

# CAPSTONE BANK

*2007 Annual Report*

---

# 2007 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 Management.....             | 23 |
| Shareholder Information.....                       | 24 |

*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, 2007 and 2006 and the related statements of operations, changes in shareholders' equity, and cash flows for the year ended December 31, 2007 and the period from August 1, 2006 (opening date) through December 31, 2006. 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, 2007 and 2006, and the results of its operations and its cash flows for the year ended December 31, 2007 and for the period from August 1, 2006 (opening date) through December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.



Galax, Virginia  
March 18, 2008

# Balance Sheets

December 31, 2007 and 2006

|  | <u>2007</u>           | <u>2006</u>          |
|--|-----------------------|----------------------|
| <b>Assets</b>  |                       |                      |
| Cash and due from banks  | \$ 533,185            | \$ 893,003           |
| Interest-bearing deposits with banks   | <u>22,426</u>         | <u>-</u>             |
| Cash and cash equivalents  | 555,611               | 893,003              |
| Federal funds sold   | 24,000                | 17,932,000           |
| Investment securities available-for-sale   | 18,846,580            | 7,963,265            |
| Restricted equity securities   | 505,500               | 47,207               |
| Loans, net of allowance for loan losses of \$1,047,000 and<br>\$356,000 for 2007 and 2006, respectively  | 82,680,312            | 28,115,073           |
| Property and equipment, net  | 540,934               | 585,755              |
| Accrued income   | 568,848               | 222,496              |
| Other assets   | <u>133,027</u>        | <u>52,715</u>        |
| Total assets   | <u>\$ 103,854,812</u> | <u>\$ 55,811,514</u> |
| <b>Liabilities and Shareholders' Equity</b>  |                       |                      |
| <b>Liabilities</b>   |                       |                      |
| Deposits:  |                       |                      |
| Noninterest-bearing  | \$ 5,879,946          | \$ 3,915,034         |
| Interest-bearing   | <u>57,665,922</u>     | <u>26,851,151</u>    |
| Total deposits   | 63,545,868            | 30,766,185           |
| Federal funds purchased and securities<br>sold under agreements to repurchase  | 7,436,370             | 2,020,422            |
| FHLB borrowings  | 9,000,000             | -                    |
| Accrued interest payable   | 391,151               | 40,397               |
| Other liabilities  | <u>461,420</u>        | <u>191,064</u>       |
| Total liabilities  | <u>80,834,809</u>     | <u>33,018,068</u>    |
| Commitments and contingencies  | -                     | -                    |
| <b>Shareholders' equity</b>  |                       |                      |
| Preferred stock, 1,000,000 shares authorized;<br>no shares issued and outstanding  | -                     | -                    |
| Common stock, \$5 par value; 10,000,000 shares<br>authorized; 2,162,400 and 2,160,000 shares issued<br>and outstanding for 2007 and 2006, respectively | 10,812,000            | 10,800,000           |
| Surplus  | 12,960,585            | 12,609,753           |
| Retained deficit   | (910,941)             | (636,819)            |
| Accumulated other comprehensive income   | <u>158,359</u>        | <u>20,512</u>        |
| Total shareholders' equity   | <u>23,020,003</u>     | <u>22,793,446</u>    |
| Total liabilities and shareholders' equity   | <u>\$ 103,854,812</u> | <u>\$ 55,811,514</u> |

See Notes to Financial Statements

# Statements of Operations

For the year ended December 31, 2007 and for the period from August 1, 2006 (opening date) through December 31, 2006

|  | <u>2007</u>         | <u>2006</u>         |
|--|---------------------|---------------------|
| <b><i>Interest and dividend income</i></b>                 |                     |                     |
| Loans and fees on loans                                    | \$ 4,843,155        | \$ 504,874          |
| Federal funds sold   | 250,021             | 440,451             |
| Investment securities, taxable                             | 756,656             | 105,789             |
| Dividends  | <u>14,392</u>       | <u>7</u>            |
| Total interest and dividend income                         | <u>5,864,224</u>    | <u>1,051,121</u>    |
| <b><i>Interest expense</i></b>                             |                     |                     |
| Deposits   | 2,143,081           | 298,646             |
| Securities sold under agreements to repurchase             | 135,098             | 11,716              |
| FHLB borrowings  | <u>146,605</u>      | <u>-</u>            |
| Total interest expense                                     | <u>2,424,784</u>    | <u>310,362</u>      |
| Net interest income  | 3,439,440           | 740,759             |
| <b><i>Provision for loan losses</i></b>                    |                     |                     |
| Net interest income after provision<br>for loan losses     | <u>691,000</u>      | <u>356,000</u>      |
|  | <u>2,748,440</u>    | <u>384,759</u>      |
| <b><i>Noninterest income</i></b>                           |                     |                     |
| Service charges on deposit accounts                        | 1,995               | 364                 |
| Other service charges and fees                             | <u>11,829</u>       | <u>1,596</u>        |
| Total noninterest income                                   | <u>13,824</u>       | <u>1,960</u>        |
| <b><i>Noninterest expense</i></b>                          |                     |                     |
| Salaries and employee benefits                             | 2,030,709           | 658,722             |
| Occupancy and equipment expense                            | 244,945             | 91,940              |
| Marketing expense  | 111,942             | 36,006              |
| Information systems expense                                | 194,971             | 53,582              |
| Other expense  | <u>453,819</u>      | <u>183,288</u>      |
| Total noninterest expense                                  | <u>3,036,386</u>    | <u>1,023,538</u>    |
| Net loss   | <u>\$ (274,122)</u> | <u>\$ (636,819)</u> |
| <b><i>Basic loss per share</i></b>                         |                     |                     |
|  | <u>\$ (.13)</u>     | <u>\$ (.29)</u>     |
| <b><i>Diluted loss per share</i></b>                       |                     |                     |
|  | <u>\$ (.13)</u>     | <u>\$ (.29)</u>     |
| <b><i>Weighted average shares outstanding</i></b>          |                     |                     |
|  | <u>2,160,607</u>    | <u>2,160,000</u>    |
| <b><i>Weighted average dilutive shares outstanding</i></b> |                     |                     |
|  | <u>2,160,607</u>    | <u>2,160,000</u>    |

See Notes to Financial Statements

## Statements of Changes in Shareholders' Equity

For the year ended December 31, 2007 and the period from August 1, 2006 (opening date) through December 31, 2006

|   | <u>Common Stock</u> |                      | <u>Surplus</u>      | <u>Retained Earnings (Deficit)</u> | <u>Accumulated Other Comprehensive Income (Loss)</u> | <u>Total</u>         |
|---|---------------------|----------------------|---------------------|------------------------------------|--|----------------------|
|   | <u>Shares</u>       | <u>Amount</u>        |                     |                                    |  |                      |
| <b>Comprehensive loss</b>   |                     |                      |                     |                                    |  |                      |
| Net loss  | -                   | \$ -                 | \$ -                | \$(636,819)                        | \$ -   | \$ (636,819)         |
| Net change in unrealized appreciation on investment securities available for sale | -                   | -                    | -                   | -                                  | 20,512   | <u>20,512</u>        |
| <b>Total comprehensive loss</b>   |                     |                      |                     |                                    |  | <u>(616,307)</u>     |
| Pre-opening expenses  | -                   | -                    | (489,037)           | -                                  | -  | (489,037)            |
| Non-cash stock option expense   | -                   | -                    | 138,790             | -                                  | -  | 138,790              |
| Shares issued pursuant to pre-opening common stock subscriptions                  | <u>2,160,000</u>    | <u>10,800,000</u>    | <u>12,960,000</u>   | <u>-</u>                           | <u>-</u>   | <u>23,760,000</u>    |
| <b>Balance, December 31, 2006</b>   | <u>2,160,000</u>    | <u>10,800,000</u>    | <u>12,609,753</u>   | <u>(636,819)</u>                   | <u>20,512</u>  | <u>22,793,446</u>    |
| <b>Comprehensive loss</b>   |                     |                      |                     |                                    |  |                      |
| Net loss  | -                   | -                    | -                   | (274,122)                          | -  | (274,122)            |
| Net change in unrealized appreciation on investment securities available for sale | -                   | -                    | -                   | -                                  | 137,847  | <u>137,847</u>       |
| <b>Total comprehensive loss</b>   |                     |                      |                     |                                    |  | <u>(136,275)</u>     |
| Non-cash stock option expense   | -                   | -                    | 336,432             | -                                  | -  | 336,432              |
| Issuance of stock   | <u>2,400</u>        | <u>12,000</u>        | <u>14,400</u>       | <u>-</u>                           | <u>-</u>   | <u>26,400</u>        |
| <b>Balance, December 31, 2007</b>   | <u>2,162,400</u>    | <u>\$ 10,812,000</u> | <u>\$12,960,585</u> | <u>\$(910,941)</u>                 | <u>\$ 158,359</u>                                    | <u>\$ 23,020,003</u> |

See Notes to Financial Statements

# Statements of Cash Flows

For the year ended December 31, 2007 and for the period from August 1, 2006 (opening date) through December 31, 2006

|   | <u>2007</u>         | <u>2006</u>         |
|---|---------------------|---------------------|
| <b><i>Cash flows from operating activities</i></b>                                      |                     |                     |
| Net loss  | \$ (274,122)        | \$ (636,819)        |
| Adjustments to reconcile net loss to net cash used by operations:                       |                     |                     |
| Depreciation and amortization   | 147,877             | 48,174              |
| Provision for loan losses   | 691,000             | 356,000             |
| Non-cash stock compensation expense   | 336,432             | 138,790             |
| Amortization of premium on securities, net of accretion                                 | (48,778)            | (1,174)             |
| Changes in assets and liabilities:  |                     |                     |
| Accrued income  | (346,352)           | 27,775              |
| Other assets  | (166,789)           | (52,715)            |
| Accrued interest payable  | 350,754             | 40,397              |
| Other liabilities   | <u>270,356</u>      | <u>72,605</u>       |
| Net cash provided (used) by operating activities  | <u>960,378</u>      | <u>(6,967)</u>      |
| <b><i>Cash flows from investing activities</i></b>                                      |                     |                     |
| Net (increase) decrease in federal funds sold   | 17,908,000          | (17,932,000)        |
| Purchases of securities available-for-sale  | (13,934,469)        | (7,928,711)         |
| Proceeds from maturities, calls, and principal paydown of securities available-for-sale | 3,324,256           | -                   |
| Purchases of restricted equity securities   | (458,293)           | (47,207)            |
| Net increase in loans   | (55,256,239)        | (28,471,073)        |
| Purchases of property and equipment   | <u>(103,056)</u>    | <u>(446,074)</u>    |
| Net cash used in investing activities   | <u>(48,519,801)</u> | <u>(54,825,065)</u> |
| <b><i>Cash flows from financing activities</i></b>                                      |                     |                     |
| Net increase in deposits  | 32,779,683          | 30,766,185          |
| Net increase in securities sold under agreements to repurchase                          | 3,699,948           | 2,020,422           |
| FHLB advances   | 10,716,000          | -                   |
| Repayment of borrowings   | -                   | (691,198)           |
| Proceeds from issuance of common stock  | <u>26,400</u>       | <u>23,760,000</u>   |
| Net cash provided by financing activities   | <u>47,222,031</u>   | <u>55,855,409</u>   |
| Net increase (decrease) in cash and cash equivalents                                    | (337,392)           | 1,023,377           |
| <b><i>Cash and cash equivalents, beginning</i></b>                                      | <u>893,003</u>      | <u>(130,374)</u>    |
| <b><i>Cash and cash equivalents, ending</i></b>   | <u>\$ 555,611</u>   | <u>\$ 893,003</u>   |
| <b><i>Supplemental disclosure of cash flow information</i></b>                          |                     |                     |
| Interest paid   | <u>\$ 2,074,030</u> | <u>\$ 269,965</u>   |
| Taxes paid  | <u>\$ 125,000</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. 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***

The notes to our audited financial statements contain a summary of our significant accounting policies. We believe our policies with respect to the methodology for our determination of the allowance for loan losses, and asset impairment judgments involve 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. These critical policies and their application are periodically reviewed with the Audit Committee and our Board of Directors.

### ***Pre-opening Expenses***

In accordance with applicable North Carolina banking regulations, the Bank charged its results of operations prior to opening date, August 1, 2006, to surplus. Generally accepted accounting principles require such operating results be charged to retained earnings. Cumulative revenue (interest income on bank deposits) and expenses prior to opening amounted to \$250,271 and \$739,308, respectively. The classification of net pre-opening expenses of \$489,037 in surplus rather than retained earnings is required by North Carolina banking regulations and does not affect the Bank's total shareholders' equity.

### ***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."

---

# Notes to Financial Statements

---

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

### *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’s entire portfolio for the years presented was available-for-sale.

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.

---

# Notes to Financial Statements

---

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

### *Allowance for Loan Losses, continued*

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

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.

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.

### *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            |

### *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 for the years presented.

### *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.

---

# Notes to Financial Statements

---

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

### *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. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Deferred income tax liability relating to unrealized appreciation (or the deferred tax asset in the case of unrealized depreciation) on investment securities available for sale is recorded in other liabilities (assets) when applicable. Such unrealized appreciation or depreciation is recorded as an adjustment to equity in the financial statements and not included in income determination until realized. Accordingly, the resulting deferred income tax liability or asset is also recorded as an adjustment to equity.

### *Basic Earnings per Share*

Basic earnings per share is computed by dividing income available to common stockholders 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.

### *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 stockholders' 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.

---

# Notes to Financial Statements

---

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

### *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 ninety days 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.

*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.

*FHLB Borrowings:* The carrying amount of FHLB 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.

---

# Notes to Financial Statements

---

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

### *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 July 2006, the FASB issued FASB Interpretation No. 48 (“FIN 48”), “Accounting for Uncertainty in Income Taxes” (“FIN 48”). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in enterprises’ financial statements in accordance with FASB Statement No. 109, “Accounting for Income Taxes.” FIN 48 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. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FASB Staff Position FIN 48-2 defers the effective date for the Company until January 1, 2009. The Company does not believe that FIN 48 will have a material impact on its financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“SFAS 157”). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This standard eliminates inconsistencies found in various prior pronouncements but does not require any new fair value measurements. SFAS 157 was effective for the Company on January 1, 2008 and did not impact the Company’s accounting measurements but will result in additional disclosures.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115” (“SFAS 159”). This statement permits, but does not require, entities to measure many financial instruments at fair value. The objective is to provide entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Entities electing this option will apply it when the entity first recognizes an eligible instrument and will report unrealized gains and losses on such instruments in current earnings. This statement 1) applies to all entities, 2) specifies certain election dates, 3) can be applied on an instrument-by-instrument basis with some exceptions, 4) is irrevocable and 5) applies only to entire instruments. One exception is demand deposit liabilities which are explicitly excluded as qualifying for fair value. With respect to SFAS 115, available-for-sale and held-to-maturity securities at the effective date are eligible for the fair value option at that date. If the fair value option is elected for those securities at the effective date, cumulative unrealized gains and losses at that date shall be included in the cumulative-effect adjustment and thereafter, such securities will be accounted for as trading securities. SFAS 159 was effective for the Company on January 1, 2008.

In December 2007, the 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. FAS 141(R) is effective for acquisitions by the Company 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 Company will assess the impact of SFAS 141(R) if and when a future acquisition occurs.

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 Company’s financial position, results of operations and cash flows.

---

## Notes to Financial Statements

---

### 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 \$1,000,000 and \$700,000 for the periods including December 31, 2007 and 2006 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 (all available-for-sale) and their approximate fair values at December 31, 2007 and 2006 are:

|                                  | <u>Amortized<br/>Cost</u> | <u>Unrealized<br/>Gains</u> | <u>Unrealized<br/>Losses</u> | <u>Fair<br/>Value</u> |
|----------------------------------|---------------------------|-----------------------------|------------------------------|-----------------------|
| <b>2007</b>                      |                           |                             |                              |                       |
| 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>  |
| <b>2006</b>                      |                           |                             |                              |                       |
| Government sponsored enterprises | \$ 4,454,917              | \$ 13,445                   | \$ (768)                     | \$ 4,467,594          |
| Mortgage-backed securities       | <u>3,474,968</u>          | <u>20,709</u>               | <u>(6)</u>                   | <u>3,495,671</u>      |
|                                  | <u>\$ 7,929,885</u>       | <u>\$ 34,154</u>            | <u>\$ (774)</u>              | <u>\$ 7,963,265</u>   |

Restricted equity securities consist of investments in common stock of the Federal Home Loan Bank of Atlanta ("FHLB") and Federal Reserve Bank. 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. The Federal Reserve requires Banks to purchase stock as a condition for membership in the Federal Reserve system.

Investment securities with amortized cost of approximately \$12,195,457 at December 31, 2007 were pledged as collateral for other purposes as required or permitted by law.

There were no realized gains and losses for the year and period ended December 31, 2007 and 2006, respectively.

## 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, 2007.

|                            | <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 | \$ 974,128                 | \$ (1,097)               | \$ -                        | \$ -                     | \$ 974,128        | \$ (1,097)               |

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.

The scheduled maturities of securities at December 31, 2007 were as follows:

|  | <u>Available-for-Sale</u> |                      |
|--|---------------------------|----------------------|
|  | <u>Amortized Cost</u>     | <u>Fair Value</u>    |
| Due in one year or less                | \$ 498,461                | \$ 499,843           |
| Due after one year through five years  | 2,978,210                 | 3,018,750            |
| Due after five years through ten years | 503,561                   | 512,188              |
| Due after ten years                    | -                         | -                    |
| Mortgage-backed securities             | 14,608,644                | 14,815,799           |
|  | <u>\$ 18,588,876</u>      | <u>\$ 18,846,580</u> |

### Note 4. Loans Receivable

The major components of loans in the balance sheet at December 31, 2007 and 2006 are as follows:

|                              | <u>2007</u>          | <u>2006</u>          |
|------------------------------|----------------------|----------------------|
| Commercial                   | \$ 11,468,670        | \$ 5,826,869         |
| Real estate:                 |                      |                      |
| Construction and development | 23,892,487           | 6,447,248            |
| Residential, 1-4 families    | 11,181,292           | 3,379,359            |
| Multi-family residential     | 3,499,915            | 2,185,272            |
| Nonfarm nonresidential       | 24,048,363           | 6,235,432            |
| Farmland                     | 1,343,893            | -                    |
| Consumer                     | 8,337,291            | 4,400,495            |
| Deferred loan fees, net      | (44,599)             | (3,602)              |
|                              | 83,727,312           | 28,471,073           |
| Allowance for loan losses    | (1,047,000)          | (356,000)            |
|                              | <u>\$ 82,680,312</u> | <u>\$ 28,115,073</u> |

## Notes to Financial Statements

### Note 5. Allowance for Loan Losses

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

|   | <u>2007</u>         | <u>2006</u>       |
|---|---------------------|-------------------|
| Balance at beginning of period                  | \$ 356,000          | \$ -              |
| Provision for loan losses charged to operations | 691,000             | 356,000           |
| Recoveries of amounts charged off               | -                   | -                 |
| Amounts charged off                             | -                   | -                 |
| Balance at end of period                        | <u>\$ 1,047,000</u> | <u>\$ 356,000</u> |

There were no loans impaired, nonaccrual or past due 90 days or more at December 31, 2007 or 2006 or for the year or period then ended.

### Note 6. Property and Equipment

#### *Components of Property and Equipment*

Components of property and equipment and total accumulated depreciation at December 31, 2007 and 2006 are as follows:

|   | <u>2007</u>       | <u>2006</u>       |
|---|-------------------|-------------------|
| Furniture and equipment                     | \$ 480,297        | \$ 436,991        |
| Computers and software                      | <u>256,688</u>    | <u>196,938</u>    |
| Property and equipment, total               | 736,985           | 633,929           |
| Less accumulated depreciation               | <u>(196,051)</u>  | <u>(48,174)</u>   |
| Property and equipment, net of depreciation | <u>\$ 540,934</u> | <u>\$ 585,755</u> |

#### *Leases*

The Bank has entered into an operating lease on its banking office in Raleigh, North Carolina. The initial term of this lease commenced on May 1, 2006 and will remain in effect through July 31, 2011, 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 2007 and 2006 was \$135,085 and \$55,330, respectively.

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

| <u>Year</u> | <u>Amount</u>     |
|-------------|-------------------|
| 2008        | \$ 131,298        |
| 2009        | 134,573           |
| 2010        | 137,937           |
| 2011        | 81,627            |
| 2012        | -                 |
| Total       | <u>\$ 485,435</u> |

## Notes to Financial Statements

### Note 7. Deposits

The aggregate amount of time deposits in denominations of one hundred thousand dollars or more at December 31, 2007 and 2006 was approximately \$22,551,000 and \$6,535,000, respectively. At December 31, 2007, the scheduled maturities of time deposits (in thousands) are as follows:

|                | <u>Less Than<br/>\$100,000</u> | <u>\$100,000<br/>or More</u> | <u>Total</u>     |
|----------------|--------------------------------|------------------------------|------------------|
| 2008           | \$ 5,856                       | \$ 22,240                    | \$ 28,096        |
| 2009 thru 2011 | 2,109                          | 311                          | 2,420            |
|                | <u>\$ 7,965</u>                | <u>\$ 22,551</u>             | <u>\$ 30,516</u> |

### Note 8. Borrowings

#### *Short-term Debt*

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

|  | <u>2007</u>  | <u>2006</u>  |
|--|--------------|--------------|
| Outstanding balance at December 31                     | \$ 7,436,370 | \$ 2,020,422 |
| Year-end weighted average rate                         | 4.05%        | 4.52%        |
| Daily average outstanding during the period            | \$ 2,996,000 | \$ 642,905   |
| Average rate for the period                            | 4.51%        | 4.38%        |
| Maximum outstanding at any month-end during the period | \$ 7,436,370 | \$ 2,020,422 |

#### *Long-term debt*

The Bank has an available line of credit with the FHLB equal to 20% of total assets. Advances under this line are secured by eligible securities and qualifying first mortgage loans.

Advances from the FHLB of Atlanta consisted of the following at December 31, 2007 and 2006.

| <u>Maturity</u>   | <u>Interest<br/>Rate</u> | <u>2007</u>         | <u>2006</u> |
|-------------------|--------------------------|---------------------|-------------|
| January 18, 2008  | 5.01%                    | \$ 1,000,000        | \$ -        |
| October 20, 2008  | 4.76%                    | 1,000,000           | -           |
| November 27, 2009 | 4.05%                    | 2,000,000           | -           |
| March 15, 2010    | 4.49%                    | 2,000,000           | -           |
| September 7, 2012 | 4.05%                    | 3,000,000           | -           |
|                   |                          | <u>\$ 9,000,000</u> | <u>\$ -</u> |

#### *Lines of Credit*

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 \$11,550,000. At December 31, 2007, \$1,716,000 was outstanding under these credit facilities. No amounts were outstanding under these credit facilities at December 31, 2006.

## 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, 2007 |            | December 31, 2006 |            |
|--|-------------------|------------|-------------------|------------|
|  | Carrying Amount   | Fair Value | Carrying Amount   | Fair Value |
| <b>Financial assets</b>  |                   |            |                   |            |
| Cash and due from banks  | \$ 533            | \$ 533     | \$ 893            | \$ 893     |
| Interest-bearing deposits with banks                                       | 22                | 22         | -                 | -          |
| Investment securities, available for sale                                  | 18,847            | 18,847     | 7,963             | 7,963      |
| Restricted equity securities   | 506               | 506        | 47                | 47         |
| Loans, net of allowance for loan losses                                    | 82,680            | 83,611     | 28,115            | 28,115     |
| <b>Financial liabilities</b>   |                   |            |                   |            |
| Deposits   | 63,546            | 63,601     | 30,766            | 30,766     |
| Federal funds purchased and securities sold under agreements to repurchase | 7,436             | 7,436      | 2,020             | 2,020      |
| FHLB borrowings  | 9,000             | 9,062      | -                 | -          |

### 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, 2007 and 2006.

|   | 2007         | 2006         |
|---|--------------|--------------|
| Net income (loss) (income available to common shareholders) | \$ (274,122) | \$ (636,819) |
| Weighted average common shares outstanding                  | 2,160,607    | 2,160,000    |
| Effect of dilutive securities, options                      | -            | -            |
| Weighted average common shares outstanding, diluted         | 2,160,607    | 2,160,000    |
| Basic earnings (loss) per share                             | \$ (.13)     | \$ (.29)     |
| Dilutive earnings (loss) per share                          | \$ (.13)     | \$ (.29)     |

Exercise of stock options discussed in the Benefit Plans note are not assumed in computing 2007 or 2006 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 and have completed one month of service. 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, 2007 and 2006 amounted to \$73,826 and \$23,750.

#### Flexible Benefits Plan

The Bank maintains a Flexible Benefits Plan which covers substantially all employees. Participants may set aside pre-tax dollars to provide for the future expenses such as insurance, dependant care or health care.

## 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 price 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.

Activity under the plans during the years ended December 31, 2007 and 2006 are summarized below:

|   | <u>Incentive Plan</u>          |                | <u>Non-statutory Plan</u>      |                |
|---|--------------------------------|----------------|--------------------------------|----------------|
|   | <u>Available<br/>for Grant</u> | <u>Granted</u> | <u>Available<br/>for Grant</u> | <u>Granted</u> |
| Plan adopted                            | 216,000                        | -              | 216,000                        | -              |
| Forfeited                               | -                              | -              | -                              | -              |
| Granted                                 | (101,358)                      | 101,358        | (216,000)                      | 216,000        |
| Exercised                               | -                              | -              | -                              | -              |
| <b><i>Balance December 31, 2006</i></b> | <u>114,642</u>                 | <u>101,358</u> | <u>-</u>                       | <u>216,000</u> |
| Forfeited                               | 9,600                          | (9,600)        | -                              | -              |
| Granted                                 | (24,000)                       | 24,000         | -                              | -              |
| Exercised                               | -                              | (2,400)        | -                              | -              |
| <b><i>Balance December 31, 2007</i></b> | <u>100,242</u>                 | <u>113,358</u> | <u>-</u>                       | <u>216,000</u> |

## Notes to Financial Statements

### Note 11. Benefit Plans, continued

The aggregate intrinsic value for options outstanding at December 31, 2007 was \$803,895. Cash received for options exercised during the year was \$26,400 with an intrinsic value of \$5,400. There was no aggregate intrinsic value for options outstanding at December 31, 2006 as the Bank's exercise price was equal to its market price at that date.

Additional information relating to the plan is listed below:

|  | <u>2007</u>       | <u>2006</u>       |
|--|-------------------|-------------------|
| <b><i>Outstanding options at December 31:</i></b>                              |                   |                   |
| Weighted average exercise price:   |                   |                   |
| Beginning of the year  | \$ 11.00          | \$ n/a            |
| End of the year  | \$ 11.06          | \$ 11.00          |
| Range of exercise prices:  |                   |                   |
| From   | \$ 11.00          | \$ 11.00          |
| To   | \$ 13.50          | \$ 11.00          |
| Weighted average remaining contractual life in years                           | 8.64              | 9.58              |
| Exercisable options  | 89,872            | -                 |
| Weighted average exercise price of exercisable options                         | \$ 11.00          | \$ n/a            |
| <b><i>Weighted average exercise price of options:</i></b>                      |                   |                   |
| Granted during the year  | \$ 11.81          | \$ 11.00          |
| 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  | \$ 86,710         | \$ 1,145,662      |
| <b><i>Significant assumptions used in determining fair value:</i></b>          |                   |                   |
| Risk-free interest rate  | 4.57%             | 5.25%             |
| 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>\$ 336,432</u> | <u>\$ 138,790</u> |

## Notes to Financial Statements

### Note 12. Income Taxes

#### *Operating Loss Carryforwards*

The Bank had a loss carryforward of \$119,571 for federal and state income tax purposes that was used to offset taxable income in 2007.

#### *Current and Deferred Income Tax Components*

The components of income tax expense for the period ended December 31, 2007 and 2006 are as follows:

|   | <u>2007</u> | <u>2006</u> |
|---|-------------|-------------|
| Current                                       | \$ 72,532   | \$ -        |
| Deferred                                      | (158,378)   | (136,148)   |
| Deferred tax asset valuation allowance change | 85,846      | 136,148     |
|   | <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, 2007 and 2006 are as follows:

|   | <u>2007</u> | <u>2006</u>  |
|---|-------------|--------------|
| Tax at statutory federal rate                 | \$ (93,201) | \$ (216,518) |
| Pre-opening interest income                   | -           | 85,092       |
| Other   | 7,355       | (4,722)      |
| Deferred tax asset valuation allowance change | 85,846      | 136,148      |
|   | <u>\$ -</u> | <u>\$ -</u>  |

#### *Deferred Income Tax Analysis*

The significant components of net deferred tax assets at December 31, 2007 and 2006 are summarized as follows:

|  | <u>2007</u>      | <u>2006</u>        |
|--|------------------|--------------------|
| <i>Deferred tax assets</i>                       |                  |                    |
| Allowance for loan losses                        | \$ 371,145       | \$ 117,600         |
| Net operating losses                             | -                | 46,094             |
| Pre-opening expenses                             | 234,933          | 252,228            |
| Stock-based compensation                         | 141,288          | 41,750             |
| Contributions                                    | -                | 2,594              |
| Deferred tax asset                               | <u>747,366</u>   | <u>460,266</u>     |
| <i>Deferred tax liabilities</i>                  |                  |                    |
| Unrealized gain on securities available for sale | 99,345           | 12,868             |
| Depreciation                                     | 62,086           | 31,428             |
| Prepaid expenses                                 | 12,549           | 20,146             |
| Deferred loan costs                              | 30,364           | 12,880             |
| Accretion of bond discount                       | 2,560            | 229                |
| Deferred tax liability                           | <u>206,904</u>   | <u>77,551</u>      |
| Deferred tax asset valuation allowance           | (481,429)        | (395,583)          |
| Net deferred tax asset (liability)               | <u>\$ 59,033</u> | <u>\$ (12,868)</u> |

---

## Notes to Financial Statements

---

### 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 for the year ended December 31, 2007.

#### *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, 2007 and 2006 are as follows:

|                              | <u>2007</u>          | <u>2006</u>         |
|------------------------------|----------------------|---------------------|
| Commitments to extend credit | \$ 30,494,000        | \$ 9,779,000        |
| Standby letters of credit    | <u>100,000</u>       | <u>100,000</u>      |
|                              | <u>\$ 30,594,000</u> | <u>\$ 9,879,000</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 consumer and small business transactions, 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.

---

## Notes to Financial Statements

---

### **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 change 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, 2007, the Bank met all capital adequacy requirements to which it was subject.

As of December 31, 2007, the Bank met the criteria to be considered well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table.

## 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, 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%         |
| <b>December 31, 2006</b>  |               |              |                                    |              |   |              |
| Total Capital             |               |              |                                    |              |   |              |
| (to Risk-Weighted Assets) | \$ 23,128     | 69.8%        | \$ 2,651                           | 8.0%         | \$ 3,314  | 10.0%        |
| Tier I Capital            |               |              |                                    |              |   |              |
| (to Risk-Weighted Assets) | \$ 22,772     | 68.7%        | \$ 1,325                           | 4.0%         | \$ 1,988  | 6.0%         |
| Tier I Capital            |               |              |                                    |              |   |              |
| (to Average Assets)       | \$ 22,772     | 48.2%        | \$ 1,888                           | 4.0%         | \$ 2,361  | 5.0%         |

### Note 15. 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>2007</u>         | <u>2006</u>         |
|---------------------------|---------------------|---------------------|
| <b>Balance, beginning</b> | \$ 5,076,531        | \$ -                |
| New loans and advances    | 3,606,761           | 5,101,433           |
| Repayments                | (3,376,684)         | (24,902)            |
| <b>Balance, ending</b>    | <u>\$ 5,306,608</u> | <u>\$ 5,076,531</u> |

---

# Board of Directors and 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<br>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  |
| Charles P. Wilkins       | Attorney/Member<br>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 of Operations  |
| Susan Gilbert Tannery | Vice President – Corporate Secretary         |

---

## Shareholder Information

---

### Annual Meeting

The annual meeting of shareholders will be held on Wednesday, May 21, 2008 at 10:00 a.m. at Northridge Country Club, 6612 Falls of Neuse Road, Raleigh, North Carolina.

### Requests for Information

Requests for information should be directed to Mrs. 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

4505 Falls of Neuse Road  
Suite 100  
Raleigh, North Carolina 27609

<http://www.capstonebank.com>