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# CORNERSTONE

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**BANCORP**

**2009 ANNUAL REPORT**

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# CORNERSTONE

BANCORP

Dear Shareholders,

On behalf of the board of directors of Cornerstone Bancorp, I would like to share our results for 2009. This year has been a difficult one for the banking industry and Cornerstone was no exception. The economy in our market areas has impacted both real estate values and borrowers' ability to repay their loans. We have attempted to work through problems with many of our customers and have made significant progress toward resolving the issues raised by the economy since 2008.

As a result of the difficulties in our local economy, Cornerstone posted a loss for the year. Much of this loss can be attributed to borrowers' failure to repay their debts, costs associated with loans that required foreclosure and the costs associated with acquiring and disposing of the collateral. The process of foreclosure is a lengthy one, and it is a strain on earnings. However, much of the collateral that we acquired through foreclosure has been newly constructed homes, which we believe will be sold in 2010 as the inventory of unsold properties moves back towards a market equilibrium level.

At the beginning of the economic downturn, Cornerstone was in a position of having capital levels well above the regulatory required minimums. The level of capital held by the Company has allowed us to weather this downturn well. We hope to return to profitability in 2010 and begin adding to our capital levels again.

Looking forward to 2010, we plan to move forward by disposing of nonperforming assets and serving our loyal customers. We are still lending to qualified borrowers and offering a wide range of financial products.

The legal and regulatory landscape for our industry is undergoing numerous changes. In 2010 we expect to face challenges associated with changes in laws and regulations. However, one thing that will not change is our commitment to the customers and communities we serve. Cornerstone will continue to offer products that cater to the needs of individuals and small businesses.

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 associates. Please let us know how we can continue to serve you and the communities of the Upstate of South Carolina.

Sincerely,

J. Rodger Anthony  
Chief Executive Officer  
March 30, 2010

## CAUTIONARY NOTICE WITH RESPECT TO 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,” “may,” “will,” “should,” “could,” “would,” “assume,” “indicate,” “contemplate,” “seek,” “target,” “potential,” 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:

- future economic and business conditions;
- the Company’s growth and ability to maintain growth;
- governmental monetary and fiscal policies;
- legislative and regulatory changes;
- the effect of interest rate changes on our level, costs and composition of deposits, loan demand, and the values of our loan collateral, securities, and interest sensitive assets and liabilities;
- the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services, as well as competitors that offer banking products and services by mail, telephone, computer, and/or the Internet;
- credit risks;
- higher than anticipated levels of defaults on loans;
- perceptions by depositors about the safety of deposits;
- 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;
- the risks of opening new offices, including, without limitation, the related costs and time of building customer relationships and integrating operations, and the risk of failure to achieve expected gains, revenue growth and/or expense savings;
- changes in accounting policies, rules, and practices;
- cost and difficulty of implementing changes in technology or products;
- loss of consumer confidence and economic disruptions resulting from terrorist activities;
- ability to weather the current economic downturn;
- loss of consumer or investor confidence; and
- other factors and information described in this report and in any of the other reports we file with the Securities and Exchange Commission under the Securities Act of 1934.

All forward-looking statements are expressly qualified in their entirety by this cautionary notice. 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.

## **BUSINESS OF THE COMPANY**

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 in 1999, and 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. In 2004, the Bank established a wholly owned subsidiary, Crescent Financial Services, Inc. ("Crescent"), which is an insurance agency that has not yet engaged in any significant operations.

### **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.

#### **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 at origination, 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 at origination for first and second mortgage loans generally does not exceed 80%, and for construction loans, generally does not exceed 75% of cost. The Bank employs a reappraisal policy to routinely monitor real estate collateral values on real estate loans where the repayment is dependent on sale of the collateral. In addition, in an effort to control interest rate risk, long term residential mortgages are not originated for the Bank's portfolio.

The principal economic risk associated with all loans, including real estate loans, is the creditworthiness of the 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 that is not fully amortized, 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. Each of these factors increases the risk of nonpayment by the borrower.

In 2007, the Company increased real estate construction loans approximately 60%. This segment of the Bank's business is managed in specific ways in order to minimize the risks normally associated with construction lending. Management requires lending personnel to visit job sites, maintain frequent contact with borrowers and arrange for third-party inspections of completed work prior to issuing additional construction loan draws. As a result of the real estate crisis in the Bank's markets throughout 2009, the Bank tightened underwriting standards. The Bank's loan policy now contains specific minimum net worth requirements for borrowers, minimum debt coverage ratios, and for loans to construct single family residential properties, written contracts with the end purchaser that contain significant consequences to the purchaser for terminating the contract.

The Bank 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 credit and debit cards 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. Credit cards are underwritten and funded by a third party provider. The Bank also provides stored value cards, 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](http://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. The Bank also offers remote check deposit services to commercial and small business customers. The Bank offers merchant and other business related services to its commercial customers.

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

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-K, filed with the Securities and Exchange Commission.

#### **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.

Management also believes that current economic conditions have added complexity to the process involved in evaluating other-than temporary-impairment ("OTTI") of the Company's debt securities. The process of determining OTTI is inherently judgmental, involving the weighing of positive and negative factors and evidence that may be objective or subjective. In the current environment, the factors that must be evaluated are numerous, and changing rapidly, making the evaluation more difficult.

## **Effect of Economic Trends**

Problems in the economy over the last eighteen months have adversely impacted the ability of some borrowers to repay their loans. Although the Company's market area has not experienced the negative effects of the recession and declines in real estate markets to the same extent as some other markets in the country, these factors have had a significant effect on our operations as evidenced by the increases in our potential problem loans, charge-offs, nonaccrual loans and real estate owned. The majority of problem loans in 2009 were real estate loans. These loans were often collateralized by newly constructed homes and were foreclosed on after real estate sales in the Company's market area decreased significantly in the summer of 2008. Borrowers were generally builders and developers who did not have the cash flow required to support the level of inventory financed with area banks. The process of foreclosure in South Carolina is lengthy and expensive. The impact of foregone interest on nonaccruing loans in the process of foreclosure combined with attorney's fees, property taxes, and costs to sell repossessed property negatively impacted the Company's income in 2009. The Bank had two commercial relationships that were not collateralized by real estate. The collateral for these loans was converted back to cash more quickly than the real estate loans, but non-real estate collateral brought a significantly lower recovery of funds and resulted in higher charge-off percentages or losses on disposal.

The current outlook for the national economy in the United States ("U.S.") is cautiously optimistic. Late in 2009 the economy began to show some signs of recovery, although high unemployment levels persist. Real estate prices in the single family home segment of our local markets appear to have leveled and sales are occurring again. The number of loans past due has declined in the fourth quarter of 2009. As of December 31, 2009, the Company owned 37 properties that were acquired through foreclosure. As of March 30, 2010, twelve properties had been sold or were under contract.

## **Governmental Response to the Financial Crisis**

During the fourth quarter of 2008 and continuing throughout 2009 the FDIC, the Federal Reserve, the Department of the Treasury and Congress took a number of actions designed to alleviate or correct mounting problems in the financial services industry. A number of these initiatives were directly applicable to community banks.

Congress enacted the Emergency Economic Stabilization Act of 2008 which, among other things, temporarily increased the maximum amount of FDIC deposit insurance from \$100,000 to \$250,000 and created a Troubled Assets Relief Program ("TARP") administered by Treasury. In October, 2008, Treasury announced a Capital Purchase Program ("CPP") under TARP to increase the capital of healthy banks. Under the CPP, Treasury would purchase preferred stock with warrants from qualified banks and bank holding companies in an amount up to 3% of the seller's risk-weighted assets as of September 30, 2008. Institutions wishing to participate in the CPP were required to file an application with their principal federal regulators. The Company filed such an application and received preliminary approval to sell preferred stock to the Treasury, but ultimately elected not to participate in the CPP because of (i) the cost of the preferred stock, (ii) the open-ended administrative burdens associated with the preferred stock, including having to agree to allow Treasury to amend unilaterally the stock purchase agreement to comply with subsequent changes in applicable federal statutes, (iii) the fact that the Company and the Bank were already well capitalized under regulatory guidelines and expected to continue to be so, and (iv) management's belief that other sources of capital were, and would continue to be, available should additional capital be needed.

The FDIC also implemented in October, 2008 a Temporary Liquidity Guarantee Program consisting of a deposit insurance component pursuant to which it undertook to provide deposit insurance in an unlimited amount for non-interest bearing transaction accounts, and a debt guarantee component pursuant to which it undertook to fully guarantee senior, unsecured debt issued by banks or bank holding companies. Coverage of both components was automatic until December 5, 2008, at which time covered institutions could opt out of one or both of the components. Institutions not opting out would be charged fees for their participation in the components. The Bank did not opt out of either component.

An unfortunate consequence of the difficulties that have beset the banking industry in the last eighteen months has been a large increase in bank failures, which has led to substantial claims being made against the FDIC's Deposit Insurance Fund. In order to increase the amount in the Deposit Insurance Fund to reflect the increased risk of additional bank failures and insurance claims, the FDIC raised its assessments on banks for 2009, and collected a



special assessment from the Bank totaling \$80,894, which was paid in September, 2009 based on deposits at June 30, 2009. The FDIC also required institutions to pay three years of deposit insurance premiums in advance. On December 30, 2009 the FDIC collected \$997,152 from the Company for deposit insurance premiums. Of that amount, \$63,002 related to the regular quarterly assessment, and \$934,150 related to the prepayment of premiums for the years 2010, 2011 and 2012. The amount of the prepayment portion is included in other assets in the accompanying consolidated balance sheets as of December 31, 2009. In 2010 and the following two years, on a quarterly basis, the FDIC will continue to calculate the assessment amount with then current financial information, and will deduct the quarterly assessment amount from the prepaid balance. The Bank will expense the current portion as calculated by the FDIC. The Bank does not earn interest on the prepaid amount.

Additional governmental efforts to ameliorate the problems afflicting the banking industry have been adopted or proposed, or are being considered by Congress and various governmental entities. The Company is presently unable to predict the impact of any such changes, although it appears that they are likely to increase operating expenses in the near term without creating completely offsetting benefits.

### **Earnings Performance**

The Company reported a loss of \$1,361,274, or \$.65 per common share, for the year ended December 31, 2009. The Company earned \$225,316 in 2008, or \$.11 per basic and diluted common share compared to \$1.6 million or \$.78 per basic common share and \$.76 per diluted common share for the year ended December 31, 2007. The Company's earnings in 2009 were significantly lower than in 2008 and 2007 due to four specific factors. First, the level of nonperforming loans and other assets in our portfolio during the year was the single largest reason for the decline in revenues for 2009. Second, our provision for loan losses increased significantly in comparison to previous years as a result of increasing pressure on borrowers due to economic conditions. Third, foreclosure costs associated with repossession of the underlying collateral on nonperforming loans were significant. Fourth, continued turmoil in the housing markets decreased our ability to broker mortgage loans for our local customers, which further decreased noninterest income in 2009. The Company's net interest income (the difference between interest earned on interest earning assets and interest paid on interest bearing liabilities) decreased to \$4.6 million, down from \$5.3 million in 2008 and \$5.8 million for 2007. The Company had noninterest income of \$982,000 in 2009 compared to \$64,000 in 2008. Noninterest income for 2008 included an other-than-temporary-loss on an investment in FNMA preferred stock. Noninterest income was \$1.075 million in 2007. The Company provided \$2.955 million, \$815,000, and \$197,000 to the allowance for loan losses in 2009, 2008, and 2007, respectively, and had other operating expenses of \$4.8 million in 2009, and \$4.3 million in 2008 and 2007.

### **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, 2009, 2008, and 2007, net interest income was \$4.6 million, \$5.3 million, and \$5.8 million, respectively. The decrease in 2009 from 2008 is attributable to higher levels of nonperforming loans and lower interest rates, partially offset by increases in the volume of loans (see "Rate/Volume Analysis of Net

Interest Income" below). In 2009, total average interest earning assets increased to \$171.7 million from \$141.2 million in 2008. The average yield on interest earning assets decreased 177 basis points to 4.68% in 2009 compared to 6.45% in 2008. The average cost of interest bearing liabilities decreased 87 basis points to 2.25% from 3.12% in 2008. Rates on interest earning assets and interest bearing liabilities have adjusted downward since the third quarter of 2007. The Company's loan portfolio adjusted to rate movements more quickly than the interest bearing deposit portfolio. However, nonperforming assets also had an impact on overall yields. The effect of both trends was narrowed interest margins. The net yield on average interest earning assets decreased in 2009 to 2.69% from 3.76% in 2008. The interest rate spread in 2009 was 2.43% compared to 3.33% in 2008.

The tables, "Average Balances, Yields and Rates", provide 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, 2009, 2008, and 2007.

**Average Balances, Yields and Rates**

(Dollars in thousands)

	Year ended December 31, 2009			Year ended December 31, 2008		
	Average Balances(1)	Interest Income/ Expense	Average Yields/ Rates(2)	Average Balances(1)	Interest Income/ Expense	Average Yields/ Rates(2)
<b>Assets</b>						
Securities	\$ 23,652	\$ 1,026	4.34%	\$ 22,607	\$ 1,161	5.14%
Federal Funds Sold	9,994	16	.16%	3,429	92	2.68%
Loans (3), (4)	<u>138,066</u>	<u>6,998</u>	5.07%	<u>115,162</u>	<u>7,849</u>	6.82%
Total interest earning assets	171,712	8,040	4.68%	141,198	9,102	6.45%
Cash and due from banks	1,187			3,624		
Allowance for loan losses	(1,982)			(1,394)		
Premises and equipment	5,424			5,687		
Cash surrender value of life insurance policies	1,801			1,731		
Other real estate owned	2,402			372		
Other assets	<u>2,308</u>			<u>1,489</u>		
Total assets	<u>\$ 182,852</u>			<u>\$ 152,707</u>		
<b>Liabilities and shareholders' equity</b>						
Interest bearing liabilities:						
Interest bearing transaction accounts	\$ 13,169	75	.57%	\$ 13,502	125	.92%
Savings and money market	34,936	657	1.88%	14,994	296	1.98%
Time deposits	<u>86,435</u>	<u>2,199</u>	2.54%	<u>76,234</u>	<u>2,808</u>	3.68%
Total interest bearing deposits	134,540	2,931	2.18%	104,730	3,229	3.08%
Federal Funds purchased and customer repurchase agreements	3,842	78	2.04%	5,351	170	3.18%
FHLB advances	8,559	238	2.78%	6,955	228	3.28%
Broker repurchase agreements	<u>5,000</u>	<u>177</u>	3.53%	<u>4,836</u>	<u>171</u>	3.53%
Total interest bearing liabilities	<u>151,941</u>	<u>3,424</u>	2.25%	<u>121,872</u>	<u>3,798</u>	3.12%
Noninterest bearing demand deposits and other liabilities	11,941			11,466		
Shareholders' equity	<u>18,970</u>			<u>19,369</u>		
Total liabilities and shareholders' equity	<u>\$ 182,852</u>			<u>\$ 152,707</u>		
Interest rate spread (5)			2.43%			3.33%
Net interest income and net yield on earning assets(6)		\$ <u>4,616</u>	2.69%		\$ <u>5,304</u>	3.76%
Interest free funds supporting earning assets (7)	\$ 19,771			\$ 19,326		

(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 4.81% in 2009 and 5.63% in 2008.

(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 \$236,777 in 2009 and \$401,297 in 2008.

(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.

### Average Balances, Yields and Rates

(Dollars in thousands)

	Year ended December 31, 2008			Year ended December 31, 2007		
	Average Balances(1)	Interest Income/ Expense	Average Yields/ Rates(2)	Average Balances(1)	Interest Income/ Expense	Average Yields/ Rates(2)
<b>Assets</b>						
Securities	\$ 22,607	\$ 1,161	5.14%	\$ 17,978	\$ 944	5.25%
Federal Funds Sold	3,429	92	2.68%	4,538	228	5.02%
Loans (3), (4)	<u>115,162</u>	<u>7,849</u>	6.82%	<u>102,917</u>	<u>8,835</u>	8.58%
Total interest earning assets	141,198	9,102	6.45%	125,433	10,007	7.98%
Cash and due from banks	3,624			2,468		
Allowance for loan losses	(1,394)			(1,263)		
Premises and equipment	5,687			5,214		
Cash surrender value of life insurance policies	1,731			1,660		
Other real estate owned	372			44		
Other assets	<u>1,489</u>			<u>1,442</u>		
Total assets	<u>\$ 152,707</u>			<u>\$ 134,998</u>		
<b>Liabilities and shareholders' equity</b>						
Interest bearing liabilities:						
Interest bearing transaction accounts	\$ 13,502	125	.92%	\$ 13,708	157	1.15%
Savings and money market	14,994	296	1.98%	10,461	222	2.12%
Time deposits	<u>76,234</u>	<u>2,808</u>	3.68%	<u>71,613</u>	<u>3,444</u>	4.81%
Total interest bearing deposits	104,730	3,229	3.08%	95,782	3,823	3.99%
Federal Funds purchased and customer repurchase agreements	5,351	170	3.18%	5,335	238	4.47%
FHLB advances	6,955	228	3.28%	<u>2,805</u>	<u>116</u>	4.13%
Broker repurchase agreements	<u>4,836</u>	<u>171</u>	3.53%			
Total interest bearing liabilities	<u>121,872</u>	<u>3,798</u>	3.12%	<u>103,922</u>	<u>4,177</u>	4.02%
Noninterest bearing demand deposits and other liabilities	11,466			12,577		
Shareholders' equity	<u>19,369</u>			<u>18,499</u>		
Total liabilities and shareholders' equity	<u>\$ 152,707</u>			<u>\$ 134,998</u>		
Interest rate spread (5)			<u>3.33%</u>			<u>3.96%</u>
Net interest income and net yield on earning assets(6)		<u>\$ 5,304</u>	<u>3.76%</u>		<u>\$ 5,830</u>	<u>4.65%</u>
Interest free funds supporting earning assets (7)	\$ 19,326			\$ 21,511		

(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 5.63% in 2008 and 5.53% in 2007.

(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 \$401,297 and \$371,754 in 2008 and 2007, respectively.

(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 discussed under 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 2009 and 2008 changes in interest rates had the most significant impact on interest income.

#### Year ended December 31, 2009 compared to 2008

	<u>Rate</u>	<u>Increase (Decrease) Due to</u>		<u>Change</u>
		<u>Volume</u>	<u>Rate/Volume(1)</u>	
		(Dollars in thousands)		
Interest earned on:				
Securities (2)	\$ (181)	\$ 54	\$ (9)	\$ (136)
Federal Funds sold	(86)	176	(165)	(75)
Loans	<u>(2,012)</u>	<u>1,561</u>	<u>(400)</u>	<u>(851)</u>
Total interest income	(2,279)	1,791	(574)	(1,062)
Interest paid on:				
Deposits	(931)	767	(134)	(298)
Federal Funds purchased and customer repurchase agreements	(61)	(48)	17	(92)
FHLB advances	(35)	53	(8)	10
Broker repurchase agreements	-	<u>6</u>	-	<u>6</u>
Total interest expense	<u>(1,027)</u>	<u>778</u>	<u>(125)</u>	<u>(374)</u>
Change in Net Interest Income	<u>\$ (1,252)</u>	<u>\$ 1,013</u>	<u>\$ (449)</u>	<u>\$ (688)</u>

- (1) Rate/ Volume 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.

#### Year ended December 31, 2008 compared to 2007

	<u>Rate</u>	<u>Increase (Decrease) Due to</u>		<u>Change</u>
		<u>Volume</u>	<u>Rate/Volume(1)</u>	
		(Dollars in thousands)		
Interest earned on:				
Securities (2)	\$ (20)	\$ 243	\$ (5)	\$ 218
Federal Funds sold	(107)	(56)	26	(137)
Loans	<u>(1,821)</u>	<u>1,051</u>	<u>(216)</u>	<u>(986)</u>
Total interest income	(1,948)	1,238	(195)	(905)
Interest paid on:				
Deposits	(851)	316	(58)	(593)
Federal Funds purchased and customer repurchase agreements	(69)	1	-	(68)
FHLB advances	(24)	171	(35)	112
Broker repurchase agreements	-	-	<u>171</u>	<u>171</u>
Total interest expense	<u>(944)</u>	<u>488</u>	<u>78</u>	<u>(378)</u>
Change in Net Interest Income	<u>\$ (1,004)</u>	<u>\$ 750</u>	<u>\$ (273)</u>	<u>\$ (527)</u>

- (1) Rate/ Volume 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.

When interest sensitive liabilities exceed interest sensitive assets for a specific repricing "horizon," a negative interest sensitivity gap results. The gap is positive when interest sensitive assets exceed interest sensitive liabilities. For a bank with a negative gap such as the Bank, 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. However, if one or more assumptions prove incorrect, the margin may not be impacted in the manner expected. On a cumulative basis, rate sensitive liabilities exceeded rate sensitive assets, resulting in a liability sensitive position at the end of 2009 of \$31.8 million, for a cumulative gap ratio of .74 calculated at the one-year time horizon, assuming that all assets and liabilities would reprice at the earliest possible time. Interest-bearing liabilities, in particular, may not reprice in conjunction with or by the same magnitude as movements in market interest rates.

The following table 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

	<u>December 31, 2009</u>							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)	\$ -	\$ -	\$ -	\$ 185	\$ 2,302	\$ 10,999	\$ 16,558	\$ 30,044
Federal funds sold	1,670	-	-	-	-	-	-	1,670
Loans(2) (3)	72,333	7,200	8,213	15,573	21,406	3,285	9,753	137,763
	<u>74,003</u>	<u>7,200</u>	<u>8,213</u>	<u>15,758</u>	<u>23,708</u>	<u>14,284</u>	<u>26,311</u>	<u>169,477</u>
Interest bearing deposits								
Interest bearing transaction accounts	13,309	-	-	-	-	-	-	13,309
MMDAs & Savings	48,077	-	-	-	-	-	-	48,077
Time deposits	1,233	14,834	37,404	21,925	4,365	-	-	79,761
Federal Funds purchased and Customer repurchase agreements	588	150	2,519	-	-	-	-	3,257
FHLB advances	-	1,538	1,613	4,302	231	2,059	-	9,743
Broker repurchase agreements	-	-	-	2,000	-	3,000	-	5,000
	<u>63,207</u>	<u>16,522</u>	<u>41,536</u>	<u>28,227</u>	<u>4,596</u>	<u>5,059</u>	<u>-</u>	<u>159,147</u>
Interest sensitivity gap	\$ 10,796	\$ (9,322)	\$(33,323)	\$ (12,469)	\$ 19,112	\$ 9,225	\$ 26,311	\$ 10,330
Cumulative interest sensitivity gap	\$ 10,796	\$ 1,474	\$(31,849)	\$ (44,318)	\$ (25,206)	\$(15,981)	\$ 10,330	
Gap ratio	1.17	.44	.20	.56	5.16	2.82	-	
Cumulative gap ratio	1.17	1.02	.74	.72	.84	.90	1.06	

	<u>December 31, 2008</u>							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)	\$ -	\$ -	\$ -	\$ 1,541	\$ 1,617	\$ 9,718	\$ 7,915	\$ 20,791
Federal funds sold	140	-	-	-	-	-	-	140
Loans (2)(3)	73,618	2,246	10,128	13,409	27,135	2,105	2,541	131,182
Total interest earning assets	<u>75,558</u>	<u>2,468</u>	<u>10,245</u>	<u>15,212</u>	<u>28,752</u>	<u>11,823</u>	<u>8,055</u>	<u>152,113</u>
Interest bearing deposits								
Interest bearing transaction accounts	13,013	-	-	-	-	-	-	13,013
MMDAs & Savings	21,135	-	-	-	-	-	-	21,135
Time deposits	3,174	22,566	41,584	9,647	1,393	-	-	78,364
Federal Funds purchased and Customer repurchase agreements	3,243	150	2,650	350	-	-	-	6,393
FHLB advances	3,500	38	113	4,302	301	2,140	-	10,394
Broker repurchase agreements	-	-	-	-	2,000	3,000	-	5,000
Total interest bearing liabilities	<u>44,065</u>	<u>22,754</u>	<u>44,347</u>	<u>14,299</u>	<u>3,694</u>	<u>5,140</u>	<u>-</u>	<u>134,299</u>
Interest sensitivity gap	\$ 31,493	\$ (20,286)	\$(34,102)	\$ 913	\$ 25,058	\$ 6,683	\$ 8,055	\$ 17,814
Cumulative interest sensitivity gap	\$ 31,493	\$ 11,207	\$(22,895)	\$ (21,982)	\$ 3,076	\$ 9,759	\$ 17,814	
Gap ratio	1.71	.11	.23	1.06	7.78	2.30	-	
Cumulative gap ratio	1.71	1.17	.79	.82	1.02	1.07	1.13	

- (1) Securities with call features have been included in the period in which the security matures.
- (2) There were no unamortized deferred loan fees included in the above tables in either year.
- (3) Nonaccruing loans of \$9.7 million are included in the 2009 table. \$2.4 million are included in the 2008 table. All nonaccruing loans are included in the >15 years category.

## 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,		
	<u>2009</u>	<u>2008</u>	<u>2007</u>
		(Dollars in thousands)	
Allowance for loan losses, beginning of year	\$ 1,699	\$ 1,293	\$ 1,200
Provision for loan losses	2,955	815	197
Charge-offs	(1,959)	(685)	(104)
Recoveries	<u>-</u>	<u>276</u>	<u>-</u>
Allowance for loan losses, end of year	<u>\$ 2,695</u>	<u>\$ 1,699</u>	<u>\$ 1,293</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.

## Noninterest Income

Noninterest income, which consists primarily of service charges on deposit accounts, mortgage loan origination fees, gains and losses on securities sales, and other fee income, increased by \$.9 million to \$1.0 million in 2009 from \$100,000 in 2008, which was a decrease from \$1.1 million in 2007. Service charges were fairly consistent in 2009 compared to 2008. The Company sold securities with a fair value of \$10.8 million, resulting in a net gain of \$299,063 in 2009. Noninterest income in 2008 included the impact of the Other Than Temporary Impairment charge in the amount of \$918,264 taken on FNMA Preferred stock in September 2008. Mortgage loan origination fee income continued a trend of decreases in 2009. Effective November 30, 2009, the Company closed its mortgage origination department due to the difficulties involved in brokering mortgage loans to third party investors. When the housing and mortgage markets stabilize, the Company intends to reevaluate offering conventional 30 and 15-year mortgage loans to its customers.

## Noninterest Expenses

Noninterest expenses, which consist primarily of salaries and employee benefits, occupancy costs, data processing expenses and professional and regulatory fees, totaled \$4.8 million in 2009, and \$4.3 million in 2008 and 2007. Salaries and employee benefits decreased slightly in 2009. There was no accrual of incentive compensation in 2009 due to economic conditions. As of the end of 2009, the Company employed 36 full-time personnel. Net occupancy and equipment expenses decreased to \$572,025 from \$600,426 in 2008, which increased from \$567,222 in 2007. Data processing, supplies, and advertising expenses all decreased in 2009 compared to 2008. The Company is constantly looking for ways to become more efficient and to find cost savings without compromising customer service. Professional and regulatory fees increased 72.3% in 2009 in comparison to 2008, primarily due to the increased cost of FDIC insurance. The Company expensed \$307,376 for FDIC premiums in 2009 compared to \$76,224 in 2008. The company expensed \$322,687 and \$117,272 for loan expenses and expenses to maintain other real estate owned in 2009 compared to \$51,706 and \$50,889, respectively, in 2008. The increases are related to foreclosure expenses and property taxes paid in order to protect the Company's interest in real estate collateral. 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, was 86.2% in 2009 compared to 81% in 2008 and 62% in 2007.



## Income Taxes

For 2009 the Company recorded an income tax benefit of \$819,737 compared to a benefit of \$17,600 in 2008 and tax expense of \$810,232 in 2007. The primary reasons for the benefit recognized in 2009 are the exclusions of nontaxable municipal bond income and operating expenses related to nonperforming assets. The benefit recognized in 2008 primarily resulted from the exclusion of nontaxable municipal bond income and the tax effect of the other than temporary impairment charge on the FNMA preferred stock. In the fourth quarter of 2008 legislation was passed by Congress making the OTTI charge includable in ordinary income for holders of FNMA and Federal Home Loan Mortgage Corporation ("FHLMC") preferred stocks. The FNMA preferred stock was sold in 2009. The financial accounting standard under which the Bank accounts for income taxes requires certain items of income and expense (principally provision for loan losses, depreciation, and prepaid expenses) to be 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 GAAP 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, 2009, 2008, and 2007, the Bank's investment portfolio comprised approximately 15.9%, 12.7%, and 13.4%, respectively, of total assets.

The following table summarizes the carrying amounts of securities held by the Bank at December 31, 2009 and 2008. Available-for-sale securities are stated at estimated fair value. The Company had no held-to-maturity securities in either period. 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. However, there can be no assurance that these stocks will be redeemed at par value in the future. 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, 2009. 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. Until 2008, securities issued by these enterprises were not obligations of the U. S. Government and were not backed by the full faith and credit of the U. S. Government or otherwise guaranteed by the U. S. Government, although they were commonly treated as guaranteed. In 2008, in an attempt to stabilize U.S. and international financial markets, the U.S. Government explicitly guaranteed certain debt instruments of the GSEs. These securities have generally been and will continue to be 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, 2009 and 2008, securities with a fair value of \$22.9 million and \$18.4 million respectively, were pledged to collateralize public deposits, sweep accounts, and customer and broker repurchase agreements. Refer to the notes to the Company's consolidated financial statements contained elsewhere herein for more information.

### Investment Securities Portfolio Composition

	December 31,	
	<u>2009</u>	<u>2008</u>
	(Dollars in thousands)	
Available for sale:		
Government sponsored enterprise bonds	\$ 10,188	\$ 9,293
Mortgage-backed securities	12,364	4,280
Municipal bonds	6,350	6,072
FNMA preferred stock	-	<u>32</u>
Total available for sale	<u>28,902</u>	<u>19,677</u>
Federal Reserve Bank of Richmond stock	405	394
Federal Home Loan Bank of Atlanta stock	<u>737</u>	<u>720</u>
Total	\$ <u>30,044</u>	\$ <u>20,791</u>

The following table presents contractual maturities and weighted average yields of securities at December 31, 2009 and 2008. Securities are presented at their carrying value (available for sale securities are carried at fair value and other securities are carried at book value, which is equal to their amortized cost.)

### Investment Securities Portfolio Maturities and Yields

	December 31, 2009		December 31, 2008	
	<u>Amount</u>	<u>Yield(1)</u>	<u>Amount</u>	<u>Yield(1)</u>
	(Dollars in thousands)		(Dollars in thousands)	
<u>Available for sale securities:</u>				
Government sponsored enterprises				
Within one year	\$ -	-%	\$ -	-%
After one through five years	2,032	4.34%	2,631	4.44%
After five through ten years	8,155	3.96%	6,662	5.90%
FNMA and FHLMC Mortgage-backed securities (2)				
After one through five years	185	3.79%	280	3.84%
After five through ten years	-	-%	-	-%
After 10 years	12,180	3.97%	4,000	5.75%
Municipal bonds				
After one through five years	269	3.62%	247	3.25%
After five through ten years	1,536	3.86%	1,888	3.80%
After 10 years	4,545	4.09%	3,937	4.09%
Other securities				
No stated maturity	<u>1,142</u>	2.33%	<u>1,146</u>	2.06%
Total	<u>\$ 30,044</u>	3.94%	<u>\$ 20,791</u>	4.88%

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

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

While seven of the Company's Government sponsored enterprise bonds and mortgage-backed securities available-for-sale are in an unrealized loss position as of December 31, 2009, none has been in an unrealized loss position for twelve months or more. 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. All of the Company's municipal bonds were in an unrealized gain position as of December 31, 2009. During 2008, the Company recognized other-than temporary-impairment on the FNMA preferred stock of \$606,054, net of tax, based on analysis under FSP 115-1 and FNMA's being placed into conservatorship by the U.S. Treasury Department. The Company sold the FNMA preferred stock in 2009 at an additional loss of \$58,788. 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, although real estate collateral is the predominant collateral in the portfolio. There are no significant concentrations of loans to any particular individuals, 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, accommodation and food services, 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 loan 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 (\$20.2 million at December 31, 2009), or 30% of Total Regulatory Capital for real estate loans other than single family residential loans (\$6.0 million as of December 31, 2009). As of December 31, 2009, the Bank had \$6.5 million of loans which exceeded regulatory loan to value guidelines. This amount is within the allowable maximum of exceptions to the guidelines. Of the total exceptions, 74.4% were not exceptions at the time the loan was made, but became exceptions upon reappraisal. Reappraisals are routinely ordered when a loan is collateral dependent and showing signs of weakness. Specifically, the Company's reappraisal policy states that collateral for single family construction loans will be reappraised if the home is complete and remains unsold for twelve months, or if the original appraiser's estimates by 25% or more, the collateral will be reappraised. Collateral will also be reappraised if there is any indication that the collateral may have decreased significantly in value. If the value of collateral decreases significantly upon reappraisal, the Company may take any one or a combination of steps to protect its position. Possible actions include requesting additional collateral from the borrower, requiring the borrower to make principal reductions on the loan, or charge-off of a portion of the loan balance.

The Company currently has concentrations in real estate lending, including construction and development loans. This segment of the Bank's business is managed in specific ways in order to minimize the risks normally associated with construction lending. Management requires lending personnel to visit job sites, maintain frequent contact with borrowers and perform or commission inspections of completed work prior to issuing additional construction loan draws. In addition, management employs additional procedures for monitoring construction loans such as engaging an independent appraiser to perform routine inspections of construction work to determine the percentage complete prior to approval of draws on construction loans. However, even tight internal controls and management oversight will not prevent some borrowers from defaulting on these types of loans. Where declining market conditions last for a long period of time, many participants in the housing and real estate construction industries cannot continue to perform as specified in their loan agreements without sales activity. In such cases, the Bank attempts to work with various borrowers in the real estate and construction industry to minimize the effect on the Bank and the borrowers. Loans in this situation are placed on nonaccrual, and included in the Company's impaired loans. See "Impaired Loans" below.

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 such loan for associated risks. Therefore, Management does not believe that these particular products subject the Company to unusual credit risk. As of December 31, 2009, the Bank did not have in its portfolio any residential mortgage loans with negative amortization features, long term interest only payment features, or loan to value ratios at origination in excess of 100%.

Until November 2009, the Bank had a mortgage loan brokerage department that accepted mortgage applications for mortgages with terms greater than 15 years. Mortgage applications were processed and sent to third parties for underwriting. Approved loans were funded by, and closed in the name of, third parties and the Bank received an origination fee. However, effective November 2009, the Bank suspended such mortgage originations. When the housing and mortgage loan markets stabilize, the Bank intends to reevaluate offering this service to its customers.

The amount of loans outstanding at December 31, 2009 and 2008 are shown in the following table according to type of loan:

### Loan Portfolio Composition

	December 31,			
	2009		2008	
	(Dollars in thousands)			
	Amount	% of Loans	Amount	% of Loans
Commercial and industrial	\$ 14,974	10.9%	\$ 18,597	14.2%
Real Estate – construction	53,827	39.1	49,670	37.9
Real Estate – mortgage				
1-4 family residential	23,285	16.9	26,429	20.1
Nonfarm, nonresidential	41,810	30.3	33,214	25.3
Multifamily residential	2,520	1.8	1,223	.9
Consumer installment	1,347	1.0	2,049	1.6
Total Loans	137,763	100.0%	131,182	100.0%
Less allowance for loan losses	(2,695)		(1,699)	
Net Loans	\$ 135,068		\$ 129,483	

### Maturity Distribution of Loans

The Bank's loan portfolio has a large component of adjustable rate loans. As of December 31, 2009, approximately \$82.4 million or 59.8% of the Bank's loan portfolio was variable rate.

The following table sets forth the maturity distribution of the Bank's loans, by type, as of December 31, 2009, as well as the type of interest requirement on loans with maturities greater than one year. 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, 2009			
	(Dollars in thousands)			
	1 Year or Less	1-5 Years	5 Years or More	Total
Commercial and industrial	\$ 10,202	\$ 4,421	\$ 351	\$ 14,974
Real Estate-construction	43,264	10,556	7	53,827
Real Estate-mortgage	20,867	35,146	11,602	67,615
Consumer	885	348	114	1,347
Total	\$ 75,218	\$ 50,471	\$ 12,074	\$ 137,763
Predetermined rate, maturity greater than one year		24,905	1,772	26,677
Variable rate, maturity greater than one year		25,566	10,302	35,868

### 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 on 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. As of December 31, 2009, the Bank had nonaccrual loans of \$9.7 million. This amount includes 28 loans, all of which are collateral dependent. These loans are secured by real estate, and were in the process of foreclosure or other collection processes as of December 31, 2009. If these loans had been current, the Company would have recorded additional interest income of \$292,243 on these loans. All previously accrued but uncollected income on these loans has been eliminated from the accompanying consolidated income statement. Impairment reserves of \$165,771 are included in the allowance for loan losses related to loans on nonaccrual as of December 31, 2009. The Company has already charged-off \$224,271 related to these loans as of December 31, 2009. The Company's investment in nonaccruing loans has been increasing throughout 2009 partly because of the length of time required to foreclose on property in South Carolina. The loans on nonaccrual at December 31, 2009 had been on nonaccrual and in the foreclosure process for an average of 134 days. This does not include the 90-day period prior to placing the loan on non-accrual during which the Bank did not record interest. The length of time required to obtain title to foreclosed property is increased if the creditor seeks a deficiency judgment against a guarantor or if the property is rented. A minimum of thirty days is added for deficiency judgments and notice requirements of ninety days are required if the property is rented.

The Company also considers restructured loans to be impaired under the definition of an impaired loan. As of December 31, 2009 the bank had 24 loans totaling \$4.05 million that are restructured in some manner. Of those 24 loans, 15 loans totaling \$1.5 million are newly constructed single family homes. These loans are current, but paying interest only. The average loan amount is \$99,444. Homes priced under \$150,000 have generally continued to sell through the economic crisis in our market area due to first time home buyer programs. Of the remaining \$2.5 million, one loan (\$555,000) is collateralized by several rental properties, one loan (\$1.3 million) is collateralized by undeveloped land, and seven loans are collateralized by various types of property. All of these additional loans are in compliance with their restructured terms, but deemed to be impaired due to changes in the original terms or due to the absence of terms that would be in effect under normal conditions. These loans are considered impaired primarily because of terms such as interest-only payment requirements that would not normally be available under current conditions. The Company has not charged off amounts associated with accruing impaired loans as of December 31, 2009. Refer to the notes to the Company's consolidated financial statements contained elsewhere herein for more information. The allowance for loan losses includes management's best estimate of the probable losses on these loans. At December 31, 2008 the Bank had \$2.4 million of nonaccrual loans or loans 90 days or more past due.

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. 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. Potential problem loans include loans such as loans that are not included in nonaccrual status, or loans that are past due 90 days or more and still accruing interest. Loans in the amount of \$4.0 million had been determined by management to be potential problem loans at December 31, 2009. The majority of these loans are secured by real estate. These loans have not been restructured as of December 31, 2009 and are not on nonaccrual, but they exhibit some weaknesses. Management is currently assessing the potential impact on the Bank and the Company. Reassessment would normally be in the form of a new appraisal on the collateral supporting the loan if the loan is collateral dependent. These loans are monitored closely by management.

### **Allowance for Loan Losses**

The allowance for loan losses is increased by direct charges to operating expense. Losses on loans are 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 takes 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, 2009.

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.

At the beginning of 2009 the Company's market area was just beginning to realize the effects of the economic downturn. Other areas of the United States were feeling the effects of inflated real estate prices earlier and in much more significant ways than the Upstate of South Carolina. We had continued to have reasonable levels of unemployment and some continued economic activity throughout most of 2008. However, during 2009 it became apparent that the construction industry in South Carolina had not only overbuilt its inventory of homes, but the industry was also responsible for a large portion of the employment base. By November of 2009, unemployment levels in South Carolina had reached 12.3% and unemployment in the Company's market areas ranged from 10.5% to 12.7% in the month of November. As a result, the Company's problem loans continued to increase throughout the year.

The table below summarizes the Company's loan loss experience in 2008 and 2009. The charge-offs on commercial loans were related to three relationships. These loans experienced the highest charge-off percentages of any of our loans, by far. By contrast, the real estate loan charge-offs were comprised of 19 relationships and 32 individual loans.

### Summary of Loan Loss Experience

	Year ended December 31,	
	2009	2008
	(Dollars in thousands)	
Total loans outstanding at end of period	\$ 137,763	\$ 131,182
Average amount of loans outstanding	\$ 138,066	\$ 115,162
<hr/>		
Balance of allowance for loan losses-beginning	\$ 1,699	\$ 1,293
Loans charged-off		
Commercial and industrial	669	186
Commercial real estate	1,289	498
Consumer installment	<u>1</u>	<u>1</u>
Total charge-offs	1,959	685
Recoveries of loans previously charged-off – commercial loans	<u>-</u>	<u>276</u>
Net (charge-offs) recoveries	(1,959)	(409)
Additions to allowance charged to expense	<u>2,955</u>	<u>815</u>
Balance of allowance for loan losses-ending	\$ <u>2,695</u>	\$ <u>1,699</u>
<hr/>		
Ratios		
Net (charge-offs) recoveries to average loans outstanding	(1.42%)	(.35%)
Net (charge-offs) recoveries to loans at end of period	(1.42%)	(.31%)
Allowance for loan losses to average loans	1.95%	1.48%
Allowance for loan losses to loans at end of period	1.96%	1.30%
Net (charge-offs) recoveries to allowance for loan losses	(72.7%)	(24.1%)
Net (charge-offs) recoveries to provision for loan losses	(66.3%)	(50.3%)

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 “Business of the Company--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.

#### Real Estate Owned

The Bank had \$6.713 million and \$575,000 of real estate owned pursuant to foreclosure or in-substance foreclosure at December 31, 2009 and 2008, respectively. Real estate owned is initially recorded at its estimated fair market value less estimated selling costs. The estimated fair value is generally determined by appraisal at the time of acquisition. The Bank’s investment in real estate owned is comprised of 37 properties at December 31, 2009. The majority of these properties are single family homes or residential lots. Two of the properties are commercial properties, and two are commercially zoned building lots. The Company’s plan for liquidating these properties involves listing the properties with experienced local real estate agents and pricing the properties appropriately for sale within a six month period. Sales plans for properties listed but unsold for more than six months will be reevaluated. Since year end, nine properties have been disposed of. The Company had no investment in repossessed assets other than real estate. See note 7 to the consolidated financial statements for further information.

## Deposits

The amounts and percentage composition of deposits held by the Bank as of December 31, 2009 and 2008 are summarized below:

### Deposit Composition

	December 31,			
	2009		2008	
	(Dollars in thousands)			
	Amount	% of Deposits	Amount	% of Deposits
Noninterest bearing demand	\$ 11,235	7.4%	\$ 10,070	8.2%
Interest bearing transaction accounts	13,308	8.7	13,013	10.6
Savings	37,317	24.5	13,849	11.3
Money market	10,760	7.1	7,286	6.0
Time deposits \$100,000 and over	51,245	33.6	41,810	34.1
Other time deposits	<u>28,516</u>	<u>18.7</u>	<u>36,554</u>	<u>29.8</u>
Total deposits	<u>\$ 152,381</u>	<u>100.0%</u>	<u>\$ 122,582</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, 2008 and 2007, are summarized below:

### Average Deposits

	Year ended December 31,			
	2009		2008	
	Amount	Rate	Amount	Rate
	(Dollars in thousands)			
Noninterest bearing demand	\$ 11,227	-%	\$ 10,914	-%
Interest bearing transaction accounts	13,169	.57%	13,502	.92%
Savings and money market	34,936	1.88%	14,994	1.98%
Time deposits	<u>86,435</u>	<u>2.54%</u>	<u>76,234</u>	<u>3.68%</u>
Total average deposits	<u>\$ 145,767</u>		<u>\$ 115,644</u>	

As of December 31, 2009, the Bank held \$51.2 million of time deposits with balances of \$100,000 or more. Of that amount, \$8.0 million mature within three months, \$8.8 million mature over three through six months, \$17.5 million mature over six through twelve months, and \$16.9 million mature over twelve months. \$400,000 of time deposits over \$100,000 or more are at floating rates of interest at December 31, 2009.

While many 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. Certain deposits included in total deposits over \$100,000 are brokered deposits. Brokered deposits are acquired in the wholesale market but are issued to the eventual customer in increments of less than \$100,000. The majority of these deposits are not redeemable prior to maturity except in the case of death. All time deposits over \$100,000 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 \$3.3 million and \$4.6 million at December 31, 2009 and 2008, respectively. Securities issued by government sponsored enterprises with an amortized cost of \$3.3 million and \$5.6 million (fair value of \$3.3 million and \$5.9 million) were used as collateral for the sweep accounts and retail repurchase agreements, at December 31, 2009 and 2008, 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, 2009 all of the Bank's customer repurchase agreements mature in 2010. During 2009 the average amount of customer repurchase agreements and sweep accounts totaled \$3.8 million. The Bank paid an average interest rate of 2.04% on these funds in 2009.

### **Broker Repurchase Agreements**

Broker repurchase agreements consist of two separate borrowings totaling \$5.0 million. These borrowings carry fixed rates of interest with call features. The agreements mature as follows: \$3.0 million maturing on January 15, 2015, callable by the broker quarterly after January 15, 2012, and \$2.0 million maturing on January 15, 2013, callable by the broker quarterly, beginning January 10, 2010. Securities with fair value of \$6.0 million and amortized cost of \$5.7 million collateralize the agreements. During 2009, the highest balance as of any month end for broker repurchase agreements was \$5.0 million and the average balance for 2009 was \$5.0 million. The average rate paid on broker repurchase agreements during 2009 was 3.53%. During 2008 the highest balance as of any month end for broker repurchase agreements was \$5.0 million and the average balance for 2008 was \$4,836,066. The average rate paid on broker repurchase agreements during 2008 was 3.53%.

### **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 53.4% of total assets at December 31, 2009.

Asset liquidity is provided from several sources, including amounts due from banks and federal funds sold, unpledged securities, and funds from maturing loans. The Company had \$6.0 million in cash and cash equivalents at December 31, 2009. The Bank has access to \$4.1 million in lines of credit with other banks and a line of credit with the Federal Home Loan Bank of Atlanta ("FHLB"), all of which are subject to various conditions and may be terminated at the option of the lender, as additional sources of liquidity funding. The lines with the other banks are for short-term use only. Approximately 50% of the lines available from other banks are unsecured, and 50% would need to be collateralized. There were no balances outstanding on these lines as of December 31, 2009.

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. As of December 31, 2009, the Bank had \$9.7 million at a weighted average rate of interest equal to 2.55%, maturing at various dates through 2018, borrowed from the FHLB. During 2009, the highest balance as of any month end for borrowings from the FHLB was \$9.8 million. The average rate paid on the advances during 2009 was 2.78%. The average balance of FHLB advances for 2009 was \$8.6 million. During 2008, the highest balance as of any month end for borrowings from the FHLB was \$10.4 million. The average rate paid on advances during 2008 was 3.28%. The average balance of FHLB advances for 2008 was \$7.0 million.

At December 31, 2009, approximately \$9.2 million of additional funds were available under the FHLB line provided that eligible collateral is available. The Bank primarily uses bonds and mortgage-backed securities issued by US Government agencies to collateralize advances. As of December 31, 2009 securities with a market value of \$5.6 were available to pledge as collateral to the FHLB should the Company require additional funding. 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, 2009 and 2008,

unfunded commitments to extend credit were \$17.6 million and \$21.9 million, respectively. At December 31, 2009, the unfunded commitments consisted of \$17.3 million at variable rates and \$304,600 at fixed rates with \$10.4 million expiring 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. 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.

In addition to commitments to extend credit, the Bank also issues standby letters of credit which are assurances to a third party that it 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 \$660,000 at December 31, 2009. 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, 2009. The Bank expects the majority of this capacity will not be utilized. During 2009, the average balance of demand deposit overdrafts was \$20,177.

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 did not maintain any obligations under non-cancelable operating lease agreements at December 31, 2009. The Company has less than one year remaining on a five-year contract with a company which provides data, item and ATM processing services. The monthly costs are approximately \$20,000. The Company expects to replace the existing contract with a new five-year contract. Refer to notes 12 and 16 to the Company's consolidated financial statements for additional discussion on these and other commitments and contingencies and financial instruments with off-balance sheet risk.

### **Capital Resources**

At December 31, 2009, total shareholders' equity decreased by approximately \$1.1 million from \$19.1 million at December 31, 2008 to \$18.0 million at December 31, 2009. The decrease was due to a net loss of \$1,361,274, items related to stock based compensation and the stock dividend, including option exercises, of \$150,749 and an unrealized gain on investment securities of \$112,983, net of tax. The Company does not anticipate it will need to raise additional capital in 2010 if the economy does not deteriorate further. The Company's current plan is to maintain its asset size in 2010, and return to modest growth in 2011.

The Company made capital expenditures for furniture and equipment in 2009 totaling approximately \$5,000. Capital expenditures for premises and equipment planned for 2010 consist of replacements of outdated computer equipment. There are no plans for additional premises in 2010.

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 adjusted total assets (Tier 1 leverage ratio). 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. Additionally, the OCC may require higher minimum capital ratios for an individual bank in view of its circumstances. The Company's and the Bank's regulatory capital requirements and positions are summarized in note 20 to the consolidated financial statements.

Because the Bank had a relatively high level of nonperforming assets at December 31, 2009 and recorded a substantial loss for 2009, the OCC may require the Bank to maintain capital ratios in excess of those generally required to be well capitalized and may seek the Bank's agreement to take other specified actions intended to reduce the risks faced by the Bank. The OCC has the authority to enforce such an agreement with various regulatory actions.

## 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, 2009 and 2008.

	<u>2009</u>	<u>2008</u>
Return on assets	(.75%)	.15%
Return on equity	(7.21%)	1.16%
Dividend payout ratio	-	265%
Equity to assets ratio (average)	10.42%	12.68%

In May, 2008 the Company declared its first cash dividend. The amount of the dividend was determined based on a number of factors, including previous year's earnings, capital levels, prospects for growth and earnings during the coming twelve months, and availability of dividends from the Bank to the Company. There can be no assurance that cash dividends will be declared in the future.

During 2010, the Bank's plan of operation is to continue to attract new deposit customers, convert our nonperforming assets into interest earning assets, to increase the ratio of services per customer and increase the account profitability of the Bank's current customers. The Bank plans to seek deposit accounts 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

The following table shows the high and low bid prices of our common stock reported by the OTC Bulletin Board for the past two years. 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 5% stock dividend declared in April 2009 to shareholders of record as of May 12, 2009.

	<u>Year ended</u>		<u>Year ended</u>	
	<u>December 31, 2009</u>		<u>December 31, 2008</u>	
	<u>Low</u>	<u>High</u>	<u>Low</u>	<u>High</u>
First Quarter	\$4.10	\$8.25	\$10.71	\$14.76
Second Quarter	\$4.10	\$6.00	\$13.09	\$13.33
Third Quarter	\$4.00	\$6.00	\$9.80	\$13.23
Fourth Quarter	\$3.55	\$5.90	\$9.52	\$10.95

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 OTC Bulletin Board under the symbol "CTOT.OB."

As of February 10, 2010, there were approximately 590 holders of record of the Company's common stock, excluding individual participants in security position listings.

The Company paid cash dividends of \$597,471 (\$.30 per share) for the first time in 2008. 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 Office of the Comptroller of the Currency (the "OCC"), the primary Federal regulator of national banks, 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.

#### **Management's Annual Report on Internal Control Over Financial Reporting**

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). A system of internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Under the supervision and with the participation of management, including the principal executive officer and the principal financial officer, the Company's management has evaluated the effectiveness of its internal control over financial reporting as of December 31, 2009 based on the criteria established in a report entitled "Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission" and the interpretive guidance issued by the Securities and Exchange Commission in Release No. 34-55929. Based on this evaluation, the Company's management has evaluated and concluded that the Company's internal control over financial reporting was effective as of December 31, 2009.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting because management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.



**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Shareholders and 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, 2009 and 2008, and the related consolidated statements of income (loss), shareholders' equity and comprehensive income (loss) and cash flows for each of the three years in the period ended December 31, 2009. 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 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 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, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with United States generally accepted accounting principles.

We were not engaged to examine management's assessment of the effectiveness of Cornerstone Bancorp and Subsidiary's internal control over financial reporting as of December 31, 2009, included in the accompanying Management's Annual Report on Internal Controls Over Financial Reporting, and, accordingly, we do not express an opinion thereon.

A handwritten signature in black ink that reads "Elliott Davis LLC". The signature is written in a cursive style.

Greenville, South Carolina  
March 30, 2010

**CORNERSTONE BANCORP AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS**

	December 31,	
	<u>2009</u>	<u>2008</u>
<b>Assets</b>		
Cash and due from banks	\$ 4,369,596	\$ 3,820,227
Federal funds sold	<u>1,670,000</u>	<u>140,000</u>
Cash and cash equivalents	6,039,596	3,960,227
<b>Investment securities</b>		
Available-for-sale	28,902,143	19,676,604
Other investments	1,142,050	1,114,150
Loans, net	135,067,914	129,483,130
Property and equipment, net	5,291,203	5,551,275
Cash surrender value of life insurance policies	1,838,663	1,768,520
Other real estate owned	6,712,948	575,000
Other assets	<u>3,975,813</u>	<u>1,722,161</u>
Total assets	<u>\$ 188,970,330</u>	<u>\$ 163,851,067</u>
<b>Liabilities And Shareholders' Equity</b>		
<b>Liabilities</b>		
Deposits		
Noninterest bearing	\$ 11,234,486	\$ 10,069,125
Interest bearing	<u>141,146,788</u>	<u>112,512,449</u>
Total deposits	152,381,274	122,581,574
Federal funds purchased	-	1,810,000
Customer repurchase agreements	3,257,002	4,582,619
Borrowings from Federal Home Loan Bank of Atlanta	9,743,172	10,394,005
Broker repurchase agreements	5,000,000	5,000,000
Other liabilities	<u>549,477</u>	<u>345,922</u>
Total liabilities	170,930,925	144,714,120
Commitments and contingencies – Notes 11 and 15		
<b>Shareholders' equity</b>		
Preferred stock, 10,000,000 shares authorized, no shares issued	-	-
Common stock, no par value, 20,000,000 shares authorized, 2,105,738 and 1,991,565 shares issued at December 31, 2009 and 2008, respectively	18,799,728	18,323,333
Retained earnings (deficit)	(921,014)	765,906
Accumulated other comprehensive income	<u>160,691</u>	<u>47,708</u>
Total shareholders' equity	<u>18,039,405</u>	<u>19,136,947</u>
Total liabilities and shareholders' equity	<u>\$ 188,970,330</u>	<u>\$ 163,851,067</u>

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

**CORNERSTONE BANCORP AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF INCOME (LOSS)**

	<u>Year ended December 31,</u>		
	<u>2009</u>	<u>2008</u>	<u>2007</u>
Interest Income			
Loans and fees on loans	\$ 6,997,466	\$ 7,848,630	\$ 8,834,764
Investment securities	1,025,983	1,161,545	944,003
Federal funds sold and other	<u>16,378</u>	<u>91,870</u>	<u>228,687</u>
Total interest income	8,039,827	9,102,045	10,007,454
Interest Expense			
Deposits	2,930,929	3,229,237	3,822,618
Federal funds sold and customer repurchase agreements	78,438	170,090	238,562
Federal Home Loan Bank advances	237,870	228,129	115,810
Broker repurchase agreements	<u>176,619</u>	<u>170,756</u>	<u>-</u>
Total interest expense	<u>3,423,856</u>	<u>3,798,212</u>	<u>4,176,990</u>
Net interest income	4,615,971	5,303,833	5,830,464
Provision for loan losses	<u>2,955,000</u>	<u>815,000</u>	<u>196,636</u>
Net interest income after provision for loan losses	1,660,971	4,488,833	5,633,828
Noninterest Income (Expense)			
Mortgage loan origination fees	154,905	275,721	437,157
Service fees on deposit accounts	572,973	579,298	542,937
Gain on sale of available-for-sale investments	299,063	-	-
Other-than-temporary-impairment of FNMA preferred stock	-	(918,264)	-
Gain (loss) on sale of repossessed assets	(228,547)	3,464	(9,672)
Other	<u>183,225</u>	<u>123,747</u>	<u>104,392</u>
Total noninterest income	<u>981,619</u>	<u>63,966</u>	<u>1,074,814</u>
Noninterest Expenses			
Salaries and benefits	2,392,717	2,415,115	2,443,315
Occupancy and equipment	572,025	600,426	567,222
Data processing	218,110	231,958	234,671
Advertising	30,258	69,859	76,530
Supplies	69,383	85,895	111,918
Professional and regulatory fees	551,330	320,027	314,516
Directors fees	138,475	130,450	127,700
Loan expenses	322,687	51,706	24,766
Other real estate owned	117,272	50,889	8,216
Deposit charge-offs	20,912	26,461	39,387
Other operating	<u>390,432</u>	<u>362,297</u>	<u>337,416</u>
Total noninterest expenses	<u>4,823,601</u>	<u>4,345,083</u>	<u>4,285,657</u>
Income (loss) before income taxes	(2,181,011)	207,716	2,422,985
Income tax provision (benefit)	<u>(819,737)</u>	<u>(17,600)</u>	<u>810,232</u>
Net income (loss)	<u>\$ (1,361,274)</u>	<u>\$ 225,316</u>	<u>\$ 1,612,753</u>
<u>Earnings (Loss) Per Common Share</u>			
Basic	\$ (.65)	\$ .11	\$ .78
Diluted	\$ (.65)	\$ .11	\$ .76
<u>Weighted Average Common Shares Outstanding</u>			
Basic	2,103,039	2,089,384	2,063,917
Diluted	2,103,039	2,143,953	2,117,693

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)**

	<u>Common stock</u>		<u>Retained earnings (deficit)</u>	<u>Accumulated other comprehensive income (loss)</u>	<u>Total shareholders' equity</u>
	<u>Shares</u>	<u>Amount</u>			
Balance, December 31, 2006	1,777,313	\$ 15,972,666	\$ 1,499,803	\$ 66,258	\$ <u>17,538,727</u>
Net income	-	-	1,612,753	-	1,612,753
Other comprehensive income, net of income taxes:					
Unrealized gain on investment securities	-	-	-	151,794	<u>151,794</u>
Comprehensive income					1,764,547
Stock based compensation	-	40,797	-	-	40,797
Stock option exercises, including Tax benefit of \$54,550	27,306	238,990	-	-	238,990
Stock dividend (10%), net of cash in lieu of fractional shares	<u>178,550</u>	<u>1,932,875</u>	<u>(1,935,106)</u>	<u>-</u>	<u>(2,231)</u>
Balance, December 31, 2007	1,983,169	18,185,328	1,177,450	218,052	<u>19,580,830</u>
Net income	-	-	225,316	-	225,316
Other comprehensive income, net of income taxes:					
Unrealized loss on investment securities	-	-	-	(170,344)	<u>(170,344)</u>
Comprehensive income					54,972
Cumulative effect of accounting change	-	-	(39,389)	-	(39,389)
Stock based compensation	-	56,172	-	-	56,172
Stock option exercises	8,396	81,833	-	-	81,833
Cash dividend paid	<u>-</u>	<u>-</u>	<u>(597,471)</u>	<u>-</u>	<u>(597,471)</u>
Balance, December 31, 2008	1,991,565	18,323,333	765,906	47,708	<u>19,136,947</u>
Net loss	-	-	(1,361,274)	-	(1,361,274)
Other comprehensive income, net of income taxes:					
Unrealized gain on investment securities	-	-	-	112,983	<u>112,983</u>
Comprehensive loss					(1,248,291)
Stock based compensation	-	72,464	-	-	72,464
Stock option exercises	14,172	80,000	-	-	80,000
Stock dividend (5%), net of cash in lieu of fractional shares	<u>100,001</u>	<u>323,931</u>	<u>(325,646)</u>	<u>-</u>	<u>(1,715)</u>
Balance, December 31, 2009	<u>2,105,738</u>	<u>\$ 18,799,728</u>	<u>\$ (921,014)</u>	<u>\$ 160,691</u>	<u>\$ 18,039,405</u>

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



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

	<u>Years ended December 31,</u>		
	<u>2009</u>	<u>2008</u>	<u>2007</u>
<b>Operating Activities</b>			
Net income (loss)	\$ (1,361,274)	\$ 225,316	\$ 1,612,753
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and net amortization	351,303	292,585	285,241
Deferred income tax (benefit) expense	(286,803)	(315,107)	4,508
Provision for loan losses	2,955,000	815,000	196,636
Other than temporary impairment of FNMA Preferred	-	918,264	-
Gain on sale of available-for-sale investments	(299,063)	-	-
(Gain) loss on sale of repossessed collateral	202,296	(3,464)	9,672
Gain on sale of fixed assets	(625)	(481)	-
Non-cash option expense	72,464	56,172	40,797
Increase in other assets	(2,184,323)	(9,958)	(216,723)
Increase (decrease) in other liabilities	<u>145,474</u>	<u>(240,717)</u>	<u>(104,341)</u>
Net cash provided by (used for) operating activities	<u>(405,551)</u>	<u>1,737,610</u>	<u>1,828,543</u>
<b>Investing Activities</b>			
Proceeds from maturities and principal paydowns of investment securities	16,654,053	4,276,949	4,358,412
Proceeds from sale of OREO	2,498,705	399,208	96,528
Purchase of investment securities	(25,495,248)	(7,085,514)	(5,005,942)
Purchase of FHLB and Federal Reserve stock, net	(27,900)	(297,650)	(2,900)
Increase in loans, net	(17,167,459)	(23,849,672)	(11,365,651)
Proceeds from sale of property and equipment	625	7,495	-
Capitalization of improvements to OREO	(63,943)	-	-
Purchase of property and equipment	<u>(5,448)</u>	<u>(32,295)</u>	<u>(1,679,829)</u>
Net cash used for investing activities	<u>(23,606,615)</u>	<u>(26,581,479)</u>	<u>(13,599,382)</u>
<b>Financing Activities</b>			
Net increase in deposits	29,799,700	11,647,106	9,268,272
Net increase (decrease) in customer repurchase agreements	(1,325,617)	(1,220,316)	738,795
Net increase (decrease) Federal funds purchased	(1,810,000)	1,810,000	-
Borrowings from Federal Home Loan Bank of Atlanta	4,500,000	11,800,000	1,000,000
Repayments to Federal Home Loan Bank of Atlanta	(5,150,833)	(4,950,833)	(150,833)
Proceeds from broker repurchase agreements	-	5,000,000	-
Proceeds from exercise of stock options	80,000	81,833	238,990
Cash dividends paid	-	(597,471)	-
Cash paid in lieu of fractional shares	<u>(1,715)</u>	<u>-</u>	<u>(2,231)</u>
Net cash provided by financing activities	<u>26,091,535</u>	<u>23,570,319</u>	<u>11,092,993</u>
Net increase (decrease) in cash and cash equivalents	2,079,369	(1,273,550)	(677,846)
Cash and cash equivalents, beginning of year	<u>3,960,227</u>	<u>5,233,777</u>	<u>5,911,623</u>
Cash and cash equivalents, end of year	<u>\$ 6,039,596</u>	<u>\$ 3,960,227</u>	<u>\$ 5,233,777</u>
<b>Cash paid for:</b>			
Interest	<u>\$ 3,457,004</u>	<u>\$ 3,803,188</u>	<u>\$ 4,145,118</u>
Income taxes	<u>\$ 54,946</u>	<u>\$ 438,048</u>	<u>\$ 932,075</u>
<b>Non-cash Supplemental information:</b>			
Loans transferred to other real estate owned	<u>\$ 8,922,517</u>	<u>\$ 931,761</u>	<u>\$ 69,000</u>
Loans charged-off, net	<u>\$ 1,958,726</u>	<u>\$ 409,567</u>	<u>\$ 103,505</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. Upon completion in January 2006, 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 Comptroller 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 the Berea area of Greenville County and the Powdersville area of Anderson County, South Carolina in addition to its headquarters in Easley in Pickens County, South Carolina. In 2004, the Bank established a wholly owned subsidiary, Crescent Financial Services, Inc. ("Crescent"), which is an insurance agency. In 2009, 2008 and 2007, 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 ("GAAP") 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") and using certain regulatory definitions. As of December 31, 2009, the Bank has concentrations of credit in real estate rental and leasing, accommodation and food services, 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. The Bank also has a concentration in loans collateralized by real estate. Although a majority of the Bank's loans are collateralized by real estate, the Bank believes that it has proper internal controls to identify and mitigate risks associated with this concentration in real estate collateral.

**Investment securities**

The Company accounts for investment securities in accordance with financial accounting standards which require that investments in equity and debt securities to be classified into three categories:

(Continued)

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

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).
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.

The financial accounting standard followed by the Company defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. Available for sale securities owned by the Company include government sponsored enterprise bonds, mortgage-backed securities issued by government sponsored enterprises, and municipal bonds. The fair values of the Company's available for sale investments, other than municipal bonds, are measured on a recurring basis using quoted market prices in active markets for identical assets and liabilities ("Level 1 inputs" under the standard). Due to the lower level of trading activity in municipal bonds, the fair market values of these investments are measured based on other inputs such as inputs that are observable or can be corroborated by observable market data for similar assets with substantially the same terms ("Level 2 inputs" under the standard.)

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. Redemption of these stock investments has historically been at par value. However, there can be no assurance that future redemptions will be at par value. Other investments are carried at cost.

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.

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

The Bank accounts for impaired loans in accordance with a financial accounting standard that requires all lenders to 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.

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.

**Other real estate owned**

Other real estate owned is carried at fair value (market value less estimated selling cost), determined using an independent appraisal.

**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 a financial accounting standard that requires that deferred tax assets and liabilities be recognized for the expected future tax consequences of events that have been recognized in the consolidated financial statements or tax returns. 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.

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

The Company has analyzed its filing positions in the federal and state jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. The Company believes that income tax filing positions taken or expected to be taken in its tax returns will more likely than not be sustained upon audit by the taxing authorities and does not anticipate any adjustments that will result in a material adverse impact on the Company's financial condition, results of operations, or cash flows. Therefore, no reserves for uncertain income tax positions have been recorded.

### **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. 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, 2009, there were no common stock equivalents included in the Company's loss per share calculation. Options to purchase 106,255 shares of common stock were antidilutive as of December 31, 2009 and were excluded from the diluted share calculation. The Company declared a five percent stock dividend to shareholders of record on May 12, 2009 and 10 percent stock dividends to shareholders of record as of May 8, 2007, May 9, 2006, May 10, 2005, May 11, 2004, March 17, 2003 and April 30, 2002. 2008 and 2007 share and per share amounts on the Consolidated Statements of income (loss) have been restated to reflect the applicable 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**

The Company discloses fair value information for financial instruments, whether or not recognized in the balance sheet, when it is practicable to estimate the fair value. Under GAAP, a financial instrument is defined 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.

(Continued)

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

**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.

**Broker repurchase agreements** – Fair values of broker 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.

### **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 18. Under the 2003 Plan, 18,000 options were granted during each of the years 2004, 2005, 2006 and 2007. 19,200 options were granted in 2008. Options to purchase 15,600 shares of common stock were granted in 2009. Stock dividends were declared subsequent to the grant dates of the Organizers’ options and some of the employees’ options. Pursuant to the terms of the 2003 Plan and the Organizers’ option agreements, the number of options outstanding was increased and the exercise price was decreased to give effect to these stock dividends.

The Company accounts for stock based compensation in accordance with GAAP. Fair value of an option grant is estimated on the date of grant using the Black-Scholes option pricing model. The risk free interest rates used for the 2009, 2008, and 2007 grants were 2.34%, 3.91%, and 4.68%, respectively, which was the 10 Year Constant Maturity Rate on U.S. 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 2009, 2008, and 2007 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. Since 2006, the stock has been quoted on the OTC Bulletin Board. Based on information available at the date of the grant, the volatility assumption used for 2009 option grants was 38.71%, for 2008 option grants was 28%, and for 2007 option grants was 12%.

### **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 June 2009, the FASB issued “The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles – a replacement of FASB Statement No. 162.” This standard establishes the FASB Accounting Standards Codification™ (“ASC”) as the source of authoritative generally accepted accounting principles for nongovernmental entities.

The standard was effective for interim and annual periods ending after September 15, 2009. It did not have any impact on the Company’s financial position. In conjunction with the issuance of the ASC, the FASB also issued its first Accounting Standards Update, “Topic 105 – Generally Accepted Accounting Principles.”

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

The update was effective for interim and annual periods ending after September 15, 2009 and did not have an impact on the Company's financial position or results of operations. It did change the referencing system for accounting standards.

"Amendments to the Impairment Guidance of EITF Issue No. 99-20," was issued in January 2009. Prior to the Staff Position, other-than-temporary impairment was determined by using either "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests that Continue to be Held by a Transferor in Securitized Financial Assets," ("EITF 99-20") or "Accounting for Certain Investments in Debt and Equity Securities," depending on the type of security. EITF 99-20 required the use of market participant assumptions regarding future cash flows regarding the probability of collecting all cash flows previously projected. Other standards determined impairment to be other than temporary if it was probable that the holder would be unable to collect all amounts due according to the contractual terms. To achieve a more consistent determination of other-than-temporary impairment, the Staff Position amends EITF 99-20 to determine any other-than-temporary impairment based on the guidance in SFAS No. 115, allowing management to use more judgment in determining any other-than-temporary impairment. The Staff Position was effective for the Company as of December 31, 2008. Management has reviewed and evaluated the Company's security portfolio for any other-than-temporary impairments.

The SEC's Office of the Chief Accountant and the staff of the FASB issued press release 2008-234 on September 30, 2008 ("Press Release") to provide clarifications on fair value accounting. The Press Release included guidance on the use of management's internal assumptions and the use of "market" quotes. It also reiterated the factors in SEC Staff Accounting Bulletin ("SAB") Topic 5M that should be considered when determining other-than-temporary impairment: the length of time and extent to which the market value has been less than cost; financial condition and near-term prospects of the issuer; and the intent and ability of the holder to retain its investment for a period of time sufficient to allow for any anticipated recovery in market value.

On October 10, 2008, the FASB issued a staff position ("FSP"), "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active." This FSP clarified the application of previously issued standards in a market that is not active, and provided an example to illustrate key considerations in determining the fair value of a financial asset when the market for that asset is not active. The FSP was effective upon issuance, including prior periods for which financial statements have not been issued. For the Company, this FSP was effective for the quarter ended September 30, 2008. The Company considered the guidance in the Press Release and in FSP SFAS 157-3 when conducting its review for other-than-temporary impairment as of the balance sheet date.

On April 9, 2009, the FASB issued three staff positions related to fair value which are discussed below.

"Recognition and Presentation of Other-Than-Temporary Impairments" categorizes losses on debt securities available-for-sale or held-to-maturity determined by management to be other-than-temporarily impaired into losses due to credit issues and losses related to all other factors. Other-than-temporary impairment (OTTI) exists when it is more likely than not that the security will mature or be sold before its amortized cost basis can be recovered. An OTTI related to credit losses should be recognized through earnings. An OTTI related to other factors should be recognized in other comprehensive income. The FSP does not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities.

"Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That are Not Orderly" recognizes that quoted prices may not be determinative of fair value when the volume and level of trading activity have significantly decreased. The evaluation of certain factors may necessitate that fair value be determined using a different valuation technique. Fair value should be the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction, not a forced liquidation or distressed sale. If a transaction is considered to not be orderly, little, if any, weight should be placed on the transaction price. If there is not sufficient information to conclude as to whether or not the transaction is orderly, the transaction price should be considered when estimating fair value. An entity's intention to hold an asset or liability is not relevant in determining fair value.

(Continued)

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

Quoted prices provided by pricing services may still be used when estimating fair value in accordance with financial accounting standards; however, the entity should evaluate whether the quoted prices are based on current information and orderly transactions. Inputs and valuation techniques are required to be disclosed in addition to any changes in valuation techniques.

"Interim Disclosures about Fair Value of Financial Instruments" requires disclosures about the fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements and also requires those disclosures in summarized financial information at interim reporting periods. A publicly traded company includes any company whose securities trade in a public market on either a stock exchange or in the over-the-counter market, or any company that is a conduit bond obligor. Additionally, when a company makes a filing with a regulatory agency in preparation for sale of its securities in a public market it is considered a publicly traded company for this purpose.

The three staff positions were effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009, in which case all three must be adopted. The Company adopted the staff positions for its second quarter quarterly report on Form 10-Q. The staff positions did not have a material impact on the consolidated financial statements.

Also on April 1, 2009, the FASB issued an FSP, "Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies." This FSP requires that assets acquired and liabilities assumed in a business combination that arise from a contingency be recognized at fair value. If fair value cannot be determined during the measurement period, the asset or liability can still be recognized if it can be determined that it is probable that the asset existed or the liability had been incurred as of the measurement date and if the amount of the asset or liability can be reasonably estimated. If it is not determined to be probable that the asset/liability existed/was incurred or no reasonable amount can be determined, no asset or liability is recognized. The entity should determine a rational basis for subsequently measuring the acquired assets and assumed liabilities. Contingent consideration agreements should be recognized initially at fair value and subsequently reevaluated. The FSP was effective for business combinations with an acquisition date on or after the beginning of the Company's first annual reporting period beginning on or after December 15, 2008. The Company will assess the impact of the FSP if and when a future acquisition occurs.

The Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 111 on April 9, 2009 to amend Topic 5.M. (ASC 320-10-S99), "Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities" and to supplement FSP SFAS 115-2 and SFAS 124-2. SAB 111 maintains the staff's previous views related to equity securities; however debt securities are excluded from its scope. The SAB provides that "other-than-temporary" impairment is not necessarily the same as "permanent" impairment and unless evidence exists to support a value equal to or greater than the carrying value of the equity security investment, a write-down to fair value should be recorded and accounted for as a realized loss. The SAB was effective upon issuance and had no impact on the Company's financial position.

The FASB issued a standard, "Subsequent Events," in May 2009 which provides guidance on when a subsequent event should be recognized in the financial statements. Subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet should be recognized at the balance sheet date. Subsequent events that provide evidence about conditions that arose after the balance sheet date but before financial statements are issued, or are available to be issued, are not required to be recognized. The date through which subsequent events have been evaluated must be disclosed as well as whether it is the date the financial statements were issued or the date the financial statements were available to be issued. For non-recognized subsequent events which should be disclosed to keep the financial statements from being misleading, the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made, should be disclosed. The standard is effective for interim or annual periods ending after June 15, 2009. See Note 23 for Management's evaluation of subsequent events.

The FASB issued ASU 2009-05, "Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value" in August, 2009 to provide guidance when estimating the fair value of a liability. When a quoted price in an active market for the identical liability is not available, fair value should be measured using (a) the quoted price of an identical liability when traded as an asset; (b) quoted prices for similar liabilities



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

or similar liabilities when traded as assets; or (c) another valuation technique consistent with the principles of Topic 820 such as an income approach or a market approach. If a restriction exists that prevents the transfer of the liability, a separate adjustment related to the restriction is not required when estimating fair value. The ASU was effective October 1, 2009 for the Company and had no impact on financial position or operations.

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 as a result of the regulators' judgments based on information available to them at the time of their examination.

**Reclassification**

Certain amounts in prior year's financial statements have been reclassified to conform to current year presentation. No changes have been made that affect the reported results of operations, financial condition or cash flows.

**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, 2009 and 2008 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, 2009 and 2008 federal funds sold amounted to \$1,670,000 and \$140,000, respectively.

**NOTE 4 – INVESTMENT SECURITIES**

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

	December 31, 2009			
	Amortized Cost	Gross unrealized		Fair value
		Gains	Losses	
Government sponsored enterprise bonds	\$ 10,339,754	\$ 38,979	\$ 191,026	\$10,187,707
Mortgage-backed securities	12,232,754	189,480	57,812	12,364,422
Municipal bonds	<u>6,086,285</u>	<u>263,729</u>	<u>-</u>	<u>6,350,014</u>
Total investment securities available-for-sale	<u>\$ 28,658,793</u>	<u>\$ 492,188</u>	<u>\$ 248,838</u>	<u>\$ 28,902,143</u>

  

	December 31, 2008			
	Amortized cost	Gross unrealized		Fair value
		Gains	Losses	
Government sponsored enterprise bonds	\$ 8,859,181	\$ 433,569	\$ -	\$ 9,292,750
FNMA preferred stock	87,200	-	54,800	32,400
Mortgage-backed securities	4,173,881	113,419	7,611	4,279,689
Municipal bonds	<u>6,484,056</u>	<u>46,120</u>	<u>458,411</u>	<u>6,071,765</u>
Total investment securities available-for-sale	<u>\$ 19,604,318</u>	<u>\$ 593,108</u>	<u>\$ 520,822</u>	<u>\$ 19,676,604</u>

While seven of the Company's Government sponsored enterprise bonds and mortgage-backed securities available-for-sale are in an unrealized loss position as of December 31, 2009, none have been in an unrealized loss position for twelve months or more. None of these securities are expected to have a loss of principal at final maturity. The Company believes it is more likely than not it will hold these securities until such time as the value recovers or the securities mature. All of the Company's municipal bonds were in an unrealized gain position as of December 31, 2009. During 2008, the Company recognized other-than-temporary-impairment on the FNMA preferred stock of \$606,054, net of tax, based on analysis under FSP 115-1 and FNMA's being placed into conservatorship by the U.S. Treasury Department. The Company sold the FNMA preferred stock in 2009 at an additional loss of \$58,788. 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, 2009.

	Less than Twelve Months		Over Twelve Months		Total Unrealized Losses
	Gross Unrealized		Gross Unrealized		
	Losses	Fair Value	Losses	Fair Value	
Government sponsored enterprise bonds	\$ 191,026	\$ 5,898,728	\$ -	\$ -	\$ 191,026
Mortgage-backed securities	57,812	7,727,556	-	-	57,812
Municipal bonds	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total	<u>\$ 248,838</u>	<u>\$ 13,626,284</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 248,838</u>

At December 31, 2009 and 2008, securities with a fair value of \$22,889,893 and \$18,440,430, respectively, were pledged to collateralize public deposits, sweep accounts, advances from the FHLB, and repurchase agreements. During 2009, the Company sold securities with a fair value of \$10,752,749 and recognized a net gain on the sale of those securities of \$299,063. There were no sales of securities for the years ended December 31, 2008 or 2007.

(Continued)

**NOTE 4 – INVESTMENT SECURITIES, Continued**

The amortized cost and fair value of securities at December 31, 2009, 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.

	December 31, 2009	
	Amortized Cost	Fair Value
Due after one through five years	\$ 2,430,513	\$ 2,486,061
Due after five through ten years	9,785,027	9,691,469
After ten years or no maturity	<u>16,443,253</u>	<u>16,724,613</u>
Total investment securities	\$ <u>28,658,793</u>	\$ <u>28,902,143</u>

The Bank, as a member institution, is required to own stock in the Reserve Bank and the FHLB. These stocks are included at cost 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. Stock held in the FHLB is pledged as collateral against advances from the FHLB.

**NOTE 5 – LOANS**

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

	December 31,	
	2009	2008
Commercial	\$ 14,974,286	\$ 18,596,972
Real estate – construction	53,827,245	49,669,669
Real estate – mortgage	67,614,913	60,866,234
Consumer	<u>1,346,807</u>	<u>2,048,818</u>
Loans, gross	137,763,251	131,181,693
Less allowance for loan losses	<u>(2,695,337)</u>	<u>(1,698,563)</u>
Loans, net	\$ <u>135,067,914</u>	\$ <u>129,483,130</u>

As of December 31, 2009, approximately \$82.4 million or 59.8% of total gross loans were variable rate loans.

The FHLB has a blanket lien on certain types of the Company's loans as collateral for FHLB advance borrowings. See Note 10. The Reserve Bank has a lien on certain other loan types should the Bank borrow from the Discount Window. As of December 31, 2009 there were no borrowings from the Discount Window of the Reserve Bank.

At December 31, 2009 the Bank had non-accrual loans of \$9.7 million, which are considered to be impaired. This amount includes 27 loans and one line of credit, all of which are collateral dependent. These loans are secured by real estate, and were in the process of foreclosure or other collection processes as of December 31, 2009. If these loans had been current, the Company would have recorded additional interest income of \$292,943 in 2009. All previously accrued but uncollected income on these loans has been eliminated from the accompanying consolidated statements of income (loss). Included in the allowance for loan losses are special reserves of \$165,771 related to these loans. The Company charged-off \$224,271 related to impaired loans in 2009.

As of December 31, 2009, the Bank has restructured another \$4.05 million of loans that are performing in accordance with their restructured terms, but are deemed to be impaired due to the changes in their terms. Average impaired loans in 2009 (average loans on nonaccrual or loans 90 days or more delinquent as to principal or interest payments) were \$7.3 million. At December 31, 2008 the Company held nonaccrual loans in the amount of \$2.4 million.

(Continued)

**NOTE 5 – LOANS, Continued**

Activity in the allowance for loan losses for the years ended December 31, 2009, 2008, and 2007 is summarized in the table below.

	Year ended December 31,		
	2009	2008	2007
Allowance for loan losses, beginning of year	\$ 1,698,563	\$ 1,293,130	\$ 1,199,999
Provision for loan losses	2,955,000	815,000	196,636
Charge-offs	(1,958,726)	(685,166)	(103,505)
Recoveries	<u>500</u>	<u>275,599</u>	<u>-</u>
Allowance for loan losses, end of year	\$ <u>2,695,337</u>	\$ <u>1,698,563</u>	\$ <u>1,293,130</u>

**NOTE 6 – PROPERTY AND EQUIPMENT**

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

	December 31,	
	2009	2008
Land and improvements	\$ 1,468,480	\$ 1,468,480
Bank premises	4,271,773	4,271,773
Furniture, equipment and software	1,531,250	1,527,107
Vehicles	<u>58,005</u>	<u>58,005</u>
Property and equipment	7,329,508	7,325,365
Accumulated depreciation	<u>(2,038,305)</u>	<u>(1,774,090)</u>
Property and equipment, net	\$ <u>5,291,203</u>	\$ <u>5,551,275</u>

Depreciation expense for the years ended December 31, 2009, 2008, and 2007, amounted to \$265,520, \$282,574, and \$286,257, 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:

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

**NOTE 7 – OTHER REAL ESTATE OWNED AND REPOSSESSED ASSETS**

The Company has acquired a significant number of real estate properties in settlement of loans via the foreclosure process. A summary of the activity in other real estate owned follows:

	December 31,	
	2009	2008
Beginning balance	\$ 575,000	\$ 69,000
Additions from foreclosures	8,691,617	951,761
Write downs of value	-	(30,017)
Sales	<u>(2,553,669)</u>	<u>(415,744)</u>
Ending other real estate owned	\$ <u>6,712,948</u>	\$ <u>575,000</u>

The Company recognized a net loss of \$228,547 on all types of repossessed collateral for the year ended December 31, 2009. In 2008, the Company recognized a gain on the sale of repossessed collateral of \$3,464. In 2007, the Company recognized a loss of \$9,672 on repossessed collateral.

**NOTE 8 – DEPOSITS**

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

	December 31,	
	2009	2008
Noninterest bearing	\$ 11,234,486	\$ 10,069,125
Interest bearing:		
NOW accounts	13,308,457	13,013,071
Money market accounts	10,760,323	7,286,130
Savings	37,317,247	13,848,956
Time, less than \$100,000	28,516,218	36,554,096
Time, \$100,000 and over	<u>51,244,543</u>	<u>41,810,196</u>
Total deposits	<u>\$ 152,381,274</u>	<u>\$ 122,581,574</u>

Interest expense on time deposits greater than \$100,000 was approximately \$1.3 million in 2009, \$1.3 million in 2008, and \$1.2 million in 2007. Securities issued by government sponsored enterprises with an amortized cost of \$1.7 million and \$2.0 million (fair value of \$1.7 million and \$2.1 million) in 2009 and 2008, respectively, were pledged as collateral for public funds.

At December 31, 2009 the scheduled maturities of time deposits are as follows:

2010	\$ 53,300,355
2011	15,810,966
2012	3,402,484
2013	2,781,458
2014 and thereafter	<u>4,465,498</u>
	<u>\$ 79,760,761</u>

**NOTE 9 – CUSTOMER REPURCHASE AGREEMENTS**

Customer repurchase agreements consist of the following:

	December 31,	
	2009	2008
Sweep accounts	\$ 587,802	\$ 1,432,619
Retail repurchase agreements	<u>2,669,200</u>	<u>3,150,000</u>
	<u>\$ 3,257,002</u>	<u>\$ 4,582,619</u>

The Bank enters into sweep and retail repurchase agreements with its customers. The sweep agreements generally mature overnight. At December 31, 2009, the Bank had six retail repurchase agreements that mature in 2010. Securities issued by government sponsored enterprises with an amortized cost of \$3,262,097 and \$5,644,221 (fair value of \$3,276,795 and \$5,905,715) were pledged as collateral for the sweep accounts and repurchase agreements, at December 31, 2009 and 2008, respectively.

**NOTE 10 – BORROWINGS FROM FEDERAL HOME LOAN BANK OF ATLANTA**

At December 31, 2009 and 2008, 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 lien on certain of the Bank's available for sale securities and loans. At December 31, the Bank had advances outstanding as follows:

<u>December 31,</u>					
<u>2009</u>	<u>2008</u>	<u>Interest Rate</u>	<u>Maturity Date</u>	<u>Terms</u>	
\$ 3,000,000	\$ -	1.07%	1/10/2011	Fixed rate	
-	3,500,000	.46	1/14/2009	Variable rate credit	
1,500,000	1,500,000	2.73	3/16/2010	Fixed rate	
1,500,000	1,500,000	2.84	9/16/2010	Fixed rate	
1,000,000	1,000,000	2.72	1/25/2011	Fixed rate	
177,778	222,222	4.49	12/01/2013	Fixed rate, amortizing	
168,519	207,408	4.89	4/14/2014	Fixed rate, amortizing	
396,875	464,375	4.78	7/27/2015	Fixed rate, amortizing	
<u>2,000,000</u>	<u>2,000,000</u>	3.52	1/16/2018	Fixed rate, convertible	
<u>\$ 9,743,172</u>	<u>\$ 10,394,005</u>				

The Company's convertible advance from the FHLB is convertible to a variable rate instrument at the option of the FHLB on January 16, 2013. During 2009 the highest balance as of any month end for borrowings from the FHLB was \$9.8 million. The average rate paid on advances during 2009 was 2.78%. The average balance of FHLB advances for 2009 was \$8.6 million. During 2008, the highest balance as of any month end for borrowings from the FHLB was \$10.4 million. The average rate paid on advances during 2008 was 3.28%. The average balance of FHLB advances for 2008 was \$7.0 million.

**NOTE 11 – BROKER REPURCHASE AGREEMENTS**

Broker repurchase agreements consist of two separate borrowings totaling \$5.0 million. These borrowings carry fixed rates of interest with call features. The agreements mature as follows: \$3.0 million maturing on January 15, 2015, callable by the broker quarterly after January 15, 2012, and \$2.0 million maturing on January 15, 2013, callable by the broker quarterly, beginning January 10, 2010. Securities with fair value of \$6.0 million and amortized cost of \$5.7 million collateralize the agreements. During 2009 the highest balance as of any month end for broker repurchase agreements was \$5.0 million and the average balance for 2009 was \$5.0 million. The average rate paid on broker repurchase agreements during 2009 was 3.53%. During 2008 the highest balance as of any month end for broker repurchase agreements was \$5.0 million and the average balance for 2008 was \$4,836,066. The average rate paid on broker repurchase agreements during 2008 was 3.53%.

**NOTE 12 – COMMITMENTS AND CONTINGENCIES**

The Bank may become party to litigation and claims arising in the normal course of business. As of December 31, 2009, there was no litigation pending other than foreclosure actions initiated by the Bank.

The Company expects to enter into a five-year contract with a data, item, and ATM processing service. Minimum monthly costs for these services are currently approximately \$20,000. Minimum monthly costs are not expected to increase substantially under the new contract. Volume-related costs may increase as volume increases.

The Company has signed change of control agreements with three of its executive officers. These agreements provide for various payments to the executives 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, 2009 the total amount guaranteed by the Bank related to merchant credit card accounts was immaterial.

Refer to Note 16 concerning financial instruments with off balance sheet risk.

### NOTE 13 – LINES OF CREDIT

At December 31, 2009, the Bank had lines of credit to purchase federal funds totaling \$4,100,000 from unrelated banks. One line is a collateralized line and the other is an uncollateralized line. The interest rate varies daily. These lines of credit are available on a short-term basis for general corporate purposes of the Bank. The lenders have reserved the right to withdraw the lines at their option. There were no balances outstanding under these lines as of December 31, 2009. \$1.8 million was outstanding on a line of credit at December 31, 2008.

### NOTE 14 – 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,					
	2009		2008		2007	
Tax expense (benefit) at statutory rate	\$ (741,544)	(34)%	\$ 70,623	34%	\$823,815	34%
Increase (decrease) in taxes resulting from:						
State income taxes, net of federal benefit	-	-	7,789	4	48,471	2
Tax-exempt investments	(78,845)	(5)	(75,249)	(36)	(31,835)	(1)
Increase in cash value of life insurance	(23,849)	(2)	(24,171)	(12)	(23,277)	(1)
Other	<u>24,501</u>	<u>2</u>	<u>3,408</u>	<u>2</u>	<u>(6,942)</u>	<u>(1)</u>
Income tax provision	<u>\$ (819,737)</u>	<u>(39)%</u>	<u>\$ (17,600)</u>	<u>(8)%</u>	<u>\$810,232</u>	<u>33%</u>

The income tax effects of cumulative temporary differences at December 31, 2009 and 2008 are as follows:

	2009	2008
Deferred tax assets:		
Allowance for loan losses	\$ 704,559	\$ 513,045
Other than temporary impairment	-	312,210
Stock based compensation	37,036	22,627
Other	<u>148,957</u>	<u>25,921</u>
	<u>890,552</u>	<u>873,803</u>
Deferred tax liabilities:		
Unrealized net gain on securities available for sale	82,739	24,577
Depreciation	68,414	82,658
Prepaid expenses	<u>25,531</u>	<u>32,401</u>
	<u>176,684</u>	<u>139,636</u>
Net deferred tax asset	<u>\$ 713,868</u>	<u>\$ 734,167</u>

The net deferred taxes are included in other assets in the consolidated balance sheets. Deferred tax assets represent the future tax benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. As of December 31, 2009 and 2008, no valuation allowance was deemed necessary.

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,		
	2009	2008	2007
Income taxes currently payable (receivable)	\$ (781,874)	\$ 436,176	\$ 805,724
Deferred income tax provision (benefit)	<u>(37,863)</u>	<u>(453,776)</u>	<u>4,508</u>
Income tax provision (benefit)	<u>\$ (819,737)</u>	<u>\$ (17,600)</u>	<u>\$ 810,232</u>

The Company has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions in accordance with FIN 48.

**NOTE 15 – 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.

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

	Year ended December 31,		
	2009	2008	2007
Balance, beginning of year	\$ 5,958,663	\$ 6,443,949	\$ 5,835,997
New loans or lines of credit	2,588,627	1,272,822	4,470,962
Payments on loans or lines of credit	<u>(908,891)</u>	<u>(1,758,108)</u>	<u>(3,863,010)</u>
Balance, end of year	\$ <u>7,638,399</u>	\$ <u>5,958,663</u>	\$ <u>6,443,949</u>

Deposits by directors, executive officers, and their related interests, at December 31, 2009 and 2008 were \$2,306,089 and \$2,911,291, respectively.

**NOTE 16 – 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, 2009 and 2008, unfunded commitments to extend credit were \$17.6 million and \$21.9 million, respectively, and outstanding letters of credit were approximately \$660,000 and \$1.1 million, respectively. At December 31, 2009, the unfunded commitments consisted of \$17.3 million at variable rates and \$304,600 at fixed rates with \$10.4 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 2009 and 2008.

The Bank offers an automatic overdraft protection product. Approximately \$1.2 million of overdraft protection is available under this product as of December 31, 2009. The Bank expects that much of this capacity will not be utilized. During 2009 the average balance of total demand deposit overdrafts was \$20,177.

**NOTE 17 – 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 2009, 2008, and 2007 amounted to \$53,458, \$54,828, and \$47,934, respectively.



**NOTE 18 – 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 were set to expire ten years from the date of grant, unless they terminated 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 and the exercise price was adjusted as a result of the stock dividends discussed in Note 19 below. During 2009 options to purchase 14,172 shares of the Company’s common stock were exercised at an exercise price of \$5.84 per share. As of December 14, 2009, the remaining unexercised Organizers’ Options expired.

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 192,162 shares as a result of the 10% stock dividends declared from 2004 to 2007 and a 5% stock dividend in 2009 as discussed in Note 19 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. During 2009, 15,600 options to purchase common shares were granted and none were exercised. During 2009, 3,866 options that fully vested in 2008 were forfeited. As of December 31, 2009, 106,255 options to purchase common shares remain outstanding under the 2003 Plan. See Note 1 for more information.

A summary of the activity in the plans is presented below:

	<u>Shares</u>	<u>Weighted Average Exercise Price(1)</u>	<u>Aggregate Intrinsic Value (2)</u>
Outstanding at December 31, 2006	<u>123,516</u>	\$ 8.19	
Granted (3)	32,383	8.98	
Exercised	(27,306)	6.43	
Forfeited or expired	<u>(1,320)</u>	10.62	
Outstanding at December 31, 2007	127,273	8.74	
Granted	19,200	11.90	
Exercised	(8,396)	9.29	
Forfeited or expired	<u>(6,265)</u>	12.20	
Outstanding at December 31, 2008	131,812	9.46	
Granted (3)	22,241	9.45	
Exercised	(14,172)	5.64	
Forfeited or expired	<u>(33,626)</u>	6.39	
Outstanding at December 31, 2009	<u>106,255</u>	10.49	
Options exercisable at end of year	59,254	9.82	\$ -
Shares available for grant	59,487		

- (1) The weighted average exercise price has been adjusted to reflect 10% stock dividends declared by the Company’s Board of Directors annually from 2002 through 2007 and a 5% stock dividend declared by the Company’s Board of Directors in 2009.
- (2) 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). At December 31, 2009 the amount represents the value that would have been received by the option holders had all option holders exercised their options on that date. This amount changes based on changes in the market value of the Company’s common stock. At December 31, 2009 the OTCBB quoted price was \$4.10. Therefore, none of the Company’s options had intrinsic value as of that date.
- (3) Granted options include new grants as well as adjustments of previous grants as a result of 10% stock dividends declared by the Company’s Board of Directors annually from 2002 through 2007 and a 5% stock dividend in 2009.

Options granted after 2005 vest over a five-year period, according to the option agreements. All options granted prior to 2006 have fully vested. The weighted average life of options outstanding was 6.39 years and 5.03 years at December 31, 2009 and 2008, respectively. Expense related to stock based compensation recorded in the accompanying consolidated statements of income (loss) was \$72,464, \$56,172, and \$40,797 for the years ended 2009, 2008, and 2007, respectively. There were 38,911 non-vested options outstanding (estimated fair value of \$234,926) at the beginning of 2009. During 2009, 9,746 options vested (estimated fair value of \$59,787), and 15,600 options were granted (estimated fair value of \$81,432). After giving effect to the five percent stock dividend declared in 2009, at December 31, 2009, 47,001 non-vested options (estimated fair value of \$265,606) were outstanding.

## NOTE 19 – DIVIDENDS

The Company paid a 5% stock dividend in 2009 to shareholders of record on May 12, 2009. The Company paid cash dividends of \$597,471 in May 2008. No other cash dividends have been paid. The Company's payment of 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. 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 8, 2007, May 9, 2006, May 10, 2005, May 11, 2004, March 17, 2003 and on April 30, 2002.

## NOTE 20 – 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 adjusted total assets ("Tier 1 leverage ratio"). Management believes, as of December 31, 2009, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2009, the most recent notification of the banking regulators categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. 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</u>		<u>Minimum</u>	
			<small>(Dollars in thousands)</small>			
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
As of December 31, 2009						
Total Capital (to risk weighted assets)	\$ 19,730	12.8%	\$12,366	8.0%	\$ 15,458	10.0%
Tier 1 Capital (to risk weighted assets)	17,788	11.5	6,183	4.0	9,274	6.0
Tier 1 leverage ratio	17,788	9.2	7,702	4.0	9,627	5.0
As of December 31, 2008						
Total Capital (to risk weighted assets)	\$ 20,366	14.4%	\$ 11,314	8.0%	\$ 14,144	10.0%
Tier 1 Capital (to risk weighted assets)	18,667	13.2	5,657	4.0	8,486	6.0
Tier 1 leverage ratio	18,667	12.1	6,161	4.0	7,702	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 2009 and 2008, the Company's capital amounts and ratios were at least as great as shown above for the Bank.

Because the Bank had a relatively high level of nonperforming assets at December 31, 2009 and recorded a substantial loss for 2009, the OCC may require the Bank to maintain capital ratios in excess of those shown to be well capitalized in the table above. The OCC may also seek the Bank's agreement to take other specified actions intended to reduce the risks faced by the Bank. The OCC has the authority to enforce such an agreement with various regulatory actions.

**NOTE 21 - ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS**

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

	December 31,			
	2009		2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b><u>Financial Assets</u></b>				
Cash and due from banks	\$ 4,369,596	\$ 4,369,596	\$ 3,820,227	\$ 3,820,227
Federal funds sold	1,670,000	1,670,000	140,000	140,000
Investment securities	30,044,193	30,044,193	20,790,754	20,790,754
Loans, gross	137,763,251	139,365,487	131,181,693	132,967,973
Cash surrender value of life insurance policies	1,838,663	1,838,663	1,768,520	1,768,520
<b><u>Financial Liabilities</u></b>				
Deposits	152,381,274	150,540,716	122,581,574	122,334,482
Fed Funds purchased and customer sweeps	587,802	587,802	3,242,619	3,242,619
Customer repurchase agreements	2,669,200	2,766,397	3,150,000	3,235,288
Borrowings from FHLB	9,743,172	9,925,595	10,394,005	10,581,424
Broker repurchase agreements	5,000,000	5,182,105	5,000,000	5,135,404

The Company adopted a new accounting standard on January 1, 2008 which requires disclosure of the levels of inputs used in determining fair value of the Company's assets measured at fair value, including available for sale securities and other real estate owned. The table below presents the balances of assets measured at fair value on a recurring or nonrecurring basis by level within the hierarchy of inputs that may be used to measure fair value.

	December 31, 2009			
	Total	Level 1	Level 2	Level 3
Investment securities, recurring	\$ <u>30,044,193</u>	\$ <u>22,552,129</u>	\$ <u>6,350,014</u>	\$ <u>1,142,050</u>
Other real estate owned, nonrecurring	\$ <u>6,712,945</u>	\$ _____	\$ _____	\$ <u>6,712,948</u>
Impaired loans, nonrecurring	\$ <u>13,793,781</u>	\$ _____	\$ _____	\$ <u>13,793,781</u>
	December 31, 2008			
Investment securities, recurring	\$ <u>20,790,754</u>	\$ <u>13,604,839</u>	\$ <u>6,071,765</u>	\$ <u>1,114,150</u>
Other real estate owned, nonrecurring	\$ <u>575,000</u>	\$ _____	\$ _____	\$ <u>575,000</u>
Impaired loans, nonrecurring	\$ <u>2,357,610</u>	\$ _____	\$ _____	\$ <u>2,357,610</u>

**NOTE 22 - PARENT COMPANY INFORMATION**

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

**Condensed Balance Sheets**

	December 31,	
	2009	2008
<b><u>Assets</u></b>		
Cash and interest bearing deposits	\$ 94,502	\$ 371,668
Investment in subsidiary	17,949,044	18,770,624
Other assets	9,720	9,005
Total Assets	\$ <u>18,053,266</u>	\$ <u>19,151,297</u>
<b><u>Liabilities And Shareholders' Equity</u></b>		
Accrued expenses	\$ 13,861	\$ 14,350
Shareholders' equity	18,039,405	19,136,947
Total Liabilities and Shareholders' Equity	\$ <u>18,053,266</u>	\$ <u>19,151,297</u>

(Continued)

**NOTE 22 - PARENT COMPANY INFORMATION, Continued****Condensed Statements Of Income**

	<u>Year ended December 31,</u>		
	<u>2009</u>	<u>2008</u>	<u>2007</u>
<b><u>Income</u></b>			
Interest	\$ 4,645	\$ 19,117	\$ 35,893
<b><u>Expenses</u></b>			
Sundry	<u>58,893</u>	<u>56,063</u>	<u>55,164</u>
Loss before equity in undistributed net income (loss) of bank subsidiary	(54,248)	(36,946)	(19,271)
Equity in undistributed net income (loss) of subsidiary	<u>(1,307,026)</u>	<u>262,262</u>	<u>1,632,024</u>
Net income (loss)	\$ <u>(1,361,274)</u>	\$ <u>225,316</u>	\$ <u>1,612,753</u>

**Condensed Statements Of Cash Flows**

	<u>Year ended December 31,</u>		
	<u>2009</u>	<u>2008</u>	<u>2007</u>
<b><u>Operating Activities</u></b>			
Net income (loss)	\$ (1,361,274)	\$ 225,316	\$ 1,612,753
Adjustments to reconcile net income to net cash provided by (used for) operating activities			
Equity in undistributed net (income) loss of subsidiary	1,307,026	(262,262)	(1,632,024)
Decrease (increase) in other assets	(715)	2	62,476
Increase (decrease) in accrued expenses	<u>(489)</u>	<u>343</u>	<u>(7,697)</u>
Net cash used for operating activities	<u>(55,452)</u>	<u>(36,601)</u>	<u>35,508</u>
<b><u>Investing Activities</u></b>			
Investment in bank subsidiary	<u>(299,999)</u>	<u>-</u>	<u>(70,000)</u>
<b><u>Financing Activities</u></b>			
Cash dividend paid	-	(597,471)	-
Cash paid in lieu of fractional shares	(1,715)	-	(2,231)
Exercise of stock options, net of tax	<u>80,000</u>	<u>81,833</u>	<u>184,439</u>
Net cash provided (used) by financing activities	<u>78,285</u>	<u>(515,638)</u>	<u>182,208</u>
Net increase (decrease) in cash	(277,166)	(552,239)	147,716
Cash, beginning of year	<u>371,668</u>	<u>923,907</u>	<u>776,191</u>
Cash, end of year	\$ <u>94,502</u>	\$ <u>371,668</u>	\$ <u>923,907</u>

**NOTE 23 - EVALUATION OF SUBSEQUENT EVENTS**

In accordance with FASB ASC 855, "Subsequent Events," issued in May 2009 and effective for periods ending after June 15, 2009, management performed an evaluation to determine whether or not there have been any subsequent events since the balance sheet date.

**BOARD OF DIRECTORS OF THE COMPANY AND CORNERSTONE NATIONAL BANK**

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

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

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

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

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

**Susan S. Jolly**  
Senior Vice President and Senior Lender of  
Cornerstone National Bank,  
Secretary of Cornerstone Bancorp

**Janice E. Childress**  
Real Estate Investor

**Robert R. Spearman**  
Surveyor - Retired

**J. Bruce Gaston**  
Certified Public Accountant

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

**George I. Wike, Jr.**  
Chairman of Cornerstone Bancorp,  
Retired Optometrist, Investor

**MANAGEMENT OF THE COMPANY**

**J. Rodger Anthony**  
President and Chief Executive Officer

**Jennifer M. Champagne**  
Senior Vice President and Chief Financial Officer

**Susan S. Jolly**  
Secretary

## MANAGEMENT OF THE BANK

<b>J. Rodger Anthony</b> Chairman and Chief Executive Officer	<b>Susan S. Jolly</b> Senior Vice President – Senior Lender
<b>Suzanne C. Burns</b> Banking Officer- Branch Manager- Easley	<b>Kim T. Lappin</b> Assistant Vice President – Consumer Lending
<b>Jennifer M. Champagne</b> Senior Vice President – Chief Financial Officer	<b>Brenda B. Maw</b> Vice President – Compliance
<b>Jean W. Dillard</b> Banking Officer- Human Resources and Internal Audit	<b>Nancy H. Smith</b> Vice President – Deposit Operations
<b>J. Robert Eades</b> Financial Advisor	<b>David H. Stafford</b> Vice President – Commercial Lending
<b>H. Scott Forbes</b> Vice President – City Executive – Powdersville	<b>Ryan D. Tiwari</b> Vice President – City Executive – Berea
	<b>Norma Jean Venesky</b> Banking Officer- Loan Administration

## EASLEY ADVISORY BOARD OF THE BANK

<b>Lu Bagwell</b> President of Lu Bagwell Interiors Chairperson of the Easley Advisory Board	<b>Joe Harrison Lesley</b> Joe's Ice Cream Parlor
<b>Roger L. Benjamin</b> Chemical Sales, Investor	<b>Elizabeth D. Lowrance</b> Educator
<b>James Samuel Cox</b> Investor	<b>Hamilton Scott Reeves</b> F & R Asphalt, Inc.
<b>James McCrorey (Mac) Lawton</b> Dixie Lumber Company	<b>Gary W. Seymore</b> Real Estate Investor
<b>James A. Lesley</b> Steelworks of the Carolinas, Inc.	<b>Ronnie Lee Smith, Attorney at Law</b> Olson, Smith, Jordan & Cox, P.A.

**BEREA ADVISORY BOARD OF THE BANK**

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Gaston and Allison, LLC

**Christopher F. Dover**  
President, Dover Cylinder Head Service, Inc.

**Grady C. Huff, Jr.**  
Huff Piping, Inc.

**David G. Kelman**  
Wash and Win, LLC

**Kenneth A. Yeager, Jr.**  
Yeager Vision Care  
Chairman of the Berea Advisory Board

**James David Rhinehardt**  
Owner, C F Noblitt Services

**POWDERSVILLE ADVISORY BOARD OF THE BANK**

**David Burriss**  
Co-Owner, Christopher David Properties

**Randy N. Long**  
President, PLC

**Robert J. Leonardi**  
President, The Auction Co. & Real Estate, Inc.  
Chairman of the Powdersville Advisory Board

**Cindy Fox Miller**  
Partner, Keller Williams Western Upstate

**James J. Lynn, DMD**  
Dentist

**Christopher Rozakos**  
Co-Owner, Christopher David Properties

**Kerry M. Pack**  
Co-owner, Mane Tamers

**G. Delma Sentell**  
Pharmacist

**Reed Long**  
Co-owner of Cell Site Technologies Inc.

**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

#### Powdersville 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

June 8, 2010  
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  
866-215-2480

#### Corporate Publications

Copies of the Company's Annual Report to Shareholders, Form 10-K (without exhibits), and quarterly Forms 10-Q (without exhibits) 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. Copies of exhibits will be furnished for a charge of \$2.00 per exhibit.

Except for the Annual Report to Shareholders, these documents are also available on the Securities and Exchange Commission's website at [www.sec.gov](http://www.sec.gov) free of charge.