CORNERSTONE BANK

2004 Annual Report

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Cornerstone Bank Web Address: www.thecornerstonebank.com

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

First-Citizens Bank & Trust Company
Corporate Trust Dept.
100 East Tryon Road
Raleigh, NC 27603
1-877-685-0576

Dear Stockholders,

With pride and joy, this 2004 Annual Report shows what we, together, have accomplished during these past four full years of operations, specifically the past year. Thank you for supporting our Bank, as stockholders and as customers.

Some highlights for 2004:

- Assets reached $120 million.
- Pre-tax income of $946,933 grew 12.5% over the previous year.
- Market share increased by 0.94%, solidifying our position of 3rd largest bank by deposits in Wilson County.
- New customer accounts, and more accounts from existing customers, were opened monthly.

Such growth also brought some growing pains. Some examples:

- Your Bank became fully taxable last year. We paid $264,996 in taxes, lowering our net income to $681,937.
- With continued growth in deposits, we have an increasing need for additional capital.
- A growing and maturing loan portfolio caused us to create larger loan loss reserves.
- We remain in a single location, comfortable in serving customers but a bit uncomfortable with space concerns for our staff.

We also have been active offering sophisticated services and products to meet the increasingly diverse financial needs of our customers. Some examples:

- We are a participating bank in the CDARS program, which is the Certificate of Deposit Account Registry Service. With CDARS, a customer can safely deposit more than $100,000 and still have full FDIC insurance. The customer receives a single statement, a known interest yield, and a single contact point, and other banks in the program then swap comparable deposits. The result is that deposits are within the limits of insurance at each bank. The system works. We will provide more details upon your request.
- We are one of 10 North Carolina community banks to invest in the new Community Trust of the Southeast. Its services are available to our customers and include retirement options, wealth transfer planning, tax planning, trust services, investment management, preservation of assets, and other highly specialized services often unavailable at community banks. We helped fill that niche.
- We remain partnered with Capital Investments for other non-banking products, especially for insurance and brokerage services.

Another pleasure of growth is the addition of staff members. We continue to hire the best and brightest of this area, and we steadily receive calls from prospective employees who want to join your organization and what it stands for. A few examples:

- Cheryl Parker joined us after 25 years at Centura, and she now handles our branch operations. She directs our training, cross-sales, and teller standards and procedures.
- Teena Lamm joined us after 15 years at BB&T, and she is a customer service representative. She is a high-profile banker in this community, and customers who prefer her personal style have also landed at Cornerstone.
- Graham Whitehead joined us from a local mortgage company, and he heads our mortgage center and assists with other retail lending needs.
- Dora Kicklighter is not a new employee but an original hire of Cornerstone five years ago, and she is now the first bank officer outside senior management. She was appointed vice president and principal accounting officer.

While much has been accomplished, much remains on our plate for the future. Some immediate steps include this:

- *Formation of a holding company*. CB Financial Corporation has been formed and we are requesting shareholder approval for it to become our bank holding company in the attached proxy statement. This change should put us in a position to grow, as we will have better access to capital through the trust preferred market and more flexibility in using our capital.
- *Market share growth*. Currently we are the 3rd largest bank in Wilson County in terms of deposits. Of the top five banks, three lost market share and much of that was to Cornerstone's gain. We distanced ourselves from the fourth bank, and closed the gap ever so slightly on the first and second banks. We have 11.35% of Wilson County deposits.
- *Additional banking centers.* We are very much aware of needing additional space for some of our accounting and back-office employees. We are currently reviewing options. We also have studied sites for an additional branch in Wilson, and we will make that decision later this year. A branch adds expenses and overhead, but we believe a new branch, properly located, can become profitable within a short period of time.
- *Additional loan production offices.* We continue to study opportunities for expanding our loan operations to other locations, even other markets. Our mortgage center, for example, could generate profits from numerous sites, as long as the right people are involved locally.

What you are probably sensing between the lines of our growth plan is that we remain careful and prudent with the profits of this Bank. *We remain adamant in never outgrowing our roots*. We are highly efficient in our operations, and are committed to enhancing the value of our stockholders' investments. We have been able to do so while also being fair to our customers.

We stayed true to serving the customers of this area even during periods of depressed net interest margins. Now, we are seeing relief, with six increases in prime rates during the past year. Economists predict more increases to follow. Because we are an asset sensitive bank, the widening of that gap should lead to improved profits, but we must also consider how we can help our customers. One example is our "Greenspan CD" which allows increases instantly with each rate change from the Federal Reserve. All the while, we have performed admirably. The performance of your Bank in the third and fourth quarters of 2004 was particularly strong.

As we begin a fifth full year of existence, we carry forth a sensible business plan which we are following closely. We are becoming the bank of preference in this market, and we believe our stockholders will remain satisfied with the results. Stockholders have been rewarded with three stock dividends in the past three years, and we believe our stockholders desire to be long-term investors in the Bank. In fact, there are very few transactions in our stock and we continue to provide an efficient no-cost matching service for buyers and sellers for those that have a need to sell their shares.

Please review the rest of our Annual Report, and realize that each of you helped get us to this point. We welcome your involvement with the Bank, we encourage you to take advantage of our products and services, and we look forward to seeing you soon.

Best wishes,

Thomas E. Brown III	Norman B. Osborn
Chairman, Board of Directors	President and CEO

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,				
	2004	2003	2002	2001	2000
	(Dollars in thousands, except per share data)				
Operating Data:					
Total interest income	$ 5,102	$ 4,285	$ 3,640	$ 2,792	$ 999
Total interest expense	1,920	1,845	1,534	1,557	512
Net interest income	3,182	2,440	2,106	1,235	487
Provision for loan losses	614	374	391	367	244
Net interest income after provision for loan losses	2,568	2,066	1,715	868	243
Total non-interest income	724	1,014	782	305	147
Total non-interest expense	2,345	2,239	1,969	1,542	1,116
Income tax expense	265	-	-	-	-
Net income (loss)	$ 682	$ 841	$ 528	$ (369)	$ (726)
Per Common Share Data: [1]					
Net income (loss) per share - basic	$ 0.71	$ 0.88	$ 0.67	$ (0.53)	$ (1.00)
Net income (loss) per share – diluted	0.70	0.88	0.67	(0.53)	(1.00)
Book value	9.79	9.07	8.24	6.97	7.53
Selected Year-End Balance Sheet Data:					
Loans	$ 89,330	$ 73,187	$ 58,649	$ 38,292	$ 16,359
Allowance for loan losses	1,216	1,033	845	523	244
Other earning assets	25,237	17,011	13,229	11,761	10,448
Total assets	119,972	98,674	74,974	54,173	29,235
Deposits	108,624	87,371	65,519	48,885	23,610
Borrowings	1,667	2,343	1,250	-	-
Stockholders' equity	9,396	8,716	7,909	5,078	5,485
Selected Average Balances:					
Total assets	$ 105,981	$ 89,666	$ 65,526	$ 41,068	$ 17,542
Loans	81,235	65,907	48,896	28,668	8,098
Total interest-earning assets	100,922	85,220	62,098	38,256	16,198
Deposits	93,852	78,742	58,210	35,397	11,736
Total interest-bearing liabilities	89,687	75,907	54,503	32,998	10,415
Stockholders' equity	8,703	8,336	6,014	5,485	5,740
Selected Performance Ratios:					
Return on average assets	0.64%	0.94%	0.81%	(0.90%)	(1.34%)
Return on average equity	7.84%	10.09%	8.78%	(6.73%)	(4.39%)
Net interest margin	3.15%	2.86%	3.39%	3.23%	4.72%
Non-interest expense to average assets	2.21%	2.50%	3.00%	3.77%	6.23%
Asset Quality Ratios:					
Allowance for loan losses to period-end loans	1.36%	1.41%	1.44%	1.37%	1.49%
Net loan charge-offs to average loans	0.53%	0.28%	0.14%	0.31%	-%
Capital Ratios:					
Total risk-based capital	12.13%	13.44%	14.63%	13.62%	29.00%
Tier 1 risk-based capital	10.88%	12.19%	13.39%	12.37%	27.70%
Leverage ratio	8.08%	9.13%	10.63%	10.00%	19.90%
Equity to assets	7.83%	8.83%	10.55%	9.37%	18.76%
Average equity to average assets	8.21%	9.30%	9.18%	13.36%	32.72%

(1) Adjusted for the 11-for-10 stock split in 2002, the 21-for-20 stock split in 2003 and the 5% stock dividend in 2004.

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, 2004 and 2003. 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 the 5% stock dividend in 2004.

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 management, the Bank's most significant accomplishments during 2004 were as follows:

- Captured additional deposit market share and now more than 11.35% of all deposits in Wilson County reside at Cornerstone Bank;
- Total assets increased 22%;
- Total loans increased 22%;
- Total deposits increased 24%;
- Net income before taxes increased 12.5% ;
- Maintained our asset quality;
- Positioned ourselves well for continued improvement of earnings in the event that interest rates continue to move upward, as a result of our asset sensitive position;
- Participated in the CDARS program, which is the Certificate of Deposit Account Registry Service, where a customer can safely deposit up to $10,000,000 and still have full FDIC insurance; and
- We are one of 10 North Carolina community banks to provide capital for opening Community Trust of the Southeast, which offers full trust services to our customers often unavailable at community banks.

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 13th consecutive quarter of profitability we have used up all tax credits and loss carry-forwards and provided income tax expense in 2004 of approximately 28% of our pre-tax income. Our tax burden may increase again in 2005;
- Maintaining our implicit pledge of fair customer pricing of deposit products and competing with sometimes irrational competition pricing;
- Finding new and maintaining existing non-interest revenue sources in light of the soft mortgage refinancing market;
- Balancing and controlling growth within our capital limitations - we anticipate augmenting regulatory capital through the issuance of trust preferred securities;
- Maintaining core deposit growth in a highly competitive market and sometimes irrational pricing competition;
- We remain in a single location, comfortable in serving customers but a bit uncomfortable with space concerns for our staff;
- Added costs associated with the current heightened regulatory environment; and
- Maintaining asset quality after a sustained period of economic sluggishness and inevitable problems with a maturing loan portfolio.

FINANCIAL CONDITION
December 31, 2004 and 2003

During 2004 the Bank continued its strong growth, ending the year with total assets of $120.0 million, an increase of $21.3 million or 21.6% from the beginning of year total assets of $98.7 million. The growth in total assets was funded primarily by inflows of customer deposits, which increased by $21.3 million or 24.3% to $108.6 million, up from $87.4 million at December 31, 2003. Other sources of funding for asset growth included net income of $682,000. Total loans grew by $16.1 million and closed the year at $89.3 million, an increase of 22% from total loans at December 31, 2003. 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 $26.0 million, or 21.7% of total assets, at December 31, 2004, representing an increase of $3.2 million over the beginning of year total of $22.8 million. Total stockholders' equity increased from $8.7 million at December 31, 2003 to $9.4 million at December 31, 2004 as a result of retention of net income of $682,000. At December 31, 2004, 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, 2004 and 2003

Overview. The Bank earned net income of $682,000 or $0.71 per basic share for the year ended December 31, 2004, as compared with net income of $841,000 or $0.88 per basic share for 2003. This decline of $159,000 or $0.17 per share in net operating results was principally attributable to a $265,000 income tax expense, or $0.28 per share, as the Bank became fully taxable in 2004. Net interest income after the provision for loan losses increased by $502,000, from $2.1 million for the year ended December 31, 2003 to $2.6 million for the year ended December 31, 2004. Non-interest income for the same year decreased by $290,000, from $1.0 million to $724,000. Non-interest expenses increased $107,000 from $2.2 million for 2003 to $2.3 million for the year ended December 31, 2004.

Net Interest Income. Net interest income increased to $3.2 million for the year ended December 31, 2004, a $742,000 or 30% increase from the $2.4 million earned in 2003. Total interest income benefited from growth in the level of average earning assets, which offset the lower asset yields during most of 2004. Total interest income also benefited from an increase in short-term interest rates, which began rising on July 1, 2004 and rose 1.25% by year-end. Average total interest-earning assets increased by $15.7 million or 18.4% during the year ended December 31, 2004, as compared to the year ended December 31, 2003, while the average interest rate earned increased by 3 basis points from 5.03% to 5.06%. Average total interest-bearing liabilities increased by $13.8 million, consistent with the increase in interest-earning assets, and yielded a 29 basis point decrease in average cost, from 2.43% during 2003 to 2.14% in 2004. For the year ended December 31, 2004, the interest rate spread was 2.92%, a 32 basis point improvement from the year ended December 31, 2003 interest rate spread of 2.60%.

Provision for Loan Losses. The Bank recorded a $614,000 provision for loan losses in 2004, after incurring $431,000 in net charge offs. 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 and business conditions and other relevant factors. In both 2004 and 2003, the provision for loan losses was made principally in response to growth in loans, as total loans outstanding increased by $16.1 million in 2004 and by $14.5 million in 2003, and to net loan charge-offs, which were $431,000 in 2004 and $186,000 in 2003. At December 31, the allowance for loan losses was $1.2 million for 2004 and $1.0 million for 2003, representing 1.36% and 1.41%, respectively, of loans outstanding. At December 31, 2004, loans delinquent more than 90 days or on non-accrual amounted to $293,000. Interest income that would have been recorded on nonaccrual loans was immaterial for the year ended December 31, 2004. There were $15,000 of non-performing loans at December 31, 2003. The $431,000 in net charge offs resulted primarily from write-downs of two commercial loan relationships.

Non-Interest Income. Non-interest income decreased by $290,000, from $1 million for 2003 to $724,000 for 2004. Service fees and charges, which represent a relatively stable and predictable source of non-interest income, totaled $365,000 for 2004, as compared with $270,000 of service fees and charges earned in 2003, an increase related principally to deposit growth. The other major source of non-interest income, mortgage loan fees, decreased in 2004, as a result of the slow down of the refinance market and rising interest rates. 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 which were unusually high during 2002 and 2003 declined in 2004 because of the increase in mortgage interest rates. As a result, the Bank's income from mortgage operations dropped from $658,000 during 2003 to $208,000 earned during the year ended December 31, 2004. The Bank's management will continue efforts to develop sources of additional non-interest income.

Non-Interest Expenses. Non-interest expenses totaled $2.3 million for the year ended December 31, 2004, an increase of $106,000 from the total of $2.2 million for the year ended December 31, 2003, as a decrease in salaries and employee benefits of $110,000 was more than offset by an aggregate increase of $216,000 in the other components of non-interest expenses. Salaries and benefits decreased as a result of lower commission based compensation related to mortgage operations, the income from which declined by 68.3% (see *Non-Interest Income*). The aggregate increase in the other categories of non-interest expenses is primarily attributable to the Bank's growth from period to period. The Bank's plan for 2005 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's 2004 income tax expense of $265,000, representing 28% of income before income taxes, reflected the utilization of $62,000 of deferred tax assets generated in prior years. The Bank recorded no income tax expense in 2003, despite having income before income taxes, because of recognition of previously generated deferred tax assets. For 2005, the Bank expects that the provision for income taxes for the year will be approximately 35% to 37% 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 increases will generally result in an immediate rise in the Bank's interest income on loans, with a more delayed impact on interest expense because increases 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. Non-accrual loans have been included in determining average loans.

	Year Ended December 31, 2004			Year Ended December 31, 2003		
	Average balance	Interest Income/ Expense	Yield/ Cost	Average balance	Interest Income/ Expense	Yield/ Cost
			(Dollars in thousands)			
Interest-earning assets:						
Loans	$ 81,235	$ 4,529	5.58%	$ 65,907	$ 3,776	5.73%
Investment securities [1]	14,239	485	3.41%	13,563	436	3.21%
Other interest-earning assets [2]	5,448	88	1.62%	5,750	73	1.27%
Total interest-earning assets	100,922	5,102	5.06%	85,220	4,285	5.03%
Other assets	5,059			4,446		
Total assets	$ 105,981			$ 89,666		
Interest-bearing liabilities:						
Deposits:						
Savings, NOW and money market	$ 46,754	756	1.62%	$ 39,325	670	1.70%
Time deposits over $100,000	12,786	348	2.72%	12,310	376	3.05%
Other time deposits	27,265	738	2.71%	22,312	736	3.30%
Borrowings	2,882	78	2.71%	1,960	63	3.21%
Total interest-bearing liabilities	89,687	1,920	2.14%	75,907	1,845	2.43%
Noninterest-bearing deposits	7,047			4,795		
Other liabilities	544			628		
Stockholders' equity	8,703			8,336		
Total liabilities and stockholders' equity	$ 105,981			$ 89,666		
Net interest income/interest rate spread		$ 3,182	2.92%		$ 2,440	2.60%
Net interest margin			3.15%			2.86%
Ratio of interest-earning assets to interest-bearing liabilities	112.53%			112.27%		

[1] Includes time deposits, investment securities available for sale and held to maturity 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, 2004 vs. 2003		
	Increase (Decrease) Due to		
	Volume	Rate	Total
	(Dollars in thousands)		
Interest income:			
Loans	$ 866	$ (113)	$ 753
Investment securities	22	27	49
Other interest-earning assets	(4)	19	15
Total interest income	884	(67)	817
Interest expense:			
Deposits:			
Savings, NOW and money market	123	(37)	86
Time deposits over $100,000	14	(42)	(28)
Other time deposits	149	(147)	2
Borrowings	27	(12)	15
Total interest expense	313	(238)	75
Net interest income increase	$ 571	$ 171	$ 742

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, 2004, were $88.1 million compared to $72.2 million at December 31, 2003, an increase of 22.0%. 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, 2004, 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 22% and 23% of the Bank's total assets at December 31, 2004 and 2003, 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 $11.5 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, 2004, there was $1.7 million outstanding under this line of credit.

Total deposits were $108.6 million and $87.4 million at December 31, 2004 and 2003, respectively. Time deposits, which are the only deposit accounts that have stated maturity dates, are generally considered to be rate sensitive. Time deposits represented 43.4% and 41.6%, respectively, of total deposits at December 31, 2004 and 2003. Time deposits of $100,000 or more represented 19.4% and 18.9% of the Bank's total deposits at December 31, 2004 and 2003, respectively. At December 31, 2004, the Bank had $2.2 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, 2004 (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 7.83 % at December 31, 2004. As the following table indicates, at December 31, 2004, the Bank exceeded regulatory capital requirements.

	At December 31, 2004		
	Actual Ratio	Minimum Requirement	Well-Capitalized Requirement
Total risk-based capital ratio	12.13%	8.00%	10.00%
Tier 1 risk-based capital ratio	10.88%	4.00%	6.00%
Leverage ratio	8.08%	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 POLICIES

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, 2004, 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, 2004, 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, 2004				
	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	$ 79,895	$ -	$ -	$ -	$ 79,895
Fixed rate	3,431	3,408	1,888	708	9,435
Securities available for sale	1,004	2,480	504	6,920	10,908
Securities held to maturity	-	-	254	1,409	1,663
Other interest-earning assets	11,303	1,091	-	272	12,666
Total interest-earning assets	$ 95,633	$ 6,979	$ 2,646	$ 9,309	$ 114,567
Interest-bearing liabilities:					
Deposits:					
Savings, NOW and money market	$ 45,276	$ -	$ -	$ -	$ 45,276
Time over $100,000	10,520	6,667	3,838	-	21,025
Other time	14,333	6,309	5,477	-	26,119
Borrowings	-	417	-	1,250	1,667
Total interest-bearing liabilities	$ 70,129	$ 13,393	$ 9,315	$ 1,250	$ 94,087
Interest sensitivity gap per period	$ 25,504	$ (6,414)	$ (6,669)	$ 8,059	$ 20,480
Cumulative interest sensitivity gap	$ 25,504	$ 19,090	$ 12,421	$ 20,480	$ 20,480
Cumulative gap as a percentage of total interest-earning assets	28.27%	21.16%	13.77%	22.70%	22.70%
Cumulative interest-earning assets as a percentage of interest-bearing liabilities	136.37%	110.05%	114.56%	119.51%	121.77%

ASSET QUALITY AND THE ALLOWANCE FOR LOAN LOSSES

The financial statements of the Bank are prepared on the accrual basis of accounting, including the recognition of interest income on the Bank's loan portfolio, unless a loan is placed on a non-accrual basis. Loans are placed on a non-accrual basis when there are serious doubts about the collectibility of principal or interest. Amounts received on non-accrual loans generally are applied first to principal and then to interest only after all principal has been collected. Restructured loans are those for which concessions, including the reduction of interest rates below a rate otherwise available to that borrower or the deferral of interest or principal, have been granted due to the borrower's weakened financial condition. Interest on restructured loans is accrued at the restructured rates when it is anticipated that no loss of original principal will occur. The Bank's impaired loans consisted of $0 and $15,000 in non-accrual loans at December 31, 2004 and 2003, 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.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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, 2004 and 2003, 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 the standards of the Public Company Accounting Oversight Board (United States). 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, 2004 and 2003 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
March 3, 2005

CORNERSTONE BANK
BALANCE SHEETS
December 31, 2004 and 2003

	2004	2003
ASSETS		
Cash and due from banks	$ 2,717,103	$ 6,070,729
Interest-earning deposits in banks	3,396,432	3,868,985
Federal funds sold	4,680,000	-
Time deposits	4,316,439	1,577,000
Investment securities available for sale, at fair value (Note C)	10,908,287	11,303,964
Investment securities held to maturity, at amortized cost (Note C)	1,663,116	-
Loans (Note D)	89,330,086	73,187,068
Allowance for loan losses	(1,215,979)	(1,033,238)
NET LOANS	88,114,107	72,153,830
Accrued interest receivable	442,982	317,359
Stock in Federal Home Loan Bank of Atlanta, at cost	272,400	260,800
Bank premises and equipment (Note E)	1,539,750	1,584,631
Bank-owned life insurance	1,285,591	1,229,448
Real estate owned	38,965	-
Other assets	597,032	307,102
TOTAL ASSETS	$ 119,972,204	$ 98,673,848
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Demand	$ 16,203,444	$ 8,075,501
Savings	1,092,772	1,108,014
Money market and NOW	44,183,864	41,851,828
Time over $100,000 (Note F)	21,025,277	16,543,406
Time (Note F)	26,118,694	19,792,738
TOTAL DEPOSITS	108,624,051	87,371,487
Federal funds purchased	-	343,000
Advances from Federal Home Loan Bank	1,666,667	2,000,000
Accrued interest payable	107,362	87,352
Accrued expenses and other liabilities	178,603	156,369
TOTAL LIABILITIES	110,576,683	89,958,208
Commitments (Notes K and M)		
Stockholders' equity (Notes J and M):		
Common stock, $5 par value, 20,000,000 shares authorized; 959,728 and 914,732 shares issued and outstanding at December 31, 2004 and 2003, respectively	4,798,640	4,573,660
Additional paid-in capital	4,112,068	3,839,817
Retained earnings	459,322	274,616
Accumulated other comprehensive income	25,491	27,547
TOTAL STOCKHOLDERS' EQUITY	9,395,521	8,715,640
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 119,972,204	$ 98,673,848

See accompanying notes.

CORNERSTONE BANK
STATEMENTS OF OPERATIONS
Years Ended December 31, 2004 and 2003

	2004	2003
INTEREST INCOME		
Loans	$ 4,529,112	$ 3,774,601
Investment securities	419,875	391,509
Federal funds sold	11,490	26,535
Interest-earning bank deposits	76,668	46,176
Other interest and dividends	65,091	45,924
TOTAL INTEREST INCOME	5,102,236	4,284,745
INTEREST EXPENSE		
Money market, NOW and savings deposits	755,746	669,456
Time deposits	1,086,784	1,112,227
Borrowings	77,560	63,178
TOTAL INTEREST EXPENSE	1,920,090	1,844,861
NET INTEREST INCOME	3,182,146	2,439,884
PROVISION FOR LOAN LOSSES (Note D)	613,856	373,769
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	2,568,290	2,066,115
NON-INTEREST INCOME		
Service charges on deposit accounts	365,133	270,201
Mortgage operations	208,234	657,563
Gain (loss) on sale of investment securities	(12,156)	16,562
Other income	163,088	69,842
TOTAL NON-INTEREST INCOME	724,299	1,014,168
NON-INTEREST EXPENSE		
Salaries and employee benefits	1,301,394	1,411,285
Occupancy and equipment	151,821	149,416
Data processing expenses	294,337	231,344
Other (Note I)	598,104	447,119
TOTAL NON-INTEREST EXPENSE	2,345,656	2,239,164
INCOME BEFORE INCOME TAXES	946,933	841,119
INCOME TAXES (Note H)	264,996	-
NET INCOME	$ 681,937	$ 841,119
NET INCOME PER SHARE		
Basic	$ 0.71	$ 0.88
Diluted	0.70	0.88
WEIGHTED AVERAGE SHARES OUTSTANDING		
Basic	959,728	959,728
Diluted	973,666	960,577

See accompanying notes.

CORNERSTONE BANK
STATEMENTS OF COMPREHENSIVE INCOME
Years Ended December 31, 2004 and 2003

	2004	2003
NET INCOME	$ 681,937	$ 841,119
OTHER COMPREHENSIVE LOSS:		
Securities available for sale:		
Unrealized holding losses on		
available-for-sale securities	(15,502)	(32,202)
Tax effect	5,977	9,602
Reclassification of (gains) losses recognized		
in net income	12,156	(16,562)
Tax effect	(4,687)	4,938
TOTAL OTHER COMPREHENSIVE LOSS	(2,056)	(34,224)
COMPREHENSIVE INCOME	$ 679,881	$ 806,895

See accompanying notes.

CORNERSTONE BANK
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 2004 and 2003

	Common stock		Additional paid-in capital	Retained earnings (deficit)	Accumulated other comprehensive income (loss)	Total equity
	Shares	Amount				
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 loss	-	-	-	-	(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
Net income	-	-	-	681,937	-	681,937
Other comprehensive loss	-	-	-	-	(2,056)	(2,056)
5% stock dividend	44,996	224,980	272,251	(497,231)	-	-
Balance at December 31, 2004	959,728	$ 4,798,640	$ 4,112,068	$ 459,322	$ 25,491	$ 9,395,521

See accompanying notes.

CORNERSTONE BANK
STATEMENTS OF CASH FLOWS
Years Ended December 31, 2004 and 2003

	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 681,937	$ 841,119
Adjustments to reconcile net income to		
net cash provided by operating activities:		
Depreciation and amortization	186,090	268,317
Realized (gain) loss on available-for-sale securities	12,156	(16,562)
Provision for loan losses	613,856	373,769
Earnings on bank-owned life insurance	(56,143)	(30,534)
Deferred income tax benefit	(33,000)	(226,000)
Change in assets and liabilities:		
Increase in accrued interest receivable	(125,623)	(11,556)
(Increase) decrease in other assets	49,847	(18,739)
Increase in accrued interest payable	20,010	5,966
Increase (decrease) in accrued expenses and other liabilities	22,234	(26,572)
NET CASH PROVIDED BY OPERATING ACTIVITIES	1,371,364	1,159,208
CASH FLOWS FROM INVESTING ACTIVITIES		
Net purchases of time deposits	(2,739,439)	(882,000)
Purchase of available-for-sale securities	(5,344,908)	(7,531,573)
Sales of available for sale investments	2,299,525	834,909
Maturities and calls of available for sale investments	3,332,634	5,373,744
Purchases of held to maturity securities	(1,662,486)	-
Net increase in loans	(16,613,098)	(14,723,341)
Purchase of Federal Home Loan Bank stock	(11,600)	(114,600)
Purchase of other assets	(305,486)	-
Purchases of bank premises and equipment	(48,916)	(38,053)
Purchase of bank-owned life insurance	-	(1,198,914)
NET CASH USED BY INVESTING ACTIVITIES	(21,093,774)	(18,279,828)
CASH FLOWS FROM FINANCING ACTIVITIES		
Increase in deposits	21,252,564	21,852,213
Net increase (decrease) in FHLB advances	(333,333)	750,000
Net increase (decrease) in federal funds purchased	(343,000)	343,000
NET CASH PROVIDED BY FINANCING ACTIVITIES	20,576,231	22,945,213
NET INCREASE IN CASH AND CASH EQUIVALENTS	853,821	5,824,593
CASH AND CASH EQUIVALENTS, BEGINNING	9,939,714	4,115,121
CASH AND CASH EQUIVALENTS, ENDING	$ 10,793,535	$ 9,939,714
CASH AND CASH EQUIVALENTS		
Cash and due from banks	$ 2,717,103	$ 6,070,729
Interest-earning deposits in banks	3,396,432	3,868,985
Federal funds sold	4,680,000	-
	$ 10,793,535	$ 9,939,714
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Interest paid on deposits and borrowings	$ 1,900,080	$ 1,512,689
Income taxes paid	219,790	247,000
Unrealized loss on investment securities available for sale, net	(2,056)	(34,224)
Transfer from loans to real estate acquired in settlement of loan	38,965	-

See accompanying notes.

NOTE A - ORGANIZATION AND OPERATIONS

Cornerstone Bank (the "Bank") was incorporated on 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 in 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.

Investment Securities Held to Maturity

Investment securities that management has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using the interest method over the period to maturity.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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.

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 business and 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.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock in Federal Home Loan Bank of Atlanta and Community Trust of the Southeast

As a requirement for membership, the Bank invests in stock of the Federal Home Loan Bank of Atlanta ("FHLB"), which is carried at cost. Because of the redemption provisions of the FHLB, the Bank estimated that fair value equals cost and that this investment was not impaired at December 31, 2004.

During 2004 the Bank invested $305,486 in Community Trust of the South, which provides a variety of services to its investor community banks, including retirement options, wealth transfer planning, tax planning, trust services, investment management, preservation of assets, and other highly specialized services often unavailable at community banks. This investment, which is carried at cost, was not evaluated for impairment because the Bank did not estimate the fair value of this investment and did not identify any events or changes in circumstances that may have had a significant adverse effect on the fair value of this investment. This investment is included in other assets in the accompanying balance sheet.

Real Estate Owned

Real estate acquired through, or in lieu of, loan foreclosure is initially recorded at fair value at the date of foreclosure establishing a new cost basis. After foreclosure, valuations of the property are periodically performed by management and the real estate is carried at the lower of cost or fair value minus estimated cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in other non-interest expense.

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.

Comprehensive Income

The Bank reports as comprehensive income all changes in stockholders' 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.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock Compensation Plans

Statement of Financial Accounting Standards ("SFAS") No. 123, *Accounting for Stock-Based Compensation*, encourages all entities to adopt a fair value based method of accounting for employee stock compensation plans, whereby compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. However, it also allows an entity to 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.

	2004	2003
	(Amounts in thousands, except per share data)	
Net income:		
As reported	$ 682	$ 841
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(52)	(18)
Pro forma	$ 630	$ 823
Basic net income per share:		
As reported	$ .71	$ .88
Pro forma	.66	.86
Diluted net income per share:		
As reported	$ .70	$ .88
Pro forma	.65	.86

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.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Per Share Results (Continued)

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

	2004	2003
Weighted average outstanding shares used for basic EPS	959,728	959,728
Plus incremental shares from assumed exercise of stock options	13,938	849
Weighted average outstanding shares used for diluted EPS	973,666	960,577

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, 2004 and 2003, 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 May 12, 2004, the Bank's Board of Directors declared a 5% stock dividend, which was distributed May 31, 2004, to shareholders of record on April 30, 2004. All references to per share results and weighted average common and common equivalent shares outstanding have been adjusted to reflect the effects of this stock dividend.

Recent Accounting Pronouncements

On March 9, 2004, the SEC Staff issued Staff Accounting Bulletin No. 105, *Application of Accounting Principles to Loan Commitments* ("SAB 105"). SAB 105 clarifies existing accounting practices relating to the valuation of issued loan commitments, including interest rate lock commitments ("IRLC"), subject to SFAS No. 149 and Derivative Implementation Group Issue C13, Scope Exceptions: When a Loan Commitment is included in the Scope of Statement 133. Furthermore, SAB 105 disallows the inclusion of the values of a servicing component and other internally developed intangible assets in the initial and subsequent IRLC valuation. The provisions of SAB 105 were effective for loan commitments entered into after March 31, 2004. The adoption of SAB 105 did not have a material impact on the financial statements.

In March 2004, the Emerging Issues Task Force ("EITF") released EITF Issue 03-01, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. The Issue provides guidance for determining whether an investment is other-than-temporarily impaired and requires certain disclosures with respect to these investments. The recognition and measurement guidance for other-than-temporary impairment has been delayed by the issuance of FASB Staff Position EITF 03-1-1 on September 30, 2004. The adoption of Issue 03-1 did not result in any other-than-temporary impairment.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recent Accounting Pronouncements (Continued)

In December 2004, the FASB issued SFAS No. 123(R), *Accounting for Stock-Based Compensation* (SFAS No. 123(R)). SFAS No. 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123(R) requires that the fair value of such equity instruments be recognized as an expense in the historical financial statements as services are performed. Prior to SFAS No. 123(R), only certain pro forma disclosures of fair value were required. For the Bank, the provisions of this Statement are effective for the first interim reporting period that begins after December 15, 2005. Accordingly, the Bank will adopt SFAS No. 123(R) commencing with the quarter ending March 31, 2006. If the Bank had included the cost of employee stock option compensation in their financial statements, their net income for the fiscal years ended December 31, 2004 and 2003 would have decreased by approximately $52,000 and $18,000, respectively. Accordingly, the adoption of SFAS No. 123(R) is expected to have a material effect on the Bank's financial statements.

Reclassifications

Certain amounts in the 2003 financial statements have been reclassified to conform to the 2004 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 investment securities, with gross unrealized gains and losses, are as follows:

	December 31, 2004			
	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	$ 5,020,122	$ 6,669	$ (18,197)	$ 5,008,594
Mortgage-backed securities	5,846,683	61,682	(8,672)	5,899,693
	$ 10,866,805	$ 68,351	$ (26,869)	$ 10,908,287

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Securities held to maturity:				
Municipal securities	$ 1,663,116	$ 22,145	$ -	$ 1,685,261

NOTE C - INVESTMENT SECURITIES (Continued)

	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

The following tables show gross unrealized losses and fair values of investment securities, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, at December 31, 2004 and 2003. At December 31, 2004, the unrealized losses relate to five U.S. government and U.S. government agency securities and five mortgage-backed securities, including one mortgage-backed security that had a continuous unrealized loss for more than twelve months. The unrealized losses relate to debt securities that have incurred fair value reductions due to higher market interest rates since the securities were purchased. The unrealized losses are not likely to reverse unless and until market interest rates decline to the levels that existed when the securities were purchased. Because none of the unrealized losses relate to the marketability of the securities or the issuer's ability to honor redemption obligations, none of the securities are deemed to be other than temporarily impaired.

	December 31, 2004					
	Less Than 12 Months		12 Months or More		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Securities available for sale:						
U. S. government securities and obligations of U.S. government agencies	$2,481,094	$ 18,197	$ -	$ -	$2,481,094	$ 18,197
Mortgage-backed securities	2,638,061	5,103	645,689	3,569	3,283,750	8,672
Total temporarily impaired securities	$5,119,155	$ 23,300	$ 645,689	$ 3,569	$5,764,844	$ 26,869

	December 31, 2003					
	Less Than 12 Months		12 Months or More		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
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 $997,813 and $1,530,938 at December 31, 2004 and 2003, respectively, were pledged to secure borrowings.

NOTE C - INVESTMENT SECURITIES (Continued)

For the years ended December 31, 2004 and 2003, proceeds from sales of securities available for sale amounted to $2,299,525 and $834,909, respectively. From the sales, gross realized losses amounted to $12,156 and $0 and gross realized gains amounted to $0 and $16,562 for the years ended December 31, 2004 and 2003, respectively.

The amortized cost, fair value and weighted average yield of the Bank's investment securities at December 31, 2004, 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	$ 1,006	$ 1,005	3.57%
Due after one but within five years	2,996	2,984	3.07%
Due after five but within ten years	1,018	1,020	6.61%
	5,020	5,009	3.89%
Mortgage-backed securities			
Due after five but within ten years	1,058	1,054	4.63%
Due after ten years	4,789	4,846	4.86%
	5,847	5,900	4.82%
Total securities available for sale			
Due within one year	1,006	1,005	3.57%
Due after one but within five years	2,996	2,984	3.07%
Due after five but within ten years	2,076	2,074	5.61%
Due after ten years	4,789	4,846	4.86%
	$ 10,867	$ 10,909	4.39%

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.

The amortized cost, fair value and weighted average yield of the Bank's investment securities held to maturity at December 31, 2004, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

NOTE C - INVESTMENT SECURITIES (Continued)

	Amortized Cost	Fair Value	Weighted Average/ Yield
	(Dollars in thousands)		
Securities held to maturity:			
Municipal securities:			
Due after one but within five years	$ 254	$ 254	3.00%
Due after five but within ten years	427	435	3.54%
Due after ten years	982	996	4.02%
Total securities held to maturity	$ 1,663	$ 1,685	3.74%

NOTE D - LOANS

Following is a summary of loans at December 31, 2004 and 2003:

	2004		2003	
	Amount	Percent of total	Amount	Percent of total
	(Dollars in thousands)			
Residential mortgage	$ 3,724	4.17%	$ 5,602	7.65%
Residential construction	4,068	4.55%	3,113	4.25%
Home equity lines of credit	5,574	6.24%	4,198	5.73%
Commercial and industrial loans	71,376	79.87%	56,120	76.65%
Loans to individuals	4,618	5.17%	4,186	5.72%
Total loans	89,360	100.00%	73,219	100.00%
Less:				
Allowance for loan losses	(1,216)		(1,033)	
Deferred loan fees and costs, net	(30)		(32)	
Net loans receivable	$ 88,114		$ 72,154	

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, 2004 there were no impaired or nonaccrual loans, and loans greater than 90 days past due that continued to accrue interest totaled $293,000. As of December 31, 2003, impaired loans consisted of nonaccrual loans totaling $15,000. Interest income that would have been recorded on nonaccrual loans for the years ended December 31, 2004 and 2003 was not material. There were no restructured loans at December 31, 2004 or December 31, 2003.

NOTE D - LOANS (Continued)

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

	At or for the Years Ended December 31, 2004	2003
	(Dollars in thousands)	
Allowance for loan losses at beginning of year	$ 1,033	$ 845
Provision for loan losses	614	374
	1,647	1,219
Loans charged-off:		
Real estate	(25)	-
Commercial and industrial	(396)	(182)
Loans to individuals	(16)	(15)
Total charge-offs	(437)	(197)
Recoveries of loans previously charged off:		
Commercial and industrial	1	11
Home equity	5	-
Loans to individuals	-	-
Total recoveries	6	11
Net charge-offs	(431)	(186)
Allowance for loan losses at end of year	$ 1,216	$ 1,033
Net charge-offs as a percent of average loans outstanding during the year	0.53%	0.28%
Allowance for loan losses as a percent of loans at period end	1.36%	1.41%

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, 2004		2003	
	Amount	% of Total Loans	Amount	% of Total Loans
	(Dollars in thousands)			
Residential mortgage	$ 51	4.17%	$ 79	7.65%
Residential construction	55	4.55%	44	4.25%
Home equity lines of credit	76	6.24%	59	5.73%
Commercial and industrial loans	971	79.87%	792	76.65%
Loans to individuals	63	5.17%	59	5.72%
Total	$ 1,216	100.00%	$ 1,033	100.00%

At December 31, 2004, the Bank had loan commitments outstanding of $330,000, pre-approved but unused lines of credit totaling $21.3 million and commercial and standby letters of credit of $73,000. 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.

NOTE D - LOANS (Continued)

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

	2004
Balance at beginning of year	$ 1,847,890
Borrowings	684,514
Repayments	(747,497)
Balance at end of year	$ 1,784,907

NOTE E - BANK PREMISES AND EQUIPMENT

Following is a summary of the Bank's premises and equipment at December 31, 2004 and 2003:

	2004	2003
Land	$ 251,037	$ 251,037
Buildings	1,237,990	1,237,990
Furniture and equipment	532,658	483,743
	2,021,685	1,972,770
Less accumulated depreciation	(481,935)	(388,139)
Total	$ 1,539,750	$ 1,584,631

Depreciation and amortization amounting to $93,797 and $91,919 for the years ended December 31, 2004 and 2003, respectively, is included in occupancy and equipment expense and data processing expense.

NOTE F - DEPOSITS

At December 31, 2004, the scheduled maturities of time deposit (dollars in thousands) are as follows:

2005	$ 24,853
2006	8,733
2007	4,243
2008	8,124
2009	1,191
Total	$ 47,144

The above table includes certificates of deposit of $100,000 and over, which at December 31, 2004, totaled $21,025,277. Of that total, $3,809,606 had scheduled maturities within three months; $4,221,943 after three but within six months; $2,488,291 after six but within twelve months; and $10,505,437 after twelve months.

NOTE F - DEPOSITS (Continued)

The weighted average cost of time deposits was 2.93% and 2.96% at December 31, 2004 and 2003, respectively.

NOTE G - BORROWINGS

The Bank may purchase federal funds through unsecured federal funds lines of credit totaling $11.5 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 (2.15% at December 31, 2004). 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, 2004. The maximum amounts outstanding under these lines of credit at any month end during 2004 and 2003 were $3,000,000 and $745,000, respectively. The average amounts outstanding under these lines of credit were $276,390 for 2004 and $12,410 for 2003.

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, 2004 was approximately $9.9 million.

Advances from the FHLB of Atlanta consisted of the following at December 31, 2004 and 2003:

Maturity	Interest Rate	2004	2003
March 14, 2006	1.88%	$ 416,667	$ 750,000
July 16, 2012	3.90%	1,250,000	1,250,000
		$ 1,666,667	$ 2,000,000

NOTE H - INCOME TAXES

The significant components of the provision for income taxes for 2004 and 2003 are as follows:

	2004	2003
Current tax provision:		
Federal	$ 255,996	$ 184,000
State	42,000	42,000
	297,996	226,000
Deferred tax provision:		
Federal	25,000	74,000
State	4,000	15,000
	29,000	89,000
Provision for income tax expense before adjustment to deferred tax asset valuation allowance	326,996	315,000
Decrease in valuation allowance	(62,000)	(315,000)
Net provision for income taxes	$ 264,996	$ -

NOTE H - INCOME TAXES (Continued)

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

	2004	2003
Tax expense computed at the statutory federal rate	$ 322,000	$ 286,000
Increase (decrease) resulting from:		
State income taxes, net of federal tax effect	30,000	37,000
Nontaxable income	(27,000)	(10,000)
Adjustment to deferred tax asset valuation allowance	(62,000)	(315,000)
Other permanent differences	1,996	2,000
Provision for income taxes	$ 264,996	$ -

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, 2004 and 2003 are as follows:

	2004	2003
Deferred tax assets relating to:		
Allowance for loan losses	$ 340,000	$ 303,000
Pre-opening costs and expenses	6,000	39,000
Total deferred tax assets	346,000	342,000
Less valuation allowance	-	(62,000)
Deferred tax assets net of valuation allowance	346,000	280,000
Deferred tax liabilities relating to:		
Fixed asset differences	(71,000)	(54,000)
Prepaid expenses	(16,000)	-
Investment securities available for sale	(15,991)	(17,281)
Total deferred tax liabilities	(102,991)	(71,281)
Net recorded deferred tax asset	$ 243,009	$ 208,719

NOTE I - OTHER NON-INTEREST EXPENSE

The major components of other non-interest expense for the years ended December 31, 2004 and 2003 are as follows:

	2004	2003
Postage, printing and office supplies	$ 74,176	$ 66,922
Advertising and promotion	88,446	79,981
Professional services	148,998	117,885
Other	286,484	182,331
Total	$ 598,104	$ 447,119

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 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, 2004 and 2003, 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, 2004				
Tier I capital (to risk-weighted assets)	$ 9,370	10.9%	4.0%	6.0%
Total capital - Tier II capital (to risk-weighted assets)	10,449	12.1	8.0	10.0
Leverage - Tier I capital (to average assets)	9,370	8.1	4.0	5.0
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

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, 2004 is as follows:

Financial instruments whose contract amounts represent credit risk:	
Commitments to extend credit	$ 330,000
Undisbursed lines of credit	21,268,000
Commercial and standby letters of credit	73,000

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 the FHLB of Atlanta, bank-owned life insurance, 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 FHLB.

Investment in Bank-Owned 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, 2004 and 2003:

	2004		2003	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
	(In thousands)			
Financial assets:				
Cash and due from banks	$ 2,717	$ 2,717	$ 6,071	$ 6,071
Interest-earning deposits in banks	3,396	3,396	3,869	3,869
Federal funds sold	4,680	4,680	-	-
Time deposits	4,316	4,316	1,577	1,577
Investment securities available for sale	10,908	10,908	11,304	11,304
Investment securities held to maturity	1,663	1,685	-	-
Federal Home Loan Bank stock	272	272	261	261
Investment in bank-owned life insurance	1,285	1,285	1,229	1,229
Loans	88,114	88,446	72,154	72,396
Financial liabilities:				
Deposits	108,624	109,012	87,371	87,472
Borrowings	1,667	1,670	2,343	2,523

NOTE M - EMPLOYEE AND DIRECTOR BENEFIT PLANS

401(k) Plan

The Bank has a 401(k) Plan (the "Plan") in which substantially all employees participate. 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, 2004 and 2003, expense attributable to the Plan amounted to $48,836 and $54,557, 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 72,820 shares of the Bank's common stock for an aggregate number of common shares reserved for options equal to 145,640. No options were granted prior to 2003. On August 31, 2003 options to purchase 119,700 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, 2004 and 2003, giving effect to the 5% stock dividend in 2004, 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, 2002	145,640	145,640	-	$ -	-	$ -
Options granted/vested	-	(119,700)	119,700	10.95	-	-
Options exercised	-	-	-	-	-	-
Options forfeited	-	-	-	-	-	-
At December 31, 2003	145,640	25,940	119,700	10.95	-	-
Options granted/vested	-				23,415	10.95
Options exercised	-	-	-	-	-	-
Options forfeited	-	2,625	(2,625)	10.95	-	-
At December 31, 2004	145,640	28,565	117,075	$ 10.95	23,415	$ 10.95

The weighted average remaining life of total options and exercisable options outstanding as of December 31, 2004, all of which have an exercise price of $10.95, is 8.7 years. No expense has been recognized in connection with the grant of these options. The fair value of each option granted in 2003 was $2.23, 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., PLT Concrete Services, Inc., PLT Utilities, 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 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 27420

Stock Transfer Agent

First-Citizens Bank & Trust Company
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 959,728 shares of common stock outstanding which were held by approximately 1,342 holders of record (excluding shares held in street name) as of December 31, 2004. The North Carolina Commissioner of Bank'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 2004 and 2003, all of which were, to the knowledge of management, at prices ranging from $12.00 to $13.00 per share. The price paid for the Bank's common stock in the last trade known to management to have occurred during 2004 was $13.00, which trade occurred on December 15, 2004.

Annual Shareholders Meeting

The 2005 Annual Meeting of shareholders of Cornerstone Bank will be held at 10:00 a.m. on May 26, 2005 at Something Different, 3342 Airport Boulevard, Wilson, North Carolina 27896.

Annual Report on Form 10-KSB

A copy of Cornerstone Bank's 2004 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.