

CORNERSTONE BANCORP INC
Form 10KSB/A
April 25, 2003
Table Of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB/A
AMENDMENT NUMBER ONE

(Mark One)

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2002

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

For the transition period from _____ to _____

Commission file number: 0-25465

CORNERSTONE BANCORP, INC./CT

(Name of small business issuer in its charter)

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

Connecticut
(State or other jurisdiction
of incorporation or organization)

06-1524044
(I.R.S. Employer
Identification No.)

550 Summer St., Stamford, Connecticut
(Address of principal office)

06901
(Zip Code)

Issuer's telephone number: (203) 356-0111

Securities registered under Section 12(b) of the Exchange Act:

Common Stock, par value \$0.01 per share
(Title of Each Class)

American Stock Exchange
(Name of each exchange on which registered)

Securities registered under Section 12(g) of the Exchange Act:

None

(Title of Each Class)

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained herein, and no disclosure will be contained, to the best of the issuer's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment of this Form 10-KSB.

The issuer's revenues for the fiscal year ended December 31, 2002 were \$13,628,000.

The aggregate market value of the issuer's common stock held by non-affiliates of the issuer was \$15,522,432 based on the closing price of \$16.85 per share as of March 1, 2003.

The number of shares outstanding of the issuer's common stock as of March 14, 2003 was 1,219,515.

DOCUMENTS INCORPORATED BY REFERENCE

Proxy Statement for Annual Meeting of Shareholders to be held on May 21, 2003 Part III.

Transitional Small Business Disclosure Format (check one): Yes No

Table Of Contents

Cornerstone Bancorp, Inc. (the Company) hereby amends its Annual Report on Form 10-KSB, for the year ended December 31, 2002 and dated March 28, 2003.

Part II

Item 7. Financial Statements

In the original filing of the Company s Annual Report on Form 10-KSB (dated March 28, 2003), the independent auditor s name and address were inadvertently omitted from the Independent Auditor s Report as set forth in the electronically filed document. Consequently, the Company hereby amends Part II, Item 7 of the Annual Report by re-submitting the independent auditor s report and related financial statements.

Table Of Contents

**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Consolidated Financial Statements

Table of Contents

	Page
<u>Independent Auditors Report</u>	F 1
Consolidated Financial Statements:	
<u>Consolidated Statements of Condition as of December 31, 2002 and 2001</u>	F 2
<u>Consolidated Statements of Income for the Years Ended December 31, 2002 and 2001</u>	F 3
<u>Consolidated Statements of Stockholders Equity for the Years Ended December 31, 2002 and 2001</u>	F 4
<u>Consolidated Statements of Cash Flows for the Years Ended December 31, 2002 and 2001</u>	F 5
<u>Notes to Consolidated Financial Statements</u>	F 6 to F 27

Table Of Contents

Independent Auditors Report

The Board of Directors and Stockholders
Cornerstone Bancorp, Inc.:

We have audited the accompanying consolidated statements of condition of Cornerstone Bancorp, Inc. and subsidiary (the Company) as of December 31, 2002 and 2001, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Cornerstone Bancorp, Inc. and subsidiary as of December 31, 2002 and 2001, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ KPMG LLP
Stamford, Connecticut

January 27, 2003

F-1

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Consolidated Statements of Condition

December 31, 2002 and 2001

(Dollars in thousands, except per share data)

	<u>2002</u>	<u>2001</u>
Assets		
Cash and cash equivalents:		
Cash and due from banks (note 2)	\$ 11,304	\$ 8,700
Federal funds sold	22,900	15,599
	<u>34,204</u>	<u>24,299</u>
Securities, including collateral of \$5,815 in 2002 and \$8,101 in 2001 for borrowings under securities repurchase agreements (note 3):		
Available for sale, at fair value	11,392	9,779
Held to maturity, at amortized cost (fair value of \$27,811 in 2002 and \$35,957 in 2001)	26,758	35,349
	<u>38,150</u>	<u>45,128</u>
Loans held for sale (note 4)	7,244	755
Loans, net of allowance for loan losses of \$2,234 in 2002 and \$1,848 in 2001 (note 4)	121,475	104,784
Accrued interest receivable	1,081	1,075
Federal Home Loan Bank stock, at cost	521	466
Premises and equipment, net (note 5)	2,962	2,915
Deferred income taxes (note 8)	781	710
Bank-owned life insurance	5,113	1,037
Other assets	523	348
	<u>212,054</u>	<u>181,517</u>
Liabilities and Stockholders Equity		
Liabilities:		
Deposits:		
Demand (non-interest bearing)	\$ 46,610	\$ 33,673
Money market demand and NOW	32,805	35,493
Regular, club, and money market savings	34,106	29,824
Time (note 6)	69,500	55,483
	<u>183,021</u>	<u>154,473</u>
Borrowings under securities repurchase agreements (note 7)	5,723	8,041
Accrued interest payable	126	164
Securities purchased, not yet settled	2,529	

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

Other liabilities	1,317	898
	<u> </u>	<u> </u>
Total liabilities	192,716	163,576
	<u> </u>	<u> </u>
Commitments and contingencies (note 9)		
Stockholders' equity (notes 10 and 12):		
Common stock, par value \$0.01 per share. Authorized 5,000,000 shares; issued 1,279,365 shares in 2002 and 1,153,135 shares in 2001	13	12
Additional paid-in capital	13,954	11,816
Retained earnings	6,205	6,848
Treasury stock, at cost (71,461 shares in 2002 and 76,415 shares in 2001)	(749)	(880)
Unearned restricted stock awards	(183)	
Accumulated other comprehensive income, net of taxes (note 11)	98	145
	<u> </u>	<u> </u>
Total stockholders' equity	19,338	17,941
	<u> </u>	<u> </u>
Total liabilities and stockholders' equity	\$ 212,054	\$ 181,517
	<u> </u>	<u> </u>

See accompanying notes to consolidated financial statements.

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Consolidated Statements of Income

Years ended December 31, 2002 and 2001

(Dollars in thousands, except per share data)

	<u>2002</u>	<u>2001</u>
Interest income:		
Loans	\$ 9,423	\$ 9,039
Securities	1,921	1,727
Federal funds sold	224	936
	<u>11,568</u>	<u>11,702</u>
Interest expense:		
Deposits	3,010	3,689
Borrowings under securities repurchase agreements and Federal Home Loan Bank advances (note 7)	80	144
	<u>3,090</u>	<u>3,833</u>
	8,478	7,869
Net interest income		
Provision for loan losses (note 4)	363	91
	<u>8,115</u>	<u>7,778</u>
Net interest income after provision for loan losses		
Non-interest income:		
Deposit service charges	507	498
Gain on sale of loans (note 4)	595	
Bank-owned life insurance	153	8
Other	805	439
	<u>2,060</u>	<u>945</u>
Total non-interest income		
Non-interest expense:		
Salaries and employee benefits (notes 12 and 14)	4,009	3,273
Occupancy (note 9)	768	640
Furniture and equipment	390	409
Data processing	564	603
Professional fees	304	289
Advertising and promotion	204	113
Other	1,001	926
	<u>7,240</u>	<u>6,253</u>
Total non-interest expense		

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

	2,935	2,470
Income before income tax expense	2,935	2,470
Income tax expense (note 8)	1,115	970
	\$ 1,820	\$ 1,500
Net income	\$ 1,820	\$ 1,500
Earnings per common share (note 13):		
Basic	\$ 1.53	\$ 1.27
Diluted	1.48	1.24

See accompanying notes to consolidated financial statements.

F-3

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Consolidated Statements of Stockholders' Equity

Years ended December 31, 2002 and 2001

(Dollars in thousands, except per share data)

	Common Stock			
	Number of Shares Outstanding	Amount	Additional Paid-in Capital	Retained Earnings
Balances at December 31, 2000	1,065,744	\$ 11	\$ 11,657	\$ 5,818
Comprehensive income:				
Net income				1,500
Other comprehensive income (note 11)				
Total comprehensive income				
Cash dividends declared (\$0.3977 per share)				(470)
Shares issued in connection with:				
Dividend Reinvestment Plan	9,529	1	137	
Directors Compensation Plan	1,447		22	
Balances at December 31, 2001	1,076,720	12	11,816	6,848
Comprehensive income:				
Net income				1,820
Other comprehensive loss (note 11)				
Total comprehensive income				
Cash dividends declared (\$0.4398 per share)				(530)
Shares issued in connection with:				
Stock dividend	109,123	1	1,932	(1,933)
Restricted stock awards	11,450		52	
Stock option exercises	3,025		27	
Dividend Reinvestment Plan	6,687		112	
Directors Compensation Plan	899		15	
Balances at December 31, 2002	1,207,904	\$ 13	\$ 13,954	\$ 6,205
	Treasury Stock	Restricted Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balances at December 31, 2000	\$ (880)	\$	\$ (22)	\$ 16,584

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

Comprehensive income:

Net income				1,500
Other comprehensive income (note 11)		167		167

Total comprehensive income				1,667
----------------------------	--	--	--	-------

Cash dividends declared (\$0.3977 per share)				(470)
--	--	--	--	-------

Shares issued in connection with:

Dividend Reinvestment Plan				138
Directors Compensation Plan				22

Balances at December 31, 2001	(880)		145	17,941
-------------------------------	-------	--	-----	--------

Comprehensive income:

Net income				1,820
Other comprehensive loss (note 11)		(47)		(47)

Total comprehensive income				1,773
----------------------------	--	--	--	-------

Cash dividends declared (\$0.4398 per share)				(530)
--	--	--	--	-------

Shares issued in connection with:

Stock dividend				
Restricted stock awards	131	(183)		
Stock option exercises				27
Dividend Reinvestment Plan				112
Directors Compensation Plan				15

Balances at December 31, 2002	\$ (749)	\$ (183)	\$ 98	\$ 19,338
-------------------------------	----------	----------	-------	-----------

See accompanying notes to consolidated financial statements.

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Consolidated Statements of Cash Flows

Years ended December 31, 2002 and 2001

(In thousands)

	<u>2002</u>	<u>2001</u>
Operating activities:		
Net income	\$ 1,820	\$ 1,500
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	576	345
Provision for loan losses	363	91
Originations of loans held for sale	(22,578)	(1,586)
Proceeds from sales of loans held for sale	16,684	831
Deferred income tax (benefit) expense	(38)	10
(Increase) decrease in accrued interest receivable	(6)	49
Increase in other assets	(175)	(169)
(Decrease) increase in accrued interest payable	(38)	21
Increase in other liabilities	419	16
Income on bank-owned life insurance	(153)	(8)
Other adjustments, net	270	(7)
	<u> </u>	<u> </u>
Net cash (used in) provided by operating activities	(2,856)	1,093
Investing activities:		
Proceeds from maturities and calls of securities available for sale	3,497	12,013
Proceeds from maturities and calls of securities held to maturity	8,422	10,171
Purchases of securities available for sale	(2,683)	(3,039)
Purchases of securities held to maturity		(30,957)
Disbursements for loan originations (other than loans held for sale), net of principal repayments	(17,917)	(5,628)
Purchases of bank-owned life insurance	(3,923)	(99)
Purchases of Federal Home Loan Bank stock	(55)	(47)
Purchases of premises and equipment	(434)	(561)
	<u> </u>	<u> </u>
Net cash used in investing activities	(13,093)	(18,147)
Financing activities:		
Net increase in deposits	28,548	30,521
Net decrease in borrowings under securities repurchase agreements	(2,318)	(521)
Dividends paid on common stock	(515)	(455)
Proceeds from issuance of common stock	139	138
	<u> </u>	<u> </u>

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

Net cash provided by financing activities	25,854	29,683
Net increase in cash and cash equivalents	9,905	12,629
Cash and cash equivalents at beginning of year	24,299	11,670
Cash and cash equivalents at end of year	\$ 34,204	\$ 24,299
Supplemental information:		
Interest payments	\$ 3,128	\$ 3,812
Income tax payments	1,203	934
Increase in liability for securities purchased, not yet settled	2,529	
Loans transferred to repossessed assets	81	

See accompanying notes to consolidated financial statements.

Table Of Contents

**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

(1) Summary of Significant Accounting Policies

Cornerstone Bancorp, Inc. (the Bancorp) is a bank holding company formed by Cornerstone Bank (the Bank) for the purpose of owning all of the Bank's outstanding common stock. On March 1, 1999, each share of the Bank's common stock was exchanged on a one-for-one basis for the Bancorp's common stock. The Bank is a state-chartered commercial bank that provides a variety of loan and deposit services to individuals and businesses primarily in Southwestern Fairfield County, Connecticut. The Bank is subject to regulations of the Federal Deposit Insurance Corporation (the FDIC) and the State of Connecticut Department of Banking, and undergoes periodic examinations by those regulatory agencies. The Bancorp is subject to regulation and supervision by the Federal Reserve Board (the FRB). The Bank's deposit accounts are insured up to applicable limits by the Bank Insurance Fund of the FDIC.

Basis of Financial Statement Presentation

The consolidated financial statements include the accounts of the Bancorp, the Bank and Cornerstone Business Credit, Inc. (a wholly-owned subsidiary of the Bank which commenced small business lending operations in 2001) (collectively, the Company). Management has prepared these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. All significant intercompany balances and transactions have been eliminated in consolidation.

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ significantly from those estimates, as a result of changing conditions and future events. An estimate that is particularly critical and susceptible to near-term change is the allowance for loan losses, which is discussed below.

For purposes of the consolidated statements of cash flows, cash equivalents represent federal funds which are generally sold on an overnight basis.

Prior year amounts are reclassified, whenever necessary, to conform to the current year presentation. Earnings per share, dividends per share, and other share and per share data for all periods has been adjusted for the effect of the 10% stock dividend distributed in June 2002.

Securities

Securities are classified as either available for sale (representing securities that may be sold in the ordinary course of business) or as held to maturity (representing debt securities for which the Company has the ability and positive intent to hold until maturity). Management determines the classification of securities at the time of purchase. Securities held to maturity are reported at amortized cost. Securities available for sale are reported at fair value, with unrealized gains and losses reported on a net-of-tax basis in stockholders' equity as accumulated other comprehensive income or loss. Securities are not acquired for trading purposes.

F-6

Table Of Contents

**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

Purchases (sales) of securities are recorded on the trade date, and the resulting payables (receivables) are reported in the consolidated statements of condition. Gains and losses realized on sales of securities are determined using the specific identification method. Premiums and discounts on debt securities are amortized to interest income over the term of the security. Unrealized losses on securities are charged to earnings if management determines that the decline in fair value of a security is other than temporary.

As a member of the Federal Home Loan Bank (FHLB) of Boston, the Bank is required to hold a certain amount of FHLB stock. This stock is a non-marketable equity security and, accordingly, is reported at cost.

Loans

Loans are reported at unpaid principal balances less the allowance for loan losses, except for loans held for sale which are reported at the lower of cost or estimated market value in the aggregate. Gains and losses on sales of loans are recorded at settlement using the specific identification method. Interest income is accrued based on contractual rates applied to principal amounts outstanding. Loan origination and commitment fees, and certain direct origination costs, are deferred and amortized to interest income over the life of the related loan.

Loans past due 90 days or more as to principal or interest are placed on non-accrual status except for certain loans which, in management's judgment, are adequately secured and probable of collection. When a loan is placed on non-accrual status, previously accrued interest that has not been collected is reversed from current interest income. Thereafter, the application of principal or interest payments received on non-accrual loans is dependent on the expectation of ultimate repayment of the loan. If ultimate repayment is reasonably assured, payments are applied to principal and interest in accordance with the contractual terms. If ultimate repayment is not reasonably assured or management judges it to be prudent, any payments received are applied to principal until ultimate repayment is reasonably assured. Loans are returned to accrual status when they demonstrate a sufficient period of payment performance and are expected to be fully collectible as to principal and interest.

Allowance for Loan Losses

The allowance for loan losses represents management's estimate of probable credit losses inherent in the existing loan portfolio. The allowance is adjusted by periodic provisions for loan losses, and by charge-offs and recoveries. When amounts on specific loans are judged by management to be uncollectible, those amounts are charged-off to reduce the allowance for loan losses. Subsequent recoveries, if any, are restored to the allowance when realized.

F-7

Table Of Contents

**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

Management's determination of the allowance for loan losses is based on the results of continuing reviews of individual loans and borrower relationships, particularly the larger relationships included in the commercial and commercial real estate loan portfolios. These reviews consider factors such as the borrower's financial condition, historical and expected ability to make loan payments, and underlying collateral values. Management's determination of the allowance for loan losses also considers the level of past due and non-performing loans, the Company's historical loan loss experience, changes in loan portfolio mix, geographic and borrower concentrations, and current economic conditions. While management uses the best available information to determine the allowance for loan losses, future adjustments to the allowance may be necessary based on changes in economic and real estate market conditions, particularly in the Company's market area of Southwestern Fairfield County, Connecticut. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination.

Statement of Financial Accounting Standards (SFAS) No. 114, *Accounting by Creditors for Impairment of a Loan*, requires recognition of an impairment loss on a loan within its scope when it is probable that the lender will be unable to collect principal and/or interest payments in accordance with the terms of the loan agreement. SFAS No. 114 does not apply to large groups of smaller-balance homogeneous loans (such as residential mortgage and consumer loans) that are collectively evaluated for impairment in accordance with SFAS No. 5, *Accounting for Contingencies*. Measurement of impairment under SFAS No. 114 may be based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, based on the loan's observable market price or the collateral's fair value if the loan is collateral dependent. If the measure of an impaired loan is less than its recorded amount, an impairment allowance is established as part of the allowance for loan losses.

Premises and Equipment

Premises and equipment are reported at cost, less accumulated depreciation and amortization. Owned assets are depreciated using the straight-line method over the estimated useful lives of the assets (three to twenty years for equipment and thirty-five years for buildings). Leasehold improvements are amortized over the shorter of their estimated service lives or the term of the lease.

Bank-Owned Life Insurance

Bank-owned life insurance is reported at the cash surrender value of the underlying policies. Increases in the cash surrender value are recorded in non-interest income. Certain of these policies were purchased in consideration of the Company's obligations under the salary continuation agreements described in note 14.

Income Taxes

Deferred tax assets and liabilities are recognized for the estimated future tax effects attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted

Table Of Contents

**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

tax rates expected to apply to future taxable income. The effect on deferred tax assets and liabilities of an enacted change in tax rates is recognized in income tax expense in the period that includes the enactment date of the change.

A deferred tax liability is recognized for all temporary differences that will result in future taxable income. A deferred tax asset is recognized for all temporary differences that will result in future tax deductions, subject to reduction of the asset by a valuation allowance in certain circumstances. This valuation allowance is recognized if, based on an analysis of available evidence, management determines that it is more likely than not that a portion or all of the deferred tax asset will not be realized. The valuation allowance is subject to ongoing adjustments based on changes in circumstances that affect management's judgment about the realizability of the deferred tax asset. Adjustments to increase or decrease the valuation allowance are charged or credited, respectively, to income tax expense.

Earnings Per Common Share

Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common shareholders (net income less dividends on preferred stock, if any) by the weighted average number of common shares outstanding during the period. Diluted EPS is computed in a similar manner, except that the weighted average number of common shares is increased (using the treasury stock method) by additional common shares that would have been outstanding if all potentially dilutive securities (such as stock options and unvested restricted stock awards) were exercised or vested during the period.

Stock-Based Compensation

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

SFAS No. 123, *Accounting for Stock-Based Compensation*, encourages the use of a fair-value-based method of accounting for employee stock compensation plans, but permits the continued use of the intrinsic-value-based method of accounting prescribed by APB Opinion No. 25. Under SFAS No. 123, the grant-date fair value of options is recognized as compensation expense over the vesting period (if any). The Company has elected to continue to apply APB Opinion No. 25 and disclose the

F-9

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

pro forma information required by SFAS No. 123. Had stock-based compensation expense been recognized in accordance with SFAS No. 123, the Company's net income and earnings per common share would have been adjusted to the following pro forma amounts for the years ended December 31:

	<u>2002</u>	<u>2001</u>
	(In thousands, except per share data)	
Net income, as reported	\$ 1,820	\$ 1,500
Add restricted stock expense included in reported net income, net of related tax effects	23	
Deduct restricted stock and stock option expense determined under the fair-value-based method, net of related tax effects	(43)	(21)
Pro forma net income	<u>\$ 1,800</u>	<u>\$ 1,479</u>
Basic earnings per common share:		
As reported	\$ 1.53	\$ 1.27
Pro forma	<u>1.51</u>	<u>1.25</u>
Diluted earnings per common share:		
As reported	\$ 1.48	\$ 1.24
Pro forma	<u>1.46</u>	<u>1.22</u>

On a per share basis, the weighted average estimated fair values of options granted during 2002 and 2001 were \$2.68 and \$2.09, respectively. These fair values were estimated using the Black Scholes option-pricing model and the following weighted average assumptions: dividend yield of 2.6% in 2002 and 2.8% in 2001; expected volatility rates of 46% in 2002 and 14% in 2001; expected option life of eight years in 2002 and six years in 2001; and risk-free interest rates of 3.6% in 2002 and 4.3% in 2001.

Borrowings Under Securities Repurchase Agreements

The Company enters into transactions with certain of its commercial customers in which it sells U.S. Government Agency securities under an agreement to repurchase the identical securities from the customer at a later date. These transactions are accounted for as secured borrowings since the Company maintains effective control over the underlying securities which are pledged as collateral. The transaction proceeds are recorded as borrowings in the consolidated statements of condition, and the collateral securities continue to be carried as assets of the Company.

Segment Information

Public companies are required to report certain financial information about significant revenue-producing segments of the business for which such information is available and utilized by the chief operating decision maker. As a community-oriented financial institution, substantially all of the

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

Company's operations involve the delivery of loan and deposit services to customers. Management makes operating decisions and assesses performance based on an ongoing review of these community banking operations, which constitute the Company's only operating segment for financial reporting purposes.

(2) Cash Reserve Requirements

The Bank is required to maintain average reserve balances under the Federal Reserve Act and Regulation D issued thereunder. These reserves were \$2,885,000 and \$2,368,000 at December 31, 2002 and 2001, respectively, and are included in cash and due from banks in the consolidated statements of condition.

(3) Securities

The amortized cost, gross unrealized gains and losses, and fair values of securities are summarized below. Mortgage-backed securities consist of pass-through securities guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae.

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(In thousands)				
December 31, 2002				
Available for sale:				
U.S. Government Agency securities	\$ 9,082	\$ 160	\$	\$ 9,242
Mortgage-backed securities	2,152		(2)	2,150
Total	\$ 11,234	\$ 160	\$ (2)	\$ 11,392
Held to maturity:				
U.S. Government Agency securities	\$ 20,746	\$ 911	\$	\$ 21,657
Mortgage-backed securities	5,937	142		6,079
Other securities	75			75
Total	\$ 26,758	\$ 1,053	\$	\$ 27,811
December 31, 2001				
Available for sale:				
U.S. Government Agency securities	\$ 9,541	\$ 242	\$ (4)	\$ 9,779
Held to maturity:				
U.S. Government Agency securities	\$ 25,918	\$ 455	\$	\$ 26,373
Mortgage-backed securities	9,356	153		9,509
Other securities	75			75

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

Total	\$ 35,349	\$ 608	\$	\$ 35,957
-------	-----------	--------	----	-----------

There were no sales of securities during the years ended December 31, 2002 and 2001.

F-11

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

The following is a summary of the amortized cost and fair value of debt securities (other than mortgage-backed securities) at December 31, 2002, by remaining period to contractual maturity. Actual maturities may differ from contractual maturities because certain issuers have the right to call or prepay their obligations.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
(In thousands)				
One year or less	\$ 3,500	\$ 3,567	\$ 4,572	\$ 4,650
Over one year, less than five years	5,582	5,675	16,199	17,032
Five years or more			50	50
Total	\$ 9,082	\$ 9,242	\$ 20,821	\$ 21,732

In addition to securities pledged as collateral for the repurchase agreement borrowings described in note 7, securities with a fair value of \$2,068,000 and \$1,018,000 were pledged as collateral for other purposes at December 31, 2002 and 2001, respectively.

(4) Loans and Concentration of Credit Risk

Most of the Company's loans are granted to customers who reside or do business in Southwestern Fairfield County, Connecticut. In addition to this geographic concentration, loans collateralized by real estate or granted to customers in real estate-related industries comprise the majority of the portfolio. While collateral provides assurance as a secondary source of repayment, the Company's underwriting standards require that a borrower's present and expected cash flows be adequate to service the debt at loan origination.

The loan portfolio (excluding loans held for sale) consisted of the following at December 31:

	2002	2001
(In thousands)		
Loans secured by real estate:		
Residential	\$ 46,085	\$ 42,740
Non-residential	49,977	43,956
Construction	11,429	5,479
Commercial loans	14,024	12,039
Consumer and other loans	2,259	2,368
Total loans	123,774	106,582
Allowance for loan losses	(2,234)	(1,848)
Deferred loan (fees) costs, net	(65)	50
Total loans, net	\$ 121,475	\$ 104,784

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

Loans held for sale at December 31, 2002 consisted of residential mortgage and Small Business Administration (SBA) loans of \$7,057,000 and \$187,000, respectively. SBA loans held for sale were \$755,000 at December 31, 2001. The estimated market value of loans held for sale at December 31, 2002 and 2001 exceeded cost and, accordingly, a lower-of-cost-or-market adjustment was not required. Proceeds from sales of residential mortgage and SBA loans totaled \$16,684,000 in 2002, resulting in a gain on sale of \$595,000. The principal balances of SBA loans serviced for others, which are not included in the Company's consolidated statements of condition, totaled \$6,796,000 at December 31, 2002.

The following is a summary of changes in the allowance for loan losses for the years ended December 31:

	<u>2002</u>	<u>2001</u>
	(In thousands)	
Balance at beginning of year	\$ 1,848	\$ 1,589
Provision for loan losses	363	91
Loan charge-offs	(49)	(25)
Recoveries	72	193
	<u>2,234</u>	<u>1,848</u>
Balance at end of year	\$ 2,234	\$ 1,848

The following is an analysis of the recorded investment in impaired loans under SFAS No. 114 at December 31:

	<u>2002</u>	<u>2001</u>
	(In thousands)	
Total loans past due 90 days or more	\$ 1,758	\$ 1,106
Less loans on accrual status (adequately secured and probable of collection)	(1,609)	(904)
	<u>149</u>	<u>202</u>
Non-accrual loans past due 90 days or more	149	202
Loans current or past due less than 90 days for which interest payments are being applied to reduce principal	11	308
	<u>160</u>	<u>510</u>
Total recorded investment in impaired loans	\$ 160	\$ 510

Repayments of approximately \$1,292,000 on loans past due 90 days or more on accrual status at December 31, 2002 were received in January 2003.

The Company's impaired loans at December 31, 2002 and 2001 were real estate secured loans with collateral values in excess of the recorded investments. Accordingly, allowances for impairment losses were not required under SFAS No. 114. The Company's average recorded investment in impaired loans was \$367,000 in 2002 and \$474,000 in 2001.

F-13

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

Interest contractually due during the respective years on loans considered impaired at December 31 totaled \$14,000 in 2002 and \$65,000 in 2001. The portion of the 2002 and 2001 amounts actually collected was \$3,000 and \$50,000, respectively. No interest income was recorded on impaired loans in 2002 and 2001 while such loans were considered to be impaired.

(5) Premises and Equipment

Premises and equipment are summarized as follows at December 31:

	<u>2002</u>	<u>2001</u>
	(In thousands)	
Land	\$ 695	\$ 695
Buildings and improvements	2,028	1,979
Furniture and equipment	2,929	2,816
Vehicles	223	196
	<u>5,875</u>	<u>5,686</u>
Total	5,875	5,686
Less accumulated depreciation and amortization	2,913	2,771
	<u>2,962</u>	<u>2,915</u>
Premises and equipment, net	\$ 2,962	\$ 2,915

(6) Time Deposits

The following is a summary of time deposits by remaining period to contractual maturity at December 31:

	<u>2002</u>	<u>2001</u>
	(In thousands)	
90 days or less	\$ 21,461	\$ 12,122
91 to 180 days	10,110	9,291
181 days to one year	21,383	13,077
	<u>52,954</u>	<u>34,490</u>
Total one year or less	52,954	34,490
Over one year, less than two years	7,328	7,917
Over two years, less than three years	4,966	4,458
Over three years, less than four years	4,119	4,592
Over four years, less than five years	123	4,026
Greater than five years	10	
	<u>69,500</u>	<u>55,483</u>
Total	\$ 69,500	\$ 55,483

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

Time deposits of \$100,000 or more aggregated \$18,415,000 and \$12,122,000 at December 31, 2002 and 2001, respectively.

F-14

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

(7) Borrowings Under Securities Repurchase Agreements and Federal Home Loan Bank Advances

Information concerning borrowings under securities repurchase agreements follows as of and for the years ended December 31:

	<u>2002</u>	<u>2001</u>
	(Dollars in thousands)	
Repurchase agreement borrowings:		
At year end	\$ 5,723	\$ 8,041
Average for the year	5,889	7,721
Maximum at any month end	6,149	9,086
Fair value of collateral securities at year end	5,815	8,101
Weighted average interest rates on borrowings:		
At year end	1.42%	1.34%
Average for the year	1.34	1.78

The repurchase agreement borrowings at December 31, 2002 mature within three months. Interest expense on securities repurchase agreements was \$79,000 in 2002 and \$138,000 in 2001.

The Bank may borrow funds from the FHLB of Boston subject to certain limitations. Borrowings are secured by the Bank's investment in FHLB stock and a blanket security agreement that requires maintenance of specified levels of qualifying collateral (principally securities and residential mortgage loans) not otherwise pledged. The Bank's FHLB borrowing capacity in the form of advances and borrowings under a short-term line of credit was \$10,422,000 at December 31, 2002. There were no FHLB advances outstanding at December 31, 2002 and 2001. Interest expense on FHLB advances was \$1,000 in 2002 and \$6,000 in 2001.

(8) Income Taxes

The components of income tax expense are as follows for the years ended December 31:

	<u>2002</u>	<u>2001</u>
	(In thousands)	
Federal:		
Current	\$ 928	\$ 770
Deferred	(33)	9
	<u>895</u>	<u>779</u>
State:		
Current	225	190
Deferred	(5)	1
	<u>220</u>	<u>191</u>

Total income tax expense	\$	1,115	\$	970
--------------------------	----	-------	----	-----

F-15

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

The following is a reconciliation of income taxes computed using the federal statutory rate of 34% to the actual income tax expense for the years ended December 31:

	<u>2002</u>	<u>2001</u>
	(In thousands)	
Income tax at federal statutory rate	\$ 998	\$ 840
State income tax, net of federal tax benefit	145	126
Bank-owned life insurance and other items	(28)	4
	<u>1,115</u>	<u>970</u>
Actual income tax expense	\$ 1,115	\$ 970

The tax effects of temporary differences that give rise to deferred tax assets and liabilities are as follows at December 31:

	<u>2002</u>	<u>2001</u>
	(In thousands)	
Deferred tax assets:		
Allowance for loan losses	\$ 720	\$ 579
Non-accrual interest	101	227
Other deductible temporary differences	78	60
	<u>899</u>	<u>866</u>
Deferred tax liabilities:		
Net unrealized gain on securities available for sale	60	93
Other taxable temporary differences	58	63
	<u>118</u>	<u>156</u>
Net deferred tax assets	\$ 781	\$ 710

Based on the Company's historical and anticipated future pre-tax earnings, management believes that it is more likely than not that the Company's deferred tax assets will be realized.

(9) Commitments and Contingencies***Financial Instruments with Off-Balance Sheet Risk***

The Company is a party to commitments to originate loans, unused lines of credit and standby letters of credit (credit-related financial instruments) that involve, to varying degrees, elements of credit risk and interest rate risk in addition to the risks associated with loans

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

recognized in the consolidated statements of condition. Substantially all of these credit-related financial instruments have been entered into with customers in the Company's primary lending area described in note 4.

F-16

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

The contract amounts of credit-related financial instruments reflect the extent of the Company's involvement with those classes of financial instruments. The Company's exposure to credit loss in the event of nonperformance by the counterparty is represented by the contract amount. The Company uses the same credit policies in extending commitments, lines of credit and standby letters of credit as it does for on-balance sheet instruments.

The contract amounts of these off-balance sheet financial instruments at December 31, 2002 and 2001 are summarized below:

	<u>2002</u>	<u>2001</u>
	(In thousands)	
Unused lines of credit	\$ 14,745	\$ 15,317
Commitments to originate loans	1,817	
Standby letters of credit	1,650	1,595

Lines of credit and commitments to originate loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These agreements generally have fixed expiration dates, or other termination clauses, and may require payment of a fee. Since certain of the lines of credit and commitments are expected to expire without being funded, the contract amounts do not necessarily represent future cash requirements. In extending lines of credit and commitments, the Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer.

Substantially all of the Company's outstanding standby letters of credit are performance standby letters of credit within the scope of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. These are irrevocable undertakings by the Company, as guarantor, to make payments in the event a specified third party fails to perform under a nonfinancial contractual obligation. Most of the Company's performance standby letters of credit arise in connection with lending relationships and have terms of one year or less. The maximum potential future payments the Company could be required to make equals the contract amount of the standby letters of credit shown in the preceding table. The Company's recognized liability for performance standby letters of credit was insignificant at December 31, 2002.

The Company also enters into forward contracts to sell residential mortgage loans it has closed (loans held for sale) or that it expects to close (commitments to originate loans held for sale). These contracts are used to reduce the Company's market price risk during the period from the commitment date to the sale date. The notional amount of the Company's forward sales contracts was approximately \$8,900,000 at December 31, 2002. Changes in the fair value of the forward sales contracts, loan origination commitments and closed loans at December 31, 2002 were insignificant.

F-17

Table Of Contents

**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

Operating Lease Commitments

The Company was obligated under various operating leases for its branch offices and other office space at December 31, 2002. The leases include renewal options and require the Company to pay applicable costs for utilities, maintenance, insurance and real estate taxes. Rent expense under operating leases was \$433,000 in 2002 and \$325,000 in 2001.

At December 31, 2002, the future minimum rental payments under operating leases, excluding renewal option periods, were \$376,000 for 2003, \$346,000 for 2004, \$263,000 for 2005, \$122,000 for 2006 and \$32,000 for 2007.

Legal Proceedings

In the normal course of business, the Company is involved in various outstanding legal proceedings. In the opinion of management, after consultation with legal counsel, the outcome of such legal proceedings should not have a material effect on the Company's financial condition, results of operations or liquidity.

(10) Stockholders Equity

Regulatory Capital Requirements

The Bank is subject to FDIC regulations that require a minimum leverage ratio of Tier I capital to total adjusted assets of 4.0%, and minimum ratios of Tier I and total capital to risk-weighted assets of 4.0% and 8.0%, respectively. The Bancorp's consolidated regulatory capital must satisfy similar requirements established by the FRB for bank holding companies.

Under its prompt corrective action regulations, the FDIC is required to take certain supervisory actions (and may take additional discretionary actions) with respect to an undercapitalized bank. Such actions could have a direct material effect on a bank's financial statements. The regulations establish a framework for the classification of banks into five categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. Generally, a bank is considered well capitalized if it has a leverage (Tier I) capital ratio of at least 5.0%, a Tier I risk-based capital ratio of at least 6.0%, and a total risk-based capital ratio of at least 10.0%.

The foregoing capital ratios are based in part on specific quantitative measures of assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by the regulators about capital components, risk weightings and other factors.

Management believes that, as of December 31, 2002 and 2001, the Bank and the Bancorp met all capital adequacy requirements to which they are subject. Further, the most recent FDIC notification categorized the Bank as a well-capitalized institution under the prompt corrective action regulations. There have been no conditions or events since that notification that management believes have changed the Bank's capital classification.

F-18

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

The following is a summary of the Bank's actual capital amounts and ratios as of December 31, 2002 and 2001, compared to the FDIC requirements for minimum capital adequacy and for classification as a well-capitalized institution. The Bancorp's consolidated capital ratios at December 31, 2002 and 2001 were substantially the same as the Bank's actual ratios set forth below.

	FDIC Requirements					
	Bank actual		Minimum capital adequacy		Classification as well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
December 31, 2002						
Leverage (tier I) capital	\$ 18,991	9.2%	\$ 8,258	4.0%	\$ 10,323	5.0%
Risk-based capital:						
Tier I	18,991	13.0	5,861	4.0	8,790	6.0
Total	20,772	14.2	11,720	8.0	14,650	10.0
December 31, 2001						
Leverage (tier I) capital	\$ 17,673	9.6%	\$ 7,397	4.0%	\$ 9,247	5.0%
Risk-based capital:						
Tier I	17,673	14.7	4,799	4.0	7,198	6.0
Total	19,177	16.0	9,598	8.0	11,997	10.0

The Bank's actual Tier I capital represents total stockholder's equity, excluding the after-tax net unrealized gain or loss on securities available for sale. The Bank's actual risk-based capital represents Tier I capital plus the allowance for loan losses up to 1.25% of risk-weighted assets.

Dividends

On April 2, 2002, the Company announced a 10% stock dividend which was distributed on June 14, 2002 to shareholders of record as of May 31, 2002. Under the terms of the dividend, stockholders received a dividend of one share of common stock for every ten shares owned as of the record date. A total of 109,123 common shares was issued. An amount equal to the fair value of these shares was charged to retained earnings, with a corresponding combined increase in common stock and additional paid-in capital.

The Bancorp's ability to pay cash dividends to its shareholders is largely dependent on the ability of the Bank to pay cash dividends to the Bancorp. Under Connecticut banking law, the Bank is permitted to pay cash dividends to the Bancorp in any calendar year only to the extent of any net profits of the Bank for that calendar year combined with its retained net profits for the preceding two years. The Bank's net profits retained in 2002 and 2001 (after cash dividends) totaled \$2,417,000.

Dividend Reinvestment Plan

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

The Company's Dividend Reinvestment Plan permits shareholders to automatically reinvest cash dividends in voluntary purchases of new shares of the Company's common stock at the current market price. A shareholder can invest up to \$5,000 in additional shares each quarter. A total of 6,687 and 9,529 additional common shares were issued under this plan during 2002 and 2001, respectively.

F-19

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

Stock Repurchase Plan

In December 1999, the Company's Board of Directors approved a stock repurchase plan pursuant to which up to 100,000 common shares may be repurchased from time to time in open market and/or privately-negotiated transactions. A total of 76,415 treasury shares were repurchased pursuant to this plan during 2000, at a total cost of \$880,000 or an average of \$11.52 per share. There were no share repurchases in 2002 and 2001.

(11) Comprehensive Income

Total comprehensive income is reported in the consolidated statements of stockholders' equity and represents the sum of net income and items of other comprehensive income or loss. The Company's other comprehensive income or loss represents the change during the year in after-tax unrealized gains and losses on securities available for sale. Components of other comprehensive income are summarized as follows for the years ended December 31:

	<u>2002</u>	<u>2001</u>
	(In thousands)	
Net unrealized holding (losses) gains arising during the year on securities available for sale	\$ (80)	\$ 275
Related deferred income taxes	33	(108)
	<u> </u>	<u> </u>
Other comprehensive (loss) income	\$ (47)	\$ 167
	<u> </u>	<u> </u>

The Company's accumulated other comprehensive income, which is included as a separate component of stockholders' equity, represents the net unrealized gains of \$158,000 and \$238,000 on securities available for sale at December 31, 2002 and 2001, respectively, less related deferred income taxes of \$60,000 and \$93,000, respectively.

(12) Stock Compensation Plans***Stock Option Plan***

The Company's 1996 Incentive and Non-Qualified Stock Plan (the 1996 Plan) provides for the issuance of up to 225,500 shares of the Company's common stock, including outstanding stock options that were granted under the 1986 Incentive and Non-Qualified Stock Plan (the 1986 Plan). At December 31, 2002, a total of 27,228 options were available for future grants under the 1996 Plan.

The terms of the 1996 Plan and the 1986 Plan are substantially the same, except that the 1996 Plan also provides for grants of options to directors and for the issuance of Stock Appreciation Rights (SARs). No SARs have been granted as of December 31, 2002. Stock options have a ten-year term and an exercise price equal to the fair value of the Company's common stock on the grant date. Options vest

F-20

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

immediately, except for options granted to those directors who, on the date of grant, have fewer than five years of service as a director of the Company. Such options become exercisable beginning on the fifth anniversary of the date on which service as a director began.

Stock option transactions during 2001 and 2002 are summarized as follows:

	Number of options	Weighted average exercise price
Outstanding at December 31, 2000	154,363	\$ 11.36
Granted	25,025	13.54
Expired	(545)	13.61
Outstanding at December 31, 2001	178,843	11.66
Granted	12,155	15.36
Expired	(726)	13.61
Exercised	(3,025)	8.99
Outstanding at December 31, 2002	187,247	11.94

Substantially all stock options outstanding at December 31, 2002 and 2001 were exercisable at those dates. Outstanding options at December 31, 2002 consisted of 176,962 non-qualified options and 10,285 incentive options with weighted average exercise prices of \$12.13 and \$8.68, respectively. The weighted average remaining term of outstanding options was 4.7 years at December 31, 2002, with option exercise prices ranging from \$8.68 to \$17.82.

Restricted Stock Plan

An initial award of shares of restricted stock was made in January 2002 under the terms of the 2001 Restricted Stock Plan. An equal number of treasury shares was appropriated for distribution on vesting dates. The restricted shares vest 40% in January 2004 and 20% in each of January 2005, 2006 and 2007. The grant-date fair value of the shares awarded amounted to \$183,000 and is being recognized as compensation expense on a straight-line basis over the vesting period. Expense recognized in 2002 amounted to \$37,000.

Directors Compensation Plan

Under the Directors Compensation Plan, non-officer directors are compensated for their services in Company common stock or cash, based on an annual election made by each qualifying director at the first Board meeting subsequent to each annual meeting. Directors who elect to receive stock are issued a whole number of shares of stock equal to the amount of their compensation divided by the fair value of the Company's common stock as of the date of each Board meeting. A total of 899 shares and 1,447 shares were issued to directors under this plan during 2002 and 2001, respectively.

F-21

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

(13) Earnings Per Common Share

The following is a summary of the basic and diluted EPS calculations for 2002 and 2001:

	<u>Income ⁽¹⁾</u>	<u>Shares</u>	<u>Earnings Per Share</u>
(In thousands, except per share data)			
2002			
Basic EPS	\$ 1,820	1,191	\$ 1.53
Effect of dilutive securities ⁽²⁾		41	
Diluted EPS	<u>\$ 1,820</u>	<u>1,232</u>	<u>\$ 1.48</u>
2001			
Basic EPS	\$ 1,500	1,179	\$ 1.27
Effect of dilutive securities ⁽²⁾		26	
Diluted EPS	<u>\$ 1,500</u>	<u>1,205</u>	<u>\$ 1.24</u>

(1) Net income applicable to common stock equaled net income for both 2002 and 2001.

(2) The effect of dilutive securities represents the number of common-equivalent shares issuable from the assumed exercise of stock options or vesting of restricted stock, computed using the treasury stock method. An average of 6,050 and 42,955 anti-dilutive stock options were excluded from the computation of common-equivalent shares in 2002 and 2001, respectively.

(14) Employee Savings Plan and Salary Continuation Agreements

The Company maintains a 401(k) Savings Plan covering substantially all employees. The plan provides for matching contributions by the Company based on a percentage of employee contributions. Total matching contributions by the Company were \$74,000 in 2002 and \$64,000 in 2001.

Effective April 1, 2002, the Company entered into salary continuation agreements with certain executive officers, providing for specified benefit payments for a 15-year period commencing upon the executive's normal retirement date. The agreements also provide for specified benefits upon early termination, disability and death. The Company's obligation to pay these benefits is unfunded. Salaries and employee benefits expense includes an accrual of \$145 for the period from the effective date of the agreements through December 31, 2002.

(15) Related Party Transactions

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

Loans made to the Company's officers, employees, directors and their associates and affiliated businesses totaled \$4,311,000 at December 31, 2002. During 2002, new loans made directly or indirectly to these related parties totaled \$333,000 and payments totaled \$524,000. These loans were made in the ordinary course of business at prevailing credit terms (including interest rates, collateral and repayment terms), and do not involve more than a normal risk of collection.

F-22

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

In the ordinary course of business, the Company also engages in transactions with companies in which certain Company directors have a business interest. Payments to such companies for commissions, services and materials totaled \$94,000 in 2002 and \$10,000 in 2001. Management believes that the amounts paid by the Company are reasonable and approximate the amounts that would have been paid to independent third parties.

(16) Fair Value of Financial Instruments

SFAS No. 107 requires entities to disclose the fair value of financial instruments for which it is practicable to estimate fair value. The definition of a financial instrument includes many of the assets and liabilities recognized in the Company's consolidated statements of condition, as well as certain off-balance sheet items. Fair value is defined in SFAS No. 107 as the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation.

Quoted market prices are used to estimate fair values when those prices are available. However, active markets do not exist for many types of financial instruments. Consequently, fair values for these instruments must be estimated by management using techniques such as discounted cash flow analysis and comparison to similar instruments. Estimates developed using these methods are highly subjective and require judgments regarding significant matters such as the amount and timing of future cash flows and the selection of discount rates that appropriately reflect market and credit risks. Changes in these judgments often have a material effect on the fair value estimates. Since these estimates are made as of a specific point in time, they are susceptible to material near-term changes. Fair values disclosed in accordance with SFAS No. 107 do not reflect any premium or discount that could result from the sale of a large volume of a particular financial instrument, nor do they reflect possible tax ramifications or estimated transaction costs.

The following is a summary of the carrying amounts and estimated fair values of the Company's financial assets and liabilities (none of which were held for trading purposes) at December 31:

	2002		2001	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
(In thousands)				
Financial assets:				
Cash and cash equivalents	\$ 34,204	\$ 34,204	\$ 24,299	\$ 24,299
Securities	38,150	39,203	45,128	45,736
Loans	128,719	128,929	105,539	107,530
FHLB stock	521	521	466	466
Accrued interest receivable	1,081	1,081	1,075	1,075
Financial liabilities:				
Deposits without stated Maturities	113,521	113,521	98,990	98,990
Time deposits	69,500	70,196	55,483	56,118
Borrowings	5,723	5,723	8,041	8,041
Accrued interest payable	126	126	164	164

F-23

Table Of Contents

**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

The following is a description of the valuation methods used by management to estimate the fair values of the Company's financial instruments:

Securities

The fair values of securities were estimated based on quoted market prices or dealer quotes, if available. If a quote was not available, fair value was estimated using quoted market prices for similar securities.

Loans

The fair values of fixed rate loans were estimated by discounting projected cash flows using current rates for similar loans. For loans that reprice periodically to market rates, the carrying amount represents the estimated fair value.

Deposits

The estimated fair values of deposits without stated maturities (such as non-interest bearing demand deposits, savings accounts, NOW accounts and money market accounts) are equal to the amounts payable on demand. The fair values of time certificates of deposit were estimated based on the discounted value of contractual cash flows. The discount rates were based on rates currently offered for time deposits with similar remaining maturities.

In accordance with SFAS No. 107, these fair values do not include the value of core deposit relationships that comprise a significant portion of the Company's deposit base. Management believes that the Company's core deposit relationships provide a relatively stable, low-cost funding source that has a substantial unrecognized value separate from the deposit balances.

Other Financial Instruments

The remaining financial assets and liabilities listed in the preceding table have fair values that approximate the respective carrying amounts because they are payable on demand or have short-term maturities and present relatively low credit risk and interest rate risk.

Fair values of the lines of credit, loan origination commitments and standby letters of credit described in note 9 were estimated based on an analysis of the interest rates and fees currently charged by the Company for similar transactions, considering the remaining terms of the instruments and the creditworthiness of the potential borrowers. At December 31, 2002 and 2001, the fair values of these financial instruments approximated the related carrying amounts, which were insignificant.

(17) Recent Accounting Standards

SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires that long-lived assets be measured at the lower of carrying amount or fair value less the cost to sell, and broadens the reporting of discontinued operations. This statement was effective in 2002 but did not affect the Company's consolidated financial statements.

F-24

Table Of Contents

**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

SFAS No. 145, *Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, updates, clarifies and simplifies several existing accounting pronouncements. Among other things, SFAS No. 145 eliminates the requirement in SFAS No. 4 to report material gains and losses from extinguishments of debt as extraordinary items, net of related income taxes. Adoption of this statement did not affect the Company's 2002 consolidated financial statements.

SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, requires that a liability be recognized for these costs only when incurred. Prior to SFAS No. 146, a liability was recognized when an entity committed to an exit plan. This statement is effective for exit or disposal activities initiated after December 31, 2002.

SFAS No. 147, *Acquisitions of Certain Financial Institutions*, eliminates the requirement to amortize an excess of fair value of liabilities assumed over the fair value of assets acquired in certain acquisitions of financial institutions. SFAS No. 147 also amends SFAS No. 144 to include in its scope long-term customer relationship intangible assets of financial institutions, such as core deposit intangibles. Adoption of this statement did not affect the Company's 2002 consolidated financial statements.

SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*, amends SFAS No. 123 to provide alternative methods of transition for an entity that voluntarily changes to the fair-value-based method of accounting for stock-based employee compensation. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123 for fiscal years ending after December 15, 2002. The required disclosures applicable to the Company are included in note 1 to the consolidated financial statements.

FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, requires that certain disclosures be made by a guarantor in its financial statements about its obligations under guarantees. The required disclosures applicable to the Company are included in note 9 to the consolidated financial statements. The interpretation also requires the recognition, at fair value, of a liability by a guarantor at the inception of certain guarantees issued or modified after December 31, 2002. This recognition requirement is not expected to have a material impact on the Company's consolidated financial statements.

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, provides guidance on the identification of entities controlled through means other than voting rights. The interpretation specifies how a business enterprise should evaluate its interests in a variable interest entity to determine whether to consolidate that entity. A variable interest entity must be consolidated by its primary beneficiary if the entity does not effectively disperse risks among the parties involved. The adoption of this interpretation is not expected to have a significant effect on the Company's consolidated financial statements.

F-25

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

(18) Parent Company Financial Information

Set forth below are the Bancorp's condensed statements of condition as of December 31, 2002 and 2001, together with the related condensed statements of income and cash flows for the years then ended.

	<u>2002</u>	<u>2001</u>
	(In thousands)	
Condensed Statements of Condition		
Assets:		
Cash	\$ 213	\$ 152
Investment in the Bank	19,089	17,819
Other	215	95
	<u> </u>	<u> </u>
Total	\$ 19,517	\$ 18,066
	<u> </u>	<u> </u>
Liabilities and stockholders' equity:		
Liabilities	\$ 179	\$ 125
Stockholders' equity	19,338	17,941
	<u> </u>	<u> </u>
Total	\$ 19,517	\$ 18,066
	<u> </u>	<u> </u>
Condensed Statements of Income		
Dividends received from the Bank	\$ 700	\$ 515
Non-interest expense	318	190
	<u> </u>	<u> </u>
Income before income tax benefit and equity in the Bank's undistributed earnings	382	325
Income tax benefit	121	75
	<u> </u>	<u> </u>
Income before equity in the Bank's undistributed earnings	503	400
Equity in the Bank's undistributed earnings	1,317	1,100
	<u> </u>	<u> </u>
Net income	\$ 1,820	\$ 1,500
	<u> </u>	<u> </u>

F-26

Table Of Contents**CORNERSTONE BANCORP, INC.
AND SUBSIDIARY**

Notes to Consolidated Financial Statements

December 31, 2002 and 2001

	<u>2002</u>	<u>2001</u>
(In thousands)		
Condensed Statements of Cash Flows		
Cash flows from operating activities:		
Net income	\$ 1,820	\$ 1,500
Equity in the Bank's undistributed earnings	(1,317)	(1,100)
Other adjustments, net	(66)	(51)
	<u>437</u>	<u>349</u>
Net cash provided by operating activities	437	349
Cash flows from financing activities:		
Dividends paid on common stock	(515)	(455)
Proceeds from issuance of common stock	139	138
	<u>(376)</u>	<u>(317)</u>
Net cash used in financing activities	(376)	(317)
Net increase in cash	61	32
Cash at beginning of year	152	120
	<u>213</u>	<u>152</u>
Cash at end of year	\$ 213	\$ 152

F-27

Table Of Contents

SIGNATURES

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

CORNERSTONE BANCORP, INC.

(Registrant)

Date: April 24, 2003

/s/ MERRILL J. FORGOTSON

Merrill J. Forgotson

President and Chief Executive Officer

Date: April 24, 2003

/s/ ERNEST J. VERRICO

Ernest J. Verrico

Vice President and Chief Financial Officer

Table Of Contents

CERTIFICATIONS

I, Merrill J. Forgotson, certify that:

1. I have reviewed this annual report as amended on Form 10-KSB/A, Amendment Number 1 for year ended December 31, 2002 (the annual report) of Cornerstone Bancorp, Inc.;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

- a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
- b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the Evaluation Date); and
- c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
- b)

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: April 24, 2003

/s/ MERRILL J. FORGOTSON

Merrill J. Forgotson

President and Chief Executive Officer

Table Of Contents

I, Ernest J. Verrico, certify that:

1. I have reviewed this annual report as amended on Form 10-KSB/A, Amendment Number 1 for year ended December 31, 2002 (the annual report) of Cornerstone Bancorp, Inc.;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officers and I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

- a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
- b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the Evaluation Date); and
- c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
- b)

Edgar Filing: CORNERSTONE BANCORP INC - Form 10KSB/A

any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: April 24, 2003

/s/ ERNEST J. VERRICO

Ernest J. Verrico

Vice President and Chief Financial Officer