

PEOPLES BANCORP OF NORTH CAROLINA INC
Form 10-Q
November 13, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: **September 30, 2006**

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

PEOPLES BANCORP OF NORTH CAROLINA, INC.
(Exact name of registrant as specified in its charter)

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

000-27205
(Commission File No.)

56-2132396
(IRS Employer Identification No.)

518 West C Street, Newton, North Carolina
(Address of principal executive offices)

28658
(Zip Code)

(828) 464-5620
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

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

| | | | |
|------------------|-------------|-----------------------|---|
| Large Accelerate | Accelerated | Non-Accelerated Filer | X |
| Filer | Filer | | |

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2 of the Exchange Act).

Yes No X

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

3,813,807 shares of common stock, outstanding at October 31, 2006.

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Statements made in this Form 10-Q, other than those concerning historical information, should be considered forward-looking statements pursuant to the safe harbor provisions of the Securities Exchange Act of 1934 and the Private Securities Litigation Act of 1995. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management and on the information available to management at the time that this Form 10-Q was 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, (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 environments 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, including but not limited to those described in Peoples Bancorp of North Carolina, Inc.’s annual report on Form 10-K for the year ended December 31, 2005

PART FINANCIAL INFORMATION**I.****Item Financial Statements****1.**

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

| <u>Assets</u> | September 30, <u>2006</u> <i>(Unaudited)</i> | December 31, <u>2005</u> |
|--|---|--------------------------------|
| Cash and due from banks | \$ 19,727,439 | 18,468,999 |
| Federal funds sold | 2,258,000 | 1,347,000 |
| Cash and cash equivalents | 21,985,439 | 19,815,999 |
| Investment securities available for sale | 118,084,586 | 115,158,184 |
| Other investments | 6,822,949 | 5,810,749 |
| Total securities | 124,907,535 | 120,968,933 |
| Mortgage loans held for sale | 1,289,217 | 2,247,900 |
| Loans | 624,302,284 | 566,663,416 |
| Less allowance for loan losses | (8,132,844) | (7,424,782) |
| Net loans | 616,169,440 | 559,238,634 |
| Premises and equipment, net | 12,870,691 | 12,662,153 |
| Cash surrender value of life insurance | 6,466,938 | 6,311,757 |
| Accrued interest receivable and other assets | 11,311,108 | 9,034,239 |
| Total assets | \$ 795,000,368 | 730,279,615 |
| <u>Liabilities and Shareholders' Equity</u> | | |
| Deposits: | | |
| Non-interest bearing demand | \$ 98,155,787 | 94,660,721 |
| NOW, MMDA & savings | 170,887,226 | 183,248,699 |
| Time, \$100,000 or more | 175,609,612 | 152,410,976 |
| Other time | 161,831,432 | 152,533,265 |
| Total deposits | 606,484,057 | 582,853,661 |
| Demand notes payable to U.S. Treasury | 1,600,000 | 1,473,693 |
| Securities sold under agreement to repurchase | 8,602,041 | 981,050 |
| FHLB borrowings | 78,800,000 | 71,600,000 |
| Junior subordinated debentures | 35,052,000 | 14,433,000 |
| Accrued interest payable and other liabilities | 3,594,467 | 4,585,217 |

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| | | |
|---|----------------|-------------|
| Total liabilities | 734,132,565 | 675,926,621 |
| Shareholders' equity: | | |
| Preferred stock, no par value; authorized 5,000,000 shares; no shares issued and outstanding | - | - |
| Common stock, no par value; authorized 20,000,000 shares; issued and outstanding 3,813,807 shares in 2006 and 3,440,805 shares in 2005 | 50,674,267 | 41,096,500 |
| Retained earnings | 11,272,225 | 14,656,160 |
| Accumulated other comprehensive income (loss) | (1,078,689) | (1,399,666) |
| Total shareholders' equity | 60,867,803 | 54,352,994 |
| Total liabilities and shareholders' equity | \$ 795,000,368 | 730,279,615 |

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|----------------------------|------------------------------------|----------------------------|
| | <u>2006</u> (Unaudited) | <u>2005</u> (Unaudited) | <u>2006</u> (Unaudited) | <u>2005</u> (Unaudited) |
| Interest income: | | | | |
| Interest and fees on loans | \$ 13,302,338 | 10,156,112 | 37,373,713 | 27,838,237 |
| Interest on federal funds sold | 40,818 | 35,041 | 62,020 | 37,946 |
| Interest on investment securities: | | | | |
| U.S. Government agencies | 1,114,266 | 893,602 | 3,206,274 | 2,596,159 |
| States and political subdivisions | 201,248 | 181,479 | 587,409 | 543,974 |
| Other | 126,404 | 92,588 | 389,311 | 284,535 |
| Total interest income | 14,785,074 | 11,358,822 | 41,618,727 | 31,300,851 |
| Interest expense: | | | | |
| NOW, MMDA & savings deposits | 817,878 | 647,734 | 2,174,238 | 1,923,016 |
| Time deposits | 3,715,792 | 2,363,754 | 10,136,246 | 6,254,678 |
| FHLB borrowings | 909,702 | 722,818 | 2,763,657 | 2,144,602 |
| Junior subordinated debentures | 700,220 | 234,536 | 1,277,540 | 667,526 |
| Other | 99,234 | 8,763 | 183,077 | 19,874 |
| Total interest expense | 6,242,826 | 3,977,605 | 16,534,758 | 11,009,696 |
| Net interest income | 8,542,248 | 7,381,217 | 25,083,969 | 20,291,155 |
| Provision for loans losses | 686,282 | 930,000 | 1,858,282 | 2,343,000 |
| Net interest income after provision for loan losses | 7,855,966 | 6,451,217 | 23,225,687 | 17,948,155 |
| Non-interest income: | | | | |
| Service charges | 976,515 | 988,294 | 2,918,390 | 2,740,863 |
| Other service charges and fees | 394,030 | 308,184 | 1,153,059 | 823,677 |
| Loss on sale of securities | (163,702) | (139,727) | (337,453) | (139,727) |
| Mortgage banking income | 115,802 | 133,543 | 355,678 | 338,299 |
| Insurance and brokerage commissions | 80,523 | 87,006 | 294,206 | 299,526 |
| Miscellaneous | 639,683 | 410,802 | 1,605,443 | 1,192,298 |
| Total non-interest income | 2,042,851 | 1,788,102 | 5,989,323 | 5,254,936 |

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| | | | | |
|-----------------------------------|--------------|-----------|------------|------------|
| Non-interest expense: | | | | |
| Salaries and employee benefits | 3,396,804 | 3,060,582 | 9,900,606 | 9,094,848 |
| Occupancy | 1,049,911 | 1,020,332 | 3,055,732 | 2,977,958 |
| Other | 1,735,065 | 1,306,732 | 4,871,334 | 3,874,376 |
| Total non-interest expenses | 6,181,780 | 5,387,646 | 17,827,672 | 15,947,182 |
| Earnings before income taxes | 3,717,037 | 2,851,673 | 11,387,338 | 7,255,909 |
| Income taxes | 1,344,300 | 1,010,200 | 4,118,100 | 2,529,600 |
| Net earnings | \$ 2,372,737 | 1,841,473 | 7,269,238 | 4,726,309 |
| Basic earnings per share | \$ 0.62 | 0.48 | 1.92 | 1.24 |
| Diluted earnings per share | \$ 0.61 | 0.48 | 1.87 | 1.23 |
| Cash dividends declared per share | \$ 0.11 | 0.09 | 0.32 | 0.27 |

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|----------------------------|------------------------------------|----------------------------|
| | <u>2006</u> (Unaudited) | <u>2005</u> (Unaudited) | <u>2006</u> (Unaudited) | <u>2005</u> (Unaudited) |
| Net earnings | \$ 2,372,737 | 1,841,473 | 7,269,238 | 4,726,309 |
| Other comprehensive income (loss): | | | | |
| Unrealized holding gains (losses) on securities available for sale | 2,261,854 | (317,691) | (84,515) | (1,224,117) |
| Reclassification adjustment for losses on sales of securities available for sale included in net earnings | 163,702 | 139,727 | 337,453 | 139,727 |
| Unrealized holding gains (losses) on derivative financial instruments qualifying as cash flow hedges | 412,427 | (114,006) | (254,476) | (189,181) |
| Reclassification adjustment for losses on derivative financial instruments qualifying as cash flow hedges included in net earnings | 84,655 | 200,458 | 386,285 | 283,256 |
| Total other comprehensive income (loss), before income taxes | 2,922,638 | (91,512) | 384,747 | (990,315) |
| Income tax expense (benefit) related to other comprehensive income: | | | | |
| Unrealized holding gains (losses) on securities available for sale | 880,992 | (123,741) | (32,919) | (476,794) |
| Reclassification adjustment for losses on sales of securities available for sale included in net earnings | 63,762 | 54,424 | 131,438 | 54,424 |

| | | | | |
|---|--------------|-----------|-----------|-----------|
| Unrealized holding gains (losses) on derivative financial instruments qualifying as cash flow hedges | 125,418 | (48,620) | (185,207) | (77,900) |
| Reclassification adjustment for losses on derivative financial instruments qualifying as cash flow hedges included in net earnings | 32,974 | 78,079 | 150,458 | 110,328 |
| Total income tax expense (benefit) related to other comprehensive income | 1,103,146 | (39,858) | 63,770 | (389,942) |
| Total other comprehensive income (loss), net of tax | 1,819,492 | (51,654) | 320,977 | (600,373) |
| Total comprehensive income | \$ 4,192,229 | 1,789,819 | 7,590,215 | 4,125,936 |

See accompanying notes to
consolidated financial
statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Nine months ended September 30, 2006 and 2005

| | <u>2006</u> | <u>2005</u> |
|---|--------------------|--------------------|
| | <i>(Unaudited)</i> | <i>(Unaudited)</i> |
| Cash flows from operating activities: | | |
| Net earnings | \$ 7,269,238 | 4,726,309 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation, amortization and accretion | 1,059,551 | 1,268,632 |
| Provision for loan losses | 1,858,282 | 2,343,000 |
| Loss on sale of investment securities | 337,453 | 139,727 |
| Recognition of loss on sale of derivative instruments | 386,285 | 283,256 |
| Amortization of deferred gain on sale of premises | (15,672) | (15,672) |
| Loss on sale of premises and equipment | - | (1,088) |
| Loss (gain) on sale of repossessed assets | (10,463) | 40,309 |
| Amortization of deferred issuance costs on trust preferred securities | 309,010 | 13,307 |
| Stock option compensation expense | 4,268 | - |
| Change in: | | |
| Mortgage loans held for sale | 958,683 | (387,055) |
| Cash surrender value of life insurance | (155,181) | (223,177) |
| Other assets | (1,818,777) | 663,274 |
| Other liabilities | (990,750) | 242,056 |
| Net cash provided by operating activities | 9,191,927 | 9,092,878 |
| Cash flows from investing activities: | | |
| Purchases of investment securities available for sale | (17,706,818) | (22,660,876) |
| Proceeds from calls and maturities of investment securities available for sale | 5,333,051 | 7,761,195 |
| Proceeds from sales of investment securities available for sale | 9,421,024 | 8,358,392 |
| Purchases of other investments | (9,737,700) | (5,052,790) |
| Proceeds from sale of other investments | 8,725,500 | 4,104,000 |
| Net change in loans | (59,416,093) | (28,153,561) |
| Purchases of premises and equipment | (1,295,262) | (1,101,163) |
| Proceeds from sale of premises and equipment | - | 1,750 |
| Proceeds from sale of repossessed assets | 498,290 | 64,719 |
| Purchases of derivative financial instruments | (961,500) | (870,000) |
| Net cash used by investing activities | (65,139,508) | (37,548,334) |

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Cash flows from financing activities:

| | | |
|---|---------------|---------------|
| Net change in deposits | 23,630,396 | 31,036,699 |
| Net change in demand notes payable to U.S. Treasury | 126,307 | 415,608 |
| Net change in securities sold under agreement to repurchase | 7,620,991 | - |
| Proceeds from FHLB borrowings | 593,700,000 | 148,200,000 |
| Repayments of FHLB borrowings | (586,500,000) | (140,200,000) |
| Proceeds from issuance of trust preferred securities | 20,619,000 | - |
| Proceeds from exercise of stock options | 567,968 | 70,855 |
| Common stock repurchased | (425,000) | (207,000) |
| Cash paid in lieu of fractional shares | (6,426) | (4,700) |
| Cash dividends paid | (1,216,215) | (1,035,858) |
| Net cash provided by financing activities | 58,117,021 | 38,275,604 |
| Net change in cash and cash equivalent | 2,169,440 | 9,820,148 |
| Cash and cash equivalents at beginning of period | 19,815,999 | 16,790,871 |
| Cash and cash equivalents at end of period | \$ 21,985,439 | 26,611,019 |

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows, continued

Nine months ended September 30, 2006 and 2005

| | <u>2006</u> | <u>2005</u> |
|--|--------------------|--------------------|
| | <i>(Unaudited)</i> | <i>(Unaudited)</i> |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the year for: | | |
| Interest | \$ 16,715,025 | 10,988,218 |
| Income taxes | \$ 5,167,100 | 1,568,000 |
| Noncash investing and financing activities: | | |
| Change in unrealized gain (loss) on investment securities available for sale, net | \$ (154,419) | (662,020) |
| Change in unrealized gain (loss) on derivative financial instruments, net | \$ (166,558) | 61,647 |
| Transfer of loans to other real estate and repossessions | \$ 627,004 | 93,710 |
| Transfer of retained earnings to common stock for issuance of stock dividend | \$ 9,430,532 | 6,274,087 |
| Reclassification of a security from other investments to securities available for sale | \$ - | 715,000 |

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (*Unaudited*)

(1) Summary of
Significant
Accounting
Policies

The consolidated financial statements include the financial statements of Peoples Bancorp of North Carolina, Inc. and its wholly owned subsidiary, Peoples Bank (the “Bank”), 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 consolidated financial statements in this report are unaudited. In the opinion of management, all adjustments (none of which were other than normal accruals) necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. 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 these consolidated financial statements in conformity with generally accepted accounting principles. Actual results could differ from those estimates.

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 the specific accounting guidance. A 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 2006 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 4, 2006 Annual Meeting of Shareholders.

Recently Issued Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) ratified the conclusions reached by the Emerging Issues Task Force (EITF) on EITF 06-4, “Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements.” This issue will require companies 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. This will be effective for fiscal years beginning after December 15, 2007. Management is currently evaluating the effect of the proposal on the Company’s results of operations and financial condition, as the Bank has split-dollar policies in place in its BOLI.

In June 2006, FASB issued Financial Interpretation No. 48 (“FIN 48”) Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements and prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This interpretation will be effective for the Company beginning in January of 2007. The Company is in the process of assessing the impact of this interpretation on its financial position and results of operations.

(2) Allowance for
Loan Losses

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The following is an analysis of the allowance for loan losses for the nine months ended September 30, 2006 and 2005:

| | 2006 | 2005 |
|------------------------------|--------------|-------------|
| Balance, beginning of period | \$ 7,424,782 | 8,048,627 |
| Provision for loan losses | 1,858,282 | 2,343,000 |
| Less: | | |
| Charge-offs | (1,420,320) | (3,410,070) |
| Recoveries | 270,100 | 353,274 |
| Net charge-offs | (1,150,220) | (3,056,796) |
| Balance, end of period | \$ 8,132,844 | 7,334,831 |

(3) 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 share. The average market price during the year is used to compute equivalent shares. All previously reported per share amounts have been restated to reflect a 10% stock dividend approved on April 20, 2006 by the Board of Directors of the Company.

The reconciliation of the amounts used in the computation of both “basic earnings per share” and “diluted earnings per share” for the three and nine months ended September 30, 2006 is as follows:

For the three months ended September 30, 2006

| | Net Earnings | Common Shares | Per Share Amount |
|--------------------------------|--------------|---------------|------------------|
| Basic earnings per share | \$ 2,372,737 | 3,804,878 | \$ 0.62 |
| Effect of dilutive securities: | | | |
| Stock options | - | 89,125 | |
| Diluted earnings per share | \$ 2,372,737 | 3,894,003 | \$ 0.61 |

For the nine months ended September 30, 2006

| | Net Earnings | Common Shares | Per Share Amount |
|--------------------------------|--------------|---------------|------------------|
| Basic earnings per share | \$ 7,269,238 | 3,793,896 | \$ 1.92 |
| Effect of dilutive securities: | | | |
| Stock options | - | 92,035 | |
| Diluted earnings per share | \$ 7,269,238 | 3,885,931 | \$ 1.87 |

The reconciliation of the amounts used in the computation of both “basic earnings per share” and “diluted earnings per share” for the three and nine months ended September 30, 2005 is as follows:

For the three months ended September 30, 2005

| | Net Earnings | Common Shares | Per Share Amount |
|--------------------------------|--------------|---------------|------------------|
| Basic earnings per share | \$ 1,841,473 | 3,798,833 | \$ 0.48 |
| Effect of dilutive securities: | | | |
| Stock options | - | 59,902 | |
| Diluted earnings per share | \$ 1,841,473 | 3,858,735 | \$ 0.48 |

For the nine months ended September 30, 2005

| | Net Earnings | Common Shares | Per Share Amount |
|--------------------------------|--------------|---------------|------------------|
| Basic earnings per share | \$ 4,726,309 | 3,797,352 | \$ 1.24 |
| Effect of dilutive securities: | | | |
| Stock options | - | 57,237 | |
| Diluted earnings per share | \$ 4,726,309 | 3,854,589 | \$ 1.23 |

(4) Derivative
Financial
Instruments
and Hedging
Activities

The Company entered into a new interest rate floor contract with a notional amount of \$45.0 million during the first quarter of 2006. This derivative instrument is used to hedge future cash flows of the first \$45.0 million of certain prime rate based variable rate home equity loans against the downward effects of their repricing in the event of a decreasing rate environment for a period of three years ending in January 2009. If the prime rate falls

below 7.50% during the term of this contract, the Company will receive payments based on the \$45.0 million notional amount times the difference between 7.50% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate on these loans is 7.50% or higher. The Company paid a premium of \$562,500 on this contract.

The Company also entered into another new interest rate floor contract with a notional amount of \$35.0 million during the second quarter of 2006. This derivative instrument is used to hedge future cash flows of the first \$35.0 million of certain prime rate based variable rate construction loans against the downward effects of their repricing in the event of a decreasing rate environment for a period of three years ending in June 2009. If the prime rate falls below 8.00% during the term of this contract, the Company will receive payments based on the \$35.0 million notional amount times the difference between 8.00% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate on these loans is 8.00% or higher. The Company paid a premium of \$399,000 on this contract.

(5) Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan (the "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 354,046 shares were reserved for possible issuance under this Plan. All rights must be granted or awarded within ten years from the 1999 effective date.

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 vest over a five-year period. Options granted subsequent to 1999 vest over a three-year period. All options expire ten years after issuance. The Company did not grant any options during the three and nine months ended September 30, 2006. A summary of the activity for the three and nine months ended September 30, 2006 is presented below:

| | Shares | Three months ended September 30, 2006 | | |
|----------------------------------|----------|---|---|---------------------------------|
| | | Weighted Average Option Price Per Share | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
| Outstanding, beginning of period | 190,249 | \$ 12.20 | | |
| Granted during the period | - | - | | |
| Forfeited during the period | (110) | 11.07 | | |
| Exercised during the period | (25,523) | 11.19 | | |
| Outstanding, end of period | 164,616 | \$ 12.33 | 5.05 | \$ 2,432,743 |
| Number of shares exercisable | 162,195 | \$ 12.28 | 5.00 | \$ 2,405,172 |
| | Shares | Nine months ended September 30, 2006 | | |
| | | Weighted | Weighted Average | Aggregate Intrinsic |

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| | | | Average Option Price Per Share | Remaining Contractual Term in years) | Value |
|----------------------------------|----------|----|---|---|--------------|
| Outstanding, beginning of period | 213,128 | \$ | 12.19 | | |
| Granted during the period | - | | - | | |
| Forfeited during the period | (110) | | 11.07 | | |
| Exercised during the period | (48,402) | | 11.71 | | |
| Outstanding, end of period | 164,616 | \$ | 12.33 | 5.05 | \$ 2,432,743 |
| Number of shares exercisable | 162,195 | \$ | 12.28 | 5.00 | \$ 2,405,172 |

The Company adopted Statement of Financial Accounting Standards (“SFAS”) No. 123(R), Share-Based Payment (“SFAS No. 123(R)”), on January 1, 2006 using the “modified prospective” method. Under this method, awards that are granted, modified, or settled after December 31, 2005, are measured and accounted for in accordance with SFAS No. 123(R). Also under this method, expense is recognized for unvested awards that were granted prior to January 1, 2006, based upon the fair value determined at the grant date under SFAS No. 123, Accounting for Stock-Based Compensation (“SFAS No. 123”). The Company recognized compensation expense for employee stock options of \$3,000 and \$4,000 for the three and nine months ended September 30, 2006, respectively. The Company has not recognized any tax benefit on compensation expense from employee stock options in either the three or nine months ended September 30, 2006. As of September 30, 2006, there was \$6,000 of total unrecognized compensation cost related to nonvested employee stock options, which is expected to be recognized over a period of two years. The Company did not recognize any compensation expense for employee stock options for the three and nine months ended September 30, 2005.

Prior to the adoption of SFAS No. 123(R), the Company accounted for stock compensation under Accounting Principles Board Opinion No. 25 and related interpretations. Accordingly, the Company previously recognized no compensation cost for employee stock options. The following table illustrates the effect on net earnings and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 as of September 30, 2005.

| | | Three months ended September 30, 2005 | Nine months ended September 30, 2005 |
|----------------------------|-----------------------|--|---|
| Net earnings | As reported | \$ 1,841,473 | 4,726,309 |
| | Effect of grants | (34,562) | (108,939) |
| | Effect of forfeitures | - | 5,253 |
| | Proforma | \$ 1,806,911 | 4,622,623 |
| Basic earnings per share | As reported | \$ 0.48 | 1.24 |
| | Proforma | \$ 0.48 | 1.22 |
| Diluted earnings per share | As reported | \$ 0.48 | 1.23 |
| | Proforma | \$ 0.47 | 1.20 |

No options were granted during the three months ended September 30, 2006 and 2005. 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 three months ended September 30, 2006 and 2005 was \$395,000 and \$4,000, respectively. There were no options vested during the three months ended September 30, 2006 and the three months ended September 30, 2005. Cash received from option exercises for the three months ended September 30, 2006 and 2005 was \$287,000 and \$6,000, respectively. The tax benefit for the tax deductions from option exercises totaled \$79,000 for the three months ended September 30, 2006. There was no tax benefit for the tax deductions from option exercises for the three months ended September 30, 2005.

No options were granted during the nine months ended September 30, 2006 and 2005. 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 nine months ended September 30, 2006 and 2005 was \$639,000 and \$28,000, respectively. There were 807 options vested during the nine months ended September 30, 2006 and 806 options vested during the nine months ended September 30, 2005. Cash received from option exercises for the nine months ended

September 30, 2006 and 2005 was \$568,000 and \$71,000, respectively. The tax benefit for the tax deductions from option exercises totaled \$176,000 and \$16,000, respectively for the nine months ended September 30, 2006 and 2005.

(6) Stock
Dividend

On April 20, 2006, the Board of Directors of the Company authorized a 10% stock dividend and a \$0.11 per share cash dividend. As a result of the stock dividend, each shareholder received one new share of stock for every ten shares of stock they held as of the record date. Shareholders received a cash payment in lieu of any fractional shares resulting from the stock dividend. The cash dividend was paid based on the number of shares held by shareholders as adjusted by the stock dividend. All previously reported per share amounts have been restated to reflect this stock dividend.

(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 are intended to be 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.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

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 Peoples Bancorp of North Carolina, Inc. Peoples Bancorp is the parent company of Peoples Bank (the "Bank") and a registered bank holding company operating under the supervision of the Federal Reserve Board. The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander Mecklenburg, Iredell and Union 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 loans secured by commercial real estate, secured and unsecured commercial 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 interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, any 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, 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 local employers may be required to eliminate employment positions of borrowers, and small businesses and other 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 conditions could result in increases or decreases to the provision for loan losses.

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 servicing 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 increased the Federal Funds Rate a total of 3.00% since December 31, 2004 with the rate set at 5.25% as of September 30, 2006. These increases had a positive impact on third quarter earnings and should continue to have a positive impact on the Bank's net interest income in the future periods. The positive impact from the increase in the Federal Funds Rate has been partially offset by the decrease in earnings realized on interest rate contracts, including both interest rate swaps and interest rate floors, utilized by the Company. The swaps were put in place during the time that the Federal Funds Rate approached 1.00% and helped to offset the decline in income

experienced in 2003 and 2004 because of the reductions in the Federal Funds Rate that the Federal Reserve implemented from January 2001 to June 2003. Additional information regarding the Company's interest rate contacts is provided below in the section entitled "Asset Liability and Interest Rate Risk Management."

The Company currently qualifies as a non-accelerated filer in accordance with Rule 12b-2 of the Securities Exchange Act of 1934. Therefore, the Company is not currently subject to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX 404"). The Company will qualify as an accelerated filer and be required to comply with SOX 404 effective December 31, 2006. The Company will incur additional consulting and audit expenses in becoming compliant and continuing to comply with SOX 404. Management does not expect expenses related to SOX 404 to have a material impact on the Company's financial statements.

The Bank opened a new Banco de la Gente office in Union County, in Monroe, North Carolina in June 2006 in a continuing effort to serve the Latino community. The Bank also plans to open a new traditional banking office in Iredell County, in Mooresville, North Carolina during the first six months of 2007. Management expects to continue to open at

least one new traditional office in Mecklenburg or Iredell counties in each of the next two to three years and additional Banco de la Gente offices in other metropolitan areas in North Carolina.

Summary of Significant Accounting Policies

The consolidated financial statements include the financial statements of Peoples Bancorp of North Carolina, Inc. and its wholly owned subsidiary, Peoples Bank, 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 2006 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 4, 2006 Annual Meeting of Shareholders. The following is a summary of the more subjective and complex accounting policies of the Company.

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 the 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 Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities." For a more complete discussion of policies, see the notes to the consolidated financial statements.

In December 2004, the FASB revised SFAS No. 123 ("SFAS No. 123 (R)"). SFAS No. 123 (R), "Share-Based Payment", requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Pro forma disclosure is no longer an alternative to financial statement recognition. SFAS No. 123 (R) is effective for periods beginning after December 31, 2005. The Company recognized compensation expense for employee stock options of \$3,000 and \$4,000 for the three and nine months ended September 30, 2006, respectively. The Company did not recognize any tax benefit on compensation expense from employee stock options in either the first, second or third quarter of 2006.

In September 2006, the FASB ratified the conclusions reached by the Emerging Issues Task Force (EITF) on EITF 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." This issue will require companies 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. This will be effective for fiscal years beginning after December 15, 2007. Management is currently evaluating the effect of the proposal on the Company's results of operations and financial condition, as the Bank has split-dollar policies in place in its BOLI.

In June 2006, FASB issued Financial Interpretation No. 48 (“FIN 48”) Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements and prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This interpretation will be effective for the Company beginning in January of 2007. The Company is in the process of assessing the impact of this interpretation on its financial position and results of operations.

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 these consolidated financial statements in conformity with generally accepted accounting principles. Actual results could differ from those estimates.

Results of Operations

Summary. Net earnings for the third quarter of 2006 were \$2.4 million, or \$0.62 basic net earnings per share and \$0.61 diluted net earnings per share as compared to \$1.8 million, or \$0.48 basic and diluted net earnings per share for the same period one year ago. Net earnings from recurring operations for the three months ended September 30, 2006 were \$2.5 million, or \$0.65 basic net income per share and \$0.64 diluted net income per share, as compared to the third quarter of 2005 net income from recurring operations of \$2.0 million, or \$0.51 basic and diluted net income per share. The increase in net earnings is primarily attributable to growth in interest-earning assets, which contributed to increases in net interest income and non-interest income. In addition the Company had a decrease in the provision for loan losses. The increases in net interest income and non-interest income and the decrease in the provision for loan losses were partially offset by an increase in non-interest expense.

The annualized return on average assets was 1.21% for the three months ended September 30, 2006 compared to 1.02% for the same period in 2005, and annualized return on average shareholders' equity was 15.75% for the three months ended September 30, 2006 compared to 13.44% for the same period in 2005.

Net earnings for the nine months ended September 30, 2006 were \$7.3 million, or \$1.92 basic net earnings per share and \$1.87 diluted net earnings per share. Net earnings from recurring operations for the nine months ended September 30, 2006 were \$7.6 million, or \$2.00 basic net income per share and \$1.95 diluted net income per share, representing a 57% increase over net earnings from recurring operations of \$4.8 million, or \$1.27 basic net income per share and \$1.25 diluted net income per share, for the same period one year ago. The increase in net earnings for the nine-month period ended September 30, 2006 is primarily attributable to growth in interest-earning assets, which contributed to increases in net interest income and non-interest income. In addition the Company had a decrease in the provision for loan losses. The increases in net interest income and non-interest income and the decrease in the provision for loan losses were partially offset by an increase in non-interest expense.

The annualized return on average assets was 1.27% for the nine months ended September 30, 2006 compared to 0.90% for the same period in 2005, and annualized return on average shareholders' equity was 16.08% for the nine months ended September 30, 2006 compared to 11.55% for the same period in 2005.

Net Interest Income. Net interest income, the major component of the Company's net earnings, was \$8.5 million for the three months ended September 30, 2006, an increase of 16% over the \$7.4 million earned in the same period in 2005. The increase in net interest income for the third quarter of 2006 was primarily attributable to increases in the prime rate resulting from Federal Reserve interest rate increases combined with increases in the average outstanding balances of loans and investment securities available-for-sale.

Interest income increased \$3.4 million or 30% for the three months ended September 30, 2006 compared with the same period in 2005. The increase was due to an increase in the average yield received on loans resulting from Federal Reserve interest rate increases combined with an increase in the average outstanding balance of loans and investment securities available-for-sale. The average yield earned on loans, including fees, was 8.67% for the three months ended September 30, 2006 as compared to 7.25% for the same period of 2005. During the quarter ended September 30, 2006, average loans increased \$52.9 million to \$608.6 million from \$555.7 million for the three months ended September 30, 2005. During the quarter ended September 30, 2006, average investment securities available-for-sale increased \$11.2 million to \$119.3 million from \$108.1 million for the three months ended September 30, 2005.

Interest expense increased \$2.3 million or 57% for the three months ended September 30, 2006 compared with the same period in 2005. The increase in interest expense was due to an increase in the cost of funds to 4.00% for the three months ended September 30, 2006 from 2.78% for the same period in 2005, combined with an increase in volume of interest-bearing liabilities. The increase in the cost of funds is primarily attributable to increases in the average rate paid on interest-bearing deposits. The average rate paid on interest-bearing checking and savings accounts was 1.89% for the three months ended September 30, 2006 as compared to 1.37% for the same period of

2005. The average rate paid on certificates of deposits was 4.40% for the three months ended September 30, 2006 compared to 3.17% for the same period one year ago.

Net interest income for the nine-month period ended September 30, 2006 was \$25.1 million, an increase of 24% over net interest income of \$20.3 million for the nine months ended September 30, 2005. This increase is attributable to an increase in interest income due to increases in the prime rate combined with increases in the average outstanding balances of loans and investment securities available-for-sale.

Interest income increased \$10.3 million or 33% to \$41.6 million for the nine months ended September 30, 2006 compared to \$31.3 million for the same period in 2005. The increase was primarily due to an increase in the average yield received on loans resulting from Federal Reserve interest rate increases combined with an increase in the average

outstanding balance of loans and investment securities available-for-sale. The average yield earned on loans, including fees, was 8.40% for the nine months ended September 30, 2006 as compared to 6.81% for the same period of 2005. During the nine months ended September 30, 2006, average loans increased \$48.8 million to \$595.2 million from \$546.4 million for the same period in 2005. Average investment securities available-for-sale increased 11% to \$117.7 million in the nine months ended September 30, 2006 compared to the same period in 2005. All other interest-earning assets including federal funds sold increased to an average of \$9.7 million in the nine months ended September 30, 2006 from \$8.8 million in the same period in 2005. The tax equivalent yield on average earning assets increased to 7.80% for the nine months ended September 30, 2006 from 6.42% for the nine months ended September 30, 2005.

Interest expense increased 50% to \$16.5 million for the nine months ended September 30, 2006 compared to \$11.0 million for the corresponding period in 2005. The increase in interest expense was due to an increase in the cost of funds to 3.65% for the nine months ended September 30, 2006 from 2.64% for the same period in 2005. The increase in the cost of funds is primarily attributable to increases in the average rate paid on interest-bearing deposits. The average rate paid on interest-bearing checking and savings accounts was 1.69% for the nine months ended September 30, 2006 as compared to 1.36% for the same period in 2005. The average rate paid on certificates of deposits was 4.09% for the nine months ended September 30, 2006 from 2.91% for the same period one year ago.

Provision for Loan Losses. For the three months ended September 30, 2006, a contribution of \$686,000 was made to the provision for loan losses compared to \$930,000 for the same period one year ago. For the nine months ended September 30, 2006 a contribution of \$1.9 million was made to the provision for loan losses compared to a \$2.3 million contribution to the provision for loan losses for the nine months ended September 30, 2005. The decrease in the provision for loan losses is primarily attributable to a decrease in non-accrual loans of \$2.0 million when compared to September 30, 2005.

Non-Interest Income. Total non-interest income was \$2.0 million in the third quarter of 2006, a 14% increase over the \$1.8 million for the same period in 2005. This increase is primarily due to an increase in service charge and fee income and other miscellaneous income resulting from activity in new branches opened in 2004, 2005 and 2006. Service charges were \$977,000 and \$988,000 for the three months ended September 30, 2006 and 2005, respectively. This decrease is primarily due to a decrease of \$41,000 in NSF Fee income. Other service charges and fees increased 28% to \$394,000 for the three-month period ended September 30, 2006 when compared to the same period one year ago. This increase is primarily attributable to an increase of \$38,000 in check cashing fee income. Mortgage banking income decreased \$18,000 during the three months ended September 30, 2006 as compared to the corresponding period in 2005. Miscellaneous income was \$640,000 for the three months ended September 30, 2006, a 56% increase from \$411,000 for the same period in 2005. This increase in miscellaneous income was partially attributable to income amounting to \$118,000 distributed by a Small Business Investment Corporation (SBIC) investment owned by the Bank, an increase of \$53,000 in debit card fee income primarily associated with increased card usage due to an increased number of demand accounts and a \$24,000 increase in income from the Bank's Real Estate Advisory Services, Inc. subsidiary. These increases were partially offset by a \$164,000 loss on sale of securities. Recurring non-interest income amounted to \$2.2 million and \$2.0 million for the three months ended September 30, 2006 and 2005, respectively. The increase in recurring non-interest income is primarily due to an increase in service charges and fees and miscellaneous other income. Net non-recurring losses on the disposition of assets totaled \$161,000 for the three months ended September 30, 2006 and included a \$164,000 loss on the sale of securities partially offset by a gain on the disposition of assets.

Total non-interest income was \$6.0 million for the nine months ended September 30, 2006, a 14% increase over the \$5.3 million for the same period in 2005. This increase is primarily due to an increase in fee income and other miscellaneous income resulting from activity in new branches opened in 2004, 2005 and 2006. Service charges were \$2.9 million for the nine months ended September 30, 2006, a 6% increase over the same period in 2005. This increase is primarily due to an increase of \$92,000 in account maintenance income. Other service charges and fees increased 40% to \$1.2 million for the nine months ended September 30, 2006 when compared to the same period one

year ago. This increase is primarily attributable to an increase of \$184,000 in check cashing fee income and an increase of \$58,000 in miscellaneous fee income. Mortgage banking income increased 5% to \$356,000 for the nine months ended September 30, 2006 when compared to the same period in 2005. Miscellaneous income increased 35% to \$1.6 million for the nine months ended September 30, 2006. This increase in miscellaneous income was partially attributable to an increase of \$154,000 in debit card fee income primarily associated with increased card usage due to an increased number of demand accounts, income amounting to \$118,000 distributed by a SBIC investment owned by the Bank and a \$69,000 increase in income from the Bank's Real Estate Advisory Services, Inc. subsidiary. These increases were partially offset by a \$337,000 loss on sale of securities, which reflects management's efforts to reposition the Bank's investment portfolio in order to reduce exposure to a decrease in interest rates. Recurring non-interest income amounted to \$6.3 million and \$5.4 million for the nine months ended September 30, 2006 and 2005, respectively. Net non-recurring losses on the disposition of assets totaled \$311,000 for the nine months ended September 30, 2006 and included the \$337,000 loss on the sale of securities partially offset by a \$26,000 gain on the disposition of assets.

Non-Interest Expense. Total non-interest expense increased 15% to \$6.2 million for the third quarter of 2006 as compared to \$5.4 million for the corresponding period in 2005. Salary and employee benefits totaled \$3.4 million for the three months ended September 30, 2006, an increase of 11% from the same period in 2005. The increase in salary and employee benefits is due to normal salary increases and increased employee incentive expense. Occupancy expense increased 3% to \$1.0 million for the quarter ended September 30, 2006. Other non-interest expense increased 33% to \$1.7 million for the three months ended September 30, 2006 as compared to the same period in 2005. The increase in other non-interest expense is attributable to an increase of \$136,000 in consulting expense due to Sarbanes-Oxley related expenses, an increase of \$148,000 in amortization of the issuance costs of the trust preferred securities issued in 2001 that management intends to call on December 31, 2006 and an increase of \$53,000 in advertising expense.

Total non-interest expense was \$17.8 million for the nine months ended September 30, 2006, an increase of 12% over the same period in 2005. Salary and employee benefits totaled \$9.9 million for the nine months ended September 30, 2006, an increase of 9% over the same period in 2005. The increase in salary and employee benefits is primarily due to normal salary increases and increased incentive expense. Occupancy expense increased 3% to \$3.1 million for the nine months ended September 30, 2006. Other non-interest expense increased 26% to \$4.9 million for the nine months ended September 30, 2006 as compared to the same period in 2005. The increase in other non-interest expense is attributable to an increase of \$178,000 in consulting expense due to Sarbanes-Oxley related expense, an increase of \$296,000 in amortization of the issuance costs of the trust preferred securities issued in 2001 that management intends to call on December 31, 2006 and an increase of \$165,000 in debit card expense. The Company also had non-recurring expense of \$178,000 from a prepayment fee associated with the early termination of a \$5.0 million Federal Home Loan Bank advance during the first quarter of 2006. Recurring non-interest expense increased 11% to \$17.6 million for the nine months ended September 30, 2006, as compared to \$15.9 million for the same period last year.

Income Taxes. The Company reported income taxes of \$1.3 million and \$1.0 million for the third quarters of 2006 and 2005, respectively. This represented effective tax rates of 36% and 35% for the respective periods.

The Company reported income taxes of \$4.1 million and \$2.5 million for the nine months ended September 30, 2006 and 2005, respectively. This represented effective tax rates of 36% and 35% for the respective periods.

Analysis of Financial Condition

Investment Securities. Available-for-sale securities amounted to \$118.1 million at September 30, 2006 compared to \$115.2 million at December 31, 2005. This increase is primarily the result of net securities purchases that are part of management's objective to grow the investment portfolio. This increase in the available-for-sale securities portfolio was partially offset by paydowns on mortgage-backed securities, calls and maturities. Average investment securities available for sale for the nine months ended September 30, 2006 amounted to \$117.7 million compared to \$108.7 million for the year ended December 31, 2005.

Loans. At September 30, 2006, loans amounted to \$624.3 million compared to \$566.7 million at December 31, 2005, an increase of \$57.6 million. Average loans represented 82% of total earning assets for the nine months ended September 30, 2006 and the year ended December 31, 2005. Mortgage loans held for sale were \$1.3 million and \$2.2 million at September 30, 2006 and December 31, 2005, respectively.

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.

An analysis of the credit quality of the loan portfolio and the adequacy of the allowance for loan losses is prepared by the Bank's credit administration personnel and presented to the Bank's Board of Directors on a regular basis. The allowance is the total of specific reserves allocated to significant individual loans plus a general reserve. After individual loans with specific allocations have been deducted, the general reserve is calculated by applying general reserve percentages to the nine risk grades within the portfolio. Loans are categorized as one of nine risk grades based on

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management's assessment of the overall credit quality of the loan, including payment history, financial position of the borrower, underlying collateral and internal credit review. The general reserve percentages are determined by management based on its evaluation of losses inherent in the various risk grades of loans. The allowance for loan losses is established through charges to expense in the form of a provision for loan losses. Loan losses and recoveries are charged and credited directly to the allowance.

The following table presents the percentage of loans assigned to each risk grade along with the general reserve percentage applied to loans in each risk grade at September 30, 2006 and December 31, 2005.

| LOAN RISK GRADE ANALYSIS: | Percentage of Loans | | General Reserve | |
|-------------------------------|---------------------|-------------------|-------------------|-------------------|
| | By Risk Grade* | | Percentage | |
| | <u>09/30/2006</u> | <u>12/31/2005</u> | <u>09/30/2006</u> | <u>12/31/2005</u> |
| Risk 1 (Excellent Quality) | 12.37% | 14.28% | 0.15% | 0.15% |
| Risk 2 (High Quality) | 16.17% | 18.16% | 0.50% | 0.50% |
| Risk 3 (Good Quality) | 58.61% | 56.40% | 1.00% | 1.00% |
| Risk 4 (Management Attention) | 10.29% | 8.38% | 2.50% | 2.50% |
| Risk 5 (Watch) | 0.59% | 0.88% | 7.00% | 7.00% |
| Risk 6 (Substandard) | 0.93% | 0.42% | 12.00% | 12.00% |
| Risk 7 (Low Substandard) | 0.53% | 0.86% | 25.00% | 25.00% |
| Risk 8 (Doubtful) | 0.00% | 0.00% | 50.00% | 50.00% |
| Risk 9 (Loss) | 0.00% | 0.00% | 100.00% | 100.00% |

*Excludes non-accrual loans

At September 30, 2006 there were no relationships exceeding \$1.0 million in the Watch risk grade, one relationship which totaled \$1.4 million in the Substandard risk grade and one relationship which totaled \$3.1 million in the Low Substandard risk grade. These customers continue to meet payment requirements. These relationships would not become non-performing assets unless they are unable to meet those payment requirements.

An allowance for loan losses is also established, as necessary, for individual loans considered to be impaired in accordance with Statement of Financial Accounting Standards ("SFAS") No. 114. A loan is considered 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. 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 collateral if the loan is collateral dependent. At September 30, 2006 and December 31, 2005, the recorded investment in loans that were considered to be impaired under SFAS No. 114 was approximately \$3.1 million and \$3.5 million, respectively, with related allowance for loan losses of approximately \$362,000 and \$478,000, respectively.

The allowance for loan losses totaled \$8.1 million at September 30, 2006 and \$7.4 million at December 31, 2005, which represented 1.30% of total loans outstanding at September 30, 2006 and 1.31% of total loans outstanding as of December 31, 2005.

The Bank's allowance for loan losses is also subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance for loan losses and the size of the allowance for loan losses compared to a group of peer banks identified by the regulators. During their routine examinations of banks, the FDIC and the North Carolina Commissioner of Banks may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

While it is the Bank's policy to charge off in the current period loans for which a loss is considered probable, there are additional risks of future losses which cannot be quantified precisely or attributed to particular loans or classes of loans. Because these risks include the state of the economy, management's judgment as to the adequacy of the allowance is necessarily approximate and imprecise. After review of all relevant matters affecting loan collectability, management believes that the allowance for loan losses is appropriate.

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 County. Although the Bank 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. Non-real estate loans also can be affected by local economic conditions. At September 30, 2006, approximately 5% of the Company's portfolio was not secured by any type of collateral. Unsecured loans generally involve higher credit risk than secured loans and, in the event of customer default, the Company has a higher exposure to

potential loan losses.

Non-performing Assets. Non-performing assets totaled \$3.8 million at September 30, 2006 or 0.48% of total assets, compared to \$5.0 million at December 31, 2005, or 0.68% of total assets. Non-accrual loans were \$3.1 million at September 30, 2006 and \$3.5 million at December 31, 2005. As a percentage of total loans outstanding, non-accrual loans were 0.50% at September 30, 2006 compared to 0.62% at December 31, 2005. There were no loans ninety days past due and still accruing at September 30, 2006 as compared to \$946,000 at December 31, 2005. Other real estate owned totaled \$650,000 as of September 30, 2006 as compared to \$531,000 at December 31, 2005. Repossessed assets as of September 30, 2006 were \$20,000. The Bank had no repossessed assets as of December 31, 2005.

Total non-performing loans, which include non-accrual loans and loans ninety days past due and still accruing, were \$3.1 million and \$4.4 million at September 30, 2006 and December 31, 2005, respectively. The ratio of non-performing loans to total loans was 0.50% at September 30, 2006, as compared to 0.79% at December 31, 2005.

Deposits. Total deposits at September 30, 2006 were \$606.5 million, an increase of \$23.6 million over deposits of \$582.9 million at December 31, 2005. Core deposits, which include non-interest bearing demand deposits, NOW, MMDA, savings and certificates of deposits of denominations less than \$100,000, were \$430.9 million at September 30, 2006 as compared to \$430.4 million at December 31, 2005. Certificates of deposit in amounts of \$100,000 or more totaled \$175.6 million at September 30, 2006 as compared to \$152.4 million at December 31, 2005. NOW, MMDA and savings accounts decreased \$12.4 million to \$170.9 million at September 30, 2006 as compared to \$183.3 million at December 31, 2005 due to customers transferring balances to certificates of deposits with higher rates. At September 30, 2006, brokered deposits amounted to \$54.8 million as compared to \$40.3 million at December 31, 2005. The increase in brokered deposits provided funding for the increased loan demand. Brokered deposits outstanding as of September 30, 2006 had a weighted average rate of 4.96% with a weighted average original term of 11 months.

Borrowed Funds. Borrowings from the Federal Home Loan Bank of Atlanta ("FHLB") totaled \$78.8 million at September 30, 2006 compared to \$71.6 million at December 31, 2005. The average balance of FHLB borrowings for the nine months ended September 30, 2006 was \$75.8 million compared to \$65.9 million for the year ended December 31, 2005. At September 30, 2006, FHLB borrowings with maturities exceeding one year amounted to \$27.0 million. The FHLB has the option to convert \$17.0 million of the total advances to a floating rate and, if converted, the Bank may repay advances without payment of a prepayment fee. The Company also has an additional \$10.0 million in variable rate convertible advances, which may be repaid without a prepayment fee if converted by the FHLB. At September 30, 2006, the Company had \$35.0 million in a short term fixed rate advance. The Company had no federal funds purchased as of September 30, 2006 or December 31, 2005.

Securities sold under agreements to repurchase amounted to \$8.6 million and \$981,000 as of September 30, 2006 and December 31, 2005, respectively.

Junior Subordinated Debentures (related to Trust Preferred Securities). In December 2001 the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust I ("PEBK Trust"), which issued \$14.0 million of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures that qualify as Tier 1 capital under Federal Reserve Board guidelines. All of the common securities of PEBK Trust are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust to purchase \$14.4 million of junior subordinated debentures of the Company, which pay a floating rate equal to prime plus 50 basis points. The proceeds received by the Company from the sale of the junior subordinated debentures were used for general purposes, primarily to provide capital to the Bank. The debentures represent the sole asset of PEBK Trust. PEBK Trust is not included in the consolidated financial statements.

The trust preferred securities issued by PEBK Trust accrue and pay quarterly distributions based on the liquidation value of \$50,000 per capital security at a floating rate of prime plus 50 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust 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 December 31, 2031, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust, in whole or in part, on or after December 31, 2006. 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. Management intends to call these trust preferred securities on December 31, 2006. In June 2006, as a result of management's decision to call these securities, the amortization of the related issuance cost was revised so it will be fully

amortized by year end. The remaining unamortized issuance cost at September 30, 2006 was \$152,000.

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 are intended to be used 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 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 September 15, 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.

Management expects to call the PEBK Trust securities and issued the new PEBK Trust II securities in an effort to reduce interest expense. Based on interest rates in effect at September 30, 2006, the rate on the PEBK Trust securities was 8.75%, while the interest rate on the PEBK Trust II securities was 7.02%.

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 to be done in conjunction with the need to maintain adequate liquidity and the overall goal of maximizing net interest income.

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. 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. Average rate sensitive assets for the nine months ended September 30, 2006 totaled \$722.6 million,

exceeding average rate sensitive liabilities of \$605.9 million by \$116.7 million.

In order to assist in achieving a desired level of interest rate sensitivity, the Company entered into off-balance sheet contracts that are considered derivative financial instruments. As of September 30, 2006, the Company had cash flow hedges with a notional amount of \$150.0 million. These derivative instruments consist of four interest rate floor contracts that are used to hedge future cash flows of the first \$150.0 million of certain variable rate commercial, construction and home equity loans against the downward effects of their repricing in the event of a decreasing rate environment for a period of three years ending in July 2008, November 2008, January 2009 and June 2009. If the prime rate falls below 6.25% during the term of the contract on the first floor, the Company will receive payments based on the \$35.0 million notional amount times the difference between 6.25% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate is 6.25% or higher. The Company paid a premium of \$161,000 on this contract. On the second floor if the prime rate falls below 7.00% during the term of the contract, the

Company will receive payments based on the \$35.0 million notional amount times the difference between 7.00% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate is 7.00% or higher. The Company paid a premium of \$203,000 on this contract. On the third floor if the prime rate falls below 7.50% during the term of the contract, the Company will receive payments based on the \$45.0 million notional amount times the difference between 7.50% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate is 7.50% or higher. The Company paid a premium of \$562,500 on this contract. On the fourth floor if the prime rate falls below 8.00% during the term of the contract, the Company will receive payments based on the \$35.0 million notional amount times the difference between 8.00% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate is 8.00% or higher. The Company paid a premium of \$399,000 on this contract. The amortization expense recognized on these four interest rate floor contracts totaled \$221,000 for the nine-month period ended September 30, 2006.

The Company settled two previously outstanding interest rate swap agreements during 2005. The first swap, with a notional amount of \$25.0 million and maturing in April 2006 was sold for a loss of \$318,000. The second swap with a notional amount of \$30.0 million and maturing in September 2006 was sold for a loss of \$552,000. The losses realized upon settlement were recognized over the original term of the agreements and during the nine-month period, ended September 30, 2006, losses of approximately \$386,000 were recognized.

The Bank utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At September 30, 2006, the Bank had \$70.4 million in loans with interest rate floors; however, none of the floors were in effect pursuant to the terms of the promissory notes on these loans.

The Bank also had \$19.9 million in loans that are tied to the prime rate and had interest rate caps in effect pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 2.08% lower than the indexed rate on the promissory notes without the interest rate caps.

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 September 30, 2006 such unfunded commitments to extend credit were \$145.4 million, while commitments in the form of standby letters of credit totaled \$3.9 million.

The Company uses several sources to meet its liquidity requirements. The primary source is core deposits, which includes demand deposits, savings accounts and 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 September 30, 2006, the Company's core deposits totaled \$430.9 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 and FHLB advances. The Bank is also able to borrow from the Federal Reserve System on a short-term basis.

At September 30, 2006, the Bank had a significant amount of deposits in amounts greater than \$100,000, including brokered deposits of \$54.8 million, which mature over the next year. The balance and cost of these deposits are more susceptible to changes in the interest rate environment than other deposits.

The Bank had a line of credit with the FHLB equal to 20% of the Bank's total assets, with an outstanding balance of \$78.8 million at September 30, 2006. The remaining availability at FHLB was \$52.6 million at September 30, 2006. The Bank also had the ability to borrow up to \$26.0 million for the purchase of overnight federal funds from three correspondent financial institutions as of September 30, 2006.

The liquidity ratio for the Bank, which is defined as net cash, interest bearing deposits with banks, federal funds sold, certain investment securities and certain FHLB advances available under the line of credit, as a percentage of net deposits (adjusted for deposit runoff projections) and short-term liabilities was 33.09% at September 30, 2006 and 36.81% at December 31, 2005. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy is 20%.

Contractual Obligations and Off-Balance Sheet Arrangements. The Company's contractual obligations and other commitments as of September 30, 2006 and December 31, 2005 are summarized in the table 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.

CONTRACTUAL OBLIGATIONS AND OTHER COMMITMENTS:

(Dollars in Thousands)

| | September 30, 2006 | December 31, 2005 |
|--|-----------------------|----------------------|
| Contractual Cash Obligations | | |
| Long-term borrowings | \$ 27,000 | 67,000 |
| Junior subordinated debentures | 35,052 | 14,433 |
| Operating lease obligations | 7,990 | 8,599 |
| Total | \$ 70,042 | 90,032 |
| Other Commitments | | |
| Commitments to extend credit | \$ 145,422 | 133,409 |
| Standby letters of credit and financial guarantees written | 3,854 | 2,692 |
| Total | \$ 149,276 | 136,101 |

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. Further discussions of derivative instruments are included above in the section entitled "Asset Liability and Interest Rate Risk Management".

Capital Resources. Shareholders' equity at September 30, 2006 was \$60.9 million compared to \$54.4 million at December 31, 2005. At September 30, 2006 and December 31, 2005, unrealized losses, net of taxes, amounted to \$1.1 million and \$1.4 million, respectively. The decrease in unrealized losses at September 30, 2006 is primarily attributable to an increase in the market value of available for sale securities and derivative instruments. Management expects that accumulated comprehensive income (loss) will continue to fluctuate due to changes in the market value of available for sale investments securities and derivative instruments caused by changes in market interest rates. Annualized return on average equity for the nine months ended September 30, 2006 was 16.08% compared to 9.96% for the year ended December 31, 2005. Total cash dividends paid during the nine months ended September 30, 2006 amounted to \$1.2 million as compared to total cash dividends of \$1.0 million paid for the first nine months of 2005.

Since implementation of a stock repurchase plan implemented in November 2005, which expires in November 2006, the Company has repurchased \$425,000, or 17,500 shares of its common stock.

Under the 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. The Company's Tier 1 capital ratio was 11.93% and 11.02% at September 30, 2006 and December 31, 2005, 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 15.06% and 12.19% at September 30, 2006 and December 31, 2005, 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 10.79% and 9.84% at September 30, 2006 and December 31, 2005, respectively.

The Bank's Tier 1 risk-based capital ratio was 10.42% and 10.46% at September 30, 2006 and December 31, 2005, respectively. The total risk-based capital ratio for the Bank was 11.61% and 11.64% at September 30, 2006 and December 31, 2005, respectively. The Bank's Tier 1 leverage capital ratio was 9.41% and 9.33% at September 30, 2006 and December 31, 2005, 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 September 30, 2006.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in the quantitative and qualitative disclosures about market risks as of September 30, 2006 from that presented in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

Item 4. Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART OTHER INFORMATION**II.****Item Legal Proceedings****1.**

In the opinion of management, the Company is not involved in any pending legal proceedings other than routine, non-material proceedings occurring in the ordinary course of business.

Item Risk Factors**1A.**

There are no material changes from the risk factors as previously disclosed in the Company's Form 10-K in response to Item 1A. to Part I to Form 10-K, filed with Securities and Exchange Commission on March 24, 2006.

Item Unregistered Sales of Equity Securities and Use of**2. Proceeds**

**ISSUER PURCHASES
OF EQUITY
SECURITIES**

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|------------------------|---|---|---|---|
| July 1 - 31, 2006 | 505 | \$ 27.48 | - | \$ 1,575,000 |
| Aug 1 - 31, 2006 | 194 | 27.17 | - | 1,575,000 |
| September 1 - 30, 2006 | - | - | - | 1,575,000 |
| Total | 699 | \$ 27.39 | - | \$ 1,575,000 |

Item Defaults Upon Senior Securities

3.

Not applicable

Item Submission of Matters to a Vote of Security Holders

4.

Not applicable

Item Other Information

5.

Not applicable

Item 6. Exhibits

Exhibit Articles of Incorporation of Peoples Bancorp of North Carolina, Inc.,
(3)(i) incorporated
by reference to Exhibit (3)(i) to the Form 8-A filed with the Securities and
Exchange Commission on September 2, 1999

Exhibit Amended and Restated Bylaws of Peoples Bancorp of North Carolina, Inc.,
(3)(ii)
incorporated by reference to Exhibit (3)(ii) to the Form 10-K filed with the
Securities and Exchange Commission on March 26, 2004

Exhibit Specimen Stock Certificate, incorporated by reference to Exhibit (4) to the
(4) Form 8-
A filed with the Securities and Exchange Commission on September 2, 1999

Exhibit Employment Agreement between Peoples Bank and Tony W. Wolfe
(10)(a) incorporated

- by reference to Exhibit (10)(a) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(b) Employment Agreement between Peoples Bank and Joseph F. Beaman, Jr. incorporated by reference to Exhibit (10)(b) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(c) Employment Agreement between Peoples Bank and William D. Cable incorporated by reference to Exhibit (10)(d) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(d) Employment Agreement between Peoples Bank and Lance A. Sellers incorporated by reference to Exhibit (10)(e) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(e) Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(f) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(f) Employment Agreement between Peoples Bank and A. Joseph Lampron, incorporated by reference to Exhibit (10)(g) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002
- Exhibit (10)(g) Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(h) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002
- Exhibit (10)(h) Rabbi Trust for the Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002
- Exhibit (10)(i) Description of Service Recognition Program maintained by Peoples Bank, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 27, 2003
- Exhibit (10)(j) Capital Securities Purchase Agreement dated as of June 26, 2006, by and among

Peoples Bancorp of North Carolina, Inc., PEBK Capital Trust II and Bear,
Sterns
Securities Corp.

- Exhibit (10)(k) Amended and Restated Trust Agreement of PEBK Capital Trust II, dated as of June 28, 2006
- Exhibit (10)(l) Guarantee Agreement of Peoples Bancorp of North Carolina, Inc. dated as of June 28, 2006
- Exhibit (10)(m) Indenture, dated as of June 28, 2006, by and between Peoples Bancorp of North Carolina, Inc. and LaSalle Bank National Association, as Trustee, relating to Junior Subordinated Debt Securities Due September 15, 2036
- Exhibit (14) Code of Business Conduct and Ethics of Peoples Bancorp of North Carolina, Inc., incorporated by reference to Exhibit (14) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2005
- Exhibit (31)(a) Certification of principal executive officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit (31)(b) Certification of principal financial officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit (32) Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

Peoples Bancorp of North Carolina, Inc.

November 10, 2006
Date

/s/ Tony W. Wolfe
Tony W. Wolfe
President and Chief Executive Officer
(Principal Executive Officer)

November 10, 2006
Date

/s/ A. Joseph Lampron
A. Joseph Lampron
Executive Vice President and Chief Financial
Officer
(Principal Financial and Principal Accounting
Officer)

