

FEDERAL DEPOSIT INSURANCE CORPORATION
Washington, D.C. 20429

FORM 10-K

- ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2004.
- TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM _____ TO _____.

FDIC Certificate No. 19861

Yadkin Valley Bank and Trust Company

(Exact name of registrant as specified in its charter)

North Carolina
(State or other jurisdiction of
incorporation or organization)

56-0905827
(I.R.S. Employer Identification No.)

209 North Bridge Street
Elkin, North Carolina 28621-3404
(Address of principal executive offices)

(336) 526-6300
(Registrant's telephone number, including area code)

Securities registered under Section 12(b) of the Act: None.

Securities registered under Section 12(g) of the Act: Common Stock, \$1.00 par value.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined by Rule 12b-2 of the Act) Yes

The aggregate market value of the registrant's Common Stock at June 30, 2004, held by those persons deemed by the registrant to be non-affiliates, was approximately \$121.7 million.

As of March 1, 2005 (the most recent practicable date), the registrant had outstanding 10,675,813 shares of Common Stock.

Documents Incorporated By Reference

<u>Document</u>	<u>Where Incorporated</u>
1. Proxy Statement for the Annual Meeting of Shareholders to be held May 19, 2005 to be mailed to shareholders within 180 days of December 31, 2004.	Part III

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PART I

Item 1 — Description of business

Corporate history and address. Yadkin Valley Bank and Trust Company (the "Bank" or "Yadkin") is a North Carolina-chartered commercial bank with its deposits insured by the Federal Deposit Insurance Corporation ("FDIC") up to applicable limits. Yadkin is not a member of the Federal Reserve System ("Federal Reserve"). We were incorporated in 1968. On July 31, 2002, we acquired Main Street BankShares, Inc. and its subsidiary, Piedmont Bank, of Statesville, North Carolina and continue to operate the former Piedmont Bank offices under the assumed name "Piedmont Bank, a division of Yadkin Valley Bank and Trust Company." On January 1, 2004, we acquired High Country Financial Corporation, and its subsidiary, High Country Bank, of Boone, North Carolina and continue to operate the former High Country Bank offices in Watauga County, North Carolina, under the assumed name "High Country Bank, a division of Yadkin Valley Bank and Trust Company." On October 1, 2004 we purchased Sidus Financial LLC, a mortgage broker firm that continues to operate as Sidus Financial, LLC. We operate in the central Piedmont and the northwestern region of North Carolina. Our common stock is listed on the NASDAQ National Market under the trading symbol "YAVY."

Yadkin's principal executive offices are located at 209 North Bridge Street, Elkin, North Carolina 28621-3404, and the telephone number is (336) 526-6300. Our periodic securities reports on Forms 10-Q and 10-K are available on our website at www.yadkinvalleybank.com.

Business. Yadkin's operations are primarily retail oriented and directed toward individuals and small and medium-sized businesses located in our banking market and, to a lesser extent, areas surrounding our immediate banking market. Yadkin provides most traditional commercial and consumer banking services, but our principal activities are the taking of demand and time deposits and the making of consumer and commercial loans. Yadkin's primary source of revenue is the interest income derived from its lending activities.

At December 31, 2004, we had total assets of \$959.8 million, net loans held for investment of \$678.7 million, deposits of \$728.7 million, and shareholders' equity of \$111.6 million. We had net income of \$9.5 million and \$8.9 million and diluted earnings per share of \$0.89 and \$1.00 for the years ended December 31, 2004 and 2003, respectively. We had net income of \$7.0 million and diluted earnings per share of \$0.89 for the year ended December 31, 2002.

Business Offices. Yadkin operates 20 full-service banking offices and is headquartered in Elkin, North Carolina. We operate the offices in Jefferson and West Jefferson (Ashe County), Wilkesboro and North Wilkesboro (Wilkes County), Elkin (Surry County), and East Bend, Jonesville and Yadkinville (Yadkin County) under the Yadkin name. The offices in Statesville and Mooresville (Iredell County), and Cornelius and Huntersville (Mecklenburg County) are operated under the Piedmont Bank assumed name. The offices in Boone (Watauga County) are operated under the High Country Bank assumed name.

Banking Market. Yadkin's current banking market consists of the central piedmont counties of Mecklenburg and Iredell, and the northwestern counties of Ashe, Surry, Watauga, Wilkes and Yadkin in North Carolina and, to a lesser extent, the surrounding areas (the "Yadkin Market"). The Yadkin Market is located along Interstate 77 north of the Charlotte metropolitan area, and west of the "Piedmont Triad" area of North Carolina to the northwestern border with Virginia and Tennessee.

Yadkin's market area is well diversified and strong. The seven counties in which our branches are located had an estimated 2003 population of over 1.13 million people. Median family income in 2000 for the seven counties ranged from a low of \$28,800 in mostly rural Ashe County to a high of over \$50,500 in urban Mecklenburg County. Approximately 98% of the work force is employed in nonagricultural wage and salary positions. Government employs approximately 10% of the work force. The major non-governmental employment sectors were manufacturing (25%), trade (23%), service (12%), and construction (10%).

Competition. Commercial banking in North Carolina is extremely competitive due to state laws that allow statewide branching. North Carolina is the home of two of the largest ten commercial banks in the United States, each of which has branches located in the Yadkin Market. As of June 30, 2004, there were 14 branches in Ashe

County operated by four commercial banks, including the Bank, and one savings institution (with its headquarters in Ashe County), holding approximately \$435 million in deposits. Deposits of the Bank on that date in Ashe County totaled \$123.2 million. On that date, there were 43 branches in Iredell County operated by 13 commercial banks, including the Bank, and two savings institutions (one with its headquarters in Iredell County), holding approximately \$1.6 billion in deposits. Deposits of the Bank on that date in Iredell County totaled \$178.7 million. On that date, there were 225 branches in Mecklenburg County operated by 17 commercial banks, including the Bank, and one savings institution, holding approximately \$72.1 billion in deposits. Deposits of the Bank on that date in Mecklenburg County totaled \$30.0 million. On that date, there were 30 branches in Surry County operated by ten commercial banks, including the Bank, with approximately \$1.0 billion in deposits. Deposits of the Bank on that date in Surry County totaled \$84.9 million. On that date, there were 20 branches in Wilkes County operated by 10 commercial banks, including the Bank, and one savings institution, with approximately \$660.4 million in deposits. Deposits of the Bank on that date in Wilkes County totaled \$81.4 million. On that date, there were ten branches in Yadkin County operated by eight commercial banks, including the Bank, with approximately \$379.6 million in deposits. Deposits of the Bank on that date in Yadkin County totaled \$72.2 million. On that date, Watauga County had 21 branches operated by nine commercial banks and three savings institutions, with total deposits of approximately \$665.9 million. Deposits of the Bank in Watauga County totaled 109.4 million. Many of these competing banks have capital resources and legal lending limits substantially in excess of those available to us. Thus we have significant competition in our market for deposits from other depository institutions.

Yadkin also competes for deposits in the Yadkin Market with other financial institutions such as credit unions, consumer finance companies, insurance companies, brokerage companies, agencies issuing United States government securities and other financial institutions with varying degrees of regulatory restrictions. In its lending activities, Yadkin competes with all other financial institutions as well as consumer finance companies, mortgage companies and other lenders. Credit unions have been permitted to expand their membership criteria and expand their loan services to include such traditional bank services as commercial lending. We expect competition in the Yadkin Market to continue to be significant.

We believe we have sufficient capital to support our operations for the foreseeable future. We intend to continue to serve the financial needs of consumers and small-to-medium size businesses located primarily in the Yadkin Market. Our lending efforts will be focused on making quality consumer loans, commercial loans to small to medium sized businesses, and home equity loans. While our deposits and loans are derived primarily from customers in our banking market, we make loans and have deposit relationships with individual and business customers in areas surrounding our immediate banking market. We offer a full range of deposit products to include checking and savings accounts, money market accounts, certificates of deposit and Individual Retirement Accounts. We rely on offering competitive interest rates and unmatched customer service to accomplish our deposit objectives.

The Bank strives to offer its products and services in the manner that meets its customers' expectations. For those customers who prefer to do their banking in a very hands-on, face-to-face manner, the Bank offers exceptional personal service. Customers who want to do their banking when and where they choose will be able to utilize the Automated Teller Machines, credit and debit card programs, and a full range of internet-based banking options.

Supervision and Regulation. Banking is a complex, highly regulated industry. The primary goals of banking regulations are to maintain a safe and sound banking system and to facilitate the conduct of sound monetary policy. In furtherance of these goals, Congress and the North Carolina General Assembly have created largely autonomous regulatory agencies and enacted numerous laws that govern banks, their holding companies and the banking industry. The descriptions of and references to the statutes and regulations below are brief summaries and do not purport to be complete. The descriptions are qualified in their entirety by reference to the specific statutes and regulations discussed.

As a North Carolina bank, Yadkin is subject to regulation, supervision and regular examination by the North Carolina Banking Commission (the "Commission") through the North Carolina Commissioner of Banks (the "Commissioner") and its applicable federal regulator is the Federal Deposit Insurance Corporation ("FDIC"). The North Carolina Banking Commission and the FDIC have the power to enforce compliance with applicable banking statutes and regulations.

Federal regulation

As a North Carolina bank, Yadkin is subject to regulation, supervision and regular examination by the FDIC. The FDIC is required to conduct regular on-site examinations of the operations of the Bank and enforces federal laws that set specific requirements for bank capital, the payment of dividends, loans to officers and directors, and types and amounts of loans and investments made by commercial banks. Among other things, the FDIC must approve the establishment of branch offices, conversions, mergers, assumption of deposit liabilities between insured banks and uninsured banks or institutions, and the acquisition or establishment of certain subsidiary corporations. The FDIC can also prevent capital or surplus diminution in transactions where the deposit accounts of the resulting, continuing or assumed bank are insured by the FDIC.

Transactions with Affiliates. A bank may not engage in specified transactions (including, for example, loans) with its affiliates unless the terms and conditions of those transactions are substantially the same or at least as favorable to the Bank as those prevailing at the time for comparable transactions with or involving other nonaffiliated entities. In the absence of comparable transactions, any transaction between a bank and its affiliates must be on terms and under circumstances, including credit standards, which in good faith would be offered or would apply to nonaffiliated companies. In addition, transactions referred to as "covered transactions" between a bank and its affiliates may not exceed 10% of the bank's capital and surplus per affiliate and an aggregate of 20% of its capital and surplus for covered transactions with all affiliates. Certain transactions with affiliates, such as loans, also must be secured by collateral of specific types and amounts. The Bank also is prohibited from purchasing low quality assets from an affiliate. Every company under common control with the Bank is deemed to be an affiliate of the Bank.

Loans to Insiders. Federal law also constrains the types and amounts of loans that the Bank may make to its executive officers, directors and principal shareholders. Among other things, these loans are limited in amount, must be approved by the Bank's board of directors in advance, and must be on terms and conditions as favorable to the Bank as those available to an unrelated person.

Regulation of Lending Activities. Loans made by the bank are also subject to numerous federal and state laws and regulations, including the Truth-In-Lending Act, Federal Consumer Credit Protection Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act and adjustable rate mortgage disclosure requirements. Remedies to the borrower or consumer and penalties to the Bank are provided if the Bank fails to comply with these laws and regulations. The scope and requirements of these laws and regulations have expanded significantly in recent years.

Branch Banking. All banks located in North Carolina are authorized to branch statewide. Accordingly, a bank located anywhere in North Carolina has the ability, subject to regulatory approval, to establish branch facilities near any of our facilities and within our market area. If other banks were to establish branch facilities near our facilities, it is uncertain whether these branch facilities would have a material adverse effect on our business. Federal law provides for nationwide interstate banking and branching, subject to certain aging and deposit concentration limits that may be imposed under applicable state laws. Applicable North Carolina statutes permit regulatory authorities to approve de novo branching in North Carolina by institutions located in states that would permit North Carolina institutions to branch on a de novo basis into those states. Federal regulations prohibit an out-of-state bank from using interstate branching authority primarily for the purpose of deposit production. These regulations include guidelines to insure that interstate branches operated by an out-of-state bank in a host state are reasonably helping to meet the credit needs of the host state communities served by the out-of-state bank.

Reserve Requirements. Pursuant to regulations of the Federal Reserve, the Bank must maintain average daily reserves against its transaction accounts. No reserves are required to be maintained on the first \$6.6 million of transaction accounts, but reserves equal to 3.0% must be maintained on the aggregate balances of those accounts between \$6.6 million and \$45.4 million, and reserves equal to 10.0% plus \$1.1 million must be maintained on aggregate balances in excess of \$45.4 million. These percentages are subject to adjustment by the Federal Reserve which has announced that, effective January 2005, no reserves will be required to be maintained on the first \$7.0 million of transaction accounts, but reserves equal to 3.0% must be maintained on the aggregate balances of those accounts between \$7.0 million and \$47.6 million, and additional reserves must be maintained on aggregate balances in excess of \$47.6 million in an amount equal to 10.0% of the excess. Because required reserves must be maintained

in the form of vault cash or in a non-interest-bearing account at a Federal Reserve Bank, the effect of the reserve requirement is to reduce the amount of the institution's interest-earning assets. As of December 31, 2004, the Bank met its reserve requirements.

Community Reinvestment. Under the Community Reinvestment Act ("CRA"), as implemented by regulations of the federal bank regulatory agencies, an insured bank has a continuing and affirmative obligation, consistent with its safe and sound operation, to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for banks, nor does it limit a bank's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires the federal bank regulatory agencies, in connection with their examination of insured banks, to assess the banks' records of meeting the credit needs of their communities, using the ratings of "outstanding," "satisfactory," "needs to improve," or "substantial noncompliance," and to take that record into account in its evaluation of certain applications by those banks. All banks are required to make public disclosure of their CRA performance ratings. The Bank received a "satisfactory" rating in its most recent CRA examination.

Governmental Monetary Policies. The commercial banking business is affected not only by general economic conditions but also by the monetary policies of the Federal Reserve, a federal banking regulatory agency that regulates the money supply in order to mitigate recessionary and inflationary pressures. Among the techniques used to implement these objectives are open market transactions in United States government securities, changes in the rate paid by banks on bank borrowings, and changes in reserve requirements against bank deposits. These techniques are used in varying combinations to influence overall growth and distribution of bank loans, investments, and deposits, and their use may also affect interest rates charged on loans or paid for deposits. The monetary policies of the Federal Reserve have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future. In view of changing conditions in the national economy and money markets, as well as the effect of actions by monetary and fiscal authorities, no prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or the business and earnings of the Bank.

Dividends. Under federal banking law, no cash dividend may be paid if a bank is undercapitalized or insolvent or if payment of the cash dividend would render the bank undercapitalized or insolvent, and no cash dividend may be paid by the bank if it is in default of any deposit insurance assessment due to the FDIC.

Deposit Insurance Assessments. The Bank is required to pay deposit insurance assessments set by the FDIC. Under the current assessment rate schedule, the Bank's assessment will range from no assessment to 0.27% of the Bank's average deposit base, with the exact assessment determined by the Bank's capital and the FDIC's supervisory opinion of its operations. Only the strongest banks are not required to pay an assessment. The insurance assessment rate may change periodically. Changes in the assessment rate may have a material effect on the Bank's operating results. The FDIC has the authority to terminate deposit insurance.

Changes in Management. Any depository institution that has been chartered less than two years, is not in compliance with the minimum capital requirements of its primary federal banking regulator (currently the FDIC), or is otherwise in a troubled condition must notify its primary federal banking regulator of the proposed addition of any person to the board of directors or the employment of any person as a senior executive officer of the institution at least 30 days before such addition or employment becomes effective. During this 30-day period, the applicable federal banking regulatory agency may disapprove of the addition of such director or employment of such officer. The Bank is not subject to any such requirements.

Enforcement Authority. The federal banking laws also contain civil and criminal penalties available for use by the appropriate regulatory agency against certain "institution-affiliated parties" primarily including management, employees and agents of a financial institution, as well as independent contractors such as attorneys and accountants and others who participate in the conduct of the financial institution's affairs and who caused or are likely to cause more than minimum financial loss to or a significant adverse affect on the institution, who knowingly or recklessly violate a law or regulation, breach a fiduciary duty or engage in unsafe or unsound practices. These practices can include the failure of an institution to timely file required reports or the submission of inaccurate reports. These laws authorize the appropriate banking agency to issue cease and desist orders that may, among other things, require affirmative action to correct any harm resulting from a violation or practice, including restitution, reimbursement,

indemnification or guarantees against loss. A financial institution may also be ordered to restrict its growth, dispose of certain assets or take other action as determined by the primary federal banking agency to be appropriate.

Capital Adequacy. The Bank is subject to capital requirements and limits on activities established by the FDIC. Under the capital regulations, the Bank generally is required to maintain Tier 1 risk-based capital, as such term is defined therein, of 4% and total risk-based capital, as such term is defined therein, of 8%. In addition, the Bank is required to provide a minimum leverage ratio of Tier 1 capital to adjusted average quarterly assets (“leverage ratio”) equal to 3%, plus an additional cushion 1% to 2% if the Bank has less than the highest regulatory rating. The Bank is not permitted to engage in any activity not permitted for a national bank unless (i) it is in compliance with its capital requirements and (ii) the FDIC determines that the activity would not pose a risk to the deposit insurance fund. With certain exceptions, the Bank also is not permitted to acquire equity investments of a type, or in an amount, not permitted for a national bank.

Prompt Corrective Action. Banks are subject to restrictions on their activities depending on their level of capital. Federal “prompt corrective action” regulations divide banks into five different categories, depending on their level of capital. Under these regulations, a bank is deemed to be “well capitalized” if it has a total risk-based capital ratio of 10% or more, a core capital ratio of six percent or more and a leverage ratio of five percent or more, and if the bank is not subject to an order or capital directive to meet and maintain a certain capital level. Under these regulations, a bank is deemed to be “adequately capitalized” if it has a total risk-based capital ratio of eight percent or more, a core capital ratio of four percent or more and a leverage ratio of four percent or more (unless it receives the highest composite rating at its most recent examination and is not experiencing or anticipating significant growth, in which instance it must maintain a leverage ratio of three percent or more). Under these regulations, a bank is deemed to be “undercapitalized” if it has a total risk-based capital ratio of less than eight percent, a core capital ratio of less than four percent or a leverage ratio of less than four percent. Under these regulations, a bank is deemed to be “significantly undercapitalized” if it has a risk-based capital ratio of less than six percent, a core capital ratio of less than three percent and a leverage ratio of less than three percent. Under such regulations, a bank is deemed to be “critically undercapitalized” if it has a tangible equity ratio of less than or equal to two percent. In addition, the applicable federal banking agency has the ability to downgrade a bank’s classification (but not to “critically undercapitalized”) based on other considerations even if the bank meets the capital guidelines. As of December 31, 2004 the Bank was well capitalized within the meaning of the capital guidelines.

If a bank is classified as undercapitalized, the bank is required to submit a capital restoration plan to the FDIC and the FDIC may also take certain actions to correct the capital position of the bank. An undercapitalized bank is prohibited from increasing its assets, engaging in a new line of business, acquiring any interest in any company or insured depository institution, or opening or acquiring a new branch office, except under certain circumstances, including the acceptance by the FDIC of a capital restoration plan for the bank.

If a state bank is classified as significantly undercapitalized, the FDIC would be required to take one or more prompt corrective actions. These actions would include, among other things, requiring sales of new securities to bolster capital, changes in management, limits on interest rates paid, prohibitions on transactions with affiliates, termination of certain risky activities and restrictions on compensation paid to executive officers. If a bank is classified as critically undercapitalized, the bank must be placed into conservatorship or receivership within 90 days, unless the FDIC determines otherwise.

The capital classification of a bank affects the frequency of regulatory examinations of the bank and impacts the ability of the bank to engage in certain activities and affects the deposit insurance premiums paid by the bank. The FDIC is required to conduct a full-scope, on-site examination of every bank on a periodic basis.

Banks also may be restricted in their ability to accept brokered deposits, depending on their capital classification. “Well capitalized” banks are permitted to accept brokered deposits, but all banks that are not well capitalized are not permitted to accept such deposits. The FDIC may, on a case-by-case basis, permit banks that are adequately capitalized to accept brokered deposits if the FDIC determines that acceptance of such deposits would not constitute an unsafe or unsound banking practice with respect to the bank.

Deposit Insurance. The Bank’s deposits are insured up to \$100,000 per insured account by the Bank

Insurance Fund of the Federal Deposit Insurance Corporation. The Bank's deposit insurance assessments may increase depending upon the risk category and subcategory to which the bank is assigned. The FDIC assesses insurance premiums on a bank's deposits at a variable rate depending on the probability that the deposit insurance fund will incur a loss with respect to the bank. The FDIC determines the deposit insurance assessment rates on the basis of the bank's capital classification and supervisory evaluations. Each of these categories has three subcategories, resulting in nine assessment risk classifications. The three subcategories with respect to capital are "well capitalized," "adequately capitalized" and "less than adequately capitalized" (that would include "undercapitalized," "significantly undercapitalized" and "critically undercapitalized" banks). The three subcategories with respect to supervisory concerns are "healthy," "supervisory concern" and "substantial supervisory concern." A bank is deemed "healthy" if it is financially sound with only a few minor weaknesses. A bank is deemed subject to "supervisory concern" if it has weaknesses that, if not corrected, could result in significant deterioration of the bank and increased risk to the Bank Insurance Fund. A bank is deemed subject to "substantial supervisory concern" if it poses a substantial probability of loss to the Bank Insurance Fund. Any increase in insurance assessments could have an adverse effect on the bank's earnings.

State regulation.

As a North Carolina-chartered bank, Yadkin is also subject to extensive supervision and regulation by the Commissioner. The Commissioner enforces state laws that set specific requirements for bank capital, the payment of dividends, loans to officers and directors, record keeping, and types and amounts of loans and investments made by commercial banks. Among other things, the approval of the Commissioner is generally required before a North Carolina-chartered commercial bank may establish branch offices. North Carolina banking law requires that any merger, liquidation or sale of substantially all of the assets of the Bank must be approved by the Commissioner and the holders of two thirds of the Bank's outstanding common stock.

Change of control. North Carolina banking laws provide that no person may directly or indirectly purchase or acquire voting stock of the Bank that would result in the change in control of the Bank unless the Commissioner has approved the acquisition. A person will be deemed to have acquired "control" of the Bank if that person directly or indirectly (i) owns, controls or has power to vote 10% or more of the voting stock of the Bank, or (ii) otherwise possesses the power to direct or cause the direction of the management and policy of the Bank.

Loans. In its lending activities, the Bank is subject to North Carolina usury laws which generally limit or restrict the rates of interest, fees and charges and other terms and conditions in connection with various types of loans. North Carolina banking law also limits the amount that may be loaned to any one borrower.

Dividends. The ability of the Bank to pay dividends is restricted under applicable law and regulations. Under North Carolina banking law, dividends must be paid out of retained earnings and no cash dividends may be paid if payment of the dividend would cause the bank's surplus to be less than 50% of its paid-in capital.

Holding companies. North Carolina banking law requires that bank holding companies register with the Commissioner. The Commissioner must also approve any acquisition of control of a state-chartered bank by a bank holding company. The Board of Directors does not currently intend to create a bank holding company for the Bank.

Future legislation and regulations.

Yadkin cannot predict what new legislation might be enacted or what regulations might be adopted or amended, or if enacted, adopted or amended, their effect on its operations. Any change in applicable law or regulation, state or federal, may have a material adverse effect on its business.

Number of Employees

At December 31, 2004, the Bank had 274 full-time employees (including our executive officers) and 85 part-time employees. None of the employees are represented by any unions or similar groups, and we have not experienced any type of strike or labor dispute. We consider our relationship with our employees to be good.

Item 2 — Description of Property

The Company currently operates out of 20 full-service banking offices, 5 mortgage brokerage offices and 7 administrative offices as set forth below:

Office location	Approximate Square Footage	Year Established/ Acquired
110 West Market Street, Elkin, NC	2,350	1968
1318 North Bridge Street Elkin, NC	4,550	1989
101 North Bridge Street, Jonesville, NC	2,275	1971
117 Paulines Street, East Bend, NC	2,400	1998
1404 West D Street, North Wilkesboro, NC	3,178	1984
301 West Main Street, Wilkesboro, NC	2,400	1991
709 East Main Street, Jefferson, NC	4,159	1986
107 North Fifth Avenue, West Jefferson, NC	2,400	1988
1488 Mount Jefferson Road, West Jefferson, NC	4,900	2001
516 Hawthorne Drive, Yadkinville, NC	2,324	2004
Offices doing business as Piedmont Bank -		
325 East Front Street, Statesville, NC	4,990	1998
127 North Cross Lane, Statesville, NC	2,485	1997
165 Williamson Road, Mooresville, NC	5,093	1998
520 East Plaza Drive, Mooresville, NC	3,689	2000
19525 West Catawba Avenue, Cornelius, NC	2,834	2000
100 North Statesville Road, Huntersville, NC	2,923	2000
Offices doing business as High Country Bank-		
149 Jefferson Road, Boone, NC	4,600	1998
176 Shadowline Drive, Boone, NC	1,700	2000
520 Church Road, Boone, NC	215	2001
783 W. King Street Ste A, Boone, NC	1,200	2004
Offices operated by Sidus Financial, LLC		
1905 Turnberry Drive, Greenville, NC	10,000	2004
1073 13 th Street SE, Hickory, NC	750	2004
350 South Cox Ste D, Asheboro, NC	800	2004
2308 Cedar Run Place, Wilson, NC	950	2004
611 N. Courthouse Rd, Richmond, VA	2,847	2004
1824 E. Main St, Easley, SC	1,000	2004
Offices housing administration and operations-		
209 North Bridge Street, Elkin, NC	6,120	1979
290 North Bridge Street, Elkin, NC	2,516	1995
204 South Elm Street, Statesville, NC	5,435	2000
120 South Elm Street, Statesville, NC	2,381	2001
482 State Farm Road, Boone, NC	2,900	2003
101 West Main Street, Elkin	13,480	2004

The new operations center building contains the loan department, bookkeeping and items processing, and electronic banking operations. Occupied in May of 2004, this 13,480 square foot building, originally built in the early 1900's, was purchased in January 2003.

Item 3 — Legal Proceedings

Although the Bank is a defendant in various legal proceedings arising in the ordinary course of business, there are no legal proceedings pending or, to the best knowledge of the Bank's management, threatened which, in the opinion of management, will have a material effect on the financial condition or results of operation of the Bank.

Item 4 — Submission of Matters to a Vote of Security Holders

None.

PART II

Item 5 — Market for Common Stock, Related Stockholder Matters, and Issuer Purchases of Equity Securities

Market for the Common Stock of the Bank. Yadkin first issued common stock during 1968 in connection with its initial incorporation and the commencement of its banking operations. Yadkin's common stock is listed on the NASDAQ National Market under the trading symbol "YAVY." As of March 1, 2005, the Bank had 4,551 shareholders of record.

The following table lists high and low published closing prices of Yadkin's common stock (as reported on the NASDAQ National Market) for the calendar quarters indicated:

<u>Year</u> <u>2004</u>	<u>Price</u>		<u>Year</u> <u>2003</u>	<u>Price</u>	
	<u>High</u>	<u>Low</u>		<u>High</u>	<u>Low</u>
<u>Quarterly Period</u>			<u>Quarterly Period</u>		
First quarter	\$17.98	\$16.00	First quarter	\$16.00	\$12.32
Second quarter	17.25	12.44	Second quarter	18.85	14.38
Third quarter	14.45	12.40	Third quarter	19.23	16.39
Fourth quarter	15.24	12.60	Fourth quarter	18.65	16.83

Dividends. During 2004 and 2003, a dividend of \$0.10 per share was paid quarterly to Yadkin shareholders of record on the record dates for each payment. In the future, any declaration and payment of cash dividends will be subject to Yadkin's Board of Directors' evaluation of its operating results, financial condition, future growth plans, general business and economic conditions, and tax and other relevant considerations. Also, the payment of cash dividends by Yadkin in the future will be subject to certain other legal and regulatory limitations (including the requirement that Yadkin's capital be maintained at certain minimum levels) and will be subject to ongoing review by banking regulators. There is no assurance that, in the future, Yadkin will have funds available to pay cash dividends, or, even if funds are available, that it will pay dividends in any particular amount or at any particular times, or that it will pay dividends at all.

Regulatory restrictions on cash dividends. North Carolina banking requires that dividends be paid out of retained earnings and prohibits the payment of cash dividends if payment of the dividend would cause the Bank's surplus to be less than 50% of its paid-in capital. Also, under federal banking law, no cash dividend may be paid if the Bank is undercapitalized or insolvent or if payment of the cash dividend would render the Bank undercapitalized or insolvent, and no cash dividend may be paid by the Bank if it is in default of any deposit insurance assessment due to the FDIC.

Issuer Purchase of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans Or Programs
10/1-10/31/04	3,064	\$14.13	3,064	248,436
11/1-11/30/04	10,607	14.52	10,607	237,829
12/1-12/31/04	3,365	14.25	3,365	234,464

Item 6 — Selected Financial Data

Selected Financial Data

Years Ended December 31,	2004	2003	2002	2001	2000
Total interest income	\$ 42,663,346	\$ 33,126,834	\$ 28,084,070	\$ 26,788,908	\$ 29,122,929
Total interest expense	12,211,296	10,281,115	9,865,506	12,232,539	13,029,523
Net interest income	30,452,050	22,845,719	18,218,564	14,556,369	16,093,406
Provision for loan losses	1,620,000	1,280,000	1,460,000	1,350,000	525,000
Net interest income after provision for loan losses	28,832,050	21,565,719	16,758,564	13,206,369	15,568,406
Total other income	9,227,890	7,290,556	5,403,693	3,836,551	2,615,605
Total other expense	24,015,608	15,811,009	11,659,188	8,180,616	7,961,414
Income before income taxes	14,044,332	13,045,266	10,503,069	8,862,304	10,222,597
Income taxes	4,559,800	4,125,936	3,462,454	2,857,000	3,489,702
Net Income	\$ 9,484,532	\$ 8,919,330	\$ 7,040,615	\$ 6,005,304	\$ 6,732,895
Net income per share information:					
Basic	\$ 0.90	\$ 1.02	\$ 0.90	\$ 0.83	\$ 0.92
Diluted	\$ 0.89	\$ 1.00	\$ 0.89	\$ 0.83	\$ 0.91
Cash dividends	\$ 0.40	\$ 0.40	\$ 0.40	\$ 0.40	\$ 0.37
Weighted average shares					
Basic	10,531,774	8,724,515	7,790,276	7,246,982	7,356,650
Diluted	10,694,761	8,902,108	7,919,299	7,253,768	7,373,564

Key Balance Sheet Data

As of December 31,	2004	2003	2002	2001	2000
Loans, net	\$ 720,297,551	\$ 474,769,820	\$ 439,255,668	\$ 239,589,066	\$ 232,409,180
Deposits	728,708,104	563,518,017	557,282,939	301,741,924	312,503,445
Total assets	959,790,276	683,807,059	663,404,841	368,713,918	371,896,320
Stockholders' equity	111,640,237	72,870,703	68,124,970	45,467,848	43,659,016

Item 7 — Management's Discussion and Analysis of Financial Condition and Results of Operations

Management's Discussion and Analysis is provided to assist in understanding and evaluating Yadkin's results of operations and financial condition. The following discussion should be read in conjunction with the consolidated financial statements and related notes included elsewhere herein.

Critical Accounting Policies

The accounting and reporting policies of the Bank and its subsidiaries are in accordance with accounting principles generally accepted in the United States and conform to general practices within the banking industry. The more critical accounting and reporting policies include the Bank's accounting for loans, the provision and allowance for loan losses and goodwill. In particular, the Bank's accounting policies relating to the provision and allowance for loan losses and possible impairment of goodwill involve the use of estimates and require significant judgements to be made by management. Different assumptions in the application of these policies could result in material changes

in the consolidated financial position or consolidated results of operations. Please see the discussion below under “Loans,” “Provision for Allowance for Loan Losses,” and “Goodwill.” Also, please refer to Note 1 in the “Notes to Consolidated Financial Statements” for additional information regarding all of the Bank’s critical and significant accounting policies.

LOANS – Loans that management has the intent and ability to hold for the foreseeable future are reported at their outstanding principal balances adjusted for any deferred fees or costs. Substantially all loans earn interest on the level yield method based on outstanding balance.

Loans that are deemed to be impaired (i.e. probable that the Bank will be unable to collect all amounts due according to the terms of the loan agreement) are measured based on the present value of expected future cash flows discounted at the loan’s effective interest rate or as a practical matter, at the loan’s observable market value or fair value of the collateral if the loan is collateral dependent. A valuation reserve is established as part of the allowance for loan losses to record the difference between the stated loan amount and the present value or market value of the impaired loan. Impaired loans may be valued on a loan-by-loan basis (e.g., loans with risk characteristics unique to an individual borrower) or on an aggregate basis (e.g. loans with similar risk characteristics). The Bank’s policy for recognition of interest income on impaired loans is the same as its interest income recognition policy for non-impaired loans. The Bank discontinues the accrual of interest when the collectibility of such interest becomes doubtful.

PROVISIONS AND ALLOWANCE FOR LOAN LOSSES – The provision for loan losses charged to operations is an amount sufficient to bring the allowance for loan losses to an estimated balance considered adequate to absorb probable incurred losses in the portfolio. Management’s determination of the adequacy of the allowance is based on an evaluation of the portfolio, current economic conditions, historical loan loss experience and other risk factors. Recovery of the carrying value of loans is dependent to some extent on future economic, operating, and other conditions that may be beyond the Bank’s control. Unanticipated future adverse changes in such conditions could result in material adjustments to the allowance for loan losses.

GOODWILL – Goodwill, which represents the excess of the purchase price over the fair value of net assets acquired in a business combination, is tested at least annually for impairment. The impairment test is a two-step process that begins with an initial impairment evaluation. If the initial evaluation suggests that an impairment of the asset value exists, the second step would determine the amount of the impairment, if any. If the tests conclude that goodwill is impaired, the carrying value would be adjusted, and an impairment loss would be recorded.

Financial Condition

The Bank’s total assets increased 40.4% from \$683.8 million at December 31, 2003 to \$959.8 million at December 31, 2004. Deposits grew 29.3% from \$563.5 million at December 31, 2003 to \$728.7 million at December 31, 2004. Total loans held for investment increased 43.1% from \$480.4 million at December 31, 2003 to \$687.3 million at December 31, 2004.

The growth in deposits for the year ended December 31, 2004 totaled \$165.2 million (29.3%). The acquisition of High Country Bank provided an increase in deposits of \$164.6 million or 29.0%. Products were designed to attract deposits to checking, savings, and money market accounts with charges for checking accounts being lower than competitors’ charges. The largest contributor to deposit growth, excluding the effects of the High Country acquisition, were demand deposits which increased by a total of \$34.9 million or 13.2% to offset the decline in certificates of deposit of \$32.9 million. Certificates of deposit were offered at rates in line with competitors’ rates and at one or more special rates and priced at 25-50 basis points higher than competitors’ rates for limited periods. These rates were needed in order to build a deposit base sufficient to fund loans. The growth in loans held for investment for 2004, net of the effects of the High Country acquisition totaled \$50.2 million (10.5%) and growth in loans held for sale, net of the loans held by Sidus was approximately \$677,000 (124.8%). Real estate-mortgage loans make up 60% of total loans followed by commercial (22%), real estate-construction (12%), consumer (6%). Excluding the impact of the business acquisitions, loans in excess of deposit growth were funded by increasing advances from the Federal Home Loan Bank, using proceeds from principal paydowns of mortgage backed securities and increasing commercial sweep accounts. The moderate loan growth was consistent throughout 2004, a year of economic growth in North Carolina. Although there is no concentration of deposits from one individual or

entity, the Bank does have 17% of its total deposits in the \$100,000 or greater certificate of deposit category. Due to the merger of many banks in the market, there were fewer places for individuals to open accounts and be insured above \$100,000 by the Federal Deposit Insurance Corporation. These deposits reflect the rates that have been paid and the financial strength of the customers. In addition to deposits, funding for the Bank's earning assets was obtained from overnight repurchase agreements with businesses in the local market area. Funds borrowed under repurchase agreements increased from \$24.5 million at December 31, 2003 to \$30.5 million at December 31, 2004. Advances from the Federal Home Loan Bank at December 31, 2003 totaled \$16.2 million and increased to \$70.9 million at December 31, 2004, an increase of \$ 54.7 million. Short-term advances increased by \$35.4 million and long-term advances increased by \$19.3 million

Results of Operations

The Bank's net income for 2004 was \$9,484,532, a 6.3% increase over 2003 net income of \$8,919,330. Basic income per common share was \$0.90 in 2004 compared to \$1.02 and \$0.90 in 2003 and 2002, respectively. Return on average assets was 1.07% in 2004, 1.39% in 2003, and 1.50% in 2002. Return on average equity was 9.20% in 2004, 12.69% in 2003, and 13.18% in 2002. Return on average equity declined in the past two years due to increases in equity due to intangible assets acquired in the High Country Bank and Sidus acquisitions, margin compression from the decrease in market rates in the first eighteen months and subsequent flattening of the slope of the yield curve during the last six months. Other contributors include a lower interest margin from assets and liabilities added in the business acquisitions, an increase in salaries and benefits from both branch openings and business acquisitions, and additional data communications expense required for responsive service delivery.

Net Interest Income

Net interest income is the primary source of operating income for the Bank. Net interest income is the difference between interest and fee income generated from earning assets and the interest paid on deposits and borrowed funds. The factors that influence net interest income include changes in interest rates and changes in volume and mix of asset and liability balances.

For analytical purposes, net interest income may be reported on a tax equivalent basis, which illustrates the tax savings on loans and investments exempt from state and/or federal income taxes. The tables that follow, Interest Rates Earned and Paid, and Interest Rate/Volume Analysis, represent components of net interest income for the years 2004, 2003, and 2002. These tables detail changes in interest income and expense and net interest income changes caused by rate and/or volume.

Taxable equivalent net interest income increased \$7.6 million or 32.9% in 2004 over 2003 compared to an increase of \$4.6 million or 25.0% in 2003 from 2002. The acquisition of High Country Bank on January 1, 2004 accounted for most of the increase in total average earning assets and each of the categories of earning assets and liabilities. Average earning assets increased \$210.1 million or 36.6% in 2004 over 2003 after increasing \$146.1 million or 34.2% in 2003. Average loans increased \$209.3 million or 46.8% in 2004 compared with an increase of \$134.5 million or 43.0% in 2003. Average investment securities increased \$3.8 million or 3.3% from 2003 to 2004 compared to an increase of \$19.7 million or 20.3% from 2002 to 2003.

The net yield on interest earning assets (taxable equivalent net interest income as percentage of average interest earning assets) decreased to 3.94% from 4.05% comparing 2004 to 2003 after decreasing to 4.05% from 4.35% for the prior comparative periods. As reflected in the rate/volume analysis on page 15, the increase in average balances of loans was the primary factor in the increase in interest earned, significantly more than the decrease caused by the overall loan interest rate decline from 2003 to 2004. During 2004, prime increased from 4.00% to 5.25%, as compared to the decline in 2003 when prime decreased from 4.25% to 4.00%. The reasons the variance analysis reflects a negative impact from rate variance include the timing of the rate changes that occurred only during the last six months.

Interest spread was 3.67% in 2004 compared to 3.75% in 2003 and 3.93% in 2002. Interest spread measures the difference between the average yield on earning assets and the average rate paid on interest bearing sources of funds. This ratio eliminates the impact of noninterest bearing funds and stockholders' equity and gives a direct perspective on the effect of market rates and fluctuations. Both the net interest margin and interest spread decreased because

funds from proceeds from maturing investments and loans were reinvested at lower rates and because loan growth was funded by a higher proportion interest-bearing liabilities in 2004 than in 2003. As a result of the rate increases during the last half of 2004, net interest margin improved during the last quarter but not enough to offset the net margin decline experienced earlier in the year. The average rate on earning assets in 2004 was 5.50% compared to 5.84% in 2003 and 6.66% in 2002. The average rate paid on liabilities in 2004 was 1.83% compared to 2.09% in 2003 and 2.73% in 2002. The average rate on earning assets decreased 34 basis points in 2004 compared to a decrease in the average rate on liabilities of 26 basis points. The positive effect of volume expansion offset by the negative effect of margin compression resulted in a \$7.6 million increase in tax equivalent net interest income for the year.

The following table presents the daily average balances, interest income and expense and average rates earned and paid on interest-earning assets and interest-bearing liabilities of the Bank for the last three years.

Interest Rates Earned and Paid

Net Interest Income Analysis-Fully Taxable Equivalent (dollars in thousands)

For Years Ended December 31,

	2004			2003			2002		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
INTEREST EARNING ASSETS									
Federal funds sold	\$ 5,388	\$ 63	1.17%	\$ 6,035	\$ 71	1.18%	\$ 8,255	\$ 120	1.45%
Interest-bearing deposits	1,380	31	2.25%	3,551	61	1.72%	9,518	170	1.79%
Investment securities (1)	120,674	4,905	4.06%	116,853	5,024	4.30%	97,124	5,452	5.61%
Total loans (2)	<u>656,314</u>	<u>38,104</u>	5.81%	<u>447,052</u>	<u>28,361</u>	6.34%	<u>312,527</u>	<u>22,715</u>	7.27%
Total average earning assets (1)	<u>783,756</u>	<u>43,103</u>	5.50%	<u>573,491</u>	<u>33,517</u>	5.84%	<u>427,424</u>	<u>28,457</u>	6.66%
Non earning assets	<u>101,720</u>			<u>67,153</u>			<u>40,614</u>		
Total average assets	<u>\$ 885,476</u>			<u>\$ 640,644</u>			<u>\$ 468,038</u>		
INTEREST BEARING LIABILITIES									
NOW and money market	201,157	2,173	1.08%	135,749	1,278	.94%	88,523	1,137	1.28%
Savings	44,222	454	1.03%	32,341	328	1.01%	23,257	233	1.00%
Time Certificates	<u>344,019</u>	<u>7,922</u>	2.30%	<u>288,297</u>	<u>8,046</u>	2.79%	<u>226,687</u>	<u>7,854</u>	3.46%
Total interest bearing deposits	589,398	10,549	1.79%	456,387	9,652	2.11%	338,467	9,224	2.73%
Repurchase agreements sold	29,218	379	1.30%	17,913	204	1.14%	10,917	203	1.86%
Borrowed funds	<u>49,255</u>	<u>1,283</u>	2.60%	<u>17,768</u>	<u>425</u>	2.40%	<u>11,512</u>	<u>439</u>	3.81%
Total interest bearing liabilities	<u>667,871</u>	<u>12,211</u>	1.83%	<u>492,068</u>	<u>10,281</u>	2.09%	<u>360,896</u>	<u>9,866</u>	2.73%
Non-interest bearing deposits	108,017			73,382			49,898		
Stockholders' equity	103,046			70,290			53,436		
Other liabilities	6,542			4,904			3,808		
Total average liabilities and stockholders' equity	<u>\$ 885,476</u>			<u>\$ 640,644</u>			<u>\$ 468,038</u>		
NET INTEREST INCOME/									
YIELD (3,4)		\$ 30,890	3.94%		\$ 23,236	4.05%	\$ 18,591		4.35%
INTEREST SPREAD (5)			3.67%			3.75%			3.93%

1. Yields related to securities exempt from both Federal and State income taxes are stated on a fully tax –equivalent basis, assuming a Federal income tax rate of 34%. They are reduced by the non-deductible portion of interest expense.

2. The loan average includes loans on which accrual of interest has been discontinued.

3. The net interest income is the difference between income from earning assets and interest expense.

4. Net interest yield is net interest income divided by total average earning assets.

5. Interest spread is the difference between the average interest rate received on earning assets and the average interest paid on interest-bearing liabilities. 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 current period's volume), and (ii) changes attributable to rate (changes in rate multiplied by the prior period's volume).

Interest Rate/Volume Variance Analysis (in thousands)

	2004-2003			2003-2002		
	Net Increase (Decrease)			Net Increase (Decrease)		
	due to change in:			due to change in:		
	Average Balance	Average Rate	Increase (Decrease)	Average Balance	Average Rate	Increase (Decrease)
INTEREST EARNING ASSETS:						
Federal funds sold	\$ (8)	\$ 0	\$ (8)	\$ (26)	\$ (23)	\$ (49)
Investment securities	141	(307)	(166)	782	(1,228)	(446)
Other Investments	(49)	19	(30)	(102)	(7)	(109)
Total loans	12,149	(2,407)	9,742	8,534	(2,887)	5,647
Interest earning assets	<u>\$ 12,234</u>	<u>\$ (2,696)</u>	<u>\$ 9,538</u>	<u>\$ 9,188</u>	<u>\$ (4,145)</u>	<u>\$ 5,043</u>
INTEREST BEARING LIABILITIES						
NOW and money market	\$ 707	\$ 188	\$ 895	\$ 445	\$ (304)	\$ 141
Savings	122	4	126	92	3	95
Time certificates	1,283	(1,407)	(124)	1,719	(1,527)	192
Total interest bearing deposits	2,112	(1,215)	897	2,256	(1,828)	428
Borrowed funds	906	127	1,033	234	(247)	(13)
Total interest bearing liabilities	<u>\$ 3,018</u>	<u>\$ (1,088)</u>	<u>\$ 1,930</u>	<u>\$ 2,490</u>	<u>\$ (2,075)</u>	<u>\$ 415</u>

Note: Variances caused by the changes in rate times the changes in volume are allocated equally.

Income on nonaccrual loans is included in the volume and rate variance analysis table only to the extent that it represents interest payments received.

Market Risk, Asset/Liability Management and Interest Rate Sensitivity

The Bank's principal business is the origination or purchase of loans, funded by customer deposits, loan sales, and, to the extent necessary, other borrowed funds. Consequently, a significant portion of the Bank's assets and liabilities are monetary in nature and fluctuations in interest rates will affect the Bank's future net interest income and cash flows. Interest rate risk is the Bank's primary market risk exposure. The Bank has not entered into derivative financial instruments such as futures, forwards, swaps, and options. Also, the Bank has no market risk-sensitive instruments held for trading purposes. The Bank's exposure to market risk is reviewed on a regular basis by its management.

The Bank measures interest rate sensitivity as the difference between amounts of interest-earning assets and interest-bearing liabilities that either reprice or mature within a given period of time. The difference or the interest rate repricing "gap" provides an indication of the extent to which an institution's interest rate spread will be affected by changes in interest rates. Generally, during a period of rising interest rates, a negative gap within shorter maturities would adversely affect net interest income, while a positive gap within shorter maturities would result in an increase in net interest income. During a period of falling interest rates, a negative gap within shorter maturities would result in an increase in net interest income while a positive gap within shorter maturities would have the opposite effect.

The interest rate sensitivity management function is designated to maintain consistent growth of net interest income with acceptable levels of risk to interest rate changes generally on a one year horizon. The rate sensitivity model,

reflecting the Bank's asset sensitivity, projected an increase in net interest margin from rate increases. This margin improvement occurred during the last quarter of 2004 following five rate increases announced by the Federal Reserve beginning June 29, 2004. However, the business acquisitions were a source of margin compression from the mix of interest rate sensitive assets and liabilities acquired. For the year 2004, the negative effect from an overall decrease in rates on earning assets was offset by positive effects of both (1) increased volume from the business acquisitions, and (2) an overall decline in rates from renewing and replacing certificates of deposits that matured in 2004 or in the last quarter of 2003. Management uses various resources to measure interest rate risk, including simulating net interest income under different rate scenarios, monitoring changes in asset and liability values under similar rate scenarios and monitoring the gap between rate sensitive assets and liabilities over different time periods. The rate sensitivity table that follows indicates the volume of interest-earning assets and interest-bearing liabilities as of December 31, 2004 that mature or are expected to reprice within a twelve-month period.

Income statement "gap" allows for the rate paid on certain deposit and liability classes to adjust less than an actual change in market rates. Management develops this information with internal historical data and professional external sources.

GAP Analysis

(IN THOUSANDS)	Three Months Or Less	Over 3 Months to 12 Months	Total 1 Year	Maturing			Total
				Over 1 Year Thru 3 Years	Over 3 Yrs Thru 5 Years	Over 5 Years	
Earning Assets							
Loans:							
Commercial	\$ 106,428	\$ 7,706	\$ 114,134	\$ 13,094	\$ 15,536	\$ 5,734	\$ 148,498
Real estate – construction	53,986	6,860	60,846	5,370	9,709	4,020	79,945
Real estate – mortgage	225,819	9,562	235,381	41,064	94,205	43,982	414,632
Consumer	14,606	3,754	18,360	13,443	11,242	1,225	44,270
Total	400,839	27,882	428,721	72,971	130,692	54,961	687,345
Securities:							
U. S. Treasuries and other agencies	1,615	10,672	12,287	30,697	12,488	1,038	56,510
State and municipal securities	648	1,130	1,778	3,105	4,240	20,666	29,789
Mortgage backed debt securities	16	60	76	68	5,975	21,007	27,126
Mutual funds/equities	1	-	1	-	-	1,040	1,041
Total	2,280	11,862	14,142	33,870	22,703	43,751	114,466
Federal funds sold	4,722	-	4,722	-	-	-	4,722
Interest bearing due from banks	3,084	95	3,179	-	-	-	3,179
Earning assets	\$ 410,925	\$ 39,839	\$ 450,764	\$ 106,841	\$ 153,395	\$ 98,712	\$ 809,712
Paying Liabilities:							
NOW accounts	\$ 91,879	-	\$ 91,879	\$ -	-	-	\$ 91,879
Money market accounts	127,445	-	127,445	-	-	-	127,445
Savings	44,727	-	44,727	-	-	-	44,727
Certificates:			-				-
Over \$100,000	38,309	43,331	81,640	29,794	11,387	-	122,821
Other certificates	44,850	103,366	148,216	60,656	16,484	-	225,356
Total deposits	347,210	146,697	493,907	90,450	27,871	-	612,228
TT& L Notes	1,847	-	1,847	-	-	-	1,847
Repurchase Agreements/Fed funds purchased	30,541	-	30,541	-	-	-	30,541
FHLB borrowing	-	41,900	41,900	5,000	15,000	9,580	71,480
Other borrowings	9,123	-	9,123	-	-	-	9,123
Total paying liabilities	\$ 388,721	\$ 188,597	\$ 577,318	\$ 95,450	\$ 42,871	\$ 9,580	\$ 725,219
GAP	\$ 22,204	\$ (148,758)	\$ (126,554)	\$ 11,391	\$ 110,524	\$ 89,132	\$ 84,493
GAP %	105.7%	21.1%	78.1%	111.9%	357.8%	1,030.4%	111.6%

Additional information regarding loans with maturity dates that exceed one year

Fixed rate loans with maturities that exceed one year	\$257.4 million
Variable rate loans with maturities that exceed one year	\$233.5 million

Net interest earnings at risk is the potential adverse change in net interest income arising from assumed changes in interest rates. The potential change is measured over a one year forecast time horizon. The table below illustrates net interest earnings at risk using a +/- 200 basis point change in interest rates; assuming a parallel shift in the treasury curve yield. The model simulates changes in repricing, prepayments, call-options, and other rate-driven parameters that affect the level and timing of cash flows.

**Income Shock Summary
(in thousands)**

	January 1, 2005 - December 31, 2005				
	Base	Rates UP (+200 bp)		Rates DN (-200bp)	
	Amount	Amount	% Change	Amount	% Change
Short-term investments	\$ 734	\$ 1,295	76.43	\$ 198	(73.02)
Securities	5,044	5,425	7.55	4,632	(8.17)
Loans	46,394	53,800	15.96	38,932	(16.08)
Interest income	52,172	60,520	16.00	43,762	(16.12)
Transaction deposits	4,242	6,881	62.21	1,837	(56.69)
Certificates of deposit	9,141	12,225	33.74	6,300	(31.08)
Borrowed money	3,902	5,904	51.31	2,043	(33.93)
Interest expense	17,285	25,010	44.69	10,180	(41.11)
Net interest income	\$ 34,887	\$ 35,510	1.79	\$ 33,582	(3.74)

Liquidity Management

The primary goal of liquidity management is to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities, and to satisfy reserve requirements. This goal is achieved through a combination of deposits, borrowing through unpledged securities, federal funds lines of credit, Federal Home Loan Bank line of credit, and availability at the Federal Reserve discount window. Liquidity needs have been met primarily through federal funds purchased and use of a line of credit at the Federal Home Loan Bank. Deposits from consumer and business customers, both time and demand, are the primary source of funds for the Bank. The Bank has not solicited deposits from outside its primary market area and has not engaged in the placement of deposits with nonmarket institutional customers. Comparing 2004 to 2003, average total deposits increased 32.1% or \$170.2 million with High Country Bank contributing \$163 million at acquisition. At December 31, 2004, total deposits reflected a 29.3% increase or \$165.2 million compared to December 31, 2003. Commercial sweep accounts, a noninsured product invested in repurchase agreements were \$30.5 million at year-end 2004 compared to \$24.5 million at year end 2003. Deposit sources are available to the Bank both within and outside its primary market area based on a function of price. Deposit competition comes from other banks, both regional and community institutions, as well as nonbank competition, including mutual funds, annuities, and other nondeposit investments. Subject to certain conditions, unused availability from the Federal Home Loan Bank at December 31, 2004 was \$105.6 million. At end of year 2004, unpledged securities totaled \$65.6 million or 57.4% of the securities portfolio.

OTHER BORROWED FUNDS

See Note 8 under "Notes to Consolidated Financial Statements".

Investment Securities

At December 31, 2004, the securities classified as available for sale, carried at market value, totaled \$114.5 million with an amortized cost of \$113.4 million. Securities available for sale are securities that will be held for an indefinite period of time, including securities that management intends to use as a part of its asset/liability strategy. These securities may be sold in response to changes in interest rates, to changes in prepayment risk, or to the need to increase regulatory capital. Securities available for sale consist of U.S. treasury notes with an average life of 1.95 years, U.S. government agencies with an average life of 2.10 years, municipal securities with an average life of 6.66 years, and mortgage backed securities with an average life of 3.15 years. Management has determined that it has both the ability and intent to hold these securities until maturity. The proceeds from maturities and sales were invested along with funds in excess of loan demand.

Maturities and Yields of Debt Securities

As of December 31, 2004

<i>Dollars in thousands</i>	<u>Within 1 year</u>		<u>1 to 5 years</u>		<u>5 to 10 years</u>		<u>After 10 years</u>		<u>Total</u>
	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>	
Available for sale securities									
U.S. Treasuries	\$ 2,055	3.23%	\$ 7,123	2.66%	\$ -	-	\$ -	-	\$ 9,178
U.S. Government agencies	9,624	3.96%	35,097	3.29%	1,038	5.05%	-	-	45,759
Mortgage backed securities	-	-	5,169	4.64%	8,087	3.79%	14,478	4.62%	27,734
Municipals	1,778	4.03%	7,345	3.77%	16,929	3.71%	3,737	3.49%	29,789
Other	<u>1</u>	1.17%	<u>965</u>	3.55%	<u>-</u>	-	<u>1,040</u>	5.61%	<u>2,006</u>
Total available for sale securities	<u>\$ 13,458</u>		<u>\$ 55,699</u>		<u>\$ 26,054</u>		<u>\$ 19,255</u>		<u>\$ 114,466</u>

The following table presents time deposits in two categories, (1) time deposits of \$100,000 or more, and (2) other time deposits.

Maturities of Time Deposits

As of December 31, 2004

<i>Dollars in thousands</i>	Within	Three to	Six to	Within	One To	<u>Total</u>
	Three	Six	Twelve	One	Five	
	<u>Months</u>	<u>Months</u>	<u>Months</u>	<u>Year</u>	<u>Years</u>	
Time deposits of \$100,000 or more	\$ 38,309	\$ 15,518	\$ 27,813	\$ 81,640	\$ 41,181	\$ 122,821
Other time deposits	\$ 45,378	\$ 38,729	\$ 33,302	\$ 117,409	\$ 107,947	\$ 225,356

Capital Adequacy

Stockholders' equity at December 31, 2004, totaled \$111.6 million, an increase of 52.4% over 2003 year-end equity of \$72.9 million. The 2004 equity total includes an unrealized net gain on available for sale securities of \$650,000 compared to \$1.5 million at December 31, 2003. The Bank's internal capital generation rate (net income less cash dividends declared, as a percentage of average equity) was 5.1% in 2004 and 7.5% in 2003. Dividends in 2004 were 44.7% of after tax earnings compared to 41.1% in 2003 and 44.9% in 2002. The Bank had pursued a policy of increasing the dividend payout as a percentage of after tax earnings in recent years until 2002. The current dividend policy is a payout of approximately 40% of earnings.

Since 1999 the shareholders have approved five stock buy back programs. The table below details the five plans and number of shares repurchased. Shares repurchased must, by North Carolina law, be cancelled and the number

of shares outstanding reduced. The table below details the stock repurchase activity from inception of the plans through January 7, 2005.

Approved by Shareholders	Shares Repurchased & Cancelled	Average Cost	Total Reduction of Capital
2000 and prior plans 250,000 shares approved	160,769	12.39	1,991,263
2001 Plan 250,000 shares approved	192,516	11.59	2,231,350
2002 Plan 300,000 shares approved	139,730	12.93	1,806,529
2003 Plan 300,000 shares approved	15,935	16.81	267,894
2004 Plan 300,000 shares approved	78,303	14.08	94,238
Total Repurchased	587,253	12.60	4,903,803

The Bank's tangible equity ratio was 7.95%, 9.06% and 8.52% at end of year 2004, 2003, and 2002, respectively. These ratios exceed all minimum regulatory capital requirements. The detail for the calculation of these ratios is in the following table.

Capital Adequacy Ratios

December 31,

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Tangible assets	\$ 921,414,360	\$ 671,779,968	\$ 650,737,731
Tangible equity*	73,264,321	60,843,612	55,457,860
Tangible equity ratio*	7.95%	9.06%	8.52%
Regulatory guidelines	3%	3%	3%

*Note: Tangible assets and tangible equity exclude goodwill and core deposit intangibles.

Loans

Net loans held for investment (total loans held for investment less allowance for loan losses) as of December 31, 2004 were \$678.7 million as compared with \$474.2 million as of December 31, 2003, an increase of 43.1% or \$204.5 million. High Country Bank loans, at time of acquisition accounted for \$156.0 million or 33.0 % of the increase. In addition, the Bank's residential mortgage loans classified as held for sale totaled \$41.6 million and \$543,000 at December 31, 2004 and 2003, respectively, representing an increase of 7,561.9% or \$41.1 million. The mortgages held for sale by Sidus accounted for 40,385,943 or 7,337.1% of the increase. The Bank places emphasis on consumer based installment and commercial loans to small and medium size businesses and residential mortgage lending. The Bank has a diversified loan portfolio with no concentrations to any one borrower, industry or market region. Loan growth in 2004 was concentrated in real estate - mortgage loans, with portfolio share increasing from 58.6% to 60.4%. Consumer loans decreased from 6.2% to 4.9% of the portfolio while commercial loans decreased from 25.1% to 21.6%. The amounts and types of loans outstanding for the past five years ended December 31 are shown on the following table.

Loans
As of December 31,

	2004		2003		2002		2001		2000	
	% of		% of		% of		% of		% of	
	Amount	Loans	Amount	Loans	Amount	Loans	Amount	Loans	Amount	Loans
<i>dollars in thousands</i>										
Loans										
Real estate-										
Construction	\$ 80,000	11.64%	\$ 48,360	10.07%	\$ 49,055	11.80%	\$ 3,578	1.59%	\$ 7,852	3.40%
Mortgage	416,855	60.65%	281,623	58.62%	226,434	54.46%	119,818	53.17%	123,927	53.63%
Commercial, financial and										
Agricultural	154,740	22.51%	120,580	25.10%	105,275	25.32%	65,725	29.16%	65,881	28.51%
Consumer	<u>35,750</u>	5.20%	<u>29,852</u>	6.21%	<u>35,002</u>	8.42%	<u>36,236</u>	16.08%	<u>33,400</u>	14.46%
Total loans	687,345	100.00%	480,415	100.00%	415,766	100.00%	225,357	100.00%	231,060	100.00%
Allowance for loan losses	<u>(8,654)</u>		<u>(6,188)</u>		<u>(6,218)</u>		<u>(3,536)</u>		<u>(3,641)</u>	
Net loans	<u>\$ 678,691</u>		<u>\$ 474,227</u>		<u>\$ 409,548</u>		<u>\$ 221,821</u>		<u>\$ 227,419</u>	

Nonperforming Assets

Nonperforming assets include loans classified as nonaccrual, foreclosures and repossessions, and loans past due 90 days or more on which interest is still being accrued. It is the general policy of the Bank to stop accruing interest when any loan is past due as to principal or interest and the collection of either is in doubt. Unsecured consumer loans are usually charged off when payments are more than 90 days delinquent. When a loan is placed on nonaccrual status, any interest previously accrued but not collected is reversed against current income.

Nonperforming assets as of December 31, 2004 totaled \$4.2 million or 0.61% of total loans compared with \$2.0 million or 0.42% in 2003 and \$2.5 million or 0.59% in 2002. Most of the increase, \$1.4 million, can be attributed to property obtained in the High Country acquisition. The Bank assertively pursues the liquidation of nonperforming assets through its collection department.

Nonperforming Assets
December 31,

	2004	2003	2002	2001	2000
Loans 90 days past due-still accruing	\$ 0	\$ 158,525	\$ 580,263	\$ 158,816	\$ 424,445
Loans on nonaccrual	3,039,575	1,489,207	1,015,217	750,828	646,097
Other real estate and repossessions	<u>1,125,427</u>	<u>381,546</u>	<u>864,860</u>	<u>166,128</u>	<u>49,081</u>
Total nonperforming assets	<u>\$ 4,165,008</u>	<u>\$ 2,029,278</u>	<u>\$ 2,460,340</u>	<u>\$ 1,075,772</u>	<u>\$ 1,119,623</u>
Loans 90 days past due/total loans	0.0%	0.03%	0.14%	0.07%	0.18%
Total nonperforming assets/total loans	0.61%	0.42%	0.59%	0.48%	0.48%

Provision and Allowance for Loan Losses

The risks inherent in the Bank's loan portfolio, including the adequacy of the allowance or reserve for loan losses, are significant estimates that are based on management's assumptions regarding, among other factors, general and local economic conditions, which are difficult to predict and are beyond the Bank's control. In estimating these risks, and the related loss reserve levels, management also considers the financial conditions of specific borrowers and credit concentrations with specific borrowers, groups of borrowers, and industries.

The provision for loan losses was \$1,620,000 in 2004 compared to \$1,280,000 in 2003 and \$1,460,000 in 2002. This provision reflects management's assessment of the adequacy of the allowance for loan losses to absorb losses inherent in the loan portfolio due to credit deterioration or changes in the risk profile. The assessment primarily considers the allowance for loan loss levels relative to risk weightings assigned by credit administration to loan types. The risk weightings are based on several factors including historical data, current economic factors, composition of the portfolio, and evaluations of the total loan portfolio and assessments of individual credits within specific loan types. Because these factors are ever changing the provision for loan losses can fluctuate. Credit reviews are based primarily on analysis of borrowers' cash flows, with asset values considered only as a second source of payment.

Management uses several measures to assess and monitor the credit risks in the loan portfolio, including a loan grading system that begins upon loan origination and continues until the loan is collected or collectibility becomes uncertain. Upon loan origination, the Bank's originating loan officer evaluates the quality of the loan and assigns one of eight risk levels, each level indicating a different level of loss reserves. The loan officer monitors the loan's performance and credit quality and makes changes to the risk grade as conditions warrant. When originated or renewed, all loans over a certain dollar amount receive in depth reviews and risk assessments by the Bank's Credit Administration. Any issues regarding the risk assessments are addressed by the senior credit administrator and factored into management's decision to originate or renew the loan as well as the level of reserves deemed to be appropriate for the loan. Furthermore, loans and commitments made each month as well as loans past due 30 days or more, are reviewed by the Board of Directors Loan Committee. The Bank's Board of Directors also reviews an analysis of the Bank's reserves relative to the range of reserves estimated by the Bank's credit administration quarterly.

Management uses the information developed from the procedures above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in determining the appropriate levels of the allowance for loan losses.

As a part of the continual grading process, individual loans are assigned a credit risk grade based on their credit quality, which is subject to change as conditions warrant. Any changes in risk assessments as determined by loan officers, credit administrators, regulatory examiners and management are also considered. Management considers certain commercial loans with weaker credit risk grades to be individually impaired and measures such impairment based upon available cash flows and the value of the collateral. Impaired loans are identified in a periodic analysis of the adequacy of the reserve. An allocation of the allowance is made for impaired loans based on factors including type of loan, loan grade, and days past due. Allowance or reserve levels are estimated for all other graded loans in the portfolio based on their assigned credit risk grade, type of loan, and other matters related to credit risk. In estimating reserve levels, the Bank also aggregates non-graded loans and reviews the historical loss experience associated with these type loans as additional criteria to allocate the allowance.

Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Bank's loan portfolio as of December 31, 2004. Management believes it has established the allowance in accordance with accounting principles generally accepted in the United States of America and in consideration of future additions to the allowance that may be necessary based on changes in economic and other conditions. Additionally, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the recognition of adjustments to the allowances based on their judgments of information available to them at the time of their examinations.

The allowance for loan losses is created by direct charges to operations. Losses on loans are charged against the allowance for loan losses in the accounting period in which they are determined by management to be uncollectible. Recoveries during the period are credited to the allowance for loan losses.

Management realizes that general economic trends greatly affect loan losses, and no assurances can be made that further charges to the loan loss allowance may not be significant in relation to the amount provided during a particular period or that further evaluation of the loan portfolio based on conditions then prevailing may not require sizable additions to the allowance, thus necessitating similarly sizable charges to operations. Net loan losses were \$1.2 million or 0.18% of average loans in 2004 compared to \$1.3 million or .29% of average loans in 2003 and \$1.0 million or .31% of average loans in 2002. Loan charge-offs in 2004 were comprised of numerous loans, mostly in

the commercial loan classification. As of December 31, 2004, the allowance for loan losses was \$8.6 million or 1.25% of year end loans. This allowance level compares with \$6.2 million or 1.29% of loans held for investment at December 31, 2003 and \$6.2 million or 1.50% at December 31, 2002. Management considers the allowance for loan losses at December 31, 2004 to be adequate.

The following table presents a reconciliation of the allowance for loan losses and reflects charge-offs and recoveries by loan category.

	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
<i>(Dollars in thousands)</i>					
Balance at beginning of year	\$ 6,187	\$ 6,218	\$ 3,536	\$ 3,641	\$ 3,588
Charge-offs:					
Real estate loans	564	398	185	50	91
Installment loans	164	304	644	1,376	332
Credit card and related plans	72	31	34	56	54
Commercial and all other	769	776	263	179	98
Leases	-	-	-	4	-
Total charge-offs	<u>1,569</u>	<u>1,509</u>	<u>1,126</u>	<u>1,665</u>	<u>575</u>
Recoveries:					
Real estate loans	213	56	16	20	30
Installment loans	60	57	107	156	56
Credit card and related plans	27	6	11	9	13
Commercial and all other	77	79	31	25	4
Total recoveries	<u>377</u>	<u>198</u>	<u>165</u>	<u>210</u>	<u>103</u>
Net Chargeoffs	1,192	1,311	961	1,455	472
Additions added to operations	1,620	1,280	1,460	1,350	525
Allowance acquired from HighCountry Bank *	2,038				
Allowance acquired from Piedmont Bank *			2,183		
Balance at end of year	<u>\$ 8,654</u>	<u>\$ 6,187</u>	<u>\$ 6,218</u>	<u>\$ 3,536</u>	<u>\$ 3,641</u>

The following table presents the allocation of the allowance for loan losses by category.

*Allowance was assigned to reduce Piedmont Bank and High Country Bank loans to fair market value at July 31, 2002 and January 1, 2004, respectively.

Allocation of the Allowance for Loan Losses

	<u>2004</u>		<u>2003</u>		<u>2002</u>		<u>2001</u>		<u>2000</u>	
	Percent of		Percent of		Percent of		Percent of		Percent of	
	Loans In Each		Loans In Each		Loans In Each		Loans In Each		Loans In Each	
	Category		Category		Category		Category		Category	
	To Total		To Total		To Total		To Total		To Total	
<i>(Dollars in thousands)</i>	Amount	Loans	Amount	Loans	Amount	Loans	Amount	Loans	Amount	Loans
Real estate	\$ 1,369	73%	\$ 1,552	69%	\$ 3,803	67%	\$ 1,659	55%	\$ 1,848	57%
Commercial, agricultural, other	3,100	22%	2,276	25%	1,419	25%	875	29%	975	29%
Consumer	4,089	5%	1,269	6%	454	8%	483	16%	538	14%
Unallocated	96		950		542		519		280	
	<u>\$ 8,654</u>	<u>100%</u>	<u>\$ 6,187</u>	<u>100%</u>	<u>\$ 6,218</u>	<u>100%</u>	<u>\$ 3,536</u>	<u>100%</u>	<u>\$ 3,641</u>	<u>100%</u>

Noninterest Income

Noninterest income is derived primarily from activities such as service fees on deposit and loan accounts,

commissions earned from the sale of insurance and investment products, income from the mortgage banking operations, gains or losses sustained from the sale of investment securities or mortgage loans, income earned from bank owned life insurance (BOLI) and gains from the capitalization of mortgage servicing rights.

Noninterest income increased 26.6% or \$1.9 million in 2004. The increase was due primarily to increased service charges from checking accounts, other service fees, and gains on sales of mortgage loans. Net gain on sales of investment securities was \$57,000 in 2004 compared to a gain of \$301,000 in 2003 and a loss of \$156,000 in 2002. BOLI income, which is essentially exempt from state and federal income taxes, was \$577,000 in 2004 compared to \$725,000 in 2003 and \$700,000 in 2002. The principal value of all bank owned life insurance on December 31, 2004 was \$16.0 million compared to \$15.4 million at December 31, 2003.

Service charges on deposit accounts increased 39.0% or \$1.1 million from 2003 to 2004 after increasing 29.7% or \$670,000 in 2003 because of higher utilization of fee income services. Other service fees increased by \$1.2 million or 70.6% in 2004, exceeding the increase of \$863,000 or 102.6% in 2003, as commissions generated both from sales of investment products and from brokered mortgages increased over the prior year. Debit card fees and merchant credit card fees also contributed to the increase in other service fees. Gains on sales of mortgage loans increased \$438,000 or 263.8% in 2004 with Sidus Financial providing \$685,000 of that increase. Without Sidus, the loss on sale of mortgages would have been \$80,000, a decrease of \$246,000 from last year. Gains on sales of mortgage loans decreased \$59,000 or 26.2% in 2003 as losses in the third quarter attributable to decreases in loan pricing partially offset larger gains realized in the first two quarters. Income from investment in bank-owned life insurance (BOLI) decreased \$148,000 (20.4%) in 2004 as market yields on these policies declined. The BOLI investment increased \$25,000 (3.6%) in 2003, because it was the first full year of income from the BOLI policies acquired in the Main Street acquisition on July 31, 2002. Mortgage banking income decreased \$453,000 or 77.4% in 2004 after an increase of \$14,000 or 2.5% in 2003, as the volume declined significantly in 2004 as compared to 2003. Servicing fees on mortgage loans increased 9.6% or \$61,000 in 2004 after a 2.5% increase in 2003. The Bank's average servicing portfolio decreased by \$3.1 million or 1.1% in 2004 following an increase of \$27.3 million or 12.8% in 2003.

Exposure to changing interest rates are expected to affect gains on mortgage sales because the mortgage origination volume is expected to increase when market rates decline and to decrease when rates rise. Since the Company maintains a stable profit margin on mortgage loans sold, volume is the primary factor for determining gains on sales of mortgages. The impact of interest rates on the gain of a single mortgage loan is negligible because the Company secures a price commitment from its investor when it agrees to lock a rate for a borrower.

Noninterest Expense

Noninterest expense includes salaries and benefits to employees, occupancy and equipment expenses, and all other operating costs. Total noninterest expenses increased 51.9% comparing 2004 to 2003 and 35.6% comparing 2003 to 2002. Other expenses attributable to the acquisition were amortization of core deposit intangible, totaling \$893,000 in 2004 and \$650,000 in 2003, a noncash expense that will continue until 2022 and is being amortized under an accelerated method. This increase in noninterest expenses, which exceeded the Bank's goal of a 3-5% increase, was expected as a result of acquisition related expenses that were not capitalized and the additional branches acquired in the acquisition.

Personnel expenses, including salaries and employee benefits, constitute the largest component of noninterest expense. Comparing 2004 to 2003, salaries and benefits increased by 49.5%. The High Country acquisition, increases in accruals for bonuses, opening of the Yadkinville branch, and increased commissions accounted for the increase in salaries and benefits. Comparing 2003 to 2002, salaries and employee benefits increased 39.4%.

Occupancy and equipment expense increased 55.2% comparing 2004 to 2003. These expenses increased 47.2% comparing 2003 to 2002. The significant projects in 2004 included implementation of a new teller and CSR platform and conversion of High Country Bank's customer accounts to the Bank's core processing system. The largest project completed during 2003 was the conversion of Piedmont Bank's customer accounts to the Bank's core processing system. Other projects included an upgrade to the optical storage and retrieval systems and enhancements to the base software systems.

Other operating expenses increased 53.7% comparing 2004 to 2003, up from 26.8% comparing 2003 to 2002. Expenses attributable to branches acquired in the acquisition continued to account for most of the increase, along with the addition of the Yadkinville branch. Other operating expenses include items such as printing/supplies, telephone, marketing, directors fees, postage, data processing, mortgage origination related expenses and professional fees. In 2004 the increased expenses reflected 12 months of combined High Country and Piedmont post-acquisition operations; compared to 2003, which had 12 months of Piedmont post-acquisition operations and 2002 which had five months of Piedmont post-acquisition operations.

Contractual Obligations, Commitments and Off-Balance Sheet Arrangements

In the normal course of business, the Bank has various outstanding contractual obligations that will require future cash outflows. The Bank's contractual obligations for maturities of deposits and borrowings are presented in **Gap Analysis** included herein under Item 7. In addition, in the normal course of business, the Bank enters into purchase obligations for goods or services. The dollar amount of such purchase obligations at December 31, 2004 is not material.

In addition to the contractual obligations described above, the Bank, in the normal course of business, issues various financial instruments, such as loan commitments, guarantees and standby letters of credit, to meet the financing needs of its customers. Such commitments for the Bank, as of December 31, 2004, are presented in Note 14 to the consolidated financial statements.

As part of its ongoing business, the Bank does 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, the Bank is not involved in any unconsolidated SPE transactions.

New Accounting Standards

See Note 1 to the consolidated financial statements for a discussion of new accounting standards and management's assessment of the potential impact on the Bank's consolidated financial statements.

Inflation

Since the assets and liabilities of a bank are primarily monetary in nature (payable in fixed, determinable amounts), the performance of a bank is affected more by changes in interest rates than by inflation. Interest rates generally increase as the rate of inflation increases, but the magnitude of the change in rates may not be the same.

While the effect of inflation is normally not as significant as is the influence on those businesses that have large investments in plant and inventories, it does have an effect. There are normally corresponding increases in the money supply, and banks will normally experience above average growth in assets, loans, and deposits. Also, general increases in the prices of goods and services will result in increased operating expenses.

Forward Looking Statement

The discussions presented in this annual report contain statements that could be deemed forward looking statements within the meaning of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995, which statements are inherently subject to risks and uncertainties. Forward looking statements are statements that include projections, predictions, expectations or beliefs about future events or results or otherwise are not statements of historical fact. Such statements are often characterized by the use of qualifying words (and their derivatives) such as "expect," "believe," "estimate," "plan," "project," or other statements concerning opinions or judgements of the Bank and its management about future events. Factors that could influence the accuracy of such forward looking statements include, but are not limited to, the financial success or changing strategies of the Bank's customers or vendors, actions of government regulators, the level of market interest rates, and general economic conditions.

Item 7A — Quantitative and Qualitative Disclosures About Market Risk