

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

**Annual Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934**

For the Fiscal Year Ended December 31, 2007

Commission File No. 000-23971

Citizens South Banking Corporation

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or
organization)

54-2069979

(I.R.S. Employer Identification Number)

519 South New Hope Road, Gastonia, NC

(Address of principal executive offices)

28054-4040

(Zip Code)

Registrant's telephone number, including area code **(704) 868-5200**

Securities Registered Pursuant to Section 12(b) of the Act:

Common Stock, par value \$0.01 per share

(Title of Class)

The NASDAQ Stock Market, LLC

(Name of exchange on which registered)

Securities Registered Pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. YES o NO x

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934. YES o NO x

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 twelve months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such requirements for the past 90 days. YES x NO o.

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer o

Accelerated Filer x

Non-Accelerated Filer o

Smaller reporting Company o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO x

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant, computed by reference to the last sale price on December 31, 2007, as reported by the Nasdaq Global Market, was approximately \$58.2 million.

As of March 14, 2008, there were 7,560,644 shares of the common stock, \$0.01 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

(1) Proxy Statement for the 2008 Annual Meeting of Stockholders of the Registrant (Part III).



**CITIZENS SOUTH BANKING CORPORATION
AND SUBSIDIARIES**

FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007

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PART I

ITEM 1. Business

Citizens South Banking Corporation

Citizens South Banking Corporation (also referred to as the "Company", the "Registrant", "We", "Us", or "Our") is a Delaware corporation that owns all of the outstanding shares of common stock of Citizens South Bank (the "Bank"). The shares of common stock of the Company trade on the Nasdaq Global Market under the ticker symbol "CSBC." The Company is a public company, and files interim, quarterly, and annual reports with the SEC. These respective reports are on file and a matter of public record with the SEC and may be read and copied at the SEC's Public Reference Room at 450 Fifth Street NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

The Company's principal business activities are overseeing and directing the business of the Bank. The Company's assets consist primarily of the outstanding capital stock of the Bank, deposits held at the Bank, and investment securities. The Company became the holding company for the Bank on September 30, 2002, in connection with the mutual-to-stock conversion of Citizens South Holdings, MHC, the mutual holding company of Citizens South Banking Corporation, a federal corporation, formerly named Gaston Federal Bancorp, Inc., which was originally formed on March 18, 1998, for the purpose of acting as the holding company for the Bank.

The Company's executive office is located at 519 South New Hope Road, P.O. Box 2249, North Carolina 28053-2249 and its telephone number at this address is (704) 868-5200. The Company also maintains a website at www.citizenssouth.com that includes important information on our Company, including a list of our products and services, branch locations, and current financial information. In addition, we make available, without charge, through our website a link to our filings with the SEC, including copies of annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to these filings, if any. Information on our website should not be considered a part of this annual report.

Citizens South Bank

Citizens South Bank, which was chartered in 1904, is a federally chartered savings bank headquartered in Gastonia, North Carolina. The Bank's principal business activity is offering FDIC-insured deposits to local customers through its 14 branch offices and investing those deposits, together with funds generated from operations and borrowings, in residential and nonresidential real estate loans, construction loans, commercial business loans, consumer loans, investment securities, and mortgage-backed securities. The Bank also acts as a broker in both the origination of loans secured by one-to-four family dwellings and in the sale of uninsured financial products. The Bank's results of operations are heavily dependent on net interest income, which is the difference between the interest earned on loans and securities and the interest paid on deposits and borrowings. Results of operations are also materially affected by the Bank's provision for loan losses, noninterest income, and noninterest expense. Noninterest income includes fee income generated from deposit and loan accounts, mortgage banking fees, commissions earned from the sale of uninsured investment products, increases in the cash value of bank-owned life insurance policies, net gains (losses) from the sale of assets and other noninterest income items. The Bank's noninterest expense primarily consists of compensation and employee benefits, occupancy expense, professional services, advertising, amortization of intangible assets and other noninterest expenses. Results of operations are also significantly affected by local economic and competitive conditions, changes in interest rates, and actions of regulatory and governmental authorities.

As of December 31, 2007, Citizens South Bank had 14 full-service branch offices in the North Carolina Counties of Gaston, Union, Rowan, and Iredell. The Bank's executive office is located at 519 South New Hope Road, P.O. Box 2249, Gastonia, North Carolina 28053-2249. Its telephone number at this address is (704) 868-5200. The Bank also maintains a website at www.citizenssouth.com that includes important information on our Bank, including a list of our products and services and branch locations.

Market Area and Competition

We consider our primary market area to be the North Carolina Counties of Gaston, Rowan, Iredell, Union, Mecklenburg, Cabarrus, Lincoln, and Cleveland, and the South Carolina County of York. Our market area predominately centers in the suburbs surrounding the metropolitan area of Charlotte, North Carolina. The metropolitan area of Charlotte has a diverse economic base that includes business sectors in banking and finance, insurance, manufacturing, textiles, apparel, fabricated metals, construction, health care, transportation, retail trade, telecommunications, government services, and education. The Bank's corporate headquarters is located in Gastonia, North Carolina, which is located in the I-85 corridor, approximately 20 miles west of Charlotte.

The Bank's corporate headquarters and seven of its branch offices are located in Gaston County, North Carolina. These offices are located in the cities of Gastonia (three offices), Dallas, Mount Holly, Belmont, and Stanley. According to data provided by the Federal Deposit Insurance Corporation ("FDIC") as of June 30, 2007, there were 15 banks and thrifts operating in Gaston County with \$2.3 billion in deposits. As of June 30, 2007, the Bank had \$252.7 million in deposits in Gaston County, or 11.2% of the total County deposits. This represents an annual growth rate of 18.6% and the third highest market share in Gaston County.

We also have three branch offices in Union County, North Carolina, in the cities of Monroe, Stallings, and Weddington. According to data provided by the FDIC as of June 30, 2007, there were 11 banks and thrifts operating in Union County with \$1.6 billion in deposits. As of June 30, 2007, the Bank had \$105.3 million in deposits in Union County, or 6.7% of the total County deposits. This represents the seventh highest market share in the County.

Two branch offices are in Rowan County, North Carolina, in the cities of Salisbury and Rockwell. According to data provided by the FDIC as of June 30, 2007, there were 13 banks and thrifts operating in Rowan County with \$1.5 billion in deposits. As of June 30, 2007, the Bank had \$121.2 million in deposits in Rowan County, or 8.2% of the total County deposits representing the fourth highest market share in the County.

We also have two branch offices in Iredell County, North Carolina, in the cities of Statesville and Mooresville. According to data provided by the FDIC as of June 30, 2007, there were 18 banks and thrifts operating in Iredell County with \$2.1 billion in deposits. As of June 30, 2007, the Bank had \$106.5 million in deposits in Iredell County, or 5.0% of the total County deposits. This represents a 22.7% annual growth rate and the seventh highest market share in the County.

Employees

As of December 31, 2007, the Company had 133 full-time and 27 part-time employees, none of whom is represented by a collective bargaining unit. The Company provides employee benefit programs, including an Employee Stock Ownership Plan, matching contributions to a 401(k) retirement/savings plan, group life, disability, health, and dental insurance, and paid vacation and sick leave. Management believes its working relationship with its employees is good.

Supervision and Regulation

Citizens South Banking Corporation is a unitary savings and loan holding company, subject to regulation and supervision by the Office of Thrift Supervision ("OTS"). The OTS has enforcement authority over Citizens South Banking Corporation and its subsidiaries. This authority permits the OTS to restrict or prohibit activities that are determined to be a risk to Citizens South Bank. Federal law prohibits a savings and loan holding company from acquiring control of another savings institution or holding company thereof, without prior written approval of the OTS. It also prohibits the acquisition or retention of, with specified exceptions, more than 5% of the equity securities of a company engaged in activities that are not closely related to banking or financial in nature or acquiring or retaining control of an institution that is not federally insured. In evaluating applications by holding companies to acquire savings institutions, the OTS must consider the financial and managerial resources, future prospects of the savings institution involved, the effect of the acquisition on the risk to the insurance fund, the convenience and needs of the community and competitive factors.

Citizens South Bank is a federally chartered savings bank and derives its lending and investment powers from the Home Owners' Loan Act, as amended, and the regulations of the OTS. Under these laws and regulations, Citizens South Bank may invest in mortgage loans secured by residential and commercial real estate, commercial business and consumer loans, certain types of debt securities and certain other assets. Citizens South Bank also may establish subsidiaries that may engage in activities not otherwise permissible for Citizens South Bank, including real estate investment and securities and insurance brokerage. Citizens South Bank is a federally chartered stock savings bank, subject to examination, supervision, and regulation by the OTS, as its primary federal regulator, and the FDIC, as the deposit insurer. Citizens South Bank is also a member of and owns stock in the Federal Home Loan Bank of Atlanta, which is a part of the Federal Home Loan Bank System. The Bank must file reports with the OTS and the FDIC concerning its activities and financial condition in addition to obtaining regulatory approvals prior to entering into certain transactions such as mergers or acquisitions. This regulation and supervision establishes a comprehensive framework of activities in which an institution may engage and is intended primarily for the protection of the insurance fund and depositors. Under this system of federal regulation, financial institutions are periodically examined to ensure that they satisfy applicable standards with respect to their capital adequacy, assets, management, earnings, liquidity and sensitivity to market interest rates. Citizens South Bank is also regulated to a lesser extent by the Board of Governors of the Federal Reserve System, governing reserves to be maintained against deposits and other matters. Citizens South Bank's relationship with its depositors and borrowers also is regulated to a great extent by both federal and state laws, especially in matters concerning the ownership of deposit accounts and the form and content of Citizens South Bank's loan documents.

The following discussion summarizes certain material elements of the regulatory framework applicable to Citizens South Banking Corporation and its subsidiaries. These summaries of statutes and regulations are not intended to be complete and such summaries are qualified in their entirety by reference to such statutes and regulations. A change in the statutes, regulations, or regulatory policies applicable to the Company, or its subsidiaries, could have a material effect on the business of the Company.

Standards for Safety and Soundness. Federal law requires each federal banking agency to prescribe certain standards for all insured depository institutions. These standards relate to, among other things, internal controls, information systems and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation, and other operational and managerial standards as the agency deems appropriate. If the appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. If an institution fails to meet these standards, the appropriate federal banking agency may require the institution to submit a compliance plan. The OTS has primary enforcement responsibility over federal savings institutions and has the authority to bring enforcement action against all "institution-affiliated parties," including certain stockholders, and attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an insured institution. Formal enforcement action may range from the issuance of a capital directive, a cease and desist order, removal of officers and/or directors of the institution, receivership, conservatorship, civil penalties, or the termination of deposit insurance. The FDIC also has the authority to recommend to the Director of the OTS that enforcement action be taken with respect to a particular savings institution. If action is not taken by the Director, the FDIC has authority to take action under specified circumstances.

OTS regulations require savings banks to meet three minimum capital standards: a 1.5% tangible capital ratio, a 4% leverage ratio and an 8% risk-based capital ratio. At December 31, 2007, Citizens South Bank's capital exceeded all applicable requirements. Under prompt corrective action regulations, the OTS is required and authorized to take supervisory actions against undercapitalized savings banks. For this purpose, a savings bank is placed in one of the following five categories based on the bank's capital: 1) well-capitalized (at least 5% leverage capital, 6% tier 1 risk-based capital and 10% total risk-based capital); 2) adequately capitalized (at least 4% leverage capital, 4% tier 1 risk-based capital and 8% total risk-based capital); 3) undercapitalized (less than 8% total risk-based capital, 4% tier 1 risk-based capital or 3% leverage capital); 4) significantly undercapitalized (less than 6% total risk-based capital, 3% tier 1 risk-based capital or 3% leverage capital); and 5) critically undercapitalized (less than 2% tangible capital). At December 31, 2007, Citizens South Bank met the criteria for being considered "well-capitalized."

OTS regulations govern capital distributions by a federal savings bank, which include cash dividends, stock repurchases and other transactions charged to the capital account. A savings bank must file an application for approval of a capital distribution if: (1) the total capital distributions for the applicable calendar year exceed the sum of the savings bank's net income for that year to date plus the savings bank's retained net income for the preceding two years; (2) the bank would not be at least adequately capitalized following the distribution; (3) the distribution would violate any applicable statute, regulation, agreement or OTS-imposed condition; or (4) the savings bank is not eligible for expedited treatment of its filings. Even if an application is not otherwise required, every savings bank that is a subsidiary of a holding company must file a notice with the OTS at least 30 days before the board of directors declares a dividend or approves a capital distribution. The OTS may disapprove a notice or application if: (1) the savings bank would be undercapitalized following the distribution; (2) the proposed capital distribution raises safety and soundness concerns; or (3) the capital distribution would violate a prohibition contained in any statute, regulation or agreement.

Community Reinvestment Act and Fair Lending Laws. All savings banks have a responsibility under the Community Reinvestment Act and related regulations of the OTS to help meet the credit needs of their communities, including low- and moderate-income neighborhoods. In connection with its examination of a federal savings bank, the OTS is required to assess the savings bank's record of compliance with the Community Reinvestment Act. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. A bank's failure to comply with the provisions of the Community Reinvestment Act could, at a minimum, result in regulatory restrictions on its activities. The failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions by the OTS, as well as other federal regulatory agencies and the Department of Justice. Citizens South Bank received a "Satisfactory" Community Reinvestment Act rating in its most recent federal examination.

Transactions with Affiliates. A federal savings bank's authority to engage in transactions with its "affiliates" is limited by OTS regulations and by Sections 23A and 23B of the Federal Reserve Act (the "FRA") and its implementing regulations. The term "affiliates" for these purposes generally means any company that controls or is under common control with an institution. Citizens South Banking Corporation and its subsidiaries are affiliates of Citizens South Bank. In general, transactions with affiliates must be on terms that are as favorable to the savings bank as comparable transactions with non-affiliates. In addition, certain types of these transactions are restricted to an aggregate percentage of the savings bank's capital. Collateral in specified amounts must usually be provided by affiliates in order to receive loans from the savings bank. In addition, OTS regulations prohibit a savings bank from lending to any of its affiliates that are engaged in activities that are not permissible for bank holding companies and from purchasing the securities of any affiliate, other than a subsidiary.

Citizens South Bank's authority to extend credit to its directors, executive officers and 10% shareholders, as well as to entities controlled by such persons, is currently governed by the requirements of Sections 22(g) and 22(h) of the FRA and Regulation O of the Federal Reserve Board. Among other things, these provisions require that extensions of credit to insiders (i) be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features, and (ii) not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of Citizens South Bank's capital. In addition, extensions of credit in excess of certain limits must be approved by Citizens South Bank's Board of Directors.

Qualified Thrift Lender Test. As a federal savings bank, Citizens South Bank is subject to a qualified thrift lender, or "QTL," test. Under the QTL test, Citizens South Bank must maintain at least 65% of its portfolio assets in qualified thrift investments in at least nine months of the most recent 12-month period. Portfolio assets generally means total assets of a savings institution, less the sum of specified liquid assets up to 20% of total assets, goodwill and other intangible assets, and the value of property used in the conduct of the savings bank's business. Qualified thrift investments includes various types of loans made for residential and housing purposes, investments related to such purposes, including certain mortgage-backed and related securities, and loans for personal, family, household and certain other purposes up to a limit of 20% of portfolio assets. Qualified thrift investments also include 100% of an institution's credit card loans, education loans and small business loans. Citizens South Bank also may satisfy the QTL test by qualifying as a "domestic building and loan association" as defined in the Internal Revenue Code of 1986. A savings bank that fails the qualified thrift lender test must either convert to a bank charter or operate under specified restrictions. At December 31, 2007, Citizens South Bank maintained approximately 77% of its portfolio assets in qualified thrift investments and satisfied the QTL test as of that date.

Insurance of Deposit Accounts. Citizens South Bank's deposits are subject to assessments by the FDIC. These deposit accounts are insured by the Deposit Insurance Fund of the FDIC, generally up to a maximum of \$100,000 per separately insured depositor and up to a maximum of \$250,000 for self-directed retirement accounts. Effective March 31, 2006, the FDIC merged the Bank Insurance Fund ("BIF") and the Savings Association Insurance Fund ("SAIF") into a single insurance fund called the Deposit Insurance Fund. As a result of the merger, the BIF and SAIF were abolished. The merger of the BIF and SAIF into the Deposit Insurance Fund does not affect the authority of the Financing Corporation ("FICO") to impose and collect, with approval of the FDIC, assessments and anticipated payments, insurance costs and custodial fees on bonds issued by the FICO in the 1980's to recapitalize the Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2017 through 2019. For the quarter ended December 31, 2007, the annualized FICO assessment was equal to 1.14 basis points for each \$100 in domestic deposits maintained at an institution.

Regulations adopted by the FDIC in 2006 established a risk-based assessment system that enabled the FDIC to more closely tie each financial institution's premiums with the risk it poses to the Deposit Insurance Fund. Under the new risk-based assessment system, which became effective in 2007, the FDIC evaluated the risk of each financial institution based on three primary sources of information: 1) its supervisory rating, 2) its financial ratios, and 3) its long-term debt issuer rating, if the institution has one. The new rates for nearly all of the financial institution industry vary between five and seven cents for every \$100 of domestic deposits. At the same time, the FDIC also adopted final regulations designating the reserve ratio for the Deposit Insurance Fund during 2007 at 1.25% of estimated insured deposits.

Federal Home Loan Bank System. Citizens South Bank is a member of the Federal Home Loan Bank System ("FHLB"), which provides a central credit facility primarily for member institutions. As a member of the FHLB of Atlanta, Citizens South Bank is required to acquire and hold shares of capital stock in the FHLB in an amount at least equal to 1% of the aggregate principal amount of its unpaid residential mortgage loans and similar obligations at the beginning of each year, or 1/20 of its borrowings from the FHLB, whichever is greater. As of December 31, 2007, Citizens South Bank was in compliance with this requirement.

Federal Reserve System. The Federal Reserve Board regulations require savings banks to maintain non-interest-earning reserves against their transaction accounts, such as negotiable order of withdrawal and regular checking accounts. At December 31, 2007, Citizens South Bank was in compliance with these reserve requirements. The balances maintained to meet the reserve requirements imposed by the Federal Reserve Board may be used to satisfy liquidity requirements imposed by the OTS.

The USA PATRIOT Act. The USA PATRIOT Act gives the federal government new powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing and broadened anti-money laundering requirements. The USA PATRIOT Act also requires the federal banking agencies to take into consideration the effectiveness of controls designed to combat money laundering activities in determining whether to approve a merger or other acquisition application of a member institution. Accordingly, if we engage in a merger or other acquisition, our controls designed to combat money laundering would be considered as part of the application process. We have established policies, procedures and systems designed to comply with these regulations.

Sarbanes-Oxley Act. The Sarbanes-Oxley Act was enacted in response to public concerns regarding corporate accountability in connection with certain accounting scandals. The stated goals of the Sarbanes-Oxley Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies, and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The Sarbanes-Oxley Act generally applies to all companies that file or are required to file periodic reports with the Securities and Exchange Commission, under the Securities Exchange Act of 1934. The Sarbanes-Oxley Act includes specific additional disclosure requirements and requires the Securities and Exchange Commission and national securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules. The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees.

Federal Securities Laws. Citizens South Banking Corporation common stock is registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934. Citizens South Banking Corporation is subject to the information, proxy solicitation, insider trading restrictions and other requirements under the Securities Exchange Act of 1934. Shares of common stock purchased by persons who are not affiliates of Citizens South Banking Corporation may be resold without registration. Shares purchased by an affiliate of Citizens South Banking Corporation will be subject to the resale restrictions of Rule 144 under the Securities Act of 1933. If Citizens South Banking Corporation meets the current public information requirements of Rule 144 under the Securities Act of 1933, each affiliate of Citizens South Banking Corporation that complies with the other conditions of Rule 144, including those that require the affiliate's sale to be aggregated with those of other persons, would be able to sell in the public market, without registration, a number of shares not to exceed, in any three-month period, the greater of 1% of the outstanding shares of Citizens South Banking Corporation, or 25% of the average weekly volume of trading in the shares during the preceding four calendar weeks. In the future, Citizens South Banking Corporation may permit affiliates to have their shares registered for sale under the Securities Act of 1933.

Taxation

Federal. The Company and the Bank are subject to the provisions of the Internal Revenue Code of 1986, as amended (the "Code") in the same general manner as other corporations. For federal income tax purposes, the Bank reports its income and expenses on the accrual method of accounting and uses a tax year ending December 31 for filing its federal income tax returns.

The Small Business Protection Act of 1996 (the "1996 Act") eliminated the use of the reserve method of accounting for bad debt reserves by savings institutions, effective for taxable years beginning after 1995. Prior to the 1996 Act, the Bank was permitted to establish a reserve for bad debts and to make annual additions to the reserve.

State of North Carolina. Under North Carolina law, the corporate income tax is 6.9% of federal taxable income as computed under the Code, subject to certain prescribed adjustments. In addition, an annual state franchise tax is imposed at a rate of 0.15% applied to the greatest of the Company's capital stock, surplus and undivided profits, investment in tangible property in North Carolina or 55% of the appraised valuation of property in North Carolina.

State of Delaware. Delaware franchise taxes are imposed on the Company. Two methods are provided for calculating the tax and the lesser tax is payable. The first method is based on the authorized number of shares. The tax under this method is \$90.00 for the first 10,000 authorized shares plus \$50.00 for each additional 10,000 authorized shares or part thereof. The second method is based on an assumed par value capital. The tax rate under this method is \$200 per \$1,000,000 or portion thereof of assumed par value capital. Assumed par is computed by dividing total assets by total issued shares (including treasury shares). Assumed par value capital is calculated by multiplying the lesser of assumed par or stated par value by total authorized shares.

ITEM 1A. Risk Factors

You should consider carefully the following risk factors in evaluating an investment in the shares of Citizens South Banking Corporation common stock.

Changes in market interest rates could adversely affect the Company's financial condition and results of operations.

Citizens South Banking Corporation's results of operations and financial condition are affected by changes in interest rates. The Company's results of operations depend substantially on net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense paid on interest-bearing liabilities. Because interest-earning assets generally reprice or mature more quickly than interest-bearing liabilities, a decrease in interest rates generally would result in a decrease in the Company's net interest income. Based on results generated by its interest rate risk model, an immediate and sustained decrease of 300 basis points throughout the yield curve would decrease its annual net interest income by 2.1% for the period ended December 31, 2007. The assumptions used in the model do not provide for actions that may be taken by management during the period to offset the effects of changes in interest rates on net interest income. We are also subject to reinvestment risk associated with changes in interest rates. Changes in interest rates may affect the average life of loans and mortgage-related securities. Decreases in interest rates can result in increased prepayments of loans and mortgage-related securities, as borrowers refinance to reduce borrowing costs. Under these circumstances, the Company is subject to reinvestment risk to the extent that it is unable to reinvest the cash received from such prepayments at rates that are comparable to the rates on existing loans and securities. Additionally, increases in interest rates may decrease loan demand and make it more difficult for borrowers to repay adjustable rate loans.

Changes in interest rates also affect the value of Citizens South Banking Corporation's interest-earning assets, and in particular its securities portfolio. Generally, the value of securities fluctuates inversely with changes in interest rates. At December 31, 2007, the Company's investment and mortgage-backed securities available for sale totaled \$116.4 million. Unrealized losses on securities available for sale, net of tax, amounted to \$343,000 and are reported as a separate component of stockholders' equity. Decreases in the fair value of securities available for sale, therefore, could have an adverse effect on stockholders' equity.

A slowdown in our local economy could impair the ability of our customers to repay their loans.

We have added a significant number of loans over the past five years from new relationships as we have entered new markets through acquisitions and *de novo* offices. As a result, our loan portfolio may not be as seasoned as the loan portfolios of our competitors in some of these new markets. Should local real estate markets or economies weaken, we may begin to experience higher default rates resulting in increased levels of non-performing loans, which would likely result in higher loan losses and reduced earnings.

The Company's commercial real estate loan portfolio exposes the Company to increased lending risks.

At December 31, 2007, Citizens South Banking Corporation's portfolio of commercial real estate, multifamily, and construction loans totaled \$365.4 million, or 65.26% of total gross loans. These types of loans generally expose a lender to greater risk of non-payment and loss than one- to four-family residential mortgage loans because repayment of the loans often depends on the successful operations and the income stream of the borrowers. Such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to one- to four-family residential mortgage loans. Also, many of the Company's borrowers have more than one commercial loan outstanding. Consequently, an adverse development with respect to one loan or one credit relationship can expose the Company to a significantly greater risk of loss compared to an adverse development with respect to a one- to four-family residential mortgage loan.

Strong competition within our market areas may limit our growth and profitability.

We face numerous competitors in both our community banking and mortgage banking operations in our primary market area which is the Charlotte, North Carolina metropolitan area. We compete for loan and deposit growth with large banks that have either a regional or a national presence, other community banks, *de novo* financial institutions, thrifts or savings institutions, credit unions, brokerage and insurance firms, and other nonbank businesses, such as retailers that engage in consumer financing activities. Price competition for loans and deposits might result in earning less on our loans and paying more on our deposits, which would reduce our net interest income. Competition also makes it more challenging to grow loans and deposits and to hire and retain experienced employees. Some of the institutions with which we compete have substantially greater resources and lending limits than we do and may offer services that we do not provide. We expect competition to continue to increase in the future as a result of legislative, regulatory, and technological changes and the continuing trend of consolidation in the financial services industry.

If the Company's allowance for loan losses is not sufficient to cover actual loan losses, then our earnings could decrease.

We make various assumptions and judgments about the collectibility of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of allowance for loan losses, we review our loan loss and delinquency experience, we evaluate current local economic conditions, and we analyze the collateral position of our loan portfolio. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in increases to our allowance. Material additions to our allowance would materially decrease our net income. In addition, federal regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize additional loan charge-offs. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory authorities could have a material adverse effect on our financial condition and results of operations.

The Company operates in a highly regulated environment and may be adversely affected by changes in laws and regulations.

Citizens South Banking Corporation and its subsidiaries are highly regulated. Our holding company is regulated by the OTS and the SEC. Our community banking subsidiary is also regulated by the OTS. Such regulation and supervision govern the activities in which we may engage and are intended primarily for the protection of the deposit insurance fund and depositors. Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of an institution, the classification of assets by the institution and the adequacy of an institution's allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations or legislation, may have a material impact on the Company's operations. In addition to the risks of noncompliance, we are required to dedicate considerable time and monetary resources in our efforts to comply with the numerous laws and regulations that govern the ways in which we conduct our community banking and mortgage banking activities.

Various factors may make takeover attempts more difficult to achieve.

Provisions of the Company's certificate of incorporation and bylaws, federal regulations, Delaware law and various other factors may make it more difficult for companies or persons to acquire control of Citizens South Banking Corporation without the consent of its Board of Directors. As a Citizens South Banking Corporation stockholder, you may want a takeover attempt to succeed because, for example, a potential acquirer could offer a premium over the then-prevailing price of Citizens South Banking Corporation's common stock. The factors that may discourage takeover attempts or make them more difficult include:

Certificate of incorporation and statutory provisions. Provisions of the certificate of incorporation and bylaws of Citizens South Banking Corporation and Delaware law may make it more difficult and expensive to pursue a takeover attempt that management opposes. These provisions also would make it more difficult to remove Citizens South Banking Corporation's current Board of Directors or management, or to elect new directors. These provisions include limitations on voting rights of beneficial owners of more than 10% of its common stock, supermajority voting requirements for certain business combinations and the election of directors to staggered terms of three years. Citizens South Banking Corporation's bylaws also contain provisions regarding the timing and content of stockholder proposals and nominations and qualification for service on the Board of Directors.

Required change in control payments and issuance of stock options and recognition plan shares. Citizens South Banking Corporation has entered into employment agreements and change of control agreements with certain executive officers, which will require payments to be made to them in the event their employment is terminated following a change in control of Citizens South Banking Corporation or Citizens South Bank. Citizens South Banking Corporation also has adopted plans to permit additional issuances of stock options and recognition plan shares to key employees and directors that will require payments to them in connection with a change in control of Citizens South Banking Corporation. These payments will have the effect of increasing the costs of acquiring Citizens South Banking Corporation, thereby discouraging future takeover attempts.

Citizens South Banking Corporation's stock-based benefit plans may dilute your ownership interest.

Citizens South Banking Corporation has adopted stock option plans and recognition and retention plans. These stock-based benefit plans can be funded from the issuance of authorized but unissued shares of common stock or through open market purchases by the Company. The Company currently is repurchasing shares of its common stock in a Board-authorized share repurchase program. Stockholders will experience a reduction or dilution in ownership interest in the event newly issued shares, instead of repurchased shares, are used to fund stock option exercises and stock awards.

ITEM 1.B. Unresolved Staff Comments

None.

ITEM 2. Properties

The following table sets forth certain information regarding full-service branch offices currently in operation at December 31, 2007. Management considers the facilities to be well maintained and sufficiently suitable for present operations. The net book value of the properties, including land, building, and leasehold improvements, net of accumulated depreciation was \$18.0 million at December 31, 2007.

| <u>Location</u> | <u>Principal Use</u> | <u>Approximate Facility Size</u> (square feet) | <u>Owned or Leased</u> |
|--|--|---|------------------------|
| 519 South New Hope Road Gastonia, North Carolina 28054-4040 | Banking Office and Corporate Headquarters | 22,400 | Owned |
| 245 West Main Avenue Gastonia, North Carolina 28052-4140 | Banking Office and Operations Center | 12,400 | Owned |
| 1670 Neal Hawkins Road Gastonia, North Carolina 28056-6429 | Banking Office and Mortgage Center | 5,320 | Owned |
| 192 East Woodrow Avenue Belmont, North Carolina 28012-3163 | Banking Office | 3,400 | Owned |
| 233 South Main Street Mount Holly, North Carolina 28120-1620 | Banking Office | 2,370 | Owned |
| 3135 Dallas High Shoals Highway Dallas, North Carolina 28034-1307 | Banking Office | 3,225 | Owned |
| 412 South Highway 27 Stanley, North Carolina 28164-2055 | Banking Office | 3,225 | Owned |
| 401 West Innes Street Salisbury, North Carolina 28144-4232 | Banking Office | 5,560 | Owned |
| 106 West Main Street Rockwell, North Carolina 28138-8859 | Banking Office | 1,500 | Owned |
| 307 North Center Street Statesville, North Carolina 28677-4063 | Banking Office and Leased Office Space | 8,260 | Owned |
| 310 West Franklin Street Monroe, North Carolina 28112-4704 | Banking Office | 4,692 | Leased |
| 13731 Providence Road Weddington, North Carolina 28104-8615 | Banking Office | 2,520 | Owned |
| 101 Stallings Road Stallings, North Carolina 28104-5065 | Banking Office | 3,560 | Leased |
| 649 Brawley School Road Mooresville, North Carolina 28177-9121 | Banking Office | 3,800 | Owned |

ITEM 3. Legal Proceedings

Periodically, there have been various claims and lawsuits involving the Company or the Bank, such as claims to enforce liens, condemnation proceedings on properties in which we hold security interests, claims involving the making and servicing of real property loans and other issues incident to our business. We are not a party to any pending legal proceedings that we believe would have a material adverse effect on the financial condition, operations, or cash flows of the Company or the Bank.

ITEM 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of the security holders during the fourth quarter of 2007.

PART II

ITEM 5. Market for Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities

a. The Company's common stock, \$0.01 par value per share, trades on the Nasdaq Global Market under the ticker symbol CSBC. Price and volume information is contained in *The Wall Street Journal* and other daily newspapers in the Nasdaq section under the Global Market System listings. As of February 1, 2008, the Company had 1,589 stockholders of record (excluding the number of persons or entities holding stock in street name through various brokerage firms), and 7,660,232 shares outstanding. The following brokers made a market in the Company's stock during 2007:

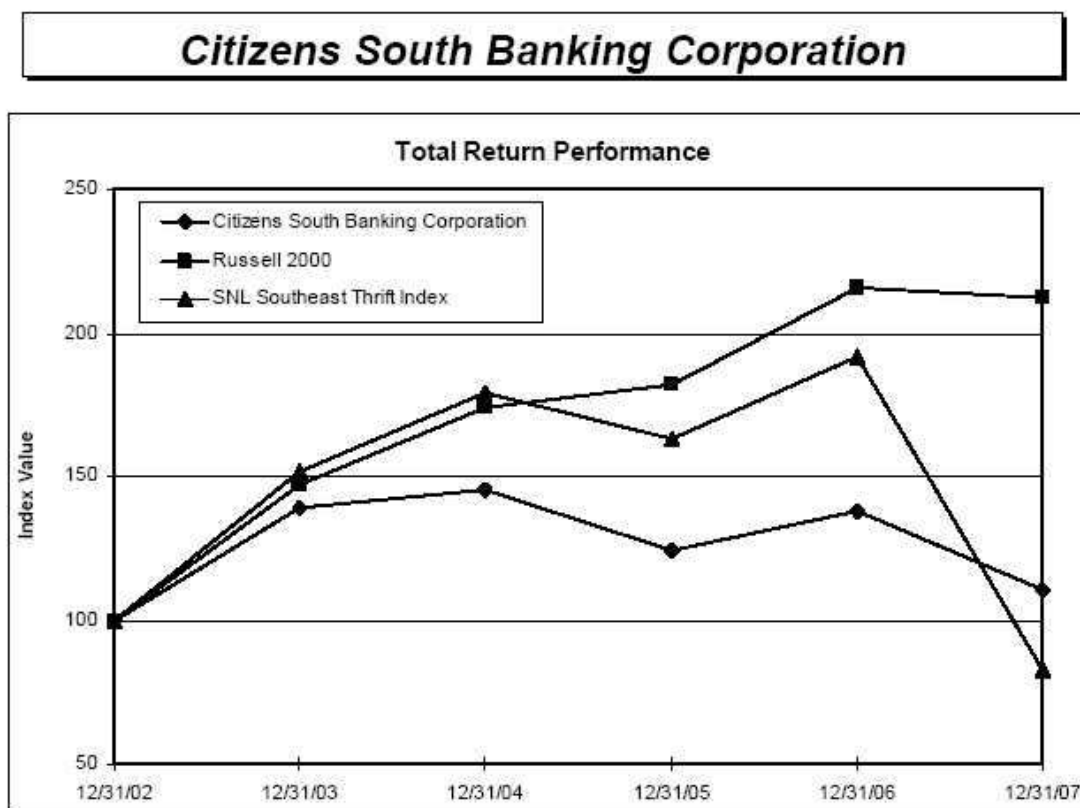
| | |
|----------------------------------|----------------|
| Burke Capital Markets, LLC | 1-404-495-5920 |
| Citigroup Global Markets, Inc. | 1-212-723-7169 |
| Fig Partners, LLC | 1-404-601-7200 |
| Friedman, Billings, Ramsey & Co. | 1-800-688-3272 |
| FTN Midwest Securities Corp. | 1-888-801-3477 |
| Howe Barnes Investments, Inc. | 1-800-621-2364 |
| Hudson Securities, Inc. | 1-800-624-0050 |
| Keefe, Bruyette & Woods, Inc. | 1-800-342-5529 |
| Knight Equity Markets, L.P. | 1-800-222-4910 |
| Merrill Lynch, Pierce, Fenner | 1-800-937-0501 |
| Morgan Keegan & Co., Inc. | 1-800-238-7533 |
| Morgan Stanley & Co., Inc. | 1-800-223-6559 |
| Sandler O'Neill & Partners | 1-212-466-8020 |
| Stanford Group Company | 1-212-492-8244 |
| Sterne, Agee & Leach | 1-800-239-2408 |
| Stifel Nicolaus and Co., Inc. | 1-800-776-6821 |
| Susquehanna Financial Group | 1-800-825-9550 |
| UBS Securities LLC | 1-212-713-2000 |

The following table sets forth quarterly market sales price ranges, dividend information, and repurchase activity for the Company's common stock over the past two years.

| <u>2007</u> | <u>Quarter 1</u> | <u>Quarter 2</u> | <u>Quarter 3</u> | <u>Quarter 4</u> |
|---------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
| Price Range: | | | | |
| High | \$ 13.40 | \$ 13.00 | \$ 12.99 | \$ 12.33 |
| Low | 12.13 | 12.38 | 12.09 | 9.72 |
| Dividend | 0.08 | 0.08 | 0.08 | 0.08 |
| Shares Repurchased | 114,712 | 121,000 | 116,725 | 163,200 |
| Avg. Price Paid Per Share | \$ 13.09 | 12.88 | \$ 12.73 | \$ 11.76 |
| <u>2006</u> | <u>Quarter 1</u> | <u>Quarter 2</u> | <u>Quarter 3</u> | <u>Quarter 4</u> |
| Price Range: | | | | |
| High | \$ 13.35 | \$ 12.80 | \$ 13.86 | \$ 13.28 |
| Low | 12.35 | 11.94 | 12.25 | 12.57 |
| Dividend | 0.075 | 0.075 | 0.075 | 0.075 |
| Shares Repurchased | 18,263 | 41,000 | 52,825 | 95,000 |
| Avg. Price Paid Per Share | \$ 12.15 | 12.43 | \$ 12.87 | \$ 12.91 |

The Company's dividend payout ratio was 43% in 2007, compared to 44% in 2006. The Company has paid a cash dividend each year since converting from a mutual to stock form of ownership. In addition, the Company has increased its cash dividend each year since its initial public offering. Given the Company's strong capital position and its access to liquidity, there are no expected changes to the Company's current dividend policy.

Set forth herein under is a stock performance graph comparing (a) the cumulative total return on the common stock for the period beginning with the last trade of Citizens South Banking Corporation's stock on December 31, 2002, as reported on the Nasdaq Stock Market, through December 31, 2007, (b) the cumulative total return on stocks included in the Russell 2000 index over such period, and (c) the cumulative total return on stocks included in the SNL Southeast Thrift Index over such period. Cumulative return assumes the reinvestment of dividends, and is expressed in dollars based on an assumed initial investment of \$100.



| <i>Index</i> | <i>Period Ending</i> | | | | | |
|------------------------------------|----------------------|----------|----------|----------|----------|----------|
| | 12/31/02 | 12/31/03 | 12/31/04 | 12/31/05 | 12/31/06 | 12/31/07 |
| Citizens South Banking Corporation | 100.00 | 139.35 | 145.34 | 124.34 | 137.85 | 110.64 |
| Russell 2000 | 100.00 | 147.25 | 174.24 | 182.18 | 215.64 | 212.26 |
| SNL Southeast Thrift Index | 100.00 | 151.65 | 179.27 | 163.14 | 191.73 | 82.56 |

There can be no assurance that the common stock's performance will continue in the future with the same or similar trend depicted in the graph. Citizens South Banking Corporation will not make or endorse any predictions as to future performance.

b. Not applicable.

c. During the three-month period ended December 31, 2007, the Company repurchased the following shares of stock.

| 2007 | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan | Maximum Number of Shares that May be Purchased Under the Plan |
|--------------|----------------------------------|------------------------------|---|---|
| October | 38,300 | \$12.39 | 0 | 200,000 |
| November | 81,900 | \$11.80 | 64,648 | 135,352 |
| December | 42,000 | \$11.38 | 42,000 | 93,352 |
| Total | 163,200 | \$11.76 | 106,648 | 93,352 |

As of December 31, 2007, the Company had repurchased a total of 3,111,083 shares, or 34.3% of the outstanding shares of common stock, at an average price of \$13.17. This stock was repurchased under a series of repurchase programs that have been authorized by the Board of Directors over the past several years. The most recent repurchase authorization was granted by the Board of Directors on October 22, 2007, for the repurchase of up to 200,000 shares, or approximately 2.5% of the Company's then outstanding shares of common stock. These repurchases may be carried out through open market purchases, block trades, and negotiated private transactions. The stock may be repurchased on an ongoing basis and will be subject to the availability of stock, general market conditions, the trading price of the stock, alternative uses for capital, and the Company's financial performance. As of December 31, 2007, the Company had repurchased a total of 106,648 shares at an average price of \$11.63 per share and had 93,392 shares remaining to be repurchased under this plan. The Company will consider repurchasing additional shares of common stock of the Company at prices management considers to be attractive and in the best interests of both the Company and its stockholders. Any repurchased shares will be held as treasury stock and will be available for general corporate purposes.

ITEM 6. Selected Financial Data

The following table sets forth certain information concerning the financial position of Citizens South Banking Corporation and its subsidiaries as of and for the dates indicated. The consolidated data is derived from, and should be read in conjunction with the Consolidated Financial Statements of the Company and its subsidiaries and related notes presented in Item 8.

| | At and for the years ended December 31, | | | | |
|---|---|------------|------------|------------|------------|
| | 2007 (1) | 2006 (1) | 2005 (1) | 2004 | 2003 |
| <i>(Dollars in Thousands, Except per Share Data)</i> | | | | | |
| Income Statement Data: | | | | | |
| Interest income | \$ 46,735 | \$ 42,919 | \$ 26,948 | \$ 21,110 | \$ 21,969 |
| Interest expense | 26,500 | 22,279 | 11,469 | 7,943 | 8,732 |
| Net interest income | 20,235 | 20,640 | 15,479 | 13,167 | 13,237 |
| Provision for loan losses | 1,290 | 1,165 | 985 | 330 | 60 |
| Net interest income after provision for loan losses | 18,945 | 19,475 | 14,494 | 12,837 | 13,177 |
| Noninterest income | 6,562 | 6,141 | 4,441 | 4,824 | 5,561 |
| Noninterest expense | 17,895 | 17,544 | 14,339 | 13,629 | 13,891 |
| Income before income taxes | 7,612 | 8,072 | 4,596 | 4,032 | 4,847 |
| Income tax expense | 1,947 | 2,617 | 1,323 | 1,077 | 1,456 |
| Net income | \$ 5,665 | \$ 5,455 | \$ 3,273 | \$ 2,955 | \$ 3,391 |
| Per Share Data: | | | | | |
| Basic net income | \$ 0.74 | \$ 0.68 | \$ 0.45 | \$ 0.39 | \$ 0.39 |
| Diluted net income | 0.73 | 0.67 | 0.45 | 0.38 | 0.39 |
| Cash dividends declared | 0.32 | 0.30 | 0.28 | 0.26 | 0.24 |
| Year-end book value | 11.05 | 10.61 | 10.16 | 9.74 | 10.11 |
| Balance Sheet Data: | | | | | |
| Total assets | \$ 779,140 | \$ 743,370 | \$ 701,094 | \$ 508,961 | \$ 495,751 |
| Loans receivable, net | 553,812 | 509,638 | 468,232 | 314,124 | 295,026 |
| Mortgage-backed and related securities | 69,893 | 60,691 | 70,236 | 81,169 | 89,168 |
| Investment securities | 46,519 | 65,326 | 53,429 | 52,407 | 56,233 |
| Deposits | 590,765 | 562,802 | 517,544 | 374,744 | 342,446 |
| Borrowings | 96,284 | 85,964 | 91,342 | 55,772 | 58,981 |
| Stockholders' equity | 84,033 | 85,961 | 84,258 | 72,394 | 87,699 |
| Performance Ratios: | | | | | |
| Return on average assets | 0.75% | 0.76% | 0.60% | 0.59% | 0.69% |
| Return on average equity | 6.68 | 6.42 | 4.40 | 3.78 | 3.61 |
| Avg. interest-earning assets to avg. interest-bearing liabilities | 107.26 | 106.53 | 109.40 | 110.96 | 118.65 |
| Noninterest expense to average total assets | 2.38 | 2.45 | 2.64 | 2.73 | 2.81 |
| Interest rate spread | 2.84 | 3.10 | 3.03 | 2.78 | 2.57 |
| Net interest margin (2) | 3.14 | 3.33 | 3.26 | 2.98 | 2.94 |
| Asset Quality Ratios: | | | | | |
| Allowance for loan losses to total loans | 1.10% | 1.12% | 1.08% | 0.95% | 1.00% |
| Net charge-offs to average loans | 0.17 | 0.10 | 0.12 | 0.09 | 0.03 |
| Nonperforming loans to total loans | 0.32 | 0.58 | 0.54 | 0.30 | 0.18 |
| Nonperforming assets to total assets | 0.30 | 0.42 | 0.53 | 0.34 | 0.14 |
| Capital Ratios: | | | | | |
| Average equity to average total assets | 11.26% | 11.86% | 13.69% | 15.64% | 18.96% |
| Equity to assets at year end | 10.79 | 11.56 | 12.02 | 14.22 | 17.69 |
| Dividend payout ratio | 43.24 | 44.12 | 62.22 | 66.67 | 61.54 |

(1) Includes operations of Trinity Bank which was acquired on October 31, 2005.

(2) Net interest margin is calculated by dividing net interest income, including tax equivalent adjustments for tax-exempt investment securities by average interest-earning assets for the period. The tax equivalent adjustments were \$557, \$191, \$155, \$0, and \$0 for 2007, 2006, 2005, 2004, and 2003, respectively.

ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview of Financial Condition and Results of Operations

Citizens South Banking Corporation (the "Company") is a Delaware corporation that owns all of the outstanding shares of common stock of Citizens South Bank (the "Bank"), a federally chartered savings bank headquartered in Gastonia, North Carolina. The Company's principal business activities are overseeing and directing the business of the Bank and investing the net stock offering proceeds retained by the Company. The Company's assets consist primarily of the outstanding capital stock of the Bank, deposits held at the Bank, and investment securities. The Bank's principal business activity is offering FDIC-insured deposit accounts to local customers through its 14 branch offices and investing those deposits, together with funds generated from operations and borrowings, in residential and nonresidential real estate loans, construction loans, commercial business loans, consumer loans, investment securities, and mortgage-backed securities. The Bank also acts as a broker in both the origination of loans secured by one-to-four family residences and in the sale of uninsured financial products (see Item 1. "Business" of this report).

Our primary business strategy since our initial public stock offering in 1998 has been to transform the Bank from a traditional savings bank to a full-service community bank, offering a complete array of both commercial and retail loan and deposits, wealth management services, mortgage banking activities, brokerage services, and other related financial services. In executing this strategy, the Company has 1) concentrated much of its lending efforts on nonresidential real estate and construction loans, 2) originated substantially all fixed-rate one-to-four family residential loans as a broker for a third party, and 3) focused its deposit gathering efforts on core deposits (demand deposit accounts, money market accounts, and savings accounts). As a result, nonresidential real estate and construction loans comprised approximately 65% of the Company's loan portfolio at December 31, 2007, compared to approximately 39% at December 31, 2003. Also, during the same period, the Company's portfolio of one-to-four family residential loans decreased from 34% of the Company's loan portfolio at December 31, 2003, to 14% of the Company's loan portfolio at December 31, 2007. Core deposits have increased as a percentage of total deposits from 37.6% at December 31, 2003 to 41.3% at December 31, 2007. Management expects to continue to execute this business strategy in 2008.

On October 31, 2005, the Company consummated the merger of Trinity Bank ("Trinity") into Citizens South Bank. At the time of the acquisition, Trinity had total assets of \$165.5 million, net loans of \$112.8 million, deposits of \$135.6 million, borrowed money of \$14.0 million and equity of \$13.3 million. Trinity was headquartered in Monroe, North Carolina, which is approximately 50 miles east of the Company's headquarters. Trinity had three offices located in Union County, North Carolina, which had the fastest population growth of any county in North Carolina based on the most current information available at the time of the acquisition. The combined bank had 14 full-service locations and ranked 8th in the Charlotte Metropolitan Statistical Area in deposit market share as of December 31, 2007.

Under the terms of the merger agreement, the Company issued a combination of common stock and cash for the outstanding common shares of Trinity Bank. Trinity shareholders were given the option of receiving 1.3931 shares of Citizens South common stock for each share of Trinity common stock, \$18.25 in cash for each share of Trinity common stock, or a mixture of stock and cash for each Trinity share, such that 50% of the shares of Trinity common stock will be exchanged for Citizens South common stock. On October 31, 2005, Trinity shareholders received merger consideration of approximately 1,280,052 shares of common stock of the Company (subject to payment of cash in lieu of fractional shares) and approximately \$16.8 million in cash (including cash paid in lieu of fractional shares), resulting in a total transaction value of approximately \$37.8 million. The transaction price represented approximately 255% of Trinity's book value. Additional information regarding this transaction may be obtained by reviewing the Registration Statement that the Company filed with the Securities and Exchange Commission on August 1, 2005, and amended September 14, 2005.

In order to provide financing for the cash portion of the Trinity acquisition, on October 28, 2005, the Company completed a private placement of an aggregate amount of \$15.0 million in trust preferred securities, liquidation amount of \$1,000 per security (the "Preferred Securities"), through a newly formed Delaware statutory trust subsidiary, CSBC Statutory Trust I (the "Trust"). In connection with the issuance of the Preferred Securities, on October 28, 2005, the Company entered into an Indenture by and between the Company and Wilmington Trust Company, as trustee. The Preferred Securities mature on December 15, 2035, but may be redeemed beginning December 15, 2010, if the Company exercises its rights to redeem the Debentures. The Preferred Securities require quarterly interest payments to the holders of the Preferred Securities, initially at a fixed rate of 6.095% through December 2010, and thereafter at a variable rate of three-month LIBOR plus 1.57%, reset quarterly. Additional information regarding the Preferred Securities may be obtained by reviewing the Form 8-K filed with the Securities and Exchange Commission on November 4, 2005.

The Bank's results of operations are heavily dependent on net interest income, which is the difference between the interest earned on loans and securities and the interest paid on deposits and borrowings. Results of operations are also materially affected by the Bank's provision for loan losses, noninterest income, and noninterest expense. Noninterest income includes fee income generated from deposit and loan accounts, mortgage banking fees, commissions earned from the sale of uninsured investment products, increases in the cash value of bank-owned life insurance policies, net gains (losses) from the sale of assets and other noninterest income. The Bank's noninterest expense primarily consists of compensation and employee benefits, occupancy expense, professional services, advertising, amortization of intangible assets and other noninterest expenses. Results of operations are also significantly affected by general economic and competitive conditions, changes in interest rates, and actions of regulatory and governmental authorities.

Certain actions were taken that adversely impacted our results of operations for the years ended December 31, 2006 and 2005. In 2005 we acquired Trinity Bank, resulting in merger and computer conversion related expenses of \$384,000. Additional merger and conversion expenses totaling \$57,000 were incurred in 2006.

Net income was \$5.7 million, or \$0.73 per diluted share, for the year ended December 31, 2007, compared to \$5.5 million, or \$0.67 per diluted share, for the year ended December 31, 2006. The earnings resulted in a return on average equity of 6.68% in 2007, compared to 6.42% in 2006, and a return on average assets of 0.75% in 2007, compared to 0.76% in 2006. Management's Discussion and Analysis is provided to assist in understanding and evaluating the results of operations and financial condition of the Company and its subsidiaries. The following discussion should be read in conjunction with the consolidated financial statements and related notes included in Item 8 of this annual report.

Forward-Looking Statements

This report contains certain forward-looking statements that represent the Company's expectations or beliefs concerning future events. Such forward-looking statements are based on our current beliefs and expectations and are inherently subject to significant business, economic, and competitive uncertainties and contingencies, many of which are beyond our control. These forward-looking statements are based on assumptions with respect to future business strategies and decisions that are subject to change based on changes in the economic and competitive environment in which we operate. Forward-looking statements speak only as of the date they are made and the Company is under no duty to update these forward-looking statements or to reflect the occurrence of unanticipated events. A number of factors could cause actual conditions, events, or results to differ significantly from those described in the forward-looking statements. Factors that could cause such a difference include, but are not limited to, the timing and amount of revenues that may be recognized by the Company, changes in local or national economic trends, increased competition among depository and financial institutions, continuation of current revenue and expense trends (including trends affecting chargeoffs and provisions for loan losses), changes in interest rates, changes in the shape of the yield curve, and adverse legal, regulatory or accounting changes. Because of the risks and uncertainties inherent in forward-looking statements, readers are cautioned not to place undue reliance on these statements. Readers should carefully review the risk factors described in other documents the Company files from time to time with the SEC, including annual reports on Form 10-K, quarterly reports on Form 10-Q, and Current Reports on Form 8-K.

Critical Accounting Policies

The accounting and financial policies of the Company and its subsidiaries are prepared in accordance with accounting principles generally accepted in the United States and conform to general practices in the banking industry. We consider accounting policies that require significant judgment and assumptions by management that have, or could have, a material impact on the carrying value of certain assets or on income to be critical accounting policies. Changes in underlying factors, assumptions or estimates could have a material impact on our future financial condition and results of operations. Based on the size of the item or significance of the estimate, the following accounting policies are considered critical to our financial results.

Allowance for Loan Losses. The allowance for loan losses is calculated with the objective of maintaining an allowance sufficient to absorb estimated probable loan losses inherent in the Bank's portfolio at the measurement date. Management's determination of the adequacy of the allowance is based on quarterly evaluations of the loan portfolio and other relevant factors. However, this evaluation is inherently subjective, as it requires an estimate of the loss for each type of loan and for each impaired loan, an estimate of the amounts and timing of expected future cash flows, and an estimate of the value of the collateral. The Company has not been an originator or purchaser of option adjustable rate or "no documentation" portfolio loans and the Company's loan portfolio does not include any mortgage loans that are considered "sub-prime."

Management has established a systematic method for periodically evaluating the credit quality of the loan portfolio in order to establish an allowance for loan losses. The methodology is set forth in a formal policy and includes a review of all loans in the portfolio on which full collectibility may or may not be reasonably assured. The loan review considers among other matters, the estimated fair value of the collateral, economic conditions, historical loan loss experience, our knowledge of inherent losses in the portfolio that are probable and reasonable estimable and other factors that warrant recognition in providing an appropriate loan loss allowance. Specific allowances are established for certain individual loans that management considers impaired under Statement of Financial Accounting Standards ("SFAS") No. 114, *Accounting by Creditors for Impairment of a Loan.* The remainder of the portfolio is segmented into groups of loans with similar risk characteristics for evaluation and analysis. In originating loans, we recognize that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower, the term of the loan, general economic conditions, and in the case of a secured loan, the quality of the collateral. We increase our allowance for loan losses by charging provisions for loan losses against our current period income. Management's periodic evaluation of the adequacy of the allowance is consistently applied and is based on our past loan loss experience, particular risks inherent in the different kinds of lending that we engage in, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, current economic conditions, and other relevant internal and external factors that affect loan collectibility. Management believes this is a critical accounting policy because this evaluation involves a high degree of complexity and requires us to make subjective judgments that often require assumptions or estimates about various matters.

Other-Than-Temporary Impairment of Securities. Management periodically reviews all investment securities with significant declines in fair value for potential other-than-temporary impairment pursuant to the guidance provided by SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. In November 2006, the Financial Accounting Standards Board ("FASB") issued Staff Position ("FSP") FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.* The FSP addressed the determination as to when an investment is considered impaired, whether the impairment is other-than-temporary, and the measurement of an impairment loss. It also included accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amended SFAS No. 115 *Accounting for Certain Investments in Debt and Equity Securities*, No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and APB Opinion 18, *The Equity Method of Accounting for Investments in Common Stock*.

Effective June 30, 2007, management evaluated the Company's investment portfolio and determined that a \$162,000 "other-than-temporary" impairment existed on a \$305,000 equity investment in a closely held company. The impairment was considered to be "other-than-temporary" due to the closely held company's continuing operating losses and deteriorating book value. The Company's remaining equity interest in the closely held company amounts to \$143,000. Effective December 31, 2007, management evaluated the Company's investment portfolio and determined that all unrealized losses were the direct result of temporary changes in interest rates and that such losses may be recovered in the foreseeable future. The Company has the ability to hold these investments to maturity if necessary in order to recover any temporary losses that may presently exist. As a result, management did not consider any additional unrealized losses as "other-than-temporary" as of December 31, 2007.

Comparison of Financial Condition for the Years Ended December 31, 2007 and 2006

Total assets increased by \$35.7 million, or 4.8%, from \$743.4 million at December 31, 2006, to \$779.1 million at December 31, 2007. The majority of this growth was due to a \$44.6 million, or 8.6%, increase in outstanding loans from \$515.4 million at December 31, 2006, to \$560.0 million at December 31, 2007. Most of the Company's loan growth was in loans secured by commercial real estate. During 2007, these loans, which include construction loans, multifamily residential loans, and nonresidential real estate loans, increased by \$36.0 million, or 10.9%, to \$365.4 million at December 31, 2007. These loans are typically secured by owner-occupied professional office buildings, retail properties, churches, speculative residential properties, or residential subdivisions located in the Charlotte, North Carolina metropolitan area, which is the Company's primary lending area. Management does not generally pursue commercial real estate loans that are secured by hotels, motels, golf courses, or resort properties. Management plans to continue to emphasize the origination of commercial real estate loans in the Company's primary lending area. Also during 2007, the Company's portfolio of one-to-four family residential loans decreased from \$83.3 million to \$78.6 million due to normal prepayments and principal amortization. The Company originates and closes substantially all new one-to-four family residential loans as a broker for independent third parties on a servicing-released basis. This generates additional fee income and reduces the potential adverse effects of rising interest rates on the Company's future earnings that normally result from holding long-term fixed-rate loans. The Company has not been an originator or purchaser of option adjustable rate or "no documentation" portfolio loans and the portfolio does not include any mortgage loans that are considered "sub-prime." Management expects that in 2008 the Company's portfolio of one-to-four family mortgage loans will continue to decrease as most new loan originations will be made as a broker for the third party. During 2007, consumer loans increased by \$12.2 million, or 17.3%, to \$82.4 million at December 31, 2007. Approximately \$67.0 million, or 81.3%, of these consumer loans were home equity loans and lines of credit secured by a second lien on residential properties. These loans typically have a loan-to-value ratio of 90% or less (including any senior liens) and are secured by owner-occupied residential properties located in the Company's normal lending area. Management plans to continue to grow its portfolio of consumer loans in 2008 by implementing an incentive plan for its retail branch managers and creating marketing campaigns directed toward growing outstanding home equity loans and lines of credit. Commercial business loans increased by \$1.4 million, or 4.3%, to \$33.6 million. Management expects similar growth of its commercial business loans in 2008.

In order to facilitate continued loan growth during 2008, the Company plans to open a full-service office in Rock Hill, South Carolina during the first quarter of 2008. Also, the Company added one commercial lender and one business banker during the fourth quarter of 2007. However, the Company's ability to grow the existing loan portfolio is largely dependent on the local economy of the Charlotte metropolitan area. Management will also continue to focus on maintaining the current credit quality of the portfolio and will not forsake the credit quality of the loan portfolio for additional growth.

Cash and cash equivalents increased by \$3.5 million, or 13.4%, from \$26.2 million at December 31, 2006, to \$29.7 million at December 31, 2007. This increase was primarily due to an \$18.8 million decrease in investment securities, a \$28.0 million increase in deposits, a \$10.3 million increase in borrowed money, net proceeds of \$1.3 million from the sale of real estate acquired through foreclosure, loans and fixed assets, and net income of \$5.7 million in 2007. These increases in cash and cash equivalents were partly offset by loan growth of \$44.6 million, a \$9.2 million increase in mortgage-backed securities, stock repurchases of \$6.4 million, and the payment of \$2.5 million in cash dividends during 2007. Management expects that cash and cash equivalents will decrease in 2008 as excess liquidity is invested in new loans and higher-yielding investment securities.

Investment securities decreased by \$18.8 million, or 28.8%, from \$65.3 million at December 31, 2006, to \$46.5 million at December 31, 2007. This decrease was primarily the result of the sale of \$8.7 million in investment securities and \$19.4 million in normal maturities and calls. Approximately \$5.7 million of the investments sold were long-term AAA-rated bank-qualified municipal securities that were issued by various municipalities that carried an underlying credit rating of less than AA. These securities were insured as AAA-rated obligations by large bond insurance companies that had a higher than expected exposure to sub-prime investments, resulting in a potential downgrade from the credit rating agencies from their current AAA rating. The sale of these municipal securities was effected in order to protect the Company from a potential downgrade from the current AAA rating, that could have resulted in a possible "other-than-temporary impairment" on these securities. As of December 31, 2007, the Company's municipal bond portfolio totaled \$31.8 million. Management expects that the remaining municipal bond portfolio has sufficient credit support from the underlying municipalities and diversity among the bond insurance companies to adequately mitigate any adverse effects of possible downgrades from the current AAA rating of one or more of the bond insurance companies. This decrease in investment securities was partly offset by the purchase \$9.8 million in investment securities in 2007. Mortgage-backed securities increased by \$9.2 million, or 15.2%, from \$60.7 million at the end of 2006, to \$69.9 million at the end of 2007. This increase was primarily due to the purchase of \$28.7 million of mortgage-backed securities, which was partly offset by the maturity and principal amortization of \$12.4 million of mortgage-backed securities and the sale of \$8.3 million of mortgage-backed securities during the year. Management expects that in 2008 the principal amortization of its mortgage-backed securities portfolio will be higher than the principal amortization experienced in 2007 as mortgage loan interest rates are expected to decrease in 2008. Management plans to reinvest the proceeds received from mortgage-backed securities into higher-yielding commercial and consumer loans as cash flows are generated from these investments through maturities and principal and interest payments.

Premises and equipment decreased by \$322,000, or 1.5%, to \$18.0 million at December 31, 2007. Normal depreciation during 2007 amounted to \$1.2 million. In addition, in 2007 the Company sold the vacant operations center of the former Citizens Bank and a right-of-way parcel of land for approximately \$801,000 and purchased a parcel of land for future expansion for \$826,000. Plans are underway to open a full-service office in York County, South Carolina in the first quarter of 2008 in a leased facility. Also in 2008, the Company will be pursuing additional branch sites in its existing market area as opportunities arise.

Total liabilities increased by \$37.7 million, or 5.7%, from \$657.4 million at December 31, 2006, to \$695.1 million at December 31, 2007. This increase was primarily due a \$30.0 million, or 5.0%, increase in deposits. Total deposits increased from \$562.8 million at December 31, 2006, to \$590.8 million at December 31, 2007. Core deposits, which management considers checking accounts, money market accounts, and savings accounts, increased by \$19.5 million, or 8.7%, during 2007. Management is committed to increasing core deposits and building new and enhancing existing customer relationships through improving technology, expanding its branch network and focused marketing efforts. In 2007 the Company developed two new products for both its commercial and retail customers that significantly contributed to the strong growth in core deposit in 2007. The first product is our remote deposit capture, which gives our commercial customers the ability to make deposits remotely without physically visiting a branch office. This allows our commercial sales force the opportunity to solicit business from commercial customers that may not be located near an existing branch office. The second product includes a new "no strings attached" high-yield checking account product that compares favorably with some of our competitors' products that offer a higher interest rate, but includes numerous conditions in order to receive the higher rate. In addition, we now offer all-day banking, which eliminated the 2:00 pm cutoff for current day processing of deposits. In 2008 we plan to continue to market these and other core products in our local area through normal media outlets and through incentive plans paid to employees for new core customer accounts. Time deposits increased by \$8.5 million, or 2.5%, to \$347.1 million at December 31, 2007. Management is focused on growing its deposit base from within the Company's market area. However, from time to time brokered time deposits may be used as an additional source of liquidity as needed. As of December 31, 2007, approximately \$3.6 million, or 0.6% of total deposits, were brokered time deposits.

Borrowed money, which includes subordinated debt and retail repurchase agreements, increased by \$10.3 million, or 12.0%, from \$86.0 million at the end of 2006 to \$96.3 million at the end of 2007. Management will use borrowed money as an additional source of liquidity as needed. In addition, from time to time, management may use borrowed money to engage in various leverage strategies to increase income as opportunities arise.

Total stockholders' equity decreased by \$2.0 million, or 2.2%, from \$86.0 million at December 31, 2006 to \$84.0 million at December 31, 2007. This decrease was primarily due to the repurchase of 515,637 shares of common stock for \$6.4 million at an average price of \$12.53 per share. These shares were repurchased as a part of stock repurchase plans announced in November 2007, January 2007 and January 2006. The January 2006 repurchase plan provided for the repurchase of 200,000 shares, or 2.5% of the outstanding shares. All of the shares authorized under this plan were repurchased by January 2007. The January 2007 repurchase plan provided for the repurchase of 400,000 shares, or 5.0% of the outstanding shares. All of the shares authorized under this plan were repurchased by November 2007. The November 2007 repurchase plan provided for the repurchase of 200,000 shares, or 2.5% of the outstanding shares. As of December 31, 2007, the Company had repurchased 106,648 shares under the plan and had 93,352 shares remaining to be repurchased. Management plans to continue to repurchase shares of common stock in the Company at prices that are considered to be attractive and in the best interests of both the Company and its stockholders. The decrease in total stockholders' equity during 2007 was also partly offset by the payment of \$2.5 million in cash dividends, or \$0.32 per share. These decreases in stockholders' equity were partly offset by \$5.7 million in net income earned in 2007 and a \$648,000 decrease in accumulated net unrealized losses on investments available for sale.

Results of Operations

The following discussion relates to operations for the year ended December 31, 2007, compared to the year ended December 31, 2006, as well as the year ended December 31, 2006, compared to the year ended December 31, 2005. The net income of the Company is heavily dependent upon net interest income. Net interest income is the difference between the interest earned on loans, investment and mortgage-backed securities, and interest-bearing deposits in other banks, offset by the interest paid on deposits and borrowings.

Comparison of Results of Operations for the Years Ended December 31, 2007 and 2006

Net income was \$5.7 million, or \$0.73 per diluted share, for the year ended December 31, 2007, compared to \$5.5 million, or \$0.67 per diluted share, for the year ended December 31, 2006. The earnings resulted in a return on average equity of 6.68% in 2007, compared to 6.42% in 2006, and a return on average assets of 0.75% in 2007, compared to 0.76% in 2006.

Net interest income decreased by \$405,000, or 2.0%, to \$20.2 million for the year ended December 31, 2007, compared to \$20.6 million for the year ended December 31, 2006. This decrease was largely due to a 19 basis point decrease in the net interest margin from 3.33% for 2006 to 3.14% for 2007. The compression of the net interest margin was caused in part by a series of three decreases in the federal funds rate by the Federal Reserve Board during the second half of 2007 that resulted in a 100 basis point decrease in the prime lending rate during the year to 7.25% at the end of 2007. At December 31, 2007, the Company had approximately \$251 million in loans, or 45% of the Company's loan portfolio, repricing each month, the majority of which were tied to the prime lending rate. While market interest rates were generally higher in 2007 than in 2006, this sharp decrease in short-term interest rates over a short period of time (less than four months) at the end of 2007 did not provide sufficient time for many of the Company's time deposits to reprice at a lower interest rate. As a result, the yield on assets for 2007 did not grow as fast as the increase in the cost of funds, causing the spread between interest-earning assets and interest-bearing liabilities to decrease from 3.10% to 2.84%. When short-term interest rates stabilize, the Company's net interest margin should begin to expand as its portfolio of time deposits reprices at lower market rates without any offsetting decreases in the yield on its prime-based loan portfolio. During 2007, the Company's ratio of average interest-earning assets to average interest-bearing liabilities increased from 106.5% in 2006 to 107.3% in 2007. This increasing ratio of average interest-earning assets to average interest-bearing liabilities partly offset the negative effect of the decreased net interest margin.

Interest income for the year ended December 31, 2007, increased by \$3.8 million, or 8.9%, to \$46.7 million. This increase was largely due to the fact that average interest-earning assets increased by \$37.9 million, or 6.1%, from \$625.1 million in 2006 to \$663.0 million in 2007. In addition, while short-term interest rates fell during the last four months of 2007, the increases in the prime lending rate during 2006, which were unchanged for the first three quarters of 2007, resulted in a 23 basis point increase in the yield on interest-earnings assets to 7.13% for 2007. Average outstanding loans increased by \$33.6 million, or 6.8%, from \$493.3 million to \$526.9 million, while the average yield on loans increased from 7.59% to 7.72% from 2006 to 2007. These changes were primarily the result of organic loan growth during the year, and higher market interest rates during the first three quarters of 2007. As a result, interest income on loans increased by \$3.2 million, or 8.6%, to \$40.7 million in 2007.

Interest earned on interest-bearing bank balances decreased by \$392,000, or 46.8%, to \$446,000 in 2007. The average balance of interest-bearing bank balances decreased by \$7.3 million, or 43.6%, to \$9.4 million and the average yield on these deposits decreased by 25 basis points to 4.76%. Interest earned on investment securities increased by \$1.0 million, or 47.5%, to \$3.2 million in 2007. Tax equivalent adjustments using a 34% tax rate were made to interest income on investment securities in the amounts of \$557,000 and \$191,000 for 2007 and 2006, respectively. This increase in interest income was primarily due to an \$11.5 million, or 22.8%, increase in the average outstanding balance of investment securities to \$62.0 million in 2007. The average tax-equivalent yield on investment securities increased by 87 basis points to 5.20% for 2007 due to the increased level of short-term interest rates during the first three quarters of 2007 and an increased level of higher-yielding municipal securities during 2007. Interest income from mortgage-backed securities increased by \$304,000, or 11.5%, to \$2.9 million in 2007. This increase was largely due to a 47 basis point increase in the average yield from 4.08% in 2006 to 4.55% in 2007. The average balance of mortgage-backed securities increased by 0.7% to \$64.6 million for 2007. The increase in the average yield on mortgage-backed securities was due in part to slower prepayment levels resulting from higher mortgage interest rates during the year. Management expects the levels of investment and mortgage-backed securities will decline during 2008, with the proceeds of any sales, maturities, and normal amortization to be used to fund additional loan originations, stock repurchases, and repayments on maturing borrowed money.

Interest expense increased \$4.2 million, or 18.9%, to \$26.5 million for the year ended December 31, 2007. This increase was largely due to average interest-bearing liabilities increasing by \$31.3 million, or 5.3%, from \$586.8 million in 2006 to \$618.1 million in 2007. In addition, the average cost of funds increased by 49 basis points to 4.29% in 2007. Interest expense on deposits increased \$4.2 million, or 23.3%, to \$22.3 million in 2007. This increase was primarily due to a \$34.8 million, or 7.0%, increase in average deposits in 2007 and a 55 basis point increase in the cost of deposits to 4.17% in 2007. Average deposits increased due to organic growth generated from the Company's normal market area. The cost of funds increased due to the increase in short-term rates during 2006 which remained in effect for the first three quarters of 2007. Interest paid on borrowed money increased by \$9,000, or 0.2%, to \$4.2 million in 2007. Average borrowings decreased by \$3.5 million, or 4.0%, to \$82.7 million for 2007, while the average rate paid on borrowings increased from 4.85% in 2006 to 5.06% in 2007 due to the maturities of lower costing borrowings during the year. Management expects that short-term interest rates will continue to decline in 2008, resulting in lower costs of funds for deposits and borrowings. The Company may increase the level of borrowings to provide liquidity for operating purposes, to purchase investment securities, repurchase stock, etc. If these borrowing levels increase, there will be a corresponding increase in interest expense.

The Company provided \$1.3 million and \$1.2 million in loan loss provisions for the years ended December 31, 2007 and 2006, respectively. The allowance for loan losses as a percentage of total loans was 1.10% at December 31, 2007, and 1.12% at December 31, 2006. The provision for loan losses increased due to strong organic growth in the Company's loan portfolio of \$44.6 million, coupled with net charge-offs of \$910,000 during the year. The level of nonperforming loans decreased by \$1.2 million, to \$1.8 million at December 31, 2007. As a result, the Company generated lower late fees generated from delinquent loans and the ratio of nonperforming loans to net loans decreased from 0.58% at December 31, 2006, to 0.32% at December 31, 2007. Also, real estate owned increased by \$390,000 to \$529,000 at December 31, 2007. The Company has not been an originator or purchaser of option adjustable rate or "no documentation" portfolio loans and the Company's loan portfolio does not include any mortgage loans that are considered "sub-prime." Therefore, none of the foreclosures were the result of any "sub-prime" activity by the Company. The properties acquired through foreclosure consist of 13 one-to-four family residential properties located in the Company's normal lending area. These properties are in various stages of disposition. Nonperforming assets decreased by \$809,000 to \$2.3 million at December 31, 2007, resulting in decrease in the ratio of nonperforming assets to total assets from 0.42% at December 31, 2006, to 0.30% at December 31, 2007. Refer to "Allowance for Loan Losses" within Item 7 for further discussion.

For the year ended December 31, 2007, noninterest income increased by \$422,000, or 6.9%, from \$6.1 million to \$6.6 million. The Company experienced an increase of \$352,000 from mortgage banking activities. This was largely due to strong mortgage-banking activity during most of 2007. Mortgage banking activity slowed toward the end of 2007; however, management expects that long-term mortgage lending rates will be more attractive in 2008, resulting in steady mortgage lending activity for 2008. The Company also recognized \$112,000 in net life insurance proceeds as a result of the untimely death of one of the Company's officers after a courageous fight with cancer. These increases in noninterest income were partly offset by decreases of \$133,000 in fee income received on deposit accounts, \$161,000 in lower fee income received from lending activities, and \$85,000 from the fair value adjustment on deferred compensation assets. The decrease in fee income on deposit accounts was largely due to the trend of lower fees generated from overdrawn checking accounts. Management believes that this negative trend is industry-wide. However, the negative trend has slowed recently and a continued focus on growing retail and commercial checking accounts should result in a moderate improvement in fee income on deposit accounts in 2008. Loan fee income decreased primarily as a result of fewer fees generated on commercial real estate and construction loans, as well as lower late fees generated from delinquent loans. The trend in 2008 will largely depend on the Company's ability to increase loan activity in a slowing economy. The decrease in the fair value adjustment on deferred compensation assets is offset by a corresponding decrease in compensation expense, resulting in no net impact on net income.

Net gain on sale of assets increased by \$254,000 to \$323,000 in 2007. During the year ended December 31, 2007, the Company sold \$8.7 million in investment securities and \$8.3 million in mortgage-backed securities at a combined net loss of \$74,000, \$334,000 of real estate acquired through foreclosure at a net loss of \$17,000, \$202,000 of loans at a net gain of \$5,000, and \$801,000 of fixed assets at a net gain \$409,000. During the year ended December 31, 2006, the Company sold \$98,000 in investment securities and \$2.2 million in mortgage-backed securities at a combined net loss of \$41,000. In addition, during 2006 the Company sold \$648,000 in premises and equipment, and \$914,000 in real estate acquired through foreclosure at a net gain of \$111,000.

Noninterest expense increased by \$352,000, or 2.0%, from \$17.5 million in 2006 to \$17.9 million in 2007. This increase was largely due to a \$335,000, or 3.6%, increase in compensation expense from \$9.4 million in 2006 to \$9.7 million in 2007. Additional staffing is expected in 2008 due to the expected opening of a new full-service branch office in the first quarter of 2008. Occupancy expense increased by \$34,000, or 1.3%, to \$2.6 million in 2007. The Company opened one mortgage loan origination office in leased space during 2007. The Company plans to open a full-service office in Rock Hill, South Carolina in the first quarter of 2008 which will be located in a leased building and will replace the existing loan production office in Rock Hill. The decrease in the amortization of intangible assets was due to the normal decrease associated with amortizing the core deposit intangible on an accelerated basis. Estimated amortization expense in 2008 is expected to be \$512,000, compared to \$629,000 in 2007. Also, in 2007, there were no merger-related expenses as compared to \$57,000 in 2006. The expenses incurred in 2006 were attributable to the acquisition of Trinity Bank in October of 2005.

The Company's provision for income taxes was \$1.9 million and \$2.6 million for the years ended December 31, 2007 and 2006, respectively. The change was primarily due to a \$460,000 decrease in pretax income. The effective tax rate decreased from 32.4% to 25.6% due to a larger percentage of income being derived from tax-advantaged assets such as municipal securities, U.S. Government Agency securities, and bank-owned life insurance that generate tax-exempt income. Management expects to decrease its level of income generated from tax-advantaged sources in 2008, resulting in an increase in the effective tax rate for 2008.

Comparison of Results of Operations for the Years Ended December 31, 2006 and 2005

Net income was \$5.5 million, or \$0.67 per diluted share, for the year ended December 31, 2006, compared to \$3.3 million, or \$0.45 per diluted share, for the year ended December 31, 2005. The earnings resulted in a return on average equity of 6.42% in 2006, compared to 4.40% in 2005, and a return on average assets of 0.76% in 2006, compared to 0.60% in 2005.

Net interest income increased by \$5.2 million, or 33.3%, to \$20.6 million during the year ended December 31, 2006, compared to \$15.5 million for the year ended December 31, 2005. This increase was largely due to the fact that the Company received the benefit of the Trinity acquisition for only two months in 2005 compared to the full 12 months in 2006. This increase was also due in part to a seven basis point increase in the average net interest rate spread from 3.03% for 2005 to 3.10% for 2006. This increase was largely due to a series of 25 basis point increases in the federal funds rate by the Federal Reserve Board during the first half of 2006 that resulted in a 100 basis point increase in the prime-lending rate during the year to 8.25% at December 31, 2006. Approximately 54% of the Company's loan portfolio repriced each month at December 31, 2006, the majority of which was tied to the prime lending rate. This also contributed to a seven basis point increase in the Company's net interest margin from 3.26% in 2005 to 3.33% in 2006. During 2006, the Company's ratio of average interest-earning assets to average interest-bearing liabilities decreased from 109.40% in 2005 to 106.53% in 2006. This declining ratio of average interest-earning assets to average interest-bearing liabilities, which partly offset the positive effect of the increased net interest rate spread, was due primarily due to the repurchase of 207,088 shares of common stock for \$2.6 million.

Interest income for the year ended December 31, 2006 increased by \$16.0 million, or 59.3%, to \$42.9 million. This increase was largely due to the fact that the Company received the benefit of the Trinity acquisition for only two months in 2005 compared to the full 12 months in 2006. Partly as a result of the acquisition, average interest-earning assets increased by \$145.6 million, or 30.4%, from \$479.5 million in 2005 to \$625.1 million in 2006. In addition, due to increases in the prime lending rate during 2006, the yield on interest-earnings assets increased by 125 basis points to 6.90% for 2006. Average outstanding loans increased by \$145.6 million, or 41.9%, from \$347.7 million to \$493.3 million, while the average yield on loans increased from 6.36% to 7.59% from 2005 to 2006. These changes were primarily the result of acquiring \$112.8 million in loans in the Trinity acquisition in October 2005, organic loan growth of \$42.2 million during the year, and a 100 basis point increase in the prime-lending rate during the year. As a result, interest income on loans increased by \$15.3 million, or 69.2%, to \$37.4 million in 2006.

Interest earned on interest-bearing bank balances increased by \$375,000, or 81.0%, to \$838,000 in 2006. The average balance of interest-bearing bank balances increased by \$3.3 million, or 24.8%, to \$16.7 million and the average yield on these deposits increased by 155 basis points to 5.01%. Interest earned on investment securities, including tax-equivalent adjustments of \$191,000 in 2007 and \$155,000 in 2006, increased by \$430,000, or 24.5%, to \$2.1 million in 2006. This increase in interest income was primarily due to a \$5.4 million, or 12.0%, increase in the average outstanding balance of investment securities to \$50.5 million in 2006. The average yield on investment securities increased by 43 basis points to 4.33% for 2006 due to the increased level of short-term interest rates during 2006. Interest income from mortgage-backed securities decreased by \$118,000, or 4.3%, to \$2.6 million in 2006. This decrease was largely due to an \$8.7 million, or 11.9%, decrease in the average balance of mortgage-backed securities to \$64.5 million during 2006. Also, during 2006, the average yield on mortgage-backed securities increased from 3.76% to 4.08%, due in part to slower prepayment levels resulting from higher mortgage interest rates during the year.

Interest expense increased \$10.8 million, or 94.3%, to \$22.3 million for the year ended December 31, 2006. This increase was largely due to the fact that the Company received the benefit of the Trinity acquisition for only two months in 2005 compared to the full 12 months in 2006. Partly as a result of the acquisition, average interest-bearing liabilities increased by \$148.5 million, or 33.9%, from \$438.3 million in 2005 to \$586.8 million in 2006. In addition, the average cost of funds increased by 118 basis points to 3.80% in 2006. Interest expense on deposits increased \$9.1 million, or 101.7%, to \$18.1 million in 2006. This increase was primarily due to a \$128.5 million, or 34.5%, increase in average deposits in 2006 and a 120 basis point increase in the cost of deposits to 3.62% in 2006. Average deposits increased due to \$135.6 million in deposits acquired from Trinity in October 2005 and \$45.3 million in organic growth. The cost of funds increased due to the 100 basis point increase in short-term rates during 2006. Interest paid on borrowed money increased by \$1.7 million, or 67.6%, to \$4.2 million in 2006. Average borrowings increased by \$20.0 million, or 30.2%, to \$86.2 million for 2006, while the average rate paid on borrowings increased from 3.76% in 2005 to 4.85% in 2006 due to higher market interest rates in 2006.

The Company provided \$1.2 million and \$985,000 in loan loss provisions for the years ended December 31, 2006 and 2005, respectively. The allowance for loan losses as a percentage of loans was 1.12% at December 31, 2006, and 1.08% at December 31, 2005. The provision for loan losses increased due to strong organic growth in the Company's loan portfolio of \$42.1 million, coupled with net charge-offs of \$505,000 during the year. The level of nonperforming loans increased by \$460,000, to \$3.1 million at December 31, 2006. As a result, the ratio of nonperforming loans to net loans increased from 0.54% at December 31, 2005, to 0.58% at December 31, 2006. Also, real estate owned decreased by \$1.0 million to \$139,000 at December 31, 2006. The properties acquired through foreclosure consist of one one-to-four family residential property and one residential lot. These properties are in various stages of disposition. As a result, the ratio of nonperforming assets to total assets decreased from 0.53% at December 31, 2005, to 0.42% at December 31, 2006.

For the year ended December 31, 2006, noninterest income increased by \$1.7 million, or 38.3%, from \$4.4 million to \$6.1 million. The Company experienced increases of \$369,000 in fee income on deposit accounts, \$709,000 from mortgage banking and lending activities, \$66,000 in dividends on FHLB stock, \$148,000 from the cash value of bank-owned life insurance, \$124,000 increase in the fair value adjustment on deferred compensation assets, and \$181,000 in other noninterest income. These increases in noninterest income were largely due to the fact that the Company received the benefit of the Trinity acquisition for only two months in 2005 compared to the full 12 months in 2006. The increase in mortgage-banking and loan fee income was also due to an increased amount of fee income from commercial loans coupled with strong mortgage-banking activity during 2006. Fee income on deposit accounts was higher largely due to the increased number of accounts which resulted in an increase in fees generated from overdrawn checking accounts. Management believes that a continued focus on growing retail and commercial checking accounts will result in a moderate improvement in fee income on deposit accounts in 2006. The increase on dividends on FHLB stock is directly related to the rate paid by the FHLB and the number of outstanding shares (based on outstanding advances). The increase in the fair value adjustment on deferred compensation assets is offset by a corresponding decrease in compensation expense, resulting in no net impact on net income.

Net gain on sale of assets increased by \$7,000, or 11.9%, to \$69,000 in 2006. During the year ended December 31, 2006, the Company sold \$98,000 in investment securities and \$2.2 million in mortgage-backed securities at a net loss of \$41,000. In addition, during 2006 the Company sold \$648,000 in premises and equipment, and \$914,000 in real estate acquired through foreclosure at a net gain of \$111,000. The proceeds from these sales were used to generate funds to repurchase shares of stock and originate loans. During the year ended December 31, 2005, the Company sold \$9.4 million in investment securities and \$30.3 million in mortgage-backed securities at a net gain of \$17,000. Most of these sales were from securities acquired from Trinity. These proceeds were primarily used to repurchase additional investments that were more reflective of the Company's investment philosophy of investing in shorter-term investment securities and mortgage-backed securities that provide a stable level of cash flow to fund future loan growth. The Company also recognized a \$45,000 net gain on sale of both \$517,000 of other real estate owned and \$191,000 of premises and equipment.

Noninterest expense increased by \$3.2 million, or 22.3%, from \$14.3 million in 2005 to \$17.5 million in 2006. This increase was largely due to the acquisition of Trinity, which added approximately 35 employees and three additional full-service offices, and the opening of a new full-service office in Belmont, North Carolina. As a result, compensation expense increased by \$2.1 million, or 29.2%, from \$7.2 million in 2005 to \$9.4 million in 2006. The Company integrated the back-office functions of Trinity during the first quarter of 2006, which resulted in a decrease of eight employees. In addition, the Company opened a loan production office in Rock Hill, South Carolina, during the first quarter of 2006, which is staffed by two additional employees. Occupancy expense increased by \$513,000, or 24.4%, primarily due to the addition of four full-service offices from the beginning of 2005 to the end of 2006. Advertising expenses increased by \$205,000, or 71.3%, from \$287,000 in 2005 to \$492,000 in 2006. This increase was primarily due to additional marketing expenses associated with entering the Union County market via the acquisition of Trinity Bank. The amortization of core deposit premium increased by \$325,000, or 79.5%, to \$734,000 in 2006. This increase was due to the amortization of the \$2.3 million core deposit intangible that resulted from the Trinity Bank acquisition which is being amortized over an eight-year period on an accelerated basis. Estimated amortization expense in 2007 is expected to be \$629,000. The Company also experienced moderate increases in telephone expense (\$66,000), office supplies (\$17,000), professional services (\$10,000), deposit insurance (\$11,000), and other noninterest expenses (\$267,000). These increases were primarily attributable to the acquisition of Trinity Bank.

These increases in noninterest expenses were partly offset by a \$327,000 decrease in merger related expenses. The Company experienced merger and conversion expenses in 2005 in the amount of \$384,000 compared to \$57,000 in 2006. In addition, data processing expense decreased by \$6,000, or 1.6%, due to the consolidation during the first quarter of 2006 of the two data processing systems resulting from the merger.

The Company's provision for income taxes was \$2.6 million and \$1.3 million for the years ended December 31, 2006 and 2005, respectively. The change was primarily due to a \$3.5 million increase in pretax income. The effective tax rate increased from 28.8% to 32.4% due to a smaller percentage of income being derived from tax-advantaged assets such as municipal securities, U.S. Government Agency securities, and bank-owned life insurance that generate tax-exempt income.

Net Interest Income

The net income of the Company is heavily dependent upon net interest income. Net interest income represents the difference between income on interest-earning assets and expense on interest-bearing liabilities. Net interest income also depends on the relative amounts of interest-earning assets and interest-bearing liabilities and the interest rate earned or paid on them, respectively. The following table sets forth certain information relating to the Company for the years ended December 31, 2007, 2006 and 2005. For the years indicated, the total dollar amount of interest income from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, is expressed both in dollars and rates. Tax equivalent adjustments using a 34% tax rate were made to interest income on tax-exempt investment securities, such as municipal bonds, in the amounts of \$557,000, \$191,000, and \$155,000 for 2007, 2006 and 2005, respectively.

Average Balances and Net Interest Income Analysis

| | December 31, 2007 | | | December 31, 2006 | | | December 31, 2005 | | |
|--|-------------------|-----------------------------|------------------------|-------------------|-----------------------------|------------------------|-------------------|-----------------------------|------------------------|
| | Average Balance | Interest Income/ Expense | Average Yield/ Cost | Average Balance | Interest Income/ Expense | Average Yield/ Cost | Average Balance | Interest Income/ Expense | Average Yield/ Cost |
| (Dollars in Thousands) | | | | | | | | | |
| Assets: | | | | | | | | | |
| Interest-earning assets: | | | | | | | | | |
| Loans receivable (1) | \$526,913 | \$ 40,679 | 7.72% | \$493,324 | \$ 37,448 | 7.59% | \$347,720 | \$ 22,128 | 6.36% |
| Interest-bearing bank deposits | 9,426 | 446 | 4.73 | 16,715 | 838 | 5.01 | 13,394 | 463 | 3.46 |
| Investment securities (2) | 62,044 | 3,227 | 5.20 | 50,537 | 2,188 | 4.33 | 45,113 | 1,758 | 3.90 |
| Mortgage-backed securities | 64,595 | 2,940 | 4.55 | 64,549 | 2,636 | 4.08 | 73,283 | 2,754 | 3.76 |
| Total interest-earning assets (2) | 662,978 | 47,292 | 7.13 | 625,125 | 43,110 | 6.90 | 479,510 | 27,103 | 5.65 |
| Noninterest-earning assets | 90,107 | | | 91,809 | | | 63,801 | | |
| Total assets | <u>\$753,085</u> | | | <u>\$716,934</u> | | | <u>\$543,311</u> | | |
| Liabilities and Stockholders' Equity: | | | | | | | | | |
| Interest-bearing liabilities: | | | | | | | | | |
| Demand deposit accounts | \$ 52,810 | \$ 917 | 1.74% | \$ 51,495 | \$ 662 | 1.29% | \$ 36,798 | \$ 211 | 0.57% |
| Money market deposit accounts | 126,247 | 4,909 | 3.89 | 109,553 | 4,187 | 3.82 | 78,092 | 1,791 | 2.29 |
| Savings accounts | 14,093 | 82 | 0.58 | 19,569 | 150 | 0.77 | 26,219 | 159 | 0.61 |
| Certificates of deposit | 342,259 | 16,407 | 4.79 | 320,008 | 13,104 | 4.09 | 231,000 | 6,816 | 2.95 |
| Borrowed funds | 82,717 | 4,185 | 5.06 | 86,183 | 4,176 | 4.85 | 66,199 | 2,492 | 3.76 |
| Total interest-bearing liabilities | 618,126 | 26,500 | 4.29 | 586,808 | 22,279 | 3.80 | 438,308 | 11,469 | 2.62 |
| Noninterest-bearing deposits | 39,893 | | | 35,310 | | | 23,218 | | |
| Noninterest-bearing liabilities | 10,282 | | | 9,781 | | | 7,423 | | |
| Total liabilities | 668,301 | | | 631,899 | | | 468,949 | | |
| Stockholders' equity | 84,784 | | | 85,035 | | | 74,362 | | |
| Total liabilities and equity | <u>\$753,085</u> | | | <u>\$716,934</u> | | | <u>\$543,311</u> | | |
| Net interest income (2) | | <u>\$ 20,792</u> | | <u>\$ 20,831</u> | | | <u>\$ 15,634</u> | | |

| | | | |
|---|--------------|--------------|--------------|
| Interest rate spread (3) | <u>2.84%</u> | <u>3.10%</u> | <u>3.03%</u> |
| Net interest margin (4) | <u>3.14%</u> | <u>3.33%</u> | <u>3.26%</u> |
| Ratio of average interest-earning assets to avg. int.-bearing liabilities | 107.26% | 106.53% | 109.40% |

-
- (1) Average loan balances include nonaccrual loans.
 - (2) Yields and interest income on tax-exempt investments have been adjusted on a tax equivalent basis using 34% for 2007, 2006, and 2005.
 - (3) Interest rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-earning liabilities.
 - (4) Net interest margin is calculated by dividing net interest income by average interest-earning assets.

Changes in interest income and expense can result from changes in both volume and rates. The following table sets forth information regarding changes in our interest income and interest expense for the periods indicated. For each category of our interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (i) changes in volume (changes in volume multiplied by old rate); (ii) changes in rate (changes in rate multiplied by old volume); and (iii) the net change. The changes attributable to the combined impact of volume and rate have been allocated proportionately to the changes due to volume and the changes due to rate.

Volume and Rate Variance Analysis

| (Dollars in Thousands) | For The Year Ended December 31, 2007 vs. December 31, 2006 | | | For the Year Ended December 31, 2006 vs. December 31, 2005 | | |
|--------------------------------|--|-------------------|----------------|--|-----------------|-----------------|
| | Increase (Decrease) Due to | | | Increase (Decrease) Due to | | |
| | Volume | Rate | Net | Volume | Rate | Net |
| Interest income: | | | | | | |
| Loans receivable | \$ 2,584 | \$ 647 | \$ 3,231 | \$ 10,489 | \$ 4,831 | \$ 15,320 |
| Interest-bearing bank deposits | (347) | (45) | (392) | 133 | 243 | 375 |
| Investment securities | 551 | 488 | 1,039 | 224 | 205 | 429 |
| Mortgage-backed securities | 2 | 302 | 304 | (432) | 314 | (118) |
| Total interest income | 2,790 | 1,392 | 4,182 | 10,414 | 5,593 | 16,007 |
| Interest expense: | | | | | | |
| Deposits | 1,593 | 2,619 | 4,212 | 4,109 | 5,017 | 9,126 |
| Borrowed funds | (92) | 101 | 9 | 863 | 821 | 1,684 |
| Total interest expense | 1,501 | 2,720 | 4,221 | 4,972 | 5,838 | 10,810 |
| Net interest income | \$ 1,289 | \$ (1,328) | \$ (39) | \$ 5,442 | \$ (245) | \$ 5,197 |

Loans

The Company generally makes commercial real estate loans, commercial business loans, consumer loans, and residential mortgage loans within its market area. In the past, we concentrated our lending activities on conventional first mortgage loans secured by one-to-four family properties. However, since converting to a stock company in 1998, the Company has focused more of its lending activities on construction loans, nonresidential real estate loans, commercial business loans and consumer loans. A substantial portion of our loan portfolio is secured by real estate, either as primary or secondary collateral, located in our primary market area. The Company has a diversified loan portfolio with no material concentrations to any one borrower or industry.

Our lending activities are subject to the written, non-discriminatory, underwriting standards and loan origination procedures established by management and approved by our Board of Directors. Loan originations come from a number of sources including real estate agents, home builders, walk-in customers, referrals and existing customers. Loan officers also call on local businesses soliciting commercial products. We advertise our loan products in various print media including local newspapers as well as the Company's website. In our marketing, we emphasize our community ties, personalized customer service, and an efficient underwriting and approval process. All real estate collateral is appraised or evaluated in accordance with regulatory requirements. On new loan originations, we require hazard, title and, to the extent applicable, flood insurance on all security property. The amounts and types of loans outstanding over the past five years are shown on the following table.

Loan Portfolio

| | December 31, 2007 | | December 31, 2006 | | December 31, 2005 | |
|---------------------------------|--------------------------|----------------|--------------------------|----------------|--------------------------|----------------|
| | Amount | Percent | Amount | Percent | Amount | Percent |
| | (Dollars in Thousands) | | | | | |
| Real estate loans: | | | | | | |
| One-to-four family residential | \$ 78,572 | 14.03% | \$ 83,265 | 16.16% | \$ 98,635 | 20.83% |
| Multifamily residential | 19,717 | 3.52 | 21,726 | 4.22 | 24,594 | 5.19 |
| Construction | 90,949 | 16.24 | 76,505 | 14.85 | 62,687 | 13.24 |
| Nonresidential | 254,782 | 45.50 | 231,265 | 44.89 | 185,319 | 39.13 |
| Total real estate loans | 444,020 | 79.29 | 412,761 | 80.12 | 371,235 | 78.39 |
| Commercial business loans | 33,583 | 6.00 | 32,202 | 6.25 | 30,128 | 6.36 |
| Consumer loans | 82,363 | 14.71 | 70,209 | 13.63 | 72,237 | 15.25 |
| Total gross loans | 559,966 | 100.00% | 515,172 | 100.00% | 473,600 | 100.00% |
| Less: | | | | | | |
| Deferred loan fees (costs), net | 10 | | (230) | | 264 | |
| Allowance for loan losses | 6,144 | | 5,764 | | 5,104 | |
| Total loans, net | \$ 553,812 | | \$ 509,638 | | \$ 468,232 | |

| | December 31, 2004 | | December 31, 2003 | |
|--------------------------------|--------------------------|----------------|--------------------------|----------------|
| | Amount | Percent | Amount | Percent |
| | (Dollars in Thousands) | | | |
| Real estate loans: | | | | |
| One-to-four family residential | \$ 91,714 | 28.92% | \$ 102,751 | 34.48% |
| Multifamily residential | 10,632 | 3.35 | 11,987 | 4.02 |
| Construction | 25,033 | 7.89 | 8,913 | 2.99 |
| Nonresidential | 114,551 | 36.12 | 94,357 | 31.66 |
| Total real estate loans | 241,930 | 76.28 | 218,008 | 73.15 |
| Commercial business loans | 14,002 | 4.41 | 14,001 | 4.70 |
| Consumer loans | 61,245 | 19.31 | 66,020 | 22.15 |
| Total gross loans | 317,177 | 100.00% | 298,029 | 100.00% |
| Less: | | | | |
| Deferred loan fees, net | 21 | | 34 | |
| Allowance for loan losses | 3,029 | | 2,969 | |
| Total loans, net | \$ 314,127 | | \$ 295,026 | |

Our Board of Directors must approve all loans in excess of \$3.5 million, or in any amount to borrowers with existing exposure to us in excess of \$3.5 million, or in any amount that when added to the borrower's existing exposure to us causes such total exposure to be in excess of \$3.5 million. In addition, all unsecured loans in excess of \$500,000, or in any amount that when added to a borrower's existing unsecured exposure to us causes such unsecured exposure to be in excess of \$500,000, must be approved by our Board of Directors. Loans of \$3.5 million or less, or customers with exposure (including the proposed loan) of \$3.5 million or less, or unsecured loans of \$500,000 or less, or customers with unsecured exposure (including the proposed loan) of \$500,000 or less, as applicable, may be approved individually or jointly by our lending officers within loan approval limits delegated by our Board of Directors. In addition, the Board of Directors has delegated "incremental" loan approval limits to certain lending officers which allow them to approve a new loan to an existing customer in an amount equal to, or less than, their incremental loan limit that would otherwise require approval by the Board of Directors or the additional approval of another lending officer. Any loan approved by a lending officer using their incremental loan limit must be ratified by the Board of Directors or approved by another lending officer, as applicable, after the loan has been made.

The following table represents the maturity distribution of the Company's loans by type, including fixed-rate loans, as of December 31, 2007. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as becoming due within one year. Loan balances do not include undisbursed loan proceeds, unearned discounts, unearned income and allowance for loan losses.

Maturity Distribution of Loan Portfolio

| | <u>One year or Less</u> | <u>One to Five Years</u> | <u>Over Five Years</u> | <u>Total</u> |
|--------------------------------|-----------------------------|------------------------------|----------------------------|-------------------|
| | (in thousands) | | | |
| Real Estate: | | | | |
| One-to-four family residential | \$ 2,148 | \$ 4,986 | \$ 71,438 | \$ 78,572 |
| Multifamily residential | 2,924 | 7,520 | 9,274 | 19,718 |
| Construction | 58,944 | 27,101 | 4,904 | 90,949 |
| Nonresidential | 73,753 | 151,958 | 29,070 | 254,781 |
| Commercial business | 17,315 | 15,374 | 894 | 33,583 |
| Consumer | 2,083 | 13,636 | 66,644 | 82,363 |
| Total loans | \$ 157,167 | \$ 220,575 | \$ 182,224 | \$ 559,966 |

The following table sets forth the dollar amount of all loans as of December 31, 2007, for which final payment is not due until after December 31, 2008. The table also shows the amount of each type of loan that has a fixed rate of interest and those that have an adjustable rate of interest.

Interest Rate Distribution of Loan Portfolio

| | <u>Fixed Rates</u> | <u>Adjustable Rates</u> | <u>Total</u> |
|--------------------------------|--------------------|-------------------------|-------------------|
| | (in thousands) | | |
| Real Estate Loans: | | | |
| One-to-four family residential | \$ 21,132 | \$ 55,292 | \$ 76,424 |
| Multifamily residential | 5,925 | 10,868 | 16,793 |
| Construction | 20,114 | 11,891 | 32,005 |
| Nonresidential | 110,432 | 70,597 | 181,029 |
| Total real estate loans | 157,603 | 148,648 | 306,251 |
| Commercial business | 12,299 | 3,969 | 16,268 |
| Consumer loans | 11,879 | 68,401 | 80,280 |
| Total loans | \$ 181,781 | \$ 221,018 | \$ 402,799 |

Scheduled contractual principal repayments of loans do not reflect the actual life of such assets. The average life of a loan is substantially less than its contractual terms because of prepayments. In addition, due-on-sale clauses on loans generally give us the right to declare loans immediately due and payable in the event, among other things, that the borrower sells the real property subject to the mortgage and the loan is not repaid. The average life of mortgage loans tends to increase, however, when current mortgage loan market rates are substantially higher than rates on existing mortgage loans and, conversely, decrease when rates on existing mortgage loans are substantially higher than current mortgage loan market rates.

Nonperforming Assets and Delinquencies. When a borrower fails to make a required payment on a loan, we attempt to cure the deficiency by contacting the borrower and collecting the payment. Computer generated late notices are mailed 15 days after a payment is due. In most cases, deficiencies are cured promptly. If a delinquency continues, additional contact is made either through a notice or other means and we will attempt to work out a payment schedule and actively encourage delinquent residential mortgage borrowers to seek home ownership counseling. While we generally prefer to work with borrowers to resolve such problems, we will institute foreclosure or other proceedings, as necessary, to minimize any potential loss. Loans are placed on nonaccrual status generally if, in the opinion of management, principal or interest payments are not likely in accordance with the terms of the loan agreement, such as when principal or interest is past due 90 days or more. Interest accrued but not collected at the date the loan is placed on nonaccrual status is reversed against income in the current period. Loans may be reinstated to accrual status when payments are under 90 days past due or, in the opinion of management, collection of the remaining past due balances can be reasonably expected. Our Board of Directors is informed monthly of the total amount of loans which are more than 30 days delinquent. Loans that are more than 90 days delinquent or in foreclosure are reviewed by the Board on an individual basis each month.

The following table sets forth information with respect to our nonperforming assets at the dates indicated. As of such dates, we had one restructured loan totaling \$1.0 million within the meaning of SFAS No. 15 "Accounting by Debtors and Creditors for Troubled Debt Restructuring." This loan is current and the customer has met all obligations under the modification agreement.

Schedule of Nonperforming Assets

| | December 31, | | | | |
|--|------------------------|----------|----------|----------|--------|
| | 2007 | 2006 | 2005 | 2004 | 2003 |
| | (Dollars in thousands) | | | | |
| Loans accounted for on a nonaccrual basis: | | | | | |
| Real estate loans: | | | | | |
| One-to-four family residential | \$ 159 | \$ 473 | \$ 681 | \$ 627 | \$ 193 |
| Multifamily residential | - | - | - | - | - |
| Construction | - | - | 956 | - | - |
| Nonresidential real estate | 520 | 888 | 397 | 209 | 20 |
| Commercial business | 146 | 78 | 274 | 30 | 203 |
| Consumer | 221 | 360 | 243 | 80 | 113 |
| Total nonaccrual loans | 1,046 | 1,799 | 2,551 | 946 | 529 |
| Accruing loans which were contractually past due 90 days or more | 766 | 1,212 | - | - | - |
| Total nonperforming loans | 1,812 | 3,011 | 2,551 | 946 | 529 |
| Real estate owned | 529 | 139 | 1,157 | 806 | 145 |
| Total nonperforming assets | \$ 2,341 | \$ 3,150 | \$ 3,708 | \$ 1,752 | \$ 674 |
| Nonperforming loans to total loans | 0.32% | 0.58% | 0.54% | 0.30% | 0.18% |
| Nonperforming assets to total assets | 0.30% | 0.42% | 0.53% | 0.34% | 0.14% |

Real Estate Acquired in Settlement of Loans. Real estate acquired by us as a result of foreclosure or by deed-in-lieu of foreclosure is classified as real estate acquired in settlement of loans until sold. Generally, foreclosed assets are held for sale and such assets are carried at the lower of cost or market value minus estimated cost to sell the property. After the date of acquisition, all costs incurred in maintaining the property are expensed and costs incurred for the improvement or development of such property are capitalized up to the extent of their net realizable value. At December 31, 2007, we had \$529,000 in real estate acquired in settlement of loans. This balance is comprised of 13 single-family residences located in the Bank's normal lending area. These properties are in various stages of disposition.

Restructured Loans. Under accounting principles generally accepted in the United States of America, we are required to account for certain loan modifications or restructurings as “troubled debt restructurings.” In general, the modification or restructuring of a debt constitutes a troubled debt restructuring if we, for economic or legal reasons related to the borrower’s financial difficulties, grant a concession to the borrowers that we would not otherwise consider. Debt restructurings or loan modifications for a borrower do not necessarily always constitute troubled debt restructurings, however, and troubled debt restructurings do not necessarily result in nonaccrual loans. We had one restructured loan as of December 31, 2007, totaling \$1.0 million.

Asset Classification. The OTS has adopted various regulations regarding problem assets of financial institutions. The regulations require that each insured institution review and classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, OTS examiners have the authority to identify problem assets and, if appropriate, require them to be classified. There are three classifications for problem assets: substandard, doubtful and loss. Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. An asset classified as loss is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. If an asset or portion thereof is classified as loss, we establish specific allowances for loan losses for the full amount of the portion of the asset classified as loss. All or a portion of general loan loss allowances established to cover possible losses related to assets classified substandard or doubtful can be included in determining an institution’s regulatory capital, while specific valuation allowances for loan losses generally do not qualify as regulatory capital. Assets that do not currently expose the insured institution to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are designated “special mention.”

As of December 31, 2007, we had \$3.4 million of assets classified as substandard and no assets classified as either doubtful or loss. The aggregate amount designated special mention as of December 31, 2007, was \$7.8 million. Pursuant to SFAS No. 114, “*Accounting by Creditors for Impairment of a Loan*,” management determined that impaired loans were not material as of December 31, 2007.

As of December 31, 2006, we had \$6.1 million in assets classified substandard and no assets classified as either doubtful or loss. The aggregate amount designated special mention as of December 31, 2006, was \$9.6 million. Pursuant to SFAS No. 114, management determined that impaired loans were not material as of December 31, 2006.

Allowance for Loan Losses

Management has established a systematic methodology for evaluating the adequacy of the Company’s allowance for loan losses. The methodology is set forth in a formal policy and considers all loans in the portfolio. Specific allowances are established for certain individual loans that management considers impaired under SFAS 114. The remainder of the portfolio is segmented into groups of loans with similar risk characteristics for evaluation and analysis. In originating loans, we recognize that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower, the term of the loan, general economic conditions, and in the case of a secured loan, the quality of the collateral. We increase our allowance for loan losses by charging provisions for loan losses against our current period income. Management’s periodic evaluation of the adequacy of the allowance is consistently applied and is based on our past loan loss experience, particular risks inherent in the different kinds of lending that we engage in, adverse situations that may affect the borrower’s ability to repay, the estimated value of any underlying collateral, current economic conditions, and other relevant internal and external factors that affect loan collectibility.

At December 31, 2007, we had an allowance for loan losses of \$6.1 million. Management believes that this amount meets the requirement for losses on loans that management considers to be impaired, for known losses, and for risks inherent in the remaining loan portfolios. Although management believes that it uses the best information available to make such determinations, future adjustments to the allowance for loan losses may be necessary and results of operations could be significantly adversely affected if circumstances differ substantially from the assumptions used in making the determinations. The allowance for loan losses is subject to periodic evaluation by various regulatory authorities and may be subject to adjustment upon their examination. The following table sets forth an analysis of our allowance for loan losses.

Allowance of Loan Losses

| | At and For the Year Ended December 31, | | | | |
|--|---|-----------------|-----------------|-----------------|-----------------|
| | 2007 | 2006 | 2005 | 2004 | 2003 |
| | (Dollars in Thousands) | | | | |
| Allowance at beginning of period | \$ 5,764 | \$ 5,104 | \$ 3,029 | \$ 2,969 | \$ 2,995 |
| Charge-offs: | | | | | |
| One-to-four family residential | 1 | - | 5 | 14 | - |
| Nonresidential mortgage loans | 309 | - | 182 | 174 | - |
| Commercial business loans | 861 | 484 | 158 | 76 | - |
| Consumer loans | 83 | 89 | 76 | 14 | 94 |
| Total charge-offs | <u>1,254</u> | <u>573</u> | <u>421</u> | <u>278</u> | <u>94</u> |
| Recoveries: | | | | | |
| One-to-four family residential | - | - | - | - | - |
| Nonresidential mortgage loans | - | 50 | 5 | 1 | - |
| Commercial business loans | 296 | 8 | 14 | 4 | - |
| Consumer loans | 48 | 10 | 2 | 3 | 8 |
| Total recoveries | <u>344</u> | <u>68</u> | <u>21</u> | <u>8</u> | <u>8</u> |
| Net charge-offs | 910 | 505 | 400 | 270 | 86 |
| Provision for loan losses | 1,290 | 1,165 | 985 | 330 | 60 |
| Allowance acquired in acquisition | - | - | 1,490 | - | - |
| Allowance at end of period | <u>\$ 6,144</u> | <u>\$ 5,764</u> | <u>\$ 5,104</u> | <u>\$ 3,029</u> | <u>\$ 2,969</u> |
| Allowance for loan losses to total gross loans | 1.10% | 1.12% | 1.08% | 0.95% | 1.00% |
| Net charge-offs to average loans | 0.17% | 0.10% | 0.12% | 0.09% | 0.03% |

The following table sets forth the breakdown of the allowance for loan losses by loan category at the dates indicated. Management believes that the allowance can be allocated by category only on an approximate basis. The allocation of the allowance to each category is not necessarily indicative of future losses and does not restrict the use of the allowance to absorb losses in any other category.

Allocation of Allowance for Loan Losses

| | December 31, 2007 | | December 31, 2006 | | December 31, 2005 | |
|---------------------------------|--------------------------|-----------------------------|--------------------------|-----------------------------|--------------------------|-----------------------------|
| | Amount | % of Total Loans | Amount | % of Total Loans | Amount | % of Total Loans |
| | (Dollars in Thousands) | | | | | |
| Real estate loans: | | | | | | |
| One-to-four family residential | \$ 250 | 14.03% | \$ 300 | 16.16% | \$ 300 | 20.83% |
| Multifamily residential | 200 | 3.52 | 250 | 4.22 | 250 | 5.19 |
| Construction | 900 | 16.24 | 750 | 14.85 | 500 | 13.24 |
| Nonresidential | 2,494 | 45.50 | 2,264 | 44.89 | 1,854 | 39.13 |
| Total real estate loans | 3,844 | 79.29 | 3,564 | 80.12 | 2,904 | 78.39 |
| Commercial business | 1,000 | 6.00 | 1,000 | 6.25 | 1,000 | 6.36 |
| Consumer loans | 1,300 | 14.71 | 1,200 | 13.63 | 1,200 | 15.25 |
| Total allowance for loan losses | \$ 6,144 | 100.00% | \$ 5,764 | 100.00% | \$ 5,104 | 100.00% |

| | December 31, 2004 | | December 31, 2003 | |
|---------------------------------|--------------------------|-----------------------------|--------------------------|-----------------------------|
| | Amount | % of Total Loans | Amount | % of Total Loans |
| | (Dollars in Thousands) | | | |
| Real estate loans: | | | | |
| One-to-four family residential | \$ 250 | 28.92% | \$ 399 | 34.48% |
| Multifamily residential | 100 | 3.35 | 100 | 4.02 |
| Construction | 300 | 7.89 | 150 | 2.99 |
| Nonresidential | 609 | 36.12 | 550 | 31.66 |
| Total real estate loans | 1,259 | 76.28 | 1,199 | 73.15 |
| Commercial business | 600 | 4.41 | 600 | 4.70 |
| Consumer loans | 1,170 | 19.31 | 1,170 | 22.15 |
| Total allowance for loan losses | \$ 3,029 | 100.00% | \$ 2,969 | 100.00% |

Deposits

Our deposit products include a broad selection of deposit instruments, including checking accounts, money market deposit accounts, savings accounts, individual retirement accounts, and term certificate accounts. We offer these products to both retail and commercial customers. Deposit account terms vary with the principal difference being the minimum balance deposit, early withdrawal penalties and the interest rate. We review our deposit mix and pricing weekly. We believe that we are competitive in the type of accounts and interest rates we offer on our deposit products. We do not seek to pay the highest deposit rates, but a competitive rate. Management determines the rates paid based on a number of conditions, including rates paid by competitors, rates on U.S. Treasury securities, rates offered on alternative lending programs, and the deposit growth rate we are seeking to achieve. The following table sets forth information concerning our deposit accounts.

Deposit Portfolio Composition

| <u>Category</u> | <u>December 31, 2007</u> | | <u>December 31, 2006</u> | | <u>December 31, 2005</u> | |
|----------------------------|--------------------------|----------------|--------------------------|-----------------|--------------------------|----------------|
| | <u>Actual</u> | <u>Average</u> | <u>Actual</u> | <u>Average</u> | <u>Actual</u> | <u>Average</u> |
| | | <u>Balance</u> | | <u>Interest</u> | | <u>Balance</u> |
| | <u>Rate</u> | | <u>Rate</u> | | <u>Rate</u> | |
| (Dollars in Thousands) | | | | | | |
| Noninterest bearing demand | \$ 43,571 | -% | \$ 37,762 | -% | \$ 35,226 | -% |
| Interest bearing demand | 58,410 | 1.7 | 52,778 | 1.3 | 50,263 | 0.6 |
| Money market deposit | 129,687 | 3.9 | 117,633 | 3.8 | 104,421 | 2.3 |
| Savings accounts | 12,038 | 0.6 | 16,027 | 0.8 | 23,654 | 0.6 |
| Certificates of deposit | 347,059 | 4.8 | 338,602 | 4.1 | 303,980 | 3.0 |
| Total Deposits | \$ 590,765 | 3.9% | \$ 562,802 | 3.4% | \$ 517,544 | 2.3% |

The following table indicates the amount of our time deposits (also referred to as certificates of deposits) with a principal balance greater than \$100,000 by time remaining until maturity as of December 31, 2007.

Maturities of Time Deposits over \$100,000

| <u>Maturity Period</u> | <u>2007</u> |
|---|------------------------|
| | (Dollars in Thousands) |
| Within three months | \$ 31,826 |
| Over three to six months | 47,154 |
| Over six to twelve months | 36,494 |
| Over twelve months | 16,712 |
| Total time deposits over \$100,000 | \$ 132,186 |

The following table sets forth the amount of time deposits in the Bank categorized by rates as of December 31st at the dates indicated.

Time Deposit Interest Rate Composition

| <u>Interest Rate</u> | <u>2007</u> | <u>2006</u> | <u>2005</u> |
|----------------------|------------------------|-------------------|-------------------|
| | (Dollars in Thousands) | | |
| Less than 2.00% | \$ 599 | \$ 940 | \$ 4,712 |
| 2.01-4.00% | 51,520 | 69,406 | 222,880 |
| 4.01-6.00% | 294,940 | 268,256 | 76,388 |
| 6.01-8.00% | - | - | - |
| | \$ 347,059 | \$ 338,602 | \$ 303,980 |

The following table sets forth the amount of time deposits in the Bank categorized by rates and maturities at December 31, 2007.

Time Deposit Maturity Schedule

| <u>Interest Rate</u> | <u>During the Years Ended December 31,</u> | | | | |
|----------------------|--|------------------|-----------------|--------------------------|-------------------|
| | <u>2008</u> | <u>2009</u> | <u>2010</u> | <u>2011 or Later</u> | <u>Total</u> |
| | (Dollars in Thousands) | | | | |
| Less than 2.0% | \$ 514 | \$ 85 | \$ - | \$ - | \$ 599 |
| 2.01-4.0% | 41,471 | 8,303 | 1,180 | 566 | 51,520 |
| 4.01-6.0% | 277,901 | 9,687 | 6,870 | 482 | 294,940 |
| Total | <u>\$ 319,886</u> | <u>\$ 18,075</u> | <u>\$ 8,050</u> | <u>\$ 1,048</u> | <u>\$ 347,059</u> |

Capital Adequacy and Resources

OTS regulations require savings banks to meet three minimum capital standards: a 1.5% tangible capital ratio, a 4% leverage ratio and an 8% risk-based capital ratio. At December 31, 2007, Citizens South Bank's capital exceeded all applicable requirements. Under prompt corrective action regulations, the OTS is required and authorized to take supervisory actions against undercapitalized savings banks. For this purpose, a savings bank is placed in one of the following five categories based on the bank's capital: 1) well-capitalized (at least 5% leverage capital, 6% tier 1 risk-based capital and 10% total risk-based capital); 2) adequately capitalized (at least 4% leverage capital, 4% tier 1 risk-based capital and 8% total risk-based capital); 3) undercapitalized (less than 8% total risk-based capital, 4% tier 1 risk-based capital or 3% leverage capital); 4) significantly undercapitalized (less than 6% total risk-based capital, 3% tier 1 risk-based capital or 3% leverage capital); and 5) critically undercapitalized (less than 2% tangible capital). At December 31, 2007, Citizens South Bank met the criteria for being considered "well-capitalized."

Funding for future growth is dependent upon the earnings of the Company and its subsidiaries. At December 31, 2007, the Company had a capital-to-assets ratio of 10.79%. As such, the Company fully expects to be able to meet future capital needs caused by growth and expansion as well as regulatory requirements. The Company plans to continue to repurchase its shares of common stock in the open market from time to time as market conditions warrant. During 2007, the Company repurchased 514,637 shares of common stock for a total purchase price of \$6.4 million.

Liquidity

The objectives of the Company's liquidity management policy include providing adequate funds to meet the cash needs of both borrowers and depositors, to provide for the on-going operations of the Company, and to capitalize on opportunities for expansion. Liquidity management addresses the Company's ability to meet deposit withdrawals on demand or at contractual maturity, to repay borrowings as they mature, and to fund new loans and investments as opportunities arise. The primary sources of internally generated funds are principal and interest payments on loans receivable, increases in local deposits, cash flows generated from operations, and cash flows generated by investments. If the Company requires funds beyond its internal funding capabilities, it may rely upon external sources of funds such in brokered deposits and borrowings, including Federal Home Loan Bank ("FHLB") advances. The Company has approximately \$130 million in additional advances available from its line of credit from the FHLB. The FHLB functions as a central reserve bank providing credit for member financial institutions. As a member of the FHLB, we are required to own capital stock in the FHLB and we are authorized to apply for advances on the security of such stock and certain of our mortgage loans and other assets (principally securities that are obligations of, or guaranteed by, the U.S. Government) provided certain creditworthiness standards have been met. Advances are made pursuant to several different credit programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based on the financial condition of the member institution and the adequacy of collateral pledged to secure the credit. The Company may also solicit brokered deposits for providing funds for asset growth.

In the normal course of business, various commitments are outstanding that are not reflected in the consolidated financial statements. Commitments to extend credit and undisbursed advances on customer lines of credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. The funding of these commitments and previously approved undisbursed lines of credit could effect the Company's liquidity position. At December 31, 2007, the Company had loan commitments of \$41.5 million, \$4.2 million in undisbursed construction loan proceeds, and unused lines of credit of \$148.3 million. The Company believes that it has adequate resources to fund loan commitments and lines of credit as they arise. The Company does not have any special purpose entities or other similar forms of off-balance sheet financing.

Under existing contractual obligations, the Company will be required to make payments in future periods. The following table presents aggregated information about payments due under such contractual obligations at December 31, 2007. The Company expects that a portion of the deposits will not be renewed upon maturity. If there is a higher than normal level of time deposits that are not renewed at maturity, then the Company may experience a decrease in liquidity. This may result in the Company offering higher than market interest rates to maintain deposits, which would increase interest expense. Transaction deposit accounts with indeterminate maturities have been classified as having payments due in one year or less.

Contractual Maturities

| | Payments Due by Period at December 31, 2007 | | | | |
|-------------------|---|-----------------------|-----------------------------|--------------------|-------------------|
| | One Year Or Less | One to Three Years | Over Three to Five Years | Over Five Years | Total |
| | (Dollars in Thousands) | | | | |
| Borrowed Funds | \$ 28,320 | \$ 16,000 | \$ 26,500 | \$ 25,464 | \$ 96,284 |
| Deposits | 563,619 | 26,124 | 1,022 | - | 590,765 |
| Lease Obligations | 440 | 671 | 372 | - | 1,483 |
| Total | \$ 592,379 | \$ 42,795 | \$ 27,894 | \$ 25,464 | \$ 688,532 |

Management of Market Risks

Market risk reflects the risk of economic loss resulting from adverse changes in market price and interest risks. The risk of loss can be reflected in diminished market values and/or reduced net interest income in future periods.

The Company's most significant form of market risk is interest rate risk, as the majority of the Company's assets and liabilities are sensitive to changes in interest rates. The structure of the Company's loan and deposit portfolios is such that significant declines in interest rates could adversely impact net interest income. The Company does not maintain a trading account, nor is it subject to currency exchange risk or commodity price risk. The Company's Asset/Liability Committee ("ALCO") is responsible for monitoring and managing exposure to interest rate risk, as discussed below in "Interest Rate Sensitivity".

Interest Rate Sensitivity

The Company's ALCO monitors the Company's level of interest rate sensitivity and ensures that the level of sensitivity of the Company's net portfolio value is maintained within limits established by the Board of Directors. Through such management, the ALCO seeks to reduce the vulnerability of the Company's operations to changes in interest rates. During the past year, the ALCO utilized the following strategies to manage interest rate risk: (1) emphasizing the origination and retention of short-term commercial business loans and nonresidential mortgage loans; (2) emphasizing the origination of adjustable-rate home equity lines of credit; (3) emphasizing the origination and retention of adjustable-rate one-to-four family residential mortgage loans; (4) originating all new fixed-rate mortgage loans as a broker for a third party; and (5) focusing on growing the Company's core deposit portfolio.

The Office of Thrift Supervision requires the computation of amounts by which the net present value of the Bank's cash flow from assets, liabilities, and off balance sheet items (the Bank's net portfolio value or "NPV") and the net interest income ("NII") of the Bank would change in the event of a range of assumed changes in market interest rates. These computations estimate the effect on a bank's NPV and NII from instantaneous and permanent one hundred- to three hundred-basis point increases and decreases in market interest rates. The following table presents the Bank's projected change in NPV and NII at December 31, 2007, as calculated by an independent third party, based upon information provided by the Bank. The Bank's level of sensitivity, given a hypothetical, immediate, and sustained change in interest rates from + 300 basis points to - 300 basis points, is within the range of acceptable sensitivity established by the Board of Directors and is detailed on the following table.

Interest Rate Sensitivity

| Hypothetical, Immediate, and Sustained Changes in Interest Rates | Estimated Theoretical Net Interest Income | | Estimated Theoretical Net Portfolio Value | |
|--|--|----------|--|----------|
| | Amount | % Change | Amount | % Change |
| | (Dollars in Thousands) | | | |
| 300 basis point rise | \$ 22,699 | 2.4% | \$ 90,154 | -13.7% |
| 200 basis point rise | 22,612 | 2.0% | 95,119 | -9.0% |
| 100 basis point rise | 22,438 | 1.3% | 100,181 | -4.1% |
| No change | 20,160 | -% | 104,476 | -% |
| 100 basis point decline | 22,207 | 0.2% | 107,273 | 2.7% |
| 200 basis point decline | 22,042 | -0.5% | 107,638 | 3.0% |
| 300 basis point decline | 21,714 | -2.1% | 110,103 | 5.4% |

Certain shortcomings are inherent in the methodology used in the above interest rate risk measurement. Modeling changes in NPV require the making of certain assumptions, which may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. In this regard, the NPV table presented assumes that the composition of the interest sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and also assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration to maturity or repricing of specific assets and liabilities. Accordingly, although the NPV table provides an indication of the Bank's interest rate risk exposure at a particular point in time, such measurements are not intended to and do not provide a precise forecast of the effect of changes in market interest rates on the Bank's net interest income and will differ from actual results.

Impact of Inflation and Changing Prices

The consolidated financial statements and related notes have been prepared in accordance with GAAP, which require the measurement of financial position and operating results in terms of historical dollars, without considering the change in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, nearly all the assets and liabilities of the Company are financial in nature. As a result, interest rates have a more significant impact on the Company's performance than the effect of inflation. Interest rates do not necessarily change in the same magnitude as the price of goods and services.

Quarterly Financial Data (unaudited)

| | <u>First Quarter</u> | <u>Second Quarter</u> | <u>Third Quarter</u> | <u>Fourth Quarter</u> |
|---|---------------------------------------|-----------------------|----------------------|-----------------------|
| | (in Thousands, Except per Share Data) | | | |
| <u>2007</u> | | | | |
| Interest income | \$ 11,365 | \$ 11,585 | \$ 11,943 | \$ 11,842 |
| Interest expense | 6,319 | 6,513 | 6,840 | 6,829 |
| Net interest income | 5,046 | 5,072 | 5,103 | 5,013 |
| Provision for loan losses | 330 | 330 | 300 | 330 |
| Net int. income after provision for loan losses . | 4,716 | 4,742 | 4,803 | 4,683 |
| Noninterest income | 1,530 | 1,988 | 1,534 | 1,511 |
| Noninterest expense | 4,285 | 4,617 | 4,554 | 4,439 |
| Income before income taxes | 1,961 | 2,113 | 1,783 | 1,755 |
| Income taxes | 561 | 524 | 434 | 428 |
| Net income | <u>\$ 1,400</u> | <u>\$ 1,589</u> | <u>\$ 1,349</u> | <u>\$ 1,327</u> |
| Per share data: | | | | |
| Net income: | | | | |
| Basic | \$ 0.18 | \$ 0.21 | \$ 0.18 | \$ 0.18 |
| Diluted | 0.18 | 0.20 | 0.18 | 0.18 |
| Cash dividends declared | 0.08 | 0.08 | 0.08 | 0.08 |
| Common stock price: | | | | |
| High | 13.40 | 13.00 | 12.99 | 12.33 |
| Low | 12.13 | 12.38 | 12.09 | 9.72 |
| <u>2006</u> | | | | |
| Interest income | \$ 9,866 | \$ 10,482 | \$ 11,125 | \$ 11,446 |
| Interest expense | 4,767 | 5,268 | 5,923 | 6,321 |
| Net interest income | 5,099 | 5,214 | 5,202 | 5,125 |
| Provision for loan losses | 285 | 280 | 300 | 300 |
| Net int. income after provision for loan losses . | 4,814 | 4,934 | 4,902 | 4,825 |
| Noninterest income | 1,414 | 1,369 | 1,643 | 1,715 |
| Noninterest expense | 4,545 | 4,282 | 4,388 | 4,329 |
| Income before income taxes | 1,683 | 2,021 | 2,157 | 2,211 |
| Income taxes | 496 | 674 | 719 | 728 |
| Net income | <u>\$ 1,187</u> | <u>\$ 1,347</u> | <u>\$ 1,438</u> | <u>\$ 1,483</u> |
| Per share data: | | | | |
| Net income: | | | | |
| Basic | \$ 0.15 | \$ 0.17 | \$ 0.18 | \$ 0.19 |
| Diluted | 0.15 | 0.17 | 0.18 | 0.18 |
| Cash dividends declared | 0.075 | 0.075 | 0.075 | 0.075 |
| Common stock price: | | | | |
| High | 13.35 | 12.80 | 13.86 | 13.28 |
| Low | 12.35 | 11.94 | 12.25 | 12.57 |

ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk

Information responsive to this item is contained in Item 7. above under the captions and "Capital Adequacy and Resources", "Liquidity" and "Management of Market Risk".

ITEM 8. Financial Statements and Supplementary Data



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
Citizens South Banking Corporation
Gastonia, North Carolina

We have audited the accompanying consolidated statements of financial condition of Citizens South Banking Corporation and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2007. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Citizens South Banking Corporation and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Citizens South Banking Corporation's internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 14, 2008, expressed an unqualified opinion thereon.

/s/ Cherry, Bekaert & Holland, L.L.P.

Gastonia, North Carolina
March 14, 2008

CITIZENS SOUTH BANKING CORPORATION

Consolidated Statements of Financial Condition

| | December 31, | |
|--|-----------------------|-----------------------|
| | 2007 | 2006 |
| Assets | | |
| Cash and due from banks | \$ 14,285,431 | \$ 17,581,168 |
| Interest-earning bank balances | 15,454,043 | 8,639,809 |
| Cash and cash equivalents | 29,739,474 | 26,220,977 |
| Investment securities available-for-sale | 46,518,568 | 65,326,045 |
| Mortgage-backed and related securities available-for-sale | 69,892,914 | 60,691,351 |
| Loans, net of deferred fees | 559,955,975 | 515,401,738 |
| Allowance for loan losses | (6,144,119) | (5,763,923) |
| Loans, net | 553,811,856 | 509,637,815 |
| Other real estate owned | 528,871 | 138,785 |
| Premises and equipment, net | 17,964,910 | 18,286,967 |
| Accrued interest receivable | 3,254,416 | 3,235,733 |
| Federal Home Loan Bank stock | 4,235,700 | 3,581,000 |
| Intangible assets | 31,037,233 | 31,666,233 |
| Bank owned life insurance | 16,099,371 | 15,526,615 |
| Other assets | 6,056,953 | 9,058,516 |
| Total assets | <u>\$ 779,140,266</u> | <u>\$ 743,370,037</u> |
| Liabilities and Stockholders' Equity | | |
| Deposits | \$ 590,764,822 | \$ 562,801,771 |
| Borrowed money | 70,465,000 | 63,485,000 |
| Subordinated debt | 15,464,000 | 15,464,000 |
| Retail repurchase agreements | 10,355,320 | 7,015,488 |
| Deferred compensation | 5,388,586 | 5,723,439 |
| Other liabilities | 2,669,316 | 2,919,104 |
| Total liabilities | 695,107,044 | 657,408,802 |
| Commitments and contingencies | | |
| Stockholders' Equity | | |
| Preferred stock, 10,000,000 shares authorized, none issued | - | - |
| Common stock, \$0.01 par value, 20,000,000 shares authorized in 2007 and 2006, 9,062,727 shares issued in 2007 and 2006, and 7,610,017 shares outstanding in 2007 and 8,111,659 shares outstanding in 2006 | 90,628 | 90,628 |
| Additional paid-in-capital | 67,718,714 | 67,439,060 |
| Unallocated common stock held by Employee Stock Ownership Plan | (1,247,345) | (1,430,189) |
| Retained earnings, substantially restricted | 36,028,442 | 33,031,512 |
| Accumulated unrealized loss on securities available-for-sale, net of tax | (343,491) | (991,084) |
| Treasury stock of 1,452,710 shares at December 31, 2007, and 951,068 shares at December 31, 2006, at cost | (18,213,726) | (12,178,692) |
| Total stockholders' equity | <u>84,033,222</u> | <u>85,961,235</u> |
| Total liabilities and stockholders' equity | <u>\$ 779,140,266</u> | <u>\$ 743,370,037</u> |

See notes to consolidated financial statements.

CITIZENS SOUTH BANKING CORPORATION

Consolidated Statements of Income

| | Year Ended December 31, 2007 | Year Ended December 31, 2006 | Year Ended December 31, 2005 |
|--|------------------------------------|------------------------------------|------------------------------------|
| Interest income | | | |
| Loans | \$ 40,679,196 | \$ 37,447,545 | \$ 22,128,174 |
| Interest-bearing bank deposits | 446,743 | 838,140 | 462,508 |
| Investment securities | 2,669,784 | 1,996,698 | 1,603,325 |
| Mortgage-backed and related securities | 2,939,447 | 2,636,696 | 2,754,091 |
| Total interest income | 46,735,170 | 42,919,079 | 26,948,098 |
| Interest expense | | | |
| Deposits | 22,314,968 | 18,103,014 | 8,976,879 |
| Borrowed funds | 4,185,148 | 4,176,204 | 2,492,434 |
| Total interest expense | 26,500,116 | 22,279,218 | 11,469,313 |
| Net interest income | 20,235,054 | 20,639,861 | 15,478,785 |
| Provision for loan losses | 1,290,000 | 1,165,000 | 985,000 |
| Net interest income after provision for loan losses | 18,945,054 | 19,474,861 | 14,493,785 |
| Noninterest income | | | |
| Fee income on deposit accounts | 2,722,037 | 2,855,419 | 2,486,197 |
| Fee income on mortgage banking activities | 990,364 | 638,080 | 276,252 |
| Fee income on lending activities | 483,983 | 644,662 | 297,106 |
| Net gain (loss) on sale of securities | (74,422) | (41,350) | 16,688 |
| Net gain on sale of other assets | 397,588 | 110,523 | 45,131 |
| Commissions on sales of financial products | 289,430 | 253,841 | 159,180 |
| Dividends on FHLB stock | 211,560 | 221,413 | 155,310 |
| Fair market adjustment on deferred compensation assets | 121,815 | 206,987 | 83,251 |
| Increase in value of bank owned life insurance | 769,467 | 762,213 | 614,452 |
| Life insurance proceeds, net | 112,063 | - | - |
| Other income | 538,537 | 489,026 | 307,718 |
| Total noninterest income | 6,562,422 | 6,140,814 | 4,441,285 |
| Noninterest expense | | | |
| Compensation and benefits | 9,728,565 | 9,393,723 | 7,271,073 |
| Occupancy | 2,648,284 | 2,614,131 | 2,100,862 |
| Office supplies expense | 195,016 | 258,434 | 241,827 |
| Advertising | 521,692 | 492,133 | 287,288 |
| Professional services | 543,881 | 550,191 | 540,281 |
| Telephone and communications | 258,885 | 350,023 | 284,116 |
| Data processing | 413,288 | 347,043 | 352,709 |
| Deposit insurance | 66,147 | 65,407 | 53,932 |
| Amortization of intangible assets | 629,000 | 734,000 | 408,907 |
| Impairment on investment securities | 161,910 | - | - |
| Merger and conversion expense | - | 56,628 | 383,809 |
| Other expense | 2,728,829 | 2,681,965 | 2,414,745 |
| Total noninterest expense | 17,895,497 | 17,543,678 | 14,339,549 |
| Income before income taxes | 7,611,979 | 8,071,997 | 4,595,521 |
| Provision for income taxes | 1,947,269 | 2,617,120 | 1,322,812 |
| Net income | \$ 5,664,710 | \$ 5,454,877 | \$ 3,272,709 |

Earnings per share

| | | | | | | |
|----------------------------|----|------|----|------|----|------|
| Basic earnings per share | \$ | 0.74 | \$ | 0.68 | \$ | 0.45 |
| Diluted earnings per share | \$ | 0.73 | \$ | 0.67 | \$ | 0.45 |

See notes to consolidated financial statements.

CITIZENS SOUTH BANKING CORPORATION

Consolidated Statements of Comprehensive Income

| | Year Ended December 31, 2007 | Year Ended December 31, 2006 | Year Ended December 31, 2005 |
|---|------------------------------------|------------------------------------|------------------------------------|
| Net income | \$ 5,664,710 | \$ 5,454,877 | \$ 3,272,709 |
| Items of other comprehensive income (loss): | | | |
| Items of other comprehensive income (loss), before tax | | | |
| Unrealized holding losses arising during period | 979,432 | 919,792 | (1,869,781) |
| Reclassification adjustment for securities (gains) losses included in net income | 74,422 | 41,350 | (16,688) |
| Other comprehensive income (loss), before tax | 1,053,854 | 961,142 | (1,886,469) |
| Change in deferred income taxes related to changes | | | |
| Change in deferred income taxes related to changes in unrealized gains or losses on securities available for sale | (406,261) | (385,192) | 737,987 |
| Items of other comprehensive income (loss) | 647,593 | 575,950 | (1,148,482) |
| Comprehensive income | \$ 6,312,303 | \$ 6,030,827 | \$ 2,124,227 |

See notes to consolidated financial statements.

CITIZENS SOUTH BANKING CORPORATION

Consolidated Statements of Changes in Stockholders' Equity

| | Preferred Stock | Common Stock | Additional Paid-In Capital | Unallocated Common Stock Held by ESOP | Retained Earnings Substantially Restricted | Accumulated Unrealized Gains (Losses), net of tax | Treasury Stock | Total Stockholders' Equity |
|--|--------------------|-----------------|----------------------------------|---|---|---|-------------------|----------------------------------|
| Balance, January 1, 2005 | - | 90,628 | 66,682,322 | (1,795,877) | 29,765,725 | (418,552) | (21,929,989) | 72,394,257 |
| Comprehensive results: | | | | | | | | |
| Net income | - | - | - | - | 3,272,709 | - | - | 3,272,709 |
| Other comprehensive results, net of tax | - | - | - | - | - | (1,148,482) | - | (1,148,482) |
| Allocation from shares purchased with loan to ESOP | - | - | 87,020 | 182,844 | - | - | - | 269,864 |
| Repurchase of common stock | - | - | - | - | - | - | (5,654,999) | (5,654,999) |
| Vesting of Recognition and Retention Plan | - | - | 279,816 | - | - | - | - | 279,816 |
| Exercise of options | - | - | - | - | (189,295) | - | 329,964 | 140,669 |
| Issuance of treasury stock (100 shares) | - | - | - | - | (470,678) | - | 17,242,300 | 16,771,622 |
| Cash dividends declared on common stock | - | - | - | - | (2,067,808) | - | - | (2,067,808) |
| Balance, December 31, 2005 | - | 90,628 | 67,049,158 | (1,613,033) | 30,310,653 | (1,567,034) | (10,012,724) | 84,257,648 |
| Comprehensive results: | | | | | | | | |
| Net income | - | - | - | - | 5,454,877 | - | - | 5,454,877 |
| Other comprehensive results, net of tax | - | - | - | - | - | 575,950 | - | 575,950 |
| Allocation from shares purchased with loan to ESOP | - | - | 84,892 | 182,844 | - | - | - | 267,736 |
| Repurchase of common stock | - | - | - | - | - | - | (2,624,719) | (2,624,719) |
| Vesting of Recognition and Retention Plan | - | - | 279,816 | - | - | - | - | 279,816 |
| Stock option expense | - | - | 25,194 | - | - | - | - | 25,194 |
| Exercise of options | - | - | - | - | (322,958) | - | 458,751 | 135,793 |
| Cash dividends declared on common stock | - | - | - | - | (2,411,060) | - | - | (2,411,060) |
| Balance, December 31, 2006 | - | 90,628 | 67,439,060 | (1,430,189) | 33,031,512 | (991,084) | (12,178,692) | 85,961,235 |
| Comprehensive results: | | | | | | | | |
| Net income | - | - | - | - | 5,664,710 | - | - | 5,664,710 |
| Other comprehensive results, net of tax | - | - | - | - | - | 647,593 | - | 647,593 |
| Allocation from shares purchased with loan to ESOP | - | - | 77,844 | 182,844 | - | - | - | 260,688 |
| Repurchase of common stock | - | - | - | - | - | - | (6,446,335) | (6,446,335) |
| Vesting of Recognition and Retention Plan (RRP) | - | - | 302,144 | - | - | - | - | 302,144 |
| Grant of 10,000 shares under RRP | - | - | (128,175) | - | - | - | 128,175 | - |

| | | | | | | | | |
|---|---|---|--------|---|-------------|---|---------|-------------|
| Stock giveaway (10 shares) | - | - | (126) | - | - | - | 126 | - |
| Stock option expense | - | - | 27,967 | - | - | - | - | 27,967 |
| Exercise of options | - | - | - | - | (199,009) | - | 283,000 | 83,991 |
| Cash dividends declared on common stock | - | - | - | - | (2,468,771) | - | - | (2,468,771) |

| | | | | | | | | | |
|-----------------------------------|----|---|-----------|---------------|----------------|---------------|--------------|--------------|------------|
| Balance, December 31, 2007 | \$ | - | \$ 90,628 | \$ 67,718,714 | \$ (1,247,345) | \$ 36,028,442 | \$ (343,491) | (18,213,726) | 84,033,222 |
|-----------------------------------|----|---|-----------|---------------|----------------|---------------|--------------|--------------|------------|

See notes to consolidated financial statements.

CITIZENS SOUTH BANKING CORPORATION

Consolidated Statements of Cash Flows

| | Year Ended December 31, 2007 | Year Ended December 31, 2006 | Year Ended December 31, 2005 |
|--|------------------------------------|------------------------------------|------------------------------------|
| Operating Activities | | | |
| Net Income | \$ 5,664,710 | \$ 5,454,877 | \$ 3,272,709 |
| Adjustments to reconcile net income to net cash provided by operating activities | | | |
| Provision for loan losses | 1,290,000 | 1,165,000 | 985,000 |
| Depreciation | 1,159,739 | 1,330,879 | 1,221,098 |
| Impairment on investment securities | 161,910 | - | - |
| Deferred income tax (benefit) | (475,628) | (408,355) | 224,212 |
| (Gain) loss on sale of investments available-for-sale | 74,422 | 41,350 | (16,688) |
| Gain on sale of other assets | (397,588) | (110,524) | (45,131) |
| Deferred loan origination fees | 87,765 | (410,116) | 243,035 |
| Amortization of intangible assets | 629,000 | 734,000 | 408,907 |
| Allocation of shares to the ESOP | 260,688 | 267,736 | 269,864 |
| Stock option expense | 27,967 | 25,194 | - |
| Vesting of shares issued for the RRP Plan | 302,144 | 279,816 | 279,816 |
| (Increase) decrease in interest receivable | (18,683) | (697,037) | (249,399) |
| Net (increase) decrease in other operating assets | 1,183,265 | (1,063,582) | 3,971,815 |
| Net cash provided by operating activities | 9,949,711 | 6,609,238 | 10,565,238 |
| Investing Activities | | | |
| Acquisition of Trinity Bank, net of cash acquired | - | - | (16,771,138) |
| Net increase in loans made to customers | (45,748,924) | (42,160,673) | (43,043,715) |
| Proceeds from the sale of investment securities | 8,675,120 | 98,300 | 9,391,794 |
| Proceeds from the sale of mortgage-backed and related securities | 8,299,293 | 2,236,956 | 30,325,830 |
| Proceeds from the sale of loans | 201,820 | - | - |
| Proceeds from the sale of premises and equipment | 800,792 | 647,813 | 191,064 |
| Proceeds from sale of REO | 333,788 | 914,074 | 517,393 |
| Maturities and prepayments of investment securities | 19,518,392 | 13,848,457 | 5,066,025 |
| Maturities and prepayments of mortgage-backed and related securities | 12,435,674 | 14,967,504 | 20,232,254 |
| Purchases of investment securities | (9,829,278) | (25,643,486) | (10,623,066) |
| Purchases of mortgage-backed and related securities | (28,675,766) | (6,940,190) | (8,788,599) |
| Purchases (sales) of FHLB stock | (654,700) | 502,700 | 331,500 |
| Purchases of premises and equipment | (1,228,756) | (232,149) | (1,375,950) |
| Net cash used in investing activities | (35,872,545) | (41,760,694) | (14,546,608) |
| Financing Activities | | | |
| Net increase in deposits | 27,963,051 | 45,257,970 | 6,534,989 |
| Dividends to stockholders | (2,468,772) | (2,411,060) | (2,067,808) |
| Exercise of options | 83,991 | 135,793 | 140,669 |
| Repurchase of common stock | (6,446,335) | (2,624,719) | (5,654,999) |
| Increase (decrease) in borrowed money | 10,319,832 | (9,051,563) | 18,981,000 |
| Increase in repurchase agreements | - | 3,445,221 | 1,171,053 |
| Increase (decrease) in advances from borrowers for insurance and taxes | (10,436) | (32,647) | (60,357) |
| Net cash provided by financing activities | 29,441,331 | 34,718,995 | 19,044,547 |
| Net increase (decrease) in cash and cash equivalents | 3,518,497 | (432,461) | 15,063,177 |
| Cash and cash equivalents at the beginning of the year | 26,220,977 | 26,653,438 | 11,590,261 |
| Cash and cash equivalents at the end of the year | \$ 29,739,474 | \$ 26,220,977 | \$ 26,653,438 |

See notes to consolidated financial statements.

CITIZENS SOUTH BANKING CORPORATION

Notes to Consolidated Financial Statements

Note 1 - Organization and Summary of Significant Accounting Policies

Organization - Citizens South Banking Corporation (also referred to as the "Company", the "Registrant", "We", "Us", or "Our") is a Delaware corporation that owns all of the outstanding shares of common stock of Citizens South Bank (the "Bank"). The shares of common stock of the Company trade on the Nasdaq Global Market under the ticker symbol "CSBC." The Company's principal business activities are overseeing and directing the business of the Bank. The Company's assets consist primarily of the outstanding capital stock of the Bank, deposits held at the Bank, and investment securities. The Company became the holding company for the Bank on September 30, 2002, in connection with the mutual-to-stock conversion of Citizens South Holdings, MHC, the mutual holding company of Citizens South Banking Corporation, a federal corporation, formerly named Gaston Federal Bancorp, Inc., which was originally formed on March 18, 1998, for the purpose of acting as the holding company for the Bank.

Citizens South Bank, which was chartered in 1904, is a federally chartered savings bank headquartered in Gastonia, North Carolina. The Bank's principal business activity is offering FDIC-insured deposits to local customers through its 14 branch offices and investing those deposits, together with funds generated from operations and borrowings, in residential and nonresidential real estate loans, construction loans, commercial business loans, consumer loans, investment securities, and mortgage-backed securities. The Bank also acts as a broker in both the origination of loans secured by one-to-four family dwellings and in the sale of uninsured financial products. The Bank's results of operations are heavily dependent on net interest income, which is the difference between the interest earned on loans and securities and the interest paid on deposits and borrowings. Results of operations are also materially affected by the Bank's provision for loan losses, noninterest income, and noninterest expense. Noninterest income includes fee income generated from deposit and loan accounts, mortgage banking fees, commissions earned from the sale of uninsured investment products, increases in the cash value of bank-owned life insurance policies, net gains (losses) from the sale of assets and other noninterest income items. The Bank's noninterest expense primarily consists of compensation and employee benefits, occupancy expense, professional services, advertising, amortization of intangible assets and other noninterest expenses. Results of operations are also significantly affected by general economic and competitive conditions, changes in interest rates, and actions of regulatory and governmental authorities. The Bank's wholly-owned subsidiary, Citizens South Financial Services, Inc. (doing business as Citizens South Investment Services) acts as an independent agent selling various uninsured financial products. As of December 31, 2007, Citizens South Bank had 14 full-service branch offices in the North Carolina Counties of Gaston, Union, Rowan, and Iredell.

Basis of Presentation - The consolidated financial statements include the accounts of Citizens South Banking Corporation, its wholly-owned subsidiary, Citizens South Bank, and the Bank's wholly-owned subsidiary, Citizens South Financial Services, Inc. All significant intercompany accounts and transactions have been eliminated. Certain of the prior year amounts have been reclassified to conform to current year presentation. Such reclassifications are immaterial to the financial statements.

Use of Estimates - The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America which require management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents - Cash and cash equivalents include cash on hand, amounts due from banks, short-term interest-bearing deposits, and federal funds sold. Generally, federal funds are purchased and sold for one-day periods.

Investment securities - Investment securities are generally classified as “available for sale” securities by management at the time of purchase. These securities are used to execute asset/liability management strategies and to manage liquidity. Securities classified as “available-for-sale” are carried at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of consolidated stockholders’ equity and as an item of other comprehensive income. Purchases and sales of securities are recorded on a trade-date basis. Gains and losses are recognized on a trade-date basis at the time of the sale using the specific identification method. Declines in the fair value of individual securities below their cost that are considered “other than temporary” result in write-downs of the individual securities to their fair value. The related write-downs are included in the consolidated earnings of the Company. Amortization of premiums and accretion of discounts are included in interest income over the life of the related security, or in the case of mortgage-backed and related securities, the estimated life of the security. No securities have been classified as either “held to maturity securities” or “trading securities.”

Loans - Loans that management has the intent and ability to hold for the foreseeable future are carried at their principal balance adjusted for any deferred loan fees or expenses. Interest income is earned on the level yield method based on the daily outstanding balance. Generally, loans are classified as nonaccrual, and the accrual of interest is discontinued, when the contractual payment of principal and interest has become 90 days past due or when, in management’s judgment, principal or interest is not collectible in accordance with the terms of the obligation. Cash receipts on nonaccrual loans are applied to principal. The accrual of interest resumes when the loan returns to performing status. The Company evaluates impairment of its residential mortgage and consumer loans on a collective basis. Commercial loans are considered to be impaired when, based on current information, it is probable that the Company will not collect all amounts due in accordance with contractual terms. Management monitors internally generated reports, including past due reports, payment histories, criticized asset reports, which include loans with historical payment problems or borrowers in troubled industries, as well as other sources of information such as borrower financial statements, the value collateral, etc. to identify impaired loans. Discounted cash flow analyses or the estimated fair value of collateral are used in determining the fair value of impaired loans. When the ultimate collectibility of the principal balance of an impaired loan is in doubt, cash receipts are applied to principal.

Allowance for Loan Losses - Management has established a systematic methodology for evaluating the adequacy of the Company’s allowance for loan losses. The methodology is set forth in a formal policy and considers all loans in the portfolio. Specific allowances are established for certain individual loans that management considers impaired under SFAS 114. The remainder of the portfolio is segmented into groups of loans with similar risk characteristics for evaluation and analysis. In originating loans, we recognize that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower, the term of the loan, general economic conditions, and in the case of a secured loan, the quality of the collateral. We increase our allowance for loan losses by charging provisions for loan losses against our current period income. Management’s periodic evaluation of the adequacy of the allowance is consistently applied and is based on our past loan loss experience, particular risks inherent in the different kinds of lending that we engage in, adverse situations that may affect the borrower’s ability to repay, the estimated value of any underlying collateral, current economic conditions, and other relevant internal and external factors that affect loan collectibility.

Concentrations of Credit Risk - The Company makes loans to individuals and small businesses primarily in the Company’s normal lending area which includes the North Carolina Counties of Gaston, Rowan, Union, Mecklenburg, Cabarrus, Lincoln, Cleveland, and Iredell Counties, along with York County, South Carolina. The Company has a diversified loan portfolio, and the borrowers' ability to repay their loans is not dependent upon any specific economic segment.

Other Real Estate Owned - Other real estate owned is comprised of real estate properties acquired in partial or total satisfaction of problem loans. The properties are recorded at the lower of cost or fair value less estimated costs to sell at the date acquired. Losses arising at the time of acquisition of such properties are charged against the allowance for loan losses. Subsequent write-downs that may be required to the carrying value of these properties are charged to current operations. Gains and losses realized from the sale of other real estate owned are included in current operations.

Premises and Equipment - Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are computed over the estimated useful lives of the assets (from three to 30 years) primarily by the straight-line method. Maintenance and repairs are charged to operations in the period incurred. Leasehold improvements are amortized on a straight-line basis over the shorter of the estimated useful life of the improvement or the lease term. Gains and losses on dispositions of fixed assets are included in current operations.

Goodwill and Other Intangible Assets - Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Other Intangible Assets*, requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually in accordance with its provisions. In connection with adoption of SFAS No. 142, the Company is required to perform an initial assessment of whether there is an indication that goodwill is impaired. The Company completed its annual impairment tests at December 31, 2007, 2006 and 2005 and determined based on that analysis that goodwill was not impaired. Goodwill is tested for impairment annually, or between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The Company had no goodwill related to acquisitions initiated prior to July 1, 2001, or other intangible assets recorded prior to the adoption of the provisions of SFAS No. 142 whose carrying amounts or amortization were changed by the adoptions of the provisions of SFAS No. 142. SFAS No. 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values. In accordance with SFAS No. 142 the Company's core deposit intangibles, are amortized over their estimated useful life of eight years on an accelerated basis.

Income Taxes - Provisions for income taxes are based on amounts reported in the consolidated statements of income, excluding non-taxable income, and include changes in deferred income taxes. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Amounts provided for deferred income taxes relate primarily to differences between tax and financial reporting for unrealized gains and losses on securities available-for-sale, allowances for loan losses, depreciation, and deferred compensation.

Income and Expenses - The Company uses the accrual method of accounting for all material income and expense items. Loan origination fees received and direct costs incurred are deferred and amortized to interest income over the contractual lives of the loans, using the level yield method. Current period expenses, such as advertising costs, are expensed as incurred.

Stock-Based Compensation - In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R), *Share-Based Payment*. SFAS No. 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addressed transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. The primary focus of this statement is on accounting for transactions in which an entity obtains employee services in exchange for share-based payment transactions. This Statement is effective for the beginning of the first interim or annual reporting period that begins after December 15, 2005. In October 2005, the Board of Directors vested all outstanding options that were issued prior to December 31, 2003, to minimize the expense recognized on stock options upon adoption of SFAS No. 123(R) in January 1, 2006. As a result, the expected additional compensation that would have been recognized during the year ended December 31, 2006, was reduced from approximately \$124,000 to \$25,194. Compensation expense related to the adoption of SFAS No. 123(R) amounted to \$27,967 for the year ended December 31, 2007.

Prior to the adoption of SFAS 123(R), the Company applied the provisions of Accounting Principles Board (“APB”) Opinion No. 25 in accounting for the plans and accordingly, no compensation expense was recognized in connection with the granting of the stock options during those periods. In accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*, the Company adopted the disclosure-only option and elected to apply the provisions of APB No. 25 for financial statement purposes. The Company recognized compensation expense for fixed awards with pro rata vesting on a straight-line basis. Had the compensation cost for the Company’s stock option plan been determined in accordance with the fair-value accounting provisions of SFAS No. 123, net income, basic earnings per share and diluted earnings per share for the year ended December 31, 2005 would have been as follows:

| | <u>2005</u> |
|----------------------------------|------------------|
| Net income: | |
| As reported | \$ 3,272,709 |
| Deduct: Stock based compensation | <u>(206,991)</u> |
| Pro forma | 3,065,718 |
| Basic earnings per share: | |
| As reported | \$ 0.45 |
| Pro forma | 0.43 |
| Diluted earnings per share: | |
| As reported | \$ 0.45 |
| Pro forma | 0.42 |

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used: dividend yield of 2.0%, expected volatility of 30%, a risk-free interest rate of 4.0%, and expected lives of seven years for the options.

New Accounting Standards - In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 157, *“Fair Value Measurements”* (“SFAS No. 157”), which enhances existing guidance for measuring assets and liabilities using fair value and requires additional disclosure about the use of fair value for measurement. This Statement does not require any new fair value measurements. SFAS No. 157 is effective for the Company January 1, 2008. The Company is currently evaluating the impact of the adoption of SFAS No. 157 on its financial position and results of operations, including the valuation methods and support for the assumptions that underlie the valuation.

In February 2007, FASB issued SFAS No. 159, *“The Fair Value Option for Financial Assets and Financial Liabilities”* (“SFAS No. 159”), which permits entities to choose and measure many financial instruments and certain other items at fair value. The objective of this Statement 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. This Statement is effective for fiscal years beginning after November 15, 2007, with early adoption permitted under certain circumstances. The Company has chosen not to early adopt the provisions of SFAS No. 159, so this Statement will be effective for the Company on January 1, 2008. The Company has evaluated this statement and does not believe it will have a material effect on the Company’s consolidated financial statements.

In September 2006, the Emerging Issues Task Force issued EITF Issue 06-4, "*Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*" ("EITF Issue 06-4"). EITF Issue 06-4 requires that for endorsement split-dollar insurance arrangements that provide a benefit to an employee that extends to postretirement periods, an employer should recognize a liability for future benefits in accordance with SFAS No. 106 or APB No. 12 based on the substantive agreement of the employee. If the employee has effectively agreed to maintain a life insurance policy during postretirement periods, the costs of the life insurance policy during the postretirement periods should be accrued in accordance with either SFAS No. 106 or APB No. 12. If the employer has agreed to provide a death benefit, the employer should recognize a liability for the future death benefit in accordance with either SFAS No. 106 or APB No. 12. EITF Issue 06-4 is effective for fiscal years beginning after December 15, 2007. The Company is currently evaluating the impact of EITF Issue 06-4 on its financial position and results of operations.

In June 2007, the FASB ratified the consensus reached by the EITF on Issue No. 06-11, "*Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards*" to provide guidance on how an entity should recognize the income tax benefit received on dividends that are paid to employees holding certain types of shares or options and are charged to retained earnings under Statement 123(R). This issue will be applied for the Company beginning January 1, 2008. The Company is currently evaluating the impact of EITF Issue 06-11 on its financial position and results of operations.

Note 2 - Business Combination

On October 31, 2005, the Company consummated the merger of Trinity Bank ("Trinity") into Citizens South Bank. Trinity was headquartered in Monroe, North Carolina, which is approximately 50 miles east of the Company's headquarters. Accordingly, the results of operations of Trinity are included in the consolidated financial statements for the two-month period ended December 31, 2005. Trinity had three offices located in Union County, North Carolina, which had the fastest population growth of any county in North Carolina. The Company pursued the acquisition of Trinity in order to gain access to this high-growth market which complements the Company's existing locations and to improve the Company's efficiency ratio by adding an increased number of customer accounts to the Company's existing operating structure.

Under the terms of the merger agreement, the Company issued a combination of common stock and cash for the outstanding common shares of Trinity Bank. Trinity shareholders were given the option of receiving 1.3931 shares of Citizens South common stock for each share of Trinity common stock, \$18.25 in cash for each share of Trinity common stock, or a mixture of stock and cash for each Trinity share, such that 50% of the shares of Trinity common stock will be exchanged for Citizens South common stock. On October 31, 2005, Trinity shareholders received merger consideration of approximately 1,280,249 shares of common stock of the Company (subject to payment of cash in lieu of fractional shares) and approximately \$16.8 million in cash (including cash paid in lieu of fractional shares), resulting in a total transaction value of approximately \$37.8 million. The transaction price represented approximately 255% of Trinity's book value, and resulted in goodwill of \$23.0 million and a core deposit intangible of \$2.3 million. The core deposit intangible is being amortized over an eight-year life on an accelerated basis.

In order to provide financing for the cash portion of the Trinity acquisition, on October 28, 2005, the Company completed a private placement of an aggregate amount of \$15.0 million in trust preferred securities, liquidation amount of \$1,000 per security (the "Preferred Securities"), through a newly formed Delaware statutory trust subsidiary, CSBC Statutory Trust I (the "Trust"). In connection with the issuance of the Preferred Securities, on October 28, 2005, the Company entered into an Indenture by and between the Company and Wilmington Trust Company, as trustee. The Preferred Securities mature on December 15, 2035, but may be redeemed beginning December 15, 2010, if the Company exercises its rights to redeem the Debentures. The Preferred Securities require quarterly interest payments to the holders of the Preferred Securities, initially at a fixed rate of 6.095% through December 2010, and thereafter at a variable rate of three-month LIBOR plus 1.57%, reset quarterly.

The following summarizes the unaudited results of operations as though the acquisition of Trinity Bank had occurred at January 1, 2005.

| | <u>2005</u> |
|-------------------------------------|---------------------|
| Interest income | \$ 33,805,000 |
| Interest expense | (14,480,000) |
| Net interest income | 19,325,000 |
| Provision for loan losses | (1,000,000) |
| Net interest income after provision | 18,325,000 |
| Noninterest income | 5,175,000 |
| Noninterest expense | (17,830,000) |
| Income before income taxes | 5,670,000 |
| Provision for income taxes | (1,718,000) |
| Net income | <u>\$ 3,952,000</u> |
| Basic earnings per share | \$ 0.55 |
| Diluted earnings per share | \$ 0.54 |

Note 3 - Investment Securities

The aggregate book and fair values, as well as gross unrealized gains and losses, of investment securities and mortgage-backed and related securities, available for sale, as of December 31, 2007 and 2006, were as follows:

| | <u>December 31, 2007</u> | | | |
|-------------------------------|--------------------------|-------------------------|--------------------------|----------------------|
| | <u>Book Value</u> | <u>Unrealized Gains</u> | <u>Unrealized Losses</u> | <u>Fair Value</u> |
| <u>Investment Securities:</u> | | | | |
| U.S. government agency bonds | \$ 11,499,539 | \$ 12,662 | \$ (38,486) | \$ 11,473,715 |
| Municipal bonds | 31,783,351 | 140,516 | (627,832) | 31,296,035 |
| Corporate bonds | 1,500,000 | - | (46,500) | 1,453,500 |
| Trust preferred securities | 1,000,000 | - | (14,500) | 985,500 |
| Other equity securities | 1,211,258 | 98,560 | - | 1,309,818 |
| Total investment securities | <u>\$ 46,994,148</u> | <u>\$ 251,738</u> | <u>\$ (727,318)</u> | <u>\$ 46,518,568</u> |

| | December 31, 2007 | | | |
|--|--------------------------|-----------------------------|------------------------------|-----------------------|
| | Book Value | Unrealized Gains | Unrealized Losses | Fair Value |
| <u>Mortgage-backed and related securities:</u> | | | | |
| Fannie Mae | \$ 41,927,008 | \$ 114,261 | \$ (307,883) | \$ 41,733,386 |
| Freddie Mac | 24,922,944 | 219,854 | (130,051) | 25,012,747 |
| Ginnie Mae | 3,126,360 | 23,876 | (3,455) | 3,146,781 |
| Total mortgage-backed and related securities | <u>\$ 69,976,312</u> | <u>\$ 357,991</u> | <u>\$ (441,389)</u> | <u>\$ 69,892,914</u> |

| | December 31, 2006 | | | |
|-------------------------------|--------------------------|-----------------------------|------------------------------|-----------------------|
| | Book Value | Unrealized Gains | Unrealized Losses | Fair Value |
| <u>Investment Securities:</u> | | | | |
| U.S. government agency bonds | \$ 33,319,355 | \$ 2,590 | \$ (320,911) | \$ 33,001,034 |
| Municipal bonds | 28,298,006 | 132,897 | (88,381) | 28,342,522 |
| Corporate bonds | 1,500,000 | - | (27,000) | 1,473,000 |
| Trust preferred securities | 1,000,000 | - | - | 1,000,000 |
| Other equity securities | 1,469,840 | 122,967 | (83,318) | 1,509,489 |
| Total investment securities | <u>\$ 65,587,201</u> | <u>\$ 258,454</u> | <u>\$ (519,610)</u> | <u>\$ 65,326,045</u> |

| | December 31, 2006 | | | |
|--|--------------------------|-----------------------------|------------------------------|-----------------------|
| | Book Value | Unrealized Gains | Unrealized Losses | Fair Value |
| <u>Mortgage-backed and related securities:</u> | | | | |
| Fannie Mae | \$ 39,783,539 | \$ 5,580 | \$ (933,030) | \$ 38,856,089 |
| Freddie Mac | 21,273,371 | 966 | (421,660) | 20,852,677 |
| Ginnie Mae | 986,116 | 1,130 | (4,661) | 982,585 |
| Total mortgage-backed and related securities | <u>\$ 62,043,026</u> | <u>\$ 7,676</u> | <u>\$ (1,359,351)</u> | <u>\$ 60,691,351</u> |

The book value and estimated fair value of debt securities, available for sale at December 31, 2007, 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.

| | December 31, 2007 | |
|--|--------------------------|-----------------------|
| | Book Value | Fair Value |
| <u>Investment Securities:</u> | | |
| Due in one year or less | \$ 4,449,605 | \$ 4,429,598 |
| Due after one year through five years | 10,479,115 | 10,510,209 |
| Due after five years through ten years | 8,573,364 | 8,582,268 |
| Due after ten years | 22,280,806 | 21,686,675 |
| Equities | 1,211,258 | 1,309,818 |
| Total investment securities | <u>\$ 46,994,148</u> | <u>\$ 46,518,568</u> |
| Mortgage-backed and related securities | <u>\$ 69,976,312</u> | <u>\$ 69,892,914</u> |

Gross realized gains on the sale of securities available for sale were \$81,524, \$92,964, and \$48,589 for the years ended December 31, 2007, December 31, 2006, and December 31, 2005, respectively. Gross realized losses on the sale of securities available for sale were \$155,946, \$134,314, and \$31,901 for the years ended December 31, 2007, December 31, 2006, and December 31, 2005, respectively. After-tax net gains on the sale of securities were (\$45,732), (\$25,409), and \$10,255 for the years ended December 31, 2007, December 31, 2006, and December 31, 2005, respectively.

As of December 31, 2007, investment securities having a carrying amount of \$36,810,929 have been pledged as collateral to secure public deposits, \$11,756,880 have been pledged as collateral for retail repurchase agreements, \$7,260,185 have been pledged as collateral for wholesale repurchase agreements, and \$200,000 have been pledged as collateral for Federal Reserve Bank Treasury Tax and Loan deposits.

Interest earned from municipal securities, which is exempt from income taxes, for the past three years were \$1,382,458, \$516,358, and \$441,102 for the years ending December 31, 2007, December 31, 2006, and December 31, 2005, respectively.

The unrealized losses and fair value of the investments by investment type segregated between those that have been in a continuous unrealized loss position for less than twelve months and more than twelve months at December 31, 2007, and December 31, 2006, are as follows:

| Description of Securities | December 31, 2007 | | | | | |
|---|---------------------|-----------------|-------------------|-----------------|---------------|-----------------|
| | Less than 12 months | | 12 months or more | | Total | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. govt. agency bonds | \$ - | \$ - | \$ 6,461,053 | \$ (38,486) | \$ 6,461,053 | \$ (38,486) |
| Municipal bonds | 18,855,607 | (600,096) | 2,552,800 | (27,736) | 21,408,407 | (627,832) |
| Corporate bonds | - | - | 1,453,500 | (46,500) | 1,453,500 | (46,500) |
| Trust preferred securities | - | - | 985,500 | (14,500) | 985,500 | (14,500) |
| Federal agency mortgage-backed securities | 2,994,589 | (6,932) | 28,737,077 | (434,457) | 31,731,666 | (441,389) |
| Total temporarily impaired securities | \$ 21,850,196 | \$ (607,028) | \$ 40,189,930 | \$ (561,679) | \$ 62,040,126 | \$ (1,168,707) |

| Description of Securities | December 31, 2006 | | | | | |
|---|---------------------|-----------------|-------------------|-----------------|---------------|-----------------|
| | Less than 12 months | | 12 months or more | | Total | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| US government agencies | \$ 4,493,967 | \$ (7,511) | \$ 22,504,477 | \$ (313,400) | \$ 26,998,444 | \$ (320,911) |
| Municipals | 1,785,668 | (7,403) | 4,951,650 | (80,978) | 6,737,318 | (88,381) |
| Corporate bonds | - | - | 1,473,000 | (27,000) | 1,473,000 | (27,000) |
| Federal agency mortgage backed securities | 7,499,952 | (13,544) | 44,926,820 | (1,345,807) | 52,426,772 | (1,359,351) |
| Subtotal debt securities | 13,779,587 | (28,458) | 73,855,947 | (1,767,185) | 87,635,534 | (1,795,643) |
| Other equity securities | 222,168 | (83,318) | - | - | 222,168 | (83,318) |
| Total temporarily impaired securities | \$ 14,001,755 | \$ (111,776) | \$ 73,855,947 | \$ (1,767,185) | \$ 87,857,702 | \$ (1,878,961) |

Management considers all of the unrealized losses that have been outstanding for 12 or more months to be temporary impairments since these impairments are primarily due to changes in interest rates. Management has the ability and intent to hold these securities until they are no longer considered to be impaired, which may be maturity.

Note 4 - Loans and Allowance for Loan Losses

The following is a summary of loans outstanding by category at December 31:

| | <u>2007</u> | <u>2006</u> |
|---|-----------------------|-----------------------|
| Real estate: | | |
| One-to-four family residential | \$ 78,572,380 | \$ 83,264,793 |
| Multi-family residential | 19,717,641 | 21,725,953 |
| Construction | 90,948,598 | 76,505,202 |
| Nonresidential | 254,781,774 | 231,264,961 |
| Commercial | 33,582,788 | 32,201,870 |
| Consumer | 82,362,726 | 70,209,136 |
| Gross loans | 559,965,907 | 515,171,915 |
| Less: | | |
| Deferred loan fees, net and other items | 9,932 | (229,823) |
| Allowance for loan losses | 6,144,119 | 5,763,923 |
| Net loans | <u>\$ 553,811,856</u> | <u>\$ 509,637,815</u> |

The Company evaluates impairment of its residential mortgage and consumer loans on a collective basis. Commercial loans individually evaluated and considered impaired under SFAS No. 114 at December 31, 2007 and 2006 were immaterial.

Changes in the allowance for loan losses for the years ended December 31, 2007, December 31, 2006 and December 31, 2005 were as follows:

| | <u>2007</u> | <u>2006</u> | <u>2005</u> |
|--|---------------------|---------------------|---------------------|
| Balance at beginning of year | \$ 5,763,923 | \$ 5,102,304 | \$ 3,029,108 |
| Provision for loan losses | 1,290,000 | 1,165,000 | 985,000 |
| Loans charged off | (1,253,619) | (523,022) | (421,603) |
| Recoveries on loans previously charged off | 343,815 | 19,641 | 21,176 |
| Allowances acquired in acquisition | - | - | 1,488,623 |
| Balance at end of year | <u>\$ 6,144,119</u> | <u>\$ 5,763,923</u> | <u>\$ 5,102,304</u> |

Directors, executive officers, and associates of such persons are customers of and had transactions with the Bank in the ordinary course of business. Included in such transactions are outstanding loans and commitments, all of which were made under normal credit terms and did not involve more than normal risk of collection. The aggregate amounts of these loans were \$8,077,988 and \$6,142,874 at December 31, 2007 and 2006, respectively. During the year ended December 31, 2007, new loans of \$8,647,678 were made and payments totaled \$6,336,287. During the year ended December 31, 2006, new loans of \$1,994,343 were made and payments totaled \$7,637,382.

The Bank held no loans for sale at December 31, 2007 and 2006.

Note 5 - Premises and Equipment

Premises and equipment at December 31 are summarized as follows:

| | <u>2007</u> | <u>2006</u> |
|--------------------------------|----------------------|----------------------|
| Land | \$ 5,371,888 | \$ 4,716,895 |
| Buildings | 13,437,635 | 13,709,581 |
| Leasehold Improvements | 268,728 | 268,728 |
| Land Improvements | 286,424 | 292,518 |
| Furniture and equipment | 4,620,676 | 4,505,787 |
| Premises and equipment | 23,985,351 | 23,493,509 |
| Less: accumulated depreciation | 6,020,441 | 5,206,542 |
| Premises and equipment, net | <u>\$ 17,964,910</u> | <u>\$ 18,286,967</u> |

Note 6 - Bank Owned Life Insurance

The Company owns bank-owned life insurance to fund certain employee benefit plans. No purchases of bank-owned life insurance were made during the years ended December 31, 2007, and December 31, 2006. The bank-owned life insurance policies are recorded in other assets at their cash surrender values of \$16,099,371 and \$15,526,615 at December 31, 2007 and 2006, respectively.

Note 7 - Intangible Assets

Amortized intangible assets at December 31, 2007 and 2006 are summarized as follows:

| | <u>2007</u> | <u>2006</u> |
|--------------------------------|---------------------|---------------------|
| Core deposit intangible | \$ 4,767,000 | \$ 4,767,000 |
| Less: Accumulated amortization | 3,371,001 | 2,742,001 |
| Core deposit intangible, net | <u>\$ 1,395,999</u> | <u>\$ 2,024,999</u> |

Amortization expense for all intangible assets subject to amortization was \$629,000 during the year ended December 31, 2007, \$734,000 during the year ended December 31, 2006, and \$408,907 during the year ended December 31, 2005. Estimated amortization expense for the next five succeeding years ending December 31 are as follows:

| | | |
|------|----|---------|
| 2008 | \$ | 512,000 |
| 2009 | \$ | 314,000 |
| 2010 | \$ | 244,000 |
| 2011 | \$ | 176,000 |
| 2012 | \$ | 111,000 |

The balance of goodwill was \$29,641,234 at December 31, 2007 and December 31, 2006. This resulted in total intangible assets of \$31,037,233 at December 31, 2007, and \$31,666,233 at December 31, 2006.

Note 8 - Deposits

Deposit balances and interest expense and average rates paid for the years ended December 31, 2007, December 31, 2006, and December 31, 2005 are summarized as follows:

| | December 31, 2007 | | | December 31, 2006 | | |
|---------------------------|----------------------|----------------------|--------------|----------------------|----------------------|--------------|
| | Actual Balance | Interest Expense | Average Rate | Actual Balance | Interest Expense | Average Rate |
| Noninterest-bearing | \$ 43,571,218 | \$ - | - | \$ 37,762,084 | \$ - | - |
| Interest-bearing checking | 58,409,636 | 917,033 | 1.74% | 52,778,385 | 662,072 | 1.29% |
| Money market deposit | 129,687,365 | 4,908,496 | 3.89 | 117,632,286 | 4,186,931 | 3.82 |
| Savings | 12,037,608 | 82,351 | 0.58 | 16,026,580 | 149,807 | 0.77 |
| Certificates of deposit | 347,058,995 | 16,407,088 | 4.79 | 338,602,436 | 13,104,204 | 4.09 |
| Total deposits | \$590,764,822 | \$ 22,314,968 | 3.88% | \$562,801,771 | \$ 18,103,014 | 3.37% |

| | December 31, 2005 | | |
|---------------------------|-----------------------|---------------------|--------------|
| | Actual Balance | Interest Expense | Average Rate |
| Noninterest-bearing | \$ 35,225,404 | \$ - | - |
| Interest-bearing checking | 50,262,906 | 210,499 | 0.57% |
| Money market deposit | 104,420,774 | 1,791,093 | 2.29 |
| Savings | 23,654,258 | 158,721 | 0.61 |
| Certificates of deposit | 303,980,459 | 6,816,566 | 2.95 |
| Total deposits | \$ 517,543,801 | \$ 8,976,879 | 2.41% |

Contractual maturities of certificates of deposit as of December 31, 2007 and 2006, are as follows:

| | 2007 | 2006 |
|--------------------|-----------------------|-----------------------|
| Under 1 year | \$ 319,912,823 | \$ 298,589,731 |
| 1 to 2 years | 18,074,932 | 20,364,963 |
| 2 to 3 years | 8,050,396 | 12,458,820 |
| 3 to 4 years | 317,539 | 6,709,883 |
| 4 years or greater | 703,305 | 479,039 |
| Total | \$ 347,058,995 | \$ 338,602,436 |

Certificates of deposit in excess of \$100,000 totaled \$132,186,117 and \$123,835,024 at December 31, 2007 and 2006, respectively, and may not be fully insured by the FDIC. Interest paid on deposits and other borrowings was \$25,924,506 for the year ended December 31, 2007, \$21,277,860, for the year ended December 31, 2006, and \$10,576,971 for the year ended December 31, 2005.

Directors, executive officers, and associates of such persons are customers of and had transactions with the Bank in the ordinary course of business. Included in such transactions are deposit accounts, all of which were made under normal terms. The aggregate amount of these deposit accounts was \$3,426,486 and \$4,636,009 at December 31, 2007 and 2006, respectively.

The deposits of the Bank are insured by the Deposit Insurance Fund (DIF), which is administered by the FDIC. The Bank's annual DIF premium rates were \$0.054, \$0.014, and \$0.014 per \$100 of deposits for the years ended December 31, 2007, December 31, 2006 and December 31, 2005, respectively.

Note 9 - Borrowed Money

As of December 31, 2007, the Company had \$64.5 million in advances from the FHLB of Atlanta that were obtained pursuant to a line of credit. These advances are collateralized by a lien on qualifying first mortgage loans in an amount necessary to satisfy outstanding indebtedness plus accrued interest. The total amount available on the line of credit is 25% of total assets of the Bank, or approximately \$194 million. The unused portion of the line of credit available to the Company at December 31, 2007, was approximately \$130 million. These advances had interest rates ranging from 1.24% to 6.25% at December 31, 2007, and December 31, 2006. In addition, the Company had a mark-to-market adjustment on advances acquired in the Trinity acquisition which had a debit balance of \$35,000 at December 31, 2007, which is considered to be due in less than one year. Interest rates on certain FHLB convertible advances may be reset on certain dates at the option of the FHLB in accordance with the terms of the note. The Bank has the option of repaying the outstanding advance or converting the interest rate from a fixed rate to a floating rate at the time the advance is called by the FHLB. These convertible advances totaled \$37.0 million at December 31, 2007, and \$12.0 million at December 31, 2006.

The Company also had \$6.0 million in repurchase agreements ("repos") from JP Morgan Chase Bank, NA ("JP Morgan") at December 31, 2007. These borrowings are collateralized by various US Government agency investment and mortgage-backed securities in an amount equal to at least 105% of the outstanding amount of the repurchase agreement. One repo, which totaled \$3.0 million with a fixed interest rate of 3.66%, had a two-year one-time call option with a ten-year maturity date. After the two-year period, the repo may be called by JP Morgan, or it may remain outstanding for the remaining eight-year period at the original interest rate of 3.66%. The remaining repo had a balance of \$3.0 million and a fixed rate of 4.48% for five years.

Maturities of borrowed money at December 31 are as follows:

| | <u>2007</u> | <u>2006</u> |
|-----------------------------|-----------------------------|-----------------------------|
| Borrowed money due: | | |
| Less than 1 year | \$ 17,965,000 | \$ 17,985,000 |
| 1 to 2 years | 8,000,000 | 13,000,000 |
| 2 to 3 years | 8,000,000 | 3,000,000 |
| 3 to 4 years | 1,500,000 | 8,000,000 |
| 4 to 5 years | 25,000,000 | 1,500,000 |
| 5 to 10 years | 8,000,000 | 18,000,000 |
| After 10 years | 2,000,000 | 2,000,000 |
| Total borrowed money | <u>\$ 70,465,000</u> | <u>\$ 63,485,000</u> |

Note 10 - Subordinated Debt

In order to provide financing for the cash portion of the Trinity acquisition, on October 28, 2005, the Company completed a private placement of an aggregate amount of \$15,000,000 in trust preferred securities, liquidation amount \$1,000 per security (the "Preferred Securities"), through a newly formed Delaware statutory trust subsidiary, CSBC Statutory Trust I (the "Trust").

In connection with the issuance of the Preferred Securities, on October 28, 2005, the Company entered into an Indenture (the "Indenture") by and between the Company and Wilmington Trust Company, as trustee, and an Amended and Restated Declaration of Trust (the "Trust Agreement") among the Company, as Sponsor, Wilmington Trust Company, as Delaware and Institutional Trustee, and the administrative trustees of the Trust.

On October 28, 2005, CSBC Statutory Trust I issued an aggregate of \$15,000,000 in trust preferred securities, liquidation amount \$1,000 per security. The Preferred Securities mature on December 15, 2035, but may be redeemed beginning December 15, 2010, if the Company exercises its right to redeem the Debentures, as described below. The Preferred Securities require quarterly distributions by the Trust to the holders of the Preferred Securities, initially at a fixed rate of 6.095% per annum through the interest payment date in December 2010, and thereafter at a variable rate of three-month LIBOR plus 1.57% per annum, reset quarterly. Distributions are cumulative and will accrue from the date of original issuance but may be deferred for a period of up to twenty consecutive quarterly interest payment periods if the Company exercises its right under the Indenture to defer the payment of interest on the Debentures, as described below. In accordance with FIN No. 46(R), "Consolidation of Variable Interest Entities", the trust is not consolidated with the financial statements of the Company.

The proceeds from the sale of the Preferred Securities received by the Trust, combined with the proceeds of \$464,000 received by the Trust from the issuance of common securities (the "Common Securities") by the Trust to the Company, were used to purchase \$15,464,000 in principal amount of unsecured junior subordinated deferrable interest debentures (the "Debentures") of the Company, issued pursuant to the Indenture.

The issuance of the Preferred Securities and the Common Securities are provided for in the Trust Agreement dated October 28, 2005, by and among the Trustee, the Company, and the administrative trustees of the Trust. The administrative trustees are the President and Chief Executive Officer, Executive Vice President and Secretary, and Executive Vice President and Chief Financial Officer.

The Debentures mature on December 15, 2035, but the Company may at its option redeem the Debentures, in whole or in part, beginning on December 15, 2010, in accordance with the provisions of the Indenture. The Debentures bear interest at a fixed rate equal to 6.095% per annum through the interest payment date in December 2010, and thereafter at a variable rate, reset quarterly, of three-month LIBOR plus 1.57% per annum. Interest is cumulative and will accrue from the date of original issuance. However, so long as there is no event of default, interest payments may be deferred by the Company at its option at any time for a period of up to twenty consecutive quarterly interest payment periods, but not beyond December 15, 2035 (each such extended interest payment period, an "Extension Period"). No interest shall be due and payable during an Extension Period, but each installment of interest that would otherwise have been due and payable during such Extension Period shall bear additional interest at an annual rate equal to the interest rate in effect for each Extension Period. Furthermore, during any Extension Period, the Company may not declare or pay any dividends on its capital stock, which includes its Common Stock, nor make any payment or redeem debt securities that rank *pari passu* with the Debentures.

The Debentures may be redeemed at par at the option of the Company beginning on December 15, 2010, and may be redeemed earlier than such date following the occurrence of a "Special Event" (as defined in the Indenture) at a price equal to 107.5% of the principal amount together with accrued interest. The Trust will be required to redeem a like amount of Preferred Securities if the Company exercises its right to redeem all or a portion of the Debentures.

Either the Trustee or the holders of at least 25% of the aggregate principal amount of the outstanding Debentures may declare the principal amount of, and all accrued interest on, all the Debentures to be due and payable immediately, or if the holders of the Debentures fail to make such declaration, the holders of at least a majority in aggregate liquidation amount of the Preferred Securities outstanding shall have a right to make such declaration, if an Event of Default occurs. An Event of Default generally includes a default in payment of any interest for 30 days, a default in payment upon maturity, a default in performance, or breach of any covenant or representation, bankruptcy or insolvency of the Company or liquidation or dissolution of the Trust. Any holder of the Preferred Securities has the right, upon the occurrence of an Event of Default related to payment of interest of principal, to institute suit directly against the Company for enforcement of payment to such holder of principal of and any premium and interest, including additional interest, on the Debentures having a principal amount equal to the aggregate liquidation amount of the Preferred Securities held by such holder.

Note 11 - Income Taxes

The provision for income taxes for the years ended December 31st are summarized below:

| | <u>2007</u> | <u>2006</u> | <u>2005</u> |
|--------------------|---------------------|---------------------|---------------------|
| Currently payable: | | | |
| Federal | \$ 2,008,139 | \$ 2,594,290 | \$ 864,250 |
| State | 414,758 | 431,185 | 234,350 |
| Total current | <u>2,422,897</u> | <u>3,025,475</u> | <u>1,098,600</u> |
| Deferred: | | | |
| Federal | (350,237) | (347,236) | 257,008 |
| State | (125,390) | (61,119) | (32,796) |
| Total deferred | <u>(475,628)</u> | <u>(408,355)</u> | <u>224,212</u> |
| Total income taxes | <u>\$ 1,947,269</u> | <u>\$ 2,617,120</u> | <u>\$ 1,322,812</u> |

The reasons for the difference between consolidated income tax expense and the amount computed by applying the statutory federal income tax rate of 34% to income before income taxes were as follows for the years ended December 31st:

| | <u>2007</u> | <u>2006</u> | <u>2005</u> |
|--|---------------------|---------------------|---------------------|
| Federal income taxes at statutory rate | \$ 2,588,073 | \$ 2,744,479 | \$ 1,562,477 |
| Effect of federal tax exempt interest | (389,183) | (151,624) | (135,946) |
| State income taxes, net of federal benefit | 190,983 | 244,244 | 133,026 |
| Increase in cash value of life insurance | (314,794) | (237,603) | (202,601) |
| Other | (127,810) | 17,624 | (34,144) |
| | <u>\$ 1,947,269</u> | <u>\$ 2,617,120</u> | <u>\$ 1,322,812</u> |
| Effective tax rate | <u>25.6%</u> | <u>32.4%</u> | <u>28.8%</u> |

Income taxes paid for the years ended December 31, 2007, 2006, and 2005 were \$3,003,664, \$3,142,078, and \$2,773,660, respectively.

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities at December 31 are as follows:

| | <u>2007</u> | <u>2006</u> |
|--|--------------|--------------|
| Deferred tax assets | | |
| Deferred compensation | \$ 990,616 | \$ 871,763 |
| Unrealized loss on securities available for sale | 215,485 | 640,326 |
| Allowance for loan losses | 2,342,897 | 2,211,211 |
| Capital loss carryforward | 282,052 | 338,196 |
| Other | 167,339 | 110,810 |
| Gross deferred tax assets | 3,998,390 | 4,172,326 |
| Deferred tax liabilities | | |
| Excess carrying value of assets acquired for financial reporting purposes over tax basis | 1,028,041 | 1,307,587 |
| Deferred loan fees | 194,606 | 144,095 |
| Other | 102,615 | 98,283 |
| Gross deferred tax liabilities | 1,325,261 | 1,549,965 |
| Net deferred tax asset | \$ 2,673,128 | \$ 2,622,361 |

The Company has adopted the provisions of Financial Accounting Standards Board ("FASB") Interpretation No. 48 ("FIN 48"). There was no material impact from the adoption of FIN 48. It is the Bank's policy to recognize interest and penalties associated with uncertain tax positions as components of income taxes. There were no interest or penalties accrued during the year. The Company's federal and state income tax returns are subject to examination for the years 2004, 2005 and 2006.

The Company, in accordance with SFAS No. 109, did not record a deferred tax liability of approximately \$3.1 million as of December 31, 2007, related to the cumulative special bad debt deduction for savings and loan associations recognized for income tax reporting prior to September 30, 1988, Citizen South Bank's base year.

Management believes that the Company will fully realize deferred tax assets based on future taxable temporary differences, refundable income taxes from carryback years, and current levels of operating income.

Note 12 - Commitments

Commitments to extend credit are agreements to lend as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. These commitments represent no more than normal lending risk that the Bank commits to its borrowers and management believes that these commitments can be funded through normal operations.

Commitments to extend credit that include both fixed and variable rates as of December 31 are as follows:

| | <u>2007</u> | <u>2006</u> |
|---|--------------|--------------|
| Residential mortgage loan commitments | \$ 7,160,455 | \$ 6,193,000 |
| Non-residential mortgage loan commitments | 20,987,431 | 34,842,430 |
| Commercial loan commitments | 6,559,700 | 1,535,000 |
| Consumer loan commitments | 6,840,137 | 3,857,000 |
| Unused lines of credit: | | |
| Commercial | 38,120,483 | 43,424,493 |
| Consumer | 71,831,349 | 61,912,898 |

The Company also had various leases in place to provide office space for two full-service offices and three loan production offices. The amount paid for this leased office space totaled \$370,410 for the year ended December 31, 2007, \$337,897 for the year ended December 31, 2006, and \$122,876 for the year ended December 31, 2005. Projected lease payments over the next five years are expected to be \$440,000 for 2008, \$420,000 for 2009, \$250,000 for 2010, \$186,000 for 2011, and \$186,000 for 2012.

Note 13 - Regulatory Capital Requirements

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

The Bank is required to maintain: tangible capital of at least 1.5% of adjusted total assets; core capital of at least 4.0% of adjusted total assets; and total capital of at least 8.0% of risk weighted assets. At December 31, 2007, the Bank's tangible capital and core capital were \$65,276,000, or 8.74% of tangible assets, and total capital was \$71,420,000, or 11.21% of risk-weighted assets. The Company's primary regulator, the Office of Thrift Supervision, informed the Bank that it was in the "well-capitalized" category as of the most recent regulatory examination, and management is not aware of any events that have occurred since that would have changed its classification.

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|------------------------|--------------|--------------------------------------|--------------|---|--------------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | (Dollars in Thousands) | | (Dollars in Thousands) | | (Dollars in Thousands) | |
| As of December 31, 2007: | | | | | | |
| Total Risk-Based Capital | | | | | | |
| (to Risk-Weighted Assets) | \$ 71,420 | 11.21% | \$ 50,953 | 8.00% | \$ 63,691 | 10.00% |
| Tier 1 Capital | | | | | | |
| (to Risk-Weighted Assets) | 65,276 | 10.25% | 25,477 | 4.00% | 38,215 | 6.00% |
| Tier 1 Capital (to Adjusted Total Assets) | 65,276 | 8.74% | 29,890 | 4.00% | 37,362 | 5.00% |
| Tangible Capital (to Adjusted Total Assets) | 65,276 | 8.74% | 11,209 | 1.50% | 22,417 | 3.00% |
| As of December 31, 2006: | | | | | | |
| Total Risk-Based Capital | | | | | | |
| (to Risk-Weighted Assets) | \$ 70,440 | 11.81% | \$ 47,733 | 8.00% | \$ 59,666 | 10.00% |
| Tier 1 Capital | | | | | | |
| (to Risk-Weighted Assets) | 64,676 | 10.81% | 23,866 | 4.00% | 35,799 | 6.00% |
| Tier 1 Capital (to Adjusted Total Assets) | 64,676 | 9.11% | 28,384 | 4.00% | 35,481 | 5.00% |
| Tangible Capital (to Adjusted Total Assets) | 64,676 | 9.11% | 10,644 | 1.50% | 21,288 | 3.00% |

On May 23, 2002, the MHC approved a Plan of Conversion and Reorganization. As a result of the Conversion, the Bank established a memo liquidation account in an amount equal to its equity at the time of the Conversion of approximately \$44 million for the benefit of eligible account holders and supplemental eligible account holders who continue to maintain their accounts at the Bank after the Conversion. In the event of a complete liquidation of the Bank, each eligible account holder and supplemental eligible account holder will be entitled to receive a distribution from the liquidation account in an amount proportionate to the current adjusted qualifying balances for accounts then held. As a result, retained earnings are substantially restricted at December 31, 2007 and 2006.

Note 14 - Employee Benefit Plans

The Bank provides supplemental benefits to substantially all employees through a 401(k) savings plan. Eligible participants may contribute up to 75% of eligible compensation, with the Bank providing matching contributions of 50% of employee contributions up to 6% of eligible compensation. The plan also provides for discretionary employer contributions. During 2007, 2006 and 2005, no discretionary employer contributions were made to the 401(k) plan. Total expense relating to this plan was \$171,926 for the year ended December 31, 2007, \$165,524 for the year ended December 31, 2006, and \$131,023 for the year ended December 31, 2005.

The Bank maintains nonqualified deferred compensation and/or supplemental retirement plans for certain of its directors and executive officers. Total expense for the all of these plans was \$463,860 for the year ended December 31, 2007, \$423,290 for the year ended December 31, 2006, and \$374,505 for the year ended December 31, 2005.

The Bank also adopted nonqualified deferred compensation plans for key employees and directors of Citizens Bank, a wholly-owned subsidiary of Innes Street Financial Corporation, which was acquired by the Company on December 31, 2001. The deferred assets related to these plans are maintained in rabbi trusts, which are included in Other Assets of the Company. The assets are accounted for at market value in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, with the resulting gains or losses in value recorded in income. The corresponding change in fair value of the deferred compensation obligation is recorded as compensation expense. As a result, there is no impact on net income as a result of this benefit.

2003 Recognition and Retention Plan ("2003 RRP") - Pursuant to resolutions of the Board of Directors of Citizens South Banking Corporation adopted on August 18, 2003, and the subsequent approval by the stockholders of the Company on October 23, 2003, the Company adopted and implemented the Citizens South Banking Corporation 2003 Recognition and Retention Plan with a total of 210,398 shares. On November 3, 2003, awards of 196,560 shares of restricted stock were made under the 2003 RRP. All of these shares vest over a seven-year period commencing on the date of the award, at the rate of 30% on November 3, 2003, 10% on January 2, 2004, 10% on November 3, 2005, and 10% per year on November 3 of each year thereafter. The fair market value of the restricted stock at the time of the grant was \$15.04 per share. During 2007, 19,456 shares vested and no shares were forfeited. In addition, 10,000 shares were granted during 2007 with 5-year cliff vesting. At December 31, 2007, 5,038 restricted shares remained unissued and available for grants under the 2003 RRP. Total expense for the 2003 RRP amounted to \$302,144 in 2007, \$279,816 in 2006 and \$279,816 in 2005.

1999 Stock Option Plan - On April 12, 1999, the Company's shareholders approved the Citizens South Bank 1999 Stock Option Plan that provided the issuance of 211,335 options for directors and officers to purchase the Company's common stock. Pursuant to the mutual holding company conversion and reorganization completed on September 30, 2002, each share of the \$1.00 par value common stock of Citizens South Banking Corporation (the former Federal corporation) was exchanged for 2.1408 shares of \$0.01 par value common stock of the Citizens South Banking Corporation (the new Delaware Corporation), which preserved the previous stockholders' interest in Citizens South Banking Corporation. Thus, the options for 211,335 shares of common stock in the 1999 Stock Option Plan were exchanged for options for 452,425 shares, with the exercise prices of previously granted options adjusted according to the same ratio. During 2007, there were no options granted, 14,985 shares were exercised, and no shares were forfeited under the 1999 Stock Option Plan. All of the 14,985 shares exercised were exercised for cash. At December 31, 2007, 1,612 options remained unissued and available for grants under the 1999 Stock Option Plan.

2003 Stock Option Plan - Pursuant to resolutions of the Board of Directors of Citizens South Banking Corporation adopted on August 18, 2003, and the subsequent approval by the stockholders of the Company on October 23, 2003, the Company adopted and implemented the Citizens South Banking Corporation 2003 Stock Option Plan with a total of 525,995 options available for award. On November 3, 2003, the following awards of stock options were made under the 2003 Stock Option Plan: Non-statutory options of 157,020 shares at \$15.04 to directors and advisory board members, vesting over a five-year period at 20% per year, commencing on the initial date of the optionee's board service to the Bank or its predecessor, Gaston Federal Bank (excluding service to the former Citizens Bank, Inc.); incentive options of 360,000 shares at \$15.04 to employees, vesting over a five-year period at 20% per year, commencing on the initial date of the optionee's employment with the Bank or its predecessor, Gaston Federal Bank (excluding service to the former Citizens Bank, Inc.). During 2007, there were 8,000 incentive options granted at the market price of the stock on the date of grant to an employee, vesting over a five-year period at 20% per year, commencing on the date of the grant, no reload options were issued, no options were exercised, and 1,000 options were forfeited. At December 31, 2007, 9,475 options remained unissued and available for grants under the 2003 Stock Option Plan.

The following is a summary of stock option activity and related information for the years ended December 31, 2007, 2006 and 2005.

| | 2007 | | 2006 | | 2005 | |
|--|----------------|------------------------------|----------------|------------------------------|----------------|------------------------------|
| | Options | Weighted Avg. Exercise Price | Options | Weighted Avg. Exercise Price | Options | Weighted Avg. Exercise Price |
| Outstanding- | | | | | | |
| Beginning of period | 740,871 | \$ 12.95 | 772,680 | \$ 12.22 | 793,151 | \$ 12.58 |
| Granted | 8,000 | 12.47 | 5,894 | 12.70 | 19,000 | 12.96 |
| Exercised | (14,985) | 5.61 | (26,203) | 5.61 | (24,471) | 5.75 |
| Forfeited | (1,000) | 12.72 | (11,500) | 14.68 | (15,000) | 15.04 |
| Outstanding-end of period | <u>732,886</u> | <u>\$ 13.09</u> | <u>740,871</u> | <u>\$ 12.95</u> | <u>772,680</u> | <u>\$ 12.22</u> |
| Exercisable-end of period | <u>709,586</u> | <u>\$ 13.11</u> | <u>718,971</u> | <u>\$ 12.96</u> | <u>747,680</u> | <u>\$ 12.20</u> |
| Weighted average fair value of options granted during the period | | <u>\$ 4.27</u> | | <u>\$ 4.35</u> | | <u>\$ 4.60</u> |

Exercise prices for options outstanding as of December 31, 2007 and 2006, ranged from \$5.14 to \$15.06. The weighted average remaining contractual life of those options was approximately four years at December 31, 2007, and five years at December 31, 2006.

Employee Stock Ownership Plan - The Bank established an Employee Stock Ownership Plan (ESOP) in 1998. The ESOP is a tax-qualified retirement plan designed to invest primarily in the Company's common stock. All full-time employees of the Bank who have completed one year of service with the Bank are eligible to participate in the ESOP. The ESOP utilized funds borrowed from the Company totaling \$1,690,680, to purchase approximately 8%, or 169,068 shares of the Company's common stock issued in the 1998 Conversion. The ESOP utilized funds borrowed from the Company totaling \$1,051,980 to purchase 105,198 additional shares of the Company's common stock issued in the 2002 Conversion. The loans to the ESOP will be primarily repaid with contributions from the Bank to the ESOP over a period not to exceed 15 years for each loan. Under the terms of the ESOP, the Bank makes contributions to the ESOP sufficient to cover all payments of principal and interest as they become due. The 1998 loan had an outstanding balance of \$563,559 with an interest rate of 7.25% and \$676,271 with an interest rate of 8.25% at December 31, 2007 and 2006, respectively. The interest rate on the loan is based on the Bank's prime rate at the end of each calendar year. The 2002 loan had an outstanding balance of \$631,188 with an interest rate of 7.25% and \$701,320 with an interest rate of 8.25% at December 31, 2007 and 2006, respectively. Unallocated shares, totaling 152,600 shares at December 31, 2007, are excluded for the calculation of earnings per share.

Shares purchased with the loan proceeds are held in a suspense account by the trustee of the plan for future allocation among participants as the loan is repaid. Contributions to the ESOP and shares released from the suspense account are allocated among participants on the basis of compensation as described in the plan. The number of shares released to participants will be determined based upon the percentage of principal and interest payments made during the year divided by the total remaining principal and interest payments including the current year's payment. Participants will vest in the shares allocated to their respective accounts over a period not to exceed three years. Any forfeited shares are allocated to the then-remaining participants in the same proportion as contributions. As of December 31, 2007, 272,265 shares have been allocated to participants and 152,600 shares remain unallocated. The fair value of the unallocated shares was \$1.5 million at December 31, 2007. The Company recognizes compensation expense attributable to the ESOP ratably over the fiscal year based upon the estimated number of ESOP shares to be allocated each December 31st. The Company recognized \$204,442, \$215,287, and \$209,419 as compensation expense in the years ended December 31, 2007, December 31, 2006, and December 31, 2005, respectively.

The trustee for the ESOP must vote all allocated shares held in the ESOP trust in accordance with the instructions of the participants. Unallocated shares held by the ESOP trust are voted by the trustee in a manner calculated to most accurately reflect the results of the allocated ESOP shares voted, subject to the requirements of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

Note 15 - Fair Value of Financial Instruments

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. The estimates are significantly affected by the assumptions used, including discount rates and estimates of future cash flows. These estimates may differ substantially from amounts that could be realized in an immediate sale or settlement of the instrument.

Fair value approximates book value for the following financial instruments due to their short-term nature: cash and due from banks, interest-earning bank balances, and advances from customers for taxes and insurance.

Fair value for investment securities and mortgage-backed and related securities are based on quoted market prices. If a quoted market price is not available, fair value is estimated using market prices for similar securities.

Fair value for variable rate loans that reprice frequently is based on the carrying value reduced by an estimate of credit losses inherent in the portfolio. Fair value for all other loans is estimated by discounting their future cash flows using interest rates currently being offered for loans of comparable terms and credit quality.

Fair value for demand deposit accounts and interest-bearing accounts with no fixed maturity is equal to the carrying value. Certificate of deposit fair values are estimated by discounting cash flows from expected maturities using interest rates currently being offered for similar instruments.

The carrying amount of repurchase agreements approximates fair value due to the short-term nature of the agreements.

Fair value for the advances from the Federal Home Loan Bank is based on discounted cash flows using current interest rates.

At December 31, 2007 and 2006, the Company had outstanding unfunded commitments to extend credit offered in the normal course of business. Fair values of these commitments are based on fees currently charged for similar instruments. At December 31, 2007 and 2006, the carrying amounts and fair values of these off-balance sheet financial instruments were immaterial.

The Company has used management's best estimates of fair values of financial instruments based on the above assumptions. This presentation does not include certain financial instruments, nonfinancial instruments or certain intangible assets such as customer relationships, deposit base intangibles, or goodwill. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company. The estimated fair values of financial instruments as of December 31 were as follows:

| | 2007 | | 2006 | |
|--|-----------------|----------------------|-----------------|----------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets: | | | | |
| Cash and due from banks | \$ 14,285,431 | \$ 14,285,431 | \$ 17,581,168 | \$ 17,581,168 |
| Interest-earning bank balances | 15,454,043 | 15,454,043 | 8,639,809 | 8,639,809 |
| Investments and mortgage-backed securities | 116,411,482 | 113,367,543 | 126,017,396 | 122,247,335 |
| Loans | 559,955,975 | 557,407,196 | 515,401,738 | 506,460,790 |
| Financial liabilities: | | | | |
| Deposits | 590,764,822 | 580,344,322 | 562,801,771 | 549,117,428 |
| Repurchase agreements | 10,355,320 | 10,355,320 | 7,015,488 | 7,015,488 |
| Borrowed money | 85,929,000 | 87,379,471 | 78,949,000 | 78,660,166 |

Note 16 - Earnings per share

Earnings per share has been determined under the provisions of SFAS No. 128, *Earnings Per Share*. Basic earnings per share is computed by dividing net income applicable to common stock by the weighted average number of common shares outstanding during the period, without considering any dilutive items. Diluted earnings per share is computed by dividing net income applicable to common stock by the weighted average number of common shares and common stock equivalents for items that are dilutive, net of shares assumed to be repurchased using the treasury stock method. Common stock equivalents arise from the assumed conversion of outstanding stock options.

The only potential stock of the Company as defined in SFAS No. 128, are stock options granted to various directors and officers of the Bank and unvested RRP shares. At December 31, 2007, the Company excluded 586,145 of the 732,886 outstanding options from the calculation of diluted earnings per share since these options had a strike price in excess of the market value of the stock at December 31, 2007. The following is a summary of the computation of basic and diluted earnings per share for the years ended December 31st:

| | <u>2007</u> | | <u>2006</u> | | <u>2005</u> |
|-------------------------------------|--------------|----|-------------|----|-------------|
| Net income | \$ 5,664,740 | \$ | 5,454,877 | \$ | 3,272,709 |
| Weighted average outstanding shares | 7,688,022 | | 8,017,956 | | 7,207,368 |
| Basic earnings per share | \$ 0.74 | \$ | 0.68 | \$ | 0.45 |
| Weighted average outstanding shares | 7,688,022 | | 8,017,956 | | 7,207,368 |
| Dilutive effect of stock options | 65,917 | | 77,320 | | 90,851 |
| Weighted average diluted shares | 7,753,940 | | 8,095,276 | | 7,298,219 |
| Diluted earnings per share | \$ 0.73 | \$ | 0.67 | \$ | 0.45 |

The Company had 9,062,727 shares of common stock issued and outstanding as of September 30, 2002. In March 2003, the Company's Board of Directors announced the authorization to repurchase of up to 343,027 shares of outstanding common stock. The Company repurchased 342,200 shares of stock at an average price of \$13.66 under this authority in October 2003. During October 2003 the Company's Board of Directors announced the authorization to repurchase up to 879,900 shares, or 10% of the outstanding common stock. The Company repurchased 877,235 shares of stock at an average price of \$13.80 under this authority by May 2004. During May 2004, the Company's Board of Directors authorized the repurchase of up to 815,000 shares, or 10% of the outstanding common stock. The Company repurchased 815,000 shares of stock at an average price of \$13.09 under this authority in February 2005. During February 2005, the Board of Directors authorized the repurchase of 370,000 shares, or 5% of the outstanding common stock. The Company repurchased 370,000 of stock at an average price of \$12.49 under this authority in January 2006. During January 2006, the Board of Directors authorized the repurchase of 200,000 shares, or 2.5% of the outstanding stock. The Company repurchased 200,000 shares of stock at an average price of \$12.78 under this authority in January 2007. During January 2007, the Company's Board of Directors authorized the repurchase of up to 400,000 shares, or 5% of the outstanding common stock. The Company repurchased 400,000 shares of stock at an average price of \$12.77 under this authority in November 2007. During November 2007, the Company's Board of Directors authorized the repurchase of up to 200,000 shares, or 2.5% of the outstanding common stock. As of December 31, 2007, the Company had repurchased 106,648 shares of stock at an average price of \$11.63 under this authorization and had 93,352 shares remaining.

As of December 31, 2007, a total of 3,111,083 shares, or 34.3% of the outstanding shares of common stock, have been repurchased under these plans at an average price of \$13.17 per share.

Note 17 - Parent-Only Financial Information

The earnings of the Bank are recognized by Citizens South Banking Corporation using the equity method of accounting. Accordingly, undistributed earnings of the Bank are recorded as increases in the Company's investment in the Bank. The following are the condensed financial statements of the Company as of December 31, 2007 and 2006, and for the years ended December 31, 2007, 2006 and 2005.

Condensed Statements of Financial Condition

| | <u>2007</u> | <u>2006</u> |
|---|----------------------|-----------------------|
| <u>Assets</u> | | |
| Cash and cash equivalents | \$ 995,258 | \$ 2,204,208 |
| Investment in securities available-for-sale | 1,978,950 | 2,198,120 |
| Investment in subsidiary | 96,412,730 | 96,548,690 |
| Other assets | 166,066 | 649,650 |
| Total assets | <u>\$ 99,553,004</u> | <u>\$ 101,600,668</u> |
| <u>Liabilities and Stockholders' Equity</u> | | |
| Liabilities | \$ 15,519,783 | \$ 15,639,433 |
| Stockholders' equity | <u>84,033,221</u> | <u>85,961,235</u> |
| Total liabilities and stockholders' equity | <u>\$ 99,553,004</u> | <u>\$ 101,600,668</u> |

Condensed Statements of Operations

| | <u>2007</u> | <u>2006</u> | <u>2005</u> |
|--|---------------------|---------------------|---------------------|
| Interest income | \$ 170,784 | \$ 151,708 | \$ 124,703 |
| Interest expense | (942,530) | (942,530) | (164,943) |
| Other noninterest income | 2,273 | 92,964 | 7,567 |
| Other noninterest expenses | <u>(1,058,972)</u> | <u>(755,776)</u> | <u>(725,991)</u> |
| Loss before income taxes and undistributed earnings from subsidiaries | (1,828,445) | (1,453,634) | (758,664) |
| Income taxes | <u>703,000</u> | <u>563,000</u> | <u>295,218</u> |
| Loss before undistributed earnings from subsidiaries | (1,125,445) | (890,634) | (463,446) |
| Equity in undistributed earnings of subsidiaries | <u>6,790,155</u> | <u>6,345,511</u> | <u>3,736,155</u> |
| Net income | <u>\$ 5,664,710</u> | <u>\$ 5,454,877</u> | <u>\$ 3,272,709</u> |

Condensed Statements of Cash Flows

| | <u>2007</u> | <u>2006</u> | <u>2005</u> |
|---|--------------|--------------|--------------|
| Operating activities | | | |
| Net income | \$ 5,664,710 | \$ 5,454,877 | \$ 3,272,709 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Gain on sale of investments | - | (92,964) | (7,500) |
| Impairment of investment securities | 161,910 | - | - |
| Equity in undistributed (earnings) of subsidiaries | (6,790,155) | (6,345,511) | (3,736,155) |
| Allocation of shares to ESOP | 260,688 | 267,736 | 269,864 |
| Stock option expense | 27,967 | 25,194 | - |
| Vesting of shares issued for the RRP | 302,144 | 279,816 | 279,816 |
| Increase in other operating subsidiaries | - | - | (623,845) |
| (Decrease) increase in other operating liabilities | 494,902 | (7,234) | - |
| Net cash provided by (used in) operating activities | 122,166 | (418,086) | (545,111) |
| Investing activities | | | |
| Proceeds from the sale of investments | - | 191,014 | 507,500 |
| Purchase of investments available-for-sale | - | - | (200,000) |
| Net cash used in investing activities | - | 191,014 | 307,500 |
| Financing activities | | | |
| Repurchase of common stock | (6,446,335) | (2,624,719) | (5,654,999) |
| Contributed capital to bank subsidiary | - | - | (15,000,000) |
| Dividends received from bank subsidiary | 7,500,000 | 6,000,000 | 6,000,000 |
| Increase in borrowed money | - | - | 15,464,000 |
| Exercise of options | 83,991 | 135,793 | 140,670 |
| Dividends to stockholders | (2,468,772) | (2,411,060) | (2,067,808) |
| Net cash provided by (used in) financing activities | (1,331,116) | 1,100,014 | (1,118,137) |
| Net increase (decrease) in cash and cash equivalents | (1,208,950) | 872,942 | (1,355,748) |
| Cash and cash equivalents, beginning of year | 2,204,208 | 1,331,266 | 2,687,014 |
| Cash and cash equivalents, end of year | \$ 995,258 | \$ 2,204,208 | \$ 1,331,266 |

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

ITEM 9A. Controls and Procedures

Under the supervision and with the participation of the Company's management, including the Company's Principal Executive Officer and Principal Financial Officer, the Company has evaluated the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms.

There has been no change in the Company's internal control over financial reporting identified in connection with the quarterly evaluation that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Management's Annual Report on Internal Control over Financial Reporting

Management of Citizens South Banking Corporation (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. There were no material changes to the Company's internal control over financial reporting during the year.

The Company's internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that material receipts and expenditures of the Company are being made only in accordance with the authorizations of management and directors of the Company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements of the Company.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2007. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on our assessment and those criteria, management believes that the Company maintained effective internal control over financial reporting as of December 31, 2007. The Company's independent registered public accounting firm has issued an attestation report on management's assessment of the Company's internal control over financial reporting. That report is presented on the following page of this report.



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
Citizens South Banking Corporation
Gastonia, North Carolina

We have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting, that Citizens South Banking Corporation and subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material aspects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2007, is fairly stated, in all material respects, based on criteria established in *Internal Control-Integrated Framework* issued by COSO. Also in our opinion, the Company maintained, in all material aspects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control-Integrated Framework* issued by COSO.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of condition of the Company as of December 31, 2007 and 2006, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2007, and our report dated March 14, 2008, expressed an unqualified opinion on these consolidated financial statements.

/s/ Cherry, Bekaert & Holland, L.L.P.

Gastonia, North Carolina
March 14, 2008

ITEM 9B. Other Information

None.

PART III

ITEM 10. Directors, Executive Officers and Corporate Governance

The "Proposal I - Election of Directors" section of the Registrant's Definitive Proxy Statement (the "Proxy Statement") to be filed pursuant to Section 14 of the Securities Exchange Act of 1934 in connection with the 2008 Annual Meeting of Shareholders is incorporated herein by reference. In addition, the Item 1. "Executive Officers of the Registrant" section of the Proxy Statement is incorporated herein by reference.

ITEM 11. Executive Compensation

The "Proposal I - Election of Directors" section of the Registrant's Proxy Statement is incorporated herein by reference.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The "Proposal I - Election of Directors" section of the Registrant's Proxy Statement is incorporated herein by reference.

ITEM 13. Certain Relationships, Related Transactions and Director Independence

The "Proposal I - Election of Directors" section of the Registrant's Proxy Statement is incorporated herein by reference.

ITEM 14. Principal Accountant Fees and Services

The "Proposal I - Election of Directors" section of the Registrant's Proxy Statement is incorporated herein by reference.

PART IV

ITEM 15. Exhibits and Financial Statement Schedules

A. Index of Exhibits

- 3.1 Certificate of Incorporation of Citizens South Banking Corporation (incorporated herein by reference to the Registration Statement on Form S-1 (File No. 333-91498), originally filed with the Commission on June 28, 2002
- 3.2 Bylaws of Citizens South Banking Corporation (incorporated herein by reference to the Registration Statement on Form S-1 (File No. 333-91498), originally filed with the Commission on June 28, 2002
- 4.1 Form of Common Stock Certificate of Citizens South Banking Corporation (incorporated herein by reference to the Registration Statement on Form S-1 (File No. 333-91498), originally filed with the Commission on June 28, 2002
- 4.2 Indenture between Citizens South Banking Corporation and Wilmington Trust Company, as trustee, dated October 28, 2005. (Incorporated by reference to the Current Report on Form 8-K (File No. 0-23971), filed with the Commission on November 3, 2005)
- 10.1 Employment Agreement with Kim S. Price dated May 17, 2004
- 10.2 Deferred Compensation and Income Continuation Agreement (incorporated by reference to the Registration Statement on Form SB-2 (File No. 333-42951), originally filed with the Commission on December 22, 1997
- 10.3 Employee Stock Option Plan (incorporated by reference to the Registration Statement on Form SB-2 (File No. 333-42951), originally filed with the Commission on December 22, 1997
- 10.4 Supplemental Executive Retirement Plan (incorporated by reference to the Registration Statement on Form SB-2 (File No. 333-42951), originally filed with the Commission on December 22, 1997
- 10.5 Severance Agreement with Gary F. Hoskins dated May 17, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.6 Severance Agreement with Paul L. Teem, Jr. dated May 17, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.7 Severance Agreement with Michael R. Maguire dated May 17, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.8 Severance Agreement with Daniel M. Boyd, IV dated May 17, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.9 Severance Agreement with V. Burton Brinson, Jr. dated May 17, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.10 Salary Continuation Agreement with Kim S. Price dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.11 Salary Continuation Agreement with Gary F. Hoskins dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)

- 10.12 Salary Continuation Agreement with Paul L. Teem, Jr. dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.13 Salary Continuation Agreement with Michael R. Maguire dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.14 Salary Continuation Agreement with Daniel M. Boyd, IV dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.15 Salary Continuation Agreement with V. Burton Brinson, Jr. dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.16 Endorsement Split Dollar Agreement with Kim S. Price dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.17 Endorsement Split Dollar Agreement with Gary F. Hoskins dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.18 Endorsement Split Dollar Agreement with Paul L. Teem, Jr. dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.19 Endorsement Split Dollar Agreement with Michael R. Maguire dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.20 Endorsement Split Dollar Agreement with Daniel M. Boyd, IV dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.21 Endorsement Split Dollar Agreement with V. Burton Brinson, Jr. dated January 1, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.22 Amended Deferred Compensation and Income Continuation Agreement with David W. Hoyle, Sr. dated March 15, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.23 Amended Deferred Compensation and Income Continuation Agreement with Ben R. Rudisill, II dated March 15, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.24 Amended Deferred Compensation and Income Continuation Agreement with James J. Fuller dated March 15, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)

- 10.25 Amended Deferred Compensation and Income Continuation Agreement with Charles D. Massey dated March 15, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.26 Amended Director Retirement Agreement with David W. Hoyle, Sr. dated March 15, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.27 Amended Director Retirement Agreement with Ben R. Rudisill, II dated March 15, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.28 Amended Director Retirement Agreement with James J. Fuller dated March 15, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.29 Amended Director Retirement Agreement with Charles D. Massey dated March 15, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.30 Amended Director Retirement Agreement with Eugene R. Matthews, II dated March 15, 2004. (Incorporated by reference to the Annual Report on Form 10-K (File No. 0-23971), filed with the Commission on March 16, 2005)
- 10.31 Amended and Restated Declaration of Trust among Citizens South Banking Corporation, Wilmington Trust Company, as Delaware and Institutional Trustee, and the Administrative Trustees named therein, dated October 28, 2005. (Incorporated by reference to the Current Report on Form 8-K (File No. 0-23971), filed with the Commission on November 3, 2005)
- 14 Code of Ethics Policy (incorporated herein by reference to the "Proposal I - Election of Directors" section of the Registrant's Proxy Statement dated April 3, 2006)
- 21 Subsidiaries of Registrant (incorporated herein by reference to the Registration Statement on Form S-1 (File No. 333-91498), originally filed with the Commission on June 28, 2002)
- 23 Consent of Cherry, Bekaert & Holland, L.L.P.
- 24 Power of Attorney (set forth on signature page)
- 31 Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32 Statement of Chief Executive Officer and Chief Financial Officer furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Signatures

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Citizens South Banking Corporation

Date: March 14, 2008

By: /s/ Kim S. Price
Kim S. Price
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

By: /s/ Kim S. Price
Kim S. Price
President, Chief Executive Officer
and
Director (Principal Executive
Officer)

By: /s/ Gary F. Hoskins
Gary F. Hoskins
Executive Vice President, Treasurer and
Chief Financial Officer

Date: March 14, 2008

Date: March 14, 2008

By: /s/ David W. Hoyle
David W. Hoyle
Chairman

By: /s/ Ben R. Rudisill, II
Ben R. Rudisill, II
Vice Chairman

Date: March 14, 2008

Date: March 14, 2008

By: /s/ Eugene R. Matthews, II
Eugene R. Matthews, II
Director

By: /s/ Charles D. Massey
Charles D. Massey
Director

Date: March 14, 2008

Date: March 14, 2008

By: /s/ James J. Fuller
James J. Fuller
Director

By: /s/ David McGuirt
David McGuirt
Director

Date: March 14, 2008

Date: March 14, 2008

EX-23 4 v107107_ex23.htm

Exhibit 23

Consent of Cherry, Bekaert & Holland, L.L.P.

The Board of Directors
Citizens South Banking Corporation
Gastonia, North Carolina

We consent to the incorporation by reference in the Registration Statements on Form S-8 (Nos. 333-103218, 333-77657 and 333-111228) of Citizens South Banking Corporation of our report dated March 14, 2008, related to the audits of the consolidated statements of condition as of December 31, 2007 and 2006, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the three year period ended December 31, 2007 and of our report dated March 14, 2008, on the effectiveness of internal control over financial reporting as of December 31, 2007, which are included in the December 31, 2007, Annual Report on Form 10-K of Citizens South Banking Corporation.

/s/ Cherry, Bekaert & Holland, L.L.P.

Gastonia, North Carolina
March 14, 2008

EX-31.1 5 v107107_ex31-1.htm

Exhibit 31.1

**Certification of Principal Executive Officer
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Kim S. Price certify that:

1. I have reviewed this Annual Report on Form 10-K of Citizens South Banking Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15(d)-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's fourth quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 14, 2008

By: /s/ Kim S. Price

Kim S. Price
President and Chief Executive Officer



Exhibit 31.2

**Certification of Principal Financial Officer
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Gary F. Hoskins certify that:

1. I have reviewed this Annual Report on Form 10-K of Citizens South Banking Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15(d)-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's fourth quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 14, 2008

By: /s/ Gary F. Hoskins

Gary F. Hoskins
Chief Financial Officer

EX-32.1 7 v107107_ex32-1.htm

Exhibit 32.1

**Statement of Chief Executive Officer Furnished
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

The undersigned, Kim S. Price, is the President and Chief Executive Officer of Citizens South Banking Corporation (the "Company").

This statement is being furnished in connection with the filing by the Company of the Company's Annual Report on Form 10-K for the year ended December 31, 2007 (the "Report").

By execution of this statement, I certify that:

- A) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)) and
- B) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of the dates and for the periods covered by the Report.

March 14, 2008
Date:

/s/ Kim S. Price

Kim S. Price
President and Chief Executive Officer

This statement is authorized to be attached as an exhibit to the Report so that this statement will accompany the Report at such time as the Report is filed with the Securities and Exchange Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350. It is not intended that this statement be deemed to be filed for purposes of the Securities Exchange Act of 1934, as amended.

EX-32.2 8 v107107_ex32-2.htm

Exhibit 32.2

**Statement of Chief Financial Officer Furnished
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

The undersigned, Gary F. Hoskins, is the Chief Financial Officer of Citizens South Banking Corporation (the "Company").

This statement is being furnished in connection with the filing by the Company of the Company's Annual Report on Form 10-K for the year ended December 31, 2007 (the "Report").

By execution of this statement, I certify that:

- A) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)) and
- B) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of the dates and for the periods covered by the Report.

March 14, 2008

Date:

/s/ Gary F. Hoskins

Gary F. Hoskins
Chief Financial Officer

This statement is authorized to be attached as an exhibit to the Report so that this statement will accompany the Report at such time as the Report is filed with the Securities and Exchange Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350. It is not intended that this statement be deemed to be filed for purposes of the Securities Exchange Act of 1934, as amended.
