----------------|----------|
| | (In thousands) | |
| Savings, NOW and super savers | \$ 180 | \$ 271 |
| Certificates of deposit | 1,242 | 1,648 |
| | ----- | ----- |
| | \$ 1,422 | \$ 1,919 |
| | ===== | ===== |

Maturities of outstanding certificates of deposit at December 31 are summarized as follows:

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| (In thousands) | 2004 | 2003 |
|-------------------------|----------|----------|
| Less than six months | \$18,215 | \$20,942 |
| Six months to one year | 23,134 | 16,764 |
| One year to three years | 12,622 | 13,414 |
| Three years or more | 1,360 | 1,013 |
| | ----- | ----- |
| | \$55,331 | \$52,133 |
| | ===== | ===== |

NOTE G - ADVANCES FROM THE FEDERAL HOME LOAN BANK

Advances from the Federal Home Loan Bank, collateralized at December 31, 2004 by pledges of certain residential mortgage loans totaling \$25.4 million and the Savings Bank's investment in Federal Home Loan Bank stock, are summarized as follows:

| Interest rate | Maturing year ending December 31, | 2004 | 2003 |
|--------------------------------|---|----------------|----------|
| | | (In thousands) | |
| 1.75% | 2004 | \$ -- | \$ 2,000 |
| 1.57% | 2005 | 2,000 | -- |
| 2.51% | 2005 | 2,000 | -- |
| 2.40% | 2005 | 2,000 | -- |
| 2.66% | 2005 | 2,000 | -- |
| 2.69% | 2007 | 2,000 | -- |
| 3.34% | 2007 | 2,000 | -- |
| 3.71% | 2007 | 2,500 | -- |
| 3.73% | 2009 | 3,000 | -- |
| | | ----- | ----- |
| | | \$17,500 | \$ 2,000 |
| | | ===== | ===== |
| Weighted-average interest rate | | 2.89% | 1.75% |
| | | ===== | ===== |

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE H - NOTES PAYABLE

The Corporation has a revolving line of credit with another financial institution which allows the Corporation to borrow up to \$3.5 million at prime rate maturing in November 2006. At December 31, 2004, the Corporation had \$3.5 million outstanding under the line, which was paid in full in January 2005.

NOTE I - INCOME TAXES

The provision for income taxes differs from that computed at the statutory

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corporate tax rate at December 31 as follows:

| | 2004 | 2003 |
|---|----------------|--------|
| | (In thousands) | |
| Federal income taxes computed at 34% statutory rate | \$ 509 | \$ 473 |
| Increase (decrease) in taxes resulting from: | | |
| Dividends received deduction | (6) | (5) |
| Tax exempt interest | (3) | (3) |
| State income taxes - net of federal tax benefits | 90 | 90 |
| Other | 11 | 9 |
| | ----- | ----- |
| Income tax provision per financial statements | \$ 601 | \$ 564 |
| | ===== | ===== |
| Effective income tax rate | 40.1% | 40.5% |
| | ===== | ===== |

The composition of the Corporation's net deferred tax asset (liability) at December 31 is as follows:

| | 2004 | 2003 |
|--|----------------|-------|
| | (In thousands) | |
| Taxes (payable) refundable on temporary differences at statutory rate: | | |
| Deferred tax assets: | | |
| Stock benefit plans | \$ 10 | \$ 10 |
| Deferred compensation | 268 | 254 |
| General loan loss allowance | 283 | 289 |
| Deferred loan origination fees | -- | 19 |
| Charitable contribution carryforward | 98 | 98 |
| | ----- | ----- |
| Total deferred tax assets | 659 | 670 |
| Deferred tax liabilities: | | |
| Federal Home Loan Bank stock dividends | (21) | (10) |
| Difference between book and tax depreciation | (71) | (85) |
| Deferred loan origination costs | (27) | -- |
| Unrealized gains on securities available for sale | (515) | (443) |
| State income taxes | (38) | (40) |
| | ----- | ----- |
| Total deferred tax liabilities | (672) | (578) |
| | ----- | ----- |
| Net deferred tax asset (liability) | \$ (13) | \$ 92 |
| | ===== | ===== |

37

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE I - INCOME TAXES (continued)

Prior to 1997, the Savings Bank was allowed a special bad debt deduction, generally limited to 8% of otherwise taxable income and subject to certain limitations based on aggregate loans and deposit account balances at the

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end of the year. If the amounts that qualified as deductions for federal income tax purposes are later used for purposes other than for bad debt losses, including distributions in liquidation, such distributions will be subject to federal income taxes at the then current corporate income tax rate. Retained earnings at December 31, 2004, includes approximately \$1.2 million for which federal income taxes have not been provided. The amount of the unrecognized deferred tax liability relating to the cumulative bad debt deduction is approximately \$400,000.

NOTE J - LOAN COMMITMENTS

The Savings Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers, including commitments to extend credit. Such commitments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the statement of financial condition. The contract or notional amounts of the commitments reflect the extent of the Savings Bank's involvement in such financial instruments.

The Savings Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual notional amount of those instruments. The Savings Bank uses the same credit policies in making commitments and conditional obligations as those utilized for on-balance-sheet instruments.

At December 31, 2004 and 2003, the Savings Bank had outstanding commitments of approximately \$1.3 million and \$3.2 million, respectively, to originate loans. The Savings Bank was obligated under unused lines of credit for home equity loans in the amount of \$2.1 million and \$1.6 million at December 31, 2004 and 2003, respectively, and unused lines of credit under commercial loans totaling \$4.5 million and \$3.9 million, respectively at those dates. Additionally, at December 31, 2004, the Savings Bank was obligated under \$297,000 of standby letters of credit. In the opinion of management, all loan commitments equaled or exceeded prevalent market interest rates as of December 31, 2004, and will be funded from normal cash flow from operations and borrowings as necessary.

NOTE K- REGULATORY CAPITAL

The Savings Bank is subject to minimum regulatory capital standards promulgated by the Office of Thrift Supervision (the "OTS"). Failure to meet minimum capital requirements can initiate certain mandatory -- and possibly additional discretionary -- actions by regulators that, if undertaken, could have a direct material effect on the financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Savings Bank must meet specific capital guidelines that involve quantitative measures of the Savings Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Savings Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

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Years ended December 31, 2004 and 2003

NOTE K - REGULATORY CAPITAL (continued)

The minimum capital standards of the OTS generally require the maintenance of regulatory capital sufficient to meet each of three tests, hereinafter described as the tangible capital requirement, the core capital requirement and the risk-based capital requirement. The tangible capital requirement provides for minimum tangible capital (defined as shareholders' equity less all intangible assets) equal to 1.5% of adjusted total assets. The core capital requirement provides for minimum core capital (tangible capital plus certain forms of supervisory goodwill and other qualifying intangible assets) generally equal to 4.0% of adjusted total assets, except for those associations with the highest examination rating and acceptable levels of risk. The risk-based capital requirement provides for the maintenance of core capital plus general loss allowances equal to 8.0% of risk-weighted assets. In computing risk-weighted assets, the Savings Bank multiplies the value of each asset on its statement of financial condition by a defined risk-weighting factor, e.g., one- to four-family residential loans carry a risk-weighted factor of 50%.

During 2004, the Savings Bank was notified by the OTS that it was categorized as "well-capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well-capitalized" the Savings Bank must maintain minimum capital ratios as set forth in the following tables.

As of December 31, 2004 and 2003, management believes that the Savings Bank met all capital adequacy requirements to which it was subject.

| | As of December 31, 2004 | | | | To be capitali prompt c action p |
|--------------------|-------------------------|-------|----------------------------------|-----------|---|
| | Actual | | For capital adequacy purposes | | |
| | Amount | Ratio | Amount | Ratio | |
| | ----- | | ----- | | ----- |
| | | | (Dollars in thousands) | | |
| Tangible capital | \$21,738 | 16.9% | = /> \$1,928 | = /> 1.5% | = /> \$6,425 |
| Core capital | \$21,738 | 16.9% | = /> \$5,140 | = /> 4.0% | = /> \$7,710 |
| Risk-based capital | \$23,252 | 28.7% | = /> \$6,480 | = /> 8.0% | = /> \$8,100 |
| | As of December 31, 2003 | | | | |
| | As of December 31, 2003 | | | | To b capitali prompt action |
| | Actual | | For capital adequacy purposes | | |
| | Amount | Ratio | Amount | Ratio | |
| | ----- | | ----- | | ----- |
| | | | (Dollars in thousands) | | |
| Tangible capital | \$20,479 | 18.2% | = /> \$1,686 | = /> 1.5% | = /> \$5,620 |
| Core capital | \$20,479 | 18.2% | = /> \$4,496 | = /> 4.0% | = /> \$6,744 |
| Risk-based capital | \$21,784 | 31.2% | = /> \$5,579 | = /> 8.0% | = /> \$6,974 |

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The Savings Bank's management believes that, under the current regulatory capital regulations, the Savings Bank will continue to meet its minimum capital requirements in the foreseeable future. However, events beyond the control of the Savings Bank, such as increased interest rates or a downturn in the economy in the Savings Bank's market area, could adversely affect future earnings and, consequently, the ability to meet future minimum regulatory capital requirements.

39

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE L - CONDENSED FINANCIAL STATEMENTS OF PFS BANCORP, INC.

The following condensed financial statements summarize the financial position of the Corporation as of December 31, 2004 and 2003, and the results of its operations and its cash flows for the years ended December 31, 2004 and 2003.

PFS BANCORP, INC.
STATEMENTS OF FINANCIAL CONDITION
December 31, 2004 and 2003
(In thousands)

| ASSETS | 2004 |
|--|--------------------|
| Interest-bearing deposits in Peoples Federal Savings Bank | \$ 424 |
| Interest-bearing deposits in other financial institutions | -- |
| Investment securities | -- |
| Loan receivable from ESOP | 730 |
| Investment in Peoples Federal Savings Bank | 22,771 |
| Prepaid expenses and other | -- |
| Prepaid income taxes | 22 |
| Deferred income taxes | 98 |
| | ----- |
| Total assets | \$ 24,045 ===== |
| LIABILITIES AND SHAREHOLDERS' EQUITY | |
| Note payable | \$ 3,500 |
| Accrued expenses and other liabilities | 16 |
| | ----- |
| Total liabilities | 3,516 |
| Shareholders' equity | |
| Common stock and additional paid-in capital | 15,122 |
| Retained earnings | 7,298 |
| Treasury stock | (1,282) |
| Shares acquired by stock benefit plans | (1,608) |
| Unrealized gains on securities designated as available for sale, net | 999 |

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| | |
|--|--------------------------|
| Total shareholders' equity | ----- 20,529 ----- |
| Total liabilities and shareholders' equity | \$ 24,045 ===== |

40

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE L - CONDENSED FINANCIAL STATEMENTS OF PFS BANCORP, INC. (continued)

PFS BANCORP, INC.

STATEMENTS OF EARNINGS

Years ended December 31, 2004 and 2003

(In thousands)

| | 2004 | 2003 |
|--|--------|--------|
| Revenue | | |
| Interest income | \$ 140 | \$ 192 |
| Gain on sale of investment securities | 6 | -- |
| Equity in earnings of Peoples Federal Savings Bank | 949 | 851 |
| | ----- | ----- |
| Total revenue | 1,095 | 1,043 |
| Interest expense | 32 | -- |
| General and administrative expenses | 199 | 232 |
| | ----- | ----- |
| Total expense | 231 | 232 |
| Earnings before income tax credits | 864 | 811 |
| Income tax credits | (33) | (16) |
| | ----- | ----- |
| NET EARNINGS | \$ 897 | \$ 827 |
| | ===== | ===== |

41

PFS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Years ended December 31, 2004 and 2003

NOTE L - CONDENSED FINANCIAL STATEMENTS OF PFS BANCORP, INC. (continued)

PFS BANCORP, INC.

STATEMENTS OF CASH FLOWS

Years ended December 31, 2004 and 2003

(In thousands)

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| | 2004 | 2003 |
|--|----------|----------|
| Cash provided by (used in) operating activities: | | |
| Net earnings for the year | \$ 897 | \$ 827 |
| Adjustments to reconcile net earnings to net cash provided by (used in) operating activities | | |
| Amortization of premiums and discounts on investment securities - net | 10 | 20 |
| Gain on sale of investment securities | (6) | -- |
| Equity in earnings of Peoples Federal Savings Bank | (949) | (851) |
| Increase (decrease) in cash due to changes in: | | |
| Accrued interest receivable | 28 | -- |
| Prepaid expenses and other assets | -- | 3 |
| Prepaid income taxes | 2 | (51) |
| Deferred income taxes | (4) | (1) |
| Other liabilities | (11) | 1 |
| | ----- | ----- |
| Net cash used in operating activities | (33) | (52) |
| Cash flows provided by (used in) investing activities: | | |
| Purchase of investment securities | (17,937) | (17,952) |
| Proceeds from maturity of investment securities | 21,584 | 18,350 |
| Proceeds from sale of investment securities | 713 | -- |
| Proceeds from repayments on loan to ESOP | 122 | 121 |
| | ----- | ----- |
| Net cash provided by investing activities | 4,482 | 519 |
| Cash flows provided by (used in) financing activities: | | |
| Proceeds from note payable | 3,500 | -- |
| Purchases of treasury stock | -- | (1,282) |
| Dividends paid on common stock | (7,700) | (449) |
| | ----- | ----- |
| Net cash used in financing activities | (4,200) | (1,731) |
| | ----- | ----- |
| Net increase (decrease) in cash and cash equivalents | 249 | (1,264) |
| Cash and cash equivalents at beginning of year | 175 | 1,439 |
| | ----- | ----- |
| Cash and cash equivalents at end of year | \$ 424 | \$ 175 |
| | ===== | ===== |

Regulations of the Office of Thrift Supervision (OTS) impose limitations on the payment of dividends and other capital distributions by savings associations. Generally, the Savings Bank's payment of dividends is limited, without prior OTS approval, to net earnings for the current calendar year plus the two preceding calendar years, less capital distributions paid over the comparable time period. Insured institutions are required to file an application with the OTS for capital distributions in excess of this limitation. During 2004 and 2003, the Savings Bank did not distribute dividends to the Corporation. The Savings Bank applied for and received approval to pay \$6.5 million of dividends to the Corporation in 2005.

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PFS Bancorp, Inc.

DIRECTORS AND EXECUTIVE OFFICERS

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PFS BANCORP, INC. AND PEOPLES FEDERAL SAVINGS BANK

Directors

Robert L. Laker
Chairman of the Board

Dale R. Moeller
Director

Mel E. Green
Director, President and Chief Executive Officer

Carl E. Petty
Director

Gilbert L. Houze
Director and Vice Chairman of the Board

Jack D. Tandy
Director and Secretary

Executive Officers

Mel E. Green
President and
Chief Executive Officer

Stuart M. Suggs
Corporate Treasurer,
Vice President,
Chief Operating Officer and
Chief Financial Officer

43

PFS Bancorp, Inc.

BANKING LOCATIONS AND SHAREHOLDER INFORMATION

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BANKING LOCATIONS

PFS Bancorp, Inc. is an Indiana-incorporated thrift holding company conducting business through its wholly-owned subsidiary, Peoples Federal Savings Bank. Peoples Federal Savings Bank is a federally-chartered, SAIF-insured stock savings bank operating through three offices in southeast Indiana.

Main Office

Second and Bridgeway Streets
Aurora, Indiana 47001
(812) 926-0631

Branch Offices

330 Industrial Access Road
Rising Sun, Indiana 47040
(812) 438-2111

705 E. Main Street
Vevay, Indiana 47043
(812) 427-2629

ANNUAL MEETING

The Annual Meeting of Shareholders of PFS Bancorp will be held on May 5, 2005, at 3:00 p.m., Eastern Daylight Savings Time, at PFS Bancorp's main office

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located at Second and Bridgeway Streets, Aurora, Indiana.

TRANSFER AGENT/REGISTRAR

Registrar and Transfer Company
10 Commerce Drive
Cranford, New Jersey 07016
(908) 272-8511

SHAREHOLDER REQUESTS

Requests for annual reports, quarterly reports and related shareholder literature should be directed to Stuart M. Suggs, Corporate Treasurer, Vice President, Chief Operating Officer and Chief Financial Officer, PFS Bancorp, Inc., Second and Bridgeway Streets, Aurora, Indiana 47001.

Shareholders needing assistance with stock records, transfers or lost certificates, please contact PFS Bancorp's transfer agent, Registrar and Transfer Company.