

CAPSTONE BANK

2009 Annual Report

2009 Annual Report

Table of Contents

Independent Auditor's Report.....	1
Balance Sheets.....	2
Statements of Operations.....	3
Statements of Changes in Shareholders' Equity.....	4
Statements of Cash Flows.....	5
Notes to Financial Statements.....	6
Board of Directors and Bank Management.....	27
Shareholder Information.....	28

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, 2009 and 2008 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, 2009 and 2008, 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
March 3, 2010

Balance Sheets

December 31, 2009 and 2008

	<u>2009</u>	<u>2008</u>
Assets		
Cash and due from banks	\$ 2,627,625	\$ 1,901,409
Time and other interest-bearing deposits with financial institutions	<u>20,205,505</u>	<u>4,452,644</u>
Cash and cash equivalents	22,833,130	6,354,053
Federal funds sold	-	14,000
Investment securities available-for-sale	25,429,234	28,752,132
Investment securities held-to-maturity	500,000	500,000
Restricted equity securities	1,308,900	1,177,100
Loans, net of allowance for loan losses of \$2,437,317 and \$1,775,000 for 2009 and 2008, respectively	128,877,872	113,439,446
Property and equipment, net	391,801	529,767
Accrued income	653,737	652,670
Derivative financial instrument	-	499,823
Foreclosed properties	105,000	-
Bank owned life insurance	3,014,290	-
Other assets	<u>1,487,371</u>	<u>251,942</u>
Total assets	<u>\$ 184,601,335</u>	<u>\$ 152,170,933</u>
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing	\$ 10,306,067	\$ 6,944,484
Interest-bearing	<u>111,219,126</u>	<u>90,019,217</u>
Total deposits	121,525,193	96,963,701
Federal funds purchased and securities sold under agreements to repurchase	4,494,070	7,902,511
FHLB borrowings	22,000,000	22,000,000
Federal Reserve Bank borrowings	10,000,000	-
Accrued interest payable	198,268	260,275
Other liabilities	<u>1,105,030</u>	<u>782,299</u>
Total liabilities	<u>159,322,561</u>	<u>127,908,786</u>
Shareholders' equity		
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 2009 and 2008	10,812,000	10,812,000
Surplus	13,570,949	13,304,814
Retained earnings (deficit)	301,304	(623,526)
Accumulated other comprehensive income	<u>594,521</u>	<u>768,859</u>
Total shareholders' equity	<u>25,278,774</u>	<u>24,262,147</u>
Total liabilities and shareholders' equity	<u>\$ 184,601,335</u>	<u>\$ 152,170,933</u>

See Notes to Financial Statements

Statements of Operations

For the years ended December 31, 2009 and 2008

	<u>2009</u>	<u>2008</u>
<i>Interest and dividend income</i>		
Loans and fees on loans	\$ 6,984,982	\$ 6,441,448
Investment securities, taxable	1,220,889	1,276,202
Investment securities, exempt from tax	120,568	74
Time and other interest-bearing deposits	396,051	23,421
Federal funds sold	3,120	29,970
Dividends	<u>3,814</u>	<u>31,430</u>
Total interest and dividend income	<u>8,729,424</u>	<u>7,802,545</u>
<i>Interest expense</i>		
Deposits	2,137,092	2,638,826
Federal funds purchased and securities sold under agreements to repurchase	8,697	121,846
Borrowings	<u>638,662</u>	<u>581,098</u>
Total interest expense	<u>2,784,451</u>	<u>3,341,770</u>
Net interest income	5,944,973	4,460,775
<i>Provision for loan losses</i>		
Net interest income after provision for loan losses	<u>892,000</u>	<u>1,077,232</u>
	<u>5,052,973</u>	<u>3,383,543</u>
<i>Noninterest income</i>		
Service charges on deposit accounts	42,895	9,388
Net gains from sales of securities	-	103,296
Other service charges and fees	<u>36,401</u>	<u>78,681</u>
Total noninterest income	<u>79,296</u>	<u>191,365</u>
<i>Noninterest expense</i>		
Salaries and employee benefits	2,383,784	1,986,899
Occupancy and equipment expense	367,660	312,542
Marketing expense	121,323	101,035
Information systems expense	306,942	267,574
FDIC insurance premiums	245,708	50,649
Other expense	<u>614,022</u>	<u>568,794</u>
Total noninterest expense	<u>4,039,439</u>	<u>3,287,493</u>
Net income before income taxes	1,092,830	287,415
<i>Income tax expense</i>		
Net income	<u>168,000</u>	<u>-</u>
	<u>\$ 924,830</u>	<u>\$ 287,415</u>
<i>Basic earnings per common share</i>		
	<u>\$.43</u>	<u>\$.13</u>
<i>Diluted earnings per common share</i>		
	<u>\$.43</u>	<u>\$.13</u>
<i>Weighted average common shares outstanding</i>		
	<u>2,162,400</u>	<u>2,162,400</u>
<i>Weighted average dilutive common shares outstanding</i>		
	<u>2,162,400</u>	<u>2,168,623</u>

See Notes to Financial Statements

Statements of Changes in Shareholders' Equity

For the years ended December 31, 2009 and 2008

	Common Stock		Surplus	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income	Total
	Shares	Amount				
Balance, December 31, 2007	2,162,400	\$ 10,812,000	\$ 12,960,585	\$ (910,941)	\$ 158,359	\$ 23,020,003
Comprehensive income						
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	<u>307,141</u>
Total comprehensive income						<u>897,915</u>
Non-cash stock option expense	-	-	344,229	-	-	<u>344,229</u>
Balance, December 31, 2008	2,162,400	10,812,000	13,304,814	(623,526)	768,859	24,262,147
Comprehensive income						
Net income	-	-	-	924,830	-	924,830
Net change in unrealized appreciation on investment securities available for sale	-	-	-	-	132,803	132,803
Net change in fair value of derivatives	-	-	-	-	(307,141)	<u>(307,141)</u>
Total comprehensive income						<u>750,492</u>
Non-cash stock option expense	-	-	266,135	-	-	<u>266,135</u>
Balance, December 31, 2009	<u>2,162,400</u>	<u>\$ 10,812,000</u>	<u>\$ 13,570,949</u>	<u>\$ 301,304</u>	<u>\$ 594,521</u>	<u>\$ 25,278,774</u>

See Notes to Financial Statements

Statements of Cash Flows

For the years ended December 31, 2009 and 2008

	<u>2009</u>	<u>2008</u>
<i>Cash flows from operating activities</i>		
Net income	\$ 924,830	\$ 287,415
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	204,195	185,144
Provision for loan losses	892,000	1,077,232
Non-cash stock compensation expense	266,135	344,229
Amortization of premium on securities, net of accretion	(124,375)	(82,800)
Amortization of deferred gain on termination of interest rate swap agreement	(348,710)	(6,605)
Net realized (gain) on securities	-	(103,296)
Income earned on Bank owned life insurance	(14,290)	-
Changes in assets and liabilities:		
Accrued income	(1,067)	(83,822)
Other assets	(1,126,060)	(212,252)
Accrued interest payable	(62,007)	(130,876)
Other liabilities	219,240	(382,170)
Net cash provided by operating activities	<u>829,891</u>	<u>892,199</u>
<i>Cash flows from investing activities</i>		
Net decrease in federal funds sold	14,000	10,000
Purchases of securities available-for-sale	(8,676,166)	(18,227,785)
Purchase of securities held-to-maturity	-	(500,000)
Proceeds from maturities, calls, and principal paydown of securities available-for-sale	12,339,556	5,748,609
Proceeds from sale of securities available for sale	-	3,253,388
Purchases of restricted equity securities	(131,800)	(671,600)
Net increase in loans	(16,435,426)	(31,836,366)
Proceeds from termination of interest rate swap agreement	452,200	420,000
Net purchases of property and equipment	(66,229)	(173,977)
Purchase of Bank owned life insurance	(3,000,000)	-
Net cash used in investing activities	<u>(15,503,865)</u>	<u>(41,977,731)</u>
<i>Cash flows from financing activities</i>		
Net increase in deposits	24,561,492	33,417,833
Net increase in federal funds purchased and securities sold under agreements to repurchase	(3,408,441)	466,141
Net change in borrowings	<u>10,000,000</u>	<u>13,000,000</u>
Net cash provided by financing activities	<u>31,153,051</u>	<u>46,883,974</u>
Net increase in cash and cash equivalents	16,479,077	5,798,442
<i>Cash and cash equivalents, beginning</i>	<u>6,354,053</u>	<u>555,611</u>
<i>Cash and cash equivalents, ending</i>	<u>\$ 22,833,130</u>	<u>\$ 6,354,053</u>
<i>Supplemental disclosure of cash flow information</i>		
Interest paid	<u>\$ 2,846,458</u>	<u>\$ 3,472,645</u>
Taxes paid	<u>\$ 818,781</u>	<u>\$ 399,448</u>
<i>Supplemental disclosure of non-cash activities</i>		
Other real estate acquired in settlement of loans	<u>\$ 105,000</u>	<u>\$ -</u>

See Notes to Financial Statements

Notes to Financial Statements

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 and a loan production office in Cary, 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 “time and other interest-bearing deposits with financial institutions.”

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.

Notes to Financial Statements

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.

Notes to Financial Statements

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 periodically 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 loans 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 asset or liability is deferred and amortized into net interest income over the life of the hedged asset or liability. 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.

Notes to Financial Statements

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.

Tax positions are analyzed in accordance with generally accepted accounting principles. Interest recognized as a result of the analysis of tax positions would be classified as interest expense. Penalties would be classified as noninterest expense.

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.

Notes to Financial Statements

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

The Bank recognizes compensation cost relating to share-based payment transactions in accordance with generally accepted accounting principles. That cost is measured based on the fair value of the equity or liability instruments issued. The expense measures the cost of employee services received in exchange for stock options based on the grant-date fair value of the award and recognizes the cost over the period the employee is required to provide services for the award.

Fair Value of Financial Instruments

Generally accepted accounting principles ("GAAP") define fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Bank determines the fair values of its financial instruments based on the fair value hierarchy established per GAAP which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Investment securities available-for-sale are recorded at fair value on a recurring basis. Certain impaired loans are carried at fair value on a non-recurring basis.

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.

Subsequent Events

These financial statements have not been updated for subsequent events occurring after March 3, 2010 which is the date these financial statements were available to be issued.

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 Bank.

In June 2009, the Financial Accounting Standards Board ("FASB") issued guidance which restructured GAAP and simplified access to all authoritative literature by providing a single source of authoritative nongovernmental GAAP.

The guidance is presented in a topically organized structure referred to as the FASB Accounting Standards Codification ("ASC"). The new structure is effective for interim or annual periods ending after September 15, 2009. All existing accounting standards have been superseded and all other accounting literature not included is considered nonauthoritative.

The FASB issued new accounting guidance on accounting for transfers of financial assets in June 2009. The guidance limits the circumstances in which a financial asset should be derecognized when the transferor has not transferred the entire financial asset by taking into consideration the transferor's continuing involvement. The standard requires that a transferor recognize and initially measure at fair value all assets obtained (including a transferor's beneficial interest) and liabilities incurred as a result of a transfer of financial assets accounted for as a sale. The concept of a qualifying special-purpose entity is no longer applicable. The standard is effective for the first annual reporting period that begins after November 15, 2009, for interim periods within the first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. The Bank does not expect the guidance to have any impact on the Bank's financial statements. The ASC was amended in December, 2009, to include this guidance.

Notes to Financial Statements

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

Recent Accounting Pronouncements, continued

In July 2006, guidance was issued related to accounting for uncertainty in income taxes. The guidance prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Guidance was also provided on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. An update to the guidance issued on September, 2009, eliminated certain disclosure requirements for nonpublic companies. The Bank adopted the guidance on January 1, 2009 with no material impact to the 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 \$588,000 and \$317,000 for the periods including December 31, 2009 and 2008, respectively.

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, 2009 and 2008 are:

	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
2009				
<i>Available-for-sale</i>				
Government sponsored enterprises	\$ 1,250,000	\$ 22,778	\$ -	\$ 1,272,778
Municipal securities	5,243,000	82,336	(39,643)	5,285,693
Mortgage-backed securities	<u>17,968,746</u>	<u>915,936</u>	<u>(13,919)</u>	<u>18,870,763</u>
	<u>\$ 24,461,746</u>	<u>\$ 1,021,050</u>	<u>\$ (53,562)</u>	<u>\$ 25,429,234</u>
<i>Held-to-maturity</i>				
Subordinated debt	<u>\$ 500,000</u>	<u>\$ -</u>	<u>\$ (17,000)</u>	<u>\$ 483,000</u>
2008				
<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>

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 \$6,969,786 at December 31, 2009 were pledged as collateral for other purposes as required or permitted by law.

There were gross realized gains of \$103,296 for the year ended December 31, 2008. The Bank did not realize any gains or losses during 2009.

Notes to Financial Statements

Note 3. Securities, continued

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, 2009. 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>
2009						
Municipal securities	\$1,748,995	\$ 39,643	\$ -	\$ -	\$1,748,995	\$ 39,643
Mortgage-backed securities	<u>777,633</u>	<u>13,919</u>	<u>-</u>	<u>-</u>	<u>777,633</u>	<u>13,919</u>
Total temporarily impaired securities	<u>\$2,526,628</u>	<u>\$ 53,562</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$2,526,628</u>	<u>\$ 53,562</u>

At December 31, 2009, the Bank had five debt securities which had aggregately depreciated 2.1% in value from the amortized cost. The depreciation was related to increases in the current interest rates for similar issues of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. Management believes all unrealized losses presented in the table above to be temporary in nature.

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.

The scheduled contractual maturities of securities at December 31, 2009 are shown below. Expected maturities could differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<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	\$ 3,577,975	\$ 2,287,818	\$ -	\$ -
Due after one year through five years	8,557,980	10,312,138	-	-
Due after five years through ten years	6,940,532	7,266,196	500,000	483,000
Due after ten years	<u>5,385,259</u>	<u>5,563,082</u>	<u>-</u>	<u>-</u>
	<u>\$ 24,461,746</u>	<u>\$ 25,429,234</u>	<u>\$ 500,000</u>	<u>\$ 483,000</u>

Note 4. Loans Receivable

The major components of loans in the balance sheet at December 31, 2009 and 2008 are as follows:

	<u>2009</u>	<u>2008</u>
Commercial	\$ 15,737,902	\$ 11,196,924
Real estate:		
Construction and development	19,672,503	31,754,589
Residential, 1-4 families	23,851,636	15,381,151
Multi-family residential	8,630,171	5,794,673
Nonfarm nonresidential	52,376,239	38,965,473
Farmland	2,217,495	1,275,345
Consumer	7,355,263	10,686,169
Other	1,355,290	-
Agricultural production	243,895	245,203
Deferred loan fees, net	<u>(125,205)</u>	<u>(85,081)</u>
	131,315,189	115,214,446
Allowance for loan losses	<u>(2,437,317)</u>	<u>(1,775,000)</u>
	<u>\$ 128,877,872</u>	<u>\$ 113,439,446</u>

Notes to Financial Statements

Note 5. Allowance for Loan Losses

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

	<u>2009</u>	<u>2008</u>
Balance at beginning of period	\$ 1,775,000	\$ 1,047,000
Provision for loan losses charged to operations	892,000	1,077,232
Recoveries of amounts charged off	-	-
Amounts charged off	<u>(229,683)</u>	<u>(349,232)</u>
Balance at end of period	<u>\$ 2,437,317</u>	<u>\$ 1,775,000</u>

The following is a summary of information pertaining to impaired and non-accrual loans:

	<u>December 31,</u>	
	<u>2009</u>	<u>2008</u>
Impaired loans without a valuation allowance	\$ 5,089,571	\$ -
Impaired loans with a valuation allowance	<u>3,801,990</u>	<u>-</u>
Total impaired loans	<u>\$ 8,891,561</u>	<u>\$ -</u>
Valuation allowance related to impaired loans	<u>\$ 782,415</u>	<u>\$ -</u>
Total non-accrual loans	<u>\$ 310,678</u>	<u>\$ -</u>
Total loans past-due ninety days or more and still accruing	<u>\$ -</u>	<u>\$ -</u>
Average investment in impaired loans	<u>\$ 2,572,903</u>	<u>\$ -</u>
Interest income recognized on impaired loans	<u>\$ 215,250</u>	<u>\$ -</u>
Interest income recognized on a cash basis on impaired loans	<u>\$ 209,006</u>	<u>\$ -</u>

No additional funds are committed to be advanced in connection with impaired loans.

Note 6. Property and Equipment

Components of Property and Equipment

Components of property and equipment and total accumulated depreciation at December 31, 2009 and 2008 are as follows:

	<u>2009</u>	<u>2008</u>
Furniture and equipment	\$ 724,999	\$ 701,883
Computers and software	<u>204,648</u>	<u>192,426</u>
Property and equipment, total	929,647	894,309
Less accumulated depreciation	<u>(537,846)</u>	<u>(364,542)</u>
Property and equipment, net of depreciation	<u>\$ 391,801</u>	<u>\$ 529,767</u>

Notes to Financial Statements

Note 6. Property and Equipment, continued

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. During 2009, the Bank entered into a one year operating lease for a loan office in Cary, North Carolina which takes effect on February 1, 2010. The Bank has the option to extend this lease for two periods of six months each. The Bank's total rent expense for 2009 and 2008 was \$201,636 and \$169,941, respectively.

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

<u>Year</u>	<u>Amount</u>
2010	\$ 218,591
2011	209,134
2012	212,868
2013	<u>107,754</u>
Total	<u>\$ 748,347</u>

Note 7. Deposits

The aggregate amount of time deposits in denominations of one hundred thousand dollars or more at December 31, 2009 and 2008 was approximately \$46,541,000 and \$34,603,000, respectively. At December 31, 2009, 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>
2010	\$ 9,845	\$ 41,709	\$ 51,554
2011 thru 2012	<u>3,987</u>	<u>4,832</u>	<u>8,819</u>
	<u>\$ 13,832</u>	<u>\$ 46,541</u>	<u>\$ 60,373</u>

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>2009</u>	<u>2008</u>
Outstanding balance at December 31	<u>\$ 4,494,070</u>	<u>\$ 7,902,511</u>
Year-end weighted average rate	<u>.19%</u>	<u>.39%</u>
Daily average outstanding during the period	<u>\$ 4,270,778</u>	<u>\$ 8,014,056</u>
Average rate for the period	<u>.17%</u>	<u>1.91%</u>
Maximum outstanding at any month-end during the period	<u>\$ 7,015,079</u>	<u>\$ 10,949,565</u>

Securities sold under agreements to repurchase amounted to \$3,524,069 and \$3,340,511 at December 31, 2009 and 2008, respectively, which mature on a daily basis and are collateralized by securities issued by U.S. Government sponsored enterprises.

Notes to Financial Statements

Note 8. Borrowings, continued

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 \$15,100,000. At December 31, 2009 and 2008, \$970,000 and \$4,562,000 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 qualifying loans amounting to approximately \$27,428,000.

Advances from the FHLB of Atlanta consisted of the following at December 31, 2009 and 2008.

<u>Maturity</u>	<u>Interest Rate</u>	<u>2009</u>	<u>2008</u>
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
January 19, 2010	3.19%	1,000,000	1,000,000
February 12, 2010	1.27%	1,000,000	-
April 14, 2010	2.62%	1,000,000	1,000,000
May 6, 2010	3.17%	1,000,000	1,000,000
May 14, 2010	3.36%	1,000,000	1,000,000
December 2, 2010	0.49%	1,000,000	-
April 14, 2011	2.91%	1,000,000	1,000,000
May 12, 2011	3.33%	1,000,000	1,000,000
May 16, 2011	1.65%	2,000,000	-
November 21, 2011	1.31%	2,000,000	-
December 2, 2011	1.04%	1,000,000	-
September 7, 2012	4.05%	3,000,000	3,000,000
April 22, 2013	2.55%	2,000,000	-
September 2, 2014	2.96%	2,000,000	-
March 5, 2018	3.68%	2,000,000	2,000,000
		<u>\$ 22,000,000</u>	<u>\$ 22,000,000</u>

Federal Reserve Bank Borrowings

Federal Reserve Bank borrowings amounting to \$10,000,000 at December 31, 2009 with a rate of 0.25% matured on January 14, 2010. The borrowings were secured by \$12,078,000 in loans as of December 31, 2009.

The borrowings were subsequently retained through the term auction facility.

Notes to Financial Statements

Note 9. Fair Value of Financial Instruments

Fair Value Hierarchy

There are three levels of inputs in the fair value hierarchy that may be used to measure fair value. Financial instruments are considered *Level 1* when valuation can be based on quoted prices in active markets for identical assets or liabilities. *Level 2* financial instruments are valued using quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or models using inputs that are observable or can be corroborated by observable market data of substantially the full term of the assets or liabilities. Financial instruments are considered *Level 3* when their values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable and when determination of the fair value requires significant management judgment or estimation.

Financial Instruments Measured at Fair Value

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 fair value 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.

Impaired Loans: Where impairment of a loan is based on a loan's observable market price or the fair value of the collateral of a collateral-dependent loan. 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.

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.

Foreclosed Properties: Foreclosed assets are adjusted to fair value upon transfer of the loans to other real estate owned. Real estate acquired in settlement of loans is recorded initially at estimated fair value of the property less estimated selling costs at the date of foreclosure. The initial recorded value may be subsequently reduced by additional allowances, which are charged to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Bank records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Bank records the foreclosed asset as nonrecurring Level 3.

Recurring Fair Value

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

<u>December 31, 2009</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investment securities available-for-sale	\$ 25,429,234	\$ -	\$ 25,429,234	\$ -
Total assets measured at fair value	<u>\$ 25,429,234</u>	<u>\$ -</u>	<u>\$ 25,429,234</u>	<u>\$ -</u>
Total liabilities measured at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Notes to Financial Statements

Note 9. Fair Value of Financial Instruments, continued

Recurring Fair Value, continued

<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	499,823	-	499,823	-
Total assets measured at fair value	<u>\$ 29,251,955</u>	<u>\$ -</u>	<u>\$ 29,251,955</u>	<u>\$ -</u>
Total liabilities measured at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Non-recurring Fair Value

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

<u>December 31, 2009</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Impaired loans	\$ 3,019,575	\$ -	\$ 3,019,575	\$ -
Foreclosed properties	105,000	-	105,000	-
Total assets measured at fair value	<u>\$ 3,124,575</u>	<u>\$ -</u>	<u>\$ 3,124,575</u>	<u>\$ -</u>
Total liabilities measured at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

There were no assets or liabilities measured at fair value on a non-recurring basis at December 31, 2008.

Estimated Fair Value of Other Financial Instruments

GAAP also requires disclosure of fair value information about financial instruments carried at book value 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. 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 not measured at fair value on the balance sheets:

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

Time and other interest-bearing deposits with banks and federal funds sold: The carrying amounts of interest-bearing deposits maturing within twelve months and federal funds sold 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.

Notes to Financial Statements

Note 9. Fair Value of Financial Instruments, continued

Estimated Fair Value of Other Financial Instruments, continued

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.

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

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

	December 31, 2009		December 31, 2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<i>Financial assets</i>				
Cash and due from banks	\$ 2,628	\$ 2,628	\$ 1,901	\$ 1,901
Time and other interest-bearing deposits with banks	20,206	20,206	4,453	4,453
Federal funds sold	-	-	14	14
Investment securities, available-for-sale	25,429	25,429	28,752	28,752
Investment securities, held-to-maturity	500	483	500	500
Restricted equity securities	1,309	1,309	1,177	1,177
Loans, net of allowance for loan losses	128,878	127,832	113,439	113,505
Derivative financial instrument	-	-	500	500
<i>Financial liabilities</i>				
Deposits	121,525	121,654	96,964	98,987
Federal funds purchased and securities sold under agreements to repurchase	4,494	4,494	7,903	7,903
FHLB borrowings	22,000	22,231	22,000	22,261
Federal Reserve Bank borrowings	10,000	10,000	-	-

Notes to Financial Statements

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, 2009 and 2008.

	<u>2009</u>	<u>2008</u>
Net income (income available to common shareholders)	\$ 924,830	\$ 287,415
<i>Weighted average common shares outstanding</i>	2,162,400	2,162,400
Effect of dilutive securities, options	-	6,223
<i>Weighted average common shares outstanding, diluted</i>	<u>2,162,400</u>	<u>2,168,623</u>
<i>Basic earnings per common share</i>	\$.43	\$.13
<i>Dilutive earnings per common share</i>	<u>\$.43</u>	<u>\$.13</u>

At December 31, 2009, there were 367,858 options outstanding that were not included in the calculation of diluted earnings per common share because their exercise price exceeded market value.

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, 2009 and 2008 amounted to \$82,094 and \$74,951, 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.

Cash Value of Life Insurance

The Bank is the owner and beneficiary of life insurance policies on certain executive officers. Policy cash values on the balance sheet totaled \$3,014,290 at December 31, 2009. No policies existed at December 31, 2008.

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.

Compensation cost relating to share-based payment transactions is 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, 2009 and 2008, the Bank recognized \$266,135 and \$344,229 respectively, in compensation expense for stock options.

At December 31, 2009 and 2008, unrecognized compensation costs amounted to \$241,151 and \$383,414, respectively which will be expensed over the next five years.

Notes to Financial Statements

Note 11. Benefit Plans, continued

Stock Option Plans, continued

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.

Activity under the plans during the years ended December 31, 2009 and 2008 are summarized below:

	<u>Incentive Plan</u>		<u>Non-statutory Plan</u>	
	<u>Available for Grant</u>	<u>Granted</u>	<u>Available for Grant</u>	<u>Granted</u>
<i>Balance December 31, 2007</i>	100,242	113,358	-	216,000
Forfeited	-	-	-	-
Granted	(14,500)	14,500	-	-
Exercised	-	-	-	-
<i>Balance December 31, 2008</i>	<u>85,742</u>	<u>127,858</u>	-	<u>216,000</u>
Forfeited	-	-	-	-
Granted	(24,000)	24,000	-	-
Exercised	-	-	-	-
<i>Balance December 31, 2009</i>	<u><u>61,742</u></u>	<u><u>151,858</u></u>	-	<u><u>216,000</u></u>

No cash was received during 2009 or 2008 for options exercised.

Notes to Financial Statements

Note 11. Benefit Plans, continued

Additional information relating to the plan is listed below:

	<u>2009</u>	<u>2008</u>
<i>Outstanding options at December 31:</i>		
Weighted average exercise price:		
Beginning of the year	\$ 11.16	\$ 11.06
End of the year	\$ 11.33	\$ 11.16
Range of exercise prices:		
From	\$ 11.00	\$ 11.00
To	\$ 13.75	\$ 13.50
Weighted average remaining contractual life in years	6.86	7.71
Aggregate intrinsic value	\$ -	\$ 852,035
Exercisable options	282,115	184,543
Weighted average exercise price of exercisable options	\$ 11.05	\$ 11.02
Weighted average remaining contractual life of exercisable options, in years	6.63	7.61
Aggregate intrinsic value of exercisable options	\$ -	\$ 483,494
<i>Weighted average exercise price of options:</i>		
Granted during the year	\$ 13.75	\$ 13.50
Exercised during the year	\$ -	\$ -
Forfeited during the year	\$ -	\$ -
Expired during the year	\$ -	\$ -
<i>Grant-date fair value:</i>		
Options granted during the year, total	\$ 78,127	\$ 53,447
Options granted during the year, weighted average	\$ 3.26	\$ 3.69
<i>Significant assumptions used in determining fair value:</i>		
Risk-free interest rate	2.18%	3.45%
Expected life in years	7	7
Expected dividend yield	.75%	.75%
Expected volatility	20%	20%

Note 12. Income Taxes

Current and Deferred Income Tax Components

The components of income tax expense for the years ended December 31, 2009 and 2008 are as follows:

	<u>2009</u>	<u>2008</u>
Current	\$ 908,770	\$ 489,551
Deferred	(398,802)	(350,090)
Deferred tax asset valuation allowance change	(341,968)	(139,461)
	<u>\$ 168,000</u>	<u>\$ -</u>

Notes to Financial Statements

Note 12. Income Taxes, continued

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, 2009 and 2008 are as follows:

	<u>2009</u>	<u>2008</u>
Tax at statutory federal rate	\$ 371,562	\$ 97,721
Compensation expense	39,275	29,249
Other	99,131	12,491
Deferred tax asset valuation allowance change	(341,968)	(139,461)
	<u>\$ 168,000</u>	<u>\$ -</u>

Deferred Income Tax Analysis

The significant components of net deferred tax assets at December 31, 2009 and 2008 are summarized as follows:

	<u>2009</u>	<u>2008</u>
<i>Deferred tax assets</i>		
Allowance for loan losses	\$ 835,374	\$ 548,460
Pre-opening expenses	200,341	217,636
Stock-based compensation	298,890	240,826
Deferred gain on termination of swap	199,259	159,363
Accrued compensation	41,284	-
Nonaccrual interest	619	-
Deferred tax asset	<u>1,575,767</u>	<u>1,166,285</u>
<i>Deferred tax liabilities</i>		
Unrealized gain on securities available for sale	372,967	289,654
Unrealized gain on interest rate swap	-	192,682
Depreciation	118,471	119,708
Prepaid expenses	26,304	20,346
Deferred loan costs	36,035	30,114
Accretion of bond discount	6,258	6,220
Deferred tax liability	<u>560,035</u>	<u>658,724</u>
Deferred tax asset valuation allowance	-	(341,968)
Net deferred tax asset	<u>\$ 1,015,732</u>	<u>\$ 165,593</u>

Based on the Bank's historical and current earnings, management believes it is more likely than not the Bank will realize the benefits of the deferred tax assets.

The Bank has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions. Years ended December 31, 2006 through December 31, 2008 remain open for audit for all major jurisdictions.

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 years ended December 31, 2009 and 2008.

Notes to Financial Statements

Note 13. Commitments and Contingencies, continued

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, 2009 and 2008 are as follows:

	<u>2009</u>	<u>2008</u>
Commitments to extend credit	\$ 23,057,000	\$ 40,652,600
Standby letters of credit	<u>160,000</u>	<u>75,764</u>
	<u>\$ 23,217,000</u>	<u>\$ 40,728,364</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 \$3.4 million.

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

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.

Notes to Financial Statements

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, 2009 and 2008, Management believes that the Bank met all capital adequacy requirements to which it was subject.

As of December 31, 2009, 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.

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>
<i>December 31, 2009</i>						
Total Capital						
(to Risk-Weighted Assets)	\$ 26,466	18.7%	\$ 11,305	8.0%	\$ 14,131	10.0%
Tier I Capital						
(to Risk-Weighted Assets)	\$ 24,684	17.5%	\$ 5,653	4.0%	\$ 8,479	6.0%
Tier I Capital						
(to Average Assets)	\$ 24,684	13.4%	\$ 7,334	4.0%	\$ 9,167	5.0%
<i>December 31, 2008</i>						
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%

Notes to Financial Statements

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:

	Years Ended December 31,	
	2009	2008
Unrealized holding gains on available-for-sale securities	\$ 132,803	\$ 406,655
Reclassification adjustment for gains realized in income	-	(103,296)
Net unrealized gains	132,803	303,359
Change in fair value of derivatives used for cash flow hedges	(32,235)	307,141
Reclassification adjustment for termination of interest rate swap agreement	(274,906)	-
Total other comprehensive income/(loss)	<u>\$ (174,338)</u>	<u>\$ 610,500</u>

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

	Years Ended December 31,	
	2009	2008
Net unrealized gain on securities available-for-sale	\$ 594,521	\$ 461,718
Net unrealized gain on derivatives used for cash flow hedges	-	307,141
Total accumulated other comprehensive income	<u>\$ 594,521</u>	<u>\$ 768,859</u>

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:

	2009	2008
Balance, beginning	\$ 8,867,761	\$ 6,888,980
New loans and advances	1,961,196	4,768,631
Repayments	(4,090,677)	(2,789,850)
Balance, ending	<u>\$ 6,738,280</u>	<u>\$ 8,867,761</u>

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

Derivative Financial Instrument

The Bank had a stand alone derivative financial instrument, at December 31, 2008, 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.

Notes to Financial Statements

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

Derivative Financial Instrument, continued

The Bank was exposed to credit-related losses in the event of nonperformance by the counterparty to this agreement. The Bank controlled the credit risk of its financial contract through limits and monitoring procedures, and did not expect its counterparty to fail its obligations. The Bank's interest rate swap agreement was 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.

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. In 2009, the Bank terminated the remaining portion of the interest rate swap at a value of \$452,200 in order to eliminate counterparty exposure and lock in a value. The gains will be recognized into interest income over the remaining original maturity of the agreement.

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

	<u>2008</u>
Notional amount	\$ 10,000,000
Weighted average receive rate	6.06%
Weighted average pay rate (prime rate)	3.25%
Weighted average maturity in years	2.4
Unrealized gain relating to interest rate swap	\$ 307,141

The unrealized gain relating to the interest rate swap was reflected separately on the balance sheet for December 31, 2008. 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. For the years ending December 2009 and 2008, interest of \$371,224 and \$167,957 was reclassified to 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.

Board of Directors and Bank Management

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*

Shareholder Information

Annual Meeting

The annual meeting of shareholders will be held on Wednesday, April 21, 2010 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 150, 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
700 Spring Forest Road
Suite 335
Raleigh, North Carolina 27609

Stock Transfer Agent

First Shareholder Services
Post Office Box 29522 (FCC61)
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

Main

4505 Falls of Neuse Road
Suite 150
Raleigh, North Carolina 27609

Loan Production

1140 Kildaire Farm Road
Suite 303
Cary, North Carolina 27511

<http://www.capstonebank.com>