

STURGIS BANCORP INC

Form 10-Q

November 15, 2004

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20429

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2004

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

For the transition period from _____ to _____

STURGIS BANCORP, INC.

(Exact name of registrant as specified in its charter)

MICHIGAN

(State of incorporation or organization)

0-49613

38-3609814

(Commission File No.)

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

113-125 E. Chicago Road, Sturgis, Michigan 49091

(Address of principal executive offices)

(269) 651-9345

(Issuer's telephone number)

(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange of 1934 Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No .

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

Class

Outstanding at November 15, 2004

Common Stock, \$1.00 par value 2,722,885

Transitional Small Business Disclosure Format (check one); Yes [] No [X]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [] No [X]

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STURGIS BANCORP, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

Throughout this Form 10-Q, Sturgis Bancorp, Inc. will be referred to as Bancorp and Sturgis Bank and Trust Company and its subsidiaries will be referred to as the Bank. Bancorp is a financial holding company under the Bank Holding Company Act of 1956, as amended. The Bank is a wholly owned subsidiary of Bancorp.

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ITEM 1. FINANCIAL STATEMENTS
STURGIS BANCORP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL CONDITION

	September 30, 2004 (Unaudited)	December 31, 2003
ASSETS		
Cash and due from banks	\$ 9,850,620	\$ 10,184,272
Short-term interest-bearing deposits	6,097,414	311,029
	<hr/>	<hr/>
Total cash and cash equivalents	15,948,034	10,495,301
Interest-bearing deposits in banks	11,377,577	15,339,462
Securities Available-for-sale	17,784,298	4,026,250
Securities Held-to-maturity	9,177,397	10,938,761
Federal Home Loan Bank stock, at cost	4,425,400	4,274,700
Loans held for sale	1,068,568	1,321,674
Loans, net	227,657,501	215,527,565
Real estate owned	713,898	749,899
Bank owned life insurance	6,828,869	6,628,534
Accrued interest receivable	1,520,495	1,591,414
Investment in limited partnership	1,144,113	1,192,077
Premises and equipment, net	6,175,688	6,488,123
Goodwill, net of accumulated amortization	5,109,419	5,109,419
Originated mortgage servicing rights	1,863,950	1,974,988
Other assets	1,635,519	1,679,426
	<hr/>	<hr/>
Total assets	\$312,430,726	\$287,337,593
	<hr/>	<hr/>
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Deposit accounts:		
Noninterest-bearing	\$ 18,117,265	\$ 12,282,992
Interest-bearing	196,411,027	187,637,221
Borrowings from Federal Home Loan Bank	51,903,283	55,804,670
Repurchase agreements	15,000,000	
Accrued interest payable	617,458	678,547
Other liabilities	1,794,904	1,775,812
	<hr/>	<hr/>
Total liabilities	283,843,937	258,179,242
Stockholders equity:		
Common stock	2,722,885	2,808,535
Additional paid-in capital	16,641,261	17,805,688
Accumulated other comprehensive income/(loss)	86,881	1,650

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Retained earnings	9,135,762	8,542,478
	<u> </u>	<u> </u>
Total stockholders' equity	28,586,789	29,158,351
	<u> </u>	<u> </u>
Total liabilities and stockholders' equity	\$312,430,726	\$287,337,593
	<u> </u>	<u> </u>

Table of Contents**STURGIS BANCORP, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENT OF INCOME**

	Three Months Ended Sept. 30,	
	2004	2003
	(Unaudited)	(Unaudited)
Interest income		
Loans	\$3,370,495	\$3,386,875
Investment securities:		
Taxable	348,552	191,004
Tax-exempt	28,139	32,906
Dividends	48,128	37,906
	<hr/>	<hr/>
Total interest income	3,795,314	3,648,691
Interest expense		
Deposits	890,824	975,867
Borrowed funds	754,314	712,902
	<hr/>	<hr/>
Total interest expense	1,645,138	1,688,769
	<hr/>	<hr/>
Net interest income	2,150,176	1,959,922
Provision for loan losses	121,782	53,600
	<hr/>	<hr/>
Net interest income after provision for loan losses	2,028,394	1,906,322
Noninterest income:		
Service charges and other fees	429,740	359,298
Commission income	248,872	371,318
Mortgage banking activities	281,466	548,902
Trust fee income	97,864	119,443
Increase in cash surrender value of life insurance	66,461	70,663
Other income	(3,847)	(12,757)
	<hr/>	<hr/>
Total noninterest income	1,120,556	1,456,867
Noninterest expenses:		
Salaries and employee benefits	1,298,789	1,264,897
Office occupancy and equipment	317,192	348,424
Data processing expense	133,109	150,709
Professional fees and services	80,324	55,607
Other	529,693	536,452
	<hr/>	<hr/>
Total noninterest expenses	2,359,107	2,356,089

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	<u> </u>	<u> </u>
Income before provision for federal income tax	789,843	1,007,100
Provision for federal income tax	<u>237,406</u>	<u>290,299</u>
Net income	<u>\$ 552,437</u>	<u>\$ 716,801</u>
Basic earnings per share	\$ 0.20	\$ 0.26
Diluted earnings per share	\$ 0.20	\$ 0.25
Dividends declared per share	\$ 0.09	\$ 0.09

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Table of Contents**STURGIS BANCORP, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENT OF INCOME**

	Nine Months Ended Sept. 30,	
	2004	2003
	(Unaudited)	(Unaudited)
Interest income		
Loans	\$ 9,887,803	\$ 10,561,047
Investment securities:		
Taxable	796,951	702,065
Tax-exempt	90,570	103,601
Dividends	216,277	295,189
	<hr/>	<hr/>
Total interest income	10,991,601	11,661,902
Interest expense		
Deposits	2,668,669	3,220,757
Borrowed funds	2,019,606	2,166,497
	<hr/>	<hr/>
Total interest expense	4,688,275	5,387,254
	<hr/>	<hr/>
Net interest income	6,303,326	6,274,648
Provision for loan losses	571,223	1,083,075
	<hr/>	<hr/>
Net interest income after provision for loan losses	5,732,103	5,191,573
Noninterest income:		
Service charges and other fees	1,232,784	1,073,941
Commission income	802,573	913,459
Mortgage banking activities	718,877	2,272,602
Trust fee income	328,969	367,224
Increase in cash surrender value of life insurance	200,335	222,721
Other income	9,896	11,292
	<hr/>	<hr/>
Total noninterest income	3,293,434	4,861,239
Noninterest expenses:		
Salaries and employee benefits	4,046,628	3,787,598
Office occupancy and equipment	920,223	1,024,312
Data processing expense	473,182	594,822
Professional fees and services	308,637	241,556
Other	1,401,432	1,524,180
	<hr/>	<hr/>
Total noninterest expenses	7,150,102	7,172,468

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	<u> </u>	<u> </u>
Income before provision for federal income tax	1,875,435	2,880,344
Provision for federal income tax	531,419	840,508
	<u> </u>	<u> </u>
Net income	\$ 1,344,016	\$ 2,039,836
	<u> </u>	<u> </u>
Basic earnings per share	\$ 0.48	\$ 0.73
Diluted earnings per share	\$ 0.48	\$ 0.73
Dividends declared per share	\$ 0.27	\$ 0.26

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Table of Contents**STURGIS BANCORP, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS**

	Nine Months Ended September 30,	
	2004	2003
	(Unaudited)	(Unaudited)
Cash Flows from Operating Activities		
Net Income	\$ 1,344,016	\$ 2,039,836
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation	393,995	478,662
Amortization of intangibles	442,959	825,541
Provision for loan losses	571,223	1,083,075
Deferred income tax expense (benefit)	(4,352)	43,750
Loss on sale of fixed assets		4,785
Premiums and discounts on investment securities	71,432	71,562
Gain on sale of loans	(381,466)	(1,358,252)
Loss (gain) on sale of real estate owned	16,781	(9,122)
Proceeds from the sale of loans held for sale	31,262,497	110,911,535
Loans originated for sale	(30,627,925)	(107,133,339)
Loss of equity in limited partnership	47,964	23,400
Increase in cash value of bank owned life insurance	(200,335)	(222,721)
Stock dividend from Federal Home Loan Bank stock	(150,700)	(106,300)
Changes in assets and liabilities:		
Increase in accrued interest and other assets	(217,095)	(1,504,830)
Decrease (increase) in accrued interest and other liabilities	(79,443)	256,857
	<hr/>	<hr/>
Net cash provided by operating activities	2,489,551	5,404,439
Cash Flows from Investing Activities		
Net decrease in interest-bearing deposits in banks	3,961,885	12,409,550
Proceeds from maturities of securities held-to-maturity	415,000	360,000
Principal reductions of mortgage-backed securities	2,646,021	827,138
Purchase of securities available-for-sale	(15,000,000)	(9,075,367)
Purchase of investment in limited partnership		(1,050,000)
Net (increase) decrease in loans	(13,516,015)	984,937
Proceeds from sale of real estate owned	834,076	1,024,564
Proceeds from sale of premises and equipment	1,547	
Purchases of premises and equipment	(84,247)	(622,225)
	<hr/>	<hr/>
Net cash (used in) provided by investing activities	(20,741,733)	4,858,597
Cash Flows from Financing Activities		
Net increase in demand and savings account deposits	7,211,742	8,294,519
Net increase (decrease) in certificates of deposits	7,396,337	(11,969,393)
Repayment of FHLB advances	(13,401,387)	(10,349,373)
Proceeds from FHLB advances	9,500,000	4,343,860

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Proceeds from repurchase agreements	15,000,000	
Dividends paid	(750,732)	(730,220)
Exercise of stock options	7,875	81,000
Stock redemption	(1,258,920)	
	<u> </u>	<u> </u>
Net cash provided by (used in) financing activities	23,704,915	(10,329,607)
	<u> </u>	<u> </u>
Net increase (decrease) in Cash and Cash Equivalents	5,452,733	(66,571)
Cash and Cash Equivalents Beginning of Period	10,495,301	13,071,284
	<u> </u>	<u> </u>
Cash and Cash Equivalents End of Period	<u>\$ 15,948,034</u>	<u>\$ 13,004,713</u>

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STURGIS BANCORP, INC. AND SUBSIDIARIES

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

Note A: FINANCIAL STATEMENTS.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of Management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine-month period ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. For further information, refer to the consolidated financial statements and footnotes thereto included in the Bancorp's Annual Report on Form 10-K for the year ended December 31, 2003.

Note B: ORGANIZATION AND ACCOUNTING POLICIES.

Basis of Presentation and Consolidation The consolidated financial statements include the accounts of Bancorp and Bank, which includes the Bank's wholly owned subsidiaries, Oakleaf Financial Services, Inc., Ludington Service Corporation, First Michiana Development Corporation of Sturgis and Oak Mortgage, LLC. All significant inter-company transactions and balances have been eliminated in consolidation.

Use of Estimates In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates and assumptions. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, and the valuation of real estate owned, deferred tax assets, mortgage servicing rights, and the impairment of goodwill.

Nature of Operations The Bank operates predominately in the south-western portion of Michigan's lower peninsula. Its primary services include accepting deposits, making commercial and mortgage loans, engaging in mortgage banking activities, and providing trust and investment brokerage advisory services.

Segment Reporting While management monitors the revenue streams of various products and services offered, operations are managed and financial performance is evaluated on a Bancorp-wide basis. Accordingly, all of Bancorp's operations are considered by management to be aggregated in one reportable operating segment.

Significant Group Concentrations of Credit Risk Most of the Bank's activities are with customers located within Michigan. The Bank's loan portfolio is concentrated in

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residential first-mortgage and commercial mortgage loans. The Bank does not have any significant concentrations to any one industry or customer.

Cash and Cash Equivalents For the purpose of the consolidated statements of cash flows, cash and cash equivalents include cash and balances due from banks, federal funds sold and other short-term investments, all of which mature within ninety days.

Interest-bearing Deposits in Banks Interest-bearing deposits in banks mature within ten years and are carried at cost.

Securities Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Securities not classified as held to maturity are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost, that are deemed to be other than temporary, are reflected in earnings as realized losses. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Federal Home Loan Bank Stock The Bank's minimum investment in the stock of the Federal Home Loan Bank of Indianapolis (FHLB) is an amount equal to at least one percent of the unpaid principal balances of the Bank's residential mortgage loans or 0.3 percent of its total assets, whichever is greater. Purchases and sales of stock are made directly with the FHLB at par value and are recorded at cost.

Loans Held for Sale Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses, if any, are recognized in a valuation allowance by charges to income.

Loans The Bank grants mortgage, commercial, and consumer loans to customers. Loans are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. In all cases, loans are placed

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on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual status or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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

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

The allowance consists of specific, general and unallocated components. The specific components relate to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired, based on current information and events, when it is probable that the Bank will be unable to collect the scheduled payments of principal or interest in accordance with the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the known circumstances surrounding the loan and the borrower, including length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the collateral value and total amount owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

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Large groups of homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures.

Servicing Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Capitalized servicing rights are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates and terms. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum. The Bank carried a valuation allowance associated with capitalized servicing rights of approximately \$2,334 at September 30, 2004 and \$22,274 at December 31, 2003.

Off-Balance Sheet Instruments In the ordinary course of business, the Bank has entered commitments to extend credit, including commitments under commercial letters of credit and standby letters of credit. Such financial instruments are recorded when they are funded.

Real Estate Owned Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value at the date of the foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less costs to liquidate the assets. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

Investment in Limited Partnerships Bancorp owns investments in limited partnerships that are structured to generate low income housing tax credits and an investment in a Michigan partnership structured to generate commissions from the sale of title insurance. Bancorp accounts for these investments under the equity method, whereby the Bancorp annually records its proportionate share of partnership profits and losses as an adjustment to the carrying value of the investment.

Goodwill and Intangible Assets Effective January 1, 2002, Bancorp adopted Statement of Financial Accounting Standards (SFAS) No. 142. Goodwill and Other Intangible Assets, which changes Bancorp's accounting for goodwill and other intangible assets acquired in a business combination. Generally, intangible assets that meet certain criteria are recognized and subsequently amortized over their estimated useful lives. Goodwill and intangible assets with indefinite lives are not amortized. However, such assets are tested for impairment at adoption of SFAS 142 and at least annually thereafter. No impairment loss was recognized upon the adoption of SFAS 142, at September 30, 2004 or December 31, 2003.

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Premises and Equipment Land is carried at cost. Premises and equipment are carried at cost, less accumulated depreciation computed on the straight-line method over the estimated useful lives of the assets.

Income Taxes Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the various temporary differences between the book and the tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

Earnings Per Common Share Basic earnings per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by Bancorp relate solely to outstanding stock options, and are determined using the treasury stock method.

Earnings per common share have been computed based on the following:

	Three Months Sept. 30, 2004	2003
	<hr/>	<hr/>
Net income	\$ 552,437	\$ 716,801
Weighted average number of common shares outstanding	2,725,788	2,808,535
Effect of dilutive options	5,278	3,105
Weighted average number of common shares outstanding used to calculate diluted earnings per share	2,731,066	2,811,640
	 Nine Months Sept. 30, 2004	 2003
	<hr/>	<hr/>
Net income	\$1,344,016	\$2,039,836
Weighted average number of common shares outstanding	2,775,418	2,808,408
Effect of dilutive options	5,210	2,179
Weighted average number of common shares outstanding used to calculate diluted earnings per share	2,780,628	2,810,587

Comprehensive Income Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

Reclassification Certain amounts appearing in the prior year's financial statements have been reclassified to conform to the current year's financial statements.

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For the purposes of the consolidated statements of cash flows, Bancorp considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

	Nine Months Ended September 30,	
	2004	2003
	<hr/>	<hr/>
Supplemental cash flow information:		
Cash paid during the periods for:		
Interest	\$4,749,364	\$5,705,651
Income taxes	565,000	1,015,000
Noncash investing and financing activities:		
Loans transferred to real estate owned	814,856	420,611

Stock Compensation Plans In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure an Amendment of FASB Statement No. 123. This Statement amends SFAS No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of SFAS No. 123 to require more prominent disclosures about the method of accounting for stock-based employee compensation and the effect of the method used on reported results in both annual and interim financial statements. This Statement was effective for financial statements for fiscal years ending after December 15, 2002. As permitted by SFAS No. 148, Bancorp will continue to apply the provisions of APB Opinion No. 25, Accounting for Stock-Based Compensation, for all employee stock option grants and has elected to disclose pro forma net income and earnings per share amounts as if the fair-value based method had been applied in measuring compensation costs.

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Bancorp's net income and earnings per share would have been adjusted to the pro forma amounts indicated below:

	Three Month Periods Ended Sept. 30,	
	2004	2003
	(Unaudited)	
Net income, as reported	\$552,437	\$716,801
Deduct: Total stock-based compensation expense determined under fair value methods for all awards		(3,655)
Proforma net income	<u>\$552,437</u>	<u>\$713,146</u>
Reported income per common share:		
Basic	\$ 0.20	\$ 0.26
Diluted	0.20	0.26
Proforma income per common share:		
Basic	0.20	0.25
Diluted	0.20	0.25
	Nine Month Periods Ended Sept. 30,	
	2004	2003
	(Unaudited)	
Net income, as reported	\$1,344,016	\$2,039,836
Deduct: Total stock-based compensation expense determined under fair value methods for all awards		(10,965)
Proforma net income	<u>\$1,344,016</u>	<u>\$2,028,871</u>
Reported income per common share:		
Basic	\$ 0.48	\$ 0.73
Diluted	0.48	0.73
Proforma income per common share:		
Basic	0.48	0.72
Diluted	0.48	0.72

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STURGIS BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited), Continued.

Note C: LOANS RECEIVABLE, NET.

A summary of the balances of loans follows:

	September 30, 2004	December 31, 2003
	(Unaudited)	
Mortgage loans on real estate:		
Residential 1-4 family	\$122,965,958	\$118,704,063
Commercial	76,139,604	66,409,463
Construction Residential	9,146,391	10,174,106
Construction Commercial	2,549,500	4,891,400
	<hr/>	<hr/>
	210,801,453	200,179,032
Commercial nonmortgage loans	13,904,596	14,784,475
Consumer and installment loans:		
Consumer and installment	8,188,846	8,324,967
Other	1,058,681	1,129,623
	<hr/>	<hr/>
	9,247,527	9,454,590
	<hr/>	<hr/>
Subtotal	233,953,576	224,418,097
Less:		
Allowance for loan losses	2,560,964	2,294,157
Unearned interest	21,251	18,262
Undisbursed portion of loans in process Residential	3,638,154	3,757,494
Undisbursed portion of loans in process Commercial	401,215	3,138,158
	<hr/>	<hr/>
Subtotal	227,331,992	215,210,026
Add:		
Deferred loan origination and other fees	325,509	317,539
	<hr/>	<hr/>
Loans, net	\$227,657,501	\$215,527,565
	<hr/>	<hr/>

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STURGIS BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited), Continued.

Note D: DEPOSITS.

Interest-bearing deposits are summarized as follows:

	September 30, 2004	December 31, 2003
	(Unaudited)	
Savings deposits	\$ 47,123,717	\$ 43,604,746
NOW accounts	55,393,096	57,534,598
Time:		
\$100,000 and over	40,030,484	29,440,282
Under \$100,000	53,863,730	57,057,595
	<hr/>	<hr/>
Total interest-bearing deposits	\$196,411,027	\$187,637,221
	<hr/>	<hr/>

Note E: BORROWED FUNDS.

Bancorp had \$51.9 million and \$55.8 million in borrowed funds from Federal Home Loan Bank of Indianapolis (FHLB) at September 30, 2004 and December 31, 2003, respectively. Interest rates range from 1.61% to 7.34% with maturities ranging from October 2004 to February 2012. Borrowed funds from FHLB are collateralized by FHLB stock and all non-employee residential and commercial mortgage loans.

Bancorp had \$15.0 million in borrowed funds from Citigroup Global Markets Inc. (Citigroup) at September 30, 2004 and none at December 31, 2003. Interest rates are 1.80% and 3.48% with maturities in November 2004 and May 2007. Borrowed funds from Citigroup are collateralized by certain mortgage-backed securities.

Annual principal payments of borrowed funds are as follows:

Twelve Months Ending September 30,	Amount	Weighted Rate
2005	\$15,057,211	2.57%
2006	3,346,072	5.70%
2007	7,500,000	3.48%
2008	10,000,000	5.50%
2009		
2010 and thereafter	31,000,000	4.51%
	<hr/>	<hr/>

Total	<u>\$66,903,283</u>	<u>3.78%</u>
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**STURGIS BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited), Concluded.**

Note F: CASH DIVIDENDS

Bancorp paid a cash dividend of \$.09 per share on its issued and outstanding common stock on March 15, 2004 to shareholders of record February 13, 2004. Total dividends paid on March 15, 2004 were \$252,836.

Bancorp paid a cash dividend of \$.09 per share on its issued and outstanding common stock on June 15, 2004 to shareholders of record May 14, 2004. Total dividends paid on June 15, 2004 were \$252,836.

Bancorp paid a cash dividend of \$.09 per share on its issued and outstanding common stock on September 15, 2004 to shareholders of record August 13, 2004. Total dividends paid on September 15, 2004 were \$245,060.

Note G: EMPLOYEE BENEFIT PLANS

The Bank has a Defined Contribution Plan/401(k). The plan permits eligible employees to contribute a percentage of their compensation with the Bank contributing 25% of the employee's pre-tax contribution, not to exceed 10% of the employee's total compensation, as defined in the agreement. The plan also permits the Bank to make additional discretionary contributions, although the Bank has not historically exceeded the 25% match described herein.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

Forward Looking Statements

This report contains statements that constitute forward-looking statements. These statements appear in several places in this report and include statements regarding intent, belief, outlook, objectives, efforts, estimates or expectations of Bancorp, primarily with respect to future events and the future financial performance of Bancorp. Any such forward-looking statements are not guarantees of future events or performance and involve risks and uncertainties, and actual results may differ materially from those in the forward-looking statement. Factors that could cause a difference between an ultimate actual outcome and a preceding forward-looking statement include, but are not limited to, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking laws and regulations; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; government and regulatory policy changes; the outcome of any pending and future litigation and contingencies; trends in consumer behavior and ability to repay loans; and changes of the world, national and local economies. Bancorp undertakes no obligation to update, amend or clarify forward-looking statements as a result of new information, future events, or otherwise.

Critical Accounting Policies

The banking industry is highly regulated. Furthermore, the nature of the banking industry is such that, other than described below, the use of estimates and management judgment are not likely to present a material risk to the financial statements. In cases where estimates or management judgment are required, internal controls and processes are established to provide assurance that such estimates and management judgments are materially correct to the best of management's knowledge.

Allowance for loan losses - Accounting for loan classifications, accrual status, and determination of the allowance for loan losses is based on regulatory guidance. This guidance includes, but is not limited to, generally accepted accounting principles, the uniform retail credit classification and account management policy issued by the Federal Financial Institutions Examination Council (FFIEC), and the joint policy statement on the allowance for loan losses methodologies issued by the FFIEC. Accordingly, the allowance for loan losses includes a reserve calculation based on an evaluation of loans determined to be impaired, risk ratings, historical losses, loans past due, and other factors. However, there is still a degree of subjectivity when formulating the level of the allowance for loan losses and historical trends may not be indicative of future levels provided to the reserve account.

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Commercial loan rating system and identification of impaired loans Bancorp has a defined risk rating system that is designed to assess the risk of individual loans and overall risk of the commercial loan portfolio. The system assigns a risk weighting to factors such as cash flow, collateral, financial condition, operating performance, repayment history, management, and strength of the customer's industry. An assessment of risk is performed as a part of the loan approval process as well as periodic updates based on the circumstances of the individual loan. Bancorp employs both internal and external loan review services to assess risk ratings.

Originated mortgage servicing rights (OMSR) Bancorp records the original OMSR based on market data. The OMSR is amortized into non-interest income in proportion to the period of the estimated future net servicing income of the underlying financial asset. Additionally, an independent third party valuation is performed to determine potential impairment of the OMSR as a result of changes in interest rates and expected future loan repayment speeds. Significant changes in interest rates or repayment speeds could have a significant impact on the carrying value of mortgage servicing assets.

Deferred income tax assets Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the various temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

Goodwill and Intangible Assets Bancorp had \$5.1 million of goodwill at September 30, 2004 and December 31, 2003. Effective January 1, 2002, Bancorp adopted Financial Accounting Standards No. 142 (SFAS 142), Goodwill and Other Intangible Assets, which changes Bancorp's accounting for goodwill and other intangible assets. Generally, intangible assets that meet certain criteria are recognized and subsequently amortized over their estimated useful lives. Goodwill and intangible assets with indefinite lives, such as Bancorp's goodwill, are not amortized. However, such assets are tested for impairment annually after adoption of SFAS 142.

Results of Operations

Bancorp reported net income of \$552,437 and \$716,801 for the three months ended September 30, 2004 and 2003, respectively. Basic earnings per share was \$0.20 and \$0.26 for the three months ended September 30, 2004 and 2003, respectively. The decrease in net income from 2003 to 2004 was primarily due to reductions in mortgage banking activities.

Bancorp reported net income of \$1,344,016 and \$2,039,836 for the nine months ended September 30, 2004 and 2003, respectively. Basic earnings per share was \$0.48 and \$0.73 for the nine months ended September 30, 2004 and 2003, respectively. The decrease in net income from 2003 to 2004 was primarily due to reductions in mortgage banking activities, which were partially offset by the reduction in provisions for loan

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losses.

Interest Income

Three months ended September 30, 2004 compared to three months ended September 30, 2003. Interest income increased \$146,623 to \$3.8 million in 2004 from \$3.6 million in 2003. This increase is primarily due to the increase in average interest-bearing assets, which were \$276.3 million and \$252.0 million for the three months ended September 30, 2004 and 2003, respectively. The average interest rate earned on loans decreased to 5.79% in 2004 from 6.34% in 2003. This decrease in the average interest rate earned is primarily due to adjustable rate loans repricing lower through 2003 and 2004. Management believes the expansion of commercial lending will lead to an improved interest margin when rates increase. Most commercial loans are contractually subject to interest rate changes monthly or annually, based on prime. The average yield on interest-earning assets decreased to 5.47% in 2004 from 5.75% in 2003. This is primarily due to changes in the composition of interest-earning assets and lower yields as interest-earning assets repriced through 2003 and 2004.

Nine months ended September 30, 2004 compared to nine months ended September 30, 2003. Interest income decreased \$670,301 to \$11.0 million in 2004 from \$11.7 million in 2003. This decrease is primarily due to the decreases in interest rates. The average interest rate earned on loans decreased to 5.81% in 2004 from 6.62% in 2003. This decrease in the average interest rate earned is primarily due to adjustable rate loans repricing lower through 2003 and 2004. Average interest-bearing assets increased to \$266.3 million from \$256.6 million for the nine months ended September 30, 2004 and 2003, respectively. Management believes the expansion of commercial lending will lead to an improved interest margin when rates increase. The average yield on interest-earning assets decreased to 5.51% in 2004 from 6.08% in 2003. This is primarily due to changes in the composition of interest-earning assets and lower yields as interest-earning assets repriced through 2003 and 2004.

Interest Expense

Three months ended September 30, 2004 compared to three months ended September 30, 2003. Interest expense decreased \$43,631 to \$1.6 million in 2004 from \$1.7 million in 2003. This was primarily due to the decrease in the average interest rate paid on interest-bearing liabilities to 2.48% from 2.77% for 2004 and 2003 respectively. The average rate paid on interest-bearing deposits was 1.85% in 2004, compared to 2.09% in 2003. The average rate paid on borrowed funds was 4.17%, compared to 5.09%. Average deposits and average borrowed funds both increased to fund the increase in average interest-bearing assets.

Nine months ended September 30, 2004 compared to nine months ended September 30, 2003. Interest expense decreased \$698,979 to \$4.7 million in 2004 from \$5.4 million in 2003. This was primarily due to the decrease in the average interest paid on interest-bearing liabilities to 2.46% in 2004 from 2.89% in 2003. The average rate paid

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on interest-bearing deposits was 1.85% in 2004, compared to 2.25% in 2003. The average rate paid on borrowed funds was 4.35% in 2004, compared to 5.03% in 2003.

Net Interest Income

Three months ended September 30, 2004 compared to three months ended September 30, 2003. Net interest income for the three months ended September 30, 2004 increased \$190,254 to \$2.2 million compared to \$2.0 million for the three months ended September 30, 2003. The Bank's net interest margin increased to 3.10% in 2004 from 3.09% in 2003. The Bank is positioned to increase net interest income when interest rates increase. The decrease in interest expense was smaller than the decrease in interest income, due to the Bank's positive interest rate gap. The positive gap position will continue to be accretive to net interest income as market interest rates increase. Management believes the positive interest rate gap is appropriate for the current interest rate environment. Management expects interest rates to gradually increase through the remainder of 2004 and 2005.

Nine months ended September 30, 2004 compared to nine months ended September 30, 2003. Net interest income for the nine months ended September 30, 2004 and 2003 was \$6.3 million, increasing \$28,678. This small increase was caused primarily by an increase in net interest-earning assets to \$11.6 million in 2004 from \$7.4 million in 2003. The Bank's net interest margin decreased to 3.16% in 2004 from 3.27% in 2003. The Bank is positioned to increase interest income when interest rates increase. The decrease in interest expense was smaller than the decrease in interest income, due to the Bank's positive interest rate gap. The positive gap position will continue to be accretive to net interest income as market interest rates increase. Management believes the positive interest rate gap is appropriate for the current interest rate environment. Management expects interest rates to gradually increase through the remainder of 2004 and 2005.

Average Balances, Interest Rates and Yields. Net interest income is affected by the difference (interest rate spread) between rates of interest earned on interest-earning assets and rates of interest paid on interest-bearing liabilities and the relative amounts of interest-bearing liabilities and interest-earning assets. When the total of interest-earning assets approximates or exceeds the total of interest-bearing liabilities, any positive interest rate spread will generate net interest income. Financial institutions have traditionally used interest rate spreads as a measure of net interest income. Another indication of an institution's net interest income is its net yield on interest-earning assets or net interest margin, which is net interest income divided by average interest-earning assets. For the three months ended September 30, there was a small increase in the net interest margin to 3.10% in 2004 from 3.09% in 2003. This increase demonstrates the effect of the Bank's positive gap position. For the nine months ended September 30, there was a decrease in the net interest margin to 3.16% in 2004 from 3.27% in 2003, demonstrating the effect of the Bank's positive gap position during the periods. A positive gap means that interest-bearing assets are repricing at a faster pace than interest-bearing liabilities. Management has anticipated an increase in rates and resisted the temptation of placing long-term, fixed rate, assets on the balance sheet. This mitigation of interest rate risk has sacrificed short-term earnings under the current interest rate environment, but has placed the institution in a more favorable position when rates rise. The most significant risk to this business

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strategy is that rates do not ultimately rise as expected. Management does not believe this scenario is likely in the long-term. Management expects interest rates to gradually increase through the remainder of 2004 and 2005. Both the increase in net interest margin for the quarters ended September 30, 2004 and 2003 and the decrease in net interest margin for the nine months ended September 30, 2004 and 2003 can be explained by the positive gap position.

**Average Balances and Interest Rates
Three Months Ended September 30,**

	2004			2003		
	Average Outstanding Balance	Interest Earned/Paid	Yield/Rate	Average Outstanding Balance	Interest Earned/Paid	Yield/Rate
Interest-Earning Assets:						
Loans (1)	\$230,036,004	\$3,345,217	5.79%	\$212,039,812	\$3,386,875	6.34%
Mortgage-backed securities	25,024,315	309,455	4.92%	8,159,753	59,798	2.91%
Investment securities (2)	7,272,619	76,204	4.17%	16,617,099	77,062	1.84%
Interest-bearing deposits	13,948,993	64,438	1.84%	15,136,069	124,956	3.28%
Total interest-earning assets	\$276,281,931	\$3,795,314	5.47%	\$251,952,733	\$3,648,691	5.75%
Interest-Bearing Liabilities:						
Deposits	\$191,934,358	\$ 890,824	1.85%	\$185,612,658	\$ 975,867	2.09%
Borrowed funds	72,044,245	754,314	4.17%	55,566,226	712,902	5.09%
Total interest-bearing liabilities	\$263,978,603	\$1,645,138	2.48%	\$241,178,885	\$1,688,769	2.78%
Net interest income		\$2,150,176			\$1,959,922	
Interest rate spread			2.99%			2.97%
Net interest-earning assets	\$ 12,303,328			\$ 10,773,848		

Net interest margin	3.10%	3.09%
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(1) Interest on loans includes fees. Nonaccrual loans and loans held for sale have been included in the average balances of loans.

(2) Yield on investment securities is reported on an actual and not a tax equivalent basis

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**Average Balances and Interest Rates
Nine Months Ended September 30,**

	2004			2003		
	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate
Interest-Earning Assets:						
Loans (1)	\$ 225,594,745	\$ 9,814,437	5.81%	\$ 213,370,310	\$ 10,561,047	6.62%
Mortgage-backed securities	18,038,081	667,050	4.94%	8,486,470	199,664	3.15%
Investment securities (2)	7,383,151	306,639	5.55%	15,692,366	418,165	3.56%
Interest-bearing deposits	15,271,555	203,475	1.78%	19,099,805	483,026	3.38%
Total interest-earning assets	\$ 266,287,532	\$ 10,991,601	5.51%	\$ 256,648,951	\$ 11,661,902	6.08%
Interest-Bearing Liabilities:						
Deposits	\$ 192,650,920	\$ 2,668,669	1.85%	\$ 191,693,163	\$ 3,220,757	2.25%
Borrowed funds	62,074,263	2,019,606	4.34%	57,597,334	2,166,497	5.03%
Total interest-bearing liabilities	\$ 254,725,183	\$ 4,688,275	2.46%	\$ 249,290,497	\$ 5,387,254	2.89%
Net interest income		\$ 6,303,326			\$ 6,274,648	
Interest rate spread			3.06%			3.19%
Net interest-earning assets	\$ 11,562,349			\$ 7,358,454		
Net interest margin			3.16%			3.27%

(1) Interest on loans includes fees. Nonaccrual loans and loans held for sale have been included in the average balances of loans.

(2) Yield on investment securities is reported on an actual and not a tax equivalent basis

Provision for Loan Losses

Three months ended September 30, 2004 compared to three months ended September 30, 2003. The provision for loan losses was \$121,782 for the three months ended September 30, 2004 and \$53,600 for the three months ended September 30, 2003, an increase of \$68,182. The provision for loan losses was based upon management's assessment of relevant factors, including types and amounts of non-performing loans, historical and anticipated loss experience on such types of loans, and economic conditions. Loans charged off during the third quarter of 2004, net of recoveries, were \$45,220, compared to \$21,509 during the third quarter of 2003.

Nine months ended September 30, 2004 compared to nine months ended September 30, 2003. The provision for loan losses was \$571,223 for the nine months ended September 30, 2004 and \$1.1 million for the nine months ended September 30, 2003, a decrease of \$511,852. The decrease is primarily due to a single commercial relationship for which the Bank provided reserves of \$630,000 in the second quarter of 2003. The provision for loan losses was based upon management's assessment of relevant factors, including types and amounts of non-performing loans, historical and anticipated loss experience on such types of loans, and economic conditions. Loans charged off during the first nine months of 2004, net of recoveries, were \$304,417, compared to \$290,004 during the first nine months of 2003.

The provision for loan losses has been a subject of debate over the last year among business, the accounting industry and regulatory agencies. It is influenced by the national, regional and local economic conditions and management's assessment of risk in the loan

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portfolio. Management believes the current level of the allowance for loan losses is adequate to cover all expected and unexpected credit risks in the portfolio. However, the mix of the Bank's loan portfolio has been changing over the last several years. The loan portfolio is becoming more heavily weighted with commercial credits. Commercial credits are inherently more risky than one-to-four-family mortgage loans. The collateral is generally more difficult to liquidate and the average size of the credit is larger. A single commercial credit defaulting has a larger impact on the provision for loan losses. The Bank allocates reserves on commercial loans at a higher percentage of the loan balance. The level of provision impacts current and future earnings of the Bank. This is why the subject is of interest to our shareholders, accountants and regulators. It is management's intention to provide an adequate amount of reserves to reflect the risk profile of the loan portfolio. If this requires high provisions in one year and less in another year, these adjustments will be effectuated. Historical levels of provisions should not be used to make assumptions regarding future required allocations.

The allowance for loan losses as a percentage of total loans has increased to 1.10% at September 30, 2004, compared to 1.04% at December 31, 2003. This increase is due to the increase in commercial mortgage loans. Management monitors the Bank's increasing exposure to commercial lending and economic developments in the Bank's market area, among other factors, in determining appropriate provisions to the allowance for loan losses. Because of the Bank's continuing growth in commercial loans, the Bank expects to continue funding the allowance for loan losses due to higher risks related to commercial lending.

The Bank has implemented processes to accelerate its collections and foreclosure actions in an effort to reduce the level of nonperforming assets and net charge-offs. Loans past due greater than 90 days and still accruing increased by \$1.6 million from December 31, 2003 to September 30, 2004, primarily due to two large residential mortgages. Management expects the enhanced processes will suppress the level of nonperforming assets and net charge-offs.

Noninterest Income

Three months ended September 30, 2004 compared to three months ended September 30, 2003. Noninterest income was \$1.1 million for the three months ended September 30, 2004 compared to \$1.5 million for the three months ended September 30, 2003, a decrease of \$336,311. The primary component of this decrease was noninterest income from mortgage banking activities. The decrease in mortgage banking activities was due to the decrease in loan sales during 2004 compared to 2003. For the three months ended September 30, 2003, loan sales were very strong, due to residential loans refinanced and sold. This refinance activity was driven by the historically low levels of interest rates available on long-term fixed rate mortgages. Most consumers qualifying to refinance took advantage of the low rates during 2003 and are not likely to refinance again in 2004. Management expects mortgage banking activity will be dominated primarily by purchases and sales, rather than refinances, during 2004. Proceeds from sale of loans decreased to \$9.5 million in the third quarter of 2004 from \$29.3 million in the third quarter of 2003. Service charges and other fees increased to \$429,740 in the third quarter of 2004 from \$359,298 in the third quarter of 2003, primarily due to an increase in the

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insufficient funds fee to \$25 per item from \$20 per item, which became effective on February 1, 2004. Brokerage commissions and trust fee income are influenced by the U.S. economy and stock market values. Brokerage commission income decreased to \$248,872 in the third quarter of 2004 from \$371,318 in the third quarter of 2003. Brokerage commission income was 22.2% of non-interest income for the third quarter of 2004 and will continue to be a large component of noninterest income.

Nine months ended September 30, 2004 compared to nine months ended September 30, 2003. Noninterest income was \$3.3 million for the nine months ended September 30, 2004 compared to \$4.9 million for the nine months ended September 30, 2003, a decrease of \$1.6 million. The primary component of this decrease was noninterest income from mortgage banking activities, which decreased to \$718,877 in 2004 from \$2.3 million in 2003. The decrease in mortgage banking activities was due to the decrease in loan sales during 2004 compared to 2003. For the nine months ended September 30, 2003, loan sales were very strong, due to residential loans refinanced and sold. This refinance activity was driven by the historically low levels of interest rates available on long-term fixed rate mortgages. Most consumers qualifying to refinance took advantage of the low rates during 2003 and are not likely to refinance again in 2004. Management expects mortgage banking activity will be dominated primarily by purchases and sales, rather than refinances, during 2004. Proceeds from sale of loans decreased to \$31.2 million in the first nine months of 2004 from \$110.9 million in the first nine months of 2003. Service charges and other fees increased to \$1.2 million in the first nine months of 2004 from \$1.1 million in the first nine months of 2003, primarily due to an increase in the insufficient funds fee to \$25 per item from \$20 per item, which became effective on February 1, 2004. Brokerage commission income decreased to \$802,573 in the first nine months of 2004 from \$913,459 in the first nine months of 2003. Brokerage commission income was 24.4% of non-interest income for the first nine months of 2004 and will continue to be a large component of noninterest income.

Noninterest Expense

Three months ended September 30, 2004 compared to three months ended September 30, 2003. Noninterest expense was \$2.4 million in the third quarter of 2004 and 2003, increasing only \$3,018. The largest component of noninterest expense is salaries and employee benefits. Salaries and employee benefits increased \$33,892 to \$1.3 million from \$1.3 million for the quarters ended September 30, 2004 and 2003, respectively. This increase in salaries and employee benefits is primarily due to lower deferral of loan origination costs. Loan origination costs deferred in the third quarter of 2004 were \$129,388, compared to \$235,713 in the third quarter of 2003. The decrease in loan origination costs deferred was due to the reduction in the number of loans originated in the third quarter of 2004 compared to the third quarter of 2003. Salary adjustments for 2004 became effective in January 2004. Other noninterest expenses for the three months ended September 30, 2004 include \$94,473 of expenses incurred through September 30, 2004 for the Company's going private transaction. At September 30, 2004, goodwill was not impaired and Management does not anticipate impairment in the year ending December 31, 2004. Management actively minimizes noninterest expense, although certain noninterest expenses are outside of Management's direct control.

Management

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expects salaries and employee benefits to increase by 3-5% annually.

Nine months ended September 30, 2004 compared to nine months ended September 30, 2003. Noninterest expense was \$7.2 million in the first nine months of 2004 and 2003, decreasing \$22,366. The largest component of noninterest expense was salaries and employee benefits, which increased \$259,030 to \$4.0 million from \$3.8 million in the nine months ended September 30, 2004 and 2003, respectively. This increase in salaries and employee benefits is primarily due to lower deferral of loan origination costs. Loan origination costs deferred in the first nine months of 2004 were \$424,889, compared to \$806,439 in the first nine months of 2003. The decrease in loan origination costs deferred was due to the reduction in the number of loans originated in the first nine months of 2004 compared to the first nine months of 2003. Other changes in salaries and employee benefits are primarily due to salary adjustments and increases in the cost of employer-provided medical insurance. Salary adjustments were the result of staffing changes and cost of living increases which took effect January 2004. Additional staffing was added in 2003 to meet the increasing sophistication of the Bank's operations. The increase in sophistication relates primarily to commercial lending operations and the Bank's wholly owned subsidiary, Oakleaf Financial. The expansion into these areas was undertaken to diversify operations and reduce the Bank's reliance on mortgage banking activities for non-interest income. Management believes that fee income produced by Oakleaf Financial will help to stabilize non-interest income from operations. To offset the increase in health insurance premiums for employees, the Bank instituted a premium sharing program in August 2003. Premium increases that were effective August 2004 for employer-provided health insurance were substantially paid by employees. Data processing expense decreased \$121,640, due to expenses incurred converting to a different servicer in the first quarter of 2003. At September 30, 2004, goodwill was not impaired and Management does not anticipate impairment in the year ending December 31, 2004. Management actively minimizes noninterest expense, although certain noninterest expenses are outside of Management's direct control. Management expects salaries and employee benefits to increase by 3-5% annually.

Cash Flows

Operating. Cash flows from operating activities are most significantly affected by net income and mortgage banking activities. Net income was \$1,344,016 and \$2,039,836 for the nine months ended September 30, 2004 and 2003, respectively. Gain on sale of loans was \$381,466 and \$1.4 million for the nine months ended September 30, 2004 and 2003, respectively. Loans originated for sale and proceeds from the sale of loans also decreased due to the historically low mortgage loan rates in 2003. Loans originated for sale were \$30.6 million and \$107.1 million for the nine months ended September 30, 2004 and 2003, respectively. Proceeds from sales of loans were \$31.3 million and \$110.9 million for the nine months ended September 30, 2004 and 2003, respectively. Because the Bank generally has a policy of selling long-term fixed rate mortgage loans, the volume of loan sales varies with customer demand for these loans. Affecting cash flows from operating activities are the add-backs of non-cash expenses, which include the provision for loan losses, depreciation, amortization of mortgage servicing rights and changes in other assets and liabilities.

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Investing. Cash flows from investing activities are most significantly affected by loans made to customers net of principal payments, changes in the Bank's investment portfolio, and increases in interest-bearing deposits in banks. For the nine months ended September 30, 2004 there was a net increase in loans of \$13.5 million, primarily commercial mortgages. Investment purchases and maturities also affect cash flows from investing activities. The Bank's management maintains investments at levels that balance returns with various risks. The Bank decreased its holdings of interest-bearing deposits in banks by \$4.0 million and \$12.4 million in the nine months ended September 30, 2004 and 2003, respectively. The Bank increased investment in securities available-for-sale by \$15.0 million and \$9.1 million in the nine months ended September 30, 2004 and 2003, respectively. Management seeks to use loans as its primary investment option. But in the absence of attractive loan opportunities or to further leverage the Bank's capital, the Bank may pursue additional investment alternatives. Considerations for investment decisions include interest rate risk, liquidity needs, liquidity risk, prepayment risk and credit risk.

Financing. Cash flows from financing activities are mostly affected by changes in deposits and borrowed funds. Deposits increased \$14.6 million and decreased \$3.8 million in the nine months ended September 30, 2004 and 2003, respectively. Certificates of deposit with balances greater than or equal to \$100,000 (commonly referred to as jumbo certificates), which normally carry greater interest rate sensitivity, increased to \$40.0 million at September 30, 2004 from \$29.4 million at December 31, 2003. The Bank views jumbo certificates of deposit as a source of liquidity. Transaction savings accounts and checking accounts increased \$1.4 million to \$102.5 million at September 30, 2004 from \$101.1 million at December 31, 2003. Transaction savings accounts and checking accounts represent 47.79% of deposits at September 30, 2004, compared to 50.59% of deposits at December 31, 2003. Bank management is actively attempting to retain and increase these core deposit account relationships. The transaction savings accounts and checking accounts provide relatively inexpensive funding for future growth, compared to alternative certificates of deposit and other borrowings at higher interest rates. In addition to deposit accounts, the Bank uses FHLB advances and repurchase agreements for financing its operating and investing activities. FHLB advances decreased \$3.9 million and \$6.0 million in the nine months ended September 30, 2004 and 2003, respectively. FHLB advances are secured by Bank assets. The primary assets used by the FHLB are loans secured by real estate. The Bank may pledge as collateral specific loans or categories of loans. This poses risk to the Bank and stockholders, in the fact these assets may become less liquid or subject to set-off. The borrowing base of the Bank is calculated by the FHLB, based substantially on mortgage loans outstanding. If the Bank's mortgage loan portfolio diminishes, it can impact the Bank's ability to utilize the FHLB as a source of funding and liquidity. The Bank also entered repurchase agreements for \$15.0 million in the first nine months of 2004. The repurchase agreements are collateralized by mortgage-backed securities with a market value at September 30, 2004 of \$17.8 million. Bancorp redeemed \$1.3 million of its common stock in open market transactions. The Bank will continue to use jumbo certificates of deposit, FHLB advances and repurchase agreements to supplement core deposits as its preferred source of funds.

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Financial Condition

General. The Bank's total assets at September 30, 2004 were \$312.4 million, compared to \$287.3 million at December 31, 2003, an increase of \$25.1 million or 8.73%. Most of the growth in total assets is in securities available for sale and commercial real estate loans. The Bank continued to sell long-term, fixed rate, residential mortgage loans. Management did not believe retaining these loans in portfolio was prudent asset management, during a time of historically low interest rates. The Bank maintained its disciplined approach to managing interest rate risk.

Loans. The Bank's net loans increased to \$227.7 million at September 30, 2004 from \$215.5 million at December 31, 2003. This increase was primarily due to residential mortgage loans and commercial real estate loans. Most of the increase in residential mortgages can be attributed to advances on revolving home equity loans, which were \$34.1 million at September 30, 2004, compared to \$27.7 million at December 31, 2003. The Bank sells long-term, fixed rate, residential mortgages in the secondary market. Historically, the major buyer of these loans has been the Federal Home Loan Mortgage Corporation (FHLMC). In 2003 the Bank entered into an arrangement to sell loans to Federal Home Loan Bank of Indianapolis (FHLBI). This relationship provides an alternative buyer for Bank loans and management believes this relationship may provide a higher profit margin on loans sold. Commercial mortgage loans increased to \$76.1 million, or 32.5% of gross loans, at September 30, 2004 from \$66.4 million, or 29.6% of gross loans, at December 31, 2003. The proceeds from sales of loans (primarily fixed-rate, residential mortgages) were \$31.3 million and \$110.9 million for the first nine months of 2004 and 2003, respectively. The mortgage loans originated for sale (\$30.6 million during the first nine months of 2004 and \$107.1 million during the first nine months of 2003) were primarily funded by the secondary mortgage market sales. The decision to sell fixed-rate mortgages with original maturities of 10-years or greater protects the Bank from the interest rate risk inherent in holding these longer term, fixed-rate loans and provides a source of liquidity to fund loan demand. An increase in market interest rates will continue to decelerate the pace of refinance activity in the residential loan portfolio, as the Bank intends to continue focusing its efforts on growing commercial loans.

At September 30, 2004, outstanding loan commitments were \$4.1 million and \$31.4 million on fixed and variable-rate loans, respectively. Of these loan commitments, Management expects \$3.3 million to be disbursed for new loans during the next six months. The additional loan commitments are unused lines of credit, which may be drawn at any time by the borrower. These loan commitments will be funded by interest-bearing deposits, maturing assets, and additional borrowings, if needed.

Loans serviced for others increased by \$612,571 to \$217.6 million at September 30, 2004 from \$217.0 million at December 31, 2003. This servicing portfolio consists of loans originated by the Bank and sold in the secondary mortgage market with servicing retained by the Bank. Management believes this provides the Bank with a competitive advantage in its market. The retention of servicing requires the Bank to keep a higher

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staffing level than if the servicing is sold. But many consumers have discovered the difficulties encountered when loan servicing is sold. The retention of servicing also allows the Bank to cross-sell other banking products and services to these customers. The value of the right to service is appraised quarterly and any temporary impairment of the value of servicing rights is recognized quarterly. The originated mortgage servicing rights asset had a valuation allowance at September 30, 2004 of \$2,334. This allowance was established to recognize the measured impairment of the asset. The Bank will continue to monitor the valuation of the servicing rights asset. If subsequent analysis shows changes in the appraised impairment, the valuation allowance will be adjusted to match the impairment. Management expects the value of servicing will increase as interest rates rise. Generally, consumers are less inclined to refinance a lower-than-market fixed rate mortgage when rates increase. If this logic prevails, the value of servicing should increase due to the expected increase in duration of the underlying cash flows.

Bancorp has no purchased mortgage servicing portfolio.

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The following table provides an analysis of the allowance for loan losses:

	Nine Months Ended September 30,		Year Ended December 31,		
	2004	2003	2003	2002	2001
Balance at the beginning of the period	\$2,294,157	\$1,920,037	\$1,920,037	\$1,300,000	\$ 803,744
Charge-offs:					
Residential mortgages	113,489	102,923	112,873	448,217	226,230
Commercial mortgages	199,284	91,507	128,959	121,053	42,900
Construction loans residential					
Construction loans commercial					
Commercial nonmortgage loans		67,921	121,566	130,718	175,675
Loans secured by deposits					
Other consumer and installment loans	100,876	84,386	142,776	250,118	162,412
Total charge-offs	413,649	346,737	516,174	950,106	607,217
Recoveries					
Residential mortgages	30,244	8,136	10,185		21,344
Commercial mortgages	4,716	2,998	5,230	2,966	
Construction loans residential					
Construction loans commercial					
Commercial nonmortgage loans	7,571			16,548	3,021
Loans secured by deposits					
Other consumer and installment loans	66,702	45,598	55,170	55,713	22,914
Total recoveries	109,233	56,732	70,585	75,227	47,279
Net charge-offs	304,416	290,004	445,589	874,879	559,938
Provision for loan losses	571,223	1,083,075	819,709	1,494,916	1,056,194
Balance at the end of the period	\$2,560,964	\$2,713,108	\$2,294,157	\$1,920,037	\$1,300,000

Ratio of net charge-offs during the period to Average loans outstanding during the period	0.13%	0.14%	0.21%	0.40%	0.25%
Allowance for loan losses to total loans	1.10%	1.25%	1.02%	0.88%	0.58%
Nonperforming assets to total assets	2.25%	1.53%	1.90%	1.76%	1.55%
Allowance for loan losses to nonperforming assets	36.47%	61.25%	41.22%	36.82%	29.91%

The following table shows the allocation of the allowance for loan losses at the dates indicated by loan type:

	<u>September 30, 2004</u>		<u>December 31, 2003</u>		<u>December 31, 2002</u>		<u>December 31, 2001</u>	
	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans
Residential mortgages	\$ 497,284	52.11%	\$ 448,026	52.90%	\$491,171	58.88%	\$304,503	67.13%
Commercial mortgages	1,621,365	32.54%	1,457,075	29.59%	956,217	23.24%	470,459	15.92%
Construction loans residential	11,016	3.91%	15,577	4.53%	8,651	3.70%	35,014	3.62%
Construction loans commercial	26,854	1.09%	3,506	2.18%	16,914	1.75%		