

# CAPSTONE BANK

*2008 Annual Report*

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# 2008 Annual Report

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*This Annual Report to Shareholders contains forward-looking statements. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, changes in the interest rate environment, management's business strategy, national, regional and local market conditions and legislative and regulatory conditions.*

*Readers should not place undue reliance on forward-looking statements, which reflect management's view only as of the date hereof. The Bank undertakes no obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances.*

## Independent Auditor's Report

Board of Directors and Shareholders  
CapStone Bank  
Raleigh, North Carolina

We have audited the balance sheets of CapStone Bank as of December 31, 2008 and 2007 and the related statements of operations, changes in shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting 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 financial statements referred to above present fairly, in all material respects, the financial position of CapStone Bank as of December 31, 2008 and 2007, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

*Elliott Davis, PLLC*

Galax, Virginia  
February 27, 2009

# Balance Sheets

December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
<b>Assets</b>		
Cash and due from banks	\$ 1,901,409	\$ 533,185
Interest-bearing deposits with banks	<u>4,452,644</u>	<u>22,426</u>
Cash and cash equivalents	6,354,053	555,611
Federal funds sold	14,000	24,000
Investment securities available-for-sale	28,752,132	18,846,580
Investment securities held-to-maturity	500,000	-
Restricted equity securities	1,177,100	505,500
Loans, net of allowance for loan losses of \$1,775,000 and \$1,047,000 for 2008 and 2007, respectively	113,439,446	82,680,312
Property and equipment, net	529,767	540,934
Accrued income	652,670	568,848
Derivative financial instrument	499,823	-
Other assets	<u>251,942</u>	<u>133,027</u>
Total assets	<u>\$ 152,170,933</u>	<u>\$ 103,854,812</u>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing	\$ 6,944,484	\$ 5,879,946
Interest-bearing	<u>90,019,217</u>	<u>57,665,922</u>
Total deposits	96,963,701	63,545,868
Federal funds purchased and securities sold under agreements to repurchase	7,902,511	7,436,370
FHLB borrowings	22,000,000	9,000,000
Accrued interest payable	260,275	391,151
Other liabilities	<u>782,299</u>	<u>461,420</u>
Total liabilities	<u>127,908,786</u>	<u>80,834,809</u>
Commitments and contingencies	-	-
<b>Shareholders' equity</b>		
Preferred stock, 1,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, \$5 par value; 10,000,000 shares authorized; 2,162,400 shares issued and outstanding for 2008 and 2007	10,812,000	10,812,000
Surplus	13,304,814	12,960,585
Retained deficit	(623,526)	(910,941)
Accumulated other comprehensive income	<u>768,859</u>	<u>158,359</u>
Total shareholders' equity	<u>24,262,147</u>	<u>23,020,003</u>
Total liabilities and shareholders' equity	<u>\$ 152,170,933</u>	<u>\$ 103,854,812</u>

See Notes to Financial Statements

# Statements of Operations

For the years ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
<b>Interest and dividend income</b>		
Loans and fees on loans	\$ 6,441,448	\$ 4,843,155
Federal funds sold	53,391	250,021
Investment securities, taxable	1,276,202	756,656
Investment securities, exempt from tax	74	-
Dividends	<u>31,430</u>	<u>14,392</u>
Total interest and dividend income	<u>7,802,545</u>	<u>5,864,224</u>
<b>Interest expense</b>		
Deposits	2,638,826	2,143,081
Federal funds purchased and securities sold under agreements to repurchase	121,846	135,098
FHLB borrowings	<u>581,098</u>	<u>146,605</u>
Total interest expense	<u>3,341,770</u>	<u>2,424,784</u>
Net interest income	4,460,775	3,439,440
<b>Provision for loan losses</b>		
Net interest income after provision for loan losses	<u>1,077,232</u>	<u>691,000</u>
	<u>3,383,543</u>	<u>2,748,440</u>
<b>Noninterest income</b>		
Service charges on deposit accounts	9,388	1,995
Net gains from sales of securities	103,296	-
Other service charges and fees	<u>78,681</u>	<u>11,829</u>
Total noninterest income	<u>191,365</u>	<u>13,824</u>
<b>Noninterest expense</b>		
Salaries and employee benefits	1,986,899	2,030,709
Occupancy and equipment expense	312,542	244,945
Marketing expense	101,035	111,942
Information systems expense	267,574	194,971
Other expense	<u>619,443</u>	<u>453,819</u>
Total noninterest expense	<u>3,287,493</u>	<u>3,036,386</u>
Net income (loss)	<u>\$ 287,415</u>	<u>\$ (274,122)</u>
<b>Basic earnings (loss) per common share</b>		
	<u>\$ .13</u>	<u>\$ (.13)</u>
<b>Diluted earnings (loss) per common share</b>		
	<u>\$ .13</u>	<u>\$ (.13)</u>
<b>Weighted average common shares outstanding</b>		
	<u>2,162,400</u>	<u>2,160,607</u>
<b>Weighted average dilutive common shares outstanding</b>		
	<u>2,168,623</u>	<u>2,160,607</u>

See Notes to Financial Statements

## Statements of Changes in Shareholders' Equity

For the years ended December 31, 2008 and 2007

	Common Stock		Surplus	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount				
<b>Balance, December 31, 2006</b>	2,160,000	\$ 10,800,000	\$ 12,609,753	\$ (636,819)	\$ 20,512	\$ 22,793,446
<b>Comprehensive loss</b>						
Net loss	-	-	-	(274,122)	-	(274,122)
Net change in unrealized appreciation on investment securities available for sale	-	-	-	-	137,847	137,847
<b>Total comprehensive loss</b>						(136,275)
Non-cash stock option expense	-	-	336,432	-	-	336,432
Issuance of stock	2,400	12,000	14,400	-	-	26,400
<b>Balance, December 31, 2007</b>	2,162,400	10,812,000	12,960,585	(910,941)	158,359	23,020,003
<b>Comprehensive income</b>						
Net income	-	-	-	287,415	-	287,415
Net change in unrealized appreciation on investment securities available for sale	-	-	-	-	303,359	303,359
Net change in fair value of derivatives	-	-	-	-	307,141	307,141
<b>Total comprehensive income</b>						897,915
Non-cash stock option expense	-	-	344,229	-	-	344,229
<b>Balance, December 31, 2008</b>	2,162,400	\$ 10,812,000	\$ 13,304,814	\$ (623,526)	\$ 768,859	\$ 24,262,147

See Notes to Financial Statements

# Statements of Cash Flows

For the years ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
<b><i>Cash flows from operating activities</i></b>		
Net income (loss)	\$ 287,415	\$ (274,122)
Adjustments to reconcile net income (loss) to net cash provided by operations:		
Depreciation and amortization	185,144	147,877
Provision for loan losses	1,077,232	691,000
Non-cash stock compensation expense	344,229	336,432
Amortization of premium on securities, net of accretion	(82,800)	(48,778)
Net realized (gain) on securities	(103,296)	-
Changes in assets and liabilities:		
Accrued income	(83,822)	(346,352)
Other assets	(212,252)	(166,789)
Accrued interest payable	(130,876)	350,754
Other liabilities	31,225	270,356
Net cash provided by operating activities	<u>1,312,199</u>	<u>960,378</u>
<b><i>Cash flows from investing activities</i></b>		
Net decrease in federal funds sold	10,000	17,908,000
Purchases of securities available-for-sale	(18,227,785)	(13,934,469)
Purchase of securities held-to-maturity	(500,000)	-
Proceeds from maturities, calls, and principal paydown of securities available-for-sale	5,748,609	3,324,256
Proceeds from sale of securities available for sale	3,253,388	-
Purchases of restricted equity securities	(671,600)	(458,293)
Net increase in loans	(31,836,366)	(55,256,239)
Purchases/disposal of property and equipment	(173,977)	(103,056)
Net cash used in investing activities	<u>(42,397,731)</u>	<u>(48,519,801)</u>
<b><i>Cash flows from financing activities</i></b>		
Net increase in deposits	33,417,833	32,779,683
Net increase in federal funds purchased and securities sold under agreements to repurchase	466,141	5,415,948
Net change in FHLB borrowings	13,000,000	9,000,000
Proceeds from issuance of common stock	-	26,400
Net cash provided by financing activities	<u>46,883,974</u>	<u>47,222,031</u>
Net increase (decrease) in cash and cash equivalents	5,798,442	(337,392)
<b><i>Cash and cash equivalents, beginning</i></b>	<u>555,611</u>	<u>893,003</u>
<b><i>Cash and cash equivalents, ending</i></b>	<u>\$ 6,354,053</u>	<u>\$ 555,611</u>
<b><i>Supplemental disclosure of cash flow information</i></b>		
Interest paid	<u>\$ 3,472,645</u>	<u>\$ 2,074,030</u>
Taxes paid	<u>\$ 399,448</u>	<u>\$ 125,000</u>

See Notes to Financial Statements

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# Notes to Financial Statements

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## **Note 1. Organization and Summary of Significant Accounting Policies**

### ***Organization***

CapStone Bank (the Bank) was organized and incorporated under the laws of the State of North Carolina and commenced operations on August 1, 2006. The Bank currently serves the city of Raleigh and Wake County, North Carolina and surrounding areas through its banking office in Raleigh, North Carolina. As a state chartered bank, which is not a member of the Federal Reserve, the Bank is subject to regulation by the State of North Carolina Banking Commission and the Federal Deposit Insurance Corporation.

The accounting and reporting policies of the Bank follow generally accepted accounting principles and general practices within the financial services industry. Following is a summary of the more significant policies:

### ***Critical Accounting Policies***

Management believes policies with respect to the methodology for the determination of the allowance for loan losses involves a high degree of complexity. Management must make difficult and subjective judgments which require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially.

### ***Business Segments***

The Bank reports its activities as a single business segment. In determining the appropriateness of segment definition, the Bank considers the materiality of a potential segment and components of the business about which financial information is available and regularly evaluated relative to resource allocation and performance assessment.

### ***Use of Estimates***

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

### ***Cash and Cash Equivalents***

For the purpose of presentation in the statement of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption “cash and due from banks” and “interest-bearing deposits with banks.”

### ***Securities***

Certain debt securities that management has the positive intent and ability to hold to maturity are classified as “held-to-maturity” and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings. Securities not classified as held-to-maturity or trading, including equity securities with readily determinable fair values, are classified as “available-for-sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. The Bank held no trading securities during the years presented.

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# Notes to Financial Statements

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## Note 1. Organization and Summary of Significant Accounting Policies, continued

### *Securities, continued*

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In determining whether other-than-temporary impairment exists, management considers many factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

### *Loans Receivable*

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal amount adjusted for any charge-offs and the allowance for loan losses. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method. Discounts and premiums on any purchased loans are amortized to income using the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments.

Interest is accrued and credited to income based on the principal amount outstanding. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest for the current year is reversed. Interest income is subsequently recognized on the cash-basis or cost-recovery method, as appropriate. When facts and circumstances indicate the borrower has regained the ability to meet the required payments, the loan is returned to accrual status. Past due status of loans is determined based on contractual terms.

### *Allowance for Loan Losses*

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

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

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

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# Notes to Financial Statements

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## Note 1. Organization and Summary of Significant Accounting Policies, continued

### *Allowance for Loan Losses, continued*

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

### *Derivative Financial Instruments*

Derivative financial instruments are recognized as assets and liabilities on the balance sheet and measured at fair value.

### *Interest Rate Swap Agreements*

For asset/liability management purposes, the Bank uses interest rate swap agreements to hedge various exposures or to modify interest rate characteristics of various balance sheet accounts. Interest rate swaps are contracts in which a series of interest rate flows are exchanged over a prescribed period. The notional amount on which the interest payments are based is not exchanged. These swap agreements are derivative instruments and generally convert a portion of the Bank's variable-rate debt to a fixed rate (cash flow hedge).

The gain or loss on a derivative designated and qualifying as a fair value hedging instrument, as well as the offsetting gain or loss on the hedged item attributable to the risk being hedged, is recognized currently in earnings in the same accounting period. The effective portion of the gain or loss on a derivative designated and qualifying as a cash flow hedging instrument is initially reported as a component of other comprehensive income and subsequently reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The ineffective portion of the gain or loss on the derivative instrument, if any, is recognized currently in earnings.

For cash flow hedges, the net settlement (upon close-out or termination) that offsets changes in the value of the hedged debt is deferred and amortized into net interest income over the life of the hedged debt. For fair value hedges, the net settlement (upon close-out or termination) that offsets changes in the value of the loans adjusts the basis of the loans and is deferred and amortized to loan interest income over the life of the loans. The portion, if any, of the net settlement amount that did not offset changes in the value of the hedged asset or liability is recognized immediately in non-interest income.

Interest rate derivative financial instruments receive hedge accounting treatment only if they are designated as a hedge and are expected to be, and are, effective in substantially reducing interest rate risk arising from the assets and liabilities identified as exposing the Bank to risk. Those derivative financial instruments that do not meet specified hedging criteria would be recorded at fair value with changes in fair value recorded in income. If periodic assessment indicated derivatives no longer provide an effective hedge, the derivative contracts would be closed out and settled, or classified as a trading activity.

Cash flows resulting from the derivative financial instruments that are accounted for as hedges of assets and liabilities are classified in the cash flow statement in the same category as the cash flows of the item being hedged.

### *Foreclosed Properties*

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value less anticipated cost to sell at the date of foreclosure establishing a new cost basis. After foreclosure, valuations are periodically performed by management, and the real estate is carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in loss on foreclosed real estate. The Bank held no foreclosed properties during the years presented.

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# Notes to Financial Statements

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## Note 1. Organization and Summary of Significant Accounting Policies, continued

### *Property and Equipment*

Bank premises, furniture and equipment, and leasehold improvements are carried at cost, less accumulated depreciation and amortization computed by the straight-line method over the following estimated useful lives:

	<u>Years</u>
Furniture and equipment	2-5
Computers and software	5

### *Transfers of Financial Assets*

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

### *Advertising Expense*

The Bank expenses advertising costs as they are incurred. These costs are included in marketing expense as presented in the statements of operations.

### *Income Taxes*

Provision for income taxes is based on amounts reported in the statements of income (after exclusion of non-taxable income such as interest on state and municipal securities) and consists of taxes currently due plus deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

The Bank has elected to defer FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109," in accordance with FASB Staff Position FIN 48-3, "Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises." It is the Bank's policy to evaluate uncertain tax positions pursuant to Statement of Financial Accounting Standard ("SFAS") No. 5, "Accounting for Contingencies." As of December 31, 2008 and 2007, the Bank had no uncertain tax positions requiring disclosure or recognition.

### *Basic Earnings per Share*

Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding during the period, after giving retroactive effect to stock splits and dividends.

### *Diluted Earnings per Share*

The computation of diluted earnings per share is similar to the computation of basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of those potential common shares.

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# Notes to Financial Statements

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## Note 1. Organization and Summary of Significant Accounting Policies, continued

### *Comprehensive Income*

Annual comprehensive income reflects the change in the Bank's equity during the year arising from transactions and events other than investment by and distributions to shareholders. It consists of net income plus certain other changes in assets and liabilities that are reported as separate components of shareholders' equity rather than as income or expense.

### *Stock Compensation Plans*

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R), *Share-Based Payment*, which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. SFAS No. 123(R) covers a wide range of share-based compensation, arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. The effect of the Statement is to require the Bank to measure the cost of employee services received in exchange for stock options based on the grant-date fair value of the award, and to recognize the cost over the period the employee is required to provide services for the award. SFAS No. 123(R) permits entities to use any option-pricing model that meets the fair value objective in the Statement.

Compensation cost has been measured using the fair value of awards on their grant dates and is recognized over the service period, which is usually the vesting period.

### *Fair Value of Financial Instruments*

Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Statement No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Bank.

The following methods and assumptions were used by the Bank in estimating its fair value disclosures for financial instruments:

*Cash and due from banks:* The carrying amounts reported in the balance sheet for cash and due from banks approximate their fair values.

*Interest-bearing deposits with banks:* The carrying amounts of interest-bearing deposits maturing within twelve months approximate their fair values. Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

*Securities:* Fair values for securities, excluding restricted equity securities, are based on quoted market prices. The carrying value of restricted equity securities approximates fair value based on the redemption provisions.

*Loans receivable:* For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts. The fair values for other loans are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics. Fair values for impaired loans are estimated using discounted cash flow analysis or underlying collateral values, where applicable. The carrying amount of accrued interest receivable approximates its fair value.

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# Notes to Financial Statements

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## Note 1. Organization and Summary of Significant Accounting Policies, continued

### *Fair Value of Financial Instruments, continued*

*Derivative financial instruments:* Fair values for interest rate swap agreements are based upon the amounts required to settle the contracts.

*Deposit liabilities:* The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

*Federal funds purchased and securities sold under agreements to repurchase:* The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing arrangements.

*FHLB Borrowings:* The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

The fair values of the Bank's long-term borrowings are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

### *Reclassification*

Certain amounts in the prior year financial statements have been reclassified to conform to the current year presentation. Net income and shareholders' equity previously reported were not affected by these reclassifications.

### *Recent Accounting Pronouncements*

The following is a summary of recent authoritative pronouncements that could impact the accounting, reporting, and/or disclosure of financial information by the Company.

In December 2007, the Financial Accounting Standards Board "FASB" issued SFAS No. 141(R), "Business Combinations," ("SFAS 141(R)") which replaces SFAS 141. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisitions by the Bank taking place on or after January 1, 2009. Early adoption is prohibited. Accordingly, a calendar year-end company is required to record and disclose business combinations following existing accounting guidance until January 1, 2009. The Bank will assess the impact of SFAS 141(R) if and when a future acquisition occurs.

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# Notes to Financial Statements

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## **Note 1. Organization and Summary of Significant Accounting Policies, continued**

### *Recent Accounting Pronouncements, continued*

In April 2008, the FASB issued FASB Staff Position No. 142-3, “Determination of the Useful Life of Intangible Assets,” (“FSP 142-3”). This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, “Goodwill and Other Intangible Assets,” (“SFAS 142”). The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R) and other U.S. generally accepted accounting principles. This FSP was effective for the Bank on January 1, 2009 and had no material impact on the Bank’s financial position, results of operations or cash flows.

In May, 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles,” (“SFAS 162”). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS 162 is effective November 15, 2008. The FASB has stated that it does not expect SFAS 162 will result in a change in current practice. The application of SFAS 162 had no effect on the Bank’s financial position, results of operations or cash flows.

FSP FIN 48-3, “Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises,” (“FSP FIN 48-3”) was issued in December 2008 to defer the effective date of FIN 48 for nonpublic enterprises to the annual financial statements for fiscal years beginning after December 15, 2008. Nonpublic companies are defined in amended SFAS 109, paragraph 289 as an enterprise other than one (a) whose debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), (b) that is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), or (c) whose financial statements are filed with a regulatory agency in preparation for the sale of any class of securities. As a nonpublic entity, the Bank is not required to adhere to FIN 48 for the year ended December 31, 2008, however the Bank is required to disclose their current accounting policy for uncertain tax positions. We do not expect the adoption of FIN 48 to have a significant impact on our financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Bank’s financial position, results of operations and cash flows.

### **Note 2. Restrictions on Cash**

To comply with banking regulations, the Bank is required to maintain certain average cash reserve balances. The daily average cash reserve requirement was approximately \$317,000 and \$1,000,000 for the periods including December 31, 2008 and 2007, respectively.

## Notes to Financial Statements

### Note 3. Securities

Debt and equity securities have been classified in the balance sheet according to management's intent. The carrying amount of securities and their approximate fair values at December 31, 2008 and 2007 are:

	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
<b>2008</b>				
<i>Available-for-sale</i>				
Government sponsored enterprises	\$ 7,751,067	\$ 132,856	\$ -	\$ 7,883,923
Municipal securities	551,924	3	-	551,927
Mortgage-backed securities	<u>19,697,769</u>	<u>618,513</u>	<u>-</u>	<u>20,316,282</u>
	<u>\$ 28,000,760</u>	<u>\$ 751,372</u>	<u>\$ -</u>	<u>\$ 28,752,132</u>
<i>Held-to-maturity</i>				
Subordinated debt	<u>\$ 500,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 500,000</u>
<b>2007</b>				
<i>Available-for-sale</i>				
Government sponsored enterprises	\$ 3,980,232	\$ 50,549	\$ -	\$ 4,030,781
Mortgage-backed securities	<u>14,608,644</u>	<u>208,252</u>	<u>1,097</u>	<u>14,815,799</u>
	<u>\$ 18,588,876</u>	<u>\$ 258,801</u>	<u>\$ 1,097</u>	<u>\$ 18,846,580</u>

All of the Bank's mortgage-backed securities are issued and guaranteed by U.S. Government sponsored enterprises.

Restricted equity securities consist of investments in common stock of the Federal Home Loan Bank of Atlanta ("FHLB"). The FHLB requires financial institutions to make equity investments in the FHLB in order to borrow from it. The Bank is required to hold that stock so long as it borrows from the FHLB.

Investment securities with amortized cost of approximately \$6,317,338 at December 31, 2008 were pledged as collateral for other purposes as required or permitted by law.

There were gross realized gains of \$103,296 and \$0 for the years ended December 31, 2008 and 2007, respectively.

The following table details unrealized losses and related fair values in the Bank's available-for-sale investment securities portfolios. This information is aggregated by the length of time that individual securities have been in a continuous unrealized loss position as of December 31, 2007. There were no individual securities with unrealized losses at December 31, 2008.

	<u>Less Than 12 Months</u>		<u>12 Months or Greater</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
<b>2007</b>						
Mortgage-backed securities	<u>\$ 974,128</u>	<u>\$ 1,097</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 974,128</u>	<u>\$ 1,097</u>

Management considers the nature of the investment, the underlying causes of the decline in market value, the severity and duration of the decline in market value and other evidence, on a security by security basis, in determining if the decline in market value is other than temporary. Management believes all unrealized losses presented in the table above to be temporary in nature.

## Notes to Financial Statements

### Note 3. Securities, continued

The scheduled contractual maturities of securities at December 31, 2008 were as follows:

	<u>Available-for-Sale</u>		<u>Held-to-Maturity</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in one year or less	\$ -	\$ -	\$ -	\$ -
Due after one year through five years	5,751,067	5,882,043	-	-
Due after five years through ten years	2,596,123	2,626,389	500,000	500,000
Due after ten years	19,653,570	20,243,700	-	-
	<u>\$ 28,000,760</u>	<u>\$ 28,752,132</u>	<u>\$ 500,000</u>	<u>\$ 500,000</u>

### Note 4. Loans Receivable

The major components of loans in the balance sheet at December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Commercial	\$ 11,196,924	\$ 11,468,670
Real estate:		
Construction and development	31,754,589	23,892,487
Residential, 1-4 families	15,381,151	11,181,292
Multi-family residential	5,794,673	3,499,915
Nonfarm nonresidential	38,965,473	24,048,363
Farmland	1,275,345	1,343,893
Consumer	10,686,169	8,337,291
Agricultural production	245,203	-
Deferred loan fees, net	(85,081)	(44,599)
	<u>115,214,446</u>	<u>83,727,312</u>
Allowance for loan losses	<u>(1,775,000)</u>	<u>(1,047,000)</u>
	<u>\$ 113,439,446</u>	<u>\$ 82,680,312</u>

### Note 5. Allowance for Loan Losses

An analysis of the allowance for loan losses is as follows:

	<u>2008</u>	<u>2007</u>
Balance at beginning of period	\$ 1,047,000	\$ 356,000
Provision for loan losses charged to operations	1,077,232	691,000
Recoveries of amounts charged off	-	-
Amounts charged off	(349,232)	-
Balance at end of period	<u>\$ 1,775,000</u>	<u>\$ 1,047,000</u>

There were no loans impaired, nonaccrual or past due 90 days or more at December 31, 2008 or 2007.

## Notes to Financial Statements

### Note 6. Property and Equipment

#### *Components of Property and Equipment*

Components of property and equipment and total accumulated depreciation at December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Furniture and equipment	\$ 701,883	\$ 480,297
Computers and software	<u>192,426</u>	<u>256,688</u>
Property and equipment, total	894,309	736,985
Less accumulated depreciation	<u>(364,542)</u>	<u>(196,051)</u>
Property and equipment, net of depreciation	<u>\$ 529,767</u>	<u>\$ 540,934</u>

#### *Leases*

The Bank has entered into an operating lease on its banking office in Raleigh, North Carolina. The amended term of this lease commenced on May 1, 2008 and will remain in effect through June 30, 2013, at which time the Bank has the option to extend the lease for one additional term of five years. The Bank's total rent expense for 2008 and 2007 was \$169,941 and \$135,085, respectively.

Future minimum payments under non-cancelable operating lease agreements are as follows:

<u>Year</u>	<u>Amount</u>
2009	\$ 197,691
2010	202,641
2011	207,687
2012	212,871
2013	<u>107,754</u>
Total	<u>\$ 928,644</u>

### Note 7. Deposits

The aggregate amount of time deposits in denominations of one hundred thousand dollars or more at December 31, 2008 and 2007 was approximately \$34,603,000 and \$22,551,000, respectively. At December 31, 2008, the scheduled maturities of time deposits (in thousands) are as follows:

	<u>Less Than \$100,000</u>	<u>\$100,000 or More</u>	<u>Total</u>
2009	\$ 16,603	\$ 26,870	\$ 43,473
2010 thru 2011	<u>3,608</u>	<u>7,733</u>	<u>11,341</u>
	<u>\$ 20,211</u>	<u>\$ 34,603</u>	<u>\$ 54,814</u>

## Notes to Financial Statements

### Note 8. Borrowings

#### *Federal Funds Purchased and Securities Sold Under Agreements to Repurchase*

Short-term debt consists of federal funds purchased and securities sold under agreements to repurchase, which generally mature within one day of the transaction date. Additional information is summarized below:

	<u>2008</u>	<u>2007</u>
Outstanding balance at December 31	\$ 7,902,511	\$ 7,436,370
Year-end weighted average rate	.39%	4.05%
Daily average outstanding during the period	\$ 8,014,056	\$ 2,996,000
Average rate for the period	1.91%	4.51%
Maximum outstanding at any month-end during the period	\$ 10,949,565	\$ 7,436,370

Securities sold under agreements to repurchase amounted to \$3,340,511 and \$5,720,300 at December 31, 2008 and 2007, respectively, which mature on a daily basis and are collateralized by securities issued by U.S. Government sponsored enterprises.

The Bank has established credit facilities to provide additional liquidity if and as needed. These consist of unsecured lines of credit with correspondent banks totaling \$17,600,000. At December 31, 2008 and 2007, \$4,562,000 and \$1,716,000 was outstanding under these credit facilities, respectively.

#### *FHLB Borrowings*

The Bank has an available line of credit with the FHLB equal to 25% of total assets. Advances under this line are secured by eligible securities and qualifying loans amounting to approximately \$26,000,000.

Advances from the FHLB of Atlanta consisted of the following at December 31, 2008 and 2007.

<u>Maturity</u>	<u>Interest Rate</u>	<u>2008</u>	<u>2007</u>
January 18, 2008	5.01%	\$ -	\$ 1,000,000
October 20, 2008	4.76%	-	1,000,000
January 5, 2009	.99%	5,000,000	-
January 16, 2009	3.32%	1,000,000	-
October 14, 2009	2.51%	1,000,000	-
November 20, 2009	2.36%	2,000,000	-
November 27, 2009	4.05%	2,000,000	2,000,000
January 19, 2010	3.19%	1,000,000	-
March 15, 2010	4.49%	-	2,000,000
April 14, 2010	2.62%	1,000,000	-
May 6, 2010	3.17%	1,000,000	-
May 14, 2010	3.36%	1,000,000	-
April 14, 2011	2.91%	1,000,000	-
May 12, 2011	3.33%	1,000,000	-
September 7, 2012	4.05%	3,000,000	3,000,000
March 5, 2018	3.68%	2,000,000	-
		<u>\$ 22,000,000</u>	<u>\$ 9,000,000</u>

# Notes to Financial Statements

## Note 9. Fair Value of Financial Instruments

The estimated fair values of the Bank's financial instruments are as follows (dollars in thousands):

	December 31, 2008		December 31, 2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial assets</b>				
Cash and due from banks	\$ 1,901	\$ 1,901	\$ 533	\$ 533
Interest-bearing deposits with banks	4,453	4,453	22	22
Investment securities, available for sale	28,752	28,752	18,847	18,847
Investment securities, held to maturity	500	500	-	-
Restricted equity securities	1,177	1,177	506	506
Loans, net of allowance for loan losses	113,439	113,505	82,680	83,611
Derivative financial instrument	500	500	-	-
<b>Financial liabilities</b>				
Deposits	96,964	98,987	63,546	63,601
Federal funds purchased and securities sold under agreements to repurchase	7,903	7,903	7,436	7,436
FHLB borrowings	22,000	22,261	9,000	9,062

FASB Statement No. 157, "Fair Value Measurements" ("SFAS No. 157"), defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

**Level 1** - Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

**Level 2** - Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

**Level 3** - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The following sections provide a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

**Securities:** Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. Currently, all of the Bank's securities are considered to be Level 2 securities.

**Impaired Loans:** SFAS No. 157 applies to loans measured for impairment using the practical expedients permitted by SFAS No. 114, "Accounting by Creditors for Impairment of a Loan," including impaired loans measured at an observable market price (if available), or at the fair value of the loan's collateral (if the loan is collateral dependent). Fair value of the loan's collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

## Notes to Financial Statements

### Note 9. Fair Value of Financial Instruments, continued

Derivative Financial Instrument: The fair value of the interest rate swap is determined using multiple market inputs including interest rates, prices, and indices to generate continuous yield or pricing curves and volatility factors, which are used to value the position.

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis.

<u>December 31, 2008</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investment securities available-for-sale	\$ 28,752,132	\$ -	\$ 28,752,132	\$ -
Net derivative financial instrument	<u>499,823</u>	<u>-</u>	<u>499,823</u>	<u>-</u>
Total assets at fair value	<u>\$ 29,251,955</u>	<u>\$ -</u>	<u>\$ 29,251,955</u>	<u>\$ -</u>
Total liabilities valued at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

There were no assets or liabilities recorded at fair value on a non-recurring basis.

### Note 10. Earnings per Share

The following table details the computation of basic and fully diluted earnings per share for the periods ended December 31, 2008 and 2007.

	<u>2008</u>	<u>2007</u>
Net income (loss) (income available to common shareholders)	<u>\$ 287,415</u>	<u>\$ (274,122)</u>
Weighted average common shares outstanding	2,162,400	2,160,607
<i>Effect of dilutive securities, options</i>	<u>6,223</u>	<u>-</u>
Weighted average common shares outstanding, diluted	<u>2,168,623</u>	<u>2,160,607</u>
Basic earnings (loss) per common share	<u>\$ .13</u>	<u>\$ (.13)</u>
Dilutive earnings (loss) per common share	<u>\$ .13</u>	<u>\$ (.13)</u>

Exercise of stock options discussed in the Benefit Plans note are not assumed in computing 2007 diluted earnings per share, as their exercise would be antidilutive.

### Note 11. Benefit Plans

#### *Defined Contribution Plan*

The Bank maintains a profit sharing plan pursuant to Section 401(k) of the Internal Revenue Code. The plan covers substantially all employees who are 21 years of age upon date of hire. Participants may contribute a percentage of compensation, subject to a maximum allowed under the Code. In addition, the Bank makes certain matching contributions and may make additional contributions at the discretion of the Board of Directors. Bank expense relating to the plan for the years ended December 31, 2008 and 2007 amounted to \$74,951 and \$73,826, respectively.

#### *Flexible Benefits Plan*

The Bank maintains a Flexible Benefits Plan which allows employees to make pre-tax salary contributions to a "flexible spending account" (FSA) to pay qualifying health and dependent care expenses.

## Notes to Financial Statements

### Note 11. Benefit Plans, continued

#### Stock Option Plans

In 2006 the Bank adopted both an Incentive Stock Option (ISO) Plan and a Nonstatutory Stock Option (NSO) Plan. Under each plan up to 216,000 shares may be issued for a total of 432,000 shares. Options granted under both plans expire no more than 10 years from date of grant. Option exercise prices under both plans shall be set by the Board of Directors at the date of grant, but shall not be less than 100% of fair market value of the related stock at the date of the grant. Options vest over five and three year periods from the date of the grant for the ISO and NSO Plans, respectively.

The Bank accounts for the plans in accordance with SFAS No. 123(R), *Share-Based Payment*, which requires that compensation cost relating to share-based payment transactions be recognized in the financial statements with measurement based upon the fair value of the equity or liability instruments issued. For the years ended December 31, 2008 and 2007, the Bank recognized \$344,229 and \$336,432 respectively, in compensation expense for stock options.

Activity under the plans during the years ended December 31, 2008 and 2007 are summarized below:

	Incentive Plan		Non-statutory Plan	
	Available for Grant	Granted	Available for Grant	Granted
<b><i>Balance December 31, 2006</i></b>	114,642	101,358	-	216,000
Forfeited	9,600	(9,600)	-	-
Granted	(24,000)	24,000	-	-
Exercised	-	(2,400)	-	-
<b><i>Balance December 31, 2007</i></b>	100,242	113,358	-	216,000
Forfeited	-	-	-	-
Granted	(14,500)	14,500	-	-
Exercised	-	-	-	-
<b><i>Balance December 31, 2008</i></b>	85,742	127,858	-	216,000

No cash was received during 2008 for options exercised. Cash received for options exercised during 2007 was \$26,400 with an intrinsic value of \$5,400.

## Notes to Financial Statements

### Note 11. Benefit Plans, continued

Additional information relating to the plan is listed below:

	<u>2008</u>	<u>2007</u>
<b><i>Outstanding options at December 31:</i></b>		
Weighted average exercise price:		
Beginning of the year	\$ 11.06	\$ 11.00
End of the year	\$ 11.16	\$ 11.06
Range of exercise prices:		
From	\$ 11.00	\$ 11.00
To	\$ 13.50	\$ 13.50
Weighted average remaining contractual life in years	7.71	8.64
Aggregate intrinsic value	\$ 852,035	\$ 803,895
Exercisable options	184,543	89,872
Weighted average exercise price of exercisable options	\$ 11.02	\$ 11.00
Weighted average remaining contractual life of exercisable options, in years	7.61	8.59
Aggregate intrinsic value of exercisable options	\$ 483,494	\$ 65,607
<b><i>Weighted average exercise price of options:</i></b>		
Granted during the year	\$ 13.50	\$ 11.81
Exercised during the year	\$ -	\$ 11.00
Forfeited during the year	\$ -	\$ 11.00
Expired during the year	\$ -	\$ -
<b><i>Grant-date fair value:</i></b>		
Options granted during the year, total	\$ 53,447	\$ 86,710
Options granted during the year, weighted average	3.69	3.61
<b><i>Significant assumptions used in determining fair value:</i></b>		
Risk-free interest rate	3.45%	4.57%
Expected life in years	7	7
Expected dividends	.75%	.75%
Expected volatility	20%	20%
<b><i>Results of operations:</i></b>		
Compensation cost recognized in income for all stock-based compensation awards	<u>\$ 344,229</u>	<u>\$ 336,432</u>

At December 31, 2008, unrecognized compensation costs amounted to \$383,414 which will be expensed over the next five years.

The weighted average fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option-pricing model. The expected volatility is based on historical volatility. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on historical exercise experience. The dividend yield assumption is based on the Bank's history and expectation of dividend payouts.

# Notes to Financial Statements

## Note 12. Income Taxes

### *Current and Deferred Income Tax Components*

The components of income tax expense for the years ended December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Current	\$ 489,551	\$ 72,532
Deferred	(350,090)	(158,378)
Deferred tax asset valuation allowance change	<u>(139,461)</u>	<u>85,846</u>
	<u>\$ -</u>	<u>\$ -</u>

### *Rate Reconciliation*

A reconciliation of income tax expense (benefit) computed at the statutory federal income tax rate to income tax expense included in the statement of operations for the period ended December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Tax at statutory federal rate	\$ 97,721	\$ (93,201)
Compensation expense	29,249	26,597
Other	12,491	(19,242)
Deferred tax asset valuation allowance change	<u>(139,461)</u>	<u>85,846</u>
	<u>\$ -</u>	<u>\$ -</u>

### *Deferred Income Tax Analysis*

The significant components of net deferred tax assets at December 31, 2008 and 2007 are summarized as follows:

	<u>2008</u>	<u>2007</u>
<i>Deferred tax assets</i>		
Allowance for loan losses	\$ 548,460	\$ 371,145
Pre-opening expenses	217,636	234,933
Stock-based compensation	240,826	141,288
Deferred gain on termination of swap	<u>159,363</u>	<u>-</u>
Deferred tax asset	<u>1,166,285</u>	<u>747,366</u>
<i>Deferred tax liabilities</i>		
Unrealized gain on securities available for sale	289,654	99,345
Unrealized gain on interest rate swap	192,682	-
Depreciation	119,708	62,086
Prepaid expenses	20,346	12,549
Deferred loan costs	30,114	30,364
Accretion of bond discount	<u>6,220</u>	<u>2,560</u>
Deferred tax liability	<u>658,724</u>	<u>206,904</u>
Deferred tax asset valuation allowance	<u>(341,968)</u>	<u>(481,429)</u>
Net deferred tax asset	<u>\$ 165,593</u>	<u>\$ 59,033</u>

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# Notes to Financial Statements

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## Note 13. Commitments and Contingencies

### *Litigation*

In the normal course of business the Bank may be involved in various legal proceedings. The Bank was not involved in any litigation during the year ended December 31, 2008.

### *Financial Instruments with Off-balance-sheet Risk*

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, credit risk in excess of the amount recognized in the balance sheet.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments

The Bank uses the same credit policies in making commitments and conditional obligations as for on-balance-sheet instruments. A summary of the Bank's commitments at December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Commitments to extend credit	\$ 40,652,600	\$ 30,494,000
Standby letters of credit	75,764	100,000
	<u>\$ 40,728,364</u>	<u>\$ 30,594,000</u>

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above and is required in instances which the Bank deems necessary.

### *Concentrations of Credit Risk*

Substantially all of the Bank's loans and commitments to extend credit have been granted to customers in the Bank's market area and such customers are generally depositors of the Bank. The concentrations of credit by type of loan are set forth in Note 4. The distribution of commitments to extend credit approximates the distribution of loans outstanding. The Bank's primary focus is toward small and medium sized commercial businesses, and accordingly, it does not have a significant number of credits to any single borrower or group of related borrowers in excess of \$3.7 million.

The Bank from time to time may have cash and cash equivalents on deposit with financial institutions that exceed federally-insured limits.

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## Notes to Financial Statements

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### **Note 13. Commitments and Contingencies, continued**

#### *Other Commitments*

The Bank has entered into an employment agreement with its President covering duties, salary, benefits, and provisions for termination and Bank obligations in the event of merger or acquisition. The Bank has also entered into several changes of control agreements with certain other officers detailing the Bank's obligation in the event of a merger or acquisition.

### **Note 14. Regulatory Restrictions**

#### *Dividends*

The Bank, as a North Carolina banking corporation, may pay dividends only out of undivided profits (retained earnings) as determined pursuant to North Carolina General Statutes Section 53-87. However, regulatory authorities may limit payment of dividends by any bank when it is determined that such a limitation is in the public interest and is necessary to ensure financial soundness of the bank. Additionally, dividends for the first three years of operations of new banks are explicitly prohibited by the North Carolina Banking Commission and the Federal Deposit Insurance Corporation unless special exceptions are made.

#### *Capital Requirements*

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital to risk-weighted assets, and of Tier I capital to average assets, as all those terms are defined in the applicable regulations. As of December 31, 2008 and 2007, Management believes that the Bank met all capital adequacy requirements to which it was subject.

As of December 31, 2008, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category.

## Notes to Financial Statements

### Note 14. Regulatory Restrictions, continued

#### Capital Requirements, continued

The Bank's actual capital amounts and ratios are also presented in the table. (dollars in thousands)

	<u>Actual</u>		<u>Minimum Capital Requirement</u>		<u>Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<b>December 31, 2008</b>						
Total Capital						
(to Risk-Weighted Assets)	\$ 24,802	20.1%	\$ 9,859	8.0%	\$ 12,324	10.0%
Tier I Capital						
(to Risk-Weighted Assets)	\$ 23,259	18.9%	\$ 4,930	4.0%	\$ 7,394	6.0%
Tier I Capital						
(to Average Assets)	\$ 23,259	15.8%	\$ 5,872	4.0%	\$ 7,340	5.0%
<b>December 31, 2007</b>						
Total Capital						
(to Risk-Weighted Assets)	\$ 23,810	25.7%	\$ 7,427	8.0%	\$ 9,284	10.0%
Tier I Capital						
(to Risk-Weighted Assets)	\$ 22,763	24.5%	\$ 3,714	4.0%	\$ 5,570	6.0%
Tier I Capital						
(to Average Assets)	\$ 22,763	28.2%	\$ 3,225	4.0%	\$ 4,031	5.0%

### Note 15. Comprehensive Income

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available-for-sale and unrealized gains and losses on cash flow hedges which are also recognized as separate components of equity.

The components of other comprehensive income are as follows:

	<u>Years Ended December 31,</u>	
	<u>2008</u>	<u>2007</u>
Unrealized holding gains on available-for-sale securities	\$ 406,655	\$ 137,847
Reclassification adjustment for gains realized in income	(103,296)	-
Net unrealized gains	303,359	137,847
Change in fair value of derivatives used for cash flow hedges	307,141	-
Total other comprehensive income	<u>\$ 610,500</u>	<u>\$ 137,847</u>

The components of accumulated other comprehensive income, included in stockholders' equity, are as follows:

	<u>Years Ended December 31,</u>	
	<u>2008</u>	<u>2007</u>
Net unrealized gain on securities available-for-sale	\$ 461,718	\$ 158,359
Net unrealized gain on derivatives used for cash flow hedges	307,141	-
Total accumulated other comprehensive income	<u>\$ 768,859</u>	<u>\$ 158,359</u>

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## Notes to Financial Statements

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### Note 16. Transactions with Related Parties

The Bank has entered into transactions with its directors, significant shareholders and their affiliates (related parties). Such transactions were made in the ordinary course of business on substantially the same terms and conditions, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other customers, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features.

Aggregate loan transactions with related parties were as follows:

	<u>2008</u>	<u>2007</u>
<i>Balance, beginning</i>	\$ 5,306,608	\$ 5,076,531
New loans and advances	4,916,016	3,606,761
Repayments	<u>(3,972,819)</u>	<u>(3,376,684)</u>
<i>Balance, ending</i>	<u>\$ 6,249,805</u>	<u>\$ 5,306,608</u>

### Note 17. On-Balance Sheet Derivative Instruments and Hedging Activities

#### *Derivative Financial Instrument*

The Bank has a stand alone derivative financial instrument in the form of an interest rate swap agreement, which derives its value from underlying interest rates. This type of transaction involves both credit and market risk. The notional amount is an amount on which calculations, payments, and the value of the derivative is based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the derivative instrument, is reflected separately on the balance sheet.

#### *Derivative Financial Instrument, continued*

The Bank is exposed to credit-related losses in the event of nonperformance by the counterparty to this agreement. The Bank controls the credit risk of its financial contract through limits and monitoring procedures, and does not expect its counterparty to fail its obligations. The Bank's interest rate swap agreement is executed under a standardized contract.

#### *Risk Management Policies-Hedging Instruments*

One of the primary focuses of the Bank's asset/liability management program is to control its risk by monitoring the sensitivity of the Bank's net income and portfolio value under varying interest rate scenarios. On a quarterly basis, the Bank simulates its net portfolio value and net income expected to be earned over a twelve-month period following the date of simulation. The simulation is based on a projection of market interest rates at varying levels and estimates the impact of such market rates on the levels of interest-earning assets and interest-bearing liabilities during the measurement period. Based upon the outcome of the simulation analysis, the Bank considers the use of derivatives as a means of reducing the volatility of net portfolio value and projected net income within certain ranges of projected changes in rates.

#### *Interest Rate Risk Management-Cash Flow Hedging Instrument*

The Bank is asset sensitive, i.e., its interest-earning assets, on an aggregate basis, reprice faster than its interest-bearing liabilities, primarily due to its level of prime based loans. As a result, declining interest rates have a negative impact on the Bank's net income. During 2008, management felt it was prudent to limit a portion of the risk of declining rates and entered into an interest rate swap agreement whereby the Bank receives fixed interest rate payments and makes variable interest rate payments determined by a specified index (prime) during the contract period.

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## Notes to Financial Statements

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### Note 17. On-Balance Sheet Derivative Instruments and Hedging Activities, continued

#### *Interest Rate Risk Management-Cash Flow Hedging Instrument, continued*

At December 31, 2008, the information pertaining to the outstanding interest rate swap agreement used to hedge prime rate loans is as follows:

Notional amount	<u>\$ 10,000,000</u>
Weighted average receive rate	<u>6.06%</u>
Weighted average pay rate (prime rate)	<u>3.25%</u>
Weighted average maturity in years	<u>2.4</u>
Unrealized gain relating to interest rate swap	<u>\$ 307,141</u>

At December 31, 2008, the unrealized gain relating to the interest rate swap is reflected separately on the balance sheet. Changes in the fair value of interest rate swaps designated as hedging instruments of the variability of cash flows associated with prime rate loans are reported in other comprehensive income. These amounts subsequently are reclassified into interest income as a yield adjustment in the same period in which the related interest on the prime rate loans affects earnings. During 2008, \$167,957 was reclassified into interest income.

Risk management results for the year ended December 31, 2008 related to the balance sheet hedging of prime rate loans indicate that the hedge was 99.97 percent effective.

#### *Interest Rate Swap Termination*

The original notional amount of the interest rate swap was \$20,000,000. In late 2008, the Bank terminated \$10,000,000 of the swap agreement at a gain of \$420,000, which will be recognized into interest income over the remaining original maturity of the agreement.

### Note 18. Subsequent Event

Subsequent to December 31, 2008, the Bank terminated the remaining \$10,000,000 of the swap agreement discussed in Note 17 at a gain of approximately \$450,000.

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# Board of Directors and Bank Management

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## Board of Directors

**Carole S. Anders** ..... *Community Volunteer*

**Ronald A. Batchelor, CPA** ..... *Partner, Batchelor, Tillery & Roberts, LLP*

**Robert A. Boyette** ..... *President, Ashland Construction Co.*

**Ronald P. Gibson** ..... *Retired, Former CEO of Highwoods Properties, Inc.*

**Robert L. Guthrie** ..... *Retired, Insurance Business*

**R. Merrill Hunter, MD** ..... *Cardiovascular Surgeon  
Carolina Cardiovascular Associates, PA*

**Steven R. Ogburn** ..... *President and CEO, CapStone Bank*

**R. Doyle Parrish** ..... *CEO, Summit Hospitality Group Ltd.*

**Michael S. Patterson** ..... *Executive Chairman, CapStone Bank*

**Edythe M. Poyner** ..... *President, Capital Land Investment Co.*

**Richard A. Urquhart, III** ..... *Vice President, Investors Management Corporation*

**Sydnor M. White, Jr.** ..... *President, White Oak Commercial, Inc.*

**Charles P. Wilkins** ..... *Attorney/Member  
Broughton, Wilkins, Smith, Sugg, and Thompson, PLLC*

## Bank Management

**Michael S. Patterson** ..... *Executive Chairman*

**Steven R. Ogburn** ..... *President and Chief Executive Officer*

**Rex D. Williams** ..... *Chief Financial Officer*

**Robert E. Branch** ..... *Senior Vice President – Chief Credit Officer*

**Rex M. Scott** ..... *Senior Vice President – Chief Operations Officer*

**Susan Gilbert Tannery** ..... *Senior Vice President – Corporate Secretary*

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## Shareholder Information

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### Annual Meeting

The annual meeting of shareholders will be held on Wednesday, March 18, 2009 at 10:00 a.m. at North Ridge Country Club, 6612 Falls of Neuse Road, Raleigh, North Carolina.

### Requests for Information

Requests for information should be directed to Ms. Susan Tannery, Corporate Secretary, at CapStone Bank, 4505 Falls of Neuse Road, Suite 100, Raleigh, North Carolina, 27609; telephone (919) 256-6803.

#### Independent Auditors

Elliott Davis, PLLC  
Certified Public Accountants  
Post Office Box 760  
Galax, Virginia 24333

#### Corporate Counsel

Gaeta & Eveson, P.A.  
Attorneys at Law  
8305 Falls of Neuse Road  
Suite 203  
Raleigh, North Carolina 27615

#### Stock Transfer Agent

First Citizens Bank  
Institutional Advisory Services  
Mail Code FCC61  
P.O. Box 29522  
Raleigh, North Carolina 27626

### Federal Deposit Insurance Corporation

The Bank is a member of the FDIC. This statement has not been reviewed, or confirmed for accuracy or relevance by the Federal Deposit Insurance Corporation.

#### Offices

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Suite 100  
Raleigh, North Carolina 27609

<http://www.capstonebank.com>