



ESTABLISHING A PATTERN FOR GROWTH  
2007 ANNUAL REPORT

**PARAGON**  
COMMERCIAL CORPORATION

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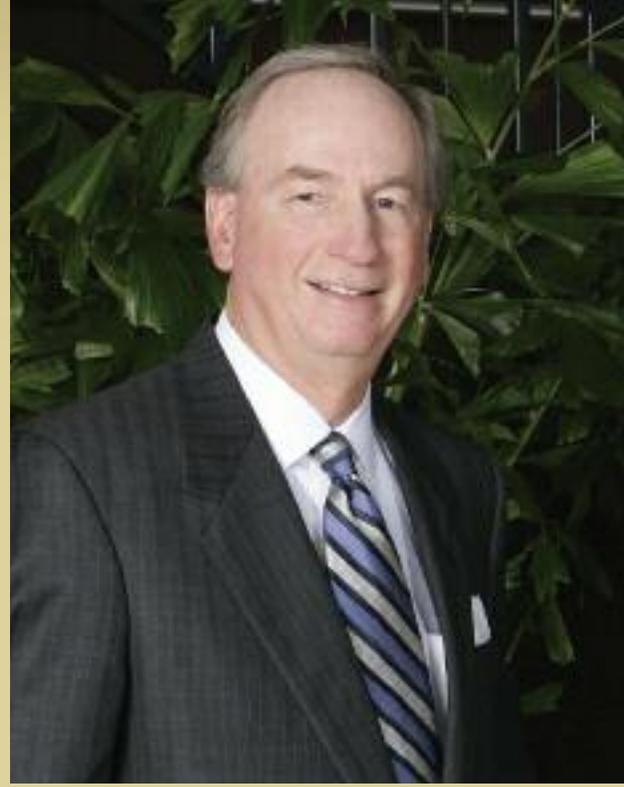




**PARAGON**  
COMMERCIAL CORPORATION

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**ROBERT C. HATLEY**  
PRESIDENT AND CEO

## PRESIDENT'S LETTER TO SHAREHOLDERS

### TO OUR SHAREHOLDERS:

Paragon continues to be the “Point of Excellence” that we envisioned in 1999. Our success has attracted quality employees and clients. It has also attracted competition. Since our inception, as many as five recently chartered North Carolina banks have tried to duplicate Paragon’s unique business banking model. We have built a quality bank with assets already exceeding \$1 billion with a staff of 88. We are proud to have accomplished this in just 8 ½ years—with no acquisitions. Paragon Commercial Bank is a truly unique success story.

Despite a challenging year for the banking industry, Paragon continues to outperform its competition. 2007 results reflected outstanding growth for the bank. Our loans and assets grew 51% and 52% respectively. No other bank in North Carolina with

assets under \$5 billion even approached our loan growth of \$267 million. We accomplished this with an emphasis (as always) on credit quality and loan yield higher than most North Carolina peers. Paragon has proven that it is indeed possible to grow aggressively without sacrificing quality.

2007 was a year of milestones. In March, we moved into our new 40,000 square foot Raleigh headquarters. More than 1,000 shareholders, clients and friends joined us for our grand opening celebration.

Our Richmond office, opened in March 2006 under the notable leadership of Mike Keck, grew to over \$106 million in loans. That office is now contributing positive earnings for the bank.

Our Charlotte team moved into their new offices at Piedmont Town Center in the prestigious South Park area of Charlotte in February 2007. Charlotte loans totaled \$79 million at year end. They are also

contributing positively to the earnings of Paragon. Both Richmond and Charlotte now represent 23% of total loans for the bank. They also combine for \$52 million in core deposits. Both offices have grown their loans and deposits appreciably in a short time frame. Both Phil Journey and Mike Keck, of Charlotte and Richmond respectively, have put quality teams in place.

In 2007 we completed our first capital raise since our initial offering. While our goal was to raise \$25 million, thanks to your confidence in us and our business model, we were able to raise \$28.3 million. This was accomplished in a not too friendly capital market environment, in just 90 days. The stock in the private placement offering sold for \$5,500 per share.

Paragon, like most banks in North Carolina and across the United States, experienced reduced earnings in 2007. We have felt the impact of shrinking net interest margin due to Federal Reserve rate cuts and increased pressure on the pricing of loans and deposits. Recent reports showed that on average, 75% of FDIC insured banks reported reduced Return on Assets in 2007 and 48% reported a reduction in Return on Equity. While we are not pleased with anything less than a substantial increase in earnings, our income dropped only 10% over 2006 compared to a 25% average drop for banks nationwide. In addition to net interest margin issues, other banks have experienced earnings pressure due to portfolio write-offs created by the sub prime problems in the mortgage sector. Paragon has no sub prime loans in its portfolio and no investments in sub prime supported securities.

Credit quality is a focus throughout the industry and the same is true at Paragon. The bank had its first experience with a significant non-performing loan in 2007. We foreclosed on property from a bankrupt borrower, and sold the property by year-end. As a result, we experienced our first net chargeoff in Paragon's 8 ½ year history. The loss impacted our ability to achieve expected earnings. It was absorbed in our loan provision and resulted in reduced income.

#### **LOOKING AHEAD, MOVING FORWARD.**

We are all reading the headlines and observing the rate cuts enacted by the Federal Reserve since September 2007. Many economists feel that a recession is looming, if not already here. While we may be somewhat cushioned by the healthy markets we serve, we recognize that the national economy affects all markets. That said, Paragon is in an excellent position to continue to prosper, even in difficult times. A unique business model and our quality team of banking professionals has proven to be a reliable hedge against economic downturn.

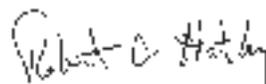
Our loan portfolio is in good condition. We are, however, adding new credit officers to ensure that our quality is not compromised during the downturn. With the changing economy, our focus is on the managed, selective growth of our loan portfolio. Management has also elected to delay the planned expansion into the Nashville market until 2009. This move will save the bank \$500,000 in 2008. Our budget calls for an increase in earnings over 2007, despite the economic outlook for 2008.

As we enter into our 10th year, we are excited about the opportunities that lie ahead for Paragon Commercial Bank and its shareholders. We take pride in the performance and integrity of our people and in the quality of our clients. These are the reasons for our success.

We have worked hard to build the Paragon brand as a model of banking excellence. In 1999 we set out to build an outstanding company. Today, Paragon continues to live up to its definition as a "Point of Excellence."

On behalf of our staff and our Board of Directors, thank you for your support. We wish you a prosperous 2008.

Sincerely,



Robert C. Hatley  
President and CEO

## PARAGON CONTINUES TO ACHIEVE BOTH STABILITY AND GROWTH IN A DIFFICULT MARKET.

*It can be said* that the true test of a bank's business model is its ability to navigate through a difficult economy. In a year where most banks suffered significant drops in net income, Paragon's net income was only 10% lower than in 2006. Despite the economic pressures of 2007 and the Federal Reserve rate cuts—Paragon ended the year with a strong 4th quarter finish of \$92 million in loan growth.

### **RAISING CAPITAL, FUELING GROWTH**

2007 saw the first capital raise of Paragon Bank since our initial offering in 1999. The effort was necessary to fund the extraordinary growth in business that the bank is experiencing in all three locations. The common stock capital raise ensures that Paragon will be well positioned for continued success in these three essential markets.



*Paragon Commercial Corporation Asset Growth (in thousands)*

**GROWING A SELECT CLIENT LIST ONE COMPANY AT A TIME**

Attracting quality clients has been a cornerstone of the Paragon success story. Attorneys Title, a division of United General Title Insurance Company, is one such client. United General’s founder Bryan Rosenberg needed to hit the ground running to succeed in a competitive market. He needed a bank that could provide a unique delivery system for its deposit and wiring services in nine locations across the state. The Paragon team developed a solution that allowed United General to open or close out accounts and provide wire fund transfers all in a matter of minutes. By streamlining these critical services, Paragon provided United General with an important competitive advantage. According to Mr. Rosenberg, “Our emphasis has always been on good, responsive service and maximum efficiency from each of our locations. The Paragon solution delivered both.”

**ASSETS GROW TO ONE BILLION DOLLARS**

One of the more striking accomplishments of Paragon is the bank’s unparalleled asset growth since its inception in 1999. On January 4, 2008, Paragon reached the billion dollar mark in asset size, attributable in good measure to a strong year of growth in 2007. As in previous years, this growth has come from within rather than through the high cost and risk of acquisition. And, while other banks experienced high employee and client turnover ratios, Paragon continues to be a force for stability in the industry with high client and employee retention rates that position us to succeed even in the face of challenging market conditions.

## REPORT OF INDEPENDENT AUDITORS

**TO THE STOCKHOLDERS AND THE BOARD OF DIRECTORS  
PARAGON COMMERCIAL CORPORATION AND SUBSIDIARY  
RALEIGH, NORTH CAROLINA**

We have audited the accompanying consolidated balance sheets of Paragon Commercial Corporation and Subsidiary as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing

an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Paragon Commercial Corporation and Subsidiary as of December 31, 2007 and 2006 and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.



Dixon Hughes PLLC  
Raleigh, North Carolina  
April 4, 2008

## CONSOLIDATED BALANCE SHEETS

(Amounts in thousands, except share data)

AT DECEMBER 31:

	2007	2006
<b>ASSETS</b>		
Cash and due from banks:		
Interest-earning	\$ 208	\$ 657
Noninterest-earning	10,964	10,558
Investment securities available for sale, at fair value	158,033	96,109
Loans	787,810	520,484
Allowance for loan losses	(8,866)	(6,560)
Net Loans	778,944	513,924
Accrued interest receivable	4,805	3,193
Bank premises and equipment	11,831	9,199
Federal Home Loan Bank stock, at cost	3,125	2,056
Bank-owned life insurance	15,320	7,854
Other assets	6,833	6,018
Total Assets	\$ 990,063	\$ 649,568
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Deposits:		
Noninterest-bearing demand	\$ 75,529	\$ 67,460
Interest-bearing checking and money market	127,619	106,764
Time deposits	519,767	371,002
Total Deposits	722,915	545,226
Repurchase agreements and federal funds purchased	79,768	21,555
Federal Home Loan Bank advances and other borrowings	93,500	25,000
Subordinated debentures	18,558	18,558
Accrued interest payable	2,726	1,035
Other liabilities	1,518	2,556
Total Liabilities	918,985	613,930
Commitments and contingencies (Notes H and N)		
Stockholders' Equity:		
Common stock, \$1 par value; 20,000,000 shares authorized; 31,280 and 26,017 issued and outstanding in 2007 and 2006, respectively	31	26
Additional paid-in capital	46,268	17,724
Accumulated other comprehensive loss	922	(637)
Retained earnings	23,857	18,525
Total Stockholders' Equity	71,078	35,638
Total Liabilities and Stockholders' Equity	\$ 990,063	\$ 649,568

See accompanying notes.

## CONSOLIDATED STATEMENTS OF INCOME

(Amounts in thousands, except share data)

at December 31:

	2007	2006
<b>INTEREST INCOME</b>		
Loans and fees on loans	\$ 54,117	\$ 37,395
Investment securities and FHLB stock	6,122	3,726
Federal funds and other	169	97
Total Interest Income	60,408	41,218
<b>INTEREST EXPENSE</b>		
Interest-bearing checking and money market accounts	4,396	3,427
Time deposits	24,861	13,211
Borrowings and repurchase agreements	5,170	3,262
Total Interest Expense	34,427	19,900
Net Interest Income	25,981	21,318
<b>PROVISION FOR LOAN LOSSES</b>		
Net Interest Income after Provision for Loan Losses	3,720	1,585
	22,261	19,733
<b>NON-INTEREST INCOME</b>		
Service charges and fees	148	98
Net loss on sale of securities	(83)	-
Mortgage origination fees and gains on sale of loans	316	320
Other fees and income	1,057	743
Total Non-Interest Income	1,438	1,161
<b>NON-INTEREST EXPENSE</b>		
Salaries and employee benefits	8,985	6,443
Occupancy expense	1,344	998
Professional fees	641	764
Other	4,784	3,640
Total Non-Interest Expense	15,754	11,845
Income before Income Taxes	7,945	9,049
<b>INCOME TAX EXPENSE</b>		
Net Income	2,613	3,112
	\$ 5,332	\$ 5,937
<b>NET INCOME PER COMMON SHARE</b>		
Basic	\$ 194.70	\$ 228.41
Diluted	\$ 187.79	\$ 219.20

See accompanying notes.

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

<i>(Amounts in thousands, except share data)</i>	Common stock Shares	Common stock Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Total stockholders' equity
<b>BALANCE AT DECEMBER 31, 2005</b>	25,730	\$ 26	\$ 16,635	\$ 12,588	\$ (695)	\$ 28,554
Comprehensive income:						
Net income	-	-	-	5,937	-	5,937
Unrealized gain on securities, net of taxes of \$29	-	-	-	-	35	35
Unrealized gain on cash flow hedges, net of taxes of \$15	-	-	-	-	23	<u>23</u>
Total comprehensive income						<u>5,995</u>
Stock based compensation	-	-	529	-	-	529
Common stock issued pursuant to:						
Exercise of stock options	201	-	149	-	-	149
Sale of common stock	86	-	411	-	-	411
<b>BALANCE AT DECEMBER 31, 2006</b>	26,017	26	17,724	18,525	(637)	35,638
Comprehensive income:						
Net income	-	-	-	5,332	-	5,332
Unrealized gain on securities, net of taxes of \$658	-	-	-	-	1,034	1,034
Unrealized gain on cash flow hedges, net of taxes of \$329	-	-	-	-	525	<u>525</u>
Total comprehensive income						<u>6,891</u>
Stock based compensation	-	-	147	-	-	147
Common stock issued pursuant to:						
Exercise of stock options	51	-	81	-	-	81
Sale of common stock	5,212	5	28,316	-	-	28,321
<b>BALANCE AT DECEMBER 31, 2007</b>	31,280	\$ 31	\$ 46,268	\$ 23,857	\$ 922	\$ 71,078

See accompanying notes.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)

at December 31:

	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 5,332	\$ 5,937
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	781	503
Provision for loan losses	3,720	1,585
Loss on disposal of equipment	3	24
Increase in cash surrender value of life insurance	(466)	(310)
Amortization (accretion) of premiums/discounts on securities, net	(128)	23
Net loss on sale of securities	83	-
Deferred tax benefit	(675)	(842)
Stock based compensation	147	529
Changes in assets and liabilities:		
Accrued interest receivable and other assets	2,115	(2,289)
Accrued interest payable and other liabilities	786	2,368
Net Cash Provided by Operating Activities	11,698	7,528
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net purchase of Federal Home Loan Bank stock	(1,069)	(411)
Purchase of securities available for sale	(80,201)	(41,701)
Proceeds from maturities and paydowns of securities available for sale	10,972	10,885
Proceeds from sales of securities available for sale	9,042	1,858
Net increase in loans	(272,873)	(146,140)
Purchase of bank-owned life insurance	(7,000)	-
Proceeds from sale of equipment	60	3
Additions to bank premises and equipment	(3,476)	(5,446)
Net Cash Used in Investing Activities	(344,545)	(180,952)
<b>Cash Flows from Financing Activities</b>		
Net increase in demand and money market deposit accounts	28,924	10,408
Net increase in time deposits	148,765	141,324
Net increase in repurchase agreements	58,213	8,915
Net increase in Federal Home Loan Bank borrowings	68,500	5,000
Net proceeds from subordinated debentures	-	8,248
Proceeds from the sale of common stock	28,321	411
Exercise of stock options	81	149
Net Cash Provided by Financing Activities	332,804	174,455
Net Change in Cash and Cash Equivalents	(43)	1,031
Cash and Cash Equivalents at Beginning of Year	11,215	10,184
Cash and Cash Equivalents at End of Year	\$ 11,172	\$ 11,215

See accompanying notes.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### **NOTE A – ORGANIZATION AND OPERATIONS**

On June 30, 2001, Paragon Commercial Corporation (the “Company”) was formed as a holding company for Paragon Commercial Bank (the “Bank”). The Company currently has no operations and conducts no business on its own other than owning the Bank and the Capital Trusts.

The Bank was incorporated on May 4, 1999 and began banking operations on May 10, 1999. The Bank is engaged in general commercial banking in Wake County, North Carolina, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation and the North Carolina Commissioner of Banks. The Bank undergoes periodic examinations by those regulatory authorities.

The Company formed Paragon Commercial Capital Trust I during 2004 in order to facilitate the issuance of trust preferred securities. The Trust is a statutory business trust formed under the laws of the state of Delaware, of which all common securities are owned by the Company. The Company formed Paragon Commercial Capital Trust II during 2006 to serve the same purpose. The junior subordinated debentures issued by the Company to the trusts are classified as debt and the Company’s equity interest in the trusts were included in other assets.

The trust preferred securities presently qualify as Tier 1 regulatory capital and are reported in Federal Reserve regulatory reports as minority interests in an unconsolidated subsidiary. The junior subordinated debentures do not qualify as Tier 1 regulatory capital.

In 2005 the Company received approval to open a loan production office in Richmond, Virginia. A full service branch opened there in the first quarter of 2006. During 2006, the Company received regulatory approval and subsequently opened a full service location in Charlotte, North Carolina.

### **NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

#### **BASIS OF PRESENTATION**

The accompanying consolidated financial statements include the accounts and transactions of Paragon

Commercial Corporation and Paragon Commercial Bank. All significant intercompany transactions and balances are eliminated in consolidation. Paragon Commercial Capital Trust I and Capital Trust II are not consolidated subsidiaries of the Company.

#### **USE OF ESTIMATES**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses.

#### **CASH AND CASH EQUIVALENTS**

For the purpose of presentation in the statements of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption “Cash and due from banks.”

#### **SECURITIES HELD TO MATURITY**

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

#### **SECURITIES AVAILABLE FOR SALE**

Available-for-sale securities are reported at fair value and consist of debt securities not classified as trading securities nor as held-to-maturity securities. Unrealized holding gains and losses on available-for-sale securities are reported as a net amount in other comprehensive income net of income taxes. Gains and losses on the sale of available-for-sale securities are determined using the specific-identification method. Declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

that are other than temporary would result in write-downs of the individual securities to their fair value. Such write-downs would be included in earnings as realized losses. Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

### **LOANS**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are reported at their outstanding principal adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received.

### **ALLOWANCE FOR LOAN LOSSES**

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. The provision for loan losses is based upon management's best estimate of the amount needed to maintain the allowance for loan losses at an adequate level. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of the current status of the portfolio, historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. Management segments the loan portfolio by loan type in considering each of the aforementioned factors and their impact upon the level of the allowance for loan losses.

Loans are considered impaired when it is probable that all amounts due will not be collected in accordance with the contractual terms of the loan agreement. The measurement of impaired loans is generally based on the present value of expected future cash flows discounted at the historical effective interest rate, or upon the fair value of the collateral if the loan is collateral dependent. If the recorded investment in the loan exceeds the measure of fair value, a valuation allowance is established as a component of the allowance for loan losses. While management uses the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, regulatory examiners may require Paragon Commercial Bank to recognize adjustments to the allowance for loan losses based on their judgments about information available to them at the time of their examination.

### **BANK PREMISES AND EQUIPMENT**

Bank premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets which are 3 – 10 years for furniture and equipment and 40 years for buildings. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. Repairs and maintenance costs are charged to operations as incurred, and additions and improvements to premises and equipment are capitalized. Upon sale or retirement, the cost and related accumulated depreciation are removed from the accounts and any gains or losses are reflected in current operations.

### **FEDERAL HOME LOAN BANK STOCK**

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

#### **DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), as amended and interpreted, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. As required by SFAS 133, the Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges.

For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. The Company assesses the effectiveness of each hedging relationship by comparing the changes in cash flows of the derivative hedging instrument with the changes in cash flows of the designated hedged transactions.

The Company's objective in using derivatives is to add stability to interest income and to manage its exposure to adverse changes in interest rates. To accomplish this objective, the Company uses interest rate collars and interest rate swaps as part of its cash flow hedging strategy. Interest rate collars designated as cash flow hedges protect the Company against movements in interest rates above and below the instrument's strike rates over the life of the agreement without exchange of the underlying principal amount. During 2007 and 2006, the collars were used to hedge the variable cash flows associated with existing variable-rate assets.

As of December 31, 2007, no derivatives were designated as fair value hedges or hedges of net investments in

foreign operations. Additionally, the Company does not use derivatives for trading or speculative purposes.

At December 31, 2007, derivatives designated as cash flow hedges with a fair value of \$1.2 million were included in other assets. The notional amount of these cash flow hedges was \$50 million. The change in net unrealized gains of \$854,000 (net of income tax benefit of \$329,000) in 2007 for derivatives designated as cash flow hedges is disclosed in the statement of changes in stockholders' equity as a component of other comprehensive income. No hedge ineffectiveness on cash flows was recognized during 2007.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest income as interest payments are received on the Company's variable-rate assets. The change in net unrealized gains on cash flow hedges reflects a reclassification of \$45,000 of net unrealized gains from accumulated other comprehensive income to interest income during 2007. During 2008, the Company unwound the cash flow hedge for a \$1.7 million premium. The premium will be accreted into income over the remaining original life of the cash flow hedge.

#### **INCOME TAXES**

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. Deferred tax assets are also recognized for operating loss carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which the temporary differences are expected to be recovered or settled. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that the tax benefits will not be realized.

#### **STOCK COMPENSATION PLANS**

The Company has a stock-based compensation plan covering certain officers and directors. The Company grants stock options under the plan for a fixed number of shares with an exercise price equal to the fair value of the shares on the date of grant. On January 1, 2006, the Company

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

adopted the provisions of FASB Statement 123 (revised 2004) (Statement 123R), *Share-based Payment*, which revises Statement 123, *Accounting for Stock-based Compensation*, and supersedes ABP Opinion 25, *Accounting for Stock Issued to Employees* (Opinion 25). Statement 123R requires entities to recognize expense related to the fair value of stock-based compensation awards, including employee stock options.

Prior to the adoption of Statement 123R, the Company accounted for stock-based compensation awards using the intrinsic value method of Opinion 25. Under this method, compensation expense was not recognized in the consolidated statements of income for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

Statement 123R allows the use of the prospective transition method. Under this transaction method, the Company is applying the provisions of Statement 123R to new awards and to awards modified, repurchased, or cancelled after the Statement 123R effective date of January 1, 2006.

The Company's pre-tax compensation cost for stock-based employee and director compensation was approximately \$147,000 and \$529,000 for the years ended December 31, 2007 and 2006, respectively. As a result of the adoption of Statement 123R, our financial results were lower than under our previous accounting method for stock-based compensation by approximately \$485,000 related to stock options granted subsequent to the effective date of Statement 123R.

### EARNINGS PER COMMON SHARE

Basic and diluted net income per common share have been computed by dividing net income for each period by the weighted average number of shares of common stock outstanding during each period. Diluted net income per common share reflects the potential dilution that could occur if outstanding stock options were exercised.

Basic and diluted net income per common share have been computed based upon net income as presented in the accompanying consolidated statements of operations divided by the weighted average number of common shares outstanding or assumed to be outstanding as follows:

	2007	2006
Shares used in the computation of earnings per share:		
Weighted average number of shares outstanding – basic	27,389	25,994
Incremental shares from assumed exercise of stock options	1,007	1,093
Weighted average number of shares outstanding – diluted	28,396	27,087

For the years ended December 31, 2007 and 2006, there were 767 and 43 antidilutive options outstanding, respectively, since the exercise price was greater than the average market price for the year.

### COMPREHENSIVE INCOME

The Company reports as comprehensive income all changes in stockholders' equity during the year from sources other than stockholders. Other comprehensive income refers to all components (revenues, expenses, gains, and losses) of comprehensive income that are excluded from net income. The Company's only two components of other comprehensive income are unrealized gains and losses on investment securities available for sale, net of income taxes and unrealized gains and losses on cash flow hedges, net of income taxes. Information concerning the Company's other comprehensive income for the years ended December 31, 2007 and 2006 is as follows:

<i>(Amounts in thousands)</i>	2007	2006
Unrealized gains on securities available for sale	\$1,609	\$ 64
Reclassification of losses recognized in net income	83	-
Income tax expense	(658)	(29)
	1,034	35
Unrealized gains on cashflow hedges	854	38
Income tax expense	(329)	(15)
	525	23
Other comprehensive income	\$1,559	\$ 58

Accumulated other comprehensive income at December 31, 2007 and 2006 consists of the followings

<i>(Amounts in thousands)</i>	<b>2007</b>	<b>2006</b>
Unrealized gains (losses) on securities available for sale	\$ 618	\$ (1,074)
Deferred income taxes	244	(414)
	374	(660)
Unrealized gain on cash flow hedges	892	38
Deferred income taxes	344	15
	548	23
Other comprehensive income (loss)	\$ 922	\$ (637)

#### **RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, (“SFAS No. 157”), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 157 will be effective for the Company beginning January 1, 2008. The Company is currently in the process of evaluating the provisions of SFAS No. 157 and determining how this framework for measuring fair value will affect the Company’s current accounting policies and procedures and our financial statements. The Company does not expect the adoption of SFAS No. 157 to have a material impact on the Company’s financial condition or results of operations.

In September 2006, the FASB issued SFAS No. 158, *Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (“SFAS No. 158”). SFAS No. 158 requires employers to recognize a net liability or asset and an offsetting adjustment to accumulated other comprehensive income to report the funded status of defined benefit pension and other post-retirement benefit plans. SFAS No. 158 requires prospective application; thus, the recognition and disclosure requirements are effective for fiscal years ending after December 31, 2006. Additionally, SFAS No. 158 requires companies to measure plan assets and obligations at their year-end balance sheet date. This requirement is effective for the Company’s fiscal year ending after December 31, 2007. The Company does not expect the adoption of SFAS No.

158 to have a material impact on the Company’s financial condition or results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (“SFAS No. 159”). This Statement permits entities to choose to measure financial instruments and certain other financial assets and financial liabilities at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company does not expect the adoption of SFAS No. 159 to have a material impact on the Company’s financial condition or results of operations.

The Emerging Issues Task Force (EITF) reached a consensus at its September 2006 meeting regarding EITF 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. EITF 06-4 requires the recognition of a liability and related compensation costs for endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to postretirement periods. The Company does not have policies that fall within the scope of EITF 06-4. EITF 06-4 is effective for fiscal years beginning after December 15, 2007 and can be applied by either a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or a change in accounting principle through a retrospective application to all prior periods. The Company has determined that there should be no impact from EITF 06-4 on its consolidated financial statements.

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

#### **RECLASSIFICATIONS**

Certain amounts in the 2006 financial statements have been reclassified to conform to the 2007 presentation. The reclassifications had no effect on net income or stockholders’ equity as previously reported.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE C – INVESTMENT SECURITIES

The following is a summary of the securities portfolio by major classification at December 31, 2007 and 2006.

<i>(Amounts in thousands)</i>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>2007</b>				
Available for sale:				
U.S. Agency obligations	\$ 21,008	\$ 225	\$ 62	\$ 21,171
Collateralized Mortgage Obligations	40,900	488	91	41,297
Mortgage-backed securities	53,062	487	169	53,380
Municipal bonds	38,325	129	389	38,065
Other	4,120	-	-	4,120
	\$ 157,415	\$ 1,329	\$ 711	\$ 158,033

<i>(Amounts in thousands)</i>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>2006</b>				
Available for sale:				
U.S. Agency obligations	\$ 13,252	\$ 23	\$ 151	\$ 13,124
Collateralized Mortgage Obligations	24,641	122	227	24,536
Mortgage-backed securities	28,886	20	553	28,353
Municipal bonds	30,404	49	357	30,096
	\$ 97,183	\$ 214	\$ 1,288	\$ 96,109

The amortized cost and fair values of securities available for sale at December 31, 2007 by contractual maturity are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

<i>(Amounts in thousands)</i>	Amortized Cost	Fair Value
Due within one year	\$ -	\$ -
Due after one year through five years	9,066	9,080
Due after five years through ten years	25,105	25,202
Due after ten years	123,244	123,751
	\$157,415	\$158,033

The following tables show gross unrealized losses and fair values of investment securities, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position at December 31, 2007 and 2006. At December 31, 2007, the unrealized losses related to 5 U.S. government agency securities, 49 municipal securities and 20 mortgage-backed securities of which 3, 16 and 17 such securities, respectively, had continuous unrealized losses for more than 12 months. The unrealized losses relate to debt securities that

have incurred fair value reductions due to higher market interest rates since the securities were purchased. The unrealized losses are not likely to reverse unless and until market interest rates decline to the levels that existed when the securities were purchased. Since none of the unrealized losses relate to the marketability of the securities or the issuer's ability to honor redemption obligations and since management has the intent and ability to hold these securities until maturity, none of the securities are deemed to be other than temporarily impaired.

<i>(Amounts in thousands)</i>	LESS THAN 12 MONTHS		12 MONTHS OR GREATER		TOTAL	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
<b>DECEMBER 31, 2007:</b>						
Securities available for sale:						
U.S. Government agencies	\$ 2,222	\$ 16	\$ 3,106	\$ 46	\$ 5,328	\$ 62
Municipals	16,951	265	7,513	125	24,464	390
Mortgage-backed securities	2,548	30	15,739	229	18,287	259
Total temporarily impaired securities	\$ 21,721	\$ 311	\$ 26,358	\$ 400	\$ 48,079	\$ 711

<i>(Amounts in thousands)</i>	LESS THAN 12 MONTHS		12 MONTHS OR GREATER		TOTAL	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
<b>DECEMBER 31, 2006:</b>						
Securities available for sale:						
U.S. Government agencies	\$ 4,820	\$ 27	\$ 6,433	\$ 124	\$ 11,253	\$ 151
Municipals	13,246	108	8,853	249	22,099	357
Mortgage-backed securities	11,530	55	25,201	725	36,731	780
Total temporarily impaired securities	\$ 29,596	\$ 190	\$ 40,487	\$ 1,098	\$ 70,083	\$ 1,288

Securities with a fair value of \$143.2 million were pledged as of December 31, 2007 to secure repurchase agreements, FHLB advances, lines of credit and other borrowings.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE D – LOANS

Following is a summary of loans at December 31, 2007 and 2006:

<i>(Amounts in thousands)</i>	2007		2006	
	Amount	Percent	Amount	Percent
Construction and development	\$ 329,362	42%	\$ 170,945	33%
Commercial real estate	287,962	36%	211,034	40%
Commercial and industrial	108,788	14%	74,109	14%
Residential real estate	39,361	5%	36,971	7%
Consumer	21,176	3%	13,103	3%
Other	2,842	0%	15,563	3%
Subtotal	789,491	<u>100%</u>	521,725	<u>100%</u>
Net deferred loan fees	(1,681)		(1,241)	
Allowance for loan losses	(8,866)		(6,560)	
Total	\$ 778,944		\$ 513,924	

Loans are primarily made in the Research Triangle and Charlotte areas of North Carolina and in the Richmond market in Virginia. Real estate loans can be affected by the condition of the local real estate market. Commercial and installment loans can be affected by the local economic conditions.

Impaired loans at December 31, 2007 were \$1.8 million. There were no loans classified as impaired at December 31, 2006. Average impaired loans during 2007 and 2006 were \$2.7 million and \$0, respectively.

An analysis of the allowance for loan losses follows:

<i>(Amounts in thousands)</i>	2007	2006
Balance at beginning of the year	\$ 6,560	\$ 5,138
Provision charged to operations	3,720	1,585
Net chargeoffs	(1,547)	(30)
Reclassification	133	(133)
Balance at end of the year	\$ 8,866	\$ 6,560

The Bank has granted loans to certain directors and executive officers of the Bank and their related interests. Such loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other borrowers and, in management's opinion, do not involve more than the normal risk of collectibility. All loans to directors and executive

officers or their interests are submitted to the Board of Directors for approval. A summary of loans to directors, executive officers and their related interests follows:

<i>(Amounts in thousands)</i>	
Loans to directors and officers as a group at December 31, 2006	\$ 1,683
Disbursements during 2007	2,379
Amounts collected during 2007	(417)
Loans to directors and officers as a group at December 31, 2007	\$ 3,645

### NOTE E – BANK PREMISES AND EQUIPMENT

Following is a summary of bank premises and equipment at December 31, 2007 and 2006:

<i>(Amounts in thousands)</i>	2007	2006
Leasehold improvements	\$ 484	\$ 696
Building	9,441	-
Furniture and equipment	3,626	2,330
Construction in progress	-	7,543
Less accumulated depreciation and amortization	(1,720)	(1,370)
Total	\$ 11,831	\$ 9,199

Depreciation and amortization amounting to \$781,000 and \$503,000 for the years ended December 31, 2007 and 2006 are included in occupancy and equipment expense.

In 2005, the Company purchased a building adjacent to its current leased facilities in Raleigh, North Carolina to be used as a new headquarters. Renovations to the building were completed in March 2007 and the Company moved its headquarters during the first quarter of 2007.

## NOTE F – DEPOSITS

At December 31, 2007, the scheduled maturities of time deposits are as follows:

<i>(Amounts in thousands)</i>	
2008	\$ 479,298
2009	39,973
2010	311
2011	180
2012	5
<b>Total</b>	<b>\$ 519,767</b>

At December 31, 2007 and 2006, time deposits in denominations of \$100,000 or more were \$516.1 million and \$364.8 million respectively. Interest expense on time deposits in denominations of \$100,000 or more aggregated were \$24.2 million in 2007 and \$13.0 million in 2006.

## NOTE G – BORROWINGS

### SHORT-TERM BORROWINGS

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The Bank may be required to provide additional collateral based on the fair value of the underlying securities.

Following is an analysis of short-term borrowed funds at December 31, 2007:

<i>(Dollars in thousands)</i>	END OF PERIOD	
	Balance	Weighted Avg. Rate
2007		
Federal funds purchased	\$ 43,432	4.36%
Repurchase agreements	36,336	3.58%
	<b>\$ 79,768</b>	<b>4.01%</b>

<i>(Dollars in thousands)</i>	DAILY AVERAGE BALANCE	
	Balance	Interest Rate
2007		
Federal funds purchased	\$ 9,980	5.08%
Repurchase agreements	30,175	3.75%
	<b>\$ 40,155</b>	<b>4.08%</b>

<i>(Dollars in thousands)</i>	MAXIMUM OUTSTANDING AT ANY MONTH END	
	2007	
Federal funds purchased	\$ 43,432	
Repurchase agreements	38,830	

At December 31, 2006, the Bank had outstanding securities sold under agreements to repurchase in the amounts of \$15.7 million and federal funds purchased of \$5.9 million. Federal funds purchased generally mature within one to four days from the transaction date.

Interest expense on securities sold under agreements to repurchase totaled \$1.1 million in 2007 and \$388,000 in 2006.

Interest on federal funds purchased totaled \$506,000 in 2007 and \$231,000 in 2006.

Repurchase agreements are collateralized by U.S. government agency and mortgage-backed securities with carrying values of \$42.6 million and fair values of \$42.8 million at December 31, 2007.

### FEDERAL HOME LOAN BANK ADVANCES

Advances from the FHLB had a weighted average rate of 4.49% and 4.82% at December 31, 2007 and 2006, respectively. Included in amounts due to the FHLB at December 2007 year end were a \$38.5 million line of credit advance and one term borrowing for \$5.0 million. The line bears interest based upon the daily federal funds rate, 4.40% at December 31, 2007, and matures on September 8, 2008. The term borrowing is a \$5.0 million variable rate note at LIBOR which reprices quarterly and matures in September 2011.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The line of credit and all other advances were collateralized by certain 1-4 family mortgages, multifamily first mortgage loans and qualifying commercial loans totaling \$175.2 million at year-end 2007. In addition, the Company pledged certain investment securities with an amortized cost of \$9.5 million at December 31, 2007.

At December 31, 2007, the Company had available lines of credit of approximately \$47.6 million at various financial institutions for borrowing on a short-term basis and an available credit line at the FHLB of up to 30% of assets contingent upon adequate collateralization. These lines are subject to annual renewal and are at varying interest rates.

### STRUCTURED REPURCHASE AGREEMENTS

In 2007 the Company entered into two \$25 million liability-side structured reverse repurchase agreements with an unaffiliated institution. Interest accrues at variable rates which averaged 4.68% during the year. The agreements are callable in October 2010 and expire in October 2012.

### SUBORDINATED DEBENTURES

In 2004, the Company issued \$10.3 million of junior subordinated debentures to Paragon Commercial Capital Trust I ("Trust I") in exchange for the proceeds of trust preferred securities issued by the Trust. The junior subordinated debentures pay interest quarterly at an annual rate, reset quarterly, equal to LIBOR plus 2.65%. The debentures are redeemable on July 23, 2009 or afterwards, in whole or in part, on any October 23, January 23, April 23, or July 23. Redemption is mandatory at July 23, 2034.

In 2006, the Company issued \$8.2 million of junior subordinated debentures to Paragon Commercial Capital Trust II ("Trust II") in exchange for the proceeds of trust preferred securities issued by the Trust. The junior subordinated debentures pay interest quarterly at an annual rate, reset quarterly, equal to LIBOR plus 1.70%. The debentures are redeemable on June 20, 2011 or afterwards, in whole or in part, on any March 30, June 30, September 30, or December 30. Redemption is mandatory at June 30, 2036.

The junior subordinated debentures are included in long-term debt and the Company's equity interest in the trust is included in other assets. The Company guarantees the trust preferred securities through the combined operation of the junior subordinated debentures and other related documents. The Company's obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company.

The trust preferred securities presently qualify as Tier 1 regulatory capital and are reported in Federal Reserve regulatory reports as a minority interest in a consolidated subsidiary. The junior subordinated debentures do not qualify as Tier 1 regulatory capital. On March 1, 2005, the Board of Governors of the Federal Reserve issued a final rule stating that trust preferred securities will continue to be included in Tier 1 capital, subject to stricter quantitative and qualitative standards. For Bank Holding Companies, trust preferred securities will continue to be included in Tier 1 capital up to 25% of core capital elements (including trust preferred securities) net of goodwill less any associated deferred tax liability.

### NOTE H – LEASES

The Bank has entered into non-cancelable operating leases for its Richmond office, Charlotte office and a mortgage office. Future minimum lease payments under these leases for the years ending December 31 are as follows:

*(Amounts in thousands)*

2008	\$ 693
2009	678
2010	623
2011	638
2012	509
Thereafter	4,394
Total	\$ 7,535

The Company purchased a building in 2005 and relocated its headquarters in March 2007. The acquired building resides on land subject to a land lease which renews every five years with the next renewal in 2008. Total rent expense for the years ended December 31, 2007 and 2006 amounted to \$887,000 and \$813,000 respectively.

## **NOTE I – RELATED PARTY TRANSACTIONS**

In addition to those transactions discussed in Note D, the Bank has entered into an agreement for accounting, data processing, and administrative services with a stockholder corporation that owned approximately 20% of the Company's common stock at December 31, 2007 and 2006. Expenses related to this agreement totaled \$385,000 and \$434,000 to this corporation during the years ended December 31, 2007 and 2006, respectively.

## **NOTE J – EMPLOYEE BENEFIT PLANS**

### **401(K) RETIREMENT PLAN**

The Bank has adopted a 401(k) retirement plan that covers all eligible employees. The Bank's contribution is limited to 6% of each employee's salary. Matching contributions are funded when accrued. Matching expenses totaled \$323,000 for the year ended December 31, 2007 and \$199,000 for the year ended December 31, 2006.

### **EMPLOYEE STOCK PURCHASE PLAN**

On September 23, 2003, the Board adopted, subject to shareholder approval, the 2003 Employee Stock Purchase Plan (the "2003 ESPP"). A split adjusted aggregate of 1,600 shares of Common stock of the Company has been reserved for issuance by the Company upon exercise of options to be granted from time to time under the 2003 ESPP. The purpose of this plan is to provide eligible employees of the Company and participating subsidiaries with a convenient means of acquiring an equity interest in the Company, to enhance such employees' sense of participation in the affairs of the Company and participating subsidiaries, and to provide an incentive for continued employment.

The 2003 ESPP provided employees of the Company the right to purchase, annually, shares of the company's common stock at 85% of fair market value. The number of shares that could be purchased in any calendar year by any individual was limited to shares with a fair market value of \$25,000.

In 2006, the Board amended the plan to conform to changes in tax law and reduced the discount offered on the shares to 5%, offering shares at 95% of the most recent trade.

During 2007 and 2006, 65 shares and 86 shares, respectively, were issued under this plan generating total proceeds of \$332,000 and \$411,000 respectively.

### **SUPPLEMENTAL RETIREMENT PLAN**

In May 2004, the Company established a non-qualifying supplemental retirement plan for the benefit of certain key executives. Under the Plan, the participants will receive a fixed retirement benefit over a 20 year period following that participant's retirement. The Plan also provides for payment of death or disability benefits in the event a participating officer becomes permanently disabled or dies prior to attainment of retirement age. Benefits vest over a ten year period beginning at Plan inception with the first 20% vesting after six years of service and 20% vesting annually thereafter.

In July 2007, the Company established another non-qualifying supplemental retirement plan for the benefit of certain other key employees. The terms of the plan were the same as those for the 2004 Plan. In addition, at the same time, the Company established a deferred compensation plan for certain key executives. Terms of the deferred compensation plan were the same as those of the other two plans except that in addition to a service requirement, certain financial objectives had to be met.

For the years ended December 31, 2007 and 2006, the Company recognized \$195,000 and \$116,000 of expense related to the Plan, respectively. The accrued liability related to this plan was approximately \$523,000 and \$328,000 as of December 31, 2007 and 2006, respectively.

In 2004, the Company invested \$4.0 million in bank-owned life insurance ("BOLI"), and in 2005, the Company invested another \$3.0 million in BOLI. Concurrent with establishing the new retirement and compensation plans in 2007, the Company invested in an additional \$7.0 million in BOLI. Income earned on these policies may be used, at the Company's sole discretion, to fund the benefits payable under the Plans. As of December 31, 2007, cash surrender values from the BOLI policies was \$15.3 million.

### **STOCK OPTION PLANS**

During 1999 the Bank adopted, with shareholder approval, an Employee Stock Option Plan. The plan made

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

available options to purchase 1,600 shares of the Bank's common stock. In addition, during 2006 the shareholders approved the addition of 250 additional options.

In 2006, the shareholders also approved the 2006 Omnibus Stock Ownership and Long Term Incentive Plan (the "Omnibus Plan"). An aggregate of 1,000 shares of the common stock of the Corporation, subject to adjustment, were reserved for issuance under the terms of the Omnibus Plan pursuant to the grant of incentive stock options, non-qualified stock options, restricted stock grants, long-term incentive compensation units and stock appre-

ciation rights. With the approval of the Omnibus Plan, the 1999 Incentive Stock Option Plan was discontinued.

Options granted under both plans become exercisable in accordance with the vesting schedule specified in the stock option agreements. All unexercised options expire ten years after the date of grant.

A summary of the transactions for the Company's option plans as of and for the years ended December 31, 2007 and 2006, including the weighted average exercise price ("WAEP") and reflecting all stock splits paid to date, is as follows:

	2007			2006		
	Available for Future Grants	Shares	WAEP	Available for Future Grants	Shares	WAEP
Outstanding at beginning of year	667	1,836	\$ 2,498.08	-	1,726	\$1,482.91
Options authorized	-	-	-	1,052	-	-
Granted	(497)	497	5,902.52	(367)	367	6,107.22
Exercised	-	(51)	1,583.33	-	(201)	740.17
Expired and forfeited	125	(125)	3,070.80	56	(56)	1,171.43
Discontinued	-	-	-	(74)	-	-
Outstanding at end of year	295	2,157	\$ 3,270.94	667	1,836	\$2,498.80
Options exercisable at year-end		1,281	\$ 2,228.97		1,126	\$2,173.68

A summary of the status of the Company's nonvested shares as of December 31, 2007 and changes during the year ended December 31, 2007 is presented below:

Nonvested shares	Shares	Weighted Average Grant Date Fair Value
Outstanding at beginning of year	710	\$ 778.90
Granted	497	1,745.74
Vested	(209)	591.51
Forfeited	(122)	836.20
Outstanding at end of year	876	\$ 1,367.86

The following table summarizes information about the Company's stock options at December 31, 2007:

Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life in Years	Number Exercisable
\$625.00 - \$1,500.00	966	3.69	860
\$1,500.01 - \$3,000.00	80	0.54	32
\$3,000.01 - \$4,500.00	162	7.62	65
\$4,500.01 - \$6,000.00	665	8.99	59
\$6,000.01 - \$6,500.00	284	8.97	265
	2,157	6.46	1,281

The weighted average fair value of options granted during 2007 was \$1,746.

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 for 2007 grants:

Dividend yield	0.0%
Expected volatility	10.9% – 12.3%
Weighted average volatility	11.47%
Risk-free interest rate	4.69%
Expected life	7 years

The expected term of these options is based on evaluations of expected future employee exercise behavior. The risk-free interest rate is based on the U.S. Treasury rates at the date of grant with maturity dates approximately equal to the expected life of the grant. Volatility is based on the historical volatility of certain public entities whose operations are similar to those of the Company, as the Company does not possess sufficient historical transactions of its own shares on which to base expected volatility. The Company has not issued dividends since the date of inception.

At December 31, 2007, the aggregate intrinsic value of options outstanding and exercisable amounted to \$4.9 million and \$4.2 million, respectively.

Cash received from option exercises under the stock option plan for the year ended December 31, 2007 was \$81,000. There was no tax benefit realized for the tax deduction from options for the year ended December 31, 2007.

As of December 31, 2007, there was approximately \$780,000 of total unrecognized compensation expense related to the Company's stock option plans. This cost is expected to be recognized over a weighted average period of 2.2 years

## NOTE K – INCOME TAXES

Allocation of federal and state income tax expense (benefit) between current and deferred portions for the years ended December 31 is as follows:

<i>(Amounts in thousands)</i>	2007	2006
Current		
Federal	\$ 2,659	\$ 3,182
State	629	772
Total Current	3,288	3,954
Deferred	(675)	(842)
	\$ 2,613	\$ 3,112

A reconciliation of income tax expense computed at the statutory federal income tax rate to income tax expense included in the consolidated statements of operations is as follows:

<i>(Amounts in thousands)</i>	2007	2006
Expense computed at statutory rate of 34%	\$ 2,701	\$ 3,077
Effect of state income taxes	415	510
Tax exempt income	(601)	(436)
Other	98	(39)
	\$ 2,613	\$ 3,112

The components of the net deferred tax asset, included in other assets, are as follows:

<i>(Amounts in thousands)</i>	2007	2006
Deferred tax assets:		
Allowance for loan losses	\$ 3,394	\$ 2,505
Deferred compensation	401	314
Net unrealized loss on available for sale securities	-	414
Other	39	26
Total deferred tax assets	3,834	3,259
Deferred tax liabilities:		
Premises and equipment	(205)	(3)
Prepaid expenses	(173)	(154)
Deferred loan costs	(213)	(119)
Net unrealized gain on available for sale securities	(244)	-
Net unrealized gain on derivative instruments	(344)	(15)
Total deferred tax liabilities	(1,179)	(291)
Net recorded deferred tax assets	\$ 2,655	\$ 2,968

No valuation allowances were required relating to deferred tax assets at December 31, 2007 or 2006.

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board Interpretation No. 48, *Accounting for Income Tax Uncertainties, an interpretation of FASB Statement No 109* (the "Interpretation"). This Interpretation provides guidance on financial statement

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

recognition and measurement of tax positions taken, or expected to be taken, in tax returns. The Company adopted this Interpretation with no material impact on its financial statements. As of January 1, 2007, there were no uncertain tax positions. The amount of uncertain tax positions may increase or decrease in the future for various reasons including adding amounts for current tax positions, expiration of open tax returns due to statutes of limitations, changes in management's judgment about the level of uncertainty, status of examinations, litigation and legislative activity and the addition or elimination of uncertain tax positions. The Company's policy is to report interest and penalties, if any, related to uncertain tax positions in income tax expense in the Consolidated Statements of Operations. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2004.

### NOTE L – OTHER NON-INTEREST EXPENSE

The major components of other non-interest expense for the years ended December 31, 2007 and 2006 are as follows:

<i>(Amounts in thousands)</i>	2007	2006
Advertising and public relations	\$ 574	\$ 485
Equipment expense	838	675
Postage, printing and office supplies	143	105
Data processing and technology	526	295
Telephone	123	139
Contract fees	73	173
Directors fees and stock compensation	417	711
Travel related expenses	239	178
FDIC assessments and supervisory fees	555	74
Other	1,295	805
Total	\$ 4,783	\$ 3,640

### NOTE M – REGULATORY MATTERS

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items 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. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2007 and 2006, that the Company and the Bank met all capital adequacy requirements to which they are subject.

As of September 30, 2007, the most recent notification from the Federal Deposit Insurance Corporation categorized Paragon Commercial Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since the notification that management believes have changed the Bank's category. The Company's and the Banks' actual capital amounts and ratios as of December 31, 2007 and 2006 are presented in the following table.

**MINIMUM REQUIREMENTS TO BE:**

<i>(Dollars in thousands)</i>	ACTUAL		ADEQUATELY CAPITALIZED		WELL CAPITALIZED	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>AS OF DECEMBER 31, 2007:</b>						
Total Capital (to Risk-Weighted Assets)						
Consolidated	\$ 97,023	11.5%	\$ 67,613	8.0%	\$ 84,517	10.0%
Bank	94,558	11.2%	67,604	8.0%	84,506	10.0%
Tier I Capital (to Risk-Weighted Assets)						
Consolidated	88,157	10.4%	33,807	4.0%	50,710	6.0%
Bank	85,692	10.1%	33,802	4.0%	50,703	6.0%
Tier I Capital (to Average Assets)						
Consolidated	88,157	9.4%	37,676	4.0%	47,095	5.0%
Bank	85,692	9.2%	37,159	4.0%	46,449	5.0%
<b>AS OF DECEMBER 31, 2006:</b>						
Total Capital (to Risk-Weighted Assets)						
Consolidated	\$ 60,968	11.1%	\$ 44,018	8.0%	\$ 55,022	10.0%
Bank	59,465	10.8%	43,939	8.0%	54,923	10.0%
Tier I Capital (to Risk-Weighted Assets)						
Consolidated	48,367	8.8%	22,009	4.0%	33,013	6.0%
Bank	52,772	9.6%	21,969	4.0%	32,954	6.0%
Tier I Capital (to Average Assets)						
Consolidated	48,367	7.6%	25,406	4.0%	31,758	5.0%
Bank	52,772	8.4%	25,141	4.0%	31,426	5.0%

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE N – OFF-BALANCE SHEET RISK

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank, upon extension of credit is based on management's credit evaluation of the borrower. Collateral obtained varies but may include real estate, stocks, bonds, and certificates of deposit.

A summary of the contract amounts of the Bank's exposure to off-balance sheet credit risk as of December 31, 2007 is as follows (amounts in thousands):

<i>(Amounts in thousands)</i>	<b>2007</b>
Financial instruments whose contract amounts represent credit risk:	
Commitments to extend credit	\$ 73,617
Undisbursed lines of credit	228,111
Standby letters of credit	5,556

### NOTE O – FAIR VALUE OF FINANCIAL INSTRUMENTS

SFAS No. 107, *Disclosures About Fair Value of Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized in

the balance sheet, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows.

In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. SFAS 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Bank.

The following methods and assumptions were used by the Bank in estimating its fair value disclosures for financial instruments:

#### CASH AND DUE FROM BANKS

The carrying amounts for cash and due from banks approximate fair value because of the short maturities of those instruments.

#### INVESTMENT SECURITIES

Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

#### FEDERAL HOME LOAN BANK STOCK

The carrying value of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

#### BANK-OWNED LIFE INSURANCE

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

#### LOANS

The fair value of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

## DEPOSITS

The fair value of demand deposits is the amount payable on demand at the reporting date. The fair value of time deposits is estimated by discounting expected cash flows using the rates currently offered for instruments of similar remaining maturities.

## ACCRUED INTEREST

The carrying amount is a reasonable estimate of fair value.

## SHORT-TERM BORROWINGS AND LONG-TERM DEBT

The fair values are based on discounting expected cash flows using the current interest rates for debt with the same or similar remaining maturities and collateral requirements.

## DERIVATIVE FINANCIAL INSTRUMENTS

The fair value for fixed-rate commitments considers the difference between current levels of interest rates and the committed rates.

## FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

With regard to financial instruments with off-balance sheet risk discussed in Note N, it is not practicable to estimate the fair value of future financing commitments.

The following table presents the estimated fair values and carrying amounts of the Bank's financial instruments, none of which are held for trading purposes, at December 31:

<i>(Amounts in thousands)</i>	2007		2006	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>FINANCIAL ASSETS:</b>				
Cash and due from banks	\$ 11,172	\$ 11,172	\$ 11,215	\$ 11,215
Investment securities available for sale	158,033	158,033	96,109	96,109
Loans, net	778,944	780,105	513,924	513,907
Accrued interest receivable	4,805	4,805	3,193	3,193
Federal Home Loan Bank stock	3,125	3,125	2,056	2,056
Bank-owned life insurance	15,320	15,320	7,854	7,854
Cash flow hedges	1,195	1,195	447	447
<b>FINANCIAL LIABILITIES:</b>				
Non-maturing deposits	203,148	203,148	174,224	174,224
Time deposits	519,767	519,950	371,002	370,528
Accrued interest payable	2,726	2,726	1,035	1,035
Repurchase agreements and federal funds purchased	79,768	79,768	21,555	21,555
FHLB advances and other borrowings	93,500	93,503	25,000	24,957
Subordinated debt	18,558	18,400	18,558	18,728

## NOTE P – EQUITY ISSUANCE

During the third quarter of 2007, the Company held a secondary offering for its common stock and issued 5,147 new shares. Shares were offered at a per share price of \$5,500. Total funds raised were \$28.3 million and the Company increased its net capital by \$28.0 million after deducting costs associated with the offering of \$320,000.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE Q – PARENT COMPANY FINANCIAL DATA

Following are the condensed financial statements of Paragon Financial Corporation as of and for the years ended December 31, 2007 and 2006:

#### CONDENSED BALANCE SHEETS

<i>(Amounts in thousands)</i>	<b>2007</b>	<b>2006</b>
<b>ASSETS:</b>		
Cash and due from banks	\$ 2,010	\$ 760
Investment in Paragon Commercial Bank	86,614	52,136
Investment in unconsolidated subsidiaries	558	558
Other assets	613	905
Total Assets	\$ 89,795	\$ 54,359
<b>LIABILITIES AND STOCKHOLDERS' EQUITY:</b>		
Subordinated debentures	\$ 18,558	\$ 18,558
Accrued interest payable and other liabilities	159	163
Total Liabilities	18,717	18,721
Stockholders' Equity:		
Common stock	31	26
Additional paid-in capital	46,268	17,724
Accumulated other comprehensive income (loss)	922	(637)
Retained earnings	23,857	18,525
Total Stockholders' Equity	71,078	35,638
Total Liabilities and Stockholder's Equity	\$ 89,795	\$ 54,359

#### CONDENSED STATEMENTS OF INCOME

<i>(Amounts in thousands)</i>	<b>2007</b>	<b>2006</b>
Equity in earnings of subsidiary	\$ 6,319	\$ 6,671
Interest expense	(1,607)	(1,158)
Other operating income	137	80
Other operating expenses	(26)	(34)
Income tax benefit	509	378
Net Income	\$ 5,332	\$ 5,937

## CONDENSED STATEMENTS OF CASH FLOWS

*(Amounts in thousands)*

	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 5,332	\$ 5,937
Adjustments to reconcile net income to net cash used in operating activities:		
Equity in earnings of subsidiary	(6,319)	(6,672)
Stock based compensation	147	529
Changes in assets and liabilities:		
Increase in other assets	292	(643)
Increase (decrease) in other liabilities	(4)	28
Net cash used in operating activities	(552)	(821)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Investment in subsidiaries and trusts	(26,600)	(7,748)
Net cash used in investing activities	(26,600)	(7,748)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from issuance of stock	28,321	411
Proceeds from exercise of stock options	81	149
Proceeds from issuance of subordinated debentures	-	8,248
Net cash provided by financing activities	28,402	8,808
Net increase in cash and cash equivalents	1,250	239
Cash and cash equivalents, beginning of year	760	521
Cash and cash equivalents, end of year	\$ 2,010	\$ 760

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE R – SUPPLEMENTAL CASH FLOW DISCLOSURE

<i>(Amounts in thousands)</i>	2007	2006
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>		
Interest paid	\$ 32,736	\$ 19,246
Income taxes paid	\$ 4,108	\$ 4,123
<b>SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES:</b>		
Change in fair value of securities available for sale, net of taxes	\$ 1,034	\$ 35
Change in fair value of cash flow hedges, net of taxes	\$ 548	\$ 23

## DIRECTORS AND OFFICERS



RALEIGH OFFICERS, LEFT TO RIGHT: CAROL LOVETTE, JOANN HARPER, JOHN TOWLES, JENNIFER TERRY, BRANDI BAKER, BRIAN REID, CONNIE THAMES, MARTIN BORDEN, PAT BARRY, GREG STEELE, VIRGINIA PARKER, TERRY POPE, CHRIS MOORE, STEVE SHUFORD



RICHMOND OFFICERS, LEFT TO RIGHT: GREG OWENS, JOHN POWELL, MICHAEL KECK, DeANN PANGBURN, DREW HOLTZMAN



CHARLOTTE OFFICERS, LEFT TO RIGHT: SCOTT GADD, MELANIE ROBINSON, PHIL JURNEY, CHARLIE BARTZ, MADIE BURCH, PHILIP CHANDLER

## DIRECTORS AND OFFICERS



EXECUTIVE OFFICERS, LEFT TO RIGHT: MATT DAVIS, CHIEF CREDIT OFFICER; BOB HATLEY, PRESIDENT & CEO, MICHAEL STORY, EXECUTIVE VICE PRESIDENT & CHIEF OPERATING OFFICER, AND STEVE CROUSE, CHIEF FINANCIAL OFFICER.



BOARD OF DIRECTORS, STANDING LEFT TO RIGHT: ALTON RUSSELL, R. FRANK GRAY, BARRY CRAWFORD, THOMAS B. OXHOLM, E. L. KELLY, ALVIN G. RAGLAND, JOHN N. MILLER, CURTIS C. BREWER, III, ROY L. HARMON  
SITTING LEFT TO RIGHT: BILLIE REDMOND, ROBERT C. HATLEY, HOWARD JUNG, BENJAMIN S. GOLDSTEIN

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Ace Hardware Stores, Inc.

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Brewer Properties, LLC

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Fidelity Group, LLC

**BENJAMIN S. GOLDSTEIN**  
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President and CEO  
Paragon Commercial Bank

**E.L. KELLY**  
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President and CEO

**MICHAEL L. STORY**  
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Chief Operating Officer

**MATTHEW C. DAVIS**  
Senior Vice President  
Chief Credit Officer

**STEVEN E. CROUSE**  
Senior Vice President  
Chief Financial Officer

## LEGAL COUNSEL

**R. FRANK GRAY**  
Jordan, Price, Wall, Gray, Jones & Carlton, PLLC

**PARAGON**  
COMMERCIAL CORPORATION

3535 Glenwood Avenue  
Raleigh, NC 27612  
919.788.7770  
[paragoncommercial.com](http://paragoncommercial.com)

