

CORNERSTONE BANK

2001 Annual Report

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Cornerstone Bank Web Address: www.thecornerstonebank.com

For stock transfers and change of address on shares owned please contact our Stock Transfer Agent

First Citizens Bank & Trust
Corporate Trust Dept.
100 East Tryon Road
Raleigh, NC 27603
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Cornerstone Bank
Report of Management

Dear Shareholders,

You will enjoy reading the figures in this annual report. Cornerstone Bank (“Cornerstone” or the “Bank”) became a profitable bank in the fourth quarter of 2001, which means that we reached profitability in about half the time normally expected for start-up banks. We were profitable throughout the fourth quarter – our seventh quarter of existence – and well ahead of the three-year period considered reasonable for new banks.

There is more good news to report:

- The Bank has already garnered about five percent of the market share for banking deposits in Wilson County. Within the next year, we could become the fourth largest bank in our market.
- All of our Directors have completed a comprehensive Directors School offered through the North Carolina Banking Commission. We are only the third bank in the State with 100% completion by every director.
- Compared to our original business plan, we are now performing at 130% ahead of profits, 47% ahead in total loans, 40% ahead in total deposits, and 38% ahead in total assets. We ended the year with total assets of \$54.2 million.
- We continue to open more than 100 new customer accounts each month, with a good blend of commercial and personal activity. We are building solid relationships with customers.
- We are focused in our mission of serving the small-to-medium-sized businesses of the area, and our unique cash management program is just one example of how we meet the financial needs of our corporate neighbors.
- Our mortgage center enjoyed a phenomenal year, closing more than \$34.2 million in new or refinanced home loans.

All of this occurred in an environment of 11 cuts in interest rates throughout the year and an economy that clearly was defined as recessed.

Much of our success is our ability to connect with the people of Wilson. Quite simply, this Bank has been embraced by the community, proving the need for a locally owned, locally managed bank.

Our Directors are a visible part of our area, with a major stake in the success of the county. Our management team is a carefully blended group of diverse strengths. Our employees are well known, experienced, and enthused by the growth of the Bank. While our employees came from other banks in the area, we have selected the “best and the brightest” and we can promise that not a single employee will have to “go backward” in career development.

Those people inside the Bank can confidently offer products and services that are appreciated by customers. Our pricing is fair, to customers and to the Bank. Our service is a standard many banks would like to copy...but many do not, possibly because of size, transfers, mergers and other distractions, not the least of which is the ongoing quest for profits and often at any cost. Our approach is different: we want to do the right things, and we want to do things right. If we do that, profits will take care of themselves. We are proving it right now.

The banking landscape, even here, is changing with all the mega-mergers underway affecting regional banking powers. We are well positioned to serve those customers “lost in the cracks” during these mergers, as well as those who simply want a familiar face at the teller line, or a direct phone line to the Bank’s officers, or a more sensible structure for fees. Businesses in the area understand the importance of knowing their banker, just as they know their attorney, accountant, physician, minister, and other key support people.

Cornerstone Bank
Report of Management

Our one-on-one, face-to-face banking is a plus for Cornerstone. Even so, we offer an enhanced web site for Internet banking, as well as a toll-free 24-hour account line, all of which allows customers to stay connected with the Bank around the clock, and around the world.

During the next year, we will continue to follow our long-term business plan, and we will continue to concentrate on relationship banking in our market. We expect continued growth in significant operational areas and believe that an increase in assets of 20% is a reasonable projection for the coming year.

One item of interest to stockholders is our plan to offer a secondary stock offering in the second half of the year. Many who supported this Bank during its inception came to the Bank when we faced difficulties through a regional flood. Now, in better times, stockholders and friends will see the acceptance of the Bank, the performance of the Bank, and the interest in owning a larger share of the Bank. We will use that opportunity to further strengthen our capital position, and prepare for continued growth and expansion in our immediate market area.

These are exciting times, and we hope you share our excitement. Thank you for being a part of Cornerstone Bank, and we encourage you to become a regular customer of the Bank. As always, we look forward to hearing from you.

Sincerely,

Thomas E. Brown III
Chairman of the Board of Directors

Norman B. Osborn
President & CEO

Cornerstone Bank
Selected Financial Information and Other Data

	At or for the Periods Ended December 31,	
	<u>2001</u>	<u>2000</u>
	(Dollars in thousands, except per share data)	
Operating data:		
Total interest income	\$ 2,783	\$ 1,122
Total interest expense	<u>1,557</u>	<u>512</u>
Net interest income	1,226	610
Provision for loan losses	<u>367</u>	<u>244</u>
Net interest income after provision for loan losses	859	366
Total non-interest income	314	24
Total non-interest expense	<u>1,542</u>	<u>1,116</u>
Net loss	<u>\$ (369)</u>	<u>\$ (726)</u>
Per common share data:		
Earnings per share - basic and diluted	\$ (0.62)	\$ (1.21)
Book value	8.46	9.13
Selected Year-End Balance Sheet Data:		
Loans	\$ 38,292	\$ 16,359
Allowance for loan losses	523	244
Other earning assets	11,761	10,448
Total assets	54,173	29,235
Deposits	48,885	23,610
Shareholders' equity	5,078	5,485
Selected Average Balances:		
Total assets	\$ 41,068	\$ 17,541
Loans	28,668	8,098
Total interest-earning assets	38,256	16,197
Deposits	35,397	11,735
Total interest-bearing liabilities	32,998	10,415
Shareholders' equity	5,485	5,740
Selected Performance Ratios:		
Return on average assets	(0.90%)	(5.19%)
Return on average equity	(6.73%)	(15.85%)
Net interest margin	3.20%	4.72%
Non-interest expense to average assets	3.75%	7.97%
Efficiency ratio	100.14%	176.03%
Asset Quality Ratios:		
Allowance for loan losses to period-end loans	1.37%	1.49%
Net loan charge-offs to average loans	0.31%	-
Capital Ratios:		
Total risk-based capital	13.62%	29.00%
Tier 1 risk-based capital	12.37%	27.70%
Leverage ratio	10.00%	19.90%
Equity to assets	9.37%	18.76%
Average equity to average assets	13.36%	32.72%

Cornerstone Bank
Management's Discussion and Analysis

The following discussion and analysis is presented to assist in understanding our financial condition and results of operations for the periods ended December 31, 2001 and 2000. You should read this discussion and the related financial data in conjunction with our audited financial statements and the related footnotes, which are included elsewhere in this Annual Report.

DESCRIPTION OF BUSINESS

Cornerstone Bank ("Cornerstone" or the "Bank") is a North Carolina chartered banking corporation. Cornerstone, which offers a full array of commercial and retail banking services, opened for business on March 15, 2000. Cornerstone presently operates one full-service banking office located at 3710 Nash Street North, Wilson, North Carolina. The Bank's principal customers consist of individuals and small to medium sized businesses.

FINANCIAL CONDITION
December 31, 2001 and 2000

During 2001 the Bank achieved very strong growth, ending the year with total assets of \$54.2 million, an increase of \$25 million or 85% from the beginning of year total assets of \$29.2 million. The growth in total assets was funded by inflows of customer deposits, which increased by \$25.3 million or 107% to \$48.9 million, up from \$23.6 million at December 31, 2000. These increased deposits provided funding to support loan growth, as total loans receivable grew by \$21.9 million, and closed the year at \$38.3 million, an increase of 134% from total loans receivable at December 31, 2000. Liquid investments, consisting of cash and due from banks, interest-earning deposits in other banks, federal funds sold and investment securities available for sale, totaled \$14.4 million, or 27% of total assets, at December 31, 2001, representing an increase of \$3.2 million over the beginning of year total of \$11.2 million. Total stockholders' equity at year end was \$5.1 million, enabling the Bank to maintain regulatory capital at levels deemed to be well capitalized under prompt corrective action provisions.

**RESULTS OF OPERATIONS FOR THE YEAR ENDED DECEMBER 31, 2001 AND THE
PERIOD FROM MARCH 15 THROUGH DECEMBER 31, 2000**

Overview. The Bank incurred a net loss of \$369,000 or \$.62 per share for the year 2001, as compared with a net loss of \$726,000 or \$1.21 per share for the Bank's initial period of operations that commenced on March 15, 2000 and ended on December 31, 2000. This improvement of \$357,000 or \$.59 per share in net operating results is principally attributable to asset growth from period to period, although direct comparisons should be considered in light of the shorter period of operations in 2000. Net interest income after the provision for loan losses increased from \$366,000 to \$859,000, while non-interest income grew from \$24,000 to \$314,000. Non-interest expenses increased by \$426,000, or 38%, from \$1.1 million for 2000 to \$1.5 million for 2001.

Net Interest Income. Like most financial institutions, the primary component of earnings for the Bank is net interest income. Net interest income is the difference between interest income, principally from loan and investment securities portfolios, and interest expense, principally on customer deposits and borrowings. Changes in net interest income result from changes in volume, spread and margin. For this purpose, volume refers to the average dollar level of interest-earning assets and interest-bearing liabilities, spread refers to the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities, and margin refers to net interest income divided by average interest-earning assets. Margin is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities, as well as by levels of noninterest-bearing liabilities and capital.

Cornerstone Bank
Management's Discussion and Analysis

Net interest income increased to \$1.2 million for the year ended December 31, 2001, a \$616,000 or 101% increase from the \$610,000 earned in 2000. Total interest income benefited from strong growth in the level of average earning assets, which offset lower asset yields caused by the dramatic trend of declining interest rates throughout the period. The rates earned on a significant portion of the Bank's loans adjust immediately when index rates such as the prime rate change. Conversely, most interest-bearing liabilities, including certificates of deposit and borrowings, have rates fixed until maturity. As a result, interest rate reductions will generally result in an immediate drop in the Bank's interest income on loans, with a more delayed impact on interest expense because reductions in interest costs will only occur upon renewals of certificates of deposit or borrowings. Average total interest-earning assets more than doubled during 2001 as compared to 2000, increasing by \$22.1 million, while the average yield earned dropped by 141 basis points from 8.68% to 7.27%. Average total interest-bearing liabilities increased by \$22.5 million, consistent with our increase in interest-earning assets, and yielded a 144 basis point decrease in average cost, from 6.16% in 2000 to 4.72% in 2001. For the year ended December 31, 2001, the net interest spread was 2.55%, a 4 basis point improvement over the 2000 net interest spread of 2.52%.

Provision for Loan Losses. The Bank recorded a \$367,000 provision for loan losses in 2001, representing an increase of \$123,000 over the \$244,000 provision made in 2000. Provisions for loan losses are charged to income to bring the allowance for loan losses to a level deemed appropriate by Management. In evaluating the allowance for loan losses, Management considers factors that include growth, composition and industry diversification of the portfolio, historical loan loss experience, current delinquency levels, adverse situations that may affect a borrower's ability to repay, estimated value of any underlying collateral, prevailing economic conditions and other relevant factors. In both 2001 and 2000 the provision for loan losses was made principally in response to growth in loans, as total loans outstanding increased by \$21.9 million in 2001 and by \$16.4 million in 2000. In addition, net loan charge-offs were \$88,000 in 2001. At December 31, the allowance for loan losses was \$523,000 for 2001 and \$244,000 for 2000, representing 1.37% and 1.49%, respectively, of loans outstanding. There were no nonperforming loans at December 31, 2001.

Non-Interest Income. Non-interest income increased \$290,000 to \$314,000 for 2001, as compared with \$24,000 for the Bank's shorter operating period in 2000. Service fees and charges, which represent a relatively stable and predictable source of non-interest income, totaled \$101,000 for 2001 as compared with \$16,000 of service fees and charges earned in 2000. The Bank's Management will continue efforts to develop sources of additional non-interest income. Through associations with various mortgage lending companies, the Bank originates a full range of competitively priced residential and commercial long-term mortgages, at both fixed and variable rates, earning fees for loans originated. By originating these mortgages, the Bank's customers receive personal face-to-face service from the Bank's employees, rather than dealing with third parties. These relationships generated income from mortgage operations of \$193,000 in 2001.

Non-Interest Expenses. Non-interest expenses increased by \$427,000, or 38%, from \$1.1 million for 2000 to \$1.5 million for 2001. Approximately two thirds of this increase relates directly to the longer period of operations in 2001 – twelve full months – as compared to the nine and one half months of operations in 2000. The remainder of the increase relates to the overall growth in operations from period to period.

Cornerstone Bank
Management's Discussion and Analysis

NET INTEREST INCOME

Like most financial institutions, the primary component of earnings for the Bank is net interest income. Net interest income is the difference between interest income, principally from loan and investment securities portfolios, and interest expense, principally on customer deposits and borrowings. Changes in net interest income result from changes in volume, spread and margin. For this purpose, volume refers to the average dollar level of interest-earning assets and interest-bearing liabilities, spread refers to the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities, and margin refers to net interest income divided by average interest-earning assets and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities, as well as levels of noninterest-bearing liabilities. The following table sets forth, for the periods indicated, information with regard to average balances of assets and liabilities, as well as the total dollar amounts of interest income from interest-earning assets and interest expense on interest-bearing liabilities, resultant yields or costs, net interest income, net interest spread, net interest margin and ratio of average interest-earning assets to average interest-bearing liabilities. Average rates for the period from the Bank's opening date of March 15, 2000 through December 31, 2000 are presented on an annualized basis.

	<u>Year Ended December 31, 2001</u>			<u>Period Ended December 31, 2000</u>		
	<u>Average balance</u>	<u>Interest Income/ Expense</u>	<u>Yield/ Cost</u>	<u>Average balance</u>	<u>Interest Income/ Expense</u>	<u>Yield/ Cost</u>
	(Dollars in thousands)					
Interest-earning assets:						
Loans	\$ 28,668	\$ 2,289	7.98%	\$ 8,098	\$ 702	10.87%
Investment securities	4,951	328	6.62%	2,893	166	7.19%
Other interest-earning assets	<u>4,637</u>	<u>166</u>	<u>3.58%</u>	<u>5,206</u>	<u>254</u>	<u>6.11%</u>
Total interest-earning assets	38,256	<u>2,783</u>	<u>7.27%</u>	16,197	<u>1,122</u>	<u>8.68%</u>
Other assets	<u>2,812</u>			<u>1,344</u>		
Total assets	<u>\$ 41,068</u>			<u>\$ 17,541</u>		
Interest-bearing liabilities:						
Deposits:						
Savings, NOW and money market	\$ 13,951	441	3.16%	\$ 5,696	257	5.66%
Time deposits over \$100,000	4,560	253	5.55%	943	50	6.65%
Other time deposits	14,458	862	5.96%	3,776	205	6.80%
Borrowings	<u>29</u>	<u>1</u>	<u>3.45%</u>	<u>-</u>	<u>-</u>	<u>-%</u>
Total interest-bearing liabilities	32,998	<u>1,557</u>	<u>4.72%</u>	10,415	<u>512</u>	<u>6.16%</u>
Noninterest-bearing deposits	2,428			1,320		
Other liabilities	157			66		
Stockholders' equity	<u>5,485</u>			<u>5,740</u>		
Total liabilities and stockholders' equity	<u>\$ 41,068</u>			<u>\$ 17,541</u>		
Net interest income/interest rate spread		<u>\$ 1,226</u>	<u>2.55%</u>	<u>\$ 610</u>	<u>2.52%</u>	
Net interest margin			<u>3.20%</u>			<u>4.72%</u>
Ratio of interest-earning assets to interest-bearing liabilities		<u>115.93%</u>		<u>155.52%</u>		

RATE/VOLUME ANALYSIS

The following table analyzes the dollar amount of changes in interest income and interest expense for major components of interest-earning assets and interest-bearing liabilities. The table distinguishes between (i) changes attributable to volume (changes in volume multiplied by the prior period's rate), (ii) changes attributable to rate (changes in rate multiplied by the prior period's volume), and (iii) net change (the sum of the previous columns). The change attributable to both rate and volume (changes in rate multiplied by changes in volume) has been allocated equally to both the changes attributable to volume and the changes attributable to rate.

	Year Ended December 31, 2001 vs. Period Ended December 31, 2000		
	Increase (Decrease) Due to		
	Volume	Rate	Total
	(Dollars in thousands)		
Interest income:			
Loans	\$ 2,093	\$ (506)	\$ 1,587
Investment securities	183	(21)	162
Other interest-earning assets	<u>23</u>	<u>(111)</u>	<u>(88)</u>
Total interest income	<u>2,299</u>	<u>(638)</u>	<u>1,661</u>
Interest expense:			
Deposits			
Savings, NOW and money market	415	(231)	184
Time deposits over \$100,000	232	(29)	203
Other time deposits	730	(73)	657
Borrowings	<u>1</u>	<u>-</u>	<u>1</u>
Total interest expense	<u>1,378</u>	<u>(333)</u>	<u>1,045</u>
Net interest income increase (decrease)	<u>\$ 921</u>	<u>\$ (305)</u>	<u>\$ 616</u>

LIQUIDITY

Our liquidity is a measure of our ability to fund loans, withdrawals and maturities of deposits, and other cash outflows in a cost effective manner. Our principal sources of liquidity are deposits, scheduled payments and prepayments of loan principal, maturities of investment securities, access to liquid deposits, and funds provided by operations. While scheduled loan payments and maturing investments are relatively predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition.

Liquid assets (consisting of cash and due from banks, interest-earning deposits with other banks, federal funds sold and investment securities classified as available for sale) comprised 27% and 38% of our total assets at December 31, 2001 and 2000, respectively.

We have been a net seller of federal funds, as our liquidity has exceeded our need to fund new loan demand. Should the need arise, we would have the capability to sell securities classified as available for sale or to borrow funds as necessary. We have established credit lines with other financial institutions to purchase up to \$4.0 million in federal funds. As a member of the Federal Home Loan Bank of Atlanta we may obtain longer-term advances up to 10% of our assets. As of December 31, 2001, we had no borrowings outstanding.

Cornerstone Bank
Management's Discussion and Analysis

Total deposits were \$48.9 million and \$23.6 million at December 31, 2001 and 2000, respectively. Time deposits, which are the only deposit accounts that have stated maturity dates, are generally considered to be rate sensitive. Because loan demand initially exceeded the rate at which core deposits were being built, the Bank relied more heavily on time deposits as a source of funds in 2000. Time deposits represented 43% and 59%, respectively, of total deposits at December 31, 2001 and 2000. Time deposits of \$100,000 or more represented 18% and 13%, respectively, of the Bank's total deposits at December 31, 2001 and 2000. At December 31, 2001, the Bank had \$3.0 million in brokered time deposits. Management believes most other time deposits are relationship-oriented. While we will need to pay competitive rates to retain these deposits at their maturities, there are other subjective factors that will determine their continued retention. Based upon prior experience, the Bank anticipates that a substantial portion of outstanding certificates of deposit will renew upon maturity.

Management believes that our current sources of funds provide adequate liquidity for our current cash flow needs.

CAPITAL

A significant measure of the strength of a financial institution is its capital base. Our federal regulators have classified and defined capital into the following components: (1) Tier I capital, which includes common stockholders' equity and qualifying preferred equity, and (2) Tier II capital, which includes a portion of the allowance for loan losses, certain qualifying long-term debt and preferred stock which does not qualify as Tier I capital. Minimum capital levels are regulated by risk-based capital adequacy guidelines which require a financial institution to maintain capital as a percent of its assets and certain off-balance sheet items adjusted for predefined credit risk factors (risk-adjusted assets). A financial institution is required to maintain, at a minimum, Tier I capital as a percentage of risk-adjusted assets of 4.0% and combined Tier I and Tier II capital as a percentage of risk-adjusted assets of 8.0%. In addition to the risk-based guidelines, federal regulations require that we maintain a minimum leverage ratio (Tier I capital as a percentage of tangible assets) of 4.0%. The Bank had an equity to assets ratio of 9.37 % at December 31, 2001. As the following table indicates, at December 31, 2001, the Bank exceeded regulatory capital requirements.

	At December 31, 2001		
	Actual Ratio	Minimum Requirement	Well-Capitalized Requirement
Total risk-based capital ratio	13.62%	8.00%	10.00%
Tier 1 risk-based capital ratio	12.37%	4.00%	6.00%
Leverage ratio	10.00%	4.00%	5.00%

Current plans call for a secondary stock offering in the second quarter of 2002. Management expects that the additional capital generated will enable the Bank to grow and continue to remain "well-capitalized" for regulatory purposes, although there can be no assurance that additional capital will not be required in the future due to greater-than-expected growth, or otherwise.

IMPACT OF INFLATION AND CHANGING PRICES

A commercial bank has an asset and liability make-up that is distinctly different from that of a company with substantial investments in plant and inventory because the major portions of a commercial bank's assets are monetary in nature. As a result, a bank's performance may be significantly influenced by changes in interest rates. Although the banking industry is more affected by changes in interest rates than by inflation in the prices of goods and services, inflation is a factor that may influence interest rates. However, the frequency and magnitude of interest rate fluctuations do not necessarily coincide with changes in the general inflation rate. Inflation does affect operating expenses in that personnel expenses and the cost of supplies and outside services tend to increase more during periods of high inflation.

ASSET/LIABILITY MANAGEMENT

The Bank's results of operations depend substantially on its net interest income. Like most financial institutions, the Bank's interest income and cost of funds are affected by general economic conditions and by competition in the market place.

The purpose of asset/liability management is to provide stable net interest income growth by protecting the Bank's earnings from undue interest rate risk, which arises from volatile interest rates and changes in the balance sheet mix, and by managing the risk/return relationships between liquidity, interest rate risk, market risk, and capital adequacy. The Bank maintains, and has complied with, a Board approved asset/liability management policy that provides guidelines for controlling exposure to interest rate risk by utilizing the following ratios and trend analysis: liquidity, equity, volatile liability dependence, portfolio maturities, maturing assets and maturing liabilities. The Bank's policy is to control the exposure of its earnings to changing interest rates by generally endeavoring to maintain a position within a narrow range around an "earnings neutral position," which is defined as the mix of assets and liabilities that generate a net interest margin that is least affected by interest rate changes.

When suitable lending opportunities are not sufficient to utilize available funds, the Bank has generally invested such funds in securities, primarily U.S. Treasury securities, securities issued by governmental agencies, mortgage-backed securities and corporate obligations. The securities portfolio contributes to the Bank's profits and plays an important part in the overall interest rate management. However, management of the securities portfolio alone cannot balance overall interest rate risk. The securities portfolio must be used in combination with other asset/liability techniques to actively manage the balance sheet. The primary objectives in the overall management of the securities portfolio are safety, liquidity, yield, asset/liability management (interest rate risk), and investing in securities that can be pledged for public deposits.

In reviewing the needs of the Bank with regard to proper management of its asset/liability program, the Bank's management estimates its future needs, taking into consideration historical periods of high loan demand and low deposit balances, estimated loan and deposit increases (due to increased demand through marketing), and forecasted interest rate changes.

The analysis of an institution's interest rate gap (the difference between the repricing of interest-earning assets and interest-bearing liabilities during a given period of time) is a standard tool for the measurement of exposure to interest rate risk. The following table sets forth the amounts of interest-earning assets and interest-bearing liabilities outstanding at December 31, 2001, which are projected to reprice or mature in each of the future time periods shown. Except as stated below, the amounts of assets and liabilities shown that reprice or mature within a particular period were determined in accordance with the contractual terms of the assets or liabilities. Loans with adjustable rates are shown as being due at the end of the next upcoming adjustment period. Money market deposit accounts and negotiable order of withdrawal or other transaction

Cornerstone Bank
Management's Discussion and Analysis

accounts are assumed to be subject to immediate repricing and depositor availability and have been placed in the shortest period. In making the gap computations, none of the assumptions sometimes made regarding prepayment rates and demand deposit retention rates have been used for any interest-earning assets or interest-bearing liabilities. In addition, the table does not reflect scheduled principal payments which will be received throughout the lives of the loans. The interest rate sensitivity of the Bank's assets and liabilities illustrated in the following table would vary substantially if different assumptions were used or if actual experience differs from that indicated by such assumptions.

	Terms to Repricing at December 31, 2001				Total
	1 Year or Less	More Than 1 Year to 3 Years	More Than 3 Years to 5 Years	More Than 5 Years	
(Dollars in thousands)					
Interest-earning assets:					
Loans:					
Variable rate	\$ 31,557	\$ -	\$ -	\$ -	\$ 31,557
Fixed rate	2,415	2,210	2,013	98	6,736
Securities available for sale	517	4,556	688	2,030	7,791
Other interest-earning assets	3,972	-	-	57	4,029
Total interest-earning assets	<u>\$ 38,461</u>	<u>\$ 6,766</u>	<u>\$ 2,701</u>	<u>\$ 2,185</u>	<u>\$ 50,113</u>
Interest-bearing liabilities:					
Deposits:					
Savings, NOW and money market	\$ 23,164	\$ -	\$ -	\$ -	\$ 23,164
Time over \$100,000	5,632	2,880	334	-	8,846
Other time	8,583	2,937	732	-	12,252
Total interest-bearing liabilities	<u>\$ 37,379</u>	<u>\$ 5,817</u>	<u>\$ 1,066</u>	<u>\$ -</u>	<u>\$ 44,262</u>
Interest sensitivity gap per period	\$ 1,082	\$ 949	\$ 1,635	\$ 2,185	\$ 5,851
Cumulative interest sensitivity gap	\$ 1,082	\$ 2,031	\$ 3,666	\$ 5,851	\$ 5,851
Cumulative gap as a percentage of total interest-earning assets	2.16%	4.05%	7.32%	11.68%	11.68%
Cumulative interest-earning assets as a percentage of interest-bearing liabilities	102.89%	104.70%	108.28%	113.22%	113.22%

ASSET QUALITY

The Financial Statements are prepared on the accrual basis of accounting, including the recognition of interest income on its loan portfolio, unless a loan is placed on a nonaccrual basis. Loans are placed on a nonaccrual basis when there are serious doubts about the collectibility of principal or interest. Amounts received on non-accrual loans generally are applied first to principal and then to interest only after all principal has been collected. Restructured loans are those for which concessions, including the reduction of interest rates below a rate otherwise available to that borrower or the deferral of interest or principal, have been granted due to the borrower's weakened financial condition. Interest on restructured loans is accrued at the restructured rates when it is anticipated that no loss of original principal will occur. The Bank had no nonaccrual, restructured or impaired loans at December 31, 2001.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level considered adequate by management to provide for anticipated loan losses based on management's assessment of various factors affecting the loan portfolio, including a review of problem loans, business conditions and loss experience and an overall evaluation of the quality of the underlying collateral. The allowance is increased by provisions charged to operations and reduced by loans charged off, net of recoveries. While management believes that it uses the best information available to determine the allowance for loan losses, unforeseen market conditions could result in adjustments to the allowance for loan losses, and net income could be significantly affected, if circumstances differ substantially from the assumptions used in making the final determination. Additional information regarding the Bank's allowance for loan losses and loan loss experience are presented in Note D to the accompanying financial statements.

RECENT ACCOUNTING PRONOUNCEMENTS

On January 1, 2001, the Bank adopted Statement of Financial Accounting Standards ("SFAS") No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This statement established accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. The Bank does not engage in any hedging activities and the adoption of this statement did not affect the Bank's financial statements.

In September 2000, the Financial Accounting Standards Board ("FASB") issued SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS No. 140 is a replacement of SFAS No. 125, although SFAS No. 140 carried forward most of the provisions of SFAS No. 125 without change. SFAS No. 140 is effective for transfers occurring after March 31, 2001 and for disclosures relating to securitizations, retained interests, and collateral received and pledged in reverse repurchase agreements for fiscal years ending after December 15, 2000. The new statement eliminates the prior requirement to record collateral received under certain securities financing transactions and requires reclassification in the balance sheet of assets pledged under certain conditions. The adoption of SFAS No. 140 on January 1, 2001 did not have a significant impact on the Bank's financial statements.

In June 2001, the FASB issued SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. SFAS No. 141 also specifies the criteria that intangible assets acquired in a purchase method business combination must meet to be recognized and reported apart from goodwill. SFAS No. 142 is effective for the Bank beginning on January 1, 2002 and will require that all goodwill and intangible assets with indefinite useful lives (including such assets acquired prior to January 1, 2002) no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS No. 142. SFAS No. 142 will also require that intangible assets with estimable useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* - see below. The adoption of SFAS No. 142 on January 1, 2002 will not affect the Bank's financial statements.

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 requires that obligations associated with the retirement of tangible long-lived assets be recorded as a liability when those obligations are incurred, with the amount of liability initially measured at fair value. SFAS No. 143 will be effective for financial statements for fiscal years beginning after June 15, 2002, though early adoption is encouraged. The application of this statement is not expected to have a material impact on the Bank's financial statements.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This statement provides guidance for differentiating between long-lived assets to be held and used, long-lived assets to be disposed of other than by sale and long-lived assets to be disposed of by sale. SFAS No. 144 supersedes SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. SFAS No. 144 also amends APB Opinion No. 30, *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. This statement is effective for fiscal years beginning after December 15, 2001. Adoption of SFAS No. 144 on January 1, 2002 will not have a significant effect on the Bank's financial statements.

FORWARD-LOOKING INFORMATION

Statements contained in this annual report, which are not historical facts, are forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Amounts herein could vary as a result of market and other factors. Such forward-looking statements are subject to risks and uncertainties which could cause actual results to differ materially from those currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in documents filed by the Bank with the Federal Deposit Insurance Corporation from time to time. Such forward-looking statements may be identified by the use of such words as "believe," "expect," "anticipate," "should," "might," "planned," "estimated," and "potential." Examples of forward-looking statements include, but are not limited to, estimates with respect to the financial condition, expected or anticipated revenue, results of operations and business of the Bank that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include, but are not limited to, general economic conditions, changes in interest rates, deposit flows, loan demand, real estate values, and competition; changes in accounting principals, policies, or guidelines; changes in legislation or regulation; and other economic, competitive, governmental, regulatory, and technological factors affecting the Bank's operations, pricing, products and services.



INDEPENDENT AUDITORS' REPORT

To the Stockholders and the Board of Directors
Cornerstone Bank
Wilson, North Carolina

We have audited the accompanying balance sheets of Cornerstone Bank as of December 31, 2001 and 2000, and the related statements of operations, changes in stockholders' equity and cash flows for the year ended December 31, 2001 and the period from March 15, 2000 (date of opening) through December 31, 2000. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the 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 financial statements referred to above present fairly, in all material respects, the financial position of Cornerstone Bank at December 31, 2001 and 2000 and the results of its operations and its cash flows for the year ended December 31, 2001 and the period from March 15, 2000 (date of opening) through December 31, 2000 in conformity with accounting principles generally accepted in the United States of America.

Dixon Odom PLLC

Sanford, North Carolina
February 13, 2002

CORNERSTONE BANK
BALANCE SHEETS
December 31, 2001 and 2000

	<u>2001</u>	<u>2000</u>
ASSETS		
Cash and due from banks	\$ 2,619,947	\$ 717,965
Interest-earning deposits in banks	785,535	661,808
Federal funds sold	3,186,000	5,280,000
Investment securities available for sale, at fair value (Note C)	7,790,530	4,506,323
Loans, net (Note D)	38,292,309	16,358,639
Allowance for loan losses	<u>(522,718)</u>	<u>(244,000)</u>
NET LOANS	37,769,591	16,114,639
Accrued interest receivable	216,733	120,924
Stock in Federal Home Loan Bank of Atlanta, at cost	56,800	500
Bank premises and equipment (Note E)	1,699,417	1,759,109
Other assets	<u>48,485</u>	<u>73,675</u>
TOTAL ASSETS	<u>\$ 54,173,038</u>	<u>\$ 29,234,943</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Demand	\$ 4,622,842	\$ 1,697,795
Savings	391,259	137,615
Money market and NOW	22,772,926	7,836,247
Time over \$100,000 (Note F)	8,845,475	3,069,526
Time (Note F)	<u>12,252,062</u>	<u>10,868,849</u>
TOTAL DEPOSITS	48,884,564	23,610,032
Accrued interest payable	59,760	72,424
Accrued expenses and other liabilities	<u>150,487</u>	<u>67,668</u>
TOTAL LIABILITIES	<u>49,094,811</u>	<u>23,750,124</u>
Commitments (Notes L and N)		
Stockholders' equity (Notes I, K and N):		
Common stock, \$5 par value, 20,000,000 shares authorized; 600,451 shares issued and outstanding	3,002,255	3,002,255
Additional paid-in capital	3,167,844	3,167,844
Accumulated deficit	(1,094,991)	(725,552)
Accumulated other comprehensive income	<u>3,119</u>	<u>40,272</u>
TOTAL STOCKHOLDERS' EQUITY	<u>5,078,227</u>	<u>5,484,819</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 54,173,038</u>	<u>\$ 29,234,943</u>

See accompanying notes.

CORNERSTONE BANK
STATEMENTS OF OPERATIONS
Year Ended December 31, 2001
Period from March 15, 2000 (Date of Opening) Through December 31, 2000

	<u>2001</u>	<u>2000</u>
INTEREST INCOME		
Loans	\$ 2,289,280	\$ 702,637
Federal funds sold	165,892	253,615
Investments	<u>327,915</u>	<u>165,713</u>
TOTAL INTEREST INCOME	<u>2,783,087</u>	<u>1,121,965</u>
INTEREST EXPENSE		
Money market, NOW and savings deposits	440,502	257,305
Time deposits	1,115,711	254,540
Borrowings	<u>839</u>	<u>-</u>
TOTAL INTEREST EXPENSE	<u>1,557,052</u>	<u>511,845</u>
NET INTEREST INCOME	1,226,035	610,120
PROVISION FOR LOAN LOSSES (Note D)	<u>367,275</u>	<u>244,000</u>
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	<u>858,760</u>	<u>366,120</u>
NON-INTEREST INCOME		
Service charges on deposit accounts	100,807	16,457
Mortgage operations	192,776	6,636
Other income	<u>20,538</u>	<u>836</u>
TOTAL NON-INTEREST INCOME	<u>314,121</u>	<u>23,929</u>
NON-INTEREST EXPENSE		
Salaries and employee benefits	922,269	677,342
Occupancy and equipment	138,222	113,109
Data processing expenses	170,454	102,429
Other (Note J)	<u>311,375</u>	<u>222,721</u>
TOTAL NON-INTEREST EXPENSE	<u>1,542,320</u>	<u>1,115,601</u>
LOSS BEFORE INCOME TAXES	(369,439)	(725,552)
INCOME TAXES (Note H)	<u>-</u>	<u>-</u>
NET LOSS	<u>\$ (369,439)</u>	<u>\$ (725,552)</u>
BASIC AND DILUTED NET LOSS PER COMMON SHARE	<u>\$ (0.62)</u>	<u>\$ (1.21)</u>
BASIC AND DILUTED WEIGHTED AVERAGE COMMON SHARES OUTSTANDING	<u>600,451</u>	<u>600,451</u>

See accompanying notes.

CORNERSTONE BANK
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Year Ended December 31, 2001
Period from March 15, 2000 (Date of Opening) Through December 31, 2000

	Common stock		Additional paid-in capital	Accumulated deficit	Accumulated other comprehensive income (loss)	Total equity
	Shares	Amount				
Balance at March 15, 2000	600,451	\$ 3,002,255	\$ 3,167,844	\$ -	\$ -	<u>\$ 6,170,099</u>
Comprehensive loss:						
Net loss	-	-	-	(725,552)	-	(725,552)
Unrealized gain on available-for-sale securities	-	-	-	-	40,272	<u>40,272</u>
Total comprehensive loss						<u>(685,280)</u>
Balance at December 31, 2000	600,451	3,002,255	3,167,844	(725,552)	40,272	<u>5,484,819</u>
Comprehensive loss:						
Net loss	-	-	-	(369,439)	-	(369,439)
Unrealized loss on available-for-sale securities	-	-	-	-	(37,153)	<u>(37,153)</u>
Total comprehensive loss						<u>(406,592)</u>
Balance at December 31, 2001	<u>600,451</u>	<u>\$ 3,002,255</u>	<u>\$ 3,167,844</u>	<u>\$ (1,094,991)</u>	<u>\$ 3,119</u>	<u>\$ 5,078,227</u>

See accompanying notes.

CORNERSTONE BANK
STATEMENTS OF CASH FLOWS
Year Ended December 31, 2001
Period from March 15, 2000 (Date of Opening) Through December 31, 2000

	<u>2001</u>	<u>2000</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (369,439)	\$ (725,552)
Adjustments to reconcile net loss to net cash provided (used) by operating activities:		
Depreciation and amortization	132,599	59,374
Realized gain on available-for-sale securities	(8,435)	-
Provision for loan losses	367,275	244,000
Change in assets and liabilities:		
Increase in accrued interest receivable	(95,809)	(120,924)
(Increase) decrease in other assets	25,190	(32,675)
Increase (decrease) in accrued interest payable	(12,664)	72,424
Increase in accrued expenses and other liabilities	<u>82,819</u>	<u>67,668</u>
NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	<u>121,536</u>	<u>(435,685)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Increase in interest-earning deposits in banks	(123,727)	(661,808)
Purchase of Federal Home Loan Bank stock	(56,300)	(500)
Net (increase) decrease in federal funds sold	2,094,000	(5,280,000)
Net increase in loans	(22,022,227)	(16,358,639)
Purchases of bank premises and equipment	(58,278)	(1,392,943)
Purchase of available-for-sale securities	(7,554,032)	(4,765,022)
Maturities, sales and calls of available for sale investments	<u>4,226,478</u>	<u>298,359</u>
NET CASH USED BY INVESTING ACTIVITIES	<u>(23,494,086)</u>	<u>(28,160,553)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Increase in deposits	25,274,532	23,610,032
Repayment of short-term borrowings	-	(1,000,000)
Payment of accrued pre-opening expenses	<u>-</u>	<u>(105,700)</u>
NET CASH PROVIDED BY FINANCING ACTIVITIES	<u>25,274,532</u>	<u>22,504,332</u>
NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS	1,901,982	(6,091,906)
CASH AND DUE FROM BANKS, BEGINNING	<u>717,965</u>	<u>6,809,871</u>
CASH AND DUE FROM BANKS, ENDING	<u>\$ 2,619,947</u>	<u>\$ 717,965</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Interest paid on deposits and borrowings	\$ 1,569,716	\$ 439,421
Income tax paid	-	-
Unrealized gain (loss) on investment securities available for sale	(37,153)	40,272

See accompanying notes.

NOTE A - ORGANIZATION AND OPERATIONS

Cornerstone Bank (the "Bank") was incorporated March 14, 2000 and began banking operations on March 15, 2000. The Bank is engaged in general commercial and retail banking in eastern North Carolina, principally Wilson County, and operates under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation and the North Carolina Commissioner of Banks. The Bank undergoes periodic examinations by those regulatory authorities.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and (ii) the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to management's determination of the allowance for losses on loans.

Cash Equivalents

For the purpose of presentation in the statement of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption "Cash and due from banks."

Securities Available for Sale

Available-for-sale securities are reported at fair value and consist of debt instruments not classified as trading securities nor as held-to-maturity securities. Unrealized holding gains and losses on available-for-sale securities are reported as a net amount in other comprehensive income. Gains and losses on the sale of available-for-sale securities are determined using the specific-identification method. Declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost, which are not deemed temporary, would result in write-downs of the individual securities to their fair value. Such write-downs would be included in the statement of earnings as realized losses. Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are reported at their outstanding principal amount, as adjusted for (i) any charge-offs, (ii) the allowance for loan losses, (iii) any deferred fees or costs on originated loans and (iv) unamortized premiums or discounts on purchased loans. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses

The provision for loan losses is based upon management's estimate of the amount needed to maintain the allowance for loan losses at an adequate level. In making the evaluation of the adequacy of the allowance for loan losses, management gives consideration to current and anticipated economic conditions, statutory examinations of the loan portfolio by regulatory agencies, delinquency information and management's internal review of the loan portfolio. Loans are considered impaired when it is probable that all amounts due under the contractual terms of the loan will not be collected. The measurement of impairment for loans that are dependent on the collateral for repayment is generally based on the present value of expected future cash flows discounted at the historical effective interest rate, or upon the fair value of the collateral if readily determinable. If the recorded investment in the loan exceeds the measure of fair value, a valuation allowance is established as a component of the allowance for loan losses. While management uses the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, regulatory examiners may require the Bank to recognize changes to the allowance for loan losses based on their judgments about information available to them at the time of their examination.

Bank Premises and Equipment

The Bank's premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets. Repairs and maintenance costs are charged to operations as incurred and additions and improvements to its premises and equipment are capitalized. Upon sale, or retirement, the cost and related accumulated depreciation are removed from the accounts, and any gains or losses are reflected in current operations.

Stock in Federal Home Loan Bank of Atlanta

As a requirement for membership, the Bank invests in stock of the Federal Home Loan Bank of Atlanta ("FHLB"). This investment is carried at cost.

Income Taxes

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. Deferred tax assets are also recognized for operating loss carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which the temporary differences are expected to be recovered or settled. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that the tax benefits will not be realized.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock Compensation Plans

Statement of Financial Accounting Standards ("SFAS") No. 123, *Accounting for Stock-Based Compensation*, encourages all entities to adopt a fair value based method of accounting for employee stock compensation plans, whereby compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. However, it also allows an entity to continue to measure compensation cost for those plans using the intrinsic value based method of accounting prescribed by Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, whereby compensation cost is the excess, if any, of the quoted market price of the stock at the grant date (or other measurement date) over the amount an employee must pay to acquire the stock. Stock options issued under the Bank's stock option plans have no intrinsic value at the grant date and, under APB Opinion No. 25, no compensation cost is recognized for them. The Bank has elected to continue with the accounting methodology in APB Opinion No. 25 and, as a result, will provide pro forma disclosures of net income and earnings per share and other disclosures as if the fair value based method of accounting were being applied.

Earnings Per Common Share

Basic earnings per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Bank relate to stock options. No options had been granted by the Bank as of December 31, 2001.

Derivative Financial Instruments

On January 1, 2001, the Bank adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This statement established accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. The Bank has no derivative financial instruments and does not engage in any hedging activities; accordingly, the adoption of the statement did not affect the Bank's financial statements.

Recent Accounting Pronouncements

In July 2001, the FASB issued SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for using the purchase method. SFAS No. 142 changes the accounting for goodwill and certain other intangible assets from an amortization method to an impairment only approach. Since the Bank does not have goodwill or other intangible assets, the adoption of SFAS Nos. 141 and 142 on January 1, 2002 is not expected to significantly affect the Bank's financial statements.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recent Accounting Pronouncements (Continued)

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*, and in August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 143 requires that obligations associated with the retirement of tangible long-lived assets be recorded as a liability when those obligations are incurred, with the amount of liability initially measured at fair value. SFAS No. 143 will be effective for financial statements for fiscal years beginning after June 15, 2002, though early adoption is encouraged. The application of this statement is not expected to have a material impact on the Bank's financial statements.

SFAS No. 144 supersedes SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*. SFAS No. 144 applies to all long-lived assets including discontinued operations, and amends Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. SFAS No. 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book or fair value less cost to sell. SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and its provisions are generally expected to be applied prospectively. The application of this statement is not expected to have a material impact on the Bank's financial statements.

NOTE C - INVESTMENT SECURITIES

The amortized cost and fair value of securities available for sale, with gross unrealized gains and losses, are as follows:

	<u>December 31, 2001</u>			
	<u>Amortized cost</u>	<u>Gross unrealized gains</u>	<u>Gross unrealized losses</u>	<u>Fair value</u>
Securities available for sale:				
U.S. government securities and obligations of U.S. government agencies	\$ 4,544,448	\$ 18,861	\$ (9,090)	\$ 4,554,219
Corporate bonds	513,488	5,201	-	518,689
Mortgage-backed securities	<u>2,729,476</u>	<u>31,854</u>	<u>(43,708)</u>	<u>2,717,622</u>
	<u>\$ 7,787,412</u>	<u>\$ 55,916</u>	<u>\$ (52,798)</u>	<u>\$ 7,790,530</u>

CORNERSTONE BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2001 and 2000

NOTE C - INVESTMENT SECURITIES (Continued)

	December 31, 2000			Fair value
	Amortized cost	Gross unrealized gains	Gross unrealized losses	
Securities available for sale:				
U.S. government securities and obligations of U.S. government agencies	\$ 3,000,000	\$ 8,906	\$ -	\$ 3,008,906
Mortgage-backed securities	<u>1,466,051</u>	<u>31,366</u>	<u>-</u>	<u>1,497,417</u>
	<u>\$ 4,466,051</u>	<u>\$ 40,272</u>	<u>\$ -</u>	<u>\$ 4,506,323</u>

For the year ended December 31, 2001, proceeds from sales of securities available for sale amounted to \$4,008,435 and gross realized gains amounted to \$8,435. There were no sales of investment securities during the period ended December 31, 2000.

The amortized cost, fair value and weighted average yield of the Bank's investment securities at December 31, 2001, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value	Weighted Average/ Yield
(Dollars in thousands)			
Securities available for sale:			
U.S. government agency securities			
Due within one year	\$ 516	\$ 517	2.59%
Due after one but within five years	<u>4,029</u>	<u>4,037</u>	3.92%
	<u>4,545</u>	<u>4,554</u>	3.77%
Mortgage-backed securities			
Due after five but within ten years	659	688	7.43%
Due after ten years	<u>2,070</u>	<u>2,030</u>	5.83%
	<u>2,729</u>	<u>2,718</u>	6.23%
Corporate bonds			
Due after one but within five years	<u>513</u>	<u>519</u>	5.49%
Total securities available for sale			
Due within one year	516	517	2.59%
Due after one but within five years	4,542	4,556	4.10%
Due after five but within ten years	659	688	7.43%
Due after ten years	<u>2,070</u>	<u>2,030</u>	5.83%
	<u>\$ 7,787</u>	<u>\$ 7,791</u>	4.74%

CORNERSTONE BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2001 and 2000

NOTE C - INVESTMENT SECURITIES (Continued)

For purposes of the maturity table, mortgage-backed securities, which are not due at a single maturity date, have been allocated over maturity groupings based on the weighted-average contractual maturities of underlying collateral. The mortgage-backed securities may mature earlier than their weighted-average contractual maturities because of principal prepayments.

Securities with a carrying value of \$1,523,438 and \$1,508,906 at December 31, 2001 and 2000, respectively, were pledged to secure public monies on deposit as required by law.

NOTE D - LOANS

Following is a summary of loans at December 31, 2001 and 2000:

	2001		2000	
	Amount	Percent of total	Amount	Percent of total
	(Dollars in thousands)			
Residential mortgage	\$ 5,059	13.21%	\$ 1,863	11.39%
Residential construction	1,291	3.37%	976	5.97%
Home equity lines of credit	1,881	4.91%	668	4.08%
Commercial and industrial loans	26,747	69.82%	11,388	69.61%
Loans to individuals	3,328	8.69%	1,464	8.95%
Total loans	38,306	100.00%	16,359	100.00%
Less:				
Allowance for loan losses	(523)		(244)	
Deferred loan fees and costs, net	(13)		-	
Net loans receivable	\$ 37,770		\$ 16,115	

Loans are primarily made in Wilson County, North Carolina. Real estate loans can be affected by the condition of the local real estate market. Commercial and installment loans can be affected by local economic conditions.

There were no nonaccrual, restructured or impaired loans at December 31, 2001. The provision for loan losses was \$367,275 for 2001 and \$244,000 for 2000.

CORNERSTONE BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2001 and 2000

NOTE D - LOANS (Continued)

Following is a summary of activity in the allowance for loan losses for the periods indicated:

	At or for the Periods Ended December 31,	
	2001	2000
	(Dollars in thousands)	
Allowance for loan losses at beginning of year	\$ 244	\$ -
Provision for loan losses	<u>367</u>	<u>244</u>
	<u>611</u>	<u>244</u>
Loans charged-off:		
Commercial and industrial	(82)	-
Loans to individuals	<u>(6)</u>	<u>-</u>
Total charge-offs	<u>(88)</u>	<u>-</u>
Allowance for loan losses at end of year	<u>\$ 523</u>	<u>\$ 244</u>
Net charge-offs as a percent of average loans outstanding during the period	0.31%	-%
Allowance for loan losses as a percent of loans at period end	1.37%	1.49%

Following is a summary of allocation of the allowance for loan losses to the indicated categories of loans and the percentage that all loans in each category bears to total loans outstanding:

	At December 31,			
	2001		2000	
	Amount	% of Total Loans	Amount	% of Total Loans
	(Dollars in thousands)			
Residential mortgage	\$ 20	13.21%	\$ 10	11.39%
Residential construction	15	3.37%	10	5.97%
Home equity lines of credit	10	4.91%	5	4.08%
Commercial and industrial loans	361	69.82%	150	69.61%
Loans to individuals	<u>45</u>	<u>8.69%</u>	<u>20</u>	<u>8.95%</u>
Total allocated	451	<u>100.00%</u>	195	<u>100.00%</u>
Unallocated	<u>72</u>		<u>49</u>	
Total	<u>\$ 523</u>		<u>\$ 244</u>	

At December 31, 2001, the Bank had loan commitments outstanding of \$987,000, pre-approved but unused lines of credit totaling \$9.3 million and commercial and standby letters of credit of \$258,000. In management's opinion, these commitments represent no more than normal lending risk to the Bank and will be funded from normal sources of liquidity.

CORNERSTONE BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2001 and 2000

NOTE D - LOANS (Continued)

The Bank has had loan transactions with its directors and executive officers. Such loans were made in the ordinary course of business and on substantially the same terms and collateral as those for comparable transactions prevailing at the time. Such loans did not involve more than the normal risk of collectibility or present other unfavorable features. A summary of related party loan transactions is as follows:

	<u>2001</u>	<u>2000</u>
Balance at beginning of period	\$ 1,298,652	\$ -
Borrowings	857,500	1,382,887
Repayments	<u>(575,688)</u>	<u>(84,235)</u>
Balance at end of year	<u>\$ 1,580,464</u>	<u>\$ 1,298,652</u>

NOTE E - BANK PREMISES AND EQUIPMENT

Following is a summary of the Bank's premises and equipment at December 31, 2001 and 2000:

	<u>2001</u>	<u>2000</u>
Land	\$ 251,037	\$ 251,037
Buildings	1,236,372	1,231,372
Furniture and equipment	<u>388,739</u>	<u>335,462</u>
	1,876,148	1,817,871
Less accumulated depreciation	<u>(176,731)</u>	<u>(58,762)</u>
Total	<u>\$ 1,699,417</u>	<u>\$ 1,759,109</u>

Depreciation and amortization amounting to \$117,969 and \$58,762 for the year ended December 31, 2001 and the period ended December 31, 2000, respectively, is included in occupancy and equipment expense and data processing expense.

NOTE F - DEPOSITS

At December 31, 2001, the scheduled maturities of time deposit are as follows:

	<u>Less than \$100,000</u>	<u>\$100,000 or more</u>	<u>Total</u>
(Dollars in thousands)			
Three months or less	\$ 1,082	\$ 1,019	\$ 2,101
More than three through six months	1,050	629	1,679
More than six through twelve months	6,450	3,984	10,434
Over one year through three years	2,938	2,880	5,818
Over three years through five years	<u>732</u>	<u>334</u>	<u>1,066</u>
	<u>\$ 12,252</u>	<u>\$ 8,846</u>	<u>\$ 21,098</u>

NOTE G - SHORT-TERM BORROWINGS

The Bank may purchase federal funds through unsecured federal funds lines of credit totaling \$4.0 million. These lines are intended for short-term borrowings and are subject to restrictions limiting the frequency and term of advances. These lines of credit are payable on demand and bear interest based upon the daily federal funds rate. There were no advances outstanding under these lines of credit at December 31, 2001.

The Bank has an available line of credit with the FHLB equal to 10% of total assets. Any borrowings under this line are secured by eligible securities. There were no advances outstanding under this line of credit at December 31, 2001.

NOTE H - INCOME TAXES

The significant components of the provision for income taxes for 2001 and 2000 are as follows:

	<u>2001</u>	<u>2000</u>
Current tax provision	\$ -	\$ -
Deferred tax benefit	<u>(126,000)</u>	<u>(280,000)</u>
Provision for income tax benefit before adjustment to deferred tax asset valuation allowance	(126,000)	(280,000)
Increase in valuation allowance	<u>126,000</u>	<u>280,000</u>
Net provision for income taxes	<u>\$ -</u>	<u>\$ -</u>

The difference between the provision for income taxes and the amounts computed by applying the statutory federal income tax rate of 34% to loss before income taxes is summarized below:

	<u>2001</u>	<u>2000</u>
Tax computed at the statutory federal rate	\$ (126,000)	\$ (247,000)
Increase (decrease) resulting from:		
State income taxes, net of federal tax effect	(10,000)	(33,000)
Adjustment to deferred tax asset valuation allowance	126,000	280,000
Other permanent differences	<u>10,000</u>	<u>-</u>
Provision for income taxes	<u>\$ -</u>	<u>\$ -</u>

CORNERSTONE BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2001 and 2000

NOTE H - INCOME TAXES (Continued)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of deferred taxes at December 31, 2001 and 2000 are as follows:

	<u>2001</u>	<u>2000</u>
Deferred tax assets relating to:		
Allowance for loan losses	\$ 154,000	\$ 78,000
Pre-opening costs and expenses	104,000	140,000
Net operating loss carryforwards	<u>314,000</u>	<u>226,000</u>
Total deferred tax assets	572,000	444,000
Less valuation allowance	<u>(567,000)</u>	<u>(441,000)</u>
Deferred tax assets net of valuation allowance	<u>5,000</u>	<u>3,000</u>
Deferred tax liabilities relating to:		
Fixed asset differences	<u>(5,000)</u>	<u>(3,000)</u>
Net recorded deferred tax asset (liabilities)	<u>\$ -</u>	<u>\$ -</u>

The Bank has net operating loss carryforwards of approximately \$837,000, expiring at various dates through 2021, which are available to offset future taxable income.

NOTE I - INITIAL CAPITALIZATION

As of March 15, 2000, the date the Bank opened for business, full payment for all 600,451 subscribed shares had been received. In accordance with North Carolina banking laws, one dollar (\$1.00) per share subscribed was paid into an organizational expense fund to defray the expenses of organizing the Bank. Upon the granting of the Bank's charter, the unexpended balance allocated for organizational expenses was transferred to the permanent surplus of the Bank. A summary of the Bank's initial capitalization, including the transactions in the organizational expense fund, is as follows:

Organizational expense fund established at \$1.00 per share subscribed	\$ 600,451
Brokerage fees and commissions	(27,532)
Pre-opening costs and expenses, net of interest income	<u>(407,330)</u>
Amount contributed to additional paid-in capital	165,589
Proceeds from stock sale at \$10.00 per share subscribed	<u>6,004,510</u>
Total initial capitalization	<u>\$ 6,170,099</u>

CORNERSTONE BANK
NOTES TO FINANCIAL STATEMENTS
December 31, 2001 and 2000

NOTE J - OTHER NON-INTEREST EXPENSE

The major components of other non-interest expense for the year ended December 31, 2001 and the period ended December 31, 2000 are as follows:

	<u>2001</u>	<u>2000</u>
Postage, printing and office supplies	\$ 40,336	\$ 31,358
Advertising and promotion	53,326	35,058
Professional services	85,031	47,664
Other	<u>132,682</u>	<u>108,641</u>
Total	<u>\$ 311,375</u>	<u>\$ 222,721</u>

NOTE K - REGULATORY MATTERS

The Bank, as a North Carolina banking corporation, may pay cash dividends only out of undivided profits as determined pursuant to North Carolina General Statutes. However, regulatory authorities may further limit the payment of dividends by any bank when it is determined that such limitation is in the public interest and is necessary to ensure financial soundness of the Bank. The payment of cash dividends by a newly organized bank is prohibited by regulation for three years unless special exceptions are made.

The Bank is subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications 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, as prescribed by regulations, of total and Tier I capital to risk-weighted assets and of Tier I capital to average assets. Management believes that, as of December 31, 2001 and 2000, the Bank meets all capital adequacy requirements to which it is subject, as set forth below:

	<u>Actual</u>	<u>Minimum</u>	<u>Minimum</u>
	<u>Ratio</u>	<u>For Capital</u>	<u>To Be Well</u>
		<u>Adequacy</u>	<u>Capitalized</u>
		<u>Purposes</u>	
As of December 31, 2001			
Tier I capital (to risk-weighted assets)	12.4%	4.0%	6.0%
Total capital - Tier II capital (to risk-weighted assets)	13.6	8.0	10.0
Leverage - Tier I capital (to average assets)	10.0	4.0	5.0
As of December 31, 2000			
Tier I capital (to risk-weighted assets)	27.7%	4.0%	6.0%
Total capital - Tier II capital (to risk-weighted assets)	29.0	8.0	10.0
Leverage - Tier I capital (to average assets)	19.9	4.0	5.0

NOTE L - OFF-BALANCE SHEET RISK

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, undisbursed lines of credit, and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial 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 conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank, upon extension of credit is based on management's credit evaluation of the borrower. Collateral obtained varies but may include real estate, stocks, bonds, and certificates of deposit.

A summary of the contract amount of the Bank's exposure to off-balance sheet credit risk as of December 31, 2001 is as follows:

Financial instruments whose contract amounts represent credit risk:	
Commitments to extend credit	\$ 987,000
Undisbursed lines of credit	9,291,000
Commercial and standby letters of credit	258,000

NOTE M - DISCLOSURES ABOUT FAIR VALUES OF FINANCIAL INSTRUMENTS

Financial instruments include cash and due from banks, interest-bearing deposits with banks, federal funds sold, investments, loans, stock in Federal Home Loan Bank of Atlanta, and deposit accounts. Fair value estimates are made at a specific moment in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Bank's entire holdings of a particular financial instrument. Because no active market readily exists for a portion of the Bank's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and Due from Banks, Interest-Earning Deposits With Banks and Federal Funds Sold

The carrying amounts for cash and due from banks, interest-earning deposits with banks and federal funds sold approximate fair value because of the short maturities of those instruments.

NOTE M - DISCLOSURES ABOUT FAIR VALUES OF FINANCIAL INSTRUMENTS (Continued)

Investment Securities

Fair value for investment securities equals quoted market price if such information is available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Loans

For certain homogenous categories of loans, such as residential mortgages, fair value is estimated using the quoted market prices for securities backed by similar loans, adjusted for differences in loan characteristics. The fair value of other types of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Stock in Federal Home Loan Bank of Atlanta

The fair value for FHLB stock approximates carrying value, based on the redemption provisions of the Federal Home Loan Bank.

Deposits

The fair value of demand deposits is the amount payable on demand at the reporting date. The fair value of time deposits and borrowings is estimated using the rates currently offered for instruments of similar remaining maturities.

Financial Instruments with Off-Balance Sheet Risk

With regard to financial instruments with off-balance sheet risk discussed in Note L, it is not practicable to estimate the fair value of future financing commitments.

The carrying amounts and estimated fair values of the Bank's financial instruments, none of which are held for trading purposes, are as follows at December 31, 2001 and 2000:

	2001		2000	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
	(In thousands)			
Financial assets:				
Cash and due from banks	\$ 2,620	\$ 2,620	\$ 718	\$ 718
Interest-earning deposits in banks	786	786	662	662
Federal funds sold	3,186	3,186	5,280	5,280
Investment securities	7,791	7,791	4,506	4,506
Federal Home Loan Bank stock	57	57	1	1
Loans	37,770	38,081	16,115	16,115
Financial liabilities:				
Deposits	48,885	47,395	23,610	23,610

NOTE N - EMPLOYEE AND DIRECTOR BENEFIT PLANS

401(k) Plan

The Bank has a 401(k) Plan (the "Plan") whereby substantially all employees participate in the Plan. The Bank makes matching contributions equal to 100 percent of the first 6 percent of an employee's compensation contributed to the Plan. Matching contributions vest to the employee equally over a four-year period. For the year ended December 31, 2001 and the period ended December 31, 2000, expense attributable to the Plan amounted to \$35,403 and \$28,354, respectively.

Stock Option Plans

During 2000, the Bank adopted, with shareholder approval, an Employee Stock Option Plan (the "Employee Plan") and a Director Stock Option Plan (the "Director Plan"). Each plan makes available options to purchase 60,045 shares of the Bank's common stock for an aggregate number of common shares reserved for options equal to 120,090. No options have been granted under either the Employee Plan or the Director Plan through December 31, 2001.

Employment Agreements

The Bank has entered into an employment agreement with its chief executive officer to ensure a stable and competent management base. This agreement provides for benefits as spelled out in the contract and cannot be terminated by the Board of Directors, except for cause, without prejudicing the officer's right to receive certain vested rights, including compensation. In the event of a change in control of the Bank, as outlined in the agreement, the acquirer will be bound to the terms of this contract.

The Bank also has entered into agreements with three executive officers which provide for severance pay benefits in the event of a change in control of the Bank resulting in the termination of such executive officers or diminished compensation, duties or benefits.

*Cornerstone Bank
Management and Bank Personnel*

DIRECTORS

John C. Anthony
Partner: Anthony, Moore and Tabb CPA's

Thomas E. Brown III
Chairman of the Board
Owner/Manager of Brown Oil Company

Avant P. Coleman
Retired: Cooperative Extension Service and
Wilson City Council for 18 years

Robert E. Kirkland III
Owner/Manager of Barnes Motor & Parts Co., Inc.

Judy A. Muirhead
Owner/ Manager of JAM Properties, JAM Rentals
and JAM Investments

W. Coalter Paxton III
President of Paxton Mini Storages, Inc. and PBS
Storage, Inc. and Manager of Paxton Bonded Warehouse, Inc.

Norman B. Osborn
President and CEO
Cornerstone Bank

Gregory A. Turnage
Owner and President of PLT Construction Inc. and
President of T. & H. Electric, Inc.

S. Christopher Williford
Vice President and Owner of Southern Piping Company, Inc.

David W. Woodard
Secretary for Cornerstone Bank
Law Partner, Connor, Bunn, Rogerson & Woodard

EXECUTIVE OFFICERS

Norman B. Osborn
President and CEO

G. Brooks Batchelor
Executive Vice President, Sr. Business Development Officer

Robert K. Ladd III
Executive Vice President, Chief Lending Officer

Robert W. Kernodle
Executive Vice President, Chief Information and Systems Officer

Cornerstone Bank
General Corporate Information

Office Location

3710 Nash Street North
Wilson, NC 27896
www.thecornerstonebank.com

Regulatory and Securities Counsel

Brooks, Pierce, McLendon
Humphrey & Leonard, L.L.P.
P. O. Box 26000
Greensboro, NC 27420

Stock Transfer Agent

First Citizens Bank & Trust
Corporate Trust Dept.
100 East Tryon Road
Raleigh, NC 27603

Independent Auditors

Dixon Odom PLLC
P.O. Box 70
Sanford, NC 27331-0070

Common Stock

The Bank had 600,451 shares of Common Stock outstanding which were held by approximately 985 holders of record (excluding shares held in street name) as of December 31, 2001. To date, the Bank has not paid any cash dividends. The Bank may not pay cash dividends in its first three years of operations.

Market for the Common Stock

There is no public trading market for the Bank's common stock. Certain sales have been facilitated by the Bank in 2001 and 2000, all of which were, to the knowledge of management, at a price of \$11.00 per share.

Annual Shareholders Meeting

The 2002 Annual Meeting of shareholders of Cornerstone Bank will be held at 10:00 a.m. on May 22, 2002 at the Del Mastro Auditorium on the campus of Wilson Technical Community College at 902 Herring Avenue, Wilson, North Carolina.

Annual Report on Form 10-KSB

A copy of Cornerstone Bank's 2001 Annual Report on Form 10-KSB, as filed with the Federal Deposit Insurance Corporation, is available without charge to shareholders upon written request to Norman B. Osborn, President and CEO, Cornerstone Bank, 3710 Nash Street North, Wilson, North Carolina 27896.

This Annual Report serves as the annual financial disclosure statement furnished pursuant to the Federal Deposit Insurance Corporation's rules and regulations. This statement has not been reviewed or confirmed for accuracy or relevance by the Federal Deposit Insurance Corporation.