PFS BANCORP INC
Form 10QSB
November 15, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-QSB

(Mark One)

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2004

OR

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from ____________ to _______________

Commission File Number: 033233

PFS BANCORP, INC.

(Exact name of small business issuer as specified in its charter)

Indiana	35-2142534
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

Second & Bridgeway Streets, Aurora, Indiana 47001

(Address of principal executive offices)

(812) 926-0631

(Issuer's telephone number)

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

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

Yes [X]   No [ ]

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:
November 12, 2004 - 1,473,728 shares of common stock

Transitional Small Business Disclosure Format (Check one): Yes [ ] No [X]

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PFS Bancorp, Inc.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(In thousands, except share data)

	September 30, 2004	December
ASSETS		

Cash and due from banks	$ 1,106	$
Interest-bearing deposits in other financial institutions	2,410	4
Cash and cash equivalents	3,516	5
Investment securities designated as available for sale - at market	8,369	10
Investment securities held to maturity - at amortized cost, which approximates market	143	
Loans receivable - net	112,618	100
Office premises and equipment - at depreciated cost	981	1
Real estate acquired through foreclosure	-	
Federal Home Loan Bank stock - at cost	825	
Accrued interest receivable	470	
Prepaid expenses and other assets	103	
Prepaid income taxes	90	
Deferred income taxes	30	
Total assets	$127,145	$118
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits	$ 81,817	$ 88
Advances from the Federal Home Loan Bank	16,500	2
Advances by borrowers for taxes and insurance	165	
Accrued interest payable	11	
Other liabilities	1,277	
Total liabilities	99,770	91
Commitments	-	
Shareholders' equity		
Preferred stock, 5,000,000 shares authorized, $.01 par value; no shares issued	-	
Common stock - 10,000,000 shares authorized, $.01 par value; 1,551,293 shares issued	16	
Additional paid-in capital	15,029	15
Retained earnings - restricted	14,438	14
Less: 77,565 shares of treasury stock at September 30, 2004 and December 31, 2003	(1,282)	(1
Shares acquired by stock benefit plans	(1,730)	(1
Accumulated other comprehensive income - unrealized gains on securities designated as available for sale, net of related tax effects	904	
Total shareholders' equity	27,375	26
Total liabilities and shareholders' equity	$127,145	$118

PFS Bancorp, Inc.

CONSOLIDATED STATEMENTS OF EARNINGS

(In thousands, except per share data)

	Nine months ended September 30,	
	2004	2003

Interest income		
Loans	$3,923	$4,022
Investment securities	238	313
Interest-bearing deposits and other	34	63
Total interest income	4,195	4,398
Interest expense		
Deposits	1,052	1,517
Borrowings	128	2
Total interest expense	1,180	1,519
Net interest income	3,015	2,879
Provision for losses on loans	72	48
Net interest income after provision for losses on loans	2,943	2,831
Other operating income		
Loss on sale of investment securities	-	(28)
Gain (loss) on sale of repossessed property	(1)	10
Other operating	375	304
Total other operating income	374	286
General, administrative and other expense		
Employee compensation and benefits	1,281	1,152
Occupancy and equipment	248	257
Data processing	195	167
Federal deposit insurance premiums	38	39
Other operating	426	405
Provision for losses on real estate acquired through foreclosure	-	39
Total general, administrative and other expense	2,188	2,059
Earnings before income taxes	1,129	1,058
Income taxes		
Current	421	455
Deferred	40	(19)
Total income taxes	461	436
NET EARNINGS	$ 668	$ 622
EARNINGS PER SHARE		
Basic	$.48	$.45
Diluted	$.47	$.45

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PFS Bancorp, Inc.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

	Nine months ended September 30, 2004	Nine months ended September 30, 2003	Three m Septe 2004
Net earnings	$668	$622	$230
Other comprehensive income (loss), net of tax:			
Unrealized holding gains (losses) on securities during the period, net of taxes (benefits) of $22, $(50), $17 and $(4) for the respective periods	45	(98)	33
Reclassification adjustment for realized losses included in earnings, net of tax benefits of $10 in 2003	-	18	-
Comprehensive income	$713	$542	$266
Accumulated comprehensive income	$904	$803	$904

PFS Bancorp, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the nine months ended September 30,
(In thousands)

	2004	2003
Cash flows from operating activities:		
Net earnings for the period	$ 668	$ 622
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:		
Amortization of deferred loan origination fees	(29)	(48)
Amortization of premiums and discounts on investment securities - net	43	62
Federal Home Loan Bank stock dividends	(27)	-
Depreciation	119	133

Provision for losses on loans	72	48
Provision for losses on real estate acquired through foreclosure	-	39
Amortization expense of stock benefit plan	71	71
Loss on sale of investment securities	-	28
Loss (gain) on sale of repossessed assets	1	(10)
Increase (decrease) in cash due to changes in:		
Accrued interest receivable	(75)	44
Prepaid expenses and other assets	23	26
Other liabilities	329	191
Accrued interest payable	(1)	(13)
Income taxes		
Current	(70)	(169)
Deferred	40	(19)
Net cash provided by operating activities	1,164	1,005
Cash flows provided by (used in) investing activities:		
Purchase of investment securities designated as available for sale	(17,933)	(23,630)
Proceeds from maturities and repayment of investment securities	19,613	23,669
Proceeds from sale of investment securities	-	3,029
Loan principal repayments	21,168	27,266
Loan disbursements	(33,586)	(28,254)
Purchase of Federal Home Loan Bank stock	(40)	(18)
Purchase of office premises and equipment	(35)	(29)
Proceeds from sale of real estate acquired through foreclosure	218	-
Net cash provided by (used in) investing activities	(10,595)	2,033
Cash flows provided by (used in) financing activities:		
Net increase (decrease) in deposits	(6,511)	417
Proceeds from Federal Home Loan Bank advances	16,500	2,500
Repayment of Federal Home Loan Bank advances	(2,000)	(3,500)
Advances by borrowers for taxes and insurance	102	31
Purchase of treasury shares	-	(1,282)
Dividends on common shares	(331)	(338)
Net cash provided by (used in) financing activities	7,760	(2,172)
Net increase (decrease) in cash and cash equivalents	(1,671)	866
Cash and cash equivalents at beginning of period	5,187	5,225
Cash and cash equivalents at end of period	$ 3,516	$ 6,091

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PFS Bancorp, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

For the nine months ended September 30,
(In thousands)

	2004	2003
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Income taxes	$ 470	$ 649

Interest on deposits and borrowings	$ 1,181	$ 1,532
Supplemental disclosure of noncash investing activities:		
Unrealized gains (losses) on securities designated as available for sale, net of related tax effects	$ 45	$ (80)
Transfers from loans to real estate acquired through foreclosure	$ 50	$ -

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PFS Bancorp, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the nine and three months ended September 30, 2004 and 2003

Forward-Looking Statements

This Form 10-QSB contains certain forward-looking statements and information relating to the Company that are based on the beliefs of management as well as assumptions made by and information currently available to management. In addition, in those and other portions of this document, the words "anticipate," "believe," "estimate," "except," "intend," "should" and similar expressions, or the negative thereof, as they relate to the Company or the Company's management, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future looking events and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize or should underlying assumptions prove incorrect, actual results may vary from those described herein as anticipated, believed, estimated, expected or intended. The Company does not intend to update these forward-looking statements.

1. Basis of Presentation

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-QSB and, therefore, do not include information or footnotes necessary for a complete presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. Accordingly, these financial statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto of the Company for the year ended December 31, 2003. However, in the opinion of management, all adjustments (consisting of only normal recurring accruals) which are necessary for a fair presentation of the consolidated financial statements have been included. The results of operations for the nine and three month periods ended September 30, 2004, are not necessarily indicative of the results which may be expected for the entire year.

2. Principles of Consolidation

The accompanying consolidated financial statements include the accounts of PFS Bancorp, Inc. (the "Company") and its wholly-owned subsidiary, Peoples Federal Savings Bank (the "Savings Bank"). All significant intercompany items have been eliminated.

3. Earnings Per Share

Basic earnings per share is computed based upon the weighted-average common shares outstanding during the period less shares in the ESOP that are unallocated and not committed to be released. Weighted-average common shares deemed outstanding gives effect to 86,632 and 97,336 unallocated ESOP shares as of September 30, 2004 and 2003, respectively. Diluted earnings per share is computed taking into consideration common shares outstanding and the dilutive effect of additional potential common shares issuable under the Company's stock option plan. The computations are as follows:

	For the nine months ended September 30, 2004	For the nine months ended September 30, 2003	For the three months ended September 30, 2004	For the three months ended September 30, 2003
Weighted-average common shares outstanding (basic)	1,387,096	1,394,860	1,387,096	1,376,392
Dilutive effect of assumed exercise of stock options	10,269	1,793	11,986	1,793
Weighted-average common shares outstanding (diluted)	1,397,365	1,396,653	1,399,082	1,378,185

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PFS Bancorp, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

For the nine and three months ended September 30, 2004 and 2003

4. Stock Option Plan

The Board of Directors had previously adopted the PFS Bancorp, Inc. Stock Option Plan (the "Plan") which provides for the issuance of 152,088 shares of authorized but unissued shares of common stock at fair value at the date of grant. The initial options granted in June 2003 totaled 62,228 at an exercise price equal to fair value of $16.85. The Plan provides that one-fifth of the options granted become exercisable on each of the first five anniversaries of the date of grant.

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

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

		Nine months ended September 30,		Three months ended September 30,	
		2004	2003	2004	2003
Net earnings (In thousands)	As reported	$668	$622	$230	$204
	Stock-based compensation, net of tax	(21)	(7)	(7)	(7)
	Pro-forma	$647	$615	$223	$197
Earnings per share					
Basic	As reported	$.48	$.45	$.16	$.15
	Stock-based compensation, net of tax	(.01)	(.01)	-	(.01)
	Pro-forma	$.47	$.44	$.16	$.14
Diluted	As reported	$.47	$.45	$.16	$.15
	Stock-based compensation, net of tax	(.01)	(.01)	-	(.01)
	Pro-forma	$.46	$.44	$.16	$.14

PFS Bancorp, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

For the nine and three months ended September 30, 2004 and 2003

4. Stock Option Plan (continued)

A summary of the status of the Plan as of September 30, 2004 and December 31, 2003 is presented below:

	Nine months ended September 30, 2004		Year ended December 31, 2003	
	Shares	Weighted-average exercise price	Shares	Weighted-average exercise price
Outstanding at beginning of period	62,228	$16.85	-	$ -
Granted	-	-	62,228	16.85
Exercised	-	-	-	-
Forfeited	-	-	-	-
Outstanding at end of period	62,228	$16.85	62,228	$16.85
Options exercisable at period-end	12,446	$16.85	-	$ -
Weighted-average fair value of options granted during the period		$ -		$ 3.82

The following information applies to options outstanding at September 30, 2004:

Number outstanding	62,228
Range of exercise prices	$16.85
Weighted-average exercise price	$16.85
Weighted-average remaining contractual life	8.75 Years

5. Critical Accounting Policies

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances which could affect these judgments include, but without limitation, changes in interest rates, changes in the performance of the economy or changes in the financial condition of borrowers. Management believes that its critical accounting policies primarily focuses on determining the allowance for loan losses. The Company's critical accounting policies are discussed in detail in its Annual Report for the year ended December 31, 2003 (incorporated by reference into the Company's 10-KSB filing) in Note A of the Notes to the Consolidated Financial Statements under "Allowance for Loan Losses." If management were to underestimate the allowance for loan losses, earnings could be reduced in the future as a result of greater than expected net loan losses. Overestimations of the required allowance could result in future increases in income, as loan loss recoveries increase or provisions for losses on loans decrease.

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

Discussion of Financial Condition Changes from December 31, 2003 to September 30, 2004

At September 30, 2004, the Company's assets totaled $127.1 million, an increase of $8.9 million, or 7.5%, compared to total assets at December 31, 2003. The increase in assets was comprised primarily of a $12.3 million, or 12.3%, increase in loans receivable which was principally funded by additional advances from the Federal Home Loan Bank, which increased by $14.5 million.

Liquid assets (i.e. cash and interest-bearing deposits) decreased by $1.7 million, or 32.2%, from December 31, 2003 levels, to a total of $3.5 million at September 30, 2004. Investment securities available for sale totaled $8.4 million at September 30, 2004, a decrease of $1.6 million, or 16.4%, from December 31, 2003 levels. The decrease resulted primarily from investment maturities of $19.6 million, which were partially offset by security purchases totaling $17.9 million during the nine month period.

As previously stated, loans receivable increased by $12.3 million, or 12.3%, during the nine month period ended September 30, 2004, to a total of $112.6 million. Loan disbursements amounted to $33.6 million and were partially offset by principal repayments of $21.2 million. During the nine months ended September 30, 2004, loan originations were comprised of $18.5 million in loans secured by one- to four-family residential real estate, $1.1 million in loans secured by multifamily residential real estate, $9.0 million in loans secured by commercial and nonresidential real estate and $5.0 million in consumer and other loans.

The allowance for loan losses totaled $809,000 and $771,000 at September 30, 2004 and December 31, 2003, respectively. Nonperforming and impaired loans totaled $434,000 and $1.1 million at September 30, 2004 and December 31, 2003, respectively. The allowance for loan losses represented 186.4% and 67.7% of nonperforming and impaired loans as of September 30, 2004 and December 31, 2003, respectively. The allowance represented approximately .71% and .76% of the total loan portfolio at September 30, 2004 and December 31, 2003, respectively. At September 30, 2004, nonperforming and impaired loans were comprised of $426,000 in loans secured by one- to four-family residential real estate and $8,000 in commercial, consumer and other loans. Management believes such loans are adequately collateralized and does not presently expect to incur any material losses on such loans. Although management believes that its allowance for loan losses at September 30, 2004 was sufficient to cover known and inherent losses in the loan portfolio based upon the available facts and circumstances, there can be no assurance that additions to such allowance will not be necessary in future periods, which could adversely affect the Company's results of operations.

Deposits totaled $81.8 million at September 30, 2004, a decrease of $6.5 million, or 7.4%, from December 31, 2003 levels. The decline was due primarily to a withdrawal from one municipality account. While management generally strives to maintain a moderate level of growth in deposits through marketing and pricing strategies, the current low interest rate environment contributed to the reduction in deposits as depositors sought alternative investments. The decline in deposits was offset by a $14.5 million increase in advances from the Federal Home Loan Bank.

Shareholders' equity amounted to $27.4 million at September 30, 2004, an increase of $453,000, or 1.7%, from December 31, 2003 levels. The increase resulted primarily from the net earnings of $668,000, a $45,000 increase in unrealized gains on securities designated as available for sale, and $71,000 of amortization related to a distribution of shares in connection with the Company's recognition and retention plan, which were partially offset by the payment of dividends of $331,000.

Peoples is required to meet minimum capital standards promulgated by the Office of Thrift Supervision ("OTS"). At September 30, 2004, Peoples' regulatory capital was well in excess of the minimum capital requirements.

Comparison of Operating Results for the Three-Month Periods Ended September 30, 2004 and 2003

General

Net earnings for the three months ended September 30, 2004 amounted to $230,000, an increase of $26,000, or 12.7%, compared to the $204,000 in net earnings reported for the three month period ended September 30, 2003. The increase in earnings was due primarily to an $85,000, or 8.9%, increase in net interest income and a $21,000, or 18.9%, increase in other income which were partially offset by a $24,000 increase in the provision for losses on loans, a $44,000, or 6.2%, increase in general, administrative and other expense, and a $12,000, or 8.2%, increase in income taxes.

Net Interest Income

Total interest income amounted to $1.5 million for the three-month period ended September 30, 2004, an increase of $51,000, or 3.6%, from the same period in 2003. Interest income on loans totaled $1.4 million during the 2004 period, an increase of $72,000, or 5.6%, from the 2003 period. This increase was due primarily to a $15.3 million, or 15.9%, increase in the average balance of loans outstanding quarter to quarter, which was partially offset set by a 48 basis point decrease in the weighted-average yield quarter to quarter, to 4.90% for the quarter ended September 30, 2004. The decline in yield is due to the repricing of our adjustable mortgages.

Interest income on investment securities decreased by $22,000, or 23.2%, for the three months ended September 30, 2004, compared to the same quarter in 2003. This decline was due primarily to a $3.8 million, or 28.0%, decrease in the average balance outstanding, partially offset by a 19 basis point increase in the weighted-average yield to 3.02% for the quarter ended September 30, 2004. Interest income on other interest-bearing deposits increased by $1,000, or 7.1%, during the three months ended September 30, 2004, compared to the same period in 2003, due primarily to a 53 basis point increase in the weighted-average yield, to 1.48% for the 2004 quarter which was offset by a $1.8 million, or 31.2%, decrease in the average balance outstanding for the three month period. The decline in the average balance of investment securities and interest-bearing deposits was primarily due to the use of such funds to fund loan growth.

Interest expense on deposits totaled $343,000 for the three month period ended September 30, 2004, a decrease of $106,000, or 23.6%, from the $449,000 recorded for the same period in 2003. The reduction in interest on deposits was due primarily to a 40 basis point decline in the weighted-average cost of deposits in the 2004 period, coupled with a $5.2 million, or 6.1%, decrease in the average balance outstanding quarter to quarter. This decline in average outstanding deposits is primarily due to withdrawals from one municipality account. Interest expense on borrowings increased by $72,000 for the three month period ended September 30, 2004, as compared to no borrowing costs in the 2003 quarter.

Comparison of Operating Results for the Three-Month Periods Ended September 30, 2004 and 2003 (continued)

Provision for Losses on Loans

As a result of an analysis of historical experience, the volume and type of lending conducted by the Savings Bank, the status of past due principal and interest payments, general economic conditions, particularly as such conditions relate to the Savings Bank's market area, and other factors related to the collectibility of the Savings Bank's loan portfolio, management elected to record a provision for losses on loans totaling $24,000 for the quarter ending September 30, 2004, compared to no provision for losses on loans for the same period in 2003. The current period provision was predicated primarily upon the continuing change in the loan portfolio mix, including an increase in loans secured by nonresidential real estate, as well as an increase in the size of the loan portfolio and the general condition of the local economy. There can be no assurance that the loan loss allowance will be sufficient to cover losses on nonperforming assets in the future.

Other Income

Other income totaled $132,000 for the three month period ended September 30, 2004, an increase of $21,000, or 18.9%, over the same period in 2003. The increase in other income was due primarily to a $17,000, or 15.3%, increase in service fees and fee income as a result of return check fees and ATM fees. In addition, there was a $4,000 gain on the sale of repossessed property for the 2004 quarter compared to no gain or loss on the sale of repossessed property in the 2003 quarter.

General, Administrative and Other Expense

General, administrative and other expense totaled $757,000 for the three months ended September 30, 2004, an increase of $44,000, or 6.2%, compared to the same quarter in 2003. This increase was due primarily to a $77,000, or 20.5%, increase in employee compensation and benefits, a $7,000, or 10.9%, increase in data processing expenses, and a $4,000, or 3.0%, increase in other operating expenses which were partially offset by a $5,000, or 5.6% decrease in occupancy and equipment expense and a $39,000 decrease in the provision for losses on real estate acquired through foreclosure. The increase in employee compensation and benefits was attributable to increased costs associated with the Company's stock benefit plans, retirement plan and insurance premiums, as well as normal merit increases quarter to quarter.

Income Taxes

The income tax provision totaled $159,000 for the three month period ended September 30, 2004, an increase of $12,000, or 8.2%, compared to the same quarter in 2003. The income tax provision includes expense for federal and Indiana state income taxes. The combined effective tax rates were 40.9% and 41.9% for the three month periods ended September 30, 2004 and 2003, respectively.

Comparison of Operating Results for the Nine-Month Periods Ended September 30, 2004 and 2003

General

Net earnings for the nine months ended September 30, 2004 amounted to $668,000, an increase of $46,000, or 7.4%, compared to the $622,000 in net earnings reported for the nine month period ended September 30, 2003. The increase in earnings was due primarily to an $136,000, or

4.7%, increase in net interest income and an $88,000, or 30.8%, increase in other income, which were partially offset by a $24,000, or 50.0%, increase in the provision for losses on loans, an $129,000, or 6.3%, increase in general, administrative and other expense and a $25,000, or 5.7%, increase in income taxes.

Net Interest Income

Total interest income amounted to $4.2 million for the nine-month period ended September 30, 2004, a decrease of $203,000, or 4.6%, from the same period in 2003. Interest income on loans totaled $3.9 million during the 2004 period, a decrease of $99,000, or 2.5%, from the 2003 period. This decline was due primarily to a 65 basis point decrease in the weighted-average yield period to period, to 4.88% for the nine month period ended September 30, 2004, which was partially offset by a $10.3 million, or 10.6%, increase in the average balance of loans outstanding period to period. The decrease in the average-yield was due to the repricing of our adjustable mortgages. The increase in the average balance was due to increased origination activity.

Interest income on investment securities decreased by $75,000, or 24.0%, for the nine months ended September 30, 2004, compared to the same period in 2003. This decline was due primarily to a $4.3 million, or 29.7%, decrease in the average balance outstanding, partially offset by a 23 basis point increase in the weighted-average yield to 3.13% for the nine month period ended September 30, 2004. Interest income on other interest-bearing deposits decreased by $29,000, or 46.0%, during the nine months ended September 30, 2004, compared to the same period in 2003, due primarily to a $3.2 million, or 46.3%, decrease in the average balance outstanding for the nine month period. The decline in the average balance of investment securities and interest-bearing deposits was primarily due to the use of such funds to fund loan growth.

Interest expense on deposits totaled $1.1 million for the nine month period ended September 30, 2004, a decrease of $465,000, or 30.7%, from the $1.5 million recorded for the same period in 2003. The reduction in interest on deposits was due primarily to a 63 basis point decline in the weighted-average cost of deposits in the 2004 period and a $4.8 million, or 5.7%, decrease in the average balance outstanding for the nine month period. This decline in average outstanding balance of deposits was primarily due to withdrawals from the deposit account of one municipality. Interest expense on borrowings increased by $126,000 to $128,000 for the nine month period ended September 30, 2004 compared to the $2,000 borrowing cost recorded for the same period in 2003. This increase in interest expense on borrowings was due to an increase in the average balance of borrowings during 2004, which was used to fund loan growth.

Comparison of Operating Results for the Nine-Month Periods Ended September 30, 2004 and 2003 (continued)

Provision for Losses on Loans

As a result of an analysis of historical experience, the volume and type of lending conducted by the Savings Bank, the status of past due principal and interest payments, general economic conditions, particularly as such conditions relate to the Savings Bank's market area, and other factors related to the collectibility of the Savings Bank's loan portfolio, management elected to record a provision for losses on loans totaling $72,000 for the nine month period ending September 30, 2004 compared to $48,000 for the same period in 2003. The current period provision was predicated primarily upon the continuing change in the loan portfolio mix, including an increase in loans secured by nonresidential real estate, as well as an increase in the size of the loan portfolio and the general condition of the local economy. There can be no assurance that the loan loss allowance will be sufficient to cover losses on nonperforming assets in the future.

Other Income

Other income totaled $374,000 for the nine month period ended September 30, 2004, an increase of $88,000, or 30.8%, over the same period in 2003. The increase in other income was due primarily to a $71,000, or 23.4%, increase in service fees and fee income as a result of return check fees and ATM fees. In addition, there was a $28,000 net loss resulting from the sale of investment securities in the 2003 nine month period. The Company did not incur any comparable loss during the 2004 period.

General, Administrative and Other Expense

General, administrative and other expense totaled $2.2 million for the nine months ended September 30, 2004, an increase of $129,000, or 6.3%, compared to the same period in 2003. This increase was due primarily to an $129,000, or 11.2%, increase in employee compensation and benefits, a $28,000, or 16.8%, increase in data processing expenses, and a $21,000, or 5.2%, increase in other operating expense which were partially offset by a $9,000, or 3.5%, decrease in occupancy and equipment expense and a $39,000 decrease in the provision for losses on real estate acquired through foreclosure. The increase in employee compensation and benefits was attributable to increased costs associated with the Company's stock benefit plans, retirement plan and insurance premiums, as well as normal merit increases period to period.

Income Taxes

The income tax provision totaled $461,000 for the nine month period ended September 30, 2004, an increase of $25,000, or 5.7%, compared to the same period in 2003. The income tax provision includes expense for federal and Indiana state income taxes. The combined effective tax rates were 40.8% and 41.2% for the nine month periods ended September 30, 2004 and 2003, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS (CONTINUED)

Subsequent Events

Subsequent to September 30, 2004, it came to management's attention that a commercial real estate loan in which the Savings Bank has a 50% participation interest will be taken into real estate acquired through foreclosure. Control of the property was surrendered to the lead lender. The Savings Bank is carrying its participation interest at $403,000. The real estate collateral will be appraised in the near-term and the asset will be recorded at the lower of cost or fair value at the time it is classified as real estate acquired through foreclosure.

In October 2004, the Board of Directors declared a $5.00 per share special dividend. In order to finance payment of the dividend, the Company borrowed $3.5 million from another financial institution secured by the stock of the Savings Bank and certain mortgage loans.

Impact of Inflation and Changing Prices

The financial statements and related financial data presented herein have been prepared in accordance with instructions to Form 10-QSB, which require the measurement of financial position and operating results in terms of historical dollars, without considering changes in relative purchasing power over time due to inflation.

Unlike most industrial companies, virtually all of the Savings Bank's assets and liabilities are monetary in nature. As a result, interest rates generally have a more significant impact on a financial institution's performance than does the effect of inflation.

ITEM 3: Controls and Procedures

Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities and Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and are operating in an effective manner.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

ITEM 1. Legal Proceedings

Not applicable

ITEM 2. Changes in Securities and Small Business Issuer Purchases of Equity Securities

Not applicable

ITEM 3. Defaults Upon Senior Securities

Not applicable

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

Not applicable

ITEM 5. Other Information

None.

ITEM 6. Exhibits

EX-31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a)

EX-31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a)

EX-32.1 Section 1350 Certification of the Chief Executive Officer

EX-32.2 Section 1350 Certification of the Chief Financial Officer

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PFS Bancorp, Inc.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 12, 2004 By: /s/Mel E. Green

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                              Mel E. Green
                              President and Chief Executive Officer


Date: November 12, 2004   By: /s/Stuart M. Suggs
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                              Stuart M. Suggs
                              Corporate Treasurer, Chief Operating Officer,
                               and Chief Financial Officer
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