

CORNERSTONE

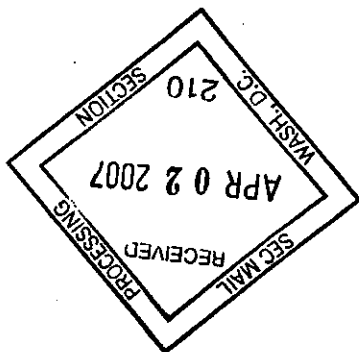
BANCORP

2006 ANNUAL REPORT

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FINANCIAL



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CORNERSTONE

BANCORP

Dear Shareholders,


On behalf of the board of directors of Cornerstone Bancorp, I am pleased to report our results for 2006, which include the fifth consecutive year of increased earnings. In 2006 we increased earnings more than 56% over 2005 and earned \$9.91 per diluted common share. At the end of 2006, book value per common share outstanding was \$9.87 per share.

Early in 2006 we successfully completed a secondary offering of our common stock. The over-subscribed offering, which began in October 2005, increased our capital by approximately \$6.0 million and added a number of new shareholders. As a result our stock has been listed on the Over-the Counter Bulletin Board. Trading in our common stock is reported under the symbol CTOT.OB.

During 2006 our Company grew total assets by 12.6% and our Bank remains a well capitalized financial institution. We are poised for more growth in 2007 and plan to accomplish that growth within our current branch network. We also plan to complete an operations center adjacent to our main office in Easley, South Carolina in the third quarter of 2007. We expect to add some much needed space for deposit operations and mortgage lending and to be able to increase the number of customer contact personnel in the main office building. Each of these additions is designed to expand and improve our customer service capabilities.

As always, our continued success depends on the support of our shareholders, customers, and friends. We appreciate your confidence and thank you for recommending us to your family and friends. Please let us know how we can continue to serve you and the communities of the Upstate of South Carolina.

Sincerely,



J. Roger Anthony
Chief Executive Officer
March 19, 2007

FORWARD LOOKING STATEMENTS

Statements included in this report which are not historical in nature are intended to be, and are hereby identified as "forward looking statements" for purposes of the safe harbor provided by Section 21E of the Securities Exchange Act of 1934, as amended. Words such as "estimate", "project", "intend", "expect", "believe", "anticipate", "plan", and similar expressions identify forward-looking statements. The Company cautions readers that forward looking statements including without limitation, those relating to the Company's new offices, future business prospects, revenues, working capital, adequacy of the allowance for loan losses, liquidity, capital needs, interest costs, and income, are subject to certain risks and uncertainties that could cause actual results to differ from those indicated in the forward looking statements, due to several important factors identified in this report, among others, and other risks and factors identified from time to time in the Company's other reports filed with the Securities and Exchange Commission.

These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs, and assumptions made by management. Such information includes, without limitation, discussions as to estimates, expectations, beliefs, plans, strategies, and objectives concerning the Company's future financial and operating performance. These statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict, particularly in light of the fact that the Company is a relatively new company with limited operating history. Therefore, actual results may differ materially from those expressed or forecasted in such forward-looking statements. The risks and uncertainties include, but are not limited to:

- the Company's growth and ability to maintain growth;
- governmental monetary and fiscal policies, as well as legislative and regulatory changes;
- the effect of interest rate changes on our level and composition of deposits, loan demand and the value of our loan collateral and securities;
- the effects of competition from other financial institutions operating in the Company's market areas and elsewhere, including institutions operating locally, regionally, nationally and internationally;
- failure of our customers to repay loans;
- failure of assumptions underlying the establishment of the allowance for loan losses, including the value of collateral securing loans; and
- loss of consumer confidence and economic disruptions resulting from terrorist activities.

The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties, and assumptions, the forward-looking events discussed in this report might not occur.

WEBSITE REFERENCES

References to the Bank's website included in, or incorporated by reference into, this report are for information purposes only, and are not intended to incorporate the website by reference into this report.

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

Cornerstone Bancorp, (the "Company") is a bank holding company and has no operations other than those carried on by its wholly owned subsidiary, Cornerstone National Bank (the "Bank"). The Bank commenced business on September 15, 1999. It conducts a general banking business from three offices in the Easley area of Pickens County, in the Berea area of Greenville County, and in the Powdersville area of Anderson County, South Carolina. The Bank established a wholly owned subsidiary, Crescent Financial Services, Inc. ("Crescent") in 2004.

The following information describes various financial aspects of the Bank's business. This information should be read in conjunction with the consolidated financial statements of the Company, which appear elsewhere in this document, and the Company's Form 10-KSB, filed with the Securities and Exchange Commission.

Services of the Bank

Deposits

The Bank offers the full range of deposit services typically available in most banks and savings and loan associations, including checking accounts, NOW accounts, retirement accounts (including Individual Retirement Accounts), and savings and other time deposits of various types, ranging from daily money market accounts to longer-term certificates of deposit. The transaction accounts and time certificates are tailored to the principal market area at rates competitive with those offered in the area. All deposit accounts are insured by the Federal Deposit Insurance Corporation ("FDIC") up to the maximum amount permitted by law. The Bank solicits these accounts from individuals, businesses, associations and organizations, and government authorities. Although the Bank intends to be competitive in its efforts to attract deposit accounts, it does not aggressively seek jumbo certificates of deposit (certificates in amounts greater than \$100,000).

Lending Activities

The Bank offers a range of lending services, including, commercial loans, consumer loans, and real estate mortgage loans. To address the risks inherent in making loans, management maintains an allowance for loan losses based on, among other things, an evaluation of the Bank's loan loss experience, management's experience at other financial institutions in the market area, peer data, the amount of and trends in past due and nonperforming loans, current economic conditions and the values of loan collateral. Based upon such factors, management makes various assumptions and judgments about the ultimate collectibility of the loan portfolio and provides an allowance for loan losses based upon a percentage of the outstanding balances and specific loans. However, because there are certain risks that cannot be precisely quantified, management's judgment of the allowance is necessarily approximate and imprecise. The adequacy and methodology of the allowance for loan losses is also subject to regulatory examination.

Real Estate Loans

One of the primary components of the Bank's loan portfolio is loans secured by first or second mortgages on residential and commercial real estate. These loans generally consist of short to mid-term commercial real estate loans, construction and development loans and residential real estate loans (including home equity and second mortgage loans). Interest rates may be fixed or adjustable and the Bank frequently charges an origination fee. The Bank seeks to manage credit risk in the commercial real estate portfolio by emphasizing loans on owner-occupied office and retail buildings where the loan-to-value ratio, established by independent appraisals, does not exceed 80%. In addition, the Bank generally requires personal guarantees of the principal owners of the property. The loan-to-value ratio for first and second mortgage loans and for construction loans generally does not exceed 80%. In an effort to control interest rate risk, long-term residential mortgages are underwritten and funded by, and closed in the name of, third party investors.

The principal economic risk associated with all loans, including real estate loans, is the creditworthiness of the Bank's borrowers. The ability of a borrower to repay a real estate loan depends upon a number of economic factors, including employment levels and fluctuations in the value of real estate. In the case of a real estate construction loan, there is generally no income from the underlying property during the construction period, and the developer's personal

obligations under the loan are typically limited. In the case of a real estate purchase loan, the borrower may be unable to repay the loan at the end of the loan term and thus may be forced to refinance the loan at a higher interest rate, or, in certain cases, the borrower may default as a result of its inability to refinance the loan. In either case, the risk of nonpayment by the borrower is increased.

The Bank also faces additional credit risks, to the extent that it engages in making adjustable rate mortgage loans ("ARMs"). In the case of an ARM, as interest rates increase, the borrower's required payments increase, thus increasing the potential for default. The marketability of all real estate loans, including ARMs, is also generally affected by the prevailing level of interest rates.

Commercial Loans

The Bank makes loans for commercial purposes in various lines of business. Commercial loans include both secured and unsecured loans for working capital (including inventory and receivables), loans for business expansion (including acquisition of real estate and improvements), and loans for purchases of equipment and machinery. Equipment loans are typically made for a term of five years or less at either fixed or variable rates, with the loan fully amortized over the term and secured by the financed equipment. Working capital loans typically have terms not exceeding one year and are usually secured by accounts receivable, inventory or personal guarantees of the principals of the business. Commercial loans vary greatly depending upon the circumstances and loan terms are structured on a case-by-case basis to better serve customer needs.

The risks associated with commercial loans vary with many economic factors, including the economy in the Bank's market areas. The well-established banks in the Bank's market areas make proportionately more loans to medium- to large-sized businesses than the Bank makes. Many of the Bank's commercial loans are made to small- to medium-sized businesses, which typically are not only smaller, but also have shorter operating histories and less sophisticated record keeping systems than larger entities. As a result, these smaller entities may be less able to withstand adverse competitive, economic and financial conditions than larger borrowers. In addition, because payments on loans secured by commercial property generally depend to a large degree on the results of operations and management of the properties, repayment of such loans may be subject, to a greater extent than other loans, to adverse conditions in the real estate market or the economy.

Consumer Loans

The Bank makes a variety of loans to individuals for personal and household purposes, including secured and unsecured installment and term loans, home equity loans and lines of credit and unsecured revolving lines of credit. The secured installment and term loans to consumers generally consist of loans to purchase automobiles, boats, recreational vehicles, mobile homes and household furnishings, with the collateral for each loan being the purchased property. The underwriting criteria for home equity loans and lines of credit are generally the same as applied by the Bank when making a first mortgage loan, as described above, and home equity lines of credit typically expire 15 years or less after origination, unless renewed or extended.

Consumer loans generally involve more credit risks than other loans because of the type and nature of the underlying collateral or because of the absence of any collateral. Consumer loan repayments are dependent on the borrower's continuing financial stability and are likely to be adversely affected by job loss, divorce and illness. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans in the case of default. In most cases, any repossessed collateral will not provide an adequate source of repayment of the outstanding loan balance. Although the underwriting process for consumer loans includes a comparison of the value of the security, if any, to the proposed loan amount, the Bank cannot predict the extent to which the borrower's ability to pay, and the value of the security, will be affected by prevailing economic and other conditions.

Other Services

The Bank participates in a regional network of automated teller machines that may be used by Bank customers in major cities throughout the Southeast. The Bank offers both VISA and MasterCard brands of bankcards together with related lines of credit. The lines of credit may be used for overdraft protection as well as pre-authorized credit for personal purchases and expenses. The Bank also provides travelers checks, direct deposit of payroll and social security checks, and automatic drafts for various accounts, but does not currently provide international or trust banking services, other than foreign currency exchange through a correspondent bank. The Bank offers an Internet banking product accessible via the Bank's custom website at www.cornerstonenationalbank.com. The interactive banking product includes an electronic bill payment service that allows customers to make scheduled and/or recurring bill payments electronically. Credit cards are underwritten and funded by a third party provider. The Bank also offers merchant and other business related services to its commercial customers. The Bank also has a residential mortgage loan department with a highly experienced staff qualified to make virtually any type of residential mortgage loan.

Critical Accounting Policies

The Company has adopted various accounting policies, which govern the application of accounting principles generally accepted in the United States of America in the preparation of the Company's financial statements. The significant accounting policies of the Company are described in the notes to the consolidated financial statements.

Certain accounting policies involve significant judgments and assumptions by management, which have a material impact on the carrying value of certain assets and liabilities. Management considers such accounting policies to be critical accounting policies. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from these judgments and estimates, which could have a material impact on the carrying values of assets and liabilities and the results of operations of the Company.

The Company believes the allowance for loan losses is a critical accounting policy that requires the most significant judgments and estimates used in preparation of its consolidated financial statements. Refer to the sections "Allowance for Loan Losses", "Potential Problem Loans", "Impaired Loans" and note 1 to the consolidated financial statements for a detailed description of the Company's estimation process and methodology related to the allowance for loan losses.

Earnings Performance

The Company earned \$1.7 million in 2006 or \$.94 per basic common share and \$.91 per diluted common share compared to \$1.1 million or \$.81 per basic common share and \$.78 per diluted common share for the year ended December 31, 2005. This compares to \$664,057 or \$.52 per basic and \$.51 per diluted common share for the year ended December 31, 2004. The Company's earnings have consistently improved due to the Bank's growth. The Company had net interest income (the difference between interest earned on interest earning assets and interest paid on interest bearing liabilities) of \$5.5 million, \$4.1 million, and \$3.2 million for 2006, 2005, and 2004, respectively. The Company also had other noninterest income of \$1.4 million, \$1.0 million, and \$719,275, in 2006, 2005, and 2004, respectively. The Company provided \$445,896, \$140,347, and \$197,010 to the allowance for loan losses in 2006, 2005, and 2004, respectively, and had other operating expenses of \$3.9 million in 2006, \$3.3 million in 2005, and \$2.7 million in 2004.

Net Interest Income

Net interest income is the amount of interest earned on interest earning assets (loans, investment securities, time deposits in other banks and federal funds sold), less the interest expenses incurred on interest bearing liabilities (interest bearing deposits and borrowed money), and is the principal source of the Bank's earnings. Net interest income is affected by the level of interest rates, volume and mix of interest earning assets and the relative funding of these assets. Due to the fact that the Bank's and therefore, the Company's, assets are largely monetary in nature, material changes in interest rates can have a material impact on the Bank's net interest income. The Company and the Bank

monitor the Bank's assets and liabilities and the interest sensitivity of these assets and liabilities using various tools, including models which attempt to calculate the impact on the Bank's net interest margin as interest rates change. However, these models, as well as the tables included here, employ assumptions about the Bank's interest sensitive assets and liabilities which may or may not prove to be accurate. Such assumptions include, but are not limited to, repayment patterns of borrowers, calls of securities, and unscheduled redemptions of certificates of deposit. The tables on the following pages include historical analyses of yields earned and rates paid on interest sensitive assets and liabilities, the effects of changes in the volume and relative mix of interest sensitive assets and liabilities, the effect of changes in interest rates, and the ratio of assets and liabilities repricing over specific time horizons. While the Company's and the Bank's management cannot predict the timing and extent of changes in interest rates, they do attempt to manage the Bank's interest rate sensitivity to enable the Company to react to protect the Company's earnings stream throughout various interest rate cycles.

For the years ended December 31, 2006, 2005, and 2004, net interest income was \$5.5 million, \$4.1 million, and \$3.2 million, respectively. The consistent increases were attributable to increases in the volume of loans (see "Rate/Volume Analysis of Net Interest Income" below) as well as the interest rate earned on loans. In 2005, increases in rates had a significant impact on interest income, particularly in interest income from loans. In 2006, total average interest earning assets increased to \$113.1 million compared to \$94.5 million in 2005. The average yield on interest earning assets increased 101 basis points to 7.62% in 2006 compared to 6.61% in 2005. The average cost of interest bearing liabilities increased 80 basis points to 3.39% in 2006 from 2.59% in 2005. Rates on interest earning assets and interest bearing liabilities have continued to adjust as accounts have matured and re-priced from interest rates considered historic lows in 2004. The net yield on average interest earning assets increased in 2006 to 4.83% from 4.35% in 2005. The interest rate spread in 2006 was 4.23% compared to 4.02% in 2005.

The table, "Average Balances, Yields and Rates", provides a detailed analysis of the effective yields and rates on the categories of interest earning assets and interest bearing liabilities for the Company for the years ended December 31, 2006 and 2005.

Average Balances, Yields and Rates

(Dollars in thousands)

	Year ended December 31, 2006			Year ended December 31, 2005		
	Average Balances(1)	Interest Income/Expense	Yields/Rates(2)	Average Balances(1)	Interest Income/Expense	Yields/Rates(2)
Assets						
Securities	\$ 17,234	\$ 792	4.59%	\$ 12,313	\$ 464	3.77%
Federal Funds Sold	5,864	294	5.01%	4,495	149	3.31%
Loans (3), (4)	<u>90,018</u>	<u>7,538</u>	8.37%	<u>77,654</u>	<u>5,631</u>	7.25%
Total interest earning assets	113,116	8,624	7.62%	94,462	6,244	6.61%
Cash and due from banks	2,396			2,104		
Allowance for loan losses	(1,120)			(969)		
Premises and equipment	4,472			4,312		
Cash surrender value of life insurance policies	1,600			1,543		
Other assets	<u>1,250</u>			<u>842</u>		
Total assets	\$ <u>121,714</u>			\$ <u>102,294</u>		
Liabilities and shareholders' equity						
Interest bearing liabilities						
Interest bearing transaction accounts	\$ 14,112	155	1.10%	\$ 13,510	140	1.04%
Savings and money market	10,074	165	1.64%	11,689	137	1.17%
Time deposits	<u>60,252</u>	<u>2,577</u>	4.28%	<u>49,939</u>	<u>1,668</u>	3.34%
Total interest bearing deposits	84,438	2,897	3.43%	75,138	1,945	2.59%
Federal Funds purchased and customer repurchase agreements	4,795	116	2.42%	3,605	54	1.50%
FHLB advances	<u>3,973</u>	<u>149</u>	3.75%	<u>3,928</u>	<u>140</u>	3.56%
Total interest bearing liabilities	93,206	<u>3,162</u>	3.39%	82,671	<u>2,139</u>	2.59%
Noninterest bearing demand deposits and other liabilities	12,389			9,573		
Shareholders' equity	<u>16,119</u>			<u>10,050</u>		
Total liabilities and shareholders' equity	\$ <u>121,714</u>			\$ <u>102,294</u>		
Interest rate spread (5)			<u>4.23%</u>			<u>4.02%</u>
Net interest income and net yield on earning assets(6)		\$ <u>5,462</u>	<u>4.83%</u>		\$ <u>4,105</u>	<u>4.35%</u>
Interest free funds supporting earning assets (7)	\$ 19,910			\$ 11,791		

(1) Average balances calculated based on a daily basis.

(2) Calculated based on the number of days in the year that each type of asset or liability was in existence. Yield calculated on a pre-tax basis. The estimated tax equivalent yield on securities was 4.80% in 2006 and 3.82% in 2005.

(3) Nonaccruing loans are included in the average loan balances and income on such loans is recognized on a cash basis.

(4) Interest income on loans includes loan fee income as well as interest income. The amount of loan fees included is not considered material.

(5) Total yield on interest earning assets less the rate paid on total interest bearing liabilities.

(6) Net interest income divided by total interest earning assets.

(7) Total interest earning assets less total interest bearing liabilities.

Rate/Volume Analysis of Net Interest Income

As indicated in the caption "Net Interest Income", the Bank's net income is largely dependent on net interest income. The table below calculates the relative impact on net interest income caused by changes in the average balances (volume) of interest sensitive assets and liabilities and the impact caused by changes in interest rates earned or paid. Each table compares two years as indicated below. The effect of a change in average balance has been determined by applying the average rate in the earlier year to the change in average balance in the later year, as compared with the earlier year. The effect of a change in the average rate has been determined by applying the average balance in the earlier year to the change in the average rate in the later year, as compared with the earlier year. In 2006 and 2005, increases in interest rates had the greatest overall impact on net interest income. However, in both years changes in balances also had a significant impact on net interest income.

Year ended December 31, 2006 compared to 2005

	Rate	Increase (Decrease) Due to (Dollars in Thousands)		Change
		Volume	Rate/Volume(1)	
Interest earned on:				
Securities (2)	\$ 102	\$ 185	\$ 41	\$ 328
Federal Funds sold	77	45	24	146
Loans	<u>872</u>	<u>896</u>	<u>139</u>	<u>1,907</u>
Total interest income	1,051	1,126	204	2,381
Interest paid on:				
Deposits	531	332	89	952
Federal Funds purchased and customer repurchase agreements	33	18	11	62
FHLB advances	<u>7</u>	<u>2</u>	<u>-</u>	<u>9</u>
Total interest expense	<u>571</u>	<u>352</u>	<u>100</u>	<u>1,023</u>
Change in Net Interest Income	\$ <u>480</u>	\$ <u>774</u>	\$ <u>104</u>	\$ <u>1,358</u>

Year ended December 31, 2005 compared to 2004

	Rate	Increase (Decrease) Due to (Dollars in Thousands)		Change
		Volume	Rate/Volume(1)	
Interest earned on:				
Securities (2)	\$ (13)	\$ (17)	\$ -	\$ (30)
Federal Funds sold	64	16	21	101
Loans	<u>732</u>	<u>768</u>	<u>141</u>	<u>1,641</u>
Total interest income	783	767	162	1,712
Interest paid on:				
Deposits	286	373	109	768
Federal Funds purchased and customer repurchase agreements	21	(26)	(8)	(13)
FHLB advances	<u>42</u>	<u>27</u>	<u>24</u>	<u>93</u>
Total interest expense	<u>349</u>	<u>374</u>	<u>125</u>	<u>848</u>
Change in Net Interest Income	\$ <u>434</u>	\$ <u>393</u>	\$ <u>37</u>	\$ <u>864</u>

- (1) Volume/Rate is calculated as the difference between the average balances for the periods multiplied by the difference between the average rates for the periods.
- (2) Income calculated on a pre-tax basis.

Interest Rate Sensitivity

Interest rate sensitivity measures the timing and magnitude of the repricing of assets compared with the repricing of liabilities and is an important part of asset/liability management. The objective of interest rate sensitivity management is to generate stable growth in net interest income, and to control the risks associated with interest rate movements. Management constantly reviews interest rate risk exposure and the expected interest rate environment so that adjustments in interest rate sensitivity can be made in a timely manner.

On a cumulative basis, rate sensitive liabilities exceeded rate sensitive assets, resulting in a liability sensitive position at the end of 2006 of \$10.5 million, for a cumulative gap ratio of .87 calculated at the one-year time horizon. When interest sensitive liabilities exceed interest sensitive assets for a specific repricing "horizon", a negative interest sensitivity gap results, as was the case at the end of 2006 with respect to the one-year time horizon. The gap is positive when interest sensitive assets exceed interest sensitive liabilities. For a bank with a negative gap, falling interest rates would be expected to have a positive effect on net interest income and increasing rates would be expected to have the opposite effect.

The table below reflects the balances of interest earning assets and interest bearing liabilities at the earlier of their repricing or maturity dates. Amounts of fixed rate loans are reflected at the loans' final maturity dates. Variable rate loans are reflected at the earlier of their contractual maturity date or the date at which the loan may be repriced contractually. Deposits in other banks and debt securities are reflected at the earlier of each instrument's repricing date for variable rate instruments or the ultimate maturity date for fixed rate instruments. Overnight federal funds sold are reflected in the earliest repricing interval due to the immediately available nature of these funds. Interest bearing liabilities with no contractual maturity, such as interest bearing transaction accounts and savings deposits are reflected in the earliest repricing interval due to contractual arrangements which give management the opportunity to vary the rates paid on these deposits within a thirty-day or shorter period. However, the Bank is under no obligation to vary the rates paid on those deposits within any given period. Fixed rate time deposits, principally certificates of deposit, are reflected at their contractual maturity dates. Federal funds purchased are presented in the immediate repricing interval because the interest rate paid adjusts at the beginning of each month. The table does not reflect repricing that could occur as a result of prepayment of loans or early withdrawal of time deposits or movement into or out of non-maturing deposit accounts.

Interest Sensitivity Analysis

	December 31, 2006							Total
	Immediate	1-3 Months	3-12 Months	1-3 Years	3-5 Years	5-15 Years	> 15 Years	
	(Dollars in Thousands)							
Interest earning assets								
Securities (1)	\$ -	\$ 1,498	\$ 1,249	\$ 988	\$ 1,248	\$ 8,103	\$ 4,904	\$ 17,990
Federal funds sold	3,215	-	-	-	-	-	-	3,215
Loans (2)	47,662	3,918	10,763	16,343	16,922	1,842	106	97,556
Total interest earning assets	50,877	5,416	12,012	17,331	18,170	9,945	5,010	118,761
Interest bearing deposits								
Interest bearing transaction accounts	15,166	-	-	-	-	-	-	15,166
MMDAs & Savings	10,093	-	-	-	-	-	-	10,093
Time deposits	-	16,957	32,115	12,091	2,876	-	-	64,039
Customer repurchase agreements	-	2,364	2,000	700	-	-	-	5,064
FHLB advances	-	38	113	1,953	302	290	-	2,696
Total interest bearing liabilities	25,259	19,359	34,228	14,744	3,178	290	-	97,058
Interest sensitivity gap	\$ 25,618	\$ (13,943)	\$ (22,216)	\$ 2,587	\$ 14,992	\$ 9,655	\$ 5,010	\$ 21,703
Cumulative interest sensitivity gap	\$ 25,618	\$ 11,675	\$ (10,541)	\$ (7,954)	\$ 7,038	\$ 16,693	\$ 21,703	
Gap ratio	2.01	.28	.35	1.18	5.72	34.21	-	
Cumulative gap ratio	2.01	1.26	.87	.92	1.07	1.17	1.22	

	December 31, 2005							Total
	Immediate	1-3 Months	3-12 Months	1-3 Years	3-5 Years	5-15 Years	> 15 Years	
	(Dollars in Thousands)							
Interest earning assets								
Securities (1)	\$ -	\$ 700	\$ 5,955	\$ 3,236	\$ 989	\$ 2,514	\$ 610	\$ 14,004
Federal funds sold	3,183	-	-	-	-	-	-	3,183
Loans (2)	47,614	3,472	7,467	11,832	15,186	1,699	62	87,332
Total interest earning assets	50,797	4,172	13,422	15,068	16,175	4,213	672	104,519
Interest bearing deposits								
Interest bearing transaction accounts	15,966	-	-	-	-	-	-	15,966
MMDAs & Savings	9,790	-	-	-	-	-	-	9,790
Time deposits	-	18,457	15,617	15,723	5,647	-	-	55,444
Customer repurchase agreements	1,784	1,300	-	-	-	-	-	3,084
FHLB advances	-	38	1,613	1,953	302	440	-	4,346
Total interest bearing liabilities	27,540	19,795	17,230	17,676	5,949	440	-	88,630
Interest sensitivity gap	\$ 23,257	\$ (15,623)	\$ (3,808)	\$ (2,608)	\$ 10,226	\$ 3,773	\$ 672	\$ 15,889
Cumulative interest sensitivity gap	\$ 23,257	\$ 7,634	\$ 3,826	\$ 1,218	\$ 11,444	\$ 15,217	\$ 15,889	
Gap ratio	1.84	.21	.78	.85	2.72	9.57	1.00	1.18
Cumulative gap ratio	1.84	1.16	1.06	1.01	1.13	1.17	1.18	

(1) Securities with call features have been included in the period in which the security matures.

(2) There were no nonaccruing loans or unamortized deferred loan fees, both of which would normally be subtracted from loans for purposes of this table.

Provision for Loan Losses

The provision for loan losses is charged to earnings based on management's continuing review and evaluation of the loan portfolio and general economic conditions. The following table summarizes the activity in the allowance for loan losses.

	Year ended December 31,		
	2006	2005	2004
		(Dollars in thousands)	
Allowance for loan losses, beginning of year	\$ 1,058	\$ 919	\$ 728
Provision for loan losses	446	140	197
Charge-offs	(304)	(1)	(6)
Recoveries	—	—	—
Allowance for loan losses, end of year	<u>\$ 1,200</u>	<u>\$ 1,058</u>	<u>\$ 919</u>

See "Impaired Loans" and "Allowance for Loan Losses" for a discussion of the factors management considers in its review of the adequacy of the allowance and provision for loan losses.

Other Income

Other income, which consists primarily of mortgage loan origination fees, service charges on deposit accounts, and other fee income, increased by \$375,887 to \$1.4 million in 2006 from \$1.0 million in 2005 and from \$719,275 in 2004. The increase in 2006 is primarily the result of a gain on sale of land of \$241,696 in 2006 which related to the sale of property adjacent to one of the Company's branch offices. The Company also reported growth in mortgage loan originations, which increased by more than \$80,000 compared to 2005. Service fees on deposit accounts rose in 2006 by \$63,859.

Other Expenses

Other expenses, which consist primarily of salaries and employee benefits, occupancy costs, and data processing expenses, totaled \$3.9 million in 2006, \$3.3 million in 2005, and \$2.7 million in 2004. Salaries and employee benefits rose to \$2.3 million in 2006 from \$2.0 million in 2005 and \$1.5 million in 2004. The increases in each year were due to the hiring of additional staff to support the Bank's growth and annual salary increases. Incentive compensation increased in 2006 and option expense of \$19,784 was included for the first time in salaries and benefits in 2006 following the adoption of SFAS No. 123(R). The cost of health insurance benefits also increased in 2006 by 23.7%. Net occupancy increased to \$567,355 in 2006 over \$512,011 in 2005 and \$438,848 in 2004. The increase in 2006 is primarily due to a full year of expenses to maintain the branch opened in July 2005. Equipment maintenance increases accounted for \$27,000 of the increase. Data processing expense increased 35.6% in 2006 after increasing by 5.5% in 2005 as compared to 2004. The data processing increases in 2006 and 2005 are primarily due to growth in the number of accounts and transactions processed by the Company's data processing provider. Advertising expenses increased 21.3% in 2006. Supplies expense decreased 5.7% in 2006. The higher supplies expense in 2005 was mainly due to set up costs for the branch opened in July 2005. Directors fees increased in 2006 due to two new directors, including one at the holding company and one at the Bank level, and due to increases in the per meeting amount paid to directors. Charge-offs on deposits included one fraudulent transaction for \$25,000 that occurred in 2006. Other operating expenses increased mainly due to expenses associated with a full year of expense for the Powdersville branch. In addition, ATM processing fees, which are included in other expense, increased 32.2% or \$16,000 during 2006 over 2005 levels. The Company's efficiency ratio, which is measured as the ratio of noninterest expense to the sum of net interest income plus other income expressed as a percentage, improved in 2006 to 58% compared to 64% in 2005 and 68% in 2004 as the Company's fixed expenses continued to be spread over a larger customer base.

Income Taxes

For 2006 the Company recorded income tax expense of \$794,998 compared to \$620,658 in 2005 and \$388,898 in 2004. The increases are due to an increase in pretax income, net of non-taxable items. The Bank accounts for income taxes under Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes." Certain items of income and expense (principally provision for loan losses, depreciation, and prepaid expenses) are included in one reporting period for financial accounting purposes and another for income tax purposes. Refer to the notes to the Company's consolidated financial statements contained elsewhere herein for more information.

Investment Securities

Management assigns securities upon purchase into one of the categories (trading, available-for-sale and held-to-maturity) designated by Statement of SFAS No. 115 based on intent, taking into consideration other factors including expectations for changes in market rates of interest, liquidity needs, asset/liability management strategies, and capital requirements. The Bank has not historically held securities for trading purposes. As of December 31, 2006, 2005, and 2004, the Bank's investment portfolio comprised approximately 14.1%, 12.4%, and 13.1%, respectively, of total assets.

The following table summarizes the carrying amounts of securities held by the Bank at December 31, 2006 and 2005. Available-for-sale securities are stated at estimated fair value. Held-to-maturity securities are stated at amortized cost. Federal Reserve Bank of Richmond and Federal Home Loan Bank of Atlanta stocks have no quoted market value, but have historically been redeemed at par value, and are therefore carried at cost. There are no individual issuers, other than government sponsored enterprises, whose securities represent more than 10% of the Company's consolidated shareholders' equity at December 31, 2006. Government sponsored enterprises ("GSEs") are agencies and corporations established by the U. S. Government, including among others, the Federal Home Loan Banks, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation and Federal Farm Credit Banks. Securities issued by these enterprises are not obligations of the U. S. Government and are not backed by the full faith and credit of the U. S. Government or otherwise guaranteed by the U. S. Government. Because of the high-quality of the issuers, however, these securities generally are eligible to be used as security for public deposits of the U. S. Treasury, government agencies and corporations and states and other political subdivisions. At December 31, 2006 and 2005, securities with a fair value of \$8,669,970 and \$7,467,531, respectively, were pledged to collateralize public deposits, sweep accounts, and repurchase agreements.

Investment Securities Portfolio Composition

	December 31,	
	2006	2005
	(Dollars in thousands)	
Available for sale:		
Government sponsored enterprises	\$ 9,191	\$ 7,676
Mortgage-backed securities	4,018	663
Municipal bonds	2,967	1,351
Total available for sale	16,176	9,690
Held to maturity		
Government sponsored enterprises	1,000	3,704
Federal Reserve Bank of Richmond stock	388	210
Federal Home Loan Bank of Atlanta stock	425	400
Total	\$ 17,989	\$ 14,004

The following table presents contractual maturities and weighted average yields of securities at December 31, 2006 and 2005. Securities are presented at their carrying value (available for sale securities are carried at fair value and held to maturity securities are carried at book value, which is equal to their amortized cost.),

Investment Securities Portfolio Maturities and Yields

	December 31, 2006		December 31, 2005	
	<u>Amount</u>	<u>Yield(1)</u>	<u>Amount</u>	<u>Yield(1)</u>
	(Dollars in thousands)		(Dollars in thousands)	
Available for sale securities:				
Government sponsored enterprises				
Within one year	\$ 1,747	3.59%	\$ 3,953	2.90%
After one through five years	1,991	5.02%	3,223	4.40%
After five through ten years	5,453	5.90%	500	5.75%
FNMA and FHLMC Mortgage-backed securities (2)				
After five through ten years	507	3.80%	663	3.80%
After 10 years	3,511	5.91%	-	-%
Municipal bonds				
After five through ten years	1,453	3.59%	1,351	3.53 %
After 10 years	1,514	4.09%	-	-%
Held to maturity securities:				
Government sponsored enterprises				
Within one year	1,000	4.92%	2,703	4.55%
After one through five years	-	-%	1,002	4.93%
Other securities				
No stated maturity	<u>813</u>	5.94%	<u>609</u>	5.08%
Total	<u>\$ 17,989</u>	5.08%	<u>\$ 14,004</u>	4.00%

(1) Yields calculated on a pre-tax basis.

(2) The securities mature on an amortizing basis. They are included here in the period of final maturity.

While thirteen of the Company's government sponsored enterprise bonds, municipal bonds and mortgage-backed securities are in an unrealized loss position as of December 31, 2006, none of these securities is expected to have a loss of principal at final maturity. The Company has the intent and ability to hold these securities until such time as the value recovers or the securities mature. The Company believes, based on industry analyst reports and credit ratings, that the deterioration in value is attributable to changes in market interest rates and not in the credit quality of the issuers and therefore, these losses are not considered other-than-temporary. The Company's investments are obligations of the United States, its sponsored enterprises, or municipal securities. In the opinion of Management, there is no concentration of credit risk in the investment portfolio.

Loan Portfolio

Management believes the loan portfolio is adequately diversified. There are no significant concentrations of loans to any particular individuals or in industries which management believes pose a material risk to the Bank, and there are no foreign loans. The Bank does have loans in certain broad categories that comprise over 25% of Tier 1 Capital adjusted for the allowance for loan losses. Those categories are as follows: real estate rental and leasing, construction, retail trade, health care and social assistance, and other services. The Company believes that the Bank has appropriate controls in place to monitor risks that may arise due to concentrations in the loan portfolio. Loans made outside the policy guidelines may present additional credit risk to the Company. In order to monitor these loans and the total number and amount of loans made with exceptions to loan policies, the Bank monitors all loans approved with policy exceptions. Monthly, statistics regarding the number of loans and the amount of loans with policy exceptions are reported to the Board of Directors. One of the policy exceptions reported is for loans exceeding the regulatory guidelines on loan to value ratios. The regulatory loan to value guidelines permit exceptions to the guidelines not to exceed 100% of Total Regulatory Capital for single family residential mortgage loans (\$17.8 million at December 31, 2006), or for real estate loans other than single family residential loans, exceptions must not exceed 30% of Total Regulatory Capital (\$5.3 million as of December 31, 2006). As of December 31, 2006, the Bank has \$2.6 million of

loans which exceed regulatory loan to value guidelines, an amount which is well within the allowable maximum of exceptions to the guidelines.

The banking industry offers products that can increase credit risk should economic conditions change over the course of a loan's life. Interest-only loans, adjustable rate loans, and loans with amortization periods that differ from the maturity date (i.e., balloon payment loans) are examples of products that could subject the Company to increased credit risk in periods of changing economic conditions. The Company evaluates each customer's credit worthiness based on current and expected economic conditions and underwrites and monitors each loan for associated risks. Therefore, Management does not believe that these particular products subject the Company to unusual credit risk. As of December 31, 2006, the Bank does not portfolio residential mortgage loans with negative amortization features, long term principal only payment features, or loan to value ratios in excess of 100%.

The Bank has a mortgage loan brokerage department that accepts mortgage applications for terms greater than 15 years. Mortgage applications are processed and sent to third parties for underwriting. Approved loans are funded by, and closed in the name of, third parties and the Bank receives an origination fee.

The amount of loans outstanding at December 31, 2006 and 2005 are shown in the following table according to type of loan:

Loan Portfolio Composition

	December 31,			
	2006		2005	
	(Dollars in thousands)			
	Amount	% of Loans	Amount	% of Loans
Commercial and industrial	\$ 17,009	17.4%	\$ 19,092	21.9%
Real Estate – construction	27,130	27.8	21,267	24.4
Real Estate – mortgage				
1-4 family residential	19,444	19.9	17,754	20.3
Nonfarm, nonresidential	29,314	30.1	25,583	29.3
Multifamily residential	1,554	1.6	2,042	2.3
Consumer installment	<u>3,105</u>	<u>3.2</u>	<u>1,594</u>	<u>1.8</u>
Total Loans	97,556	100.0%	87,332	100.0%
Less allowance for loan losses	<u>(1,200)</u>		<u>(1,058)</u>	
Net Loans	\$ <u>96,356</u>		\$ <u>86,274</u>	

Maturity Distribution of Loans

The Bank's loan portfolio has a large component of adjustable rate loans. As of December 31, 2006, approximately \$53.4 million or 54.8% of the Bank's loan portfolio was variable.

The following table sets forth the maturity distribution of the Bank's loans, by type, as of December 31, 2006, as well as the type of interest requirement on such loans. For purposes of this table, variable rate loans are included in the period of their final maturity, as opposed to their repricing date.

Maturity Distribution on Loans

	December 31, 2006			Total
	1 Year or Less	1-5 Years	5 Years or More	
Commercial and industrial	\$ 11,867	\$ 4,123	\$ 1,019	\$ 17,009
Real Estate-construction	21,518	5,210	402	27,130
Real Estate-mortgage	12,068	33,203	5,041	50,312
Consumer	<u>2,133</u>	<u>932</u>	<u>40</u>	<u>3,105</u>
Total	<u>\$ 47,586</u>	<u>\$ 43,468</u>	<u>\$ 6,502</u>	<u>\$ 97,556</u>
Predetermined rate, maturity greater than one year		\$ 33,292	\$ 1,878	\$ 35,170
Variable rate, maturity greater than one year		\$ 10,176	\$ 4,624	\$ 14,800

For purposes of the table above, variable rate loans are included in the period of maturity, rather than in the period in which they can reprice.

Impaired Loans

A loan will be considered to be impaired when, in management's judgment based on current information and events, it is probable that the loan's principal or interest will not be collectible in accordance with the terms of the original loan agreement. Impaired loans, when not material, will be carried in the balance sheet at a value not to exceed their observable market price or the fair value of the collateral if the repayment of the loan is expected to be provided solely by the underlying collateral. The carrying values of any material impaired loans will be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, which is the contractual interest rate adjusted for any deferred loan fees or costs, premium or discount existing at the inception or acquisition of the loan.

Loans which management identifies as impaired generally will be nonperforming loans. Nonperforming loans include nonaccrual loans or loans which are 90 days or more delinquent as to principal or interest payments. At December 31, 2006 and 2005, the Bank had no nonaccrual loans or loans 90 days or more past due and no restructured loans.

Generally, the accrual of interest will be discontinued on impaired loans when principal or interest becomes 90 days past due, or when payment in full is not anticipated, and any previously accrued interest on such loans will be reversed against current income. Any subsequent interest income will be recognized on a cash basis when received unless collectibility of a significant amount of principal is in serious doubt. In such cases, collections are credited first to the remaining principal balance on a cost recovery basis. An impaired loan will not be returned to accrual status unless principal and interest are current and the borrower has demonstrated the ability to continue making payments as agreed.

Potential Problem Loans

Management identifies and maintains a list of potential problem loans. These are loans that are not included in nonaccrual status, or loans that are past due 90 days or more and still accruing interest. A loan is added to the potential problem list when management becomes aware of information about possible credit problems of borrowers that causes serious doubts as to the ability of such borrowers to comply with the current loan repayment terms. These loans are designated as such in order to be monitored more closely than other credits in the Bank's portfolio. There were loans in the amount of \$403,000 that have been determined by management to be potential problem loans at December 31, 2006. The loans are secured by real estate. Management is currently assessing the potential impact on the Bank and the

Company, but it is not possible to determine an estimate of the impact at this time.

Allowance for Loan Losses

The allowance for loan losses is increased by direct charges to operating expense. Losses on loans will be charged against the allowance in the period in which management determines that it is likely that such loans have become uncollectible. Recoveries of previously charged off loans will be credited to the allowance. In reviewing the adequacy of the allowance for loan losses at each year end, management will take into consideration the historical loan losses experienced by the bank, current economic conditions affecting the borrowers' ability to repay, the volume of loans, and the trends in delinquent, nonaccruing, and any potential problem loans, and the quality of collateral securing nonperforming and problem loans. Management considers the allowance for loan losses to be adequate to cover its estimate of loan losses inherent in the loan portfolio as of December 31, 2006.

In calculating the amount required in the allowance for loan losses, management applies a consistent methodology that is updated quarterly. The methodology utilizes a loan risk grading system and detailed loan reviews to assess credit risks and the overall quality of the loan portfolio. Also, the calculation provides for management's assessment of trends in national and local economic conditions that might affect the general quality of the loan portfolio.

Summary of Loan Loss Experience

	Year ended December 31,	
	2006	2005
	(Dollars in thousands)	
Total loans outstanding at end of period	\$ 97,556	\$ 87,332
Average amount of loans outstanding	\$ 90,018	\$ 77,654
Balance of allowance for loan losses-beginning	\$ 1,058	\$ 919
Loans charged-off		
Commercial	275	-
Commercial real estate	26	-
Consumer installment	<u>3</u>	<u>1</u>
Total charge-offs	304	1
Recoveries of loans previously charged-off	<u>-</u>	<u>-</u>
Net (charge-offs) recoveries	(304)	(1)
Additions to allowance charged to expense	<u>446</u>	<u>140</u>
Balance of allowance for loan losses-ending	\$ <u>1,200</u>	\$ <u>1,058</u>
Ratios		
Net (charge-offs) recoveries to average loans outstanding	(.34%)	<(.01%)
Net (charge-offs) recoveries to loans at end of period	(.31%)	<(.01%)
Allowance for loan losses to average loans	1.33%	1.36%
Allowance for loan losses to loans at end of period	1.23%	1.21%
Net (charge-offs) recoveries to allowance for loan losses	(25.3%)	(.10%)
Net (charge-offs) recoveries to provision for loan losses	(68.2%)	(1.02%)

The allowance for loan losses is not restricted to specific categories of loans and is available to absorb losses in all categories. Each category of loans is reviewed for characteristics that increase or decrease risk of loss, such as the availability and marketability of collateral, degree of susceptibility to changes in economic conditions, etc., for purposes of estimating the allowance for loan losses. (See "Services of the Bank" for a discussion of risk characteristics for each loan category.) Individual loans are graded using an internal grading system that considers information specific

to the loan. If warranted, a specific allocation may be associated with that loan for purposes of estimating the adequacy of the allowance for loan losses. During 2006, the Company charged off loans totaling \$304,000. Of that amount, approximately \$275,000 of loans were considered to be potential problem loans as of December 31, 2005. Those loans were ultimately charged off. Management continues to pursue recovery of some or all of these amounts. However, it is not possible to determine the amount, if any, that can be recovered at this time.

Real Estate Owned

The Bank had no real estate owned pursuant to foreclosure or in-substance foreclosure at December 31, 2006. Real estate owned is initially recorded at the lower of net loan principal balance or its estimated fair market value less estimated selling costs. The estimated fair value is determined by appraisal at the time of acquisition.

Deposits

The amounts and percentage composition of deposits held by the Bank as of December 31, 2006 and 2005 are summarized below:

Deposit Composition

	December 31,			
	2006		2005	
	(Dollars in thousands)			
	Amount	% of Deposits	Amount	% of Deposits
Noninterest bearing demand	\$ 12,368	12.2%	\$ 10,452	11.4%
Interest bearing transaction accounts	15,166	14.9	15,966	17.4
Savings	3,744	3.7	3,545	3.9
Money market	6,349	6.2	6,244	6.8
Time deposits \$100,000 and over	28,113	27.7	26,006	28.4
Other time deposits	<u>35,926</u>	<u>35.3</u>	<u>29,439</u>	<u>32.1</u>
Total deposits	<u>\$ 101,666</u>	<u>100.0%</u>	<u>\$ 91,652</u>	<u>100.0%</u>

The average amounts of and average rate paid on deposits held by the Bank for the years ended December 31, 2006 and 2005, are summarized below:

Average Deposits

	Year ended December 31,			
	2006		2005	
	Amount	Rate	Amount	Rate
	(Dollars in thousands)			
Noninterest bearing demand	\$ 11,181	-%	\$ 9,241	-%
Interest bearing transaction accounts	14,112	1.10%	13,510	1.04%
Savings and money market	10,074	1.63%	11,689	1.17%
Time deposits	<u>60,252</u>	<u>4.28%</u>	<u>49,939</u>	<u>3.34%</u>
Total average deposits	<u>\$ 95,619</u>		<u>\$ 84,379</u>	

As of December 31, 2006, the Bank held \$28.1 million of time deposits with balances of \$100,000 or more. Of that amount, \$6.7 million mature within three months, \$7.6 million mature over three through six months, \$7.5 million mature over six through twelve months, and \$6.3 million mature over twelve months. \$2.6 million of time deposits over \$100,000 or more are at floating rates of interest at December 31, 2006. The majority of time deposits \$100,000 and over are acquired from customers within the Bank's service area in the ordinary course of business.

While most of the large time deposits are acquired from customers with standing relationships with the Bank, it is a common industry practice not to consider these types of deposits as core deposits because their retention can be expected to be heavily influenced by rates offered, and therefore such deposits may have the characteristics of shorter-term purchased funds. Time deposits \$100,000 and over involve the maintenance of an appropriate matching of maturity distribution and a diversification of sources to achieve an appropriate level of liquidity.

Customer Repurchase Agreements

Customer repurchase agreements consist of sweep accounts and retail repurchase agreements, and totaled \$5.1 million and \$3.1 million at December 31, 2006 and 2005, respectively. Securities issued by government sponsored enterprises with an amortized cost of \$6.7 million and \$5.3 million (fair value of \$6.7 million and \$5.2 million) were used as collateral for the sweep accounts and retail repurchase agreements, at December 31, 2006 and 2005, respectively. All of the sweep accounts pay interest on a floating rate basis. The customer repurchase agreements pay interest on a fixed rate basis and have maturities of varying lengths: As of December 31, 2006, the Bank had five customer repurchase agreements that mature in 2007 and one that matures in 2008. During 2006 the average amount of customer repurchase agreements and sweep accounts totaled \$4.8 million. The Bank paid an average interest rate of 2.43% on these funds in 2006.

Liquidity

Liquidity is the ability to meet current and future obligations through liquidation or maturity of existing assets or the acquisition of additional liabilities. Adequate liquidity is necessary to meet the requirements of customers for loans and deposit withdrawals in the most timely and economical manner. Some liquidity is ensured by maintaining assets that may be immediately converted into cash at minimal cost (amounts due from banks and federal funds sold). However, the most manageable sources of liquidity are composed of liabilities, with the primary focus on liquidity management being on the ability to obtain deposits within the Bank's service area. Core deposits (total deposits less time deposits greater than \$100,000) provide a relatively stable funding base, and were equal to 57.6% of total assets at December 31, 2006.

Asset liquidity is provided from several sources, including amounts due from banks and federal funds sold, and funds from maturing loans. The Company had over \$5.9 million in cash and cash equivalents at December 31, 2006. The Bank has \$4.8 million available through lines of credit with other banks and a line with the Federal Home Loan Bank of Atlanta ("FHLB") as additional sources of liquidity funding. The line with the FHLB is equal to 10% of assets provided that adequate collateral is available for pledging. The line may be used for short or long term funding needs and may be used on a fixed or variable-rate basis. The lines with the other banks are for short-term use only and are unsecured. As of December 31, 2006, the Bank had \$2.7 million at various fixed rates of interest, maturing at various dates through 2015, borrowed from the FHLB. The highest balance at any month end was \$4.3 million. The average balance for 2006 was \$4.0 million. The average rate paid on the borrowings for 2006 was 3.75%. The weighted average interest rate as of December 31, 2006 was 4.10%. At December 31, 2005, the Bank had \$4.3 million at various fixed rates of interest, maturing at various dates through 2015, borrowed from the FHLB. During 2005, the highest balance as of any month end for borrowings from the FHLB was \$6.7 million. The average rate paid on the advances during 2005 was 3.56%. The average balance of FHLB advances for 2005 was \$3.9 million. At December 31, 2006 approximately \$10.0 million of additional funds were available under the FHLB line provided that eligible collateral is available. Management believes that the Bank's overall liquidity sources are adequate to meet its operating needs in the ordinary course of its business.

Off-Balance Sheet Risk

The Company, through the operations of the Bank, makes contractual commitments to extend credit in the ordinary course of its business activities. These commitments are legally binding agreements to lend money to customers of the Bank at predetermined interest rates for a specified period of time. At December 31, 2006, the Bank had issued commitments to extend credit of \$20.6 million through various types of lending arrangements. Of these commitments, \$18.5 million are at variable rates and \$14.1 million of the total expire within one year. Past experience indicates that many of these commitments to extend credit will expire unused and it is unlikely that a large portion would be used in a short period of time.

In addition to commitments to extend credit, the Bank also issues standby letters of credit which are assurances to a third party that they will not suffer a loss if the Bank's customer fails to meet its contractual obligation to the third party. Standby letters of credit totaled approximately \$659,000 at December 31, 2006. Past experience indicates that many of these standby letters of credit will expire unused. However, through its various sources of liquidity discussed above, the Bank believes that it will have the necessary resources to meet these obligations should the need arise.

The Bank offers an automatic overdraft protection product. Approximately \$1.2 million of overdraft protection is available under this product as of December 31, 2006. The Bank expects the majority of this capacity will not be utilized. During 2006 the average balance of demand deposit overdrafts was approximately \$24,000.

Neither the Company nor the Bank is involved in other off-balance sheet contractual relationships, unconsolidated related entities that have off-balance sheet arrangements or transactions that could result in liquidity needs or other commitments or significantly impact earnings. The Company has signed contracts for construction of an operations center next to the Company's main office building. Total costs of construction and furnishings are estimated at \$1.6 million. Construction is expected to be completed in the third quarter of 2007. The Company did not maintain any obligations under non-cancelable operating lease agreements at December 31, 2006. The Company has approximately three years remaining on a five-year contract with a company which provides data, item and ATM processing services. The annual costs are approximately \$204,000. Refer to notes 10 and 14 to the Company's consolidated financial statements for additional discussion on commitments and contingencies and financial instruments with off-balance sheet risk.

Capital Resources

At December 31, 2006, total shareholders' equity increased by approximately \$3.7 million from \$13.8 million at December 31, 2005 to \$17.5 million at December 31, 2006. A portion of the increase was a result of a secondary offering of common stock by the Company completed in January 2006, which increased common stock by \$1.9 million as of December 31, 2006. The remainder of the increase was due to net income of \$1.7 million and an unrealized gain on investment securities of \$147,734, partially offset by cash paid in lieu of fractional shares of \$3,036 as a result of a stock dividend paid in 2006. The Company does not anticipate it will be required to raise additional capital in 2007 if growth occurs in line with current expectations.

The Company made capital expenditures for bank premises and furniture and equipment in 2006 totaling approximately \$137,000. The Company has signed contracts for construction of an operations center next to the Company's main office building. Total costs of construction and furnishings are estimated at \$1.6 million. Such expenditures were made, or are expected to be made, from cash on hand.

The Company and the Bank are subject to regulatory capital adequacy standards. Under these standards, financial institutions are required to maintain certain minimum ratios of capital to risk-weighted assets and average total assets. Under the provisions of the Federal Deposit Insurance Corporation Improvements Act of 1991, federal financial institution regulatory authorities are required to implement prescribed "prompt corrective action" upon the deterioration of the capital position of a bank. If the capital position of an affected institution were to fall below certain levels, increasingly stringent regulatory corrective actions are mandated. The Company's and the Bank's regulatory capital requirements and positions are summarized in note 18 to the consolidated financial statements.

Return on Equity and Assets

The following table shows the return on assets (net income divided by average total assets), return on equity (net income divided by average equity), dividend payout ratio (cash dividends declared per share divided by net income per share), and equity to assets ratio (average equity divided by average total assets) for the years ended December 31, 2006 and 2005.

	<u>2006</u>	<u>2005</u>
Return on assets	1.36%	1.02%
Return on equity	10.30%	10.56%
Dividend payout ratio	-%	-%
Equity to assets ratio (average)	13.20%	9.66%

The return on assets improved in 2006 due largely to growth in the Bank. The slight decline in return on equity was the result of a public offering of the Company's common stock. The Company offered 445,000 shares of common stock in late 2005 and early 2006. The shares were only slightly dilutive to 2005, due to the date of the offering. However, the additional shares were more dilutive to 2006 results.

During 2007, the Bank's plan of operation is to attract new deposit and loan customers, especially in the market areas around our branch offices, to increase the ratio of services per customer and increase the account profitability of the Bank's current customers. Deposit accounts will be sought from individuals and businesses in the Easley, Berea, Powdersville and surrounding markets. The Bank intends to offer competitive rates for such accounts and may seek new accounts by offering rates slightly above those prevailing in the market. Management will continue to emphasize personal service, accessibility, and flexibility as reasons for customers to do business with the Bank. Personal contacts by management, advertising, and competitive prices and services will be the Bank's principal marketing tools.

Inflation

Since the assets and liabilities of a bank are primarily monetary in nature (payable in fixed, determinable amounts), the performance of a bank is affected more by changes in interest rates than by inflation. Interest rates generally increase as the rate of inflation increases, but the magnitude of the change in rates may not be the same.

While the effect of inflation on banks is normally not as significant as is its influence on those businesses that have large investments in plant and inventories, it does have an effect. During periods of high inflation, there are normally corresponding increases in the money supply, and banks will normally experience above-average growth in assets, loans and deposits. Also general increases in the prices of goods and services usually result in increased operating expenses.

Market for Common Equity and Related Stockholder Matters

Although the common stock of the Company may be traded from time to time on an individual basis, no active trading market has developed and none may develop in the foreseeable future. The common stock is not listed on any exchange. The stock is quoted on the Over-the-Counter Bulletin Board under the symbol "CTOT.OB". During the fourth quarter of 2005 and the first two weeks of 2006, the Company sold 445,000 shares of its common stock in a public offering for \$13.50 per share.

The following table shows the high and low bid prices of our common stock reported by the OTC Bulletin Board since the completion of our public offering for the periods shown. The prices reflect inter-dealer prices, without retail mark-up, mark-down, or commission and may not represent actual transactions. The prices have been adjusted to reflect a 10% stock dividend declared in April 2006. "N/A" indicates periods where no data was available.

	Year ended	
	<u>December 31, 2006</u>	
	<u>Low</u>	<u>High</u>
First Quarter	N/A	N/A
Second Quarter	N/A	N/A
Third Quarter	N/A	\$ 14.10
Fourth Quarter	\$ 15.00	\$ 16.50

As of February 14, 2007, there were approximately 621 holders of record of the Company's common stock, excluding individual participants in security position listings.

To date the Company has not paid any cash dividends, and to maintain its capital, does not expect to pay cash dividends in the near future. The dividend policy of the Company is subject to the discretion of the Board of Directors and depends upon a number of factors, including earnings, financial conditions, cash needs and general business conditions, as well as applicable regulatory considerations. Because the Company has no operations other than those of the Bank and only has limited income of its own, the Company would rely on dividends from the Bank as its principal source of cash to pay cash dividends.

Each national banking association is required by federal law to obtain the prior approval of the OCC for the payment of dividends if the total of all dividends declared by the board of directors of such bank in any year will exceed the total of (i) such bank's net profits (as defined and interpreted by regulation) for that year plus (ii) the retained net profits (as defined and interpreted by regulation) for the preceding two years, less any required transfers to surplus. In addition, national banks can only pay dividends to the extent that retained net profits (including the portion transferred to surplus) exceed bad debts (as defined by regulation).

The payment of dividends by the Company and the Bank may also be affected or limited by other factors, such as the requirements to maintain adequate capital above regulatory guidelines. In addition, if, in the opinion of the applicable regulatory authority, a bank under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice (which, depending on the financial condition of the Bank, could include the payment of dividends), such authority may require, after notice and hearing, that such bank cease and desist from such practice. The OCC has indicated that paying dividends that deplete a national bank's capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve, the OCC and the FDIC have issued policy statements, which provide that bank holding companies and insured banks should generally only pay cash dividends out of current operating earnings.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors
Cornerstone Bancorp and Subsidiary
Easley, South Carolina

We have audited the accompanying consolidated balance sheets of *Cornerstone Bancorp and Subsidiary* (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in shareholders' equity and comprehensive income (loss) and cash flows for each of the years in the three year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of *Cornerstone Bancorp and Subsidiary* as of December 31, 2006 and 2005 and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2006 in conformity with United States generally accepted accounting principles.

Elliott Davis, LLC

Greenville, South Carolina
March 19, 2007

**CORNERSTONE BANCORP AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2006	2005
Assets		
Cash and due from banks	\$ 2,696,623	\$ 2,716,965
Federal funds sold	3,215,000	3,183,000
Cash and cash equivalents	5,911,623	5,899,965
Investment securities		
Available-for-sale	16,175,621	9,689,665
Held-to-maturity (Fair value \$999,729 in 2006 and \$3,707,125 in 2005)	1,000,252	3,704,861
Other investments	813,600	609,800
Loans, net	96,356,387	86,273,605
Property and equipment, net	4,414,995	4,577,858
Cash surrender value of life insurance policies	1,628,967	1,573,038
Other assets	1,324,434	972,872
Total assets	\$ 127,625,879	\$ 113,301,664
Liabilities And Shareholders' Equity		
Liabilities		
Deposits		
Noninterest bearing	\$ 12,367,950	\$ 10,451,922
Interest bearing	89,298,246	81,200,119
Total deposits	101,666,196	91,652,041
Customer repurchase agreements	5,064,140	3,083,884
Borrowings from Federal Home Loan Bank of Atlanta	2,695,671	4,346,505
Other liabilities	661,145	391,249
Total liabilities	110,087,152	99,473,679
Commitments and contingencies – Notes 10 and 14		
Shareholders' equity		
Preferred stock, 10,000 shares authorized, no shares issued	-	-
Common stock, no par value, 20,000,000 shares authorized, 1,777,313 and 1,475,743 shares issued at December 31, 2006 and 2005, respectively	15,972,666	13,071,896
Retained earnings	1,499,803	837,565
Accumulated other comprehensive income (loss)	66,258	(81,476)
Total shareholders' equity	17,538,727	13,827,985
Total liabilities and shareholders' equity	\$ 127,625,879	\$ 113,301,664

The accompanying notes are an integral part of these consolidated financial statements.

**CORNERSTONE BANCORP AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME**

	<u>Year ended December 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Interest Income			
Loans and fees on loans	\$ 7,538,140	\$ 5,631,109	\$ 3,990,474
Investment securities	791,730	463,770	493,578
Federal funds sold and other	<u>294,579</u>	<u>148,694</u>	<u>47,618</u>
Total interest income	8,624,449	6,243,573	4,531,670
Interest Expense			
Deposits	2,896,671	1,944,612	1,176,198
Federal funds sold and customer repurchase agreements	116,409	53,873	67,348
Federal Home Loan Bank advances	<u>149,016</u>	<u>140,456</u>	<u>47,097</u>
Total interest expense	<u>3,162,096</u>	<u>2,138,941</u>	<u>1,290,643</u>
Net interest income	5,462,353	4,104,632	3,241,027
Provision for loan losses	<u>445,896</u>	<u>140,347</u>	<u>197,010</u>
Net interest income after provision for loan losses	5,016,457	3,964,285	3,044,017
Noninterest Income			
Mortgage loan origination fees	582,290	501,352	289,962
Service fees on deposit accounts	472,420	408,561	383,125
Gain on sale of security	-	-	5,230
Gain on sale of land	241,696	-	-
Other	<u>89,971</u>	<u>100,577</u>	<u>40,958</u>
Total noninterest income	<u>1,386,377</u>	<u>1,010,490</u>	<u>719,275</u>
Noninterest Expenses			
Salaries and benefits	2,305,982	1,953,315	1,520,890
Occupancy and equipment	567,355	512,011	438,848
Data processing	203,814	150,336	142,523
Advertising	90,423	74,517	54,332
Supplies	94,157	99,805	65,402
Professional fees	166,006	110,645	95,790
Directors fees	105,850	69,175	58,100
Deposit charge-offs	51,516	24,383	65,999
Other operating	<u>362,997</u>	<u>298,665</u>	<u>268,453</u>
Total noninterest expenses	<u>3,948,100</u>	<u>3,292,852</u>	<u>2,710,337</u>
Income before income taxes	2,454,734	1,681,923	1,052,955
Income tax provision	<u>794,998</u>	<u>620,658</u>	<u>388,898</u>
Net income	<u>\$ 1,659,736</u>	<u>\$ 1,061,265</u>	<u>\$ 664,057</u>
Earnings Per Common Share			
Basic	\$.94	\$.81	\$.52
Diluted	\$.91	\$.78	\$.51
Weighted Average Common Shares Outstanding			
Basic	1,773,071	1,315,875	1,288,032
Diluted	1,820,476	1,360,414	1,314,367

The accompanying notes are an integral part of these consolidated financial statements.

CORNERSTONE BANCORP AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
AND COMPREHENSIVE INCOME (LOSS)

	Common stock		Retained earnings	Accumulated other comprehensive income (loss)	Total shareholders' equity
	Shares	Amount			
Balance, December 31, 2003	967,968	\$ 7,984,608	\$ 150,314	\$ 31,730	\$ 8,166,652
Net income	-	-	664,057	-	664,057
Other comprehensive income, net of income taxes:					
Unrealized loss on investment securities	-	-	-	(51,889)	(51,889)
Comprehensive income					612,168
Stock dividend (10%), net of cash in lieu of fractional shares	96,688	269,204	(270,564)	-	(1,360)
Balance, December 31, 2004	1,064,656	8,253,812	543,807	(20,159)	8,777,460
Net income	-	-	1,061,265	-	1,061,265
Other comprehensive income, net of income taxes:					
Unrealized loss on investment securities	-	-	-	(61,317)	(61,317)
Comprehensive income					999,948
Stock dividend (10%), net of cash in lieu of fractional shares	106,282	764,937	(767,507)	-	(2,570)
Issuance of shares in secondary offering, net of offering expenses of \$61,721	304,805	4,053,147	-	-	4,053,147
Balance, December 31, 2005	1,475,743	13,071,896	837,565	(81,476)	13,827,985
Net income	-	-	1,659,736	-	1,659,736
Other comprehensive income, net of income taxes:					
Unrealized gain on investment securities	-	-	-	147,734	147,734
Comprehensive income					1,807,470
Stock based compensation	-	19,784	-	-	19,784
Stock dividend (10%), net of cash in lieu of fractional shares	161,375	994,462	(997,498)	-	(3,036)
Issuance of shares in secondary offering, net of offering expenses	140,195	1,886,524	-	-	1,886,524
Balance, December 31, 2006	1,777,313	\$ 15,972,666	\$ 1,499,803	\$ 66,258	\$ 17,538,727

The accompanying notes are an integral part of these consolidated financial statements

**CORNERSTONE BANCORP AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<u>Year ended December 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Operating Activities			
Net income	\$ 1,659,736	\$ 1,061,265	\$ 664,057
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and net amortization	276,521	258,796	233,714
Deferred income tax benefit	(95,733)	(9,743)	(72,500)
Provision for loan losses	445,896	140,347	197,010
Gain on sale of land	(241,696)	-	(1,255)
Gain on sale of security	-	-	(5,230)
Non-cash option expense	19,784	-	-
Increase in other assets	(311,758)	(282,515)	(34,709)
Increase (decrease) in other liabilities	<u>193,791</u>	<u>(66,593)</u>	<u>36,302</u>
Net cash provided by operating activities	<u>1,946,541</u>	<u>1,101,557</u>	<u>1,017,389</u>
Investing Activities			
Proceeds from maturities and principal paydowns of investment securities	8,077,893	1,644,197	6,972,660
Proceeds from sales of securities	-	-	708,422
Purchase of investment securities	(11,643,855)	(2,458,873)	(5,872,451)
Purchase of FHLB and Federal Reserve stock, net	(203,800)	(77,700)	(72,100)
Purchase of life insurance policies	-	-	(421,183)
Increase in loans, net	(10,528,678)	(12,175,183)	(15,754,645)
Proceeds from sale of property and equipment	273,493	-	8,299
Purchase of property and equipment	<u>(137,001)</u>	<u>(1,041,253)</u>	<u>(523,780)</u>
Net cash used for investing activities	<u>(14,161,948)</u>	<u>(14,108,812)</u>	<u>(14,954,778)</u>
Financing Activities			
Net increase in deposits	10,014,155	9,133,097	17,232,725
Net increase (decrease) in customer repurchase agreements	1,980,256	(2,400,109)	(288,199)
Borrowings from Federal Home Loan Bank of Atlanta	-	4,045,000	3,400,000
Repayments to Federal Home Loan Bank of Atlanta	(1,650,834)	(3,060,787)	(5,000,000)
Proceeds from sale of common stock, net	1,886,524	4,053,147	-
Cash paid in lieu of fractional shares	<u>(3,036)</u>	<u>(2,570)</u>	<u>(1,360)</u>
Net cash provided by financing activities	<u>12,227,065</u>	<u>11,767,778</u>	<u>15,343,166</u>
Net increase (decrease) in cash and cash equivalents	11,658	(1,239,477)	1,405,777
Cash and cash equivalents, beginning of year	<u>5,899,965</u>	<u>7,139,442</u>	<u>5,733,665</u>
Cash and cash equivalents, end of year	<u>\$ 5,911,623</u>	<u>\$ 5,899,965</u>	<u>\$ 7,139,442</u>
Cash paid for:			
Interest	<u>\$ 3,118,302</u>	<u>\$ 2,128,897</u>	<u>\$ 1,246,900</u>
Income taxes	<u>\$ 822,000</u>	<u>\$ 835,000</u>	<u>\$ 388,991</u>

The accompanying notes are an integral part of these consolidated financial statements

CORNERSTONE BANCORP AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES

Cornerstone Bancorp, (the "Company") was incorporated under the laws of the State of South Carolina for the purpose of operating as a bank holding company for Cornerstone National Bank (the "Bank"). The Company obtained regulatory approval to acquire the Bank and opened the Bank for business in 1999 with a total capitalization of \$6.0 million. To increase capital available for growth, the Company offered 445,000 shares of its common stock pursuant to a prospectus dated October 4, 2005. As of December 31, 2005, 304,805 shares had been sold. Subsequent to December 31, 2005, by extension through January 15, 2006, the remaining 140,195 shares were sold. Upon completion, the offering added approximately \$6.0 million to the Company's total capitalization.

The Bank provides full commercial banking services to customers and is subject to regulation by the Office of the Controller of the Currency ("OCC") and the Federal Deposit Insurance Corporation. The Company is subject to regulation by Federal Reserve and to limited regulation by the South Carolina State Board of Financial Institutions. The Bank maintains branch locations in Greenville and Piedmont, South Carolina in addition to its headquarters in Easley, South Carolina. In 2004, the Bank established a wholly owned subsidiary, Crescent Financial Services, Inc. ("Crescent"), which is an insurance agency. In 2006, 2005 and 2004, Crescent's transactions were immaterial to the consolidated financial statements.

Basis of presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, the Bank. The Company operates as one business segment. All significant intercompany balances and transactions have been eliminated. The accounting and reporting policies conform to accounting principles generally accepted in the United States of America and to general practices in the banking industry. The Company uses the accrual basis of accounting.

Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amount of income and expenses during the reporting periods. Actual results could differ from those estimates. The Company's most significant estimates relate to the allowance for loan losses and income taxes.

Concentrations of credit risk

The Company makes loans to individuals and businesses in and around Upstate South Carolina for various personal and commercial purposes. The Bank has a diversified loan portfolio and the borrowers' ability to repay their loans is not dependent upon any specific economic sector. The Bank monitors concentrations in its customer base using the North American Industry Codes ("NAIC"). As of December 31, 2006, the Bank has concentrations of credit in real estate rental and leasing, construction, retail trade, health care and social assistance, and other services, which by NAIC category comprise over 25% of Tier 1 Capital adjusted for the allowance for loan losses.

Investment securities

The Company accounts for investment securities in accordance with Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities". The statement requires investments in equity and debt securities to be classified into three categories:

1. Available-for-sale securities: These are securities that are not classified as either held to maturity or as trading securities. These securities are reported at fair market value. Unrealized gains and losses are reported, net of income taxes, as separate components of shareholders' equity (accumulated other comprehensive income).

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES, Continued

2. **Held-to-maturity securities:** These are investment securities that the Company has the ability and intent to hold until maturity. These securities are stated at cost, adjusted for amortization of premiums and the accretion of discounts.
3. **Trading securities:** These are securities that are bought and held principally for the purpose of selling in the near future. Trading securities are reported at fair market value, and related unrealized gains and losses are recognized in the income statement. The Company has no trading securities.

The Company reviews all investments with unrealized losses as of the balance sheet date for possible impairment. Our review consists of an examination of each security with regard to its issuer, credit rating, time to maturity and likelihood of sale prior to maturity. Any losses determined to be other than temporary are recognized through the income statement.

Other investments include the Bank's stock investments in the Federal Reserve Bank of Richmond ("Reserve Bank") and the Federal Home Loan Bank of Atlanta ("FHLB"). The Bank, as a member institution, is required to own certain stock investments in the Reserve Bank and FHLB. The stock is generally pledged against any borrowings from the Reserve Bank and FHLB. No ready market exists for the stock and it has no quoted market value. However, redemption of these stock investments has historically been at par value.

Gains or losses on dispositions of investment securities are based on the differences between the net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method.

Loans, interest and fee income on loans

Loans are stated at the principal balance outstanding. Unearned discount and the allowance for possible loan losses are deducted from total loans in the balance sheet. Interest income is recognized over the term of the loan based on the principal amount outstanding.

Generally, the accrual of interest will be discontinued on impaired loans when principal or interest becomes 90 days past due, or when payment in full is not anticipated, and any previously accrued interest on such loans will be reversed against current income. Any subsequent interest income will be recognized on a cash basis when received unless collectibility of a significant amount of principal is in serious doubt. In such cases, collections are credited first to the remaining principal balance on a cost recovery basis. An impaired loan will not be returned to accrual status unless principal and interest are current and the borrower has demonstrated the ability to continue making payments as agreed. Non-performing assets include real estate acquired through foreclosure or deed taken in lieu of foreclosure, and loans on non-accrual status.

Fee income on loans is recognized as income at the time loans are originated. Due to the short-term nature of the majority of the Bank's loans and the immateriality of the net deferred amount, this method approximates the income that would be earned if the Company deferred loan fees and costs under SFAS 91.

Allowance for loan losses

The Company provides for loan losses using the allowance method. Loans that are determined to be uncollectible are charged against the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance. The provision for loan losses charged to operating expenses reflects the amount deemed appropriate by management to establish an adequate reserve to meet the probable loan losses incurred in the current loan portfolio. Management's judgment is based on periodic and regular evaluation of individual loans, the overall risk characteristics of the various portfolio segments, past experience with losses, delinquency trends, and prevailing economic conditions. While management uses the best information available to make evaluations, future adjustments to the allowance may be necessary if economic conditions differ substantially from the assumptions used in making the evaluations. The allowance for loan losses is also subject to periodic evaluation by various regulatory authorities and may be subject to adjustment upon their examination.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES, Continued

The Bank accounts for impaired loans in accordance with SFAS No. 114, "Accounting by Creditors for Impairment of a Loan." This standard requires that all lenders value a loan at the loan's fair value if it is probable that the lender will be unable to collect all amounts due according to the terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and 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 the circumstances of the loan and the borrower, including the length of the delay, reasons for the delay, the borrower's payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is determined on a case-by-case basis. The fair value of an impaired loan may be determined based upon the present value of expected cash flows, market price of the loan, if available, or value of the underlying collateral. Expected cash flows are required to be discounted at the loan's effective interest rate.

Under SFAS No. 114, when the ultimate collectibility of an impaired loan's principal is in doubt, wholly or partially, all cash receipts are applied to principal. Once the reported principal balance has been reduced to zero, future cash receipts are applied to interest income, to the extent that any interest has been foregone. Further cash receipts are recorded as recoveries of any amounts previously charged off.

A loan is also considered impaired if its terms are modified in a troubled debt restructuring. For these accruing impaired loans, cash receipts are typically applied to principal and interest receivable in accordance with the terms of the restructured loan agreement. Interest income is recognized on these loans using the accrual method of accounting.

Property and equipment

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets. Maintenance and repairs are charged to operations, while major improvements are capitalized. Upon retirement, sale or other disposition of property and equipment, the cost and accumulated depreciation are eliminated from the accounts, and gain or loss is included in income from operations.

Income taxes

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." Under SFAS No. 109, deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been recognized in the consolidated financial statements or tax return. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled.

Advertising and public relations expense

Advertising, promotional and other business development costs are generally expensed as incurred. External costs incurred in producing media advertising are expensed the first time the advertising takes place. External costs relating to direct mailing costs are expensed in the period in which the direct mailings are sent.

Earnings per common share

Basic earnings per common share is computed on the basis of the weighted average number of common shares outstanding in accordance with SFAS No. 128, "Earnings per Share." The treasury stock method is used to compute the effect of stock options on the weighted average number of common shares outstanding for diluted earnings per common share. As of December 31, 2006 there were 47,405 common stock equivalents, all of which were related to options issued by the Company. Options to purchase 19,800 shares of common stock were antidilutive as of December 31, 2006 and were omitted from the diluted share calculation. The Company declared 10 percent stock dividends to shareholders of record as of May 9, 2006, May 10, 2005, May 11, 2004, March 17,

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES, Continued

2003 and April 30, 2002. All share and per share amounts on the Consolidated Statements of Income have been restated to reflect these transactions.

Cash surrender value of life insurance policies

Cash surrender value of life insurance policies represents the cash value of policies on certain officers of the Bank.

Statement of cash flows

For purposes of reporting cash flows, cash and cash equivalents are those amounts which have an original maturity of three months or less.

Fair values of financial instruments

SFAS No. 107, "Disclosures About Fair Value of Financial Instruments," as amended by SFAS No. 119, requires disclosure of fair value information for financial instruments, whether or not recognized in the balance sheet, when it is practicable to estimate the fair value. SFAS No. 107 defines a financial instrument as cash, evidence of an ownership interest in an entity or contractual obligations that require the exchange of cash or other financial instruments. Certain items are specifically excluded from the disclosure requirements, including the Company's common stock. In addition, other nonfinancial instruments such as premises and equipment and other assets and liabilities are not subject to the disclosure requirements.

The following methods and assumptions were used by the Company in estimating fair values of financial instruments as disclosed herein:

Cash and due from banks - The carrying amounts of cash and due from banks approximate their fair value.

Federal funds sold - The carrying amounts of federal funds sold approximate their fair value.

Investment securities - Fair values for investment securities are based on quoted market prices. The carrying amounts of Reserve Bank and FHLB stocks approximate their fair values.

Cash surrender value of life insurance policies - The cash surrender value of life insurance policies held by the Bank approximates fair values of the policies.

Loans - For variable rate loans that reprice frequently and for loans that mature within one year, fair values are based on carrying values. Fair values for all other loans are estimated using discounted cash flow analyses, with interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for impaired loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Deposits - Fair values for deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar accounts to a schedule of aggregated expected monthly maturities. Repricing time frames for non-maturing deposits are estimated using FDICIA 305 guidelines.

Customer repurchase agreements - Fair values of repurchase agreements are estimated using a discounted cash flow analysis that applies interest rates currently being offered on similar accounts to a schedule of aggregated expected monthly maturities.

Borrowings from Federal Home Loan Bank of Atlanta - Borrowings from the FHLB which have variable rates of interest are deemed to be carried at fair value. Fair values of fixed rate advances are estimated using a discounted cash flow calculation that applies interest rates currently being offered on advances to a schedule of aggregated expected maturities.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES, Continued

Stock Based Compensation

The Company has issued stock options to certain directors who were organizers of the Company and the Bank, and also has a stock-based director and employee compensation plan (the "2003 Plan") as further described in Note 16. Under the 2003 Plan, 18,000 options were granted during each of 2004, 2005, and 2006. Subsequent to the grant dates, 10% stock dividends were declared, which converted the number of options outstanding and decreased the exercise price as well. See Note 16 for additional information.

In 2006 the Company adopted the provisions of SFAS No. 123(R) "Share Based Payment." SFAS No. 123(R) requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in their financial statements. In preparation for adoption of the standard, the Company elected to accelerate the vesting of options granted in 2004 and 2005 under the 2003 Plan.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 (R), "Accounting for Stock-Based Compensation," to stock-based compensation. It includes the effect of accelerating the vesting of options granted under the 2003 plan in 2005.

	<u>Year ended December 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Net income:			
As reported	\$ 1,629,736	\$ 1,061,265	\$ 664,057
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	13,057	-	-
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	<u>(13,057)</u>	<u>(105,581)</u>	<u>(5,844)</u>
Pro forma	\$ <u>1,629,736</u>	\$ <u>955,684</u>	\$ <u>658,213</u>
Basic earnings per common share			
As reported	\$.94	\$.81	\$.52
Pro forma	\$.94	\$.73	\$.51
Diluted earnings per common share			
As reported	\$.91	\$.78	\$.51
Pro forma	\$.91	\$.70	\$.50

The fair value of an option grant is estimated on the date of grant using the Black-Scholes option pricing model. The risk free interest rate used for the 2006, 2005 and 2004 grants was 4.36%, 4.01%, and 4.15%, respectively, which was the 10 Year Constant Maturity Rate on US Treasury Securities during the months in which the options were granted. The assumed dividend rate was zero and the expected option life was 10 years for 2006, 2005 and 2004 grants. Volatility is difficult to measure accurately due to the low volume of trading of the Company's stock. The common stock is not listed on any exchange and has no active trading market. Beginning in 2006, the stock is quoted on the Over-the-Counter Bulletin Board. The volatility assumption used for 2006 option grants was 18% and for 2005 and 2004 option grants was 6% based on information available at the date of the grants.

Recently issued accounting standards

The following is a summary of recent authoritative pronouncements that affect accounting, reporting, and disclosure of financial information by the Company:

In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes." FIN 48 clarifies the accounting for uncertainty in income

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES, Continued

taxes recognized in enterprises' financial statements in accordance with SFAS 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. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently analyzing the effects of FIN 48 its financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." 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 does not require any new fair value measurements, but rather eliminates inconsistencies found in various prior pronouncements. SFAS 157 is effective for the Company on January 1, 2008 and is not expected to have a significant impact on the Company's financial position, results of operations, or cash flows.

In September, 2006, The FASB ratified the consensuses reached by the FASB's Emerging Issues Task Force ("EITF") relating to EITF 06-4 "Accounting for the Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." EITF 06-4 addresses employer accounting for endorsement split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods. Employers should recognize a liability for future benefits in accordance with SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions", or Accounting Principles Board ("APB") Opinion No. 12, "Omnibus Opinion—1967." EITF 06-4 is effective for fiscal years beginning after December 15, 2006. Entities should recognize the effects of applying this Issue through either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods. The Company is currently analyzing the effect of adoption of EITF 06-4 on its financial position, results of operations and cash flows.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 ("SAB 108"). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a potential current year misstatement. Prior to SAB 108, Companies might evaluate the materiality of financial statement misstatements using either the income statement or balance sheet approach, with the income statement approach focusing on new misstatements added in the current year, and the balance sheet approach focusing on the cumulative amount of misstatement present in a company's balance sheet. Misstatements that would be material under one approach could be viewed as immaterial under another approach, and not be corrected. SAB 108 now requires that companies view financial statement misstatements as material if they are material according to either the income statement or balance sheet approach. The Company has analyzed SAB 108 and determined that upon adoption it will have no impact on the reported financial position, results of operations, or cash flows.

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." 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 is effective for the Company on January 1, 2008. Earlier adoption is permitted in 2007 if the Company also elects to apply the provisions of SFAS 157, "Fair Value Measurement." The Company is currently analyzing the fair value option provided under SFAS 159.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES, Continued

Accounting standards that have been issued or proposed by the FASB that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

Risks and Uncertainties

In the normal course of its business the Company encounters two significant types of risks: economic and regulatory. There are three main components of economic risk: interest rate risk, credit risk and market risk. The Company is subject to interest rate risk to the degree that its interest-bearing liabilities mature or reprice at different times, or on different bases, than its interest-earning assets. Credit risk is the risk of default on the Company's loan and investment portfolios that results from borrowers' inability or unwillingness to make contractually required payments. Market risk reflects changes in the value of collateral underlying loans receivable and the valuation of real estate held by the Company.

The Company is subject to the regulations of various governmental agencies. These regulations can and do change significantly from period to period. The Company also undergoes periodic examinations by the regulatory agencies, which may subject it to further changes with respect to asset valuations, amounts of required loss allowances and operating restrictions from the regulators' judgments based on information available to them at the time of their examination.

NOTE 2 – RESTRICTIONS ON CASH AND DUE FROM BANKS

The Bank is required to maintain average reserve balances, computed by applying prescribed percentages to its various types of deposits, either at the Bank or on deposit with the Reserve Bank. At December 31, 2006 and 2005 these required reserves were met by vault cash.

NOTE 3 – FEDERAL FUNDS SOLD

When the Bank's cash reserves (Note 2) are in excess of the required amount, it may lend any excess to other banks on a daily basis. As of December 31, 2006 and 2005 federal funds sold amounted to \$3,215,000 and \$3,183,000, respectively.

NOTE 4 – INVESTMENT SECURITIES

The amortized cost and fair value of investment securities available-for-sale are as follows:

	December 31, 2006			Fair value
	Amortized cost	Gross unrealized		
		Gains	Losses	
Government sponsored enterprises	\$ 9,120,619	\$ 98,216	\$ 28,076	\$ 9,190,759
Mortgage-backed securities	3,992,287	47,763	21,728	4,018,322
Municipal bonds	<u>2,962,324</u>	<u>11,908</u>	<u>7,692</u>	<u>2,966,540</u>
Total investment securities available-for-sale	\$ <u>16,075,230</u>	\$ <u>157,887</u>	\$ <u>57,496</u>	\$ <u>16,175,621</u>
December 31, 2005				
	Amortized cost	Gross unrealized		Fair value
		Gains	Losses	
Government sponsored enterprises	\$ 7,762,658	\$ -	\$ 87,089	\$ 7,675,569
Mortgage-backed securities	689,226	-	26,147	663,079
Municipal bonds	<u>1,361,229</u>	<u>116</u>	<u>10,328</u>	<u>1,351,017</u>
Total investment securities available-for-sale	\$ <u>9,813,113</u>	\$ <u>116</u>	\$ <u>123,564</u>	\$ <u>9,689,665</u>

(Continued)

NOTE 4 – INVESTMENT SECURITIES, Continued

While thirteen of the Company's Government sponsored enterprise bonds, municipal bonds and mortgage-backed securities available for sale are in an unrealized loss position as of December 31, 2006, none of these securities is expected to have a loss of principal at final maturity. The Company has the intent and ability to hold these securities until such time as the value recovers or the securities mature. The Company believes, based on industry analyst reports and credit ratings, that the deterioration in value is attributable to changes in market interest rates and not in the credit quality of the issuers and therefore, these losses are not considered other-than-temporary. The table below summarizes, by investment category, the length of time that individual securities have been in a continuous loss position as of December 31, 2006.

	<u>Less than Twelve Months</u>		<u>Over Twelve Months</u>		<u>Total Unrealized Losses</u>
	<u>Gross Unrealized</u>		<u>Gross Unrealized</u>		
	<u>Losses</u>	<u>Fair Value</u>	<u>Losses</u>	<u>Fair Value</u>	
Government sponsored enterprises	\$ 1,362	\$ 498,239	\$ 26,714	\$ 2,236,444	\$ 28,076
Mortgage-backed securities	16,855	262,213	4,873	244,966	21,728
Municipal bonds	<u>289</u>	<u>250,570</u>	<u>7,403</u>	<u>891,313</u>	<u>7,692</u>
Total	\$ <u>18,506</u>	\$ <u>1,011,022</u>	\$ <u>38,990</u>	\$ <u>3,372,723</u>	\$ <u>57,496</u>

The amortized cost and fair value of investment securities held-to-maturity as of December 31, 2006 and 2005 are summarized in the table below. The security held to maturity as of December 31, 2006 has been in a continuous unrealized loss position for less than twelve months. The Company has the intent and ability to hold this security until it matures in February, 2007.

	<u>Held-to-Maturity</u>			
	<u>December 31, 2006</u>			
	<u>Amortized cost</u>	<u>Gross unrealized</u>		<u>Fair value</u>
		<u>Gains</u>	<u>Losses</u>	
Government sponsored enterprises	\$ <u>1,000,252</u>	\$ _____	\$ <u>523</u>	\$ <u>999,729</u>
	<u>December 31, 2005</u>			
	<u>Amortized cost</u>	<u>Gross unrealized</u>		<u>Fair value</u>
		<u>Gains</u>	<u>Losses</u>	
Government sponsored enterprises	\$ <u>3,704,861</u>	\$ <u>5,079</u>	\$ <u>2,815</u>	\$ <u>3,707,125</u>

The Bank, as a member institution, is required to own stock in the Reserve Bank and the FHLB. These stocks are included in the accompanying Consolidated Balance Sheets under the caption "Other investments". No ready market exists for these stock investments and they have no quoted market value. However, redemption of these stocks has historically been at par value.

The amortized cost and fair value of securities at December 31, 2006, by contractual maturity, are shown in the following chart. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<u>December 31, 2006</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>
Within one year	\$ 2,763,410	\$ 2,746,174
Due after one through five years	1,999,600	1,991,225
Due after five through ten years	7,344,315	7,413,546
After ten years or no maturity	<u>5,781,757</u>	<u>5,838,005</u>
Total investment securities	\$ <u>17,889,082</u>	\$ <u>17,988,950</u>

(Continued)

NOTE 4 – INVESTMENT SECURITIES, Continued

At December 31, 2006 and 2005, securities with a fair value of \$8,669,970 and \$7,467,531, respectively, were pledged to collateralize public deposits, sweep accounts, and repurchase agreements. There were no realized gains or losses for the years ended December 31, 2006 or 2005. The Company sold one security in 2004 at a gain of \$5,230.

NOTE 5 – LOANS

The composition of net loans by major loan category is presented below.

	December 31,	
	2006	2005
Commercial	\$ 17,009,520	\$ 19,092,140
Real estate – construction	27,129,952	21,267,137
Real estate – mortgage	50,312,320	45,379,096
Consumer	<u>3,104,594</u>	<u>1,593,527</u>
Loans, gross	97,556,386	87,331,900
Less allowance for loan losses	<u>(1,199,999)</u>	<u>(1,058,295)</u>
Loans, net	\$ <u>96,356,387</u>	\$ <u>86,273,605</u>

At December 31, 2006 and 2005 there were no nonaccruing or impaired loans. Activity in the allowance for loan losses for the years ended December 31, 2006, 2005, and 2004 is summarized in the table below.

	Year ended December 31,		
	2006	2005	2004
Allowance for loan losses, beginning of year	\$ 1,058,295	\$ 919,384	\$ 727,971
Provision for loan losses	445,896	140,347	197,010
Charge-offs	(304,192)	(1,436)	(5,597)
Recoveries	<u>-</u>	<u>-</u>	<u>-</u>
Allowance for loan losses, end of year	\$ <u>1,199,999</u>	\$ <u>1,058,295</u>	\$ <u>919,384</u>

As of December 31, 2006, approximately \$53.4 million or 54.8% of total gross loans were variable rate loans. As of December 31, 2006, the FHLB held a blanket lien on single family real estate loans identified by the Bank to the FHLB as eligible collateral for borrowings.

NOTE 6 – PROPERTY AND EQUIPMENT

Components of property and equipment included in the balance sheet are as follows:

	December 31,	
	2006	2005
Land and improvements	\$ 1,445,531	\$ 1,477,328
Bank premises	2,801,162	2,801,162
Furniture, equipment and software	1,310,318	1,252,628
Vehicles	66,065	66,065
Construction in progress	<u>64,209</u>	<u>-</u>
Property and equipment	5,687,285	5,597,183
Accumulated depreciation	<u>(1,272,290)</u>	<u>(1,019,325)</u>
Property and equipment, net	\$ <u>4,414,995</u>	\$ <u>4,577,858</u>

(Continued)

NOTE 6 – PROPERTY AND EQUIPMENT, Continued

Construction in progress relates to costs incurred to date for the Company's operations center. The cost of building and furnishing the operations center is expected to be approximately \$1.6 million. Construction is expected to be completed in the third quarter of 2007.

Depreciation expense for the years ended December 31, 2006, 2005, and 2004, amounted to \$268,067, \$242,378, and \$212,605, respectively. Depreciation is charged to operations over the estimated useful lives of the assets. The estimated useful lives and methods of depreciation for the principal items follow:

<u>Type of Asset</u>	<u>Life in Years</u>	<u>Depreciation Method</u>
Furniture, equipment and software	3 to 7	Straight-line
Improvements	5 to 40	Straight-line
Vehicles	5	Straight-line

NOTE 7 – DEPOSITS

The following is a detail of the deposit accounts as of:

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Noninterest bearing	\$ 12,367,950	\$ 10,451,922
Interest bearing:		
NOW accounts	15,166,095	15,965,816
Money market accounts	6,349,116	6,244,480
Savings	3,743,368	3,545,435
Time, less than \$100,000	35,926,319	29,438,852
Time, \$100,000 and over	<u>28,113,348</u>	<u>26,005,536</u>
Total deposits	<u>\$ 101,666,196</u>	<u>\$ 91,652,041</u>

Interest expense on time deposits greater than \$100,000 was \$1,058,667 in 2006, \$699,928 in 2005, and \$374,435 in 2004. Securities issued by government sponsored enterprises with an amortized cost of \$1,933,158 and \$2,233,158 (fair value of \$1,940,549 and \$2,228,844) in 2006 and 2005, respectively, were pledged as collateral for public funds.

At December 31, 2006 the scheduled maturities of certificates of deposit are as follows:

2007	\$ 49,072,273
2008	6,345,737
2009	5,745,423
2010	2,874,542
2011	<u>1,692</u>
	<u>\$ 64,039,667</u>

NOTE 8 – CUSTOMER REPURCHASE AGREEMENTS

Customer repurchase agreements consist of the following:

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Sweep accounts	\$ 1,864,140	\$ 1,783,884
Retail repurchase agreements	3,200,000	1,300,000
	<u>\$ 5,064,140</u>	<u>\$ 3,083,884</u>

(Continued)

NOTE 8 – CUSTOMER REPURCHASE AGREEMENTS, Continued

The Bank enters into sweep and retail repurchase agreements with its customers. The sweep agreements generally mature overnight. At December 31, 2006, the Bank had five retail repurchase agreements that mature in 2007 and one that matures in 2008. Securities issued by government sponsored enterprises with an amortized cost of \$6,700,000 and \$5,300,000 (fair value of \$6,729,421 and \$5,238,686) were pledged as collateral for the sweep accounts and repurchase agreements, at December 31, 2006 and 2005, respectively.

NOTE 9 – BORROWINGS FROM FEDERAL HOME LOAN BANK OF ATLANTA

At December 31, 2006 and 2005, the Bank had a line of credit to borrow funds from the FHLB in the amount of 10% of the Bank's assets. Funds borrowed from the FHLB are collateralized by a blanket lien on eligible single family mortgage loans. At December 31, the Bank had advances outstanding as follows:

<u>December 31,</u>		<u>Interest Rate</u>	<u>Maturity Date</u>	<u>Terms</u>
<u>2006</u>	<u>2005</u>			
\$ -	\$ 1,500,000	2.91%	10/20/2006	Fixed rate
1,500,000	1,500,000	3.60	10/20/2008	Fixed rate
311,111	355,556	4.49	12/01/2013	Fixed rate, amortizing
285,185	324,074	4.89	4/14/2014	Fixed rate, amortizing
<u>599,375</u>	<u>666,875</u>	4.78	7/27/2015	Fixed rate, amortizing
<u>\$ 2,695,671</u>	<u>\$ 4,346,505</u>			

During 2006, the highest balance outstanding at any month end was \$4.3 million. The average balance of FHLB advances for 2006 was \$4.0 million. The average interest rate paid on advances in 2006 was 3.75%. During 2005, the highest balance as of any month end for borrowings from the FHLB was \$6.7 million. The average rate paid on the advances during 2005 was 3.56%. The average balance of FHLB advances for 2005 was \$3.9 million.

NOTE 10 – COMMITMENTS AND CONTINGENCIES

The Bank may become party to litigation and claims arising in the normal course of business. As of December 31, 2006, there was no litigation pending.

The Company has approximately three years remaining on its contract with a data, item, and ATM processing service. Monthly costs for these services are currently approximately \$17,000.

The Company has signed contracts for construction of an operations center next to the Company's main office building. Total costs of construction and furnishings are estimated at \$1.6 million. Construction is expected to be completed in the third quarter of 2007.

The Company has signed change of control agreements with four of its executive officers. These agreements provide for various payments to the executives in certain circumstances in the event of a change in control of the Company.

From time to time the Bank may guarantee merchant credit card accounts on behalf of certain customers. At December 31, 2006 the total amount guaranteed by the Bank related to merchant credit card accounts was immaterial.

Refer to Note 14 concerning financial instruments with off balance sheet risk.

NOTE 11 – UNUSED LINES OF CREDIT

At December 31, 2006, the Bank had unused lines of credit to purchase federal funds totaling \$4,800,000 from unrelated banks. These lines of credit are available on a one to fourteen-day basis for general corporate purposes of the Bank. The lenders have reserved the right to withdraw the lines at their option.

NOTE 12 – INCOME TAXES

The provision for income taxes is reconciled to the amount of income tax computed at the federal statutory rate on income before income taxes as follows:

	Year ended December 31,					
	2006		2005		2004	
Tax expense at statutory rate	\$ 834,610	34%	\$ 571,850	34%	\$ 357,800	34%
Increase (decrease) in taxes resulting from:						
State income taxes, net of federal benefit	49,495	2	32,500	2	20,800	2
Tax-exempt investments	(25,462)	(1)	(4,986)	-	(861)	-
Increase in cash value of life insurance	(19,016)	(1)	(19,674)	(1)	(4,023)	-
Other	(44,629)	(2)	40,968	2	15,182	1
Income tax provision	\$ <u>794,998</u>	<u>32%</u>	\$ <u>620,658</u>	<u>37%</u>	\$ <u>388,898</u>	<u>37%</u>

The income tax effects of cumulative temporary differences at December 31, 2006 and 2005 are as follows:

	2006	2005
Deferred tax assets:		
Allowance for loan losses	\$ 379,915	\$ 358,732
Unrealized net loss on securities available for sale	-	41,972
Other	<u>63,539</u>	<u>9,121</u>
	<u>443,454</u>	<u>409,825</u>
Deferred tax liabilities:		
Unrealized net gain on securities available for sale	34,133	-
Depreciation	106,145	121,678
Prepaid expenses	<u>27,833</u>	<u>32,432</u>
	<u>168,111</u>	<u>154,110</u>
Net deferred tax asset	\$ <u>275,343</u>	\$ <u>255,715</u>

The net deferred taxes are included in other assets in the consolidated balance sheets.

The following summary of the provision for income taxes includes tax deferrals that arise from temporary differences in the recognition of certain items of revenue and expense for tax and financial reporting purposes:

	Year ended December 31,		
	2006	2005	2004
Income taxes currently payable	\$ 890,731	\$ 630,401	\$ 461,398
Deferred income tax benefit	<u>(95,733)</u>	<u>(9,743)</u>	<u>(72,500)</u>
Income tax provision	\$ <u>794,998</u>	\$ <u>620,658</u>	\$ <u>388,898</u>

NOTE 13 – RELATED PARTY TRANSACTIONS

Certain directors, executive officers and companies with which they are affiliated, are customers of and have loan transactions with the Bank in the ordinary course of business. These loans were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable arms-length transactions.

(Continued)

NOTE 13 – RELATED PARTY TRANSACTIONS, Continued

A summary of loan transactions with directors, including their affiliates, and executive officers is as follows:

	Year ended December 31,		
	2006	2005	2004
Balance, beginning of year	\$ 6,269,599	\$ 4,476,992	\$ 3,725,723
New loans or lines of credit	4,354,342	4,418,461	3,627,940
Payments on loans or lines of credit	<u>(4,787,944)</u>	<u>(2,625,854)</u>	<u>(2,876,671)</u>
Balance, end of year	\$ <u>5,835,997</u>	\$ <u>6,269,599</u>	\$ <u>4,476,992</u>

Deposits by directors, executive officers, and their related interests, at December 31, 2006 and 2005 were \$2,843,416 and \$2,829,561, respectively.

NOTE 14 – FINANCIAL INSTRUMENTS WITH OFF BALANCE SHEET RISK

In the ordinary course of business, and to meet the financing needs of its customers, the Bank is a party to various financial instruments with off balance sheet risk. These financial instruments, which include commitments to extend credit and standby letters of credit, involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

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 amounts of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any material condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. At December 31, 2006 and 2005, unfunded commitments to extend credit were \$20.6 million and \$17.3 million, respectively, and outstanding letters of credit were \$658,971 and \$544,660, respectively. At December 31, 2006, the unfunded commitments consisted of \$18.5 million at variable rates and \$2.0 million at fixed rates with \$14.1 million expiring within one year. The Bank evaluates each customer's credit worthiness 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 borrower. Collateral varies but may include accounts receivable, inventory, property, plant and equipment, and commercial and residential real estate.

Fair values of off balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing, and were immaterial in 2006 and 2005.

The Bank also offers an automatic overdraft protection product. Approximately \$1.2 million of overdraft protection is available under this product as of December 31, 2006. The Bank expects that much of this capacity will not be utilized. During 2006 the average balance of demand deposit overdrafts was \$23,751.

NOTE 15 – EMPLOYEE BENEFIT PLAN

The Company sponsors a Simple IRA Plan for the benefit of all eligible employees. The Bank contributes up to three percent of the employee's compensation. Employer contributions made to the Plan in 2006, 2005, and 2004, amounted to \$40,499, \$35,925, and \$31,822, respectively.

NOTE 16 – STOCK OPTION PLANS

In 1999, the Board of Directors awarded options (the “Organizers’ Options”) to purchase 4,000 shares of the Company’s common stock to each of the organizing directors of the Company and the Bank (an aggregate of 40,000 shares). These options had an exercise price of \$10.00 per share and became exercisable in one-third increments each year beginning on December 14, 2000. The Organizers’ Options expire ten years from the date of grant, unless they terminate sooner as a result of the holder’s ceasing to be a director. Pursuant to the option agreements as further discussed below, the total number of such options outstanding has been adjusted to 57,978, and the exercise price has been adjusted to \$6.21 per share as a result of the stock dividends discussed in Note 17 below.

In 2003, the Company’s shareholders approved the Cornerstone Bancorp 2003 Stock Option Plan (the “2003 Plan”), which reserved 125,000 shares of the Company’s common stock for issuance upon exercise of options. Pursuant to the 2003 Plan as further discussed below, the number of shares reserved for issuance has been increased to 166,375 shares as a result of the 10% stock dividends declared in 2004, 2005, and 2006 which is discussed in Note 17 below. Employees and Directors are eligible to participate in the 2003 Plan, which has a term of 10 years. Awards under the 2003 Plan must be made by the Board of Directors or by a Committee of Directors designated by the Board at an exercise price equal to the fair market value of the Company’s common stock on the date of grant. A summary of the activity in the plans is presented below:

	Year ended December 31,						
	2006			2005		2004	
	Shares	Weighted Average Exercise Price	Average Intrinsic Value (1)	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	103,709	\$ 7.90		81,929	\$ 7.14	57,974	\$ 6.21
Granted	19,800	12.27		21,780	10.75	23,955	9.39
Exercised	-			-		-	
Forfeited or expired	-			-		-	
Outstanding at end of year	<u>123,509</u>	\$ 8.60	\$ 913,967	<u>103,709</u>	\$ 7.90	<u>81,929</u>	\$ 7.14
Options exercisable at end of year	103,709	\$ 7.90	\$ 840,043	103,709	\$ 7.90	57,974	\$ 6.21
Shares available for grant	100,837			120,637		142,420	

(1) The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2006. This amount changes based on changes in the market value of the Company’s common stock.

As described in Note 1, vesting of options granted in 2004 and 2005 was accelerated to December 31, 2005. Options granted in 2006 vest over a five-year period, according to the option agreements.

As described in Note 17 below, the Company’s Board of Directors declared 10 percent stock dividends to shareholders of record on May 9, 2006, May 10, 2005, May 11, 2004, March 17, 2003, and on April 30, 2002. The agreements relating to the Organizers’ Options provide for proportionate adjustments in the number of shares subject to options and the exercise price of options in the event of stock dividends, stock splits and other similar stock transactions. Similarly, the 2003 Plan provides for proportionate adjustments in the number of shares reserved for issuance under the 2003 Plan, the number of shares subject to outstanding options and the exercise prices of outstanding options in the event of such transactions.

NOTE 17 – DIVIDENDS

The Company has never paid cash dividends. The Company's ability to pay cash dividends is within the discretion of its Board of Directors, and is dependent on the Company's receiving cash dividends from the Bank. Federal banking regulations restrict the amount of dividends that the Bank can pay to the Company. Furthermore, because of its current growth plans, the Company has no current plans to pay cash dividends even if it would be able to do so. Future dividend policy will depend on the Company's earnings, capital requirements, financial condition and other factors considered relevant by the Company's Board of Directors. The Company's Board of Directors declared 10 percent stock dividends to shareholders of record on May 9, 2006, May 10, 2005, May 11, 2004, March 17, 2003 and on April 30, 2002.

NOTE 18 – REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possible 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 1 capital to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2006, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2006, the most recent notification of the banking regulators categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institution's category. The Bank's actual capital amounts and ratios and minimum regulatory amounts and ratios are presented as follows:

	<u>Actual</u>		<u>For capital adequacy purposes</u>		<u>To be well capitalized under prompt corrective action provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Minimum Amount</u>	<u>Minimum Ratio</u>	<u>Minimum Amount</u>	<u>Minimum Ratio</u>
(Dollars in thousands)						
As of December 31, 2006						
Total Capital (to risk weighted assets)	\$ 17,847	16.9%	\$ 8,463	8.0%	\$ 10,579	10.0%
Tier 1 Capital (to risk weighted assets)	16,647	15.7	4,232	4.0	6,347	6.0
Tier 1 Capital (to average assets)	16,647	13.2	5,052	4.0	6,315	5.0
As of December 31, 2005						
Total Capital (to risk weighted assets)	\$ 12,082	12.8%	\$ 7,557	8.0%	\$ 9,447	10.0%
Tier 1 Capital (to risk weighted assets)	11,024	11.7	3,779	4.0	5,668	6.0
Tier 1 Capital (to average assets)	11,024	9.9	4,433	4.0	5541	5.0

The Company is also subject to capital adequacy guidelines established by the Reserve Bank, which establish the minimum ratios for capital adequacy as they apply to the Bank. For 2006 and 2005, the Company's capital amounts and ratios were at least as great as shown above for the Bank.

NOTE 19 - ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair values of the Company's financial instruments were as follows:

	December 31,			
	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<u>Financial Assets</u>				
Cash and due from banks	\$ 2,696,623	\$ 2,696,623	\$ 2,716,965	\$ 2,716,965
Federal funds sold	3,215,000	3,215,000	3,183,000	3,183,000
Investment securities	17,989,473	17,988,950	14,004,326	14,006,590
Loans, gross	97,556,386	97,210,365	87,331,900	86,975,740
Cash surrender value of life insurance policies	1,628,967	1,628,967	1,573,038	1,573,038
<u>Financial Liabilities</u>				
Deposits	101,666,196	98,158,426	91,652,041	88,379,085
Customer repurchase agreements	5,064,140	5,050,715	3,083,884	3,051,367
Borrowings from FHLB	2,695,671	2,644,065	4,346,505	4,277,218

NOTE 20 - PARENT COMPANY INFORMATION

Following is condensed financial information of Cornerstone Bancorp (parent company only):

Condensed Balance Sheets

	December 31,	
	2006	2005
	<u>Assets</u>	
Cash and interest bearing deposits	\$ 776,191	\$ 2,860,340
Investment in subsidiary	16,712,757	10,942,761
Other assets	71,483	40,000
Total Assets	<u>\$ 17,560,431</u>	<u>\$ 13,843,101</u>
<u>Liabilities And Shareholders' Equity</u>		
Accrued expenses	\$ 21,704	\$ 15,116
Shareholders' equity	17,538,727	13,827,985
Total Liabilities and Shareholders' Equity	<u>\$ 17,560,431</u>	<u>\$ 13,843,101</u>

Condensed Statements Of Income

	Year ended December 31,		
	2006	2005	2004
<u>Income</u>			
Interest	\$ 25,658	\$ 13,031	\$ 9,469
<u>Expenses</u>			
Sundry	32,400	46,094	44,428
Loss before equity in undistributed net income of bank subsidiary	(6,742)	(33,063)	(34,959)
Equity in undistributed net income of subsidiary	1,666,478	1,094,328	699,016
Net income	<u>\$ 1,659,736</u>	<u>\$ 1,061,265</u>	<u>\$ 664,057</u>

(Continued)

NOTE 20 - PARENT COMPANY INFORMATION, Continued

Condensed Statements Of Cash Flows

	<u>Year ended December 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
<u>Operating Activities</u>			
Net income	\$ 1,659,736	\$ 1,061,265	\$ 664,057
Adjustments to reconcile net income to net cash provided by (used for) operating activities			
Equity in undistributed net income of subsidiary	(1,666,478)	(1,094,328)	(699,016)
Increase in other assets	(31,483)	-	-
Increase in accrued expenses	6,588	6,789	2,337
Net cash used for operating activities	<u>(31,637)</u>	<u>(26,274)</u>	<u>32,622</u>
<u>Investing Activities</u>			
Investment in bank subsidiary	<u>(3,936,000)</u>	<u>(2,000,000)</u>	-
<u>Financing Activities</u>			
Proceeds from sale of common stock, net	1,886,524	4,053,147	-
Cash paid in lieu of fractional shares	<u>(3,036)</u>	<u>(2,570)</u>	<u>(1,360)</u>
Net cash provided by (used for) financing activities	<u>1,883,488</u>	<u>4,050,577</u>	<u>(1,360)</u>
Net increase (decrease) in cash	(2,084,149)	2,024,303	(33,982)
Cash, beginning of year	<u>2,860,340</u>	<u>836,037</u>	<u>870,019</u>
Cash, end of year	<u>\$ 776,191</u>	<u>\$ 2,860,340</u>	<u>\$ 836,037</u>

BOARD OF DIRECTORS

J. Rodger Anthony
Chairman and Chief Executive
Officer of Cornerstone National Bank,
President and Chief Executive Officer of
Cornerstone Bancorp

Walter L. Brooks
President and Co-owner of G & B
Enterprises

Ben L. Garvin
President of Cornerstone National Bank,
Secretary and Treasurer Cornerstone Bancorp

S. Ervin Hendricks, Jr.
President and Co-owner of Nu-Life
Environmental, Inc., President and Owner
of Advance Machine Works

Robert R. Spearman
Surveyor - Retired

T. Edward Childress, III
Chairman of Cornerstone Bancorp,
Shareholder of Health Management
Resources, Inc., Long-Term Care
Facility Owner, Registered Pharmacist

Jennifer M. Champagne
Senior Vice President and Chief Financial Officer of
Cornerstone Bancorp and Cornerstone
National Bank

J. Bruce Gaston
Certified Public Accountant

Joe E. Hooper
President and Owner of Pride Mechanical and
Fabrication Company, Inc.

John M. Warren, Jr., M.D.
Co-founder of Easley OB-GYN Associates, P.A.

George I. Wike, Jr.
Retired Optometrist, Investor

MANAGEMENT OF THE COMPANY

J. Rodger Anthony
President and Chief Executive Officer

Ben L. Garvin
Secretary and Treasurer

Jennifer M. Champagne
Senior Vice President and Chief Financial Officer

MANAGEMENT OF THE BANK

J. Rodger Anthony
Chairman and Chief Executive Officer

Ben L. Garvin
President

Jennifer M. Champagne
Senior Vice President – Chief Financial Officer

Susan S. Jolly
Senior Vice President – Senior Loan Officer

H. Scott Forbes
Vice President – City Executive – Powdersville

B. Neal Gross
Vice President – Commercial Lending

Heidi G. Humphries
Vice President – Mortgage

Brenda B. Maw
Vice President – Compliance

Nancy H. Smith
Vice President – Deposit Operations

Ryan D. Tiwari
Vice President – City Executive – Berea

Kim T. Lappin
Assistant Vice President – Consumer Lending

Suzanne C. Burns
Banking Officer- Branch Manager- Easley

Jean W. Dillard
Banking Officer- Human Resources and Internal Audit

Norma Jean Venesky
Banking Officer- Loan Administration

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President of Lu Bagwell Interiors

Donald C. Brown
President of Pace Electric Company, Inc.

James Samuel Cox
Investor

James McCrorey (Mac) Lawton
Dixie Lumber Company

James A. Lesley
Steelworks of the Carolinas, Inc.

Joe Harrison Lesley
Joe's Ice Cream Parlor

Elizabeth D. Lowrance
Educator, Chairperson of the Easley Advisory Board

Hamilton Scott Reeves
F & R Asphalt, Inc.

Gary W. Seymore
Real Estate Investor

Ronnie Lee Smith, Attorney at Law
Olson, Smith, Jordan & Cox, P.A.

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Gaston and Allison, LLC

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Huff Piping, Inc.

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Wash and Win, LLC, Chairman of the Berea Advisory
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Yeager Vision Care

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Randy N. Long
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James J. Lynn, DMD
Dentist

Cindy Fox Miller
Vice President, Barnes and Tripp Real Estate

Kerry M. Pack
Co-owner, Mane Tamers,
Chairman of the Powdersville Advisory Board

G. Delma Sentell
Pharmacist

M. Frederick Zink
Veterinarian

SHAREHOLDER AND INVESTOR INFORMATION

General Information

Cornerstone Bancorp and Cornerstone National Bank
Post Office Box 428
Easley, SC 29641-0428

Main Office Address:
1670 East Main Street, Easley, SC 29640
Telephone: (864) 306-1444
Facsimile: (864) 306-1473

Berea Office Address:
45 Farris Bridge Road, Greenville, SC 29617
Telephone: (864) 294-9711
Facsimile: (864) 294-0975

Powersville Office Address:
11000 Anderson Road
Piedmont, SC 29673
Telephone: (864) 331-2880
Facsimile: (864) 331-2898

24-hour Telephone Banking: (864) 306-6244
Internet Web Site: <http://www.cornerstonenatlbank.com>

Annual Meeting

May 8, 2007
4:00 p.m.
Cornerstone National Bank
1670 East Main Street
Easley, South Carolina 29640

Independent Registered Public Accounting Firm

Elliott Davis, LLC

Legal Counsel

Haynsworth Sinkler Boyd, P.A.

Shareholder Services

Shareholder Inquiries:
All shareholder inquiries should be
directed to the Chief Financial Officer
at the main office.

Registrar and Transfer Agent

First Citizens Bank and Trust
PO Box 29522
Raleigh, North Carolina 27626-0522
919-716-2006

Corporate Publications

Additional copies of the Company's Annual Report, Form 10-KSB and quarterly Forms 10-QSB will be furnished without charge upon written request to Jennifer M. Champagne, Chief Financial Officer, Cornerstone Bancorp, Post Office Box 428, Easley, South Carolina, 29641.

Except for the Annual Report, these documents are also available on the Securities and Exchange Commission's website at www.sec.gov free of charge.