CORNERSTONE BANK

2003 Annual Report

TABLE OF CONTENTS

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
1-877-685-0576

Dear Stockholders,

In the following pages, you will find the financial report for the year 2003, with highlights that include net income of $841,000, and a ninth consecutive quarter of profitability.

But the report of this year, as good as it was, is not the full story of this bank. The real story is the response of this community to this bank during the first three full years of operations.

At year-end, assets were at $98.7 million, and now this bank has grown to more than $100 million in asset size, which was accomplished by its forth anniversary on March 15, 2004. Quite simply, it means that people have moved their accounts to our bank, sometime within the past four years. It happens often, with more than 100 new accounts each month. The annual June 30, 2003 FDIC report of market shares speaks volumes: Cornerstone Bank is now third in deposits in Wilson County, up from fifth one year earlier.

Currently, more than one of every ten dollars in Wilson County is deposited at Cornerstone. We want to increase market share each year, and we are comfortable with our connections to the community.

That, of course, implies growth, and let me explain our position on that. We believed, four years ago, that this was a time and place for a new bank, as long as we could stay close to our roots. Four years ago, there was a perception of too many bank moves, too many mergers, too many headquarters in high rises from hundreds of miles away, and an eye on growth maybe thousands of miles away.

Instead, we wanted to stand for something else, for something other than “bigness”. We promised to never outgrow our ability to focus on customers and businesses at home. We are clearly a locally owned and locally managed bank, with management that is accessible and visible. Sometimes, people just feel like they need to sit down and talk to the president. Here, they can.

Yet we realize that growth is part of survival. In fact, we cracked the state’s “Financial 100” list as reported in the November 2003 issue of *Business North Carolina*. It lists the state’s banks and credit unions based on revenue (income derived from interest and non-interest earnings). We are growing, and part of the success is that we do not have to compromise our strategies to balance operations from other areas.

We will continue to grow, and we have a sensible and energetic plan for the next five years. The cornerstone, if you will, is the decision to grow ***from*** the current base, instead of ***away*** from the current base. What a difference a word can make.

You will see in this report that we continue to add deposits, and in turn add loans. What does not show up in such figures is that local deposits are turned into local loans. We are helping fuel the local economy.

Something else concerning the economy: this bank has maintained uncommonly high deposit rates. For example, our Seniors Checking accounts and an Investors Checking accounts offer interest earnings of seven, eight, even nines times more than comparable accounts at neighboring banks. Obviously, it would be easy for this bank to improve profits by simply lowering those deposit rates, but we have been steadfast in our pricing philosophy, despite the gloomy economic conditions nationwide...and despite the difficulty of other banks during this period of distressed net interest margins.

But we believe in golden rule banking. Profits take care of themselves, and they have, as long as we continue to honor and respect customers and shareholders. We are proud to say that customers and shareholders are often one and the same.

Another area of operations that might not show up in the following figures is that this bank's profitability has many reasons, one including its operating efficiencies and ability to stay on budget. Like any business, or any family, there are many distractions, many temptations, and many complications. We have stayed focused.

Our staff also has helped with all of that. They are handpicked in hiring, and most of those hired are still here. How many companies can say that the original, first-year staff is still onboard, four years later? Our staff is experienced, smart, empowered to serve customers, and genuinely happy about what, together, we have accomplished.

We are the local banker. People depend on expertise right here; just like they rely on a local attorney, a local doctor, a local pharmacist, a local mechanic, a local florist...whatever the service, people prefer a local contact. We have provided that for banking, and for financial advice.

Currently we are a $100+ million bank, still in a single location. Currently we have more than 1,500 stockholders, mostly local. Our stock is not listed on exchanges, because there rarely is an exchange. If needed, we maintain a list of ready buyers to match with the few sellers. People are holding our stock for the future. They see what we see. We're just the little local bank that suddenly – in four years – is not so little any more.

We have become a bank of preference in this area, and that is a two-way street. People prefer this bank, and this bank prefers these people.

Following are the outstanding results of the past year. I hope you'll read them, also, with a sense of pride of the past three plus years.

Sincerely,

Norman B. Osborn
President

Thomas E. Brown III
Chairman

The selected financial information and other data presented below has been derived, in part, from the audited financial statements of the Bank. The selected financial information and other data should be read in conjunction with the financial statements and notes thereto presented elsewhere herein.

	At or for the Periods Ended December 31,			
	2003	2002	2001	2000
	(Dollars in thousands, except per share data)			
Operating Data:				
Total interest income	$ 4,285	$ 3,640	$ 2,792	$ 999
Total interest expense	1,845	1,534	1,557	512
Net interest income	2,440	2,106	1,235	487
Provision for loan losses	374	391	367	244
Net interest income after provision for loan losses	2,066	1,715	868	243
Total non-interest income	1,014	782	305	147
Total non-interest expense	2,239	1,969	1,542	1,116
Net income (loss)	$ 841	$ 528	$ (369)	$ (726)
Per Common Share Data: [1]				
Earnings per share - basic and diluted	$ .92	$ 0.70	$ (0.53)	$ (1.05)
Book value	9.53	8.65	7.32	7.91
Selected Year-End Balance Sheet Data:				
Loans	$ 73,187	$ 58,649	$ 38,292	$ 16,359
Allowance for loan losses	1,033	845	523	244
Other earning assets	17,011	13,229	11,761	10,448
Total assets	98,674	74,974	54,173	29,235
Deposits	87,371	65,519	48,885	23,610
Borrowings	2,343	1,250	-	-
Shareholders' equity	8,716	7,909	5,078	5,485
Selected Average Balances:				
Total assets	$ 89,666	$ 65,526	$ 41,068	$ 17,542
Loans	65,907	48,896	28,668	8,098
Total interest-earning assets	85,220	62,098	38,256	16,198
Deposits	73,947	58,210	35,397	11,736
Total interest-bearing liabilities	75,907	54,503	32,998	10,415
Shareholders' equity	8,336	6,014	5,485	5,740
Selected Performance Ratios:				
Return on average assets	0.94%	0.81%	(0.90%)	(1.34%)
Return on average equity	10.09%	8.78%	(6.73%)	(4.39%)
Net interest margin	2.86%	3.39%	3.23%	4.72%
Non-interest expense to average assets	2.50%	3.00%	3.77%	6.23%
Asset Quality Ratios:				
Allowance for loan losses to period-end loans	1.41%	1.44%	1.37%	1.49%
Net loan charge-offs to average loans	0.28%	0.14%	0.31%	-%
Capital Ratios:				
Total risk-based capital	13.44%	14.63%	13.62%	29.00%
Tier 1 risk-based capital	12.19%	13.39%	12.37%	27.70%
Leverage ratio	9.13%	10.63%	10.00%	19.90%
Equity to assets	8.83%	10.55%	9.37%	18.76%
Average equity to average assets	9.30%	9.18%	13.36%	32.72%

[1] Adjusted for the 11-for-10 stock split in 2002 and the 21-for-20 stock split in 2003.

The following discussion and analysis is presented to assist readers in understanding Cornerstone Bank's financial condition and results of operations for the years ended December 31, 2003 and 2002. You should read this discussion and the related financial data in conjunction with the audited financial statements and the related footnotes, which are included elsewhere in this Annual Report. All references in this Annual Report to net income per share, price per share, book value per share and weighted average common and common equivalent shares outstanding have been adjusted to reflect an eleven-for-ten stock split effected in the form of a 10% stock dividend issued in 2002, and a twenty-one-for-twenty stock split effected in the form of a 5% stock dividend in 2003.

DESCRIPTION OF BUSINESS

Cornerstone Bank ("Cornerstone" or the "Bank"), a North Carolina chartered banking corporation, 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 lending activities are oriented to the consumer/retail customer as well as to the small-to-medium sized businesses located in Wilson County. The Bank offers the standard complement of commercial, consumer, and mortgage lending products, as well as the ability to structure products to fit specialized needs. The deposit services offered by the Bank include business and personal checking, savings account and certificates of deposit. The Bank intends to focus on customer relationships in building its deposit base and to compete aggressively for transaction accounts.

EXECUTIVE OVERVIEW

Significant accomplishments

In the opinion of Cornerstone Bank's management, the Bank's most significant accomplishments during 2003 were as follows:

- Captured additional 2.67% of the deposit market share and now more than 10% of all deposits in Wilson County reside at Cornerstone Bank
- Jumped from 5th to 3rd in market share of deposits in Wilson County
- Cornerstone Bank cracked the state's "Financial 100" list as reported by the November 2003 issue of *Business North Carolina*. It lists the state's banks and credit unions based on revenue (income derived from interest and non-interest earnings)
- Total assets increased 32%;
- Total loans increased 25%;
- Total deposits increased 33%;
- Net income increased 59%;
- Total non-interest income increased 30%;
- Maintained our asset quality;
- Positioned ourselves well for improved earnings in the event that interest rates move upward or stay even, as a result of our slightly asset sensitive position;

Challenges

Cornerstone Bank has grown at a rapid pace since opening on the Ides of March in 2000. While the achievement of the bank's strategic initiatives and established long-term financial goals is subject to many uncertainties and challenges, management has identified the challenges that are most relevant and most likely to have a near-term effect on operations, which are presented below:

- After completing our 9th consecutive quarter of profitability we have used up substantially all tax credits and loss carry-forwards and expect to provide income tax expense in 2004 of approximately 30% of our pre-tax income. This presents a challenge in maintaining growth in profitability.
- Maintaining net-interest margins as we continue in a historical low interest rate environment, while maintaining our implicit pledge of fair customer pricing of deposit products and competing with sometime irrational competition pricing.
- Finding new and maintaining existing non-interest revenue sources in light of the softening mortgage refinancing market.
- Balancing and controlling growth within our capital limitations
- Maintaining core deposit growth in a highly competitive market and something irrational pricing competition.
- Balancing physical resource needs as we continue to grow, while maintaining non-interest expenses.
- Added costs associated with the current heightened regulatory environment.
- Maintaining asset quality after a sustained period of economic sluggishness.

FINANCIAL CONDITION
December 31, 2003 and 2002

During 2003 the Bank continued its strong growth, ending the year with total assets of $98.7 million, an increase of $23.7 million or 31.6% from the beginning of year total assets of $75.0 million. The growth in total assets was funded primarily by inflows of customer deposits, which increased by $21.9 million or 33.4% to $87.4 million, up from $65.5 million at December 31, 2002. Other sources of funding for asset growth included borrowings of $1.1 million and net income of $841,000. Total loans receivable grew by $14.5 million and closed the year at $73.2 million, an increase of 24.8% from total loans receivable at December 31, 2002. Liquid investments, consisting of cash and due from banks, interest-earning deposits in other banks, federal funds sold, time deposits and investment securities available for sale, totaled $22.8 million, or 23.1% of total assets, at December 31, 2003, representing an increase of $7.8 million over the beginning of year total of $15 million. Total stockholders' equity increased from $7.9 million at December 31, 2002 to $8.7 million at December 31, 2003 as a result of retention of net income of $841,000. At December 31, 2003, the Bank's capital exceeds the levels that are deemed to be "well-capitalized" under applicable regulatory capital requirements.

RESULTS OF OPERATIONS
For the Years Ended December 31, 2003 and 2002

Overview. The Bank earned net income of $841,000 or $0.92 per share for the year ended December 31, 2003, as compared with net income of $528,000 or $0.70 per share for 2002. This improvement of $313,000 or $0.22 per share in net operating results was principally attributable to an increase in net interest income that resulted from asset growth from period to period and to a much higher level of non-interest income. Net interest income after the provision for loan losses increased by $352,000, from $1.7 million for the year ended December 31, 2002 to $2.1 million for the year ended December 31, 2003. Non-interest income for the same year grew by $231,000, from $783,000 to $1.0 million, almost offsetting an increase of $270,000 in non-interest expenses from $2.0 million for 2002 to $2.2 million for the year ended December 31, 2003.

Net Interest Income. Net interest income increased to $2.4 million for the year ended December 31, 2003, a $334,000 or 15.9% increase from the $2.1 million earned in 2002. Total interest income benefited from growth in the level of average earning assets, which offset lower asset yields caused by the long-term decline in interest rates. The reduced level of interest rate yields resulted from the continuation of historically low interest rates. As normal loan payoffs occur, funds are being re-loaned or re-invested at lower rates. Rates paid by the Bank on deposits have also continued to declined, but not at the same pace as earning assets due to longer term CDs maturing in the future. As a result, the decrease in the average rate paid on interest-bearing deposits during 2003 was less than the decrease in the average rate earned on interest-earning assets. Average total interest-earning assets increased by $23.1 million or 37.2% during the year ended December 31, 2003, as compared to the year ended December 31, 2002, while the average interest rate earned dropped by 83 basis points from 5.86% to 5.03%. Average total interest-bearing liabilities increased by $21.4 million, consistent with the increase in interest-earning assets, and yielded only a 38 basis point decrease in average cost, from 2.81% during 2002 to 2.43% in 2003. For the year ended December 31, 2003, the interest rate spread was 2.60%, a 45 basis point decline from the year ended December 31, 2002 interest rate spread of 3.05%.

Provision for Loan Losses. The Bank recorded a $374,000 provision for loan losses in 2003, after incurring $186,000 in net charge offs, representing a decrease of $17,000 compared to the $391,000 provision made in 2002. 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 2003 and 2002, the provision for loan losses was made principally in response to growth in loans, as total loans outstanding increased by $14.5 million in 2003 and by $20.4 million in 2002. Net loan charge-offs were $186,000 in 2003 and $69,000 in 2002. At December 31, the allowance for loan losses was $1,033,000 for 2003 and $845,000 for 2002, representing 1.41% and 1.44%, respectively, of loans outstanding. At December 31, 2003, loans delinquent more than 90 days or on non-accrual amounted to $15,000. Interest income that would have been recorded on nonaccrual loans was immaterial for the year ended December 31, 2003. There were $25,000 of nonperforming loans at December 31, 2002. The $186,000 in net charge offs resulted primarily from a $182,000 write-down of loans to one commercial loan relationship. Subsequent to year-end, loans aggregating $359,000 to this loan relationship have been restructured and are currently performing under the restructured terms.

Non-Interest Income. Non-interest income grew by $231,000, from $783,000 for 2002 to $1,014,000 for 2003. Service fees and charges, which represent a relatively stable and predictable source of non-interest income, totaled $270,000 for 2003, as compared with $170,000 of service fees and charges earned in 2002. The other major source of the increase in non-interest income in 2003 was from the Bank's mortgage operations. Through associations with certain 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. Because the Bank originates these mortgages, the Bank's customers receive personal face-to-face service from the Bank's employees, rather than dealing with third parties. Mortgage loan originations have remained stable during 2003 because of the continued favorable interest rate market. As a result, the Bank had income from mortgage operations of $658,000 during 2003, an increase of $72,000 from the $586,000 earned during the year ended December 31, 2002. The Bank's management will continue efforts to develop sources of additional non-interest income.

Non-Interest Expenses. Non-interest expenses totaled $2.2 million for the year ended December 31, 2003, an increase of $270,000 from the total of $2.0 million for the year ended December 31, 2002. The increase is attributable to the Bank's growth from period to period. The Bank's total assets averaged $89.7 million during 2003, an increase of $24.1 million, or 36.8%, over the 2002 average of $65.5 million. Net interest income increased by 15.9% and non-interest income increased by 29.6%. In comparison, total non-interest expenses for the year ended December 31, 2003 increased by 13.7%, a significantly lower percentage increase than those applicable to asset growth and revenues. The Bank's plan for 2004 calls for continued asset growth, and management expects that growth in revenues will continue to exceed increases in non-interest costs and expenses until the Bank adds one or more new branches.

Income Taxes. The Bank recorded no income tax expense for the year ended December 31, 2003, despite having income before income taxes, because of recognition of previously generated deferred tax assets. For 2004, the Bank expects that the provision for income taxes for the year will be approximately 28% to 30% of total income before income taxes.

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 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. 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. Nonaccrual loans have been included in determining average loans.

	Year Ended December 31, 2003			Year Ended December 31, 2002		
	Average balance	Interest Income/ Expense	Yield/ Cost	Average balance	Interest Income/ Expense	Yield/ Cost
			(Dollars in thousands)			
Interest-earning assets:						
Loans	$ 65,907	$ 3,776	5.73%	$ 48,896	$ 3,159	6.46%
Investment securities [1]	13,563	436	3.21%	9,737	437	4.49%
Other interest-earning assets [2]	5,750	73	1.27%	3,465	44	1.27%
Total interest-earning assets	85,220	4,285	5.03%	62,098	3,640	5.86%
Other assets	4,446			3,428		
Total assets	$ 89,666			$ 65,526		
Interest-bearing liabilities:						
Deposits:						
Savings, NOW and money market	$ 39,325	670	1.70%	$ 28,454	589	2.07%
Time deposits over $100,000	12,310	376	3.05%	10,466	383	3.66%
Other time deposits	22,312	736	3.30%	15,004	540	3.60%
Borrowings	1,960	63	3.21%	579	22	3.80%
Total interest-bearing liabilities	75,907	1,845	2.43%	54,503	1,534	2.81%
Noninterest-bearing deposits	4,795			4,286		
Other liabilities	628			723		
Stockholders' equity	8,336			6,014		
Total liabilities and stockholders' equity	$ 89,666			$ 65,526		
Net interest income/interest rate spread		$ 2,440	2.60%		$ 2,106	3.05%
Net interest margin			2.86%			3.39%
Ratio of interest-earning assets to interest-bearing liabilities	112.27%			113.94%		

[1] Includes time deposits, investment securities available for sale and stock in FHLB.
[2] Includes interest-earning deposits in banks and federal funds sold.

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.

	Years Ended December 31, 2003 vs. 2002		
	Increase (Decrease) Due to		
	Volume	Rate	Total
	(Dollars in thousands)		
Interest income:			
Loans	$ 1,037	$ (420)	$ 617
Investment securities	147	(148)	(1)
Other interest-earning assets	29	-	29
Total interest income	1,213	(568)	645
Interest expense:			
Deposits:			
Savings, NOW and money market	205	(124)	81
Time deposits over $100,000	62	(69)	(7)
Other time deposits	252	(56)	196
Borrowings	48	(7)	41
Total interest expense	567	(256)	311
Net interest income increase (decrease)	$ 646	$ (312)	$ 334

LOAN PORTFOLIO

The Bank's primary source of revenue is interest and fee income from its lending activities. These lending activities consist principally of originating commercial operating and working capital loans, residential mortgage loans, home equity lines of credit, other consumer loans and loans secured by commercial real estate. The Bank's current lending strategy is to fully serve its deposit customers, including all market segments, and to establish greater market share throughout Wilson County.

Total loans, net of the allowance for loan losses and net deferred loan origination fees, at December 31, 2003, were $72.2 million compared to $57.8 million at December 31, 2002, an increase of 24.8%. The Bank has a diversified loan portfolio with no significant concentrations to any one borrower or industry. The amounts of loans outstanding at December 31, 2003, by category, are shown in Note D to the financial statements included elsewhere herein.

LIQUIDITY

"Liquidity" refers to the ability of the Bank to fund loans, withdrawals and maturities of deposits, and other cash outflows in a cost effective manner. The Bank's 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, time deposits and investment securities classified as available for sale) comprised 23% and 20% of the Bank's total assets at December 31, 2003 and 2002, respectively.

Through most of its existence, the Bank has been a net seller of federal funds, as its liquidity has exceeded its need to fund new loan demand. Should the need arise, the Bank would have the capability to sell securities classified as available for sale or to borrow funds as necessary. The Bank has established credit lines with other financial institutions to purchase up to $6.0 million in federal funds. As a member of the Federal Home Loan Bank of Atlanta, Cornerstone may obtain longer-term advances up to 10% of its assets. As of December 31, 2003, there was $2.0 million outstanding under this line of credit.

Total deposits were $87.4 million and $65.5 million at December 31, 2003 and 2002, respectively. Time deposits, which are the only deposit accounts that have stated maturity dates, are generally considered to be rate sensitive. Time deposits represented 41.6% and 45.2%, respectively, of total deposits at December 31, 2003 and 2002. Time deposits of $100,000 or more represented 18.9% and 18.7% of the Bank's total deposits at December 31, 2003 and 2002, respectively. At December 31, 2003, the Bank had $3.3 million in brokered time deposits. Management believes most other time deposits are relationship-oriented. While the Bank 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.

At December 31, 2003 (and at all times during the years presented in this report), the Bank's management believes that its liquidity sources, including unused lines of credit, were at an acceptable level and remained adequate to meet its operating needs.

CAPITAL

A significant measure of the strength of a financial institution is its capital base. 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 8.83 % at December 31, 2003. As the following table indicates, at December 31, 2003, the Bank exceeded regulatory capital requirements.

	At December 31, 2003		
	Actual Ratio	Minimum Requirement	Well-Capitalized Requirement
Total risk-based capital ratio	13.44%	8.00%	10.00%
Tier 1 risk-based capital ratio	12.19%	4.00%	6.00%
Leverage ratio	9.13%	4.00%	5.00%

Management expects that the Bank will remain "well-capitalized" for regulatory purposes, although there can be no assurance that additional capital will not be required in the near future due to greater-than-expected growth, or otherwise.

CRITICAL ACCOUNTING POLICY

The Bank's discussion and analysis of its financial condition and results of operations are based upon its financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Bank to make estimates and judgments regarding uncertainties that affect the reported amount of assets, liabilities, revenues and expenses. On an ongoing basis, the Bank evaluates its estimates that are based upon historical experience and other assumptions believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

The Bank's most significant accounting policy is the determination of its allowance for loan losses. Cornerstone records provisions for loan losses based upon known problem loans and estimated deficiencies in the existing loan portfolio. The Bank's methodology for determining the level of its allowance for loan losses consists of two key components, which are a specific allowance for identified problem or impaired loans and a formula allowance for the remainder of the portfolio.

Identified problem and impaired loans are measured for impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral, if the loan is collateral dependent. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant change. The adequacy of the allowance is also reviewed by management based upon its evaluation of then-existing economic and business conditions affecting the key lending areas of the Bank and other conditions, such as new loan products, collateral values, loan concentrations, changes in the mix and volume of the loan portfolio; trends in portfolio credit quality, including delinquency and charge-off rates; and current economic conditions that may affect a borrower's ability to repay. Although management believes it has established and maintained the allowance for loan losses at appropriate levels, future adjustments may be necessary if economic and other conditions differ substantially from the current operating environment.

A summary of the Bank's significant accounting policies is set forth in Note B to the accompanying financial statements.

RECENT ACCOUNTING PRONOUNCEMENTS

See Note B to the accompanying financial statements for a full description of recent accounting pronouncements including the respective expected dates of adoption and effects on results of operations and financial condition.

OFF-BALANCE SHEET ARRANGEMENTS

Information about the Bank's off-balance sheet risk exposure is presented in Note K to the accompanying financial statements. As part of our ongoing business, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as special purpose entities (SPEs), which generally are established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As of December 31, 2003, we are not involved in any unconsolidated SPE transactions.

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 liquidity, safety, 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, 2003, 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 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 that 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, 2003				
	1 Year or Less	More Than 1 Year to 3 Years	More Than 3 Years to 5 Years	More Than 5 Years	Total
	(Dollars in thousands)				
Interest-earning assets:					
Loans:					
Variable rate	$ 59,668	$ -	$ -	$ -	$ 59,668
Fixed rate	3,931	2,729	6,632	259	13,551
Securities available for sale	1,527	2,522	826	6,429	11,304
Other interest-earning assets	5,049	297	100	261	5,707
Total interest-earning assets	$ 70,175	$ 5,548	$ 7,558	$ 6,949	$ 90,230
Interest-bearing liabilities:					
Deposits:					
Savings, NOW and money market	$ 42,960	$ -	$ -	$ -	$ 42,960
Time over $100,000	10,534	4,105	1,904	-	16,543
Other time	13,202	4,051	2,520	20	19,793
Borrowings	343	750	-	1,250	2,343
Total interest-bearing liabilities	$ 67,039	$ 8,906	$ 4,424	$ 1,270	$ 81,639
Interest sensitivity gap per period	$ 3,136	$ (3,358)	$ 3,134	$ 5,679	$ 8,591
Cumulative interest sensitivity gap	$ 3,136	$ (222)	$ 2,912	$ 8,591	$ 8,591
Cumulative gap as a percentage of total interest-earning assets	3.48%	(0.25)%	3.23%	9.52%	9.52%
Cumulative interest-earning assets as a percentage of interest-bearing liabilities	104.68%	99.71%	103.62%	110.52%	110.52%

ASSET QUALITY AND THE ALLOWANCE FOR LOAN LOSSES

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 nonaccrual 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's impaired loans consisted of $15,000 and $25,000 in non-accrual loans at December 31, 2003 and 2002, respectively. The Bank had no restructured loans at either date.

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.

FORWARD-LOOKING INFORMATION

This report contains certain forward-looking statements with respect to the financial condition, results of operations and business of the Bank. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Bank and on the information available to management at the time that these disclosures were prepared. These statements can be identified by the use of words like "expect," "anticipate," "estimate" and "believe," variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the Bank's markets, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environment and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in the Bank's other filings with the Federal Deposit Insurance Corporation. The Bank undertakes no obligation to update any forward-looking statements.

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, 2003 and 2002, and the related statements of operations, comprehensive income, changes in stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting 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, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Dixon Hughes PLLC

Sanford, North Carolina
February 23, 2004

CORNERSTONE BANK
BALANCE SHEETS
December 31, 2003 and 2002

	2003	2002
ASSETS		
Cash and due from banks	$ 6,070,729	$ 1,771,290
Interest-earning deposits in banks	3,868,985	700,831
Federal funds sold	-	1,643,000
Time deposits	1,577,000	695,000
Investment securities available for sale, at fair value (Note C)	11,303,964	10,189,644
Loans (Note D)	73,187,068	58,649,219
Allowance for loan losses	(1,033,238)	(844,961)
NET LOANS	72,153,830	57,804,258
Accrued interest receivable	317,359	305,803
Stock in Federal Home Loan Bank of Atlanta, at cost	260,800	146,200
Bank premises and equipment (Note E)	1,584,631	1,638,497
Bank-owned life insurance	1,229,448	-
Other assets	307,102	79,644
TOTAL ASSETS	$ 98,673,848	$ 74,974,167
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Demand	$ 8,075,501	$ 4,097,801
Savings	1,108,014	696,505
Money market and NOW	41,851,828	31,100,124
Time over $100,000 (Note F)	16,543,406	12,188,136
Time (Note F)	19,792,738	17,436,708
TOTAL DEPOSITS	87,371,487	65,519,274
Advances from Federal Home Loan Bank	2,000,000	1,250,000
Federal funds purchased	343,000	-
Accrued interest payable	87,352	81,386
Accrued expenses and other liabilities	156,369	214,762
TOTAL LIABILITIES	89,958,208	67,065,422
Commitments (Notes K and M)		
Stockholders' equity (Notes J and M):		
Common stock, $5 par value, 20,000,000 shares authorized; 914,732 and 871,540 shares issued and outstanding at December 31, 2003 and 2002, respectively	4,573,660	4,357,700
Additional paid-in capital	3,839,817	4,055,777
Retained earnings (deficit)	274,616	(566,503)
Accumulated other comprehensive income	27,547	61,771
TOTAL STOCKHOLDERS' EQUITY	8,715,640	7,908,745
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 98,673,848	$ 74,974,167

See accompanying notes.

CORNERSTONE BANK
STATEMENTS OF OPERATIONS
Years Ended December 31, 2003 and 2002

	2003	2002
INTEREST INCOME		
Loans	$ 3,774,601	$ 3,159,112
Investment securities	391,509	405,840
Federal funds sold	26,535	43,513
Interest-earning bank deposits	46,176	11,663
Other interest and dividends	45,924	19,879
TOTAL INTEREST INCOME	4,284,745	3,640,007
INTEREST EXPENSE		
Money market, NOW and savings deposits	669,456	588,853
Time deposits	1,112,227	922,945
Borrowings	63,178	22,517
TOTAL INTEREST EXPENSE	1,844,861	1,534,315
NET INTEREST INCOME	2,439,884	2,105,692
PROVISION FOR LOAN LOSSES (Note D)	373,769	391,258
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	2,066,115	1,714,434
NON-INTEREST INCOME		
Service charges on deposit accounts	270,201	169,504
Mortgage operations	657,563	585,870
Gain (loss) on sale of investment securities	16,562	(2,553)
Other income	69,842	29,945
TOTAL NON-INTEREST INCOME	1,014,168	782,766
NON-INTEREST EXPENSE		
Salaries and employee benefits	1,411,285	1,229,626
Occupancy and equipment	149,416	148,523
Data processing expenses	231,344	217,502
Other (Note I)	447,119	373,061
TOTAL NON-INTEREST EXPENSE	2,239,164	1,968,712
INCOME BEFORE INCOME TAXES	841,119	528,488
INCOME TAXES (Note H)	-	-
NET INCOME	$ 841,119	$ 528,488
BASIC AND DILUTED NET INCOME PER COMMON SHARE	$ 0.92	$ 0.70
BASIC AND DILUTED WEIGHTED AVERAGE COMMON SHARES OUTSTANDING	914,732	756,055

See accompanying notes.

CORNERSTONE BANK
STATEMENTS OF COMPREHENSIVE INCOME
Years Ended December 31, 2003 and 2002

	2003	2002
NET INCOME	$ 841,119	$ 528,488
OTHER COMPREHENSIVE INCOME:		
Securities available for sale:		
Unrealized holding gains (losses) on		
available-for-sale securities	(32,202)	87,920
Tax effect	9,602	(30,923)
Reclassification of (gains) losses recognized		
in net income	(16,562)	2,553
Tax effect	4,938	(898)
TOTAL OTHER COMPREHENSIVE INCOME (LOSS)	(34,224)	58,652
COMPREHENSIVE INCOME	$ 806,895	$ 587,140

See accompanying notes.

CORNERSTONE BANK
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 2003 and 2002

	Common stock		Additional paid-in capital	Retained earnings (deficit)	Accumulated other comprehensive income (loss)	Total equity
	Shares	Amount				
Balance at December 31, 2001	600,451	$ 3,002,255	$ 3,167,844	$ (1,094,991)	$ 3,119	$ 5,078,227
Net income	-	-	-	528,488	-	528,488
Other comprehensive income	-	-	-	-	58,652	58,652
Eleven-for-ten stock split	60,045	300,225	(300,225)	-	-	-
Issuance of common stock	211,044	1,055,220	1,188,158	-	-	2,243,378
Balance at December 31, 2002	871,540	4,357,700	4,055,777	(566,503)	61,771	7,908,745
Net income	-	-	-	841,119	-	841,119
Other comprehensive income	-	-	-	-	(34,224)	(34,224)
Twenty-one-for-twenty stock split	43,192	215,960	(215,960)	-	-	-
Balance at December 31, 2003	914,732	$ 4,573,660	$ 3,839,817	$ 274,616	$ 27,547	$ 8,715,640

See accompanying notes.

CORNERSTONE BANK
STATEMENTS OF CASH FLOWS
Years Ended December 31, 2003 and 2002

	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 841,119	$ 528,488
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	268,317	187,696
Realized (gain) loss on available-for-sale securities	(16,562)	2,553
Provision for loan losses	373,769	391,258
Deferred income tax benefit	(226,000)	-
Change in assets and liabilities:		
Increase in accrued interest receivable	(11,556)	(89,070)
Increase in other assets	(18,739)	(31,159)
Decrease in accrued interest payable	5,966	21,626
Increase (decrease) in accrued expenses and other liabilities	(26,572)	32,454
NET CASH PROVIDED BY OPERATING ACTIVITIES	1,189,742	1,043,846
CASH FLOWS FROM INVESTING ACTIVITIES		
Net purchases of time deposits	(882,000)	(695,000)
Purchase of available-for-sale securities	(7,531,573)	(9,550,788)
Sales of available for sale investments	834,909	5,895,000
Maturities and calls of available for sale investments	5,373,744	1,276,387
Net increase in loans	(14,723,341)	(20,425,925)
Purchase of Federal Home Loan Bank stock	(114,600)	(89,400)
Purchases of bank premises and equipment	(38,053)	(58,569)
Purchase of bank-owned life insurance	(1,229,448)	-
NET CASH USED BY INVESTING ACTIVITIES	(18,310,362)	(23,648,295)
CASH FLOWS FROM FINANCING ACTIVITIES		
Increase in deposits	21,852,213	16,634,710
Net increase in FHLB advances	750,000	1,250,000
Net increase in federal funds purchased	343,000	-
Proceeds from issuance of common stock	-	2,243,378
NET CASH PROVIDED BY FINANCING ACTIVITIES	22,945,213	20,128,088
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	5,824,593	(2,476,361)
CASH AND CASH EQUIVALENTS, BEGINNING	4,115,121	6,591,482
CASH AND CASH EQUIVALENTS, ENDING	$ 9,939,714	$ 4,115,121
CASH AND CASH EQUIVALENTS:		
Cash and due from banks	$ 6,070,729	$ 1,771,290
Interest-earning deposits in banks	3,868,985	700,831
Federal funds sold	-	1,643,000
	$ 9,939,714	$ 4,115,121
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Interest paid on deposits and borrowings	$ 1,512,689	$ 1,512,689
Income taxes paid	247,000	-
Unrealized gain (loss) on investment securities available for sale, net	(34,224)	58,652

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 accounting principles generally accepted in the United States of America 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 loan losses.

Cash and Cash Equivalents

For the purpose of presentation in the statement of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet captions "Cash and due from banks", "Interest-earning deposits in banks" and "Federal funds sold."

Investment Securities Available for Sale

Investment securities available for sale are reported at fair value and consist of debt instruments that are not classified as either trading securities or as held to maturity securities. Unrealized holding gains and losses, net of deferred income tax, on available for sale securities are reported as a net amount in other comprehensive income. Gains and losses on the sale of investment securities available for sale are determined using the specific-identification method. Declines in the fair value of individual investment securities available for sale below their cost that are other than temporary would result in write-downs of the individual securities to their fair value. Such write-downs would be included in 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 adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans and 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 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 impaired loans 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 the loan is collateral dependent. 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.

Mortgage Operations

The Bank originates single family, residential first mortgage loans on a presold basis. The Bank recognizes certain origination and service release fees upon the sale, which are included in non-interest income on the statements of operations under the caption "Mortgage operations."

Bank Premises and Equipment

Bank 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. Estimated useful lives are 35 years for buildings, 3 to 15 years for furniture, fixtures and equipment and 2 to 5 years for computers and related equipment. Repairs and maintenance costs are charged to operations as incurred and additions and improvements to 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)

Comprehensive Income

The Bank reports as comprehensive income all changes in shareholders' equity during the year from sources other than shareholders. Other comprehensive income refers to all components (revenues, expenses, gains, and losses) of comprehensive income that are excluded from net income. The Bank's only component of other comprehensive income is unrealized gains and losses on investment securities available for sale.

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 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 to be issued under the Bank's stock option plans are expected to have no intrinsic value at the grant date and, under APB Opinion No. 25, no compensation cost will be recognized for them. Upon the grant of options, the Bank expects to apply 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.

	2003	2002
	(Amounts in thousands, except per share data)	
Net income:		
As reported	$ 841	$ 528
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	18	-
Pro forma	$ 823	$ 528
Basic net income per share:		
As reported	$ .92	$ .70
Pro forma	.90	.70
Diluted net income per share:		
As reported	$ .92	$ .70
Pro forma	.90	.70

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Per Share Results

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 outstanding stock option, and are determined using the treasury stock method.

The basic and diluted weighted average shares outstanding are as follows:

	2003	2002
Weighted average outstanding shares used for basic EPS	914,732	756,055
Plus incremental shares from assumed exercise of:		
Stock options	809	-
Weighted average outstanding shares used for diluted EPS	915,541	756,055

There were no adjustments required to be made to net income in the computation of diluted earnings per share. For the years ended December 31, 2003 and 2002, there were no options that were antidilutive as a result of the exercise price exceeding the average market price of the Bank's common stock for the year.

On April 15, 2002, the Bank's Board of Directors declared an 11-for-10 stock split to be effected in the form of a 10% stock dividend, which was distributed May 15, 2002 to shareholders of record on April 15, 2002. On April 15, 2003, the Bank's Board of Directors declared a 21-for-20 stock split to be effected in the form of a 5% stock dividend, which was distributed May 15, 2003 to shareholders of record on April 15, 2003. All references to per share results and weighted average common and common equivalent shares outstanding have been adjusted to reflect the effects of these stock splits.

Recent Accounting Pronouncements

In December 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*. SFAS No. 148 amends SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 is effective for financial statements for fiscal years ending after December 15, 2002. The Bank continues to account for its stock-based compensation in accordance with APB Opinion No. 25 and has adopted the disclosure provisions of SFAS No. 148 effective for the years presented herein.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recent Accounting Pronouncements (Continued)

In April 2003, FASB issued SFAS No. 149, *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 improves financial reporting by requiring that contracts with comparable characteristics be accounted for similarly. In particular, SFAS No. 149 clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative, clarifies when a derivative contains a financing component, amends the definition of an "underlying" to conform it to language used in FIN 45 and amends certain other existing pronouncements. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. In addition, with some exceptions, all provisions of SFAS No. 149 should be applied prospectively. The adoption of SFAS No. 149 did not have a material impact on the Bank's financial statements.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). This Statement is effective for financial instruments entered into or modified by the Bank after May 31, 2003, and is effective at the beginning of the first interim period beginning after June 15, 2003. However, the FASB has deferred indefinitely the classification and measurement provisions as they related to certain mandatorily redeemable noncontrolling interests. The adoption of SFAS No. 150 did not have a material impact on the Bank's financial statements.

In November 2003, the Emerging Issues Task Force (EITF) reached a partial consensus on Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. Issue 03-1 requires certain quantitative and qualitative disclosures for investments subject to SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, that are impaired at the balance sheet date but for which an other-than-temporary impairment has not been recognized. The Bank adopted the partial consensus on Issue 03-1 during 2003 and has provided the new disclosures in Note C. The EITF is expected to continue deliberating other aspects of Issue 03-1, including when to recognize other-than-temporary impairment.

Reclassifications

Certain amounts in the 2002 financial statements have been reclassified to conform to the 2003 presentation. The reclassifications had no effect on net income or stockholders' equity as previously reported.

NOTE C - INVESTMENT SECURITIES

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

	December 31, 2003			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Securities available for sale:				
U.S. government securities and obligations of U.S. government agencies	$ 5,579,773	$ 38,746	$ -	$ 5,618,519
Mortgage-backed securities	5,679,363	38,294	(32,212)	5,685,445
	$ 11,259,136	$ 77,040	$ (32,212)	$ 11,303,964

	December 31, 2002			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Securities available for sale:				
U.S. government securities and obligations of U.S. government agencies	$ 4,597,826	$ 42,079	$ -	$ 4,639,905
Corporate bonds	504,222	3,419	-	507,641
Mortgage-backed securities	4,994,004	95,899	(47,805)	5,042,098
	$ 10,096,052	$ 141,397	$ (47,805)	$ 10,189,644

The following table shows investments' gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, at December 31, 2003. These investment securities are considered to be temporarily impaired because, if held to maturity, the Company will not incur any losses.

	Less Than 12 Months		12 Months or More		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
			(Amounts in thousands)			
Securities available for sale:						
Mortgage-backed securities	$3,455,106	$ 31,591	$ 780,020	$ 621	$4,235,126	$ (32,212)
Total temporarily impaired securities	$3,455,106	$ 31,591	$ 780,020	$ 621	$4,235,126	$ (32,212)

Securities with a carrying value of $1,530,938 and $2,540,313 at December 31, 2003 and 2002, respectively, were pledged to secure borrowings.

NOTE C - INVESTMENT SECURITIES (Continued)

For the years ended December 31, 2003 and 2002, proceeds from sales of securities available for sale amounted to $834,909 and $5,895,000, respectively. Gross realized gains amounted to $16,562 and gross realized losses amounted to $2,553 for the years ended December 31, 2003 and 2002, respectively.

The amortized cost, fair value and weighted average yield of the Bank's investment securities at December 31, 2003, 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	$ 1,513	$ 1,527	4.53%
Due after one but within five years	3,014	3,030	2.95%
Due after five but within ten years	1,053	1,062	6.57%
	5,580	5,619	4.07%
Mortgage-backed securities			
Due within one year	320	318	4.52%
Due after five but within ten years	1,752	1,749	4.85%
Due after ten years	3,607	3,618	5.25%
	5,679	5,685	5.09%
Total securities available for sale			
Due within one year	1,513	1,527	4.53%
Due after one but within five years	3,334	3,348	3.10%
Due after five but within ten years	2,805	2,811	5.50%
Due after ten years	3,607	3,618	5.25%
	$ 11,259	$ 11,304	4.58%

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.

NOTE D - LOANS

Following is a summary of loans at December 31, 2003 and 2002:

	2003		2002	
	Amount	Percent of total	Amount	Percent of total
	(Dollars in thousands)			
Residential mortgage	$ 5,602	7.65%	$ 4,978	8.48%
Residential construction	3,113	4.25%	2,950	5.03%
Home equity lines of credit	4,198	5.73%	4,098	6.99%
Commercial and industrial loans	56,120	76.65%	43,861	74.75%
Loans to individuals	4,186	5.72%	2,787	4.75%
Total loans	73,219	100.00%	58,674	100.00%
Less:				
Allowance for loan losses	(1,033)		(845)	
Deferred loan fees and costs, net	(32)		(25)	
Net loans receivable	$ 72,154		$ 57,804	

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.

As of December 31, 2003 and 2002, impaired loans consisted of nonaccrual loans totaling $15,000 and $25,000, respectively. Interest income that would have been recorded on nonaccrual loans for the years ended December 31, 2003 and 2002 was not material. There were no restructured loans at December 31, 2003 or December 31, 2002.

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

	At or for the Years Ended December 31,	
	2003	2002
	(Dollars in thousands)	
Allowance for loan losses at beginning of year	$ 845	$ 523
Provision for loan losses	374	391
	1,219	914
Loans charged-off:		
Commercial and industrial	(182)	(38)
Loans to individuals	(15)	(33)
Total charge-offs	(197)	(71)
Recoveries of loans previously charged off:		
Commercial and industrial	11	-
Loans to individuals	-	2
Total recoveries	11	2
Net charge-offs	(186)	(69)
Allowance for loan losses at end of year	$ 1,033	$ 845
Net charge-offs as a percent of average loans outstanding during the year	0.28%	0.14%
Allowance for loan losses as a percent of loans at period end	1.41%	1.44%

NOTE D - LOANS (Continued)

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,			
	2003		2002	
	Amount	% of Total Loans	Amount	% of Total Loans
	(Dollars in thousands)			
Residential mortgage	$ 79	7.65%	$ 52	8.48%
Residential construction	44	4.25%	72	5.03%
Home equity lines of credit	59	5.73%	68	6.99%
Commercial and industrial loans	792	76.65%	496	74.75%
Loans to individuals	59	5.72%	41	4.75%
Total allocated	1,033	100.00%	729	100.00%
Unallocated	-		116	
Total	$ 1,033		$ 845	

At December 31, 2003, the Bank had loan commitments outstanding of $500,000, pre-approved but unused lines of credit totaling $14.5 million and commercial and standby letters of credit of $88,000. 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.

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:

	2003
Balance at beginning of year	$ 1,568,213
Borrowings	1,206,570
Repayments	(926,893)
Balance at end of year	$ 1,847,890

NOTE E - BANK PREMISES AND EQUIPMENT

Following is a summary of the Bank's premises and equipment at December 31, 2003 and 2002:

	2003	2002
Land	$ 251,037	$ 251,037
Buildings	1,237,990	1,237,990
Furniture and equipment	483,743	445,690
	1,972,770	1,934,717
Less accumulated depreciation	(388,139)	(296,220)
Total	$ 1,584,631	$ 1,638,497

Depreciation and amortization amounting to $91,919 and $119,489 for the years ended December 31, 2003 and 2002, respectively, is included in occupancy and equipment expense and data processing expense.

NOTE F - DEPOSITS

At December 31, 2002, the scheduled maturities of time deposit (dollars in thousands) are as follows:

2004	$ 23,736
2005	3,850
2006	4,307
2007	3,755
2008	668
Thereafter	20
Total	$ 36,336

The above table includes certificates of deposit of $100,000 and over, which at December 31, 2003, totaled $16,543,000. Of that total, $6,140,000 had scheduled maturities within three months; $1,817,000 after three but within six months; $2,577,000 after six but within twelve months; and $6,009,000 after twelve months.

The weighted average cost of time deposits was 2.96% and 3.38% at December 31, 2003 and 2002, respectively.

NOTE G - BORROWINGS

The Bank may purchase federal funds through unsecured federal funds lines of credit totaling $6.0 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 (1.36% at December 31, 2003). Advances totaling $343,000 were outstanding under these lines at December 31, 2003. There were no advances outstanding under these lines of credit at December 31, 2002. The maximum amounts outstanding under these lines of credit at any month end during 2003 and 2002 were $745,000 and $1,109,000, respectively. The average amounts outstanding under these lines of credit were $12,410 for 2003 and $3,750 for 2002.

NOTE G - BORROWINGS (Continued)

The Bank has an available line of credit with the FHLB equal to 10% of total assets. Advances under this line are secured by eligible securities and qualifying first mortgage loans. The balance of qualifying pledged first mortgage loans as of December 31, 2003 was approximately $9.1 million.

Advances from the Federal Home Loan Bank of Atlanta consisted of the following at December 31, 2003 and 2002:

Maturity	Interest Rate	2003	2002
March 14, 2006	1.88%	$ 750,000	$ -
July 16, 2012	3.90%	1,250,000	1,250,000
		$ 2,000,000	$ 1,250,000

NOTE H - INCOME TAXES

The significant components of the provision for income taxes for 2003 and 2002 are as follows:

	2003	2002
Current tax expense:		
Federal	$ 184,000	$ -
State	42,000	-
	226,000	-
Deferred tax expense:		
Federal	74,000	143,000
State	15,000	47,000
	89,000	190,000
Provision for income tax expense before adjustment to deferred tax asset valuation allowance	315,000	190,000
Decrease in valuation allowance	(315,000)	(190,000)
Net provision for income taxes	$ -	$ -

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

	2003	2002
Tax expense (benefit) computed at the statutory federal rate	$ 286,000	$ 180,000
Increase (decrease) resulting from:		
State income taxes, net of federal tax effect	37,000	22,000
Adjustment to deferred tax asset valuation allowance	(315,000)	(190,000)
Other permanent differences	(8,000)	(12,000)
Provision for income taxes	$ -	$ -

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, 2003 and 2002 are as follows:

	2003	2002
Deferred tax assets relating to:		
Allowance for loan losses	$ 303,000	$ 249,000
Pre-opening costs and expenses	39,000	73,000
Net operating loss carryforwards	-	83,000
Other	-	1,000
Total deferred tax assets	342,000	406,000
Less valuation allowance	(62,000)	(377,000)
Deferred tax assets net of valuation allowance	280,000	29,000
Deferred tax liabilities relating to:		
Fixed asset differences	(54,000)	(29,000)
Investment securities available for sale	(17,281)	(31,821)
Total deferred tax liabilities	(71,281)	(60,821)
Net recorded deferred tax asset (liabilities)	$ 208,719	$ (31,821)

NOTE I - OTHER NON-INTEREST EXPENSE

The major components of other non-interest expense for the years ended December 31, 2003 and 2002 are as follows:

	2003	2002
Postage, printing and office supplies	$ 66,922	$ 61,895
Advertising and promotion	79,981	64,742
Professional services	117,885	93,699
Other	182,331	152,725
Total	$ 447,119	$ 373,061

NOTE J - 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.

NOTE J - REGULATORY MATTERS (Continued)

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, 2003 and 2002, the Bank meets all capital adequacy requirements to which it is subject, as set forth below:

	For the Bank		Minimum Requirements	
	Capital Amount	Capital Ratio	For Capital Adequacy	To Be Well Capitalized
As of December 31, 2003				
Tier I capital (to risk-weighted assets)	$ 8,688	12.2%	4.0%	6.0%
Total capital - Tier II capital (to risk-weighted assets)	9,579	13.4	8.0	10.0
Leverage - Tier I capital (to average assets)	8,688	9.1	4.0	5.0
As of December 31, 2002				
Tier I capital (to risk-weighted assets)	$ 7,847	13.4%	4.0%	6.0%
Total capital - Tier II capital (to risk-weighted assets)	8,580	14.6	8.0	10.0
Leverage - Tier I capital (to average assets)	7,847	10.6	4.0	5.0

NOTE K - 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 sheets. 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.

NOTE K - OFF-BALANCE SHEET RISK (Continued)

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, 2003 is as follows:

Financial instruments whose contract amounts represent credit risk:	
Commitments to extend credit	$ 500,000
Undisbursed lines of credit	14,468,000
Commercial and standby letters of credit	88,000

NOTE L - DISCLOSURES ABOUT FAIR VALUES OF FINANCIAL INSTRUMENTS

Financial instruments include cash and due from banks, interest-bearing deposits in banks, federal funds sold, time deposits, investments, loans, stock in Federal Home Loan Bank of Atlanta, deposit accounts and borrowings. 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 In Banks and Federal Funds Sold

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

Time Deposits

The fair value of time deposits is estimated using rates currently offered for instruments of similar maturity.

NOTE L - 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.

Investment in Life Insurance

The carrying value of life insurance approximates fair value because this investment is carried at cash surrender value, as determined by the insurer.

Deposits and Borrowings

The fair value of demand, savings, money market and NOW deposits is the amount payable on demand at the reporting date. The fair value of time deposits and borrowings is estimated based on discounting cash flows 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 K, it is not practicable to estimate the fair value of future financing commitments.

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

Financial Instruments with Off-Balance Sheet Risk (Continued)

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, 2003 and 2002:

	2003		2002	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
	(In thousands)			
Financial assets:				
Cash and due from banks	$ 6,071	$ 6,071	$ 1,771	$ 1,771
Interest-earning deposits in banks	3,869	3,869	701	701
Federal funds sold	-	-	1,643	1,643
Time deposits	1,577	1,577	695	695
Investment securities	11,304	11,304	10,190	10,190
Federal Home Loan Bank stock	261	261	146	146
Investment in life insurance	1,229	1,229	-	-
Loans	72,154	72,396	57,804	58,801
Financial liabilities:				
Deposits	87,371	87,472	65,519	65,707
Borrowings	2,343	2,523	1,250	1,250

NOTE M - 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 years ended December 31, 2003 and 2002, expense attributable to the Plan amounted to $54,557 and $46,210, respectively.

Stock Option Plans

During 2002 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 69,352 shares of the Bank's common stock for an aggregate number of common shares reserved for options equal to 138,704. No options were granted prior to 2003 when, on August 31, options to purchase 114,000 shares of common stock were granted. All options granted vest over five years, with 20% vesting on the first anniversary of the grant date, and 20% vesting annually thereafter. All unexercised options expire ten years after the date of grant. A summary of the Bank's option plans as of and for the years ended December 31, 2003 and 2002, giving effect to the 11-for-10 stock split effected in the form of a 10% stock dividend in 2002 and the 21-for-20 stock split effected in the form of a 5% stock dividend in 2003, is as follows:

NOTE M - EMPLOYEE AND DIRECTOR BENEFIT PLANS (Continued)

Stock Option Plans (Continued)

			Outstanding Options		Exercisable Options	
	Shares in Plans	Shares Available for Future Grants	Number Outstanding	Weighted Average Exercise Price	Number Outstanding	Weighted Average Exercise Price
At December 31, 2001	138,704	138,704	-	$ -	-	$ -
Options granted/vested	-	-	-	-	-	-
At December 31, 2002	138,704	138,704	-	-	-	-
Options granted/vested	-	(114,000)	114,000	11.50	-	-
Options exercised	-	-	-	-	-	-
Options forfeited	-	-	-	-	-	-
At December 31, 2003	138,704	24,704	114,000	$ 11.50	-	$ -

The weighted average remaining life of total options outstanding as of December 31, 2003, all of which have an exercise price of $11.50 but none of which were exercisable on that date, is 9.7 years. No expense has been recognized in connection with the grant of these options. The fair value of each option granted in 2003 was $2.34, and was determined as of the date of grant using the Black-Scholes option pricing model, assuming a risk-free interest rate of 3.25%, a dividend yield of 0%, volatility of 0%, and an expected life of seven years.

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.

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

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
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

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 27401

Stock Transfer Agent

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

Independent Auditors

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

Common Stock

The Bank had 914,732 shares of Common Stock outstanding which were held by approximately 1,349 holders of record (excluding shares held in street name) as of December 31, 2003. The North Carolina Commissioner of Bank's approval of the Bank's organization was conditioned on the requirement that for a period of three years following commencement of its operations, the Bank not pay any cash dividend. Thereafter, the Commissioner's prior approval is required for the payment of any cash dividend by the Bank. To date, the Bank has not paid any cash dividend.

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 2003 and 2002, all of which were, to the knowledge of management, at a price of $11.00 to $12.00 per share.

Annual Shareholders Meeting

The 2004 Annual Meeting of shareholders of Cornerstone Bank will be held at 10:00 a.m. on May 25, 2004 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 2003 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.