

SOUND BANKING COMPANY
Morehead City, North Carolina
INDEPENDENT AUDITORS' REPORT
AND
FINANCIAL STATEMENTS
As of and for the Years Ended
December 31, 2008 and 2007

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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.



Turlington and Company, L.L.P.
Certified Public Accountants

INDEPENDENT AUDITORS' REPORT

To the Stockholders and Board of Directors
Sound Banking Company
Morehead City, North Carolina

We have audited the accompanying balance sheets of Sound Banking Company as of December 31, 2008 and 2007, and the related statements of operations, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 Sound Banking Company as of December 31, 2008 and 2007, 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.

Turlington and Company, L.L.P.

Lexington, North Carolina
March 24, 2009

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SOUND BANKING COMPANY

BALANCE SHEETS

	December 31	
	2008	2007
	<u>(Dollars in Thousands)</u>	
ASSETS		
Cash and due from banks	\$ 1,290	\$ 3,081
Interest-earning deposits with banks	2,096	28
Federal funds sold	2,299	976
Time deposits		1,907
Investment securities available-for-sale, at fair value	16,378	11,433
Loans	97,019	90,258
Allowance for loan losses	(1,725)	(1,038)
NET LOANS	95,294	89,220
Accrued interest receivable	554	652
Stock in Federal Home Loan Bank, at cost	911	273
Bank premises and equipment	3,012	3,135
Bank owned life insurance	2,537	2,433
Other assets	2,525	448
TOTAL ASSETS	<u>\$ 126,896</u>	<u>\$ 113,586</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Demand	\$ 8,925	\$ 10,716
Savings, money market, and NOW	35,475	29,839
Time	54,777	58,731
TOTAL DEPOSITS	99,177	99,286
Short-term borrowings	6,000	2,000
Long-term borrowings	11,700	2,000
Accrued interest payable	384	813
Accrued expenses and other liabilities	442	299
TOTAL LIABILITIES	117,703	104,398
Stockholders' equity:		
Noncumulative, preferred stock, \$5 par value, 10,000,000 shares authorized, 48,075 shares issued and outstanding at December 31, 2008 and 2007	240	240
Common stock, \$5 par value, 10,000,000 shares authorized, 801,568 shares issued and outstanding at December 31, 2008 and 2007	4,008	4,008
Additional paid-in capital	3,606	3,532
Retained earnings	1,445	1,397
Accumulated other comprehensive income (loss)	(106)	11
TOTAL STOCKHOLDERS' EQUITY	9,193	9,188
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 126,896</u>	<u>\$ 113,586</u>

The accompanying notes are an integral part of the financial statements

SOUND BANKING COMPANY

STATEMENTS OF OPERATIONS

	Years Ended December 31	
	2008	2007
	(Dollars in thousands, except per share data)	
INTEREST INCOME:		
Loans, including fees	\$ 5,850	\$ 7,221
Investment securities available-for-sale	1,035	595
Federal funds sold	22	76
Time deposits	56	87
TOTAL INTEREST INCOME	6,963	7,979
INTEREST EXPENSE:		
Savings, money market, and NOW deposits	551	700
Time deposits	2,276	3,024
Short-term borrowings	427	131
Long-term borrowings	101	145
TOTAL INTEREST EXPENSE	3,355	4,000
NET INTEREST INCOME	3,608	3,979
PROVISION FOR LOAN LOSSES	785	264
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	2,823	3,715
NON-INTEREST INCOME:		
Service charges on deposit accounts	541	412
Mortgage operations	104	180
Earnings on bank owned life insurance	103	94
Gain on sales of securities	44	2
Other	136	116
TOTAL NON-INTEREST INCOME	928	804
NON-INTEREST EXPENSE:		
Salaries and employee benefits	1,863	1,865
Occupancy and equipment	531	484
Data processing and outside service fees	346	305
Other	963	892
TOTAL NON-INTEREST EXPENSE	3,703	3,546
INCOME BEFORE INCOME TAXES	48	973
INCOME TAXES	-	314
NET INCOME	\$ 48	\$ 659
NET INCOME PER COMMON SHARE:		
Basic	\$ 0.06	\$ 0.82
Diluted	\$ 0.06	\$ 0.79

The accompanying notes are an integral part of the financial statements

SOUND BANKING COMPANY

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 2008 and 2007

	Preferred Stock :		Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Shares	Amount	Shares	Amount				
	(Dollars in Thousands)							
Balance at December 31, 2006	40,064	\$ 200	665,678	\$ 3,328	\$ 3,451	\$ 1,446	(\$ 47)	\$ 8,378
Comprehensive income:								
Net income	-	-	-	-	-	659	-	659
Unrealized gain on available-for-sale securities, net of tax of \$35	-	-	-	-	-	-	58	58
Total comprehensive income								717
Shares issued from options exercised	-	-	2,329	12	14	-	-	26
Shares issued in a 20% stock split, including cash for fractional shares	8,011	40	133,561	668	-	(708)	-	-
Stock based compensation	-	-	-	-	61	-	-	61
Tax benefit from the exercise of stock options	-	-	-	-	6	-	-	6
Balance at December 31, 2007	48,075	240	801,568	4,008	3,532	1,397	11	9,188
Comprehensive income (loss):								
Net income	-	-	-	-	-	48	-	48
Unrealized loss on available-for-sale securities, net of tax of \$274	-	-	-	-	-	-	(458)	(458)
Unrealized gain on interest rate swap	-	-	-	-	-	-	341	341
Total comprehensive income (loss)								(69)
Stock based compensation	-	-	-	-	74	-	-	74
Balance at December 31, 2008	48,075	\$ 240	801,568	\$ 4,008	\$ 3,606	\$ 1,445	(\$ 106)	\$ 9,193

The accompanying notes are an integral part of the financial statements

SOUND BANKING COMPANY

STATEMENTS OF CASH FLOWS

	Years Ended December 31	
	2008	2007
	(Dollars in Thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 48	\$ 659
Adjustments to reconcile net income to net cash provided by (used for) operating activities:		
Depreciation and amortization	224	194
Provision for loan losses	785	264
Earnings on bank owned life insurance	(103)	(94)
Gain on sales of securities	(44)	(2)
Deferred income taxes	(185)	41
Stock based compensation	74	61
Change in assets and liabilities:		
(Increase) decrease in accrued interest receivable	98	(45)
Increase in other assets	(1,764)	(143)
Decrease in accrued interest payable	(429)	(248)
Increase in accrued expenses and other liabilities	143	158
NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES	(1,153)	845
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of available-for-sale securities	(18,632)	(3,828)
Maturities and calls of available-for-sale securities	1,000	2,250
Proceeds from sales of available-for-sale securities	10,469	1,502
Principal payments from mortgage-backed securities	1,479	
Net increase in loans	(6,663)	(8,952)
Purchases of bank premises and equipment	(101)	(402)
Unrealized gain on interest rate swap	341	
Net redemption of (investment in) time deposits	1,907	(84)
Purchase of Federal Home Loan Bank stock	(638)	(12)
NET CASH USED FOR INVESTING ACTIVITIES	(10,838)	(9,526)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Increase (decrease) in deposits	(109)	9,380
Proceeds from borrowings	13,700	4,000
Payments to issuance of junior subordinate debentures	-	(2,000)
Proceeds from exercise of stock options	-	26
Tax benefit from the exercise of stock options	-	6
NET CASH PROVIDED BY FINANCING ACTIVITIES	13,591	11,412
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,600	2,731
CASH AND CASH EQUIVALENTS, BEGINNING OF YEARS	4,085	1,354
CASH AND CASH EQUIVALENTS, END OF YEARS	\$ 5,685	\$ 4,085
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Interest paid on deposits and borrowings	\$ 2,926	\$ 4,249
Taxes paid	\$ 273	\$ 546
Unrealized gain (loss) on investment securities available-for-sale, net of tax	(\$ 458)	\$ 58

The accompanying notes are an integral part of the financial statements

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS

As of and for the Years Ended December 31, 2008 and 2007

NOTE A - ORGANIZATION AND OPERATIONS

Sound Banking Company (the "Bank") was incorporated August 9, 2001 and began banking operations on September 4, 2001. The Bank is engaged in general commercial and retail banking in Southeastern North Carolina, principally Carteret and Craven Counties, 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 the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and 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 the determination of the allowance for loan losses.

Cash and Cash Equivalents

For the purpose of presentation in the statements of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheets captioned "Cash and due from banks", "Interest-earning deposits with 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 on available-for-sale securities are reported as a net amount in other comprehensive income, net of tax. 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 held to maturity and investment securities available-for-sale below their cost that are other-than-temporary would result in write-downs of individual securities to their fair value. Such write-downs would be included in earnings as realized losses. Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are reported at their outstanding principal adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan. The accrual of interest on 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.

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Allowance for Loan Losses

The provision for loan losses is based upon management's estimate of the amount needed to maintain the allowance for loan losses at an adequate level. In making the evaluation of the adequacy of the allowance for loan losses, management gives consideration to current economic conditions, statutory examinations of the loan portfolio by regulatory agencies, delinquency information, and management's internal review of the loan portfolio. Loans are considered impaired when it is probable that all amounts due will not be collected in accordance with the contractual terms of the loan agreement. The measurement of impaired loans is generally based on the present value of the 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 behalf of other mortgage lenders, who fund the loans directly with the closing agent. The Bank recognizes certain origination and service release fees, which are included in non-interest income on the statements of operations under the caption "Mortgage operations".

Stock in Federal Home Loan Bank of Atlanta

As a requirement for membership, the Bank invests in stock of the Federal Home Loan Bank of Atlanta (FHLB). This investment is carried at cost. Due to the redemption provisions of the FHLB, the Bank estimated that fair value equals cost and that this investment was not impaired at December 31, 2008.

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. The estimated useful lives of furniture and equipment are from 3 to 10 years while the estimated lives for buildings are 39 to 40 years. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. 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.

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 has two components of other comprehensive income, unrealized gains and losses on investment securities available-for-sale (net of tax) and unrealized gains and losses on an interest rate swap.

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Stock Compensation Plans

Effective January 1, 2006, the Bank adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment*, (SFAS No. 123R) which was issued by the Financial Accounting Standards Board (FASB) in December 2004. SFAS No. 123R revises SFAS No. 123, *Accounting for Stock Based Compensation*, and supersedes Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, (APB No. 25) and its related interpretations. SFAS No. 123R requires recognition of the cost of employee services received in exchange for an award of equity instruments in the financial statements over the period the employee is required to perform the services in exchange for the award (usually the vesting period). SFAS No. 123R also requires measurement of the cost of employee services received in exchange for an award based on the grant-date fair value of the award. SFAS No. 123R also amends SFAS No. 95, *Statement of Cash Flows*, to require that excess tax benefits be reported as financing cash inflows, rather than as a reduction of taxes paid, which is included within operating cash flows.

The Bank adopted SFAS No. 123R using the modified prospective application as permitted under SFAS No. 123R. Accordingly, prior period amounts have not been restated. Under this application, the Bank is required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption.

Prior to the adoption of SFAS No. 123R, the Bank used the intrinsic value method as prescribed by APB No. 25 and thus recognized no compensation expense for options granted with exercise prices equal to the fair market value of the Bank's common stock on the date of the grant.

The Bank has two share-based compensation plans in effect at December 31, 2008. The compensation cost that has been charged against income for those plans was approximately \$74,000 for the twelve months ended December 31, 2008.

The adoption of SFAS No. 123R and its fair value compensation cost recognition provisions had the following effect (increase/(decrease)) on our statements of operations for the year ended December 31, 2008:

Income before income taxes	(\$	74,000)
Net income	(\$	74,000)
Net income per share - basic	(\$.01)
Net income per share - diluted	(\$.01)

Net Income Per Common Share and Common Shares Outstanding

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. The following table provides a reconciliation of income available to common shareholders and the average number of shares outstanding for the years ended December 31, 2008 and 2007. Options to purchase 139,633 and 136,882 shares, respectively, of common stock were outstanding at December 31, 2008 and 2007.

	Years Ended December 31	
	2008	2007
	(Dollars in Thousands)	
Net income (numerator)	\$ 48	\$ 659

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Net Income Per Common Share and Common Shares Outstanding (Continued)

	Years Ended December 31	
	2008	2007
Weighted average shares outstanding for basic EPS (denominator)	801,546	800,303
Dilutive effect of stock options	(922)	32,742
Adjusted shares for diluted EPS	<u>800,624</u>	<u>833,045</u>

For the years ended December 31, 2008 and 2007, there were 44,175 and 5,216 options, respectively, that were antidilutive since the exercise price exceeded the average market price of the Bank's common stock for the years. These options have been omitted from the calculation of diluted earnings per share for each year.

Preferred Stock

At December 31, 2008, the Bank had 48,075 shares of noncumulative, nonvoting preferred stock issued and outstanding. The holders of the preferred stock are entitled to a preference in the distribution of dividends so that the holders of the shares receive an equivalent dividend when declared and paid by the Bank prior to the receipt of dividends by the holders of common stock. The holders of the preferred stock are entitled to a preference in the distribution of assets of the Bank in the event of any liquidation, dissolution, or winding-up of the Bank, whether voluntary or involuntary, equal to \$9.83 per share. Voting rights are awarded to the preferred stock holders only upon a change of control of the Bank or in situations otherwise required by law. On those matters, the preferred stock holders receive one vote for each share owned and will vote together with the holders of common stock and not as a separate class.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Bank adopted SFAS No. 157 on January 1, 2008, with no material impact on its financial statements.

In 2006, the Emerging Issues Task Force issued EITF Issue 06-4, *Accounting for Deferred Compensation and Postretirement Benefits Aspects of Endorsement Split-Dollar Life Insurance Arrangements*, which requires the recognition of a liability related to the postretirement benefits covered by an endorsement split-dollar life insurance arrangement. The employer (who is also the policyholder) has a liability for the benefit it is providing to its employee. As such, if the policyholder has agreed to maintain the insurance policy in force for the employee's benefit during his or her retirement, then the liability recognized during the employee's active service period should be based on the future cost of insurance to be incurred during the employee's retirement. Alternatively, if the policyholder has agreed to provide the employee with a death benefit, then the liability for the future death benefit should be recognized by following the guidance in Statement 106 or Opinion 12, as appropriate. This issue is applicable for interim or annual reporting periods beginning after December 15, 2007. The Bank has determined that the impact of this new standard is immaterial to the financial statements.

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Recent Accounting Pronouncements (Continued)

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Bank adopted SFAS No. 159 on January 1, 2008, however, the Bank has not elected to measure eligible items at fair value and continues to evaluate the future impact it may have on its financial statements.

In November 2007, the SEC issued Staff Accounting Bulletin No. 109, *Miscellaneous Accounting - Written Loan Commitments Recorded at Fair Value through Earnings* (SAB 109). SAB 109 addresses written loan commitments that are accounted for at fair value through earnings under generally accepted accounting principles. SAB 109 supersedes SAB 105, *Accounting for Derivative Instruments and Hedging Activities*, and concludes that expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SAB 105 indicated that the SEC staff believed that internally developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment. SAB 109 retains that staff view and broadens its application to all written loan commitments that are accounted for as fair value through earnings. The SEC expects registrants to apply the views in Question 1 of SAB 109 on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The Bank adopted SAB 109 on January 1, 2008, with no material impact on its financial statements.

In December 2007, the SEC issued Staff Accounting Bulletin No. 110, *Share-Based Payment - Certain Assumptions Used in Valuation Methods - Expected Term* (SAB 110). SAB 110 provides guidance on developing an estimated term of "plain vanilla" share options in accordance with SFAS No. 123(R), *Share-Based Payment*. Due to the fact that detailed external information about employees exercise behavior may not, as originally thought, be readily available by December 31, 2007, the SEC staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007. The Bank adopted SAB 110 on January 1, 2008, with no material impact on its financial statements.

From time to time the FASB issues exposure drafts for proposed statements of financial accounting standards. Such exposure drafts are subject to comment from the public, to revisions by the FASB, and to final issuance by the FASB as statements of financial accounting standards. Management considers the effect of the proposed statements on the financial statements of the Bank and monitors the status of changes to and proposed effective dates of exposure drafts.

Reclassifications

Certain amounts in the 2007 financial statements have been reclassified to conform to the presentation adopted for 2008. These reclassifications had no effect on net income or stockholders' equity as previously reported.

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE C - INVESTMENT SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in Thousands)			
<u>December 31, 2008</u>				
Securities available-for-sale:				
Mortgage-backed securities	\$ 9,921	\$ 116	(\$ 4)	\$ 10,033
Municipal securities	4,508	19	(218)	4,309
Corporate bonds	2,670	46	(680)	2,036
	<u>\$ 17,099</u>	<u>\$ 181</u>	<u>(\$ 902)</u>	<u>\$ 16,378</u>
<u>December 31, 2007</u>				
Securities available-for-sale:				
U. S. government securities and obligations of U. S. government agencies	\$ 1,500	\$ 11	\$ -	\$ 1,511
Mortgage-backed securities	6,150	44	(36)	6,158
Municipal securities	3,763	16	(15)	3,764
	<u>\$ 11,413</u>	<u>\$ 71</u>	<u>(\$ 51)</u>	<u>\$ 11,433</u>

For the years ended December 31, 2008 and 2007, proceeds from sales of securities available-for-sale amounted to approximately \$10.5 million and \$1.5 million, respectively. From those transactions, the Bank realized gross gains of \$44,000 in 2008 and \$2,000 in 2007.

The following tables show the gross unrealized losses and fair value of investments, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2008 and 2007. For available-for-sale securities, the unrealized losses relate to twelve municipal securities, two corporate bonds, and two mortgage-backed securities. All investment securities with unrealized losses are considered by management to be temporarily impaired given the credit ratings on these investment securities and management's intent and ability to hold these securities until recovery. Should the Bank decide in the future to sell securities in an unrealized loss position, or determine that impairment of any securities is other-than-temporary, irrespective of a decision to sell, an impairment loss would be recognized in the period such determination is made.

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in Thousands)					
<u>December 31, 2008</u>						
Securities available-for-sale:						
Mortgage-backed securities	\$ 1,325	(\$ 4)	\$ -	\$ -	\$ 1,325	(\$ 4)
Municipal securities	3,470	(218)	-	-	3,470	(218)
Corporate bonds	1,330	(680)	-	-	1,330	(680)
Total temporarily impaired securities	<u>\$ 6,125</u>	<u>(\$ 902)</u>			<u>\$ 6,125</u>	<u>(\$ 902)</u>

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE C - INVESTMENT SECURITIES (CONTINUED)

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
	(Dollars in Thousands)					
<u>December 31, 2007</u>						
Securities available-for-sale:						
Mortgage-backed securities	\$ -	\$ -	\$ 2,244	(\$ 36)	\$ 2,244	(\$ 36)
Municipal securities	<u>535</u>	<u>(1)</u>	<u>1,624</u>	<u>(14)</u>	<u>2,159</u>	<u>(15)</u>
Total temporarily impaired securities	<u>\$ 535</u>	<u>(\$ 1)</u>	<u>\$ 3,868</u>	<u>(\$ 50)</u>	<u>\$ 4,403</u>	<u>(\$ 51)</u>

The amortized cost, fair value, and weighted average yield of the Bank's investment securities at December 31, 2008, 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.

	<u>Amortized Cost</u>	<u>Fair Value</u>
	(Dollars in Thousands)	
Securities available-for-sale:		
Mortgage-backed securities:		
Due after one but within five years	\$ 899	\$ 913
Due after five but within ten years	7,691	7,757
Due after ten years	<u>1,331</u>	<u>1,363</u>
	<u>\$ 9,921</u>	<u>\$ 10,033</u>
Municipal securities:		
Due after five but within ten years	\$ 2,106	\$ 2,019
Due after ten years	<u>2,402</u>	<u>2,290</u>
	<u>\$ 4,508</u>	<u>\$ 4,309</u>
Corporate bonds:		
Due after five but within ten years	\$ 660	\$ 706
Due after ten years	<u>2,010</u>	<u>1,330</u>
	<u>\$ 2,670</u>	<u>\$ 2,036</u>
Total securities available for sale:		
Due after one but within five years	\$ 899	\$ 913
Due after five but within ten years	10,457	10,482
Due after ten years	<u>5,743</u>	<u>4,983</u>
	<u>\$ 17,099</u>	<u>\$ 16,378</u>

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

Securities with an amortized cost of \$4.6 million and a fair value of \$4.6 million were pledged to secure public monies as required by law at December 31, 2008.

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE D - LOANS

Following is a summary of loans at December 31, 2008 and 2007:

	2008		2007	
	Amount	Percent of Total	Amount	Percent of Total
	(Dollars in Thousands)			
Residential real estate loans:				
One to four family residential	\$ 21,927	22.60%	\$ 14,136	15.66%
Multi-family residential	1,339	1.38%	1,811	2.01%
Construction	8,868	9.14%	6,577	7.29%
Home equity lines of credit	<u>13,657</u>	<u>14.08%</u>	<u>11,842</u>	<u>13.12%</u>
Total real estate loans	<u>45,791</u>	<u>47.20%</u>	<u>34,366</u>	<u>38.08%</u>
Other loans:				
Commercial and industrial	7,430	7.66%	8,783	9.73%
Construction	19,051	19.64%	24,826	27.51%
Nonfarm nonresidential	18,116	18.67%	14,557	16.13%
Loans to individuals	<u>6,631</u>	<u>6.83%</u>	<u>7,726</u>	<u>8.55%</u>
Total other loans	<u>51,228</u>	<u>52.80%</u>	<u>55,892</u>	<u>61.92%</u>
Total loans	97,019	<u>100.00%</u>	90,258	<u>100.00%</u>
Less:				
Allowance for loan losses	(1,725)		(1,038)	
Deferred loan fees and costs, net	<u>-</u>		<u>-</u>	
Total loans, net	<u>\$ 95,294</u>		<u>\$ 89,220</u>	

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

There were no restructured loans at December 31, 2008 and 2007. Loans 90 days or more delinquent for which the accrual of interest had ceased totaled approximately \$2,563,000 and \$15,000, respectively, at December 31, 2008 and 2007. The average recorded investment in impaired loans and interest income that would have been recorded on nonaccrual loans was immaterial for the years ended December 31, 2008 and 2007. There was no allowance for loan losses allocated to the impaired loans at December 31, 2008 and 2007.

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

	At December 31	
	2008	2007
	(Dollars in Thousands)	
Allowance for loan losses at beginning of years	\$ 1,038	\$ 1,059
Provision for loan losses	<u>785</u>	<u>264</u>
	<u>1,823</u>	<u>1,323</u>
Charge-offs	(138)	(301)
Recoveries	<u>40</u>	<u>16</u>
Net recoveries (charge-offs)	<u>(98)</u>	<u>(285)</u>
Allowance for loan losses at end of years	<u>\$ 1,725</u>	<u>\$ 1,038</u>

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE D - LOANS (CONTINUED)

At December 31, 2008, the Bank had loan commitments outstanding of \$3.8 million and pre-approved but unused lines of credit totaling \$16.4 million. In management's opinion, these commitments represent no more than normal lending risk to the Bank and will be funded from normal sources of liquidity.

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

Balance at January 1, 2008	\$	515
Net change		<u>448</u>
Balance at December 31, 2008	\$	<u><u>963</u></u>

NOTE E - BANK PREMISES AND EQUIPMENT

Following is a summary of bank premises and equipment at December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
	(Dollars in Thousands)	
Land	\$ 430	\$ 430
Buildings and improvements	2,282	2,282
Leasehold improvements	170	147
Furniture and equipment	<u>880</u>	<u>802</u>
	3,762	3,661
Less, accumulated depreciation	(<u>750</u>)	(<u>526</u>)
Total	<u><u>\$ 3,012</u></u>	<u><u>\$ 3,135</u></u>

Depreciation, which amounted to approximately \$224,000 and \$194,000, respectively, for the years ended December 31, 2008 and 2007, is included in occupancy and equipment expense on the statements of operations.

NOTE F - DEPOSITS

At December 31, 2008, the scheduled maturities of time deposits are as follows (dollars in thousands):

2009	\$	52,024
2010		2,028
2011		579
2012		124
2013 and After		<u>22</u>
Total	\$	<u><u>54,777</u></u>

The aggregate amount of time deposits in denominations of \$100,000 or more at December 31, 2008 and 2007 was \$33.5 million and \$35.0 million, respectively. Interest expense on such deposits aggregated \$905,000 in 2008 and \$1.2 million in 2007.

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE G - BORROWINGS

The Bank may purchase federal funds through unsecured lines of credit totaling \$6.3 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. Also, as a member of the Federal Home Loan Bank of Atlanta, the Bank may obtain advances of up to 30% of total assets. The Bank has outstanding advances or borrowings of \$15.7 million and \$2.0 million, respectively, at December 31, 2008 and 2007.

In June of 2006, the Bank issued \$2.0 million of Floating Rate Junior Subordinated Debentures (the "Junior Subordinated Debentures") to Wilmington Trust Company, with a scheduled maturity date of June 15, 2016. The Junior Subordinated Debentures pay cumulative cash distributions quarterly, at an annual rate, reset quarterly, equal to the 3-month LIBOR (2.00% at December 31, 2008) plus 1.75%. The Junior Subordinated Debentures are redeemable on or after June 15, 2011, in whole or in part and are subordinate to all other claims against, incurred, assumed, or guaranteed by the Bank.

NOTE H - INCOME TAXES

The significant components of the provision for income taxes for the years ended December 31, 2008 and 2007 are as follows:

	2008	2007
	(Dollars in Thousands)	
Current tax provision	\$ 185	\$ 273
Deferred tax provision	(185)	41
Net provision for income taxes	\$ -	\$ 314

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

	2008	2007
	(Dollars in Thousands)	
Expense computed at statutory rate of 34%	\$ 16	\$ 331
Effect of state income taxes	3	44
Other	(19)	(61)
	\$ -	\$ 314

Significant components of deferred taxes at December 31, 2008 and 2007 are as follows:

	2008	2007
	(Dollars in Thousands)	
Deferred tax assets:		
Allowance for loan losses	\$ 488	\$ 298
Retirement plan	125	88
Unrealized losses on securities	274	-
Other	2	1
Total deferred tax assets	889	387
Deferred tax liabilities:		
Prepaid expenses	-	(14)
Premises and equipment	(57)	(53)
Unrealized gains on securities	-	(7)
Total deferred tax liabilities	(57)	(74)
Valuation allowance	(173)	-
Net recorded deferred tax assets	\$ 659	\$ 313

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE I - OTHER NON-INTEREST EXPENSE

The major components of other non-interest expense for the years ended December 31, 2008 and 2007 are as follows:

	2008	2007
	(Dollars in Thousands)	
Postage, printing, and office supplies	\$ 120	\$ 126
Advertising and promotion	45	74
Professional services	199	172
Armored carrier	11	8
Other	588	512
Total	\$ 963	\$ 892

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 limit the payment of dividends by any bank when it is determined that such limitation is in the public interest and is necessary to ensure financial soundness of the bank. The payment of cash dividends by a newly organized bank is prohibited by regulation for three years unless special exceptions are made.

The Bank is subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios, as prescribed by regulations, of total and Tier I capital to risk-weighted assets and of Tier I capital to average assets. Management believes that as of December 31, 2008 and 2007 the Bank meets all capital adequacy requirements to which it is subject, as set forth below:

	Actual		Minimum for Capital Adequacy Purposes		Minimum to be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in Thousands)					
<u>December 31, 2008</u>						
Total capital (to risk-weighted assets)	\$ 12,619	11.99%	\$ 8,422	8.00%	\$ 10,528	10.00%
Tier I capital (to risk-weighted assets)	9,298	8.83%	4,211	4.00%	6,317	6.00%
Tier I capital (to average assets)	9,298	7.46%	4,987	4.00%	6,234	5.00%

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE J - REGULATORY MATTERS (CONTINUED)

	<u>Actual</u>		<u>Minimum for Capital Adequacy Purposes</u>		<u>Minimum to be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<u>December 31, 2007</u>						
Total capital (to risk-weighted assets)	\$ 12,214	12.24%	\$ 7,983	8.00%	\$ 9,978	10.00%
Tier I capital (to risk-weighted assets)	9,176	9.20%	3,991	4.00%	5,987	6.00%
Tier I capital (to average assets)	9,176	7.96%	4,613	4.00%	5,766	5.00%

NOTE K - OFF-BALANCE SHEET RISK

The Bank is a party to financial instruments with off-balance sheet credit risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and undisbursed lines 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.

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 credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank, upon extension of credit is based on management's credit evaluation of the borrower. Collateral obtained varies but may include real estate, stocks, bonds, and certificates of deposit.

A summary of contract amount of the Bank's exposure to off-balance sheet credit risk as of December 31, 2008 is as follows (dollars in thousands):

Financial instruments whose contract amounts represent credit risk:	
Commitments to extend credit	\$ 3,750
Undisbursed lines of credit	16,423

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE L - DISCLOSURES ABOUT FAIR VALUES OF FINANCIAL INSTRUMENTS

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

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

Cash and Due from Banks, Interest-Earning Deposits with Banks, Federal Funds Sold, Accrued Interest Receivable, and Accrued Interest Payable

The carrying amounts for cash and due from banks, interest-earning deposits in banks, federal funds sold, accrued interest receivable, and accrued interest payable 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.

Investment Securities Available for Sale

Fair value for investment securities available-for-sale 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 of Federal Home Loan Bank stock approximates carrying value, based on the redemption provisions of the Federal Home Loan Bank.

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

The fair value of demand deposits, savings, money market, and NOW accounts is the amount payable on demand at the reporting date. The fair value of time deposits is estimated by discounting expected future cash flows using the rates currently offered for instruments of similar remaining maturities.

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

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

Borrowings

The fair values are based on discounting expected cash flows at the interest rate for debt with the same or similar 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.

The following table presents the carrying values and estimated fair values of the Bank's financial instruments at December 31, 2008 and 2007:

	<u>2008</u>		<u>2007</u>	
	<u>Carrying Amount</u>	<u>Estimated Fair Value</u>	<u>Carrying Amount</u>	<u>Estimated Fair Value</u>
	(Dollars in Thousands)			
Financial assets:				
Cash and due from banks	\$ 1,290	\$ 1,290	\$ 3,081	\$ 3,081
Interest-earning deposits with banks	2,096	2,096	28	28
Federal funds sold	2,299	2,299	976	976
Time deposits	-	-	1,907	1,907
Investment securities available-for-sale	16,378	16,378	11,433	11,433
Loans, net	95,294	95,133	89,220	88,733
Accrued interest receivable	554	554	652	652
Stock in the Federal Home Loan Bank	911	911	273	273
Bank owned life insurance	2,537	2,537	2,433	2,433
Financial liabilities:				
Deposits	99,177	99,511	99,286	97,308
Borrowings	17,700	17,700	4,000	4,000
Accrued interest payable	384	384	813	813

NOTE M - FAIR VALUE HIERACHY

Statement of Financial Accounting Standards (SFAS) No. 157 established a fair value hierarchy to prioritize the inputs of valuation techniques used to measure fair value. Outlined below is the application of the fair value hierarchy established by SFAS No. 157 to Sound Banking Company's assets that are carried at fair value:

- Level 1 - Inputs to the valuation methodology are quoted prices for identical assets in active markets.
- Level 2 - Inputs to the valuation methodology include quoted prices for similar assets in active markets and significant other observable inputs.
- Level 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE M - FAIR VALUE HIERACHY (CONTINUED)

Assets and liabilities measured at fair value on a recurring basis at December 31, 2008 were as follows:

<u>Description</u>	<u>December 31 2008</u>	<u>Quoted Prices In Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Available-for-sale securities	\$ 16,377,528		\$ 16,377,528	
Other real estate owed	1,415,105		1,415,105	
Interest rate swap	<u>340,764</u>		<u>340,764</u>	
	<u>\$ 18,133,397</u>		<u>\$ 18,133,397</u>	

NOTE N - EMPLOYEE AND DIRECTOR BENEFIT PLAN

The Bank has a 401(k) plan whereby substantially all employees are eligible to participate in the plan. Matching contributions are made to the plan at the Bank's discretion and vest to the employee equally over a five-year period. The Bank made contributions to the plan for the years ended December 31, 2008 and 2007 of approximately \$27,000 and \$25,000, respectively.

The Bank has entered into employment agreements with certain of its executive officers to ensure a stable and competent management base. The agreements provide for a two-year term, which may be extended. The agreements also provide 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 and in certain other events, as defined in the agreements, the Bank or any successor to the Bank will be bound to the terms of the contract.

During 2006, the Bank entered into a Supplemental Executive Retirement Agreement (a "Retirement Agreement") and a Split-Dollar Endorsement Agreement (an "Insurance Agreement") with both of its senior executives. Under the Retirement Agreement, the Bank has agreed to pay benefits to the executives following retirement at or after age 65, or following earlier terminations of employment under certain circumstances, based on the average annual base compensation for the three full calendar years preceding such termination of employment. In the case of either executive's retirement at or after age 65, annual benefits will be payable for life, with 15 years of guaranteed annual payments. Similar benefits will be payable, beginning at age 65, following a termination of either officer's employment as a result of his disability, or following a voluntary or involuntary termination of his employment for any reason following a change of control of the Bank. Benefits will accrue based upon the performance of the underlying life insurance policies both during employment and after retirement. For the years ended December 31, 2008 and 2007, the Bank recognized \$97,000 and \$92,000, respectively, of expense related to these agreements. The accrued liability under these agreements was approximately \$324,000 and \$228,000, respectively, at December 31, 2008 and 2007, and is included in accrued expenses and other liabilities in the accompanying balance sheets.

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 83,616 shares of the Bank's common stock for an aggregate number of common shares reserved for options of 167,232. The options granted under both the Director Plan and the Employee Plan vest over a three-year period with none vesting at the time of the grant. 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, 2008 and 2007 is as follows:

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE N - EMPLOYEE AND DIRECTOR BENEFIT PLAN (CONTINUED)

Stock Option Plans (Continued)

	<u>Shares in Plans</u>	<u>Shares Available for Future Grants</u>	<u>Options Outstanding</u>		<u>Exercisable Options</u>	
			<u>Number Outstanding</u>	<u>Weighted- Average Exercise Price</u>	<u>Number Outstanding</u>	<u>Weighted- Average Exercise Price</u>
At December 31, 2005	167,232	64,813	100,418	\$ 9.23	86,212	\$ 9.17
Options granted/vested	-	(29,202)	29,202	12.26	7,590	9.16
Options exercised	-	-	(7,694)	9.17	(7,694)	9.17
Options forfeited	-	<u>427</u>	<u>(427)</u>	<u>9.58</u>	-	-
At December 31, 2006	167,232	36,038	121,499	9.96	86,108	9.19
Options granted/vested	-	(18,427)	18,427	15.46	13,569	11.54
Options exercised	-	-	(2,759)	9.19	(2,520)	9.19
Options forfeited	-	<u>285</u>	<u>(285)</u>	<u>9.58</u>	-	-
At December 31, 2007	167,232	17,896	136,882	10.72	97,157	9.52
Options granted/vested	-	(5,331)	5,331	13.15	16,871	11.91
Options exercised	-	-	-	-	-	-
Options forfeited	-	<u>2,580</u>	<u>(2,580)</u>	<u>13.55</u>	-	-
At December 31, 2008	<u>167,232</u>	<u>15,145</u>	<u>139,633</u>	<u>\$ 10.76</u>	<u>114,028</u>	<u>\$ 10.05</u>

The following table summarizes information about the stock options outstanding at December 31, 2008:

<u>Exercise Price</u>	<u>Options Outstanding</u>		<u>Options Exercisable</u>	
	<u>Number Outstanding December 31 2008</u>	<u>Weighted- Average Remaining Contractual Life (Years)</u>	<u>Number Exercisable December 31 2008</u>	<u>Weighted- Average Exercise Price</u>
\$9.17 - \$11.00	95,238	4.22	93,528	\$ 9.25
\$11.01 - \$15.00	21,951	7.57	11,280	11.54
\$15.01 - \$17.83	<u>22,444</u>	<u>7.90</u>	<u>9,220</u>	<u>16.35</u>
	<u>139,633</u>	<u>5.34</u>	<u>114,028</u>	<u>\$ 10.05</u>

The fair value of each option granted in 2008 and 2007 was \$5.11 and \$5.21, respectively. These values were determined as of the date of grant using the Black-Scholes option pricing model, assuming risk-free interest rates of 3.22% and 4.75%, dividend yields of 0%, volatility of 30.04% and 17.84%, and an expected life of seven years for 2008 and 2007, respectively.

For the year ended December 31, 2007, the intrinsic value of options exercised and fair value of options vested amounted to approximately \$64,000 and \$120,000, respectively. The aggregate intrinsic value of options outstanding and exercisable at December 31, 2008 amounted to approximately \$-0- and \$-0-, respectively.

As of December 31, 2008, there was approximately \$102,000 of unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plans. The cost is expected to be recognized over a weighted-average period of 2.37 years.

SOUND BANKING COMPANY

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE O - LEASES

The Bank leases, under separate agreements, a financial center facility in Cape Carteret, a branch in Beaufort, and a loan production office in New Bern. Rental expense during 2008 and 2007 was \$90,200 and \$60,200, respectively.

Future minimum lease payments under these noncancelable operating leases as of December 31, 2008 are as follows:

2009	\$	89,013
2010		57,813
2011		57,813
2012		57,813
2013		57,813
Thereafter		<u>520,317</u>
	\$	<u>840,582</u>

The Bank has sublet surplus office space within its permanent facility to a tenant under a rental arrangement with current terms expiring in 2009, with various renewal terms. The expected future rental income under this rental arrangement through the current term is \$35,000 for 2009.

NOTE P - INTEREST RATE SWAP

The Bank entered into an interest rate swap agreement on June 23, 2008 in order to modify the interest characteristics of its fixed rate loans from a fixed rate to a variable rate basis. This agreement expires on June 23, 2011. Under the agreement, the Bank pays a floating rate of prime as determined daily and receives a fixed rate of 6.6%. Differentials paid or received under the agreement are recognized as adjustments to expense. The Bank has designated the derivative as an effective cash flow hedge. Changes in the fair value of the swap are recorded as other comprehensive income.

The Bank has recorded an asset of \$340,764 at December 31, 2008 for the value of the swap agreement. Management believes that this is a conservative estimate of fair value.

NOTE Q - STOCK SPLIT

During 2007, the Board of Directors of Sound Banking Company approved a 20% stock dividend.

NOTE R - SUBSEQUENT EVENTS

On January 9, 2009, the Bank received \$3,070,000 from the Capital Purchase Program through the U. S. Treasury Department. The Bank issued 3,070 shares of preferred stock under the agreement. In addition to the preferred stock, the Bank also issued 154 warrants at \$0.01 per share which were exercised immediately upon issuance.