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e year ended December 31, 2010. No investments in Bank stock have been made by the plan.

Under the Bank's 401(k) Plan, the Bank matches employee contributions to a maximum of 2.50% of annual compensation. The Bank's 2010 contribution to the 401(k) Plan pursuant to this formula was approximately \$208,000. All contributions to the 401(k) Plan are tax deferred.

The Profit Sharing Plan and 401(k) Plan permit participants to choose from ten investment funds which are selected by a committee comprised of senior management. Employees are eligible to participate in both the 401(k) Plan and Profit Sharing Plan beginning in the second month of employment. Both plans provide for vesting of 20% of the benefit after two years employment and 20% each year thereafter until participants are 100% vested after six years employment.

Indebtedness of and Transactions with Management and Directors

The Company is a "listed issuer" under the rules and regulations of the Exchange Act whose common stock is listed on NASDAQ. The Company uses the definition of independence contained in NASDAQ's listing standards to determine the independence of its directors and that the Board of Directors and each standing committee of the Board is in compliance with NASDAQ listing standards for independence.

Certain directors and executive officers of the Bank and their immediate families and associates were customers of and had transactions with the Bank in the ordinary course of business during 2010. All outstanding loans, extensions of credit or overdrafts, endorsements and guarantees outstanding at any time during 2010 to the Bank's executive officers and directors and their family members were made in the ordinary course of its business. These loans are currently made on substantially the same terms, including interest rates and collateral, as those then prevailing for comparable transactions with persons not related to the lender, and did not involve more than the normal risk of collectability or present any other unfavorable features.

The Bank leases two of its facilities from Shortgrass Associates, L.L.C. ("Shortgrass"). Director John W. Lineberger, Jr., owns 25% of the membership interests in Shortgrass. Pursuant to the terms of the leases for the two facilities leased by the Bank, during 2010 the Bank paid a total of \$193,725 to Shortgrass in lease payments for these facilities. Each of the facilities is subject to a 20-year lease between the Bank and Shortgrass. The Board of Directors routinely, and no less than annually, reviews all transactions, direct and indirect, between the Company or the Bank and any employee or director, or any of such person's immediate family members. Transactions are reviewed as to comparable market values for similar transactions. All material facts of the transactions and the director's interest are discussed by all disinterested directors and a decision made about whether the transaction is fair to the Company and the Bank. A majority vote of all disinterested directors is required to approve the transaction.

The Board of Directors also evaluates the influence family relationships may have on the independence of directors who are related by blood or marriage. Christine S. Abernethy, a greater than ten percent shareholder of the Company, has two sons, Robert C. Abernethy and James S. Abernethy, who serve on the Board of Directors. All of the non-related directors have determined that the family relationships among Christine S. Abernethy, James S. Abernethy and Robert C. Abernethy do not affect the brothers' independence as directors.

PROPOSAL 2

ADVISORY (NON-BINDING) PROPOSAL TO APPROVE THE COMPENSATION OF THE COMPANY'S NAMED EXECUTIVE OFFICERS

The Company believes that our 2010 compensation policies and procedures are centered on a pay-for-performance culture and are strongly aligned with the long-term interests of our shareholders. These policies and procedures are described in detail on pages 12 to 15 of this Proxy Statement.

The ARRA provides that all participants in the TARP permit a non-binding shareholder vote to approve the compensation of the participant's executives. Therefore, the Board of Directors is providing our shareholders with the right to cast an advisory vote on the compensation of the Company's NEOs at the 2011 Annual Meeting of Shareholders.

This proposal, commonly known as a "say-on-pay" proposal, gives you as a shareholder the opportunity to vote on the compensation of our NEOs through the following resolution:

"RESOLVED, that the shareholders of Peoples Bancorp of North Carolina, Inc. approve the compensation of its Named Executive Officers named in the Summary Compensation Table in this Proxy Statement, as described in the narrative and the tabular disclosure regarding the compensation of the Named Executive Officers contained in this Proxy Statement."

Under the ARRA, your vote on this matter is advisory and will therefore not be binding upon the Board of Directors. However, the Compensation Committee will take the outcome of the vote into account when determining further executive compensation arrangements.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR THE APPROVAL OF THIS PROPOSAL.

PROPOSAL 3

RATIFICATION OF SELECTION OF INDEPENDENT AUDITOR

Porter Keadle Moore, LLP, of Atlanta, Georgia (“PKM”), has been selected by the Audit Committee as the Company’s and the Bank’s independent auditor for the year ending December 31, 2011. Such selection is being submitted to the Company’s shareholders for ratification. Representatives of PKM are expected to attend the Annual Meeting and will be afforded an opportunity to make a statement, if they so desire, and to respond to appropriate questions from shareholders.

Audit Fees

The aggregate fees billed by PKM for professional services rendered in connection with the (i) audit of the Company’s annual financial statements for 2010 and 2009; (ii) review of the financial statements included in the Company’s quarterly filings on Form 10-Q during those fiscal years; and (iii) review of the Company’s internal controls over financial reporting in 2010 and 2009 were approximately \$167,000 and \$186,000, respectively.

Audit Related Fees

The aggregate fees billed by PKM in 2010 and 2009 for professional services rendered for assurance and related services that are reasonably related to the performance of the audit or review of the Company’s financial statements and not included in “Audit Fees” above were approximately \$59,000 and \$20,000, respectively. These fees were primarily related to the audit of the Company’s Profit Sharing and 401(k) Plan and the testing of management’s assertions regarding internal controls in accordance with the Federal Deposit Insurance Corporation Improvement Act.

Tax Fees

The aggregate fees billed in each of the last two fiscal years for professional services rendered by PKM for tax compliance, tax advice, and tax planning were approximately \$28,000 and \$24,000 in 2010 and 2009, respectively. These fees were primarily related to the preparation of the Company’s income tax returns, assistance with quarterly income tax estimates and preparation of Forms 5500 for various benefit plans.

All Other Fees

In addition to the fees outlined above, PKM billed fees in the amount of approximately \$1,600 in 2010 and \$1,300 in 2009.

The fees billed by PKM are pre-approved by the Audit and Enterprise Risk Committee of the Company in accordance with the policies and procedures for the Audit and Enterprise Risk Committee set forth in the Committee’s charter. The Audit and Enterprise Risk Committee typically pre-approves all audit and non-audit services provided by the Company’s independent auditors and may not engage the independent auditors to perform any prohibited non-audit services. For 2010, 99% of the total fees paid for audit, audit related and tax services were pre-approved. For 2009, 98% of the total fees paid for audit, audit related and tax services were pre-approved. The Audit and Enterprise Risk Committee has determined that the rendering of non-audit professional services by PKM, as identified above, is compatible with maintaining PKM’s independence.

THE BOARD OF DIRECTORS RECOMMENDS THAT THE SHAREHOLDERS VOTE FOR RATIFICATION OF THE APPOINTMENT OF PKM AS INDEPENDENT AUDITOR FOR THE COMPANY AND THE BANK FOR THE FISCAL YEAR ENDING DECEMBER 31, 2011.

DATE FOR RECEIPT OF SHAREHOLDER PROPOSALS

It is presently anticipated that the 2012 Annual Meeting of Shareholders of the Company will be held on May 3, 2012. In order for shareholder proposals to be included in the Company's proxy materials for that meeting, such proposals must be received by the Secretary of the Company at the Company's principal executive office no later than December 7, 2011 and meet all other applicable requirements for inclusion in the Proxy Statement.

In the alternative, a shareholder may commence his or her own proxy solicitation and present a proposal from the floor at the 2012 Annual Meeting of Shareholders of the Company. In order to do so, the shareholder must notify the Secretary of the Company in writing, at the Company's principal executive office no later than February 19, 2012, of his or her proposal. If the Secretary of the Company is not notified of the shareholder's proposal by February 19, 2012, the Board of Directors may vote on the proposal pursuant to the discretionary authority granted by the proxies solicited by the Board of Directors for the 2012 Annual Meeting.

OTHER MATTERS

Management knows of no other matters to be presented for consideration at the Annual Meeting or any adjournments thereof. If any other matters shall properly come before the Annual Meeting, it is intended that the proxyholders named in the enclosed form of proxy will vote the shares represented thereby in accordance with their judgment, pursuant to the discretionary authority granted therein.

MISCELLANEOUS

The Annual Report of the Company for the year ended December 31, 2010, which includes financial statements audited and reported upon by the Company's independent auditor, is being mailed as Appendix A to this Proxy Statement; however, it is not intended that the Annual Report be deemed a part of this Proxy Statement or a solicitation of proxies.

THE FORM 10-K FILED BY THE COMPANY WITH THE SEC, INCLUDING THE FINANCIAL STATEMENTS AND SCHEDULES THERETO, WILL BE PROVIDED FREE OF CHARGE UPON WRITTEN REQUEST DIRECTED TO: PEOPLES BANCORP OF NORTH CAROLINA, INC., POST OFFICE BOX 467, 518 WEST C STREET, NEWTON, NORTH CAROLINA 28658-0467, ATTENTION: A. JOSEPH LAMPRON, JR..

By Order of the Board of
Directors,

/s/ Tony W. Wolfe
Tony W. Wolfe
President and Chief
Executive Officer

Newton, North Carolina
April 5, 2011

APPENDIX A
ANNUAL REPORT
OF
PEOPLES BANCORP OF NORTH CAROLINA, INC.

PEOPLES BANCORP OF NORTH CAROLINA, INC.

General Description of Business

Peoples Bancorp of North Carolina, Inc. (the "Company"), was formed in 1999 to serve as the holding company for Peoples Bank (the "Bank"). The Company is a bank holding company registered with the Board of Governors of the Federal Reserve System (the "Federal Reserve") under the Bank Holding Company Act of 1956, as amended (the "BHCA"). The Company's principal source of income is any dividends which are declared and paid by the Bank on its capital stock. The Company has no operations and conducts no business of its own other than owning the Bank. Accordingly, the discussion of the business which follows concerns the business conducted by the Bank, unless otherwise indicated.

The Bank, founded in 1912, is a state-chartered commercial bank serving the citizens and business interests of the Catawba Valley and surrounding communities through 22 banking offices located in Lincolnton, Newton, Denver, Catawba, Conover, Maiden, Claremont, Hiddenite, Hickory, Charlotte, Monroe, Cornelius, Mooresville and Raleigh North Carolina. The Bank also operates a loan production office in Denver, North Carolina. At December 31, 2010, the Company had total assets of \$1.1 billion, net loans of \$710.7 million, deposits of \$838.7 million, total securities of \$278.2 million, and shareholders' equity of \$96.9 million.

The Bank operates four offices focused on the Latino population under the name Banco de la Gente ("Banco"). These offices are operated as a division of the Bank. Banco offers normal and customary banking services as are offered in the Bank's other branches such as the taking of deposits and the making of loans and therefore is not considered a reportable segment of the Company.

The Bank has a diversified loan portfolio, with no foreign loans and few agricultural loans. Real estate loans are predominately variable rate commercial property loans, which include residential development loans to commercial customers. Commercial loans are spread throughout a variety of industries with no one particular industry or group of related industries accounting for a significant portion of the commercial loan portfolio. The majority of the Bank's deposit and loan customers are individuals and small to medium-sized businesses located in the Bank's market area. The Bank's loan portfolio also includes Individual Taxpayer Identification Number (ITIN) mortgage loans generated through the Bank's Banco offices. Additional discussion of the Bank's loan portfolio and sources of funds for loans can be found in "Management's Discussion and Analysis of Financial Condition and Results of Operations" on pages A-4 through A-28.

The operations of the Bank and depository institutions in general are significantly influenced by general economic conditions and by related monetary and fiscal policies of depository institution regulatory agencies, including the Federal Reserve, the Federal Deposit Insurance Corporation (the "FDIC") and the North Carolina Commissioner of Banks (the "Commissioner").

At December 31, 2010, the Company employed 244 full-time employees and 44 part-time employees, which equated to 273 full-time equivalent employees.

Subsidiaries

The Bank is a subsidiary of the Company. The Bank has two subsidiaries, Peoples Investment Services, Inc. and Real Estate Advisory Services, Inc. Through a relationship with Raymond James Financial Services, Inc., Peoples Investment Services, Inc. provides the Bank's customers access to investment counseling and non-deposit investment products such as stocks, bonds, mutual funds, tax deferred annuities, and related brokerage services. Real Estate Advisory Services, Inc. provides real estate appraisal and real estate brokerage services.

In June 2006, the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust II (“PEBK Trust II”), which issued \$20.0 million of guaranteed preferred beneficial interests in the Company’s junior subordinated deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase \$20.6 million of junior subordinated debentures of the Company, which pay a floating rate equal to three month LIBOR plus 163 basis points. The proceeds received by the Company from the sale of the junior subordinated debentures were used in December 2006 to repay the trust preferred securities issued by PEBK Trust in December 2001 and for general purposes. The debentures represent the sole asset of PEBK Trust II. PEBK Trust II is not included in the consolidated financial statements.

The trust preferred securities issued by PEBK Trust II accrue and pay quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II does not have funds with which to make the distributions and other payments. The net combined effect of the trust preferred securities transaction is that the Company is obligated to make the distributions and other payments required on the trust preferred securities.

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These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, on or after June 28, 2011. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount and any accrued but unpaid interest.

The Company established a new subsidiary, Community Bank Real Estate Solutions, LLC (“CBRES”), in 2009. CBRES serves as a “clearing-house” for appraisal services for community banks. Other banks are able to contract with CBRES to find and engage appropriate appraisal companies in the area where the property is located. This type of service ensures that the appraisal process remains independent from the financing process within the bank.

This report contains certain forward-looking statements with respect to the financial condition, results of operations and business of Peoples Bancorp of North Carolina, Inc. (the “Company”). These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Company and on the information available to management at the time that these disclosures were prepared. These statements can be identified by the use of words like “expect,” “anticipate,” “estimate” and “believe,” variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by Peoples Bank (the “Bank”), (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environment and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in the Company’s other filings with the Securities and Exchange Commission. The Company undertakes no obligation to update any forward-looking statements.

SELECTED FINANCIAL DATA
Dollars in Thousands Except Per Share Amounts

	2010	2009	2008	2007	2006
Summary of Operations					
Interest income	\$ 47,680	50,037	56,322	61,732	55,393
Interest expense	14,348	17,187	23,526	27,585	23,110
Net interest earnings	33,332	32,850	32,796	34,147	32,283
Provision for loan losses	16,438	10,535	4,794	2,038	2,513
Net interest earnings after provision					
for loan losses	16,894	22,315	28,002	32,109	29,770
Non-interest income	13,884	11,823	10,495	8,816	7,554
Non-interest expense	28,948	29,883	28,893	25,993	22,983
Earnings before taxes	1,830	4,255	9,604	14,932	14,341
Income taxes	(11)	1,339	3,213	5,340	5,170
Net earnings	1,841	2,916	6,391	9,592	9,171
Dividends and accretion of preferred stock	1,394	1,246	-	-	-
Net earnings available to common shareholders	\$ 447	1,670	6,391	9,592	9,171
Selected Year-End Balances					
Assets	\$ 1,067,652	1,048,494	968,762	907,262	818,948
Available for sale securities	272,449	195,115	124,916	120,968	117,581
Loans, net	710,667	762,643	770,163	713,174	643,078
Mortgage loans held for sale	3,814	2,840	-	-	-
Interest-earning assets	1,010,983	988,017	921,101	853,878	780,082
Deposits	838,712	809,343	721,062	693,639	633,820
Interest-bearing liabilities	850,233	826,838	758,334	718,870	650,364
Shareholders' equity	\$ 96,858	99,223	101,128	70,102	62,835
Shares outstanding*	5,541,413	5,539,056	5,539,056	5,624,234	5,745,951
Selected Average Balances					
Assets	\$ 1,078,136	1,016,257	929,799	846,836	772,585
Available for sale securities	219,798	161,135	115,853	120,296	118,137
Loans	757,532	782,464	747,203	665,379	604,427
Interest-earning assets	999,054	956,680	876,425	801,094	732,244
Deposits	840,342	772,075	720,918	659,174	605,407
Interest-bearing liabilities	849,870	796,260	740,478	665,727	613,686
Shareholders' equity	\$ 101,529	101,162	76,241	70,586	62,465
Shares outstanding*	5,539,308	5,539,056	5,588,314	5,700,860	5,701,829
Profitability Ratios					
Return on average total assets	0.17%	0.29%	0.69%	1.13%	1.19%
Return on average shareholders' equity	1.81%	2.88%	8.38%	13.59%	14.68%
Dividend payout ratio**	100.11%	86.22%	41.93%	24.30%	20.78%

**Liquidity and Capital Ratios
(averages)**

Loan to deposit	90.15%	101.35%	103.65%	100.94%	99.84%
Shareholders' equity to total assets	9.42%	9.95%	8.20%	8.34%	8.09%

Per share of Common Stock*

Basic net income	\$	0.08	0.30	1.14	1.68	1.61
Diluted net income	\$	0.08	0.30	1.13	1.65	1.58
Cash dividends	\$	0.08	0.26	0.48	0.41	0.33
Book value	\$	12.96	13.39	13.73	12.46	10.94

*Shares outstanding and per share computations have been retroactively restated to reflect a 10% stock dividend during second quarter 2006 and a 3-for-2 stock split during second quarter 2007.

**As a percentage of net earnings available to common shareholders.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS

The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors and the Company's consolidated financial statements and notes thereto on pages A-29 through A-63.

Introduction

Management's discussion and analysis of earnings and related data are presented to assist in understanding the consolidated financial condition and results of operations of the Company, for the years ended December 31, 2010, 2009 and 2008. The Company is a registered bank holding company operating under the supervision of the Federal Reserve Board and the parent company of Peoples Bank (the "Bank"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg, Iredell, Union and Wake counties, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation (the "FDIC").

Overview

Our business consists principally of attracting deposits from the general public and investing these funds in commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment securities portfolios and our cost of funds, which consists of interest paid on deposits and borrowed funds. Net interest income also is affected by the relative amounts of our interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, a positive interest rate spread will generate net interest income. Our profitability is also affected by the level of other income and operating expenses. Other income consists primarily of miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds. Operating expenses consist of compensation and benefits, occupancy related expenses, federal deposit and other insurance premiums, data processing, advertising and other expenses.

Our operations are influenced significantly by local economic conditions and by policies of financial institution regulatory authorities. The earnings on our assets are influenced by the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), inflation, interest rates, market and monetary fluctuations. Lending activities are affected by the demand for commercial and other types of loans, which in turn is affected by the interest rates at which such financing may be offered. Our cost of funds is influenced by interest rates on competing investments and by rates offered on similar investments by competing financial institutions in our market area, as well as general market interest rates. These factors can cause fluctuations in our net interest income and other income. In addition, local economic conditions can impact the credit risk of our loan portfolio, in that (1) local employers may be required to eliminate employment positions of individual borrowers, and (2) small businesses and commercial borrowers may experience a downturn in their operating performance and become unable to make timely payments on their loans. Management evaluates these factors in estimating its allowance for loan losses and changes in these economic factors could result in increases or decreases to the provision for loan losses.

Economic conditions in 2010 continued to deteriorate and had a negative impact on our financial condition and results of operations. Unfavorable trends, such as increased unemployment, falling real estate prices, increased loan default and increased bankruptcy rates demonstrate the difficult business conditions that are affecting the general economy and therefore our operating results. The unemployment rates in our primary market area have been higher than state and national averages throughout 2010.

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Although we are unable to control the external factors that influence our business, by maintaining high levels of balance sheet liquidity, managing our interest rate exposures and by actively monitoring asset quality, we seek to minimize the potentially adverse risks of unforeseen and unfavorable economic trends.

Our business emphasis has been to operate as a well-capitalized, profitable and independent community-oriented financial institution dedicated to providing quality customer service. We are committed to meeting the financial needs of the communities in which we operate. We believe that we can be more effective in serving our customers than many of our non-local competitors because of our ability to quickly and effectively provide senior management responses to customer needs and inquiries. Our ability to provide these services is enhanced by the stability of our senior management team.

The Federal Reserve has decreased the Federal Funds Rate 4.00% since December 31, 2007 with the rate set at 0.25% since December 2008. These decreases had a negative impact on 2008, 2009 and 2010 earnings and will continue to have a negative impact on the Bank's net interest income in the future periods. The negative impact from the decrease in the Federal Funds Rate has been partially offset by the increase in earnings realized on interest rate contracts, including

both an interest rate swap and interest rate floors, utilized by the Company. Additional information regarding the Company's interest rate contacts is provided below in the section entitled "Asset Liability and Interest Rate Risk Management."

On December 23, 2008, the Company entered into a Securities Purchase Agreement ("Purchase Agreement") with the United States Department of the Treasury ("UST"). Under the Purchase Agreement, the Company agreed to issue and sell 25,054 shares of Series A preferred stock and warrants to purchase 357,234 shares of common stock associated with the Company's participation in the U.S. Treasury Department's Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP"). Proceeds from this issuance of preferred shares were allocated between preferred stock and the warrant based on their relative fair values at the time of the sale. Of the \$25.1 million in proceeds, \$24.4 million was allocated to the Series A preferred stock and \$704,000 was allocated to the common stock warrant. The discount recorded on the preferred stock that resulted from allocating a portion of the proceeds to the warrant is being accreted directly to retained earnings over a five-year period applying a level yield. As of December 31, 2010, the Company has accreted a total of \$266,000 of the discount related to the Series A preferred stock. The Company paid dividends of \$1.3 million on the Series A preferred stock during 2010 and cumulative undeclared dividends at December 31, 2010 were \$157,000.

The Series A preferred stock qualifies as Tier 1 capital and will pay cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Series A preferred stock may be redeemed at the stated amount of \$1,000 per share plus any accrued and unpaid dividends. Under the terms of the original Purchase Agreement, the Company could not redeem the preferred shares until December 23, 2011 unless the total amount of the issuance, \$25.1 million, was replaced with the same amount of other forms of capital that would qualify as Tier 1 capital. However, with the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA"), the Company can now redeem the preferred shares at any time, if approved by the Company's primary regulator. The Series A preferred stock is non-voting except for class voting rights on matters that would adversely affect the rights of the holders of the Series A preferred stock.

The exercise price of the warrant is \$10.52 per common share and it is exercisable at anytime on or before December 18, 2018.

The Company is subject to the following restrictions while the Series A preferred stock is outstanding: 1) UST approval is required for the Company to repurchase shares of outstanding common stock; 2) the full dividend for the latest completed CPP dividend period must be declared and paid in full before dividends may be paid to common shareholders; 3) UST approval is required for any increase in common dividends per share above the last quarterly dividend of \$0.12 per share paid prior to December 23, 2008; and 4) the Company may not take tax deductions for any senior executive officer whose compensation is above \$500,000. There were additional restrictions on executive compensation added in the ARRA for companies participating in the TARP, including participants in the CPP.

It is the intent of the Company to utilize CPP funds to provide capital to support making loans to qualified borrowers in the Bank's market area. The funds will also be used to absorb losses incurred when modifying loans or making concessions to borrowers in order to keep borrowers out of foreclosure. The Bank is also working with its current builders and contractors to provide financing for potential buyers who may not be able to qualify for financing in the current mortgage market in order to help these customers sell existing single family homes. The Company will also use the CPP capital infusion as additional Tier I capital to protect the Bank from potential losses that may be incurred during this current recessionary period.

The Company continues to face challenges resulting from the impact of the current economy on the housing and real estate markets. The Bank continues to monitor and evaluate all significant loans in its portfolio, and will continue to manage its credit risk exposure with the expectation that stabilization of the real estate market will not occur within

the next 18 to 24 months. The CPP funds have enhanced our capital position as the Company infused the Bank with \$8.0 million additional regulatory capital. The Company has \$17.0 million available that can be infused into the Bank as additional capital if needed to maintain its position as a well-capitalized bank. We anticipate increased loan losses in the short run and have prepared for that expectation. We have quality individuals managing our past due loans and foreclosed properties to minimize our potential losses. As the economy recovers, we are positioned to take advantage of all opportunities that present themselves. We anticipate that the net interest margin will remain at or near the 3.46% net margin for 2010. The amount and timing of any future Federal Reserve rate adjustment remains uncertain, and may further impact the Bank if those adjustments are significant.

Management expects to look for branching opportunities in nearby markets in the future but there are no additional offices planned in 2011.

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Summary of Significant Accounting Policies

The consolidated financial statements include the financial statements of the Company and its wholly owned subsidiaries, the Bank and Community Bank Real Estate Solutions, LLC, along with the Bank's wholly owned subsidiaries, Peoples Investment Services, Inc. and Real Estate Advisory Services, Inc. (collectively called the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation.

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. The following is a summary of some of the more subjective and complex accounting policies of the Company. A more complete description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2010 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 5, 2011 Annual Meeting of Shareholders.

Many of the Company's assets and liabilities are recorded using various techniques that require significant judgment as to recoverability. The collectability of loans is reflected through the Company's estimate of the allowance for loan losses. The Company performs periodic and systematic detailed reviews of its lending portfolio to assess overall collectability. In addition, certain assets and liabilities are reflected at their estimated fair value in the consolidated financial statements. Such amounts are based on either quoted market prices or estimated values derived from dealer quotes used by the Company, market comparisons or internally generated modeling techniques. The Company's internal models generally involve present value of cash flow techniques. The various techniques are discussed in greater detail elsewhere in management's discussion and analysis and the notes to consolidated financial statements.

There are other complex accounting standards that require the Company to employ significant judgment in interpreting and applying certain of the principles prescribed by those standards. These judgments include, but are not limited to, the determination of whether a financial instrument or other contract meets the definition of a derivative in accordance with Generally Accepted Accounting Principles ("GAAP"). For a more complete discussion of policies, see the notes to consolidated financial statements.

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

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, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of 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 designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. As of December 31, 2010, the Company had cash flow hedges with a notional amount of \$50.0 million. This derivative instrument consists of one interest rate swap contract.

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The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Balance Sheet as of December 31, 2010 and December 31, 2009.

(Dollars in thousands)

	Asset Derivatives				Liability Derivatives			
	As of December 31, 2010		As of December 31, 2009		As of December 31, 2010		As of December 31, 2009	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest rate derivative contracts	Other assets	\$ 648	Other assets	\$ 1,762	N/A	\$ -	N/A	\$ -

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floor designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium. As of December 31, 2010, the Company had one interest rate swap with a notional amount of \$50.0 million that was designated as a cash flow hedge of interest rate risk.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in Accumulated Other Comprehensive Income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2010 and 2009, such derivatives were used to hedge the variable cash inflows associated with existing pools of prime-based loan assets. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. The Company recognized a hedge ineffectiveness gain of \$1,000 in earnings during the year ended December 31, 2009.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest income or expense as interest payments are received/made on the Company's variable-rate assets/liabilities. During the next twelve months, the Company estimates that \$648,000 will be reclassified as an increase to interest income.

The tables below present the effect of the Company's derivative financial instruments on the Income Statement for the years ended December 31, 2010 and 2009.

(Dollars in thousands)

Amount of Gain (Loss) Recognized in	Location of Gain (Loss) Reclassified	Amount of Gain (Loss) Reclassified from Accumulated
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	OCI on Derivatives Years ended December 31,		from Accumulated OCI into Income	OCI into Income Years ended December 31,	
	2010	2009		2010	2009
Interest rate derivative contracts	\$ 404	\$ 434	Interest income	\$ 1,518	\$ 3,114
			Non-interest income	\$ -	\$ 46

Relating to the post retirement benefit plan, the Company is required to recognize an obligation for either the present value of the entire promised death benefit or the annual “cost of insurance” required to keep the policy in force during the post-retirement years. The Company made a \$467,000 reduction to retained earnings in 2008 pursuant to the guidance of the pronouncement to record the portion of this benefit earned by participants prior to adoption of the pronouncement. In 2009 the Company made a \$358,000 addition to retained earnings to reflect an adjustment of the cumulative effect due to amendments to the individual split-dollar plans implemented during 2009.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The table below presents the balance of securities available for sale and derivatives, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of December 31, 2010 and 2009.

(Dollars in thousands)

	Fair Value Measurements December 31, 2010	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 139,361	-	139,361	-
U.S. government sponsored enterprises	\$ 42,640	-	42,640	-
State and political subdivisions	\$ 87,829	-	87,829	-
Trust preferred securities	\$ 1,250	-	-	1,250
Equity securities	\$ 1,369	1,369	-	-
Mortgage loans held for sale	\$ 3,814	-	3,814	-
Market value of derivatives (in other assets)	\$ 648	-	648	-

	Fair Value Measurements December 31, 2009	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 107,526	-	107,526	-
U.S. government sponsored enterprises	\$ 41,142	-	41,142	-
State and political subdivisions	\$ 44,336	-	44,336	-
Trust preferred securities	\$ 1,250	-	-	1,250
Equity securities	\$ 861	861	-	-
Mortgage loans held for sale	\$ 2,840	-	2,840	-
Market value of derivatives (in other assets)	\$ 1,762	-	1,762	-

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Fair values of derivative instruments are determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the year ended December 31, 2010:

(Dollars in thousands)

Investment Securities
Available for Sale
Level 3 Valuation

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Balance, beginning of period	\$	1,250
Change in book value		-
Change in gain/(loss) realized and unrealized		-
Purchases/(sales)		-
Transfers in and/or out of Level 3		-
Balance, end of period	\$	1,250
Change in unrealized gain/(loss) for assets still held in Level 3	\$	-

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The Company's December 31, 2010 and 2009 fair value measurement for impaired loans and other real estate on a non-recurring basis is presented below:

(Dollars in thousands)

		Fair Value Measurements December 31, 2010	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2010
Impaired loans	\$	40,062	-	26,798	13,264	(10,591)
Other real estate	\$	6,673	-	6,673	-	(340)

		Fair Value Measurements December 31, 2009	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2009
Impaired loans	\$	22,789	-	14,174	8,615	(1,924)
Other real estate	\$	3,997	-	3,997	-	(100)

At each reporting period, the Company determines which loans are impaired. Accordingly, the Company's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan, which is generally collateral-dependent, is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by third-party valuation specialists. Factors including the assumptions and techniques utilized by the appraiser are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. No interest income is recognized on impaired loans subsequent to their classification as impaired.

The following table presents the Company's impaired loans as of December 31, 2010:

(Dollars in thousands)

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Impairment \$ -	Related Allowance	Average Recorded Impairment
Real Estate Loans						
Construction and land development	31,346	20,787	2,130	22,916	1,055	18,767
Single-family residential	12,376	9,847	990	10,837	168	12,573
Commercial	6,018	4,991	359	5,351	148	4,769
Multifamily and Farmland	-	-	-	-	-	27
Total impaired real estate loans	49,740	35,625	3,479	39,104	1,371	36,136
	1,243	811	5	816	5	1,479

Commercial loans (not secured by real estate)						
Consumer loans (not secured by real estate)	152	142	-	142	-	79
All other loans (not secured by real estate)	-	-	-	-	-	-
Total impaired loans	\$ 51,135	36,578	3,484	40,062	1,376	37,694

In February 2010, the FASB issued Accounting Standards Update No. 2010-09, Subsequent Events: Amendments to Certain Recognition and Disclosure Requirements ("ASU No. 2010-09"). ASU No. 2010-09 removes some contradictions between the requirements of U.S. GAAP and the filing rules of the Securities and Exchange Commission ("SEC"). SEC filers are required to evaluate subsequent events through the date the financial statements are issued, and they are no longer required to disclose the date through which subsequent events have been evaluated. This guidance was effective upon issuance except for the use of the issued date for conduit debt obligors, and did not have a material impact on the Company's results of operations, financial position or disclosures.

In February 2010, the FASB issued Accounting Standards Update No. 2010-10, Consolidation: Amendments for Certain Investment Funds ("ASU No. 2010-10"). ASU No. 2010-10 indefinitely defers the effective date for certain investment funds resulting from the issuance of ASU No. 2009-17. ASU No. 2010-10 also clarifies that (1) interests of related parties must be considered in determining whether fees paid to decision makers or service providers constitute a variable interest, and (2) a quantitative calculation should not be the only basis on which such determination is made. This guidance is effective as of the beginning of the first annual period beginning after November 15, 2009, and for interim periods within that first annual reporting period. The adoption of this ASU did not have a material impact on the Company's results of operations, financial position or disclosures.

In March 2010, the FASB issued Accounting Standards Update No. 2010-11, Derivatives and Hedging: Scope Exception Related to Embedded Credit Derivatives (“ASU No. 2010-11”). ASU No. 2010-11 clarifies the type of embedded credit derivative that is exempt from embedded derivative bifurcation requirements by resolving a potential ambiguity about the breadth of the embedded credit derivative scope exception with regard to some types of contracts, such as collateralized debt obligations (“CDO's”) and synthetic CDO's. The scope exception will no longer apply to some contracts that contain an embedded credit derivative feature that transfers credit risk. The ASU is effective for fiscal quarters beginning after June 15, 2010. The adoption of this ASU did not have a material impact on the Company's results of operations, financial position or disclosures.

In July 2010, the FASB issued Accounting Standards Update No. 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses (“ASU No. 2010-20”). ASU No. 2010-20 will expand loan credit quality and allowance for loan losses disclosure requirements. The ASU is effective for fiscal quarters ending on or after December 15, 2010. The adoption of this guidance did not have a material impact on the Company's results of operations or financial position; however, additional disclosures are required for this ASU. See Note 3 to the Consolidated Financial Statements.

In January 2011, the FASB issued Accounting Standards Update No. 2011-01, Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20 (“ASU No. 2011-01”). ASU No. 2011-01 deferred the effective date of troubled debt restructurings disclosure requirements for public entities to be concurrent with the effective date of the guidance for determining what constitutes a troubled debt restructuring, as presented in proposed Accounting Standards Update, Receivables (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors. The ASU is anticipated to be effective for interim and annual periods ending after June 15, 2011. The adoption of this guidance is not expected to have a material impact on the Company's results of operations or financial position; however, additional disclosures will be required for this ASU.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

Management of the Company has made a number of estimates and assumptions relating to reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare the accompanying consolidated financial statements in conformity with GAAP. Actual results could differ from those estimates.

The remainder of management’s discussion and analysis of the Company’s results of operations and financial position should be read in conjunction with the consolidated financial statements and related notes presented on pages A-29 through A-63.

Results of Operations

Summary. The Company reported earnings of \$1.8 million in 2010, or \$0.33 basic and diluted net earnings per common share before adjustment for preferred stock dividends and accretion as compared to \$2.9 million, or \$0.53 basic and diluted net earnings per common share for 2009. After adjusting for dividends and accretion on preferred stock, net earnings available to common shareholders for the year ended December 31, 2010 were \$447,000 or \$0.08 basic and diluted net earnings per common share. The Company’s decrease in net earnings for 2010 is primarily attributable to an increase in provision for loan losses, which was partially offset by an increase in net interest income, an increase in non-interest income and a decrease in non-interest expense.

Net earnings for 2009 represented a decrease of 54% as compared to 2008 net earnings of \$6.4 million or \$1.14 basic net earnings per common share and \$1.13 diluted net earnings per common share. The decrease in 2009 net earnings was primarily attributable to an increase in provision for loan losses and an increase in non-interest expense, which were partially offset by an increase in non-interest income.

The return on average assets in 2010 was 0.17%, compared to 0.29% in 2009 and 0.69% in 2008. The return on average shareholders' equity was 1.81% in 2010 compared to 2.88% in 2009 and 8.38% in 2008.

Net Interest Income. Net interest income, the major component of the Company's net income, is the amount by which interest and fees generated by interest-earning assets exceed the total cost of funds used to carry them. Net interest income is affected by changes in the volume and mix of interest-earning assets and interest-bearing liabilities, as well as changes in the yields earned and rates paid. Net interest margin is calculated by dividing tax-equivalent net interest income by average interest-earning assets, and represents the Company's net yield on its interest-earning assets.

Net interest income for 2010 increased to \$33.3 million compared to \$32.9 million in 2009. This increase is primarily attributable to a reduction in interest expense due to a decrease in the cost of funds for time deposits. Net interest income increased slightly in 2009 from \$32.8 million in 2008.

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Table 1 sets forth for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest incurred on such amounts and the average rate earned or incurred for the years ended December 31, 2010, 2009 and 2008. The table also sets forth the average rate earned on total interest-earning assets, the average rate paid on total interest-bearing liabilities, and the net yield on average total interest-earning assets for the same periods. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields and interest income on tax-exempt investments have been adjusted to tax equivalent basis using an effective tax rate of 38.55% for securities that are both federal and state tax exempt and an effective tax rate of 6.90% for state tax exempt securities. Non-accrual loans and the interest income that was recorded on these loans, if any, are included in the yield calculations for loans in all periods reported.

Table 1- Average Balance Table

(Dollars in thousands)	December 31, 2010			December 31, 2009			December 31, 2008		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
Interest-earning assets:									
Loans	\$ 757,532	38,674	5.11%	782,464	40,058	5.12%	747,203	46,808	6.26%
Interest rate derivative contracts	-	1,518	0.20%	-	3,114	0.40%	-	3,403	0.45%
Loan fees	-	75	0.01%	-	39	0.00%	-	393	0.05%
Total loans	757,532	40,267	5.32%	782,464	43,211	5.52%	747,203	50,604	6.77%
Investments - taxable	110,493	3,490	3.16%	81,642	3,477	4.26%	26,591	1,253	4.71%
Investments - nontaxable*	109,304	5,096	4.66%	79,493	4,226	5.32%	89,262	4,924	5.52%
Federal funds sold	89	-	0.00%	704	1	0.14%	3,050	55	1.80%
Other	21,636	103	0.48%	12,377	53	0.43%	10,319	293	2.84%
Total interest-earning assets	999,054	48,956	4.90%	956,680	50,968	5.33%	876,425	57,129	6.52%
Cash and due from banks	46,124			31,225			21,331		
Other assets	49,765			41,866			41,626		
Allowance for loan losses	(16,807)			(13,514)			(9,583)		
Total assets	\$ 1,078,136			1,016,257			929,799		
Interest-bearing liabilities:									
NOW accounts	\$ 133,401	1,674	1.25%	112,452	1,373	1.22%	92,612	1,269	1.37%
	82,018	879	1.07%	35,762	368	1.03%	17,423	50	0.29%

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Regular savings accounts									
Money market accounts									
	96,736	919	0.95%	94,537	1,224	1.29%	93,564	1,930	2.06%
Time deposits	405,300	6,786	1.67%	412,127	9,687	2.35%	406,127	15,008	3.70%
FHLB / FRB borrowings									
	71,989	3,285	4.56%	84,547	3,596	4.25%	79,417	3,616	4.55%
Demand notes payable to U.S. Treasury									
	815	-	0.00%	805	-	0.00%	859	14	1.63%
Trust preferred securities									
	20,619	411	1.99%	20,619	546	2.65%	20,619	1,016	4.93%
Other	38,991	394	1.01%	35,411	393	1.11%	29,857	624	2.09%
Total interest-bearing liabilities									
	849,870	14,348	1.69%	796,260	17,187	2.16%	740,478	23,527	3.18%
Demand deposits	122,887			117,197			111,192		
Other liabilities	3,513			2,428			4,021		
Shareholders' equity	101,529			101,162			76,241		
Total liabilities and shareholder's equity \$									
	1,077,799			1,017,047			931,932		
Net interest spread									
		34,608	3.21%		33,781	3.17%		33,602	3.34%
Net yield on interest-earning assets									
			3.46%			3.53%			3.83%
Taxable equivalent adjustment									
Investment securities		1,276			931			806	
Net interest income		33,332			32,850			32,796	

*Includes U.S. government agency securities that are non-taxable for state income tax purposes of \$50.3 million in 2010, \$45.5 million in 2009 and \$63.6 million in 2008. An effective tax rate of 6.90% was used to calculate the tax equivalent yield on these securities.

Changes in interest income and interest expense can result from variances in both volume and rates. Table 2 describes the impact on the Company's tax equivalent net interest income resulting from changes in average balances and average rates for the periods indicated. The changes in interest due to both volume and rate have been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the changes in each.

Table 2 - Rate/Volume Variance Analysis-Tax Equivalent Basis

(Dollars in thousands)	December 31, 2010			December 31, 2009		
	Changes in average volume	Changes in average rates	Total Increase (Decrease)	Changes in average volume	Changes in average rates	Total Increase (Decrease)
Interest income:						
Loans: Net of unearned income	\$ (1,351)	(1,593)	(2,944)	2,168	(9,561)	(7,393)
Investments - taxable	1,070	(1,057)	13	2,470	(246)	2,224
Investments - nontaxable	1,487	(617)	870	(529)	(169)	(698)
Federal funds sold	(1)	-	(1)	(23)	(31)	(54)
Other	43	7	50	33	(273)	(240)
Total interest income	1,248	(3,260)	(2,012)	4,119	(10,280)	(6,161)
Interest expense:						
NOW accounts	259	42	301	257	(153)	104
Regular savings accounts	486	25	511	121	197	318
Money market accounts	25	(330)	(305)	16	(722)	(706)
Time deposits	(137)	(2,764)	(2,901)	181	(5,502)	(5,321)
FHLB / FRB Borrowings	(554)	243	(311)	226	(246)	(20)
Demand notes payable to						
U.S. Treasury	-	-	-	-	(14)	(14)
Trust Preferred Securities	-	(135)	(135)	-	(470)	(470)
Other	38	(37)	1	89	(320)	(231)
Total interest expense	117	(2,956)	(2,839)	890	(7,230)	(6,340)
Net interest income	\$ 1,131	(304)	827	3,229	(3,050)	179

Net interest income on a tax equivalent basis totaled \$34.6 million in 2010 as compared to \$33.8 million in 2009. The interest rate spread, which represents the rate earned on interest-earning assets less the rate paid on interest-bearing liabilities, was 3.21% in 2010, an increase from the 2009 net interest spread of 3.17%. The net yield on interest-earning assets in 2010 decreased to 3.46% from the 2009 net yield on interest-earning assets of 3.53%.

Tax equivalent interest income decreased \$2.0 million or 4% in 2010 primarily due to a reduction loan balances and in increase in non-performing loans. The yield on interest-earning assets decreased to 4.90% in 2010 from 5.33% in 2009. Average interest-earning assets increased \$42.4 million primarily as the result of a \$58.7 million increase in average investment securities, which was partially offset by a \$24.9 million decrease in the average outstanding balance of loans. All other interest-earning assets including federal funds sold were \$21.7 million in 2010 and \$13.1 million in 2009.

Interest expense decreased \$2.8 million or 17% in 2010 due to a decrease in the average rate paid on interest-bearing liabilities. The cost of funds decreased to 1.69% in 2010 from 2.16% in 2009. This decrease in the cost of funds was

primarily attributable to decreases in the average rate paid on interest-bearing checking and savings accounts and certificates of deposit. The \$53.6 million growth in average interest-bearing liabilities was primarily attributable to an increase in interest-bearing checking and savings accounts of \$69.4 million to \$312.2 million in 2010 from \$242.8 million in 2009.

In 2009 net interest income on a tax equivalent basis increased \$33.8 million in 2009 from \$33.6 million in 2008. The interest rate spread was 3.17% in 2009, a decrease from the 2008 net interest spread of 3.34%. The net yield on interest-earning assets in 2009 decreased to 3.53% from the 2008 net yield on interest-earning assets in of 3.83 %.

Provision for Loan Losses. Provisions for loan losses are charged to income in order to bring the total allowance for loan losses to a level deemed appropriate by management of the Company based on factors such as

management's judgment as to losses within the Company's loan portfolio, including the valuation of impaired loans, loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies and management's assessment of the quality of the loan portfolio and general economic climate.

The provision for loan losses was \$16.4 million, \$10.5 million, and \$4.8 million for the years ended December 31, 2010, 2009 and 2008, respectively. The increase in the provision for loan losses for 2010 is primarily attributable to an increase in non-performing assets and a \$10.2 million increase in net charge-offs. Please see the section below entitled "Allowance for Loan Losses" for a more complete discussion of the Bank's policy for addressing potential loan losses.

Non-Interest Income. Non-interest income for 2010 totaled \$13.9 million, an increase of \$2.1 million or 17% from non-interest income of \$11.8 million for 2009. This increase in non-interest income is primarily attributable to a \$2.0 million increase in gains on sale of securities.

Non-interest income for 2009 increased \$1.3 million or 13% from non-interest income of \$10.5 million for 2008. The increase in non-interest income for 2009 are primarily due to an increase gains on sale of securities.

The Company periodically evaluates its investments for any impairment which would be deemed other than temporary. As part of its evaluation in 2010, the Company determined that the fair values of two equity securities were less than the original cost of the investments and that the decline in fair value was not temporary in nature. As a result, the Company wrote down its original investments by \$291,000. The remaining fair value of the investments at December 31, 2010 was approximately \$409,000. Similarly, as part of its evaluation in 2009, the Company wrote down three equity securities by \$723,000. The remaining fair value of the investments at December 31, 2009 was \$11,000.

During the year ended 2008, the Company wrote down one investment by \$300,000. The remaining fair value of the investment at December 31, 2008 was \$22,000.

Net losses on other real estate and repossessed assets were \$704,000, \$501,000 and \$287,000 for 2010, 2009 and 2008, respectively. The increases in net losses on other real estate and repossessed assets during 2010, 2009 and 2008 were primarily attributable to increased write-downs on foreclosed property during the years ended December 31, 2010, 2009 and 2008. Management determined that the market value of these assets had decreased significantly and charges were appropriate in 2010, 2009 and 2008.

Table 3 presents a summary of non-interest income for the years ended December 31, 2010, 2009 and 2008.

Table 3 - Non-Interest Income

(Dollars in thousands)	2010	2009	2008
Service charges	\$5,626	5,573	5,203
Other service charges and fees	2,195	2,058	2,399
Other than temporary impairment losses	(291)	(723)	(300)
Gain on sale of securities	3,348	1,795	133
Mortgage banking income	532	827	660
Insurance and brokerage commissions	390	414	426
Loss on foreclosed and repossessed assets	(704)	(501)	(287)
Miscellaneous	2,788	2,380	2,261
Total non-interest income	\$13,884	11,823	10,495

Non-Interest Expense. Total non-interest expense amounted to \$28.9 million for 2010, a decrease of 3% from 2009. Non-interest expense for 2009 increased 3% to \$29.9 million from non-interest expense of \$28.9 million for 2008.

Salary and employee benefit expense was \$14.1 million in 2010, compared to \$14.8 million during 2009, a decrease of \$634,000 or 4%, following a \$436,00 or 3% decrease in salary and employee benefit expense in 2009 from 2008. The decrease in salary and employee benefits in 2010 was primarily due to a reduction in supplemental retirement plan expense. The decrease in salary and employee benefits in 2009 was primarily attributable to a reduction in incentive expense.

Table 4 presents a summary of non-interest expense for the years ended December 31, 2010, 2009 and 2008.

Table 4 - Non-Interest Expense

(Dollars in thousands)	2010	2009	2008
Salaries and wages	\$11,408	\$11,530	11,591
Employee benefits	2,716	3,228	3,603
Total personnel expense	14,124	14,758	15,194
Occupancy expense	5,436	5,409	5,029
Office supplies	391	426	564
FDIC deposit insurance	1,434	1,766	547
Professional services	467	358	422
Postage	352	342	360
Telephone	629	616	476
Director fees and expense	263	350	450
Advertising	714	860	1,076
Consulting fees	288	198	385
Taxes and licenses	320	248	193
Other operating expense	4,530	4,552	4,197
Total non-interest expense	\$28,948	\$29,883	28,893

Income Taxes. The Company reported an income tax benefit of \$11,000 for the year ended December 31, 2010. Total income tax expense was \$1.3 million in 2009 compared to \$3.2 million in 2008 and \$5.3 million in 2007. The Company's effective tax rates were -0.60%, 31.47% and 33.46% in 2010, 2009 and 2008, respectively. The decrease in the effective tax rate in 2010 is primarily due to an increase in non-taxable investment income combined with a decrease in earnings before taxes.

Liquidity. The objectives of the Company's liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company's liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of December 31, 2010 such unfunded commitments to extend credit were \$137.0 million, while commitments in the form of standby letters of credit totaled \$3.6 million.

The Company uses several sources to meet its liquidity requirements. The primary source is core deposits, which includes demand deposits, savings accounts and non-brokered certificates of deposits of denominations less than \$100,000. The Company considers these to be a stable portion of the Company's liability mix and the result of on-going consumer and commercial banking relationships. As of December 31, 2010, the Company's core deposits totaled \$592.7 million, or 71% of total deposits.

The other sources of funding for the Company are through large denomination certificates of deposit, including brokered deposits, federal funds purchased, securities under agreement to repurchase and FHLB borrowings. The Bank is also able to borrow from the Federal Reserve on a short-term basis. The Bank's policies include the ability to access wholesale funding up to 40% of total assets. The Bank's wholesale funding includes FHLB borrowings, FRB borrowings, brokered deposits, internet certificates of deposit and certificates of deposit issued to the State of North Carolina. The Company's ratio of wholesale funding to total assets was 8.69% as of December 31, 2010.

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At December 31, 2010, the Bank had a significant amount of deposits in amounts greater than \$100,000, including brokered deposits of \$87.4 million, which have an average maturity of 13 months. Brokered deposits include certificates of deposit participated through the Certificate of Deposit Account Registry Service (CDARS) on behalf of local customers. CDARS balances totaled \$53.0 million as of December 31, 2010. The balance and cost of brokered deposits are more susceptible to changes in the interest rate environment than other deposits. Access to the brokered deposit market could be restricted if the Bank were to fall below the well capitalized level. For additional information, please see the section below entitled "Deposits."

The Bank has a line of credit with the FHLB equal to 20% of the Bank's total assets, with an outstanding balance of \$70.0 million at December 31, 2010. At December 31, 2010, the carrying value of loans pledged as collateral totaled approximately \$153.8 million. As additional collateral, the Bank has pledged securities to FHLB. At December 31, 2010, the market value of securities pledged to FHLB totaled \$10.0 million. The remaining availability at FHLB was

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\$7.2 million at December 31, 2010. The Bank had no borrowings from the FRB at December 31, 2010. The FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At December 31, 2010, the carrying value of loans pledged as collateral to the FRB totaled approximately \$348.9 million.

The Bank also had the ability to borrow up to \$55.5 million for the purchase of overnight federal funds from five correspondent financial institutions as of December 31, 2010.

The liquidity ratio for the Bank, which is defined as net cash, interest-bearing deposits with banks, federal funds sold and certain investment securities, as a percentage of net deposits and short-term liabilities was 25.87% at December 31, 2010, 19.10% at December 31, 2009 and 11.71% at December 31, 2008. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy for on balance sheet liquidity is 10%.

As disclosed in the Company's Consolidated Statements of Cash Flows included elsewhere herein, net cash provided by operating activities was approximately \$17.8 million during 2010. Net cash used in investing activities of \$44.0 million consisted primarily of purchases of available-for-sale investments totaling \$232.9 million, which were partially offset by maturities, calls and sales of available-for-sale investments, which totaled \$152.7 million. Net cash provided by financing activities amounted to \$18.9 million, primarily from a \$29.4 million net increase in deposits, which was partially offset by a reduction in FRB borrowings of \$7.0 million.

Asset Liability and Interest Rate Risk Management. The objective of the Company's Asset Liability and Interest Rate Risk strategies is to identify and manage the sensitivity of net interest income to changing interest rates and to minimize the interest rate risk between interest-earning assets and interest-bearing liabilities at various maturities. This is done in conjunction with the need to maintain adequate liquidity and the overall goal of maximizing net interest income. Table 5 presents an interest rate sensitivity analysis for the interest-earning assets and interest-bearing liabilities for the year ended December 31, 2010.

Table 5 - Interest Sensitivity Analysis

(Dollars in thousands)	Immediate	1-3 months	4-12 months	Total Within One Year	Over One Year & Non-sensitive	Total
Interest-earning assets:						
Loans	\$448,896	9,683	14,514	473,093	253,067	726,160
Mortgage loans held for sale	3,814	-	-	3,814	-	3,814
Investment securities available for sale	-	9,743	28,959	38,702	233,747	272,449
Interest-bearing deposit accounts	1,456	-	-	1,456	-	1,456
Certificates of deposit	-	-	735	735	-	735
Other interest-earning assets	-	-	-	-	6,369	6,369
Total interest-earning assets	454,166	19,426	44,208	517,800	493,183	1,010,983
Interest-bearing liabilities:						
NOW, savings, and money market deposits	332,511	-	-	332,511	-	332,511
Time deposits	24,318	92,162	126,852	243,332	148,077	391,409
Other short term borrowings	1,600	-	-	1,600	-	1,600
FHLB borrowings	-	-	-	-	70,000	70,000

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Securities sold under						
agreement to repurchase	34,094	-	-	34,094	-	34,094
Trust preferred securities	-	20,619	-	20,619	-	20,619
Total interest-bearing liabilities	392,523	112,781	126,852	632,156	218,077	850,233
Interest-sensitive gap	\$61,643	(93,355)(82,644)(114,356)275,106	160,750
Cumulative interest-sensitive gap	\$61,643	(31,712)(114,356)(114,356)160,750	
Interest-earning assets as a percentage of interest-bearing liabilities						
	115.70%	17.22%	34.85%	81.91%	226.15%	

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The Company manages its exposure to fluctuations in interest rates through policies established by the Asset/Liability Committee (“ALCO”) of the Bank. The ALCO meets monthly and has the responsibility for approving asset/liability management policies, formulating and implementing strategies to improve balance sheet positioning and/or earnings and reviewing the interest rate sensitivity of the Company. ALCO tries to minimize interest rate risk between interest-earning assets and interest-bearing liabilities by attempting to minimize wide fluctuations in net interest income due to interest rate movements. The ability to control these fluctuations has a direct impact on the profitability of the Company. Management monitors this activity on a regular basis through analysis of its portfolios to determine the difference between rate sensitive assets and rate sensitive liabilities.

The Company’s rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available for sale securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits and borrowed funds. As shown in Table 5, the Company’s balance sheet is asset-sensitive, meaning that in a given period there will be more assets than liabilities subject to immediate repricing as interest rates change in the market. Because most of the Company’s loans are tied to the prime rate, they reprice more rapidly than rate sensitive interest-bearing deposits. During periods of rising rates, this results in increased net interest income. The opposite occurs during periods of declining rates. Rate sensitive assets at December 31, 2010 totaled \$1.0 billion, exceeding rate sensitive liabilities of \$850.2 million by \$160.8 million.

Included in the rate sensitive assets are \$418.7 million in variable rate loans indexed to prime rate subject to immediate repricing upon changes by the Federal Open Market Committee (“FOMC”). The Bank utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At December 31, 2010, the Bank had \$322.9 million in loans with interest rate floors. The floors were in effect on \$320.8 million of these loans pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 1.12% higher than the indexed rate on the promissory notes without interest rate floors.

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. As of December 31, 2010, the Company had a cash flow hedge with a notional amount of \$50.0 million. This derivative instrument consists of one interest rate swap contract. The interest rate swap contract is used to convert \$50.0 million of variable rate loans to a fixed rate. Under the swap contract, the Company receives a fixed rate of 6.245% and pays a variable rate based on the current prime rate (3.25% at December 31, 2010) on the notional amount of \$50.0 million. The swap agreement matures in June 2011. The Company recognized \$1.5 million in interest income on interest rate derivative contracts during the year ended December 31, 2010. Based on the current interest rate environment, it is expected the Company will continue to receive income on this interest rate contract through June 2011. The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in Accumulated Other Comprehensive Income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2010, such derivatives were used to hedge the variable cash inflows associated with existing pools of prime-based loan assets. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. The Company recognized a hedge ineffectiveness gain of \$1,000 in earnings during the year ended December 31, 2009.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest income or expense as interest payments are received/made on the Company’s variable-rate assets/liabilities. During the next twelve months, the Company estimates that \$648,000 will be reclassified as an increase to interest income.

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Table 6 presents additional information on the Company's derivative financial instruments as of December 31, 2010.

Table 6 - Derivative Instruments
(Dollars in thousands)

Type of Derivative	Notional Amount	Contract Rate	Year-to-date Income
Interest rate swap contact expiring 06/01/11	50,000	6.245%	1,518
	\$ 50,000		\$ 1,518

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An analysis of the Company's financial condition and growth can be made by examining the changes and trends in interest-earning assets and interest-bearing liabilities. A discussion of these changes and trends follows.

Analysis of Financial Condition

Investment Securities. All of the Company's investment securities are held in the available-for-sale ("AFS") category. At December 31, 2010 the market value of AFS securities totaled \$272.4 million, compared to \$195.1 million and \$124.9 million at December 31, 2009 and 2008, respectively. The increase in 2010 investment securities reflects the investment of additional funds received from growth in deposits and a decrease in loans. Table 7 presents the market value of the AFS securities held at December 31, 2010, 2009 and 2008.

Table 7 - Summary of Investment Portfolio

(Dollars in thousands)	2010	2009	2008
Obligations of United States government sponsored enterprises	\$ 42,640	41,142	58,487
Obligations of states and political subdivisions	87,829	44,336	26,973
Mortgage-backed securities	139,361	107,526	37,271
Trust preferred securities	1,250	1,250	1,250
Equity securities	1,369	861	935
Total securities	\$ 272,449	195,115	124,916

The composition of the investment securities portfolio reflects the Company's investment strategy of maintaining an appropriate level of liquidity while providing a relatively stable source of income. The investment portfolio also provides a balance to interest rate risk and credit risk in other categories of the balance sheet while providing a vehicle for the investment of available funds, furnishing liquidity, and supplying securities to pledge as required collateral for certain deposits.

The Company's investment portfolio consists of U.S. government sponsored enterprise securities, municipal securities, U.S. government enterprise sponsored mortgage-backed securities, and trust preferred securities and equity securities. AFS securities averaged \$219.8 million in 2010, \$161.1 million in 2009 and \$115.9 million in 2008. Table 8 presents the amortized cost of AFS securities held by the Company by maturity category at December 31, 2010. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields are calculated on a tax equivalent basis. Yields and interest income on tax-exempt investments have been adjusted to tax equivalent basis using an effective tax rate 38.55% for securities that are both federal and state tax exempt and an effective tax rate of 6.90% for state tax exempt securities.

Table 8 - Maturity Distribution and Weighted Average Yield on Investments

(Dollars in thousands)	One Year or Less		After One Year Through 5 Years		After 5 Years Through 10 Years		After 10 Years		Totals	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Book value:										

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United States Government sponsored enterprises	\$85	3.28%	35,248	2.94%	6,179	2.98%	1,128	3.27%	42,640	3.09%
States and political subdivisions	3,626	4.69%	18,083	3.82%	47,826	3.57%	18,295	4.25%	87,831	4.08%
Mortgage backed securities	32,373	3.11%	88,814	3.08%	13,786	3.00%	4,388	3.33%	139,361	3.12%
Trust preferred securities	-	-	-	-	1,000	4.40%	250	5.30%	1,250	4.94%
Equity securities	-	-	-	-	-	-	982	0.00%	982	0.00%
Total securities	\$36,084	2.22%	142,145	1.97%	68,791	2.79%	25,043	3.23%	272,063	3.05%

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Loans. The loan portfolio is the largest category of the Company's earning assets and is comprised of commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. The Company grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg, Union and Wake counties in North Carolina.

Although the Company has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by real estate, which is dependent upon the real estate market. Real estate mortgage loans include both commercial and residential mortgage loans. At December 31, 2010, the Company had \$124.0 million in residential mortgage loans, \$99.9 million in home equity loans and \$283.6 million in commercial mortgage loans, which include \$219.9 million using commercial property as collateral and \$63.7 million using residential property as collateral. Residential mortgage loans include \$68.4 million made to customers in the Company's traditional banking offices and \$55.6 million in mortgage loans originated in the Company's Latino banking operations. All residential mortgage loans are originated as fully amortizing loans, with no negative amortization.

At December 31, 2010, the Company had \$124.0 million in acquisition, development and construction ("AD&C") loans. Table 9 presents a breakout of these loans.

Table 9 - AD&C Loans

(Dollars in thousands)	Number of Loans	Balance Outstanding	Non-accrual Balance
Land acquisition and development - commercial purposes	81	\$25,190	\$3,292
Land acquisition and development - residential purposes	371	84,499	19,053
1 to 4 family residential construction	45	13,039	342
Commercial construction	3	1,320	248
Total acquisition, development and construction	500	\$124,048	\$22,935

The mortgage loans originated in the traditional banking offices are generally 15 to 30 year fixed rate loans with attributes that prevent the loans from being sellable in the secondary market. These factors may include higher loan-to-value ratio, limited documentation on income, non-conforming appraisal or non-conforming property type; these loans are generally made to existing Bank customers. These loans have been originated throughout the Company's five county service area, with no geographic concentration. At December 31, 2010, there were 166 loans mortgage loans originated in the traditional banking offices with an outstanding balance of \$17.4 million that were 30 days or more past due and 79 loans with an outstanding balance of \$9.4 million in non-accrual.

The mortgage loans originated in the Company's Latino operations are primarily adjustable rate mortgage loans that adjust annually after the end of the first five years of the loan. The loans are tied to the one-year T-Bill index and, if they were to adjust at December 31, 2010, would have a reduction in the interest rate on the loan. The underwriting on these loans includes both full income verification and no income verification, with loan-to-value ratios of up to 95% without private mortgage insurance. A majority of these loans would be considered subprime loans, as they were underwritten using stated income rather than fully documented income verification. No other loans in the Company's portfolio would be considered subprime. The majority of these loans have been originated within the Charlotte, NC metro area (Mecklenburg County). At this time, Charlotte has experienced a decline in values within the residential real estate market. At December 31, 2010 there were 148 loans with an outstanding balance of \$16.0 million 30 days or more past due and 37 loans with an outstanding balance of \$3.5 million in non-accrual. Total losses on this portfolio, since the first loans were originated in 2004, have amounted to approximately \$1.2 million through December 31, 2010.

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As a recipient of CPP funds, the Bank will continue to work with delinquent borrowers in an attempt to mitigate foreclosure. The funds have been used to absorb losses incurred when modifying loans or making concessions to borrowers in order to keep borrowers out of foreclosure.

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The composition of the Company's loan portfolio is presented in Table 10.

Table 10 - Loan Portfolio

(Dollars in thousands)	2010		2009		2008		2007		2006	
	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans
Breakdown of loan receivables:										
Commercial	\$60,994	8.40%	\$67,487	8.67%	76,945	9.85%	82,190	11.38%	85,064	13.06%
Real estate - mortgage	507,250	69.85%	512,963	65.93%	474,732	60.77%	417,709	57.83%	364,595	55.97%
Real estate - construction	124,048	17.08%	169,680	21.81%	216,188	27.67%	209,644	29.03%	187,960	28.86%
Consumer	33,868	4.66%	27,926	3.59%	13,323	1.71%	12,734	1.76%	13,762	2.11%
Total loans	\$726,160	100.00%	\$778,056	100.00%	781,188	100.00%	722,277	100.00%	651,381	100.00%
Less: Allowance for loan losses	15,493		15,413		11,025		9,103		8,303	
Net loans	\$710,667		\$762,643		770,163		713,174		643,078	

As of December 31, 2010, gross loans outstanding were \$726.2 million, a decrease of \$51.9 million from the December 31, 2009 balance of \$778.1 million. Commercial loans decreased \$6.5 million in 2010. Real estate mortgage loans decreased \$5.7 million when compared to 2009. Real estate construction loans decreased \$45.6 million in 2010 as a result of a decrease in AD&C loans. Consumer loans increased \$5.9 million in 2010. Loans originated or renewed during the year ended December 31, 2010 amounting to approximately \$85.5 million were offset by paydowns and payoffs of existing loans. Average loans represented 76% and 82% of total earning assets for the years ended December 31, 2010 and 2009, respectively. The Company had \$3.8 million and \$2.8 million in mortgage loans held for sale as of December 31, 2010 and 2009, respectively.

At December 31, 2010, troubled debt restructured ("TDR") loans amounted to \$56.7 million, including \$10.0 million in performing TDR loans. The terms of these loans have been renegotiated to provide a reduction in principal or interest as a result of the deteriorating financial position of the borrower. At December 31, 2009, TDR loans amounted to \$9.2 million, including \$3.8 million in performing TDR loans. The increase in TDR loans at December 31, 2010 compared to December 31, 2009 is primarily due to the classification of all non-accrual loans as TDR as of December 31, 2010.

Table 11 identifies the maturities of all loans as of December 31, 2010 and addresses the sensitivity of these loans to changes in interest rates.

Table 11 - Maturity and Repricing Data for Loans

(Dollars in thousands)	Within one year or less	After one year through five years	After five years	Total loans

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Commercial	\$50,968	9,220	806	60,994
Real estate - mortgage	287,256	151,011	68,983	507,250
Real estate - construction	114,322	8,479	1,247	124,048
Consumer	20,548	11,884	1,436	33,868
Total loans	\$473,094	180,594	72,472	726,160
Total fixed rate loans	\$25,349	148,198	72,472	246,019
Total floating rate loans	447,745	32,396	-	480,141
Total loans	\$473,094	180,594	72,472	726,160

In the normal course of business, there are various commitments outstanding to extend credit that are not reflected in the financial statements. At December 31, 2010, outstanding loan commitments totaled \$137.0 million. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the commitment contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Additional information regarding

commitments is provided below in the section entitled “Contractual Obligations” and in Note 10 to the Consolidated Financial Statements.

Allowance for Loan Losses. The allowance for loan losses reflects management's assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The Bank periodically analyzes the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate in light of anticipated risks and loan losses. In assessing the adequacy of the allowance, size, quality and risk of loans in the portfolio are reviewed. Other factors considered are:

- the Bank's loan loss experience;
- the amount of past due and non-performing loans;
 - specific known risks;
- the status and amount of other past due and non-performing assets;
 - underlying estimated values of collateral securing loans;
 - current and anticipated economic conditions; and
- other factors which management believes affect the allowance for potential credit losses.

Management uses several measures to assess and monitor the credit risks in the loan portfolio, including a loan grading system that begins upon loan origination and continues until the loan is collected or collectibility becomes doubtful. Upon loan origination, the Bank's originating loan officer evaluates the quality of the loan and assigns one of nine risk grades. The loan officer monitors the loan's performance and credit quality and makes changes to the credit grade as conditions warrant. When originated or renewed, all loans over a certain dollar amount receive in-depth reviews and risk assessments by the Bank's Credit Administration. Before making any changes in these risk grades, management considers assessments as determined by the third party credit review firm (as described below), regulatory examiners and the Bank's Credit Administration. Any issues regarding the risk assessments are addressed by the Bank's senior credit administrators and factored into management's decision to originate or renew the loan. The Bank's Board of Directors reviews, on a monthly basis, an analysis of the Bank's reserves relative to the range of reserves estimated by the Bank's Credit Administration.

As an additional measure, the Bank engages an independent third party to review the underwriting, documentation and risk grading analyses. This independent third party reviews and evaluates all loan relationships greater than \$1.0 million. The third party's evaluation and report is shared with management and the Bank's Board of Directors.

Management considers certain commercial loans with weak credit risk grades to be individually impaired and measures such impairment based upon available cash flows and the value of the collateral. Allowance or reserve levels are estimated for all other graded loans in the portfolio based on their assigned credit risk grade, type of loan and other matters related to credit risk.

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

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Company's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below.

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The general allowance reflects reserves established for collective loan impairment. These reserves are based upon historical net charge-offs using the last two years' experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends.

The unallocated allowance is determined through management's assessment of probable losses that are in the portfolio but are not adequately captured by the other two components of the allowance, including consideration of current economic and business conditions and regulatory requirements. The unallocated allowance also reflects management's acknowledgement of the imprecision and subjectivity that underlie the modeling of credit risk. Due to the subjectivity involved in determining the overall allowance, including the unallocated portion, this unallocated portion may fluctuate from period to period based on management's evaluation of the factors affecting the assumptions used in calculating the allowance.

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Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Company's loan portfolio as of the date of the financial statements. Management believes it has established the allowance in accordance with GAAP and in consideration of the current economic environment. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the year ended December 31, 2010 as compared to the year ended December 31, 2009. Such revisions, estimates and assumptions are made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

Additionally, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require adjustments to the allowance based on their judgments of information available to them at the time of their examinations. Management believes it has established the allowance for credit losses pursuant to GAAP, and has taken into account the views of its regulators and the current economic environment.

Net charge-offs for 2010 were \$16.4 million. The ratio of net charge-offs to average total loans was 2.16% in 2010, 0.79% in 2009 and 0.38% in 2008. The Bank strives to proactively work with its customers to identify potential problems. If found, the Bank works to quickly recognize identifiable losses and to establish a plan, with the borrower, if possible, to have the loans paid off. This process increased the levels of charge-offs and provision for loan losses in 2010. Management expects the ratio of net charge-offs to average total loans to increase again in 2011 due to the recessionary economic conditions and the decline in real estate values and new home sales. The allowance for loan losses was \$15.5 million or 2.13% of total loans outstanding at December 31, 2010. For December 31, 2009 and 2008, the allowance for loan losses amounted to \$15.4 million or 1.98% of total loans outstanding and \$11.0 million, or 1.41% of total loans outstanding, respectively. Management would expect provision expense and the percentage of the allowance for loan losses to total loans to increase in 2011 if non-performing loans and net charge-offs continue to increase as a result of the current recessionary economic conditions.

Table 12 presents the percentage of loans assigned to each risk grade along with the general reserve percentage applied to loans in each risk grade at December 31, 2010 and 2009.

Table 12 - Loan Risk Grade Analysis

Risk Grade	Percentage of Loans By Risk Grade*	
	2010	2009
Risk Grade 1 (Excellent Quality)	3.36%	3.51%
Risk Grade 2 (High Quality)	16.60%	16.30%
Risk Grade 3 (Good Quality)	47.00%	50.99%
Risk Grade 4 (Management Attention)	21.31%	17.12%
Risk Grade 5 (Watch)	2.84%	7.41%
Risk Grade 6 (Substandard)	3.09%	1.45%
Risk Grade 7 (Low Substandard)	0.00%	0.04%
Risk Grade 8 (Doubtful)	0.00%	0.00%
Risk Grade 9 (Loss)	0.00%	0.00%

* Excludes non-accrual loans

Table 13 presents an analysis of the allowance for loan losses, including charge-off activity.

Table 13 - Analysis of Allowance for Loan Losses

(Dollars in thousands)	2010	2009	2008	2007	2006
Allowance for loan losses at beginning	\$ 15,413	\$ 11,025	9,103	8,303	7,425
Loans charged off:					
Commercial	1,730	697	249	414	505
Real estate - mortgage	4,194	3,384	1,506	471	568
Real estate - construction	10,224	1,754	644	252	250
Consumer	763	835	748	489	636
Total loans charged off	16,911	6,670	3,147	1,626	1,959
Recoveries of losses previously charged off:					
Commercial	62	111	87	86	64
Real estate - mortgage	162	161	8	21	108
Real estate - construction	89	36	30	102	2
Consumer	240	215	150	179	150
Total recoveries	553	523	275	388	324
Net loans charged off	16,358	6,147	2,872	1,238	1,635
Provision for loan losses	16,438	10,535	4,794	2,038	2,513
Allowance for loan losses at end of year	\$ 15,493	\$ 15,413	11,025	9,103	8,303
Loans charged off net of recoveries, as a percent of average loans outstanding	2.16%	0.79%	0.38%	0.19%	0.27%
Allowance for loan losses as a percent of total loans outstanding at end of year	2.13%	1.98%	1.41%	1.26%	1.27%

Non-performing Assets. Non-performing assets totaled \$46.9 million at December 31, 2010 or 4.40% of total assets, compared to \$28.8 million at December 31, 2009, or 2.74% of total assets. Non-accrual loans were \$40.1 million at December 31, 2010 and \$22.8 million at December 31, 2009. As a percentage of total loans outstanding, non-accrual loans were 5.52% at December 31, 2010 compared to 2.93% at December 31, 2009. Non-performing loans include \$23.1 million in AD&C loans, \$16.2 million in commercial and residential mortgage loans and \$1.0 million in other loans at December 31, 2010 as compared to \$4.8 million in AD&C loans, \$18.3 million in commercial and residential mortgage loans and \$1.7 million in other loans as of December 31, 2009. Included in AD&C non-accrual loans at December 31, 2010 is \$10.9 million in loans to the largest AD&C relationship in the Bank that are current but whose repayment is dependent upon the underlying collateral and whose terms are interest only. The Bank had loans 90 days past due and still accruing totaling \$211,000 and \$2.0 million as of December 31, 2010 and December 31, 2009, respectively. Other Real Estate Owned totaled \$6.7 million as of December 31, 2010 as compared to \$4.0 million at December 31, 2009. The Bank had no repossessed assets as of December 31, 2010 and December 31, 2009.

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At December 31, 2010, the Company had non-performing loans, defined as non-accrual and accruing loans past due more than 90 days, of \$40.3 million or 5.52% of total loans. Non-performing loans at December 31, 2009 were \$24.8 million, or 3.18% of total loans.

Management continually monitors the loan portfolio to ensure that all loans potentially having a material adverse impact on future operating results, liquidity or capital resources have been classified as non-performing. Should economic conditions deteriorate, the inability of distressed customers to service their existing debt could cause higher levels of non-performing loans. Management anticipates continued weakness in the housing market, which combined with the current economic conditions could result in higher levels of non-performing loans in 2011.

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It is the general policy of the Company to stop accruing interest income and place the recognition of interest on a cash basis when a loan is placed on non-accrual status and any interest previously accrued but not collected is reversed against current income. Generally a loan is placed on non-accrual status when it is over 90 days past due and there is reasonable doubt that all principal will be collected.

A summary of non-performing assets at December 31 for each of the years presented is shown in Table 14.

Table 14 - Non-performing Assets

(Dollars in thousands)	2010	2009	2008	2007	2006
Non-accrual loans	\$ 40,062	\$ 22,789	11,815	7,987	7,560
Loans 90 days or more past due and still accruing	210	1,977	514	-	78
Total non-performing loans	40,272	24,766	12,329	7,987	7,638
All other real estate owned	6,673	3,997	1,867	483	344
Total non-performing assets	\$ 46,945	\$ 28,763	14,196	8,470	7,982
As a percent of total loans at year end					
Non-accrual loans	5.52%	2.93%	1.51%	1.11%	1.16%
Loans 90 days or more past due and still accruing	0.03%	0.25%	0.07%	0.00%	0.01%
Total non-performing assets	6.46%	3.70%	1.82%	1.17%	1.23%
Total non-performing assets as a percent of total assets at year end					
	4.40%	2.74%	1.47%	0.93%	0.97%

Deposits. The Company primarily uses deposits to fund its loan and investment portfolios. The Company offers a variety of deposit accounts to individuals and businesses. Deposit accounts include checking, savings, money market and time deposits. As of December 31, 2010, total deposits were \$838.7 million, an increase of \$29.4 million or 4% increase over the December 31, 2009 balance of \$809.3 million. Core deposits, which include demand deposits, savings accounts and non-brokered certificates of deposits of denominations less than \$100,000, increased to \$592.7 million at December 31, 2010 from \$569.0 million at December 31, 2009.

Time deposits in amounts of \$100,000 or more totaled \$241.4 million and \$233.1 million at December 31, 2010 and 2009, respectively. At December 31, 2010, brokered deposits amounted to \$87.4 million as compared to \$84.0 million at December 31, 2009. CDARS balances included in brokered deposits amounted to \$53.0 million and \$49.4 million as of December 31, 2010 and 2009, respectively. Brokered deposits are generally considered to be more susceptible to withdrawal as a result of interest rate changes and to be a less stable source of funds, as compared to deposits from the local market. Brokered deposits outstanding as of December 31, 2010 have a weighted average rate of 1.20% with a weighted average original term of 13 months.

Table 15 is a summary of the maturity distribution of time deposits in amounts of \$100,000 or more as of December 31, 2010.

Table 15 - Maturities of Time Deposits over \$100,000

(Dollars in thousands)	2010
Three months or less	\$72,430
Over three months through six months	28,025

Over six months through twelve months	44,508
Over twelve months	96,403
Total	\$241,366

Borrowed Funds. The Company has access to various short-term borrowings, including the purchase of federal funds and borrowing arrangements from the FHLB and other financial institutions. At December 31, 2010 FHLB borrowings totaled \$70.0 million compared to \$77.0 million at December 31, 2009 and 2008. Average FHLB borrowings for 2010 were \$72.0 million, compared to average balances of \$77.3 million for 2009 and \$79.2 million for 2008. The maximum amount of outstanding FHLB borrowings was \$77.0 million in 2010, and \$87.9 in 2009 and \$97.6 in 2008. The FHLB borrowings outstanding at December 31, 2010 had fixed interest rates ranging from 2.23% to 4.71%. At December 31, 2010, all of the Bank's FHLB borrowings had maturities exceeding one year. The FHLB has the option to convert \$50.0 million of the total advances to a floating rate and, if converted, the Bank may repay advances without a prepayment fee. Additional information regarding FHLB borrowings is provided in Note 6 to the Consolidated Financial Statements.

The Bank had no borrowings from the FRB at December 31, 2010 and 2009. The Bank did not have any FRB borrowings outstanding during 2010. The maximum amount of outstanding FRB borrowings was \$17.5 million in 2009.

Demand notes payable to the U. S. Treasury, which represent treasury tax and loan payments received from customers, amounted to approximately \$1.6 million and \$636,000 at December 31, 2010 and 2009, respectively.

Securities sold under agreements to repurchase amounted to \$34.1 million and \$36.9 million as of December 31, 2010 and 2009, respectively.

Junior Subordinated Debentures (related to Trust Preferred Securities). In June 2006 the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust II (“PEBK Trust II”), which issued \$20.0 million of guaranteed preferred beneficial interests in the Company’s junior subordinated deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase \$20.6 million of junior subordinated debentures of the Company, which pay a floating rate equal to three-month LIBOR plus 163 basis points. The proceeds received by the Company from the sale of the junior subordinated debentures were used to repay in December 2006 the trust preferred securities issued by PEBK Trust in December 2001 and for general purposes. The debentures represent the sole asset of PEBK Trust II. PEBK Trust II is not included in the consolidated financial statements.

The trust preferred securities issued by PEBK Trust II accrue and pay quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II has funds with which to make the distributions and other payments. The net combined effect of the trust preferred securities transaction is that the Company is obligated to make the distributions and other payments required on the trust preferred securities.

These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, on or after June 28, 2011. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount and any accrued but unpaid interest.

Contractual Obligations and Off-Balance Sheet Arrangements. The Company’s contractual obligations and other commitments as of December 31, 2010 are summarized in Table 16 below. The Company’s contractual obligations include the repayment of principal and interest related to FHLB advances and junior subordinated debentures, as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.

Table 16 - Contractual Obligations and Other Commitments

(Dollars in thousands)	Within One Year	One to Three Years	Three to Five Years Five Years	Five Years or More	Total
Contractual Cash Obligations					
Long-term borrowings	\$-	-	10,000	60,000	70,000
Junior subordinated debentures	-	-	-	20,619	20,619
Operating lease obligations	600	727	453	1,440	3,220

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Total	\$ 600	727	10,453	82,059	93,839
Other Commitments					
Commitments to extend credit	\$41,000	6,592	1,397	88,026	137,015
Standby letters of credit and financial guarantees written	3,590	-	-	-	3,590
Total	\$44,590	6,592	1,397	88,026	140,605

The Company enters into derivative contracts to manage various financial risks. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or referenced interest rate. Derivative contracts are carried at fair value on the consolidated balance sheet with the fair value representing the net present value of expected future cash receipts or payments based on market interest rates as of the balance sheet date. Derivative contracts are written in amounts referred to as notional amounts, which only provide the basis for calculating payments between counterparties and are not a measure of financial risk. Therefore, the derivative amounts recorded on the balance sheet do not represent the amounts that may ultimately be paid under these contracts.

Further discussions of derivative instruments are included above in the section entitled “Asset Liability and Interest Rate Risk Management” beginning on page A-15 and in Notes 1, 10, 11 and 16 to the Consolidated Financial Statements.

Capital Resources. Shareholders’ equity at December 31, 2010 was \$96.9 million compared to \$99.2 million at December 31, 2009 and \$101.1 million at December 31, 2008. Unrealized gains and losses, net of taxes, at December 31, 2010, 2009 and 2008 amounted to gains of \$387,000, \$2.9 million and \$5.5 million, respectively. Average shareholders’ equity as a percentage of total average assets is one measure used to determine capital strength. Average shareholders’ equity as a percentage of total average assets was 9.42%, 9.95% and 8.20% for 2010, 2009 and 2008. The return on average shareholders’ equity was 1.81% at December 31, 2010 as compared to 2.88% and 8.38% as of December 31, 2009 and December 31, 2008, respectively. Total cash dividends paid on common stock during 2009 amounted to \$443,000. Cash dividends totaling \$1.4 million and \$2.7 million were paid on common stock during 2009 and 2008, respectively. The Company paid dividends totaling \$1.3 million and \$1.1 million on preferred stock during 2010 and 2009, respectively.

In March 2008, the Company’s Board of Directors authorized the repurchase of up to 100,000 common shares of the Company’s outstanding common stock through its existing Stock Repurchase Plan effective through the end of March 2009. The Company repurchased 65,500 shares, or \$776,000, of its common stock under this plan as of December 31, 2008. Because of the Company’s participation in the UST’s CPP, discussed below, the Company can no longer repurchase shares of its common stock under the Stock Repurchase Plan without UST approval.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights.

On December 23, 2008, the Company entered into a Purchase Agreement with the UST. Under the Purchase Agreement, the Company agreed to issue and sell 25,054 shares of Series A preferred stock and a warrant to purchase 357,234 shares of common stock associated with the Company’s participation in the CPP under the TARP. Proceeds from this issuance of preferred shares were allocated between preferred stock and the warrant based on their relative fair values at the time of the sale. Of the \$25.1 million in proceeds, \$24.4 million was allocated to the Series A preferred stock and \$704,000 was allocated to the common stock warrant. The discount recorded on the preferred stock that resulted from allocating a portion of the proceeds to the warrant is being accreted directly to retained earnings over a five-year period applying a level yield. As of December 31, 2010, the Company has accreted a total of \$266,000 of the discount related to the Series A preferred stock. The Company paid dividends of \$1.3 million on the Series A preferred stock during 2010 and cumulative undeclared dividends at December 31, 2010 were \$157,000.

The Series A preferred stock qualifies as Tier 1 capital and will pay cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Series A preferred stock may be redeemed at the stated amount of \$1,000 per share plus any accrued and unpaid dividends. Under the terms of the original Purchase Agreement, the Company could not redeem the preferred shares until December 23, 2011 unless the total amount of the issuance, \$25.1 million, was replaced with the same amount of other forms of capital that would qualify as Tier 1 capital. However, with the enactment of the ARRA, the Company can now redeem the preferred shares at any time, if approved by the Company’s primary regulator. The Series A preferred stock is non-voting except for class voting rights on matters that would adversely affect the rights of the holders of the Series A preferred stock.

The exercise price of the warrant is \$10.52 per common share and it is exercisable at anytime on or before December 18, 2018.

The Company is subject to the following restrictions while the Series A preferred stock is outstanding: 1) UST approval is required for the Company to repurchase shares of outstanding common stock; 2) the full dividend for the latest completed CPP dividend period must be declared and paid in full before dividends may be paid to common shareholders; 3) UST approval is required for any increase in common dividends per share above the last quarterly dividend of \$0.12 per share paid prior to December 23, 2008; and 4) the Company may not take tax deductions for any senior executive officer whose compensation is above \$500,000. There were additional restrictions on executive compensation added in the ARRA for companies participating in the TARP, including participants in the CPP.

Under regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 4.0% or greater. Tier 1 capital is generally defined as shareholders' equity and trust preferred securities less all intangible assets and goodwill. Tier 1 capital at December 31, 2010, 2009 and 2008 includes \$20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 14.24%, 13.74% and 13.65% at December 31, 2010, 2009 and 2008, respectively. Total risk-based capital is defined as Tier 1 capital plus supplementary capital. Supplementary capital, or Tier 2 capital, consists of the Company's

allowance for loan losses, not exceeding 1.25% of the Company's risk-weighted assets. Total risk-based capital ratio is therefore defined as the ratio of total capital (Tier 1 capital and Tier 2 capital) to risk-weighted assets. The Company's total risk-based capital ratio was 15.51%, 15.00% and 14.90% at December 31, 2010, 2009 and 2008, respectively. In addition to the Tier 1 and total risk-based capital requirements, financial institutions are also required to maintain a leverage ratio of Tier 1 capital to total average assets of 4.0% or greater. The Company's Tier 1 leverage capital ratio was 10.70%, 11.42% and 12.40% at December 31, 2010, 2009 and 2008, respectively.

The Bank's Tier 1 risk-based capital ratio was 11.87%, 11.22% and 9.85% at December 31, 2010, 2009 and 2008, respectively. The total risk-based capital ratio for the Bank was 13.15%, 12.48% and 11.10% at December 31, 2010, 2009 and 2008, respectively. The Bank's Tier 1 leverage capital ratio was 8.91%, 9.33% and 8.94% at December 31, 2010, 2009 and 2008 respectively.

A bank is considered to be "well capitalized" if it has a total risk-based capital ratio of 10.0 % or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and has a leverage ratio of 5.0% or greater. Based upon these guidelines, the Bank was considered to be "well capitalized" at December 31, 2010, 2009 and 2008.

The Company's key equity ratios as of December 31, 2010, 2009 and 2008 are presented in Table 17.

Table 17 - Equity Ratios

	2010	2009	2008
Return on average assets	0.17%	0.29%	0.69%
Return on average equity	1.81%	2.88%	8.38%
Dividend payout ratio *	100.11%	86.22%	41.93%
Average equity to average assets	9.62%	9.95%	8.20%

* As a percentage of net earnings available to common shareholders.

Quarterly Financial Data. The Company's consolidated quarterly operating results for the years ended December 31, 2010 and 2009 are presented in Table 18.

Table 18 - Quarterly Financial Data

(Dollars in thousands, except per share amounts)	2010				2009			
	First	Second	Third	Fourth	First	Second	Third	Fourth
Total interest income	\$ 11,930	11,879	11,995	11,876	\$ 12,581	12,523	12,403	12,530
Total interest expense	3,825	3,682	3,516	3,325	4,702	4,324	4,132	4,029
Net interest income	8,105	8,197	8,479	8,551	7,879	8,199	8,271	8,501
Provision for loan losses	2,382	3,179	4,656	6,221	1,766	2,251	3,139	3,379
Other income	2,610	3,130	3,857	4,287	2,186	4,251	2,503	2,883
Other expense	7,189	7,057	7,182	7,520	7,342	7,956	7,344	7,241
Income before income taxes	1,144	1,091	498	(903)	957	2,243	291	764
Income taxes	269	227	(42)	(465)	332	883	(9)	133

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Net earnings	875	864	540	(438)	625	1,360	300	631
Dividends and accretion of preferred stock	348	349	348	349	201	349	348	348
Net earnings (loss) available to common shareholders	\$ 527	515	192	(787)	\$ 424	1,011	(48)	283
Basic earnings per common share	\$ 0.10	0.09	0.03	(0.14)	\$ 0.08	0.18	(0.01)	0.05
Diluted earnings per common share	\$ 0.10	0.09	0.03	(0.14)	\$ 0.08	0.18	(0.01)	0.05

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QUANTATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk reflects the risk of economic loss resulting from adverse changes in market prices and interest rates. This risk of loss can be reflected in either diminished current market values or reduced potential net interest income in future periods.

The Company's market risk arises primarily from interest rate risk inherent in its lending and deposit taking activities. The structure of the Company's loan and deposit portfolios is such that a significant decline (increase) in interest rates may adversely (positively) impact net market values and interest income. Management seeks to manage the risk through the utilization of its investment securities and off-balance sheet derivative instruments. During the years ended December 31, 2010, 2009 and 2008, the Company used interest rate contracts to manage market risk as discussed above in the section entitled "Asset Liability and Interest Rate Risk Management."

Table 19 presents in tabular form the contractual balances and the estimated fair value of the Company's on-balance sheet financial instruments and the notional amount and estimated fair value of the Company's off-balance sheet derivative instruments at their expected maturity dates for the period ended December 31, 2010. The expected maturity categories take into consideration historical prepayment experience as well as management's expectations based on the interest rate environment at December 31, 2010. All convertible FHLB advances are callable at the option of FHLB. For core deposits without contractual maturity (i.e. interest bearing checking, savings, and money market accounts), the table presents principal cash flows based on management's judgment concerning their most likely runoff or repricing behaviors.

Table 19 - Market Risk Table

(Dollars In Thousands)	Principal/Notional Amount Maturing in Year Ended December 31,						Fair Value
	2011	2012	2013	2014 & 2015	Thereafter	Total	
Loans Receivable							
Fixed rate	\$ 37,748	33,980	43,539	75,720	55,032	246,020	248,249
Average interest rate	6.45%	6.85%	6.36%	5.92%	8.07%		
Variable rate	\$ 174,299	56,362	45,545	63,453	140,484	480,142	478,124
Average interest rate	4.67%	4.52%	4.58%	4.70%	5.05%		
						726,163	726,373
Investment Securities							
Interest bearing cash	\$ 1,456	-	-	-	-	1,456	1,456
Average interest rate	0.01%	-	-	-	-		
Securities available for sale	\$ 40,621	28,292	31,912	47,095	124,529	272,449	272,449
Average interest rate	4.26%	4.93%	5.06%	4.74%	4.62%		
Nonmarketable equity securities	\$ -	-	-	-	5,761	5,761	5,761
Average interest rate	-	-	-	-	0.34%		
Certificates of Deposit	\$ 735	-	-	-	-	735	735
Average interest rate	1.49%	-	-	-	-		
Debt Obligations							
Deposits	\$ 243,154	114,373	23,400	10,478	447,307	838,712	837,779
Average interest rate	1.07%	2.04%	2.24%	2.36%	0.76%		
Advances from FHLB	\$ -	-	20,000	25,000	25,000	70,000	79,950
Average interest rate	-	-	4.27%	4.20%	4.30%		

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Demand notes payable to U.S. Treasury	\$	1,600	-	-	-	-	1,600	1,600
Average interest rate		-	-	-	-	-		
Securities sold under agreement to repurchase	\$	34,094	-	-	-	-	34,094	34,094
Average interest rate		0.94%	-	-	-	-		
Junior subordinated debentures	\$	-	-	-	-	20,619	20,619	20,619
Average interest rate		-	-	-	-	1.87%		
Derivative Instruments (notional amount)								
Interest rate swap contracts	\$	50,000	-	-	-	-	50,000	648
Average interest rate		6.25%	-	-	-	-		

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Table 20 presents the simulated impact to net interest income under varying interest rate scenarios and the theoretical impact of rate changes over a twelve-month period referred to as “rate ramps.” The table shows the estimated theoretical impact on the Company’s tax equivalent net interest income from hypothetical rate changes of plus and minus 1%, 2% and 3% as compared to the estimated theoretical impact of rates remaining unchanged. The table also shows the simulated impact to market value of equity under varying interest rate scenarios and the theoretical impact of immediate and sustained rate changes referred to as “rate shocks” of plus and minus 1%, 2% and 3% compared to the theoretical impact of rates remaining unchanged. The prospective effects of the hypothetical interest rate changes are based upon various assumptions, including relative and estimated levels of key interest rates. This type of modeling has limited usefulness because it does not allow for the strategies management would utilize in response to sudden and sustained rate changes. Also, management does not believe that rate changes of the magnitude presented are likely in the forecast period presented.

Table 20 - Interest Rate Risk

(Dollars in thousands)

Hypothetical rate change (ramp over 12 months)	Estimated Resulting Theoretical Net Interest Income	
	Amount	% Change
+3%	\$ 33,879	-2.39%
+2%	\$ 33,822	-2.55%
+1%	\$ 34,030	-1.95%
0%	\$ 34,707	0.00%
-1%	\$ 34,650	-0.16%
-2%	\$ 33,858	-2.45%
-3%	\$ 32,954	-5.05%

Hypothetical rate change (immediate shock)	Estimated Resulting Theoretical Market Value of Equity	
	Amount	% Change
+3%	\$ 86,322	-23.17%
+2%	\$ 97,155	-13.53%
+1%	\$ 104,931	-6.61%
0%	\$ 112,356	0.00%
-1%	\$ 113,002	0.57%
-2%	\$ 111,772	-0.52%
-3%	\$ 104,816	-6.71%

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES
 Consolidated Financial Statements
 December 31, 2010, 2009 and 2008

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Porter Keadle Moore, LLP

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
Peoples Bancorp of North Carolina, Inc.
Newton, North Carolina

We have audited the accompanying consolidated balance sheets of Peoples Bancorp of North Carolina, Inc. and subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of earnings, changes in shareholders' equity, comprehensive income and cash flows for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included 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 Peoples Bancorp of North Carolina, Inc. and subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

We were not engaged to examine management's assessment of the effectiveness of Peoples Bancorp of North Carolina, Inc.'s internal control over financial reporting as of December 31, 2010, included in the accompanying Management's Report of Internal Controls Over Financial Reporting and, accordingly, we do not express an opinion thereon.

/s/Porter Keadle Moore, LLP

Atlanta, Georgia
March 25, 2011

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

December 31, 2010 and 2009

(Dollars in thousands)

Assets	2010	2009
Cash and due from banks, including reserve requirements\$ of \$8,698,000 and \$5,017,000	22,521	29,633
Interest bearing deposits	1,456	1,707
Cash and cash equivalents	23,977	31,340
Certificates of deposit	735	3,345
Investment securities available for sale	272,449	195,115
Other investments	5,761	6,346
Total securities	278,210	201,461
Mortgage loans held for sale	3,814	2,840
Loans	726,160	778,056
Less allowance for loan losses	(15,493)	(15,413)
Net loans	710,667	762,643
Premises and equipment, net	17,334	17,947
Cash surrender value of life insurance	7,539	7,282
Accrued interest receivable and other assets	25,376	21,636
Total assets	\$ 1,067,652	1,048,494
Liabilities and Shareholders' Equity		
Deposits:		
Non-interest bearing demand	\$ 114,792	117,636
NOW, MMDA & savings	332,511	290,273
Time, \$100,000 or more	241,366	233,142
Other time	150,043	168,292
Total deposits	838,712	809,343
Demand notes payable to U.S. Treasury	1,600	636
Securities sold under agreement to repurchase	34,094	36,876
FHLB borrowings	70,000	77,000
Junior subordinated debentures	20,619	20,619
Accrued interest payable and other liabilities	5,769	4,797
Total liabilities	970,794	949,271

Commitments

Shareholders' equity:

Series A preferred stock, \$1,000 stated value; authorized

5,000,000 shares; issued and outstanding

25,054 shares in 2010 and 2009 24,617 24,476

Common stock, no par value; authorized

20,000,000 shares; issued and outstanding

5,541,413 shares in 2010 and 5,539,056 shares in 2009 48,281 48,269

Retained earnings 23,573 23,573

Accumulated other comprehensive income 387 2,905

Total shareholders' equity 96,858 99,223

Total liabilities and shareholders' equity \$ 1,067,652 1,048,494

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

For the Years Ended December 31, 2010, 2009 and 2008

(Dollars in thousands, except per share amounts)

	2010	2009	2008
Interest income:			
Interest and fees on loans	\$ 40,267	43,211	50,604
Interest on federal funds sold	-	1	55
Interest on investment securities:			
U.S. Government sponsored enterprises	5,035	5,461	4,392
States and political subdivisions	2,173	1,242	904
Other	205	122	367
Total interest income	47,680	50,037	56,322
Interest expense:			
NOW, MMDA & savings deposits	3,472	2,965	3,249
Time deposits	6,786	9,687	15,008
FHLB borrowings	3,285	3,577	3,616
Junior subordinated debentures	411	546	1,016
Other	394	412	637
Total interest expense	14,348	17,187	23,526
Net interest income	33,332	32,850	32,796
Provision for loan losses	16,438	10,535	4,794
Net interest income after provision for loan losses	16,894	22,315	28,002
Other income:			
Service charges	5,626	5,573	5,203
Other service charges and fees	2,195	2,058	2,399
Other than temporary impairment losses	(291)	(723)	(300)
Gain on sale of securities	3,348	1,795	133
Mortgage banking income	532	827	660
Insurance and brokerage commissions	390	414	426
Loss on sale and write-down of other real estate and repossessed assets	(704)	(501)	(287)
Miscellaneous	2,788	2,380	2,261
Total non-interest income	13,884	11,823	10,495
Non-interest expense:			

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Salaries and employee benefits	14,124	14,758	15,194
Occupancy	5,436	5,409	5,029
Other	9,388	9,716	8,670
Total non-interest expense	28,948	29,883	28,893
Earnings before income taxes	1,830	4,255	9,604
Income tax (benefit) expense	(11)	1,339	3,213
Net earnings	1,841	2,916	6,391
Dividends and accretion of preferred stock	1,394	1,246	-
Net earnings available to common shareholders	\$ 447	1,670	6,391
Basic net earnings per common share	\$ 0.08	0.30	1.14
Diluted net earnings per common share	\$ 0.08	0.30	1.13
Cash dividends declared per common share	\$ 0.08	0.26	0.48

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC.

Consolidated Statements of Changes in Shareholders' Equity

For the Years Ended December 31, 2010, 2009 and 2008

(Dollars in thousands)

	Stock Shares		Stock Amount		Retained	Accumulated Other Comprehensive	Total
	Preferred	Common	Preferred	Common	Earnings	Income	
Balance, December 31, 2007	-	5,624,234	\$ -	48,652	19,742	1,708	70,102
Cumulative effect of adoption of EITF 06-4	-	-	-	-	(467)	-	(467)
Issuance of Series A preferred stock	25,054	-	24,350	704	-	-	25,054
Cash dividends declared on common stock	-	-	-	-	(2,681)	-	(2,681)
Repurchase and retirement of common stock	-	(90,500)	-	(1,126)	-	-	(1,126)
Exercise of stock options	-	5,322	-	44	-	-	44
Restricted stock/stock option compensation expense	-	-	-	(5)	-	-	(5)
Net earnings	-	-	-	-	6,391	-	6,391
Change in accumulated other comprehensive income, net of tax	-	-	-	-	-	3,816	3,816
Balance, December 31, 2008	25,054	5,539,056	\$ 24,350	48,269	22,985	5,524	101,128
Adjustment to the							

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cumulative effect of adoption of EITF 06-4	-	-	-	-	358	-	358
Accretion of Series A preferred stock	-	-	126	-	(126)	-	-
Cash dividends declared on Series A preferred stock	-	-	-	-	(1,120)	-	(1,120)
Cash dividends declared on common stock	-	-	-	-	(1,440)	-	(1,440)
Net earnings	-	-	-	-	2,916	-	2,916
Change in accumulated other comprehensive income, net of tax	-	-	-	-	-	(2,619)	(2,619)
Balance, December 31, 2009	25,054	5,539,056	\$ 24,476	48,269	23,573	2,905	99,223
Accretion of Series A preferred stock	-	-	141	-	(141)	-	-
Cash dividends declared on Series A preferred stock	-	-	-	-	(1,253)	-	(1,253)
Cash dividends declared on common stock	-	-	-	-	(447)	-	(447)
Restricted stock payout	-	2,357	-	12	-	-	12
Net earnings	-	-	-	-	1,841	-	1,841
Change in accumulated other comprehensive income, net of tax	-	-	-	-	-	(2,518)	(2,518)
Balance, December 31, 2010	25,054	5,541,413	\$ 24,617	48,281	23,573	387	96,858

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Loss)

For the Years Ended December 31, 2010, 2009 and 2008

(Dollars in thousands)

	2010	2009	2008
Net earnings	\$ 1,841	2,916	6,391
Other comprehensive income (loss):			
Unrealized holding gains on securities available for sale	46	214	2,145
Reclassification adjustment for other than temporary impairment losses included in net earnings	291	723	300
Reclassification adjustment for gains on sales of securities available for sale included in net earnings	(3,348)	(1,795)	(133)
Unrealized holding (losses) gains on derivative financial instruments qualifying as cash flow hedges	(1,114)	(2,726)	3,744
Reclassification adjustment for gains on derivative financial instruments qualifying as cash flow hedges included in net earnings	-	(1)	-
Total other comprehensive income (loss), before income taxes	(4,125)	(3,585)	6,056
Income tax (benefit) expense related to other comprehensive income (loss):			
Unrealized holding gains on securities available for sale	18	83	836
Reclassification adjustment for losses (gains) on sales and write-downs of securities available for sale included in net earnings	(1,191)	(417)	65

Unrealized holding (losses) gains on derivative financial instruments qualifying as cash flow hedges	(434)	(632)	1,339
Total income tax (benefit) expense related to other comprehensive income	(1,607)	(966)	2,240
Total other comprehensive (loss) income, net of tax	(2,518)	(2,619)	3,816
Total comprehensive (loss) income	\$ (677)	297	10,207

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC.

Consolidated Statements of Cash Flows

For the Years Ended December 31, 2010, 2009 and 2008

(Dollars in thousands)

	2010	2009	2008
Cash flows from operating activities:			
Net earnings	\$ 1,841	2,916	6,391
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation, amortization and accretion	4,971	2,931	1,679
Provision for loan losses	16,438	10,535	4,794
Deferred income taxes	(523)	(1,720)	(485)
Gain on sale of investment securities	(3,348)	(1,795)	(133)
Write-down of investment securities	291	723	300
Gain on ineffective portion of derivative financial instruments	-	(1)	-
(Gain)/loss on sale of other real estate and repossessions	(191)	24	47
Write-down of other real estate and repossessions	895	477	240
Restricted stock expense	10	4	12
Change in:			
Mortgage loans held for sale	(974)	(2,840)	-
Cash surrender value of life insurance	(257)	(263)	(243)
Other assets	(2,316)	(6,581)	(19)
Other liabilities	961	300	(1,851)
Net cash provided by operating activities	17,798	4,710	10,732
Cash flows from investing activities:			
Net change in certificates of deposit	2,610	(3,345)	-
Purchases of investment securities available for sale	(232,915)	(141,770)	(41,659)
Proceeds from calls, maturities and paydowns of investment securities			
available for sale	86,935	40,629	16,488
Proceeds from sales of investment securities available for sale	65,774	30,743	23,448
Purchases of other investments	-	(1,426)	(4,180)
Proceeds from sale of other investments	585	809	4,311
Net change in loans	28,703	(7,916)	(65,188)
Purchases of premises and equipment	(1,441)	(1,614)	(1,857)

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Proceeds from sale of premises and equipment	-	24	34
Proceeds from sale of other real estate and repossessions	5,725	3,435	2,868
Net cash used by investing activities	(44,024)	(80,431)	(65,735)
Cash flows from financing activities:			
Net change in deposits	29,369	88,281	27,424
Net change in demand notes payable to U.S. Treasury	964	(964)	-
Net change in securities sold under agreement to repurchase	(2,782)	(625)	9,917
Proceeds from FHLB borrowings	-	24,100	97,100
Repayments of FHLB borrowings	(7,000)	(24,100)	(107,600)
Proceeds from FRB borrowings	-	45,000	5,000
Repayments of FRB borrowings	-	(50,000)	-
Proceeds from issuance of Series A preferred stock	-	-	25,054
Restricted stock payout	12	-	-
Stock options exercised	-	-	44
Common stock repurchased	-	-	(1,126)
Cash dividends paid on Series A preferred stock	(1,253)	(1,120)	-
Cash dividends paid on common stock	(447)	(1,440)	(2,681)
Net cash provided by financing activities	18,863	79,132	53,132
Net change in cash and cash equivalent	(7,363)	3,411	(1,871)
Cash and cash equivalents at beginning of period	31,340	27,929	29,800
Cash and cash equivalents at end of period	\$ 23,977	31,340	27,929

PEOPLES BANCORP OF NORTH CAROLINA, INC.

Consolidated Statements of Cash Flows, continued

For the Years ended December 31, 2010, 2009 and 2008

(Dollars in thousands)

	2010	2009	2008
Supplemental disclosures of cash flow information:			
Cash paid during the year for:			
Interest	\$ 14,419	17,541	23,799
Income taxes	\$ 1,700	2,230	4,166
Noncash investing and financing activities:			
Change in unrealized gain on investment securities available for sale, net			
	\$ 1,838	(524)	1,411
Change in unrealized gain on derivative financial instruments, net			
	\$ 680	(2,095)	2,405
Transfer of loans to other real estate and repossessions			
	\$ 9,105	6,067	4,539
Financed portion of sale of other real estate			
	\$ 2,270	1,166	1,133
Accretion of Series A preferred stock			
	\$ 141	126	-
Cumulative effect and resulting adjustment of adoption of EITF 06-4			
	\$ -	(358)	467

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC.

Notes to Consolidated Financial Statements

(1) Summary of Significant Accounting Policies

Organization

Peoples Bancorp of North Carolina, Inc. (“Bancorp”) received regulatory approval to operate as a bank holding company on July 22, 1999, and became effective August 31, 1999. Bancorp is primarily regulated by the Board of Governors of the Federal Reserve System, and serves as the one-bank holding company for Peoples Bank (the “Bank”).

The Bank commenced business in 1912 upon receipt of its banking charter from the North Carolina State Banking Commission (the “SBC”). The Bank is primarily regulated by the SBC and the Federal Deposit Insurance Corporation (the “FDIC”) and undergoes periodic examinations by these regulatory agencies. The Bank, whose main office is in Newton, North Carolina, provides a full range of commercial and consumer banking services primarily in Catawba, Alexander, Lincoln, Mecklenburg, Iredell, Union and Wake counties in North Carolina.

Peoples Investment Services, Inc. is a wholly owned subsidiary of the Bank and began operations in 1996 to provide investment and trust services through agreements with an outside party.

Real Estate Advisory Services, Inc. is a wholly owned subsidiary of the Bank and began operations in 1997 to provide real estate appraisal and property management services to individuals and commercial customers of the Bank.

Community Bank Real Estate Solutions, LLC is a wholly owned subsidiary of Bancorp and began operations in 2009 as a “clearing house” for appraisal services for community banks. Other banks are able to contract with Community Bank Real Estate Solutions, LLC to find and engage appropriate appraisal companies in the area where property is located.

Principles of Consolidation

The consolidated financial statements include the financial statements of Peoples Bancorp of North Carolina, Inc. and its wholly owned subsidiaries, the Bank and Community Bank Real Estate Solutions, LLC, along with the Bank’s wholly owned subsidiaries, Peoples Investment Services, Inc. and Real Estate Advisory Services, Inc. (collectively called the “Company”). All significant intercompany balances and transactions have been eliminated in consolidation.

Basis of Presentation

The accounting principles followed by the Company, and the methods of applying these principles, conform with accounting principles generally accepted in the United States of America (“GAAP”) and with general practices in the banking industry. In preparing the financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts in the financial statements. Actual results could differ significantly from these estimates. Material estimates common to the banking industry that are particularly susceptible to significant change in the near term include, but are not limited to, the determination of the allowance for loan losses and valuation of real estate acquired in connection with or in lieu of foreclosure on loans.

Cash and Cash Equivalents

Cash and due from banks, interest bearing deposits and federal funds sold are considered cash and cash equivalents for cash flow reporting purposes. Generally, federal funds are sold for one-day periods.

Investment Securities

The Company classifies its securities in one of three categories: trading, available for sale, or held to maturity. Trading securities are bought and held principally for sale in the near term. Held to maturity securities are those securities for which the Company has the ability and intent to hold until maturity. All other securities not included in trading or held to maturity are classified as available for sale. At December 31, 2010 and 2009, the Company classified all of its investment securities as available for sale.

Available for sale securities are recorded at fair value. Unrealized holding gains and losses, net of the related tax effect, are excluded from earnings and are reported as a separate component of shareholders' equity until realized.

Management evaluates investment securities for other-than-temporary impairment on an annual basis. A decline in the market value of any investment below cost that is deemed other-than-temporary is charged to earnings for the decline in value deemed to be credit related and a new cost basis in the security is established. The decline in value attributed to non-credit related factors is recognized in comprehensive income.

Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to the yield. Realized gains and losses for securities classified as available for sale are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

Other Investments

Other investments include equity securities with no readily determinable fair value. These investments are carried at cost.

Mortgage Loans Held for Sale

Mortgage loans held for sale are carried at lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are reported at the principal amount outstanding, net of the allowance for loan losses. Interest on loans is calculated by using the simple interest method on daily balances of the principal amount outstanding. The recognition of certain loan origination fee income and certain loan origination costs is deferred when such loans are originated and amortized over the life of the loan.

Impaired loans are measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or at the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is impaired when, based on current information and events, it is probable that all amounts due according to the contractual terms of the loan will not be collected.

Accrual of interest is discontinued on a loan when management believes, after considering economic conditions and collection efforts that the borrower's financial condition is such that collection of interest is doubtful. Interest previously accrued but not collected is reversed against current period earnings and interest is recognized on a cash basis when such loans are placed on non-accrual status.

Allowance for Loan Losses

The allowance for loan losses reflects management's assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The Bank periodically analyzes the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate in light of anticipated risks and loan losses. In assessing the adequacy of the allowance, size, quality and risk of loans in the portfolio are reviewed. Other factors considered are:

- the Bank's loan loss experience;
- the amount of past due and non-performing loans;
 - specific known risks;
- the status and amount of other past due and non-performing assets;
 - underlying estimated values of collateral securing loans;
 - current and anticipated economic conditions; and
- other factors which management believes affect the allowance for potential credit losses.

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The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Company's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below.

The general allowance reflects reserves established under GAAP for collective loan impairment. These reserves are based upon historical net charge-offs using the last three years' experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends.

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The unallocated allowance is determined through management's assessment of probable losses that are in the portfolio but are not adequately captured by the other two components of the allowance, including consideration of current economic and business conditions and regulatory requirements. The unallocated allowance also reflects management's acknowledgement of the imprecision and subjectivity that underlie the modeling of credit risk. Due to the subjectivity involved in determining the overall allowance, including the unallocated portion, this unallocated portion may fluctuate from period to period based on management's evaluation of the factors affecting the assumptions used in calculating the allowance.

Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Company's loan portfolio as of the date of the financial statements. Management believes it has established the allowance in accordance with GAAP and in consideration of the current economic environment. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the year ended December 31, 2010 as compared to the year ended December 31, 2009. Such revisions, estimates and assumptions are made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

Additionally, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowances for loan losses. Such agencies may require adjustments to the allowances based on their judgments of information available to them at the time of their examinations. Also, a loan review process further assists with evaluating credit quality and assessing potential performance issues.

Mortgage Banking Activities

Mortgage banking income represents net gains from the sale of mortgage loans and fees received from borrowers and loan investors related to the Company's origination of single-family residential mortgage loans.

Mortgage servicing rights ("MSR's") represent the unamortized cost of purchased and originated contractual rights to service mortgages for others in exchange for a servicing fee. MSRs are amortized over the period of estimated net servicing income and are periodically adjusted for actual prepayments of the underlying mortgage loans. The Company recognized no servicing assets during 2010, 2009 and 2008.

Mortgage loans serviced for others are not included in the accompanying balance sheets. The unpaid principal balances of mortgage loans serviced for others was approximately \$5.3 million, \$6.6 million and \$9.3 million at December 31, 2010, 2009 and 2008, respectively.

The Company originates certain fixed rate mortgage loans and commits these loans for sale. The commitments to originate fixed rate mortgage loans and the commitments to sell these loans to a third party are both derivative contracts. The fair value of these derivative contracts is immaterial and has no effect on the recorded amounts in the financial statements.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed primarily using the straight-line method over the estimated useful lives of the assets. When assets are retired or otherwise disposed, the cost and related accumulated depreciation are removed from the accounts, and any gain or loss is reflected in earnings for the period. The cost of maintenance and repairs that do not improve or extend the useful life of the respective asset is charged to earnings as incurred, whereas significant renewals and improvements are capitalized. The range of estimated useful lives for premises and equipment are generally as follows:

Buildings and improvements	10 - 50 years
Furniture and equipment	3 - 10 years

Foreclosed Assets

Foreclosed assets include all assets received in full or partial satisfaction of a loan and include real and personal property. Foreclosed assets are reported at fair value less estimated selling costs, and are included in other assets on the balance sheet. The balance of other real estate owned was \$6.7 million and \$4.0 million at December 31, 2010 and 2009, respectively.

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Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Additionally, the recognition of future tax benefits, such as net operating loss carryforwards, is required to the extent that the realization of such benefits is more likely than not. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which the assets and liabilities are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period that includes the enactment date.

In the event the future tax consequences of differences between the financial reporting bases and the tax bases of the Company's assets and liabilities results in deferred tax assets, an evaluation of the probability of being able to realize the future benefits indicated by such asset is required. A valuation allowance is provided for the portion of the deferred tax asset when it is more likely than not that some portion or all of the deferred tax asset will not be realized. In assessing the realizability of the deferred tax assets, management considers the scheduled reversals of deferred tax liabilities, projected future taxable income, and tax planning strategies.

The Company accounts for income taxes in accordance with income tax accounting guidance, FASB ASC 740, Income Taxes. On January 1, 2007, the Company adopted the accounting guidance related to accounting for uncertainty in income taxes, which sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions. This guidance prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. This guidance also provides disclosure guidelines for unrecognized tax benefits, interest and penalties. The Company assessed the impact of this guidance and determined that it did not have a material impact on the Company's financial position, results of operations or disclosures.

Derivative Financial Instruments and Hedging Activities

In the normal course of business, the Company enters into derivative contracts to manage interest rate risk by modifying the characteristics of the related balance sheet instruments in order to reduce the adverse effect of changes in interest rates. All derivative financial instruments are recorded at fair value in the financial statements.

On the date a derivative contract is entered into, the Company designates the derivative as a fair value hedge, a cash flow hedge, or a trading instrument. Changes in the fair value of instruments used as fair value hedges are accounted for in the earnings of the period simultaneous with accounting for the fair value change of the item being hedged. Changes in the fair value of the effective portion of cash flow hedges are accounted for in other comprehensive income rather than earnings. Changes in fair value of instruments that are not intended as a hedge are accounted for in the earnings of the period of the change.

If a derivative instrument designated as a fair value hedge is terminated or the hedge designation removed, the difference between a hedged item's then carrying amount and its face amount is recognized into income over the original hedge period. Likewise, if a derivative instrument designated as a cash flow hedge is terminated or the hedge designation removed, related amounts accumulated in other accumulated comprehensive income are reclassified into

earnings over the original hedge period during which the hedged item affects income.

The Company formally documents all hedging relationships, including an assessment that the derivative instruments are expected to be highly effective in offsetting the changes in fair values or cash flows of the hedged items.

Advertising Costs

Advertising costs are expensed as incurred.

Accumulated Other Comprehensive Income

At December 31, 2010, accumulated other comprehensive income consisted of net unrealized losses on securities available for sale of \$8,000 and net unrealized gains on derivatives of \$395,000. At December 31, 2009,

accumulated other comprehensive income consisted of net unrealized gains on securities available for sale of \$1.8 million and net unrealized gains on derivatives of \$1.1 million.

Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan (the "1999 Plan") whereby certain stock-based rights, such as stock options, restricted stock, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees. The 1999 Plan expired on May 13, 2009.

Under the Plan, the Company granted incentive stock options to certain eligible employees in order that they may purchase Company stock at a price equal to the fair market value on the date of the grant. The options granted in 1999 vested over a five-year period. Options granted subsequent to 1999 vest over a three-year period.

All options expire after ten years. A summary of the activity in the Plan is presented below:

Stock Option Activity For the years ended December 31, 2010, 2009 and 2008

	Shares	Weighted Average Option Price Per Share	Weighted Average Remaining Contractual Term (in years)
Outstanding, December 31, 2007	192,725	\$ 8.24	
Granted during the period	-	\$ -	
Forfeited during the period	(2,458)	\$ 8.02	
Exercised during the period	(5,322)	\$ 8.26	
Outstanding, December 31, 2008	184,945	\$ 8.24	
Granted during the period	-	\$ -	
Expired during the period	(15,483)	\$ 9.02	
Exercised during the period	-	\$ -	
Outstanding, December 31, 2009	169,462	\$ 8.17	
Granted during the period	-	\$ -	
Expired during the period	(19,391)	\$ 6.99	
Exercised during the period	-	\$ -	
Outstanding, December 31, 2010	150,071	\$ 8.32	1.50
Exercisable, December 31, 2010	150,071	\$ 8.32	1.50

Options outstanding at December 31, 2010 are exercisable at option prices ranging from \$7.76 to \$10.57. As of December 31, 2010, the exercise price on options outstanding is more than the current market value; therefore, options outstanding as of December 31, 2010 have no intrinsic value. Such options have a weighted average remaining contractual life of approximately two years.

The Company recognized compensation expense for employee stock options and restricted stock awards of \$10,000, \$4,000 and \$12,000 for the years ended December 31, 2010, 2009 and 2008, respectively. As of December 31, 2010 and 2009, there was no unrecognized compensation cost related to nonvested employee stock options.

No options were granted or exercised during the years ended December 31, 2010 and 2009. The total intrinsic value (amount by which the fair market value of the underlying stock exceeds the exercise price of an option on exercise date) of options exercised during the year ended December 31, 2008 was \$26,000. Cash received from option exercises for the year ended December 31, 2008 was \$44,000. There were no tax deductions from options exercised for the year ended December 31, 2008.

The Company granted 3,000 shares of restricted stock in 2007 at a grant date fair value of \$17.40 per share. The Company granted 1,750 shares of restricted stock at a grant date fair value of \$12.80 per share during third quarter 2008 and 2,000 shares of restricted stock at a fair value of \$11.37 per share during fourth quarter 2008. The

Company recognizes compensation expense on the restricted stock over the period of time the restrictions are in place (three years from the grant date for the grants to date). The amount of expense recorded each period reflects the changes in the Company's stock price during the period. As of December 31, 2010 and 2009, there was \$4,000 and \$14,000 of total unrecognized compensation cost related to restricted stock grants, respectively, which is expected to be recognized over a period of three years.

The Company has a new Omnibus Stock Ownership and Long Term Incentive Plan, which was approved by shareholders' on May 7, 2009 (the "2009 Plan") whereby certain stock-based rights, such as stock options, restricted stock, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees. A total of 360,000 shares are currently reserved for possible issuance under the 2009 Plan. All rights must be granted or awarded within ten years from the May 7, 2009 effective date of the 2009 Plan. The Company has not granted any rights under this plan.

Net Earnings Per Share

Net earnings per common share is based on the weighted average number of common shares outstanding during the period while the effects of potential common shares outstanding during the period are included in diluted earnings per common share. The average market price during the year is used to compute equivalent shares.

The reconciliations of the amounts used in the computation of both "basic earnings per common share" and "diluted earnings per common share" for the years ended December 31, 2010, 2009 and 2008 are as follows:

For the year ended December 31, 2010:

	Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	\$ 447	5,539,308	\$ 0.08
Effect of dilutive securities:			
Stock options	-	4,107	
Diluted earnings per common share	\$ 447	5,543,415	\$ 0.08

For the year ended December 31, 2009:

	Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	\$ 1,670	5,539,056	\$ 0.30
Effect of dilutive securities:			
Stock options	-	3,681	
Diluted earnings per common share	\$ 1,670	5,542,737	\$ 0.30

For the year ended December 31, 2008:

	Net Earnings Available to Common Shareholders (Dollars in	Common Shares	Per Share Amount

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thousands)

Basic earnings per common share	\$	6,391	5,588,314	\$	1.14
Effect of dilutive securities:					
Stock options		-	58,980		
Diluted earnings per common share	\$	6,391	5,647,294	\$	1.13

Recent Accounting Pronouncements

In January 2010, the FASB issued Accounting Standards Update No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements ("ASU No. 2010-06"). ASU No. 2010-06 amends Subtopic 820-10 to clarify existing disclosures, requires new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU

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No. 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of ASU is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In February 2010, the FASB issued Accounting Standards Update No. 2010-09, Subsequent Events: Amendments to Certain Recognition and Disclosure Requirements ("ASU No. 2010-09"). ASU No. 2010-09 removes some contradictions between the requirements of U.S. GAAP and the filing rules of the Securities and Exchange Commission ("SEC"). SEC filers are required to evaluate subsequent events through the date the financial statements are issued, and they are no longer required to disclose the date through which subsequent events have been evaluated. This guidance was effective upon issuance except for the use of the issued date for conduit debt obligors, and did not have a material impact on the Company's results of operations, financial position or disclosures.

In February 2010, the FASB issued Accounting Standards Update No. 2010-10, Consolidation: Amendments for Certain Investment Funds ("ASU No. 2010-10"). ASU No. 2010-10 indefinitely defers the effective date for certain investment funds resulting from the issuance of ASU No. 2009-17. ASU No. 2010-10 also clarifies that (1) interests of related parties must be considered in determining whether fees paid to decision makers or service providers constitute a variable interest, and (2) a quantitative calculation should not be the only basis on which such determination is made. This guidance is effective as of the beginning of the first annual period beginning after November 15, 2009, and for interim periods within that first annual reporting period. The adoption of this ASU did not have a material impact on the Company's results of operations, financial position or disclosures.

In March 2010, the FASB issued Accounting Standards Update No. 2010-11, Derivatives and Hedging: Scope Exception Related to Embedded Credit Derivatives ("ASU No. 2010-11"). ASU No. 2010-11 clarifies the type of embedded credit derivative that is exempt from embedded derivative bifurcation requirements by resolving a potential ambiguity about the breadth of the embedded credit derivative scope exception with regard to some types of contracts, such as collateralized debt obligations ("CDO's") and synthetic CDO's. The scope exception will no longer apply to some contracts that contain an embedded credit derivative feature that transfers credit risk. The ASU is effective for fiscal quarters beginning after June 15, 2010. The adoption of this ASU did not have a material impact on the Company's results of operations, financial position or disclosures.

In July 2010, the FASB issued Accounting Standards Update No. 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses ("ASU No. 2010-20"). ASU No. 2010-20 expanded loan credit quality and allowance for loan losses disclosure requirements. The ASU is effective for fiscal quarters ending on or after December 15, 2010. The adoption of this guidance did not have a material impact on the Company's results of operations or financial position; however, additional disclosures are required for this ASU. See Note 3 – Loans.

In January 2011, the FASB issued Accounting Standards Update No. 2011-01, Deferral of the Effective date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20 ("ASU No. 2011-01"). ASU No. 2011-01 deferred the effective date of troubled debt restructurings disclosure requirements for public entities to be concurrent with the effective date of the guidance for determining what constitutes a troubled debt restructuring, as presented in proposed Accounting Standards Update, Receivables (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors. The ASU is anticipated to be effective for interim and annual periods ending after June 15, 2011. The adoption of this guidance is not expected to have a material impact on the Company's results of operations or financial position; however, additional disclosures will be required for this ASU.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's results of operations, financial position or disclosures.

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(2) Investment Securities

Investment securities available for sale at December 31, 2010 and 2009 are as follows:

(Dollars in thousands)

	Amortized Cost	December 31, 2010		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Mortgage-backed securities	\$ 137,811	2,119	569	139,361
U.S. government sponsored enterprises	42,933	393	686	42,640
State and political subdivisions	89,486	793	2,450	87,829
Trust preferred securities	1,250	-	-	1,250
Equity securities	982	387	-	1,369
Total	\$ 272,462	3,692	3,705	272,449

(Dollars in thousands)

	Amortized Cost	December 31, 2009		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Mortgage-backed securities	\$ 105,915	1,830	219	107,526
U.S. government sponsored enterprises	40,259	934	51	41,142
State and political subdivisions	43,460	1,065	189	44,336
Trust preferred securities	1,250	-	-	1,250
Equity securities	1,233	-	372	861
Total	\$ 192,117	3,829	831	195,115

The current fair value and associated unrealized losses on investments in debt securities with unrealized losses at December 31, 2010 and 2009 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

	Less than 12 Months		December 31, 2010 12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	\$ 59,471	569	-	-	59,471	569
U.S. government sponsored enterprises	24,123	686	-	-	24,123	686
	56,374	2,450	-	-	56,374	2,450

State and political
subdivisions

Total	\$ 139,968	3,705	-	-	139,968	3,705
December 31, 2009						
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	\$ 16,970	219	-	-	16,970	219
U.S. government sponsored enterprises	8,683	51	-	-	8,683	51
State and political subdivisions	9,249	182	153	7	9,402	189
Equity securities	-	-	861	372	861	372
Total	\$ 34,902	452	1,014	379	35,916	831

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At December 31, 2010, unrealized losses in the investment securities portfolio relating to debt securities totaled \$3.7 million. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the December 31, 2010 tables above, 45 out of 124 securities issued by state and political subdivisions contained unrealized losses and 85 out of 157 securities issued by U.S. government sponsored enterprises, including mortgage-backed securities, contained unrealized losses. These unrealized losses are considered temporary because of acceptable investment grades on each security and the repayment sources of principal and interest are government backed.

The Company periodically evaluates its investments for any impairment which would be deemed other than temporary. As part of its evaluation in 2010, the Company determined that the fair values of two equity securities were less than the original cost of the investments and that the decline in fair value was not temporary in nature. As a result, the Company wrote down its original investments by \$291,000. The remaining fair value of the investments at December 31, 2010 was approximately \$409,000. Similarly, as part of its evaluation in 2009, the Company wrote down three equity securities by \$723,000. The remaining fair value of the investments at December 31, 2009 was \$11,000.

The amortized cost and estimated fair value of investment securities available for sale at December 31, 2010, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)

	Amortized Cost	Estimated Fair Value
Due within one year	\$ 3,679	3,711
Due from one to five years	53,288	53,330
Due from five to ten years	56,390	55,005
Due after ten years	20,312	19,673
Mortgage-backed securities	137,811	139,361
Equity securities	982	1,369
Total	\$ 272,462	272,449

Proceeds from sales of securities available for sale during 2010 were \$65.8 million and resulted in a gross gain of \$3.3 million. During 2009 and 2008, the proceeds from sales of securities available for sale were \$30.7 million and \$23.4 million, respectively and resulted in gross gains of \$1.8 million and \$160,000, respectively.

Securities with a fair value of approximately \$75.5 million and \$69.6 million at December 31, 2010 and 2009, respectively, were pledged to secure public deposits and for other purposes as required by law.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The table below presents the balance of securities available for sale and derivatives, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of December 31, 2010 and 2009.

(Dollars in thousands)

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	Fair Value Measurements December 31, 2010	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 139,361	-	139,361	-
U.S. government sponsored enterprises	\$ 42,640	-	42,640	-
State and political subdivisions	\$ 87,829	-	87,829	-
Trust preferred securities	\$ 1,250	-	-	1,250
Equity securities	\$ 1,369	1,369	-	-
Mortgage loans held for sale	\$ 3,814	-	3,814	-
Market value of derivatives (in other assets)	\$ 648	-	648	-

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(Dollars in thousands)

	Fair Value Measurements December 31, 2009	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 107,526	-	107,526	-
U.S. government sponsored enterprises	\$ 41,142	-	41,142	-
State and political subdivisions	\$ 44,336	-	44,336	-
Trust preferred securities	\$ 1,250	-	-	1,250
Equity securities	\$ 861	861	-	-
Mortgage loans held for sale	\$ 2,840	-	2,840	-
Market value of derivatives (in other assets)	\$ 1,762	-	1,762	-

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Fair values of derivative instruments are determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the year ended December 31, 2010:

(Dollars in thousands)

	Investment Securities Available for Sale Level 3 Valuation
Balance, beginning of period	\$ 1,250
Change in book value	-
Change in gain/(loss) realized and unrealized	-
Purchases/(sales)	-
Transfers in and/or out of Level 3	-
Balance, end of period	\$ 1,250
Change in unrealized gain/(loss) for assets still held in Level 3	\$ -

(3)

Loans

Major classifications of loans at December 31, 2010 and 2009 are summarized as follows:

(Dollars in thousands)

	2010	2009
Real Estate Loans		
Construction and land development	\$ 124,048	169,680

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Single-family residential	287,307	281,686
Commercial	213,487	224,975
Multifamily and Farmland	6,456	6,302
Total real estate loans	631,298	682,643
Commercial loans (not secured by real estate)	60,994	67,487
Consumer loans (not secured by real estate)	11,500	12,943
All other loans (not secured by real estate)	22,368	14,983
Total loans	726,160	778,056
Less allowance for loan losses	15,493	15,413
Total net loans	\$ 710,667	762,643

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The Company grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg, Union and Wake counties of North Carolina. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by improved and unimproved real estate, the value of which is dependent upon the real estate market.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past 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 in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. The following table presents an age analysis of past due loans, by loan type, as of December 31, 2010:

(Dollars in thousands)

	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Total Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Real Estate Loans						
Construction and land development	\$ 2,306	8,870	11,176	112,872	124,048	197
Single-family residential	19,377	5,936	25,313	261,994	287,307	-
Commercial	382	1,482	1,864	211,623	213,487	-
Multifamily and Farmland	-	-	-	6,456	6,456	-
Total real estate loans	22,065	16,288	38,353	592,945	631,298	197
Commercial loans (not secured by real estate)	1,098	720	1,818	59,176	60,994	13
Consumer loans (not secured by real estate)	98	13	111	11,389	11,500	-
All other loans (not secured by real estate)	-	-	-	22,368	22,368	-
Total loans	\$ 23,261	17,021	40,282	685,878	726,160	210

The following table present the Company's non-accrual loans as of December 31, 2010 and 2009:

(Dollars in thousands)

	2010	2009
Real Estate Loans		
Construction and land development	22,916	4,787
Single-family residential	10,837	11,847
Commercial	5,351	4,519
Multifamily and Farmland	-	117
Total real estate loans	39,104	21,270

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Commercial loans (not secured by real estate)	816	1,498
Consumer loans (not secured by real estate)	142	21
All other loans (not secured by real estate)	-	-
Total	\$ 40,062	22,789

At each reporting period, the Company determines which loans are impaired. Accordingly, the Company's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan, which is generally collateral-dependent, is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by third-party valuation specialists. Factors including the assumptions and techniques utilized by the appraiser are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. No interest income is recognized on impaired loans subsequent to their classification as impaired.

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The following table presents the Company's impaired loans as of December 31, 2010:

(Dollars in thousands)

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Impairment	Related Allowance	Average Recorded Impairment
Real Estate Loans				\$ -		
Construction and land development	31,346	20,787	2,130	22,916	1,055	18,767
Single-family residential	12,376	9,847	990	10,837	168	12,573
Commercial	6,018	4,991	359	5,351	148	4,769
Multifamily and Farmland	-	-	-	-	-	27
Total impaired real estate loans	49,740	35,625	3,479	39,104	1,371	36,136
Commercial loans (not secured by real estate)	1,243	811	5	816	5	1,479
Consumer loans (not secured by real estate)	152	142	-	142	-	79
All other loans (not secured by real estate)	-	-	-	-	-	-
Total impaired loans	\$ 51,135	36,578	3,484	40,062	1,376	37,694

The Company's December 31, 2010 and 2009 fair value measurement for impaired loans and other real estate is presented below:

(Dollars in thousands)

	Fair Value Measurements December 31, 2010	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2010
Impaired loans	\$ 40,062	-	26,798	13,264	(10,591)
Other real estate	\$ 6,673	-	6,673	-	(340)

	Fair Value Measurements December 31, 2009	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2009
Impaired loans	\$ 22,789	-	14,174	8,615	(1,924)
Other real estate	\$ 3,997	-	3,997	-	(100)

Changes in the allowance for loan losses were as follows:

(Dollars in thousands)

2010 2009 2008

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Balance at beginning of year	\$	15,413	11,025	9,103
Amounts charged off		(16,911)	(6,670)	(3,147)
Recoveries on amounts previously charged off		553	523	275
Provision for loan losses		16,438	10,535	4,794
Balance at end of year	\$	15,493	15,413	11,025

The Company utilizes an internal risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 1 to 9. A description of the general characteristics of the nine risk grades is as follows:

- Risk Grade 1 – Excellent Quality: Loans are well above average quality and a minimal amount of credit risk exists. CD or cash secured loans or properly margined actively traded stock or bond secured loans would fall in this grade.
- Risk Grade 2 – High Quality: Loans are of good quality with risk levels well within the Bank's range of acceptability. The company or individual is established with a history of successful performance though somewhat susceptible to economic changes.
- Risk Grade 3 – Good Quality: Loans of average quality with risk levels within the Bank's range of acceptability but higher than normal. This may be a new company or an existing company in a transitional phase (e.g. expansion, acquisition, market change).

- Risk Grade 4 – Management Attention: These loans have very high risk and servicing needs but still are acceptable. Evidence of marginal performance or deteriorating trends are evident. These are not problem credits presently, but may be in the future if the borrower is unable to change its present course.
- Risk Grade 5 – Watch: These loans are currently performing satisfactorily, but there are potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Bank’s position at some future date. This frequently results from deviating from prudent lending practices, for instance over-advancing on collateral.
- Risk Grade 6 – Substandard: A substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or the collateral pledged (if there is any). There is a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.
- Risk Grade 7 – Low Substandard: These loans have the general characteristics of a Grade 6 Substandard loan, with heightened potential concerns. The exact amount of loss is not yet known because neither the liquidation value of the collateral nor the borrower’s predicted repayment ability is known with confidence.
- Risk Grade 8 – Doubtful: Loans classified Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.
- Risk Grade 9 – Loss: Loans classified Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be effected in the future. Loss is a temporary grade until the appropriate authority is obtained to charge the loan off.

The following table presents weighted average risk grades and balances of the total loan portfolio, along with balances of classified loans, by loan type as of December 31, 2010. Classified loans include loans in risk grades 6, 7, 8 and 9.

(Dollars in thousands)

	Weighted Average Risk Grade of Loans Outstanding	Loans Outstanding	Classified Loans
Real Estate Loans			
Construction and land development	4.19	\$ 124,048	29,890
Single-family residential	2.97	287,307	15,859
Commercial	3.33	213,487	12,965
Multifamily and Farmland	2.83	6,456	223
Total real estate loans		631,298	58,936
Commercial loans (not secured by real estate)	3.09	60,994	1,710
Consumer loans (not secured by real estate)	2.48	11,500	151
All other loans (not secured by real estate)	2.77	22,368	-
Total loans		\$ 726,160	60,797

At December 31, 2010, troubled debt restructured (“TDR”) loans amounted to \$56.7 million, including \$10.0 million in performing TDR loans. The terms of these loans have been renegotiated to provide a reduction in principal or interest as a result of the deteriorating financial position of the borrower. At December 31, 2009, TDR loans amounted to

\$9.2 million, including \$3.8 million in performing TDR loans. The increase in TDR loans at December 31, 2010 compared to December 31, 2009 is primarily due to the classification of all non-accrual loans as TDR as of December 31, 2010.

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The following table presents an analysis of TDR loans by loan type as of December 31, 2010.

(Dollars in thousands)

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real Estate Loans			\$
Construction and land development	47	\$ 27,901	23,121
Single-family residential	221	26,808	25,296
Commercial	17	8,155	6,243
Multifamily and Farmland	1	322	223
Total real estate TDR loans	286	63,186	54,883
Commercial loans (not secured by real estate)	26	6,196	1,719
Consumer loans (not secured by real estate)	12	148	142
All other loans (not secured by real estate)	-	-	-
Total TDR loans	324	\$ 69,530	56,744

(4) Premises and Equipment

Major classifications of premises and equipment are summarized as follows:

(Dollars in thousands)

	2010	2009
Land	\$ 3,581	3,581
Buildings and improvements	14,759	14,737
Furniture and equipment	15,575	18,624
Total premises and equipment	33,915	36,942
Less accumulated depreciation	16,581	18,995
Total net premises and equipment	\$ 17,334	17,947

Depreciation expense was approximately \$2.1 million for the year ended December 31, 2010. The Company recognized approximately \$1.9 and \$1.8 million in depreciation expense for the years ended December 31, 2009 and 2008.

(5) Time Deposits

At December 31, 2010, the scheduled maturities of time deposits are as follows:

(Dollars in thousands)

2011	\$ 243,332
2012	114,459

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2013	23,140
2014	2,255
2015 and thereafter	8,223
Total	\$ 391,409

At December 31, 2010 and 2009, the Company has approximately \$87.4 million and \$84.0 million, respectively, in time deposits purchased through third party brokers, including certificates of deposit participated through the Certificate of Deposit Account Registry Service (CDARS) on behalf of local customers. CDARS balances totaled \$53.0 million and \$49.4 million as of December 31, 2010 and 2009, respectively. The weighted average rate of brokered deposits as of December 31, 2010 and 2009 was 1.20% and 1.90%, respectively.

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(6) Federal Home Loan Bank and Federal Reserve Bank Borrowings

The Bank has borrowings from the Federal Home Loan Bank of Atlanta (“FHLB”) with monthly or quarterly interest payments at December 31, 2010. The FHLB borrowings are collateralized by a blanket assignment on all residential first mortgage loans, home equity lines of credit and loans secured by multi-family real estate that the Bank owns. At December 31, 2010, the carrying value of loans pledged as collateral totaled approximately \$153.8 million. As additional collateral, the Bank has pledged securities to the FHLB. At December 31, 2010, the market value of securities pledged to the FHLB totaled \$10.0 million.

Borrowings from the FHLB outstanding at December 31, 2010 consist of the following:

(Dollars in thousands)

Maturity Date	Call Date	Rate	Rate Type	Amount
June 24, 2015	N/A	3.710%	Convertible	\$ 5,000
March 25, 2019	N/A	4.260%	Convertible	5,000
March 31, 2016	March 31, 2009 and every three months thereafter	4.620%	Convertible	5,000
October 5, 2016	N/A	4.450%	Convertible	5,000
January 30, 2017	October 30, 2008 and every three months thereafter	4.500%	Convertible	5,000
June 8, 2017	December 8, 2008 and every three months thereafter	4.713%	Convertible	15,000
July 11, 2017	January 11, 2008 and every three months thereafter	4.440%	Convertible	5,000
July 24, 2017	April 24, 2008 and every month thereafter	4.420%	Convertible	5,000
November 12, 2014	N/A	2.230%	Fixed Rate Hybrid	5,000
November 13, 2017	N/A	4.260%	Fixed Rate Hybrid	15,000
				\$ 70,000

The FHLB has the option to convert \$50.0 million of the total advances to a floating rate and, if converted, the Bank may repay advances without a prepayment fee.

The Bank is required to purchase and hold certain amounts of FHLB stock in order to obtain FHLB borrowings. No ready market exists for the FHLB stock, and it has no quoted market value. The stock is redeemable at \$100 per share subject to certain limitations set by the FHLB. At December 31, 2010 and 2009, the Bank owned FHLB stock amounting to \$4.9 million and \$5.5 million, respectively.

As of December 31, 2010 and 2009, the Bank had no borrowings from the Federal Reserve Bank (“FRB”). FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At December 31, 2010, the carrying value of loans pledged as collateral totaled approximately \$348.9 million.

(7) Junior Subordinated Debentures

In June 2006, the Company formed a second wholly owned Delaware statutory trust, PEBK Capital Trust II (“PEBK Trust II”), which issued \$20.0 million of guaranteed preferred beneficial interests in the Company’s junior subordinated deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase \$20.6 million of junior subordinated debentures of the Company, which pay a floating rate equal to three month LIBOR plus 163 basis points. The proceeds received by the Company from the sale of the junior subordinated debentures were used to repay in December 2006 the trust preferred securities issued by PEBK Trust in December 2001 and for general purposes. The debentures represent the sole asset of PEBK Trust II. PEBK Trust II is not included in the consolidated financial statements.

The trust preferred securities issued by PEBK Trust II accrue and pay quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II has funds with which to make the distributions and other payments. The net combined effect of all the documents entered into in connection with the trust preferred securities is that the Company is liable to make the distributions and other payments required on the trust preferred securities.

These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, on or after June 28, 2011. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount and any accrued but unpaid interest.

(8) Income Taxes

The provision for income taxes is summarized as follows:

(Dollars in thousands)

	2010	2009	2008
Current	\$ 512	3,059	3,698
Deferred	(523)	(1,720)	(485)
Total	\$ (11)	1,339	3,213

The differences between the provision for income taxes and the amount computed by applying the statutory federal income tax rate to earnings before income taxes are as follows:

(Dollars in thousands)

	2010	2009	2008
Pre-tax income at statutory rates (34%)	\$ 622	1,447	3,265
Differences:			
Tax exempt interest income	(721)	(429)	(313)
Nondeductible interest and other expense	58	38	60
Cash surrender value of life insurance	(87)	(89)	(83)
State taxes, net of federal benefits	(8)	100	257
Nondeductible capital losses	99	234	-
Other, net	26	38	27
Total	\$ (11)	1,339	3,213

The following summarizes the tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities. The net deferred tax asset is included as a component of other assets at December 31, 2010 and 2009.

(Dollars in thousands)

	2010	2009
Deferred tax assets:		
Allowance for loan losses	\$ 5,973	5,942
Amortizable intangible assets	-	11
Accrued retirement expense	1,086	987
Income from non-accrual loans	43	14
Other	507	112

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Total gross deferred tax assets	7,609	7,066
Deferred tax liabilities:		
Deferred loan fees	1,259	1,404
Premises and equipment	493	328
Unrealized gain (loss) on available for sale securities	(5) 1,168
Unrealized gain on cash flow hedges	252	686
Total gross deferred tax liabilities	1,999	3,586
Net deferred tax asset	\$ 5,610	3,480

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(9) Related Party Transactions

The Company conducts transactions with its directors and executive officers, including companies in which they have beneficial interests, in the normal course of business. It is the policy of the Company that loan transactions with directors and officers are made on substantially the same terms as those prevailing at the time made for comparable loans to other persons. The following is a summary of activity for related party loans for 2010:

(Dollars in thousands)

Beginning balance	\$ 5,940
New loans	7,517
Repayments	7,409
Ending balance	\$ 6,048

At December 31, 2010 and 2009, the Company had deposit relationships with related parties of approximately \$15.4 million and \$17.2 million, respectively.

(10) Commitments and Contingencies

The Company leases various office spaces for banking and operational facilities and equipment under operating lease arrangements. Future minimum lease payments required for all operating leases having a remaining term in excess of one year at December 31, 2010 are as follows:

(Dollars in thousands)

Year ending December 31,	
2011	\$ 600
2012	471
2013	256
2014	242
2015	211
Thereafter	1,440
Total minimum obligation	\$ 3,220

Total rent expense was approximately \$815,000, \$922,000 and \$1.0 million for 2010, 2009 and 2008, respectively.

The Company is 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, standby letters of credit and financial guarantees. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit and financial guarantees written is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

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In most cases, the Company requires collateral or other security to support financial instruments with credit risk.

(Dollars in thousands)

	Contractual Amount	
	2010	2009
Financial instruments whose contract amount represent credit risk:		
Commitments to extend credit	\$ 137,015	140,207
Standby letters of credit and financial guarantees written	\$ 3,590	3,302

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Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and because they may expire without being drawn upon, the total commitment amount of \$140.6 million does not necessarily represent future cash requirements.

Standby letters of credit and financial guarantees written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to businesses in the Company's delineated market area. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company holds real estate, equipment, automobiles and customer deposits as collateral supporting those commitments for which collateral is deemed necessary.

In the normal course of business, the Company is a party (both as plaintiff and defendant) to a number of lawsuits. In the opinion of management and counsel, none of these cases should have a material adverse effect on the financial position of the Bank or the Company.

The Company has employment agreements with certain key employees. The agreements, among other things, include salary, bonus, incentive stock option, and change in control provisions.

The Company has \$55.5 million available for the purchase of overnight federal funds from five correspondent financial institutions.

(11) Derivative Financial Instruments and Hedging Transactions

Accounting Policy for Derivative Instruments and Hedging Activities

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

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, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of 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 designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

Risk Management Objective of Using Derivatives

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit

risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. As of December 31, 2010, the Company had a cash flow hedge with a notional amount of \$50.0 million. This derivative instrument consists of one interest rate swap contract.

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Balance Sheet as of December 31, 2010 and 2009.

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(Dollars in thousands)

	Asset Derivatives			
	As of December 31, 2010		As of December 31, 2009	
	Balance	Fair	Balance	Fair
	Sheet	Value	Sheet	Value
	Location		Location	
Interest rate derivative contracts	Other assets	\$ 648	Other assets	\$ 1,762

Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floors designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium. As of December 31, 2010, the Company had one interest rate swap with a notional amount of \$50.0 million that was designated as a cash flow hedge of interest rate risk.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in Accumulated Other Comprehensive Income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2010, 2009 and 2008, such derivatives were used to hedge the variable cash inflows associated with existing pools of prime-based loan assets. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. The Company recognized hedge ineffectiveness gains of \$1,000 in earnings during the year ended December 31, 2009.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest income or expense as interest payments are received/made on the Company's variable-rate assets/liabilities. During the next twelve months, the Company estimates that \$648,000 will be reclassified as an increase to interest income.

Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company's derivative financial instruments on the Income Statement for the years ended December 31, 2010 and 2009.

(Dollars in thousands)

Amount of Gain (Loss) Recognized in OCI on Derivatives Years ended December 31,		Location of Gain (Loss)	
		Reclassified from Accumulated OCI into Income	Amount of Gain (Loss) Reclassified from Accumulated OCI into Income Years ended December 31,
2010	2009	2010	2009

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	\$		\$	\$
	404	\$		
Interest rate derivative contracts		434	Interest income	1,518
			Non-interest	
			income	\$ 46
				-

(12) Employee and Director Benefit Programs

The Company has a profit sharing and 401(k) plan for the benefit of substantially all employees subject to certain minimum age and service requirements. Under this plan, the Company matched employee contributions to a maximum of 2.50% of annual compensation for 2010 and 5.00% of annual compensation for 2009 and 2008. The Company's contribution pursuant to this formula was approximately \$208,000, \$482,000 and \$483,000 for the years 2010, 2009 and 2008, respectively. Investments of the plan are determined by the compensation committee consisting of selected outside directors and senior executive officers. No investments in Company stock have been made by the plan. The vesting schedule for the plan begins at 20 percent after two years of employment and graduates 20 percent each year until reaching 100 percent after six years of employment.

In December 2001, the Company initiated a postretirement benefit plan to provide retirement benefits to key officers and its Board of Directors and to provide death benefits for their designated beneficiaries. Under the plan, the Company purchased life insurance contracts on the lives of the key officers and each director. The increase in cash surrender value of the contracts constitutes the Company's contribution to the plan each year. Plan participants are to be paid annual benefits for a specified number of years commencing upon retirement. Expenses incurred for benefits relating to this plan were approximately \$279,000, \$609,000 and \$365,000 during 2010, 2009 and 2008, respectively.

The Company is currently paying medical benefits for certain retired employees. Postretirement benefits expense, including amortization of the transition obligation, as applicable, was approximately \$23,000 for the years ended December 31, 2010, 2009 and 2008.

The following table sets forth the change in the accumulated benefit obligation for the Company's two postretirement benefit plans described above:

(Dollars in thousands)

	2010	2009
Benefit obligation at beginning of period	\$ 2,355	1,779
Service cost	244	500
Interest cost	53	105
Benefits paid	(45)	(29)
Benefit obligation at end of period	\$ 2,607	2,355

The amounts recognized in the Company's consolidated balance sheet as of December 31, 2010 and 2009 are shown in the following two tables:

(Dollars in thousands)

	2010	2009
Benefit obligation	\$ 2,607	2,355
Fair value of plan assets	-	-

(Dollars in thousands)

	2010	2009
Funded status	\$ (2,607)	(2,355)
Unrecognized prior service cost/benefit	-	-
Unrecognized net actuarial loss	-	-
Net amount recognized	\$ (2,607)	(2,355)
Unfunded accrued liability	\$ (2,607)	(2,355)
Intangible assets	-	-
Net amount recognized	\$ (2,607)	(2,355)

Net periodic benefit cost of the Company's two post retirement benefit plans for the years ended December 31, 2010 and 2009 consisted of the following:

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(Dollars in thousands)

	2010	2009
Service cost	\$ 244	500
Interest cost	53	105
Net periodic cost	\$ 297	605
Weighted average discount rate assumption used to determine benefit obligation	6.65%	6.66%

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During the year ended December 31, 2010, the Company paid benefits totaling \$45,000. Information about the expected benefit payments for the Company's two postretirement benefit plans is as follows:

(Dollars in thousands)

Year ending December 31,	
2011	\$ 54
2012	\$ 62
2013	\$ 199
2014	\$ 222
2015	\$ 252
Thereafter	\$ 9,108

Relating to the post retirement benefit plan, the Company is required to recognize an obligation for either the present value of the entire promised death benefit or the annual "cost of insurance" required to keep the policy in force during the post-retirement years. The Company made a \$467,000 reduction to retained earnings in 2008 pursuant to the guidance of the pronouncement to record the portion of this benefit earned by participants prior to adoption of this pronouncement. In 2009, the Company made a \$358,000 addition to retained earnings to reflect an adjustment of the cumulative effect due to policy amendments to the individual split-dollar plans implemented during 2009.

Members of the Board of Directors are eligible to participate in the Company's Omnibus Stock Ownership and Long Term Incentive Plan (the "Stock Benefits Plan"). Each director was awarded 9,737 book value shares (adjusted for stock dividends and stock splits) under the Stock Benefits Plan. The book value of the shares awarded ranged from \$6.31 to \$8.64. All book value shares were fully vested on May 6, 2009 and were exercised in 2009. The Company did not record any expenses associated with this plan in 2010. The Company recorded expenses of approximately \$59,000 and \$136,000 associated with the benefits of this plan in the years ended December 31, 2009, and 2008, respectively.

A summary of book value shares activity under the Stock Benefits Plan for the years ended December 31, 2010, 2009 and 2008 is presented below.

	2010		2009		2008	
	Shares	Weighted Average Price of Book Value Shares	Shares	Weighted Average Price of Book Value Shares	Shares	Weighted Average Price of Book Value Shares
Outstanding, beginning of period	-	\$ -	97,377	\$ 7.38	97,377	\$ 7.38
Exercised during the period	-	\$ -	(97,377)	\$ 7.38	-	\$ -
Outstanding, end of period	-	\$ -	-	\$ -	97,377	\$ 7.38
Number of shares exercisable	-	\$ -	-	\$ -	89,580	\$ 7.27

The Company has a new Omnibus Stock Ownership and Long Term Incentive Plan, which was approved by shareholders' on May 7, 2009 (the "2009 Plan") whereby certain stock-based rights, such as stock options, restricted stock, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees. A total of 360,000 shares are currently reserved for possible issuance under the 2009 Plan. All rights

must be granted or awarded within ten years from the May 7, 2009 effective date of the 2009 Plan. The Company has not granted any rights under this plan.

(13)

Regulatory Matters

The Company is 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 financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the 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.

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Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios of capital in relation to both on- and off-balance sheet items at various risk weights. Total capital consists of two tiers of capital. Tier 1 Capital includes common shareholders' equity and trust preferred securities less adjustments for intangible assets. Tier 2 Capital consists of the allowance for loan losses up to 1.25% of risk-weighted assets and other adjustments. Management believes, as of December 31, 2010, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2010, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

The Company's and the Bank's actual capital amounts and ratios are presented below:

(Dollars in thousands)

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2010:						
Total Capital (to Risk-Weighted Assets)						
Consolidated	\$ 126,912	15.51%	65,455	8.00%	N/A	N/A
Bank	\$ 107,294	13.15%	65,291	8.00%	81,614	10.00%
Tier 1 Capital (to Risk-Weighted Assets)						
Consolidated	\$ 116,470	14.24%	32,728	4.00%	N/A	N/A
Bank	\$ 96,853	11.87%	32,646	4.00%	48,968	6.00%
Tier 1 Capital (to Average Assets)						
Consolidated	\$ 116,470	10.70%	43,533	4.00%	N/A	N/A
Bank	\$ 96,853	8.91%	43,491	4.00%	54,363	5.00%
As of December 31, 2009:						
Total Capital (to Risk-Weighted Assets)						
Consolidated	\$ 126,689	15.00%	67,586	8.00%	N/A	N/A
Bank	\$ 105,217	12.48%	67,444	8.00%	84,305	10.00%
Tier 1 Capital (to Risk-Weighted Assets)						
Consolidated	\$ 116,091	13.74%	33,793	4.00%	N/A	N/A
Bank	\$ 94,619	11.22%	33,722	4.00%	50,583	6.00%
Tier 1 Capital (to Average Assets)						

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Consolidated	\$	116,091	11.42%	40,650	4.00%	N/A	N/A
Bank	\$	94,619	9.33%	40,581	4.00%	50,726	5.00%

(14) Shareholders' Equity

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights.

On December 23, 2008, the Company entered into a Securities Purchase Agreement ("Purchase Agreement") with the United States Treasury (the "UST"). Under the Purchase Agreement, the Company agreed to issue and sell 25,054 shares of Series A preferred stock and a warrant to purchase 357,234 shares of common stock associated with the Company's participation in the UST's Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP"). Proceeds from this issuance of preferred shares were allocated between preferred stock and the warrant based on their relative fair values at the time of the sale. Of the \$25.1 million in proceeds, \$24.4 million was allocated to the Series A preferred stock and \$704,000 was allocated to the common stock warrant. The discount recorded on the preferred stock that resulted from allocating a portion of the proceeds to

the warrant is being accreted directly to retained earnings over a five-year period applying a level yield. As of December 31, 2010, the Company has accreted a total of \$266,000 of the discount related to the Series A preferred stock. The Company paid dividends of \$1.3 million on the Series A preferred stock during 2010 and cumulative undeclared dividends at December 31, 2010 were \$157,000.

The Series A preferred stock qualifies as Tier 1 capital and will pay cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Series A preferred stock may be redeemed at the stated amount of \$1,000 per share plus any accrued and unpaid dividends. Under the terms of the original Purchase Agreement, the Company could not redeem the preferred shares until December 23, 2011 unless the total amount of the issuance, \$25.1 million, was replaced with the same amount of other forms of capital that would qualify as Tier 1 capital. However, with the enactment of the American Recovery and Reinvestment Act of 2009 (“ARRA”), the Company can now redeem the preferred shares at any time, if approved by the Company’s primary regulator. The Series A preferred stock is non-voting except for class voting rights on matters that would adversely affect the rights of the holders of the Series A preferred stock.

The exercise price of the warrant is \$10.52 per common share and it is exercisable at anytime on or before December 18, 2018.

The Company is subject to the following restrictions while the Series A preferred stock is outstanding: 1) UST approval is required for the Company to repurchase shares of outstanding common stock; 2) the full dividend for the latest completed CPP dividend period must be declared and paid in full before dividends may be paid to common shareholders; 3) UST approval is required for any increase in common dividends per share above the last quarterly dividend of \$0.12 per share paid prior to December 23, 2008; and 4) the Company may not take tax deductions for any senior executive officer whose compensation is above \$500,000. There were additional restrictions on executive compensation added in the ARRA for companies participating in the TARP, including participants in the CPP.

The Board of Directors of the Bank may declare a dividend of all of its retained earnings as it may deem appropriate, subject to the requirements of the General Statutes of North Carolina, without prior approval from the requisite regulatory authorities. As of December 31, 2010, this amount was approximately \$43.6 million.

(15) Other Operating Expense

Other operating expense for the years ended December 31 included the following items that exceeded one percent of total revenues at some point during the following three-year period:

(Dollars in thousands)

	2010	2009	2008
Advertising	\$ 714	860	1,076
FDIC insurance	\$ 1,434	1,766	547
Visa debit card expense	\$ 606	1,064	761
Telephone	\$ 629	616	476

(16) Fair Value of Financial Instruments

The Company is required to disclose fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company’s financial instruments are detailed below. Where quoted prices are not available, fair values are based on estimates using discounted cash flows and other valuation techniques. The use of discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash

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flows. The following disclosures should not be considered a surrogate of the liquidation value of the Company, but rather a good faith estimate of the increase or decrease in value of financial instruments held by the Company since purchase, origination, or issuance.

Cash and Cash Equivalents

For cash, due from banks and interest bearing deposits, the carrying amount is a reasonable estimate of fair value.

Certificates of Deposit

The carrying amount of certificates of deposits is a reasonable estimate of fair value.

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Investment Securities Available for Sale

Fair values for investment securities are based on quoted market prices.

Other Investments

For other investments, the carrying value is a reasonable estimate of fair value.

Mortgage Loans Held for Sale

Mortgage loans held for sale are carried at lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value.

Loans

The fair value of fixed rate 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. For variable rate loans, the carrying amount is a reasonable estimate of fair value.

Cash Surrender Value of Life Insurance

For cash surrender value of life insurance, the carrying value is a reasonable estimate of fair value.

Derivative Instruments

For derivative instruments, fair value is estimated as the amount that the Company would receive or pay to terminate the contracts at the reporting date, taking into account the current unrealized gains or losses on open contracts.

Deposits and Demand Notes Payable

The fair value of demand deposits, interest-bearing demand deposits, savings, and demand notes payable to U.S. Treasury is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities.

Securities Sold Under Agreements to Repurchase

For securities sold under agreements to repurchase, the carrying value is a reasonable estimate of fair value.

FHLB Borrowings

The fair value of FHLB borrowings is estimated based upon discounted future cash flows using a discount rate comparable to the current market rate for such borrowings.

Junior Subordinated Debentures

Because the Company's junior subordinated debentures were issued at a floating rate, the carrying amount is a reasonable estimate of fair value.

Commitments to Extend Credit and Standby Letters of Credit

Commitments to extend credit and standby letters of credit are generally short-term and at variable interest rates. Therefore, both the carrying value and estimated fair value associated with these instruments are immaterial.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on many judgments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial instruments include the deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

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The carrying amount and estimated fair value of the Company's financial instruments at December 31, 2010 and 2009 are as follows:

	December 31, 2010		December 31, 2009	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
(dollars in thousands)				
Assets:				
Cash and cash equivalents	\$ 23,977	23,977	31,340	31,340
Certificates of deposit	\$ 735	735	3,345	3,345
Investment securities available for sale	\$ 272,449	272,449	195,115	195,115
Other investments	\$ 5,761	5,761	6,346	6,346
Mortgage loans held for sale	\$ 3,814	3,814	2,840	2,840
Loans, net	\$ 710,667	710,880	762,643	763,939
Cash surrender value of life insurance	\$ 7,539	7,539	7,282	7,282
Derivative instruments	\$ 648	648	1,762	1,762
Liabilities:				
Deposits and demand notes payable	\$ 840,312	839,379	809,979	809,717
Securities sold under agreements to repurchase	\$ 34,094	34,094	36,876	36,876
FHLB borrowings	\$ 70,000	79,950	77,000	86,680
Junior subordinated debentures	\$ 20,619	20,619	20,619	20,619

(17) Peoples Bancorp of North Carolina, Inc. (Parent Company Only) Condensed Financial Statements

Balance Sheets

December 31, 2010 and 2009

(Dollars in thousands)

Assets	2010	2009
Cash	\$ 425	300
Interest-bearing time deposit	17,000	19,000
Investment in subsidiaries	98,164	98,455
Investment securities available for sale	1,659	1,668
Other assets	393	437
Total assets	\$ 117,641	119,860
Liabilities and Shareholders' Equity		
Accrued expenses	\$ 164	18
Junior subordinated debentures	20,619	20,619
Shareholders' equity	96,858	99,223
Total liabilities and shareholders' equity	\$ 117,641	119,860

Statements of Earnings

For the Years Ended December 31, 2010, 2009 and 2008

(Dollars in thousands)

Revenues:	2010	2009	2008
Dividends from subsidiaries	\$ -	-	1,929
Interest and dividend income	311	454	443
Loss on sale of securities	(291)	(149)	(327)
Total revenues	20	305	2,045
Expenses:			
Interest	411	546	1,016
Other operating expenses	191	230	244
Total expenses	602	776	1,260

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(Loss) earnings before income tax benefit and equity in

undistributed earnings of subsidiaries	(582)	(471)	785
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Income tax benefit	24	84	389
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(Loss) earnings before equity in undistributed earnings of subsidiaries

	(558)	(387)	1,174
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Equity in undistributed earnings of subsidiaries	2,399	3,303	5,217
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Net earnings	\$ 1,841	2,916	6,391
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Statements of Cash Flows

For the Years Ended December 31, 2010, 2009 and 2008
(Dollars in thousands)

	2010	2009	2008
Cash flows from operating activities:			
Net earnings	\$ 1,841	2,916	6,391
Adjustments to reconcile net earnings to net cash (used) provided by operating activities:			
Book value shares accrual	-	(720)	136
Equity in undistributed earnings of subsidiaries	(2,399)	(3,303)	(5,217)
Deferred income tax benefit	-	278	(53)
Loss on sale of investment securities	291	149	327
Change in:			
Other assets	(66)	(319)	(3)
Accrued income	-	17	(17)
Accrued expense	147	252	15
Net cash (used) provided by operating activities	(186)	(730)	1,579
Cash flows from investing activities:			
Purchases of investment securities available for sale			
	(36,000)	(15,000)	(1,000)
Proceeds from maturities of investment securities available for sale			
	36,000	15,000	-
Proceeds from sales of investment securities available for sale			
	-	-	3
Net change in interest-bearing time deposit	2,000	(14,000)	3,000
Payments for investments in subsidiaries	-	(8,010)	-
Net cash provided (used) by investing activities	2,000	(22,010)	2,003
Cash flows from financing activities:			
Proceeds from issuance of Series A preferred stock			
	-	-	25,054
Cash dividends paid on Series A preferred stock	(1,253)	(1,120)	-
Cash dividends paid on common stock	(448)	(1,440)	(2,680)
Common stock repurchased	-	-	(1,126)
Restricted stock payout	12	-	-
Proceeds from exercise of stock options	-	-	44
Net cash (used) provided by financing activities	(1,689)	(2,560)	21,292

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Net change in cash	125	(25,300)	24,874
Cash at beginning of year	300	25,600	726
Cash at end of year	\$ 425	300	25,600
Noncash investing and financing activities:			
Change in unrealized gain on investment securities			
available for sale, net	\$ (172)	3	(142)

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DIRECTORS AND OFFICERS OF THE COMPANY

DIRECTORS

Robert C. Abernethy – Chairman
Chairman of the Board, Peoples Bancorp of North Carolina, Inc. and Peoples Bank;
President, Secretary and Treasurer, Carolina Glove Company, Inc. (glove manufacturer)
Secretary and Assistant Treasurer, Midstate Contractors, Inc. (paving company)

James S. Abernethy
Vice President, Carolina Glove Company, Inc. (glove manufacturer)
President and Assistant Secretary, Midstate Contractors, Inc. (paving company)
Vice President, Secretary and Chairman of the Board of Directors, Alexander Railroad Company

Douglas S. Howard
Owner, Howard Ventures (asset management firm)
Secretary and Treasurer, Denver Equipment of Charlotte, Inc.

John W. Lineberger, Jr.
President, Lincoln Bonded Warehouse Company (commercial warehousing facility)

Gary E. Matthews
President and Director, Matthews Construction Company, Inc. (general contractor)

Billy L. Price, Jr. MD
Managing Partner and Practitioner of Internal Medicine, Catawba Valley Internal Medicine, PA

Larry E. Robinson
President and Chief Executive Officer, The Blue Ridge Distributing Co., Inc. (beer and wine distributor)
Partner and Chief Operating Officer, United Beverages of North Carolina, LLC (beer distributor)

William Gregory (Greg) Terry
Executive Vice President, Drum & Willis-Reynolds Funeral Homes and Crematory

Dan Ray Timmerman, Sr.
President and Chief Executive Officer, Timmerman Manufacturing, Inc. (wrought iron furniture, railings and gates manufacturer)

Benjamin I. Zachary
President, Treasurer, General Manager and Director, Alexander Railroad Company

OFFICERS

Tony W. Wolfe
President and Chief Executive Officer

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A. Joseph Lampron, Jr.
Executive Vice President, Chief Financial Officer and Corporate Treasurer

Joseph F. Beaman, Jr.
Executive Vice President and Corporate Secretary

Lance A. Sellers
Executive Vice President and Assistant Corporate Secretary

William D. Cable, Sr.
Executive Vice President and Assistant Corporate Treasurer

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See proxy card 1 below.

See proxy card 2 page 1 below.

See proxy card 2 page 2 below.