

PEOPLES BANCORP OF NORTH CAROLINA INC
Form DEF 14A
April 03, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

SCHEDULE 14A

(Rule 14a-101)

Proxy Statement Pursuant to Section 14(a)
of the Securities Exchange Act of 1934

Filed by the Registrant [X]

Filed by a Party other than the Registrant []

Check the appropriate box:

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| <input type="checkbox"/> [] Preliminary Proxy Statement | <input type="checkbox"/> [] Confidential, for Use of the Commission |
| <input checked="" type="checkbox"/> [X] Definitive Proxy Statement | Only (as permitted by Rule 14a-6(e)(2)) |
| <input type="checkbox"/> [] Definitive Additional Materials | |
| <input type="checkbox"/> [] Soliciting Material Pursuant to §240.14a-12 | |

Peoples Bancorp of North Carolina, Inc.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

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[X] No fee required.

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(3)

Filing Party:

(4)

Date Filed:

**PEOPLES BANCORP
OF NORTH CAROLINA, INC.**

Notice of 2006 Annual Meeting,
Proxy Statement and
Annual Report

PEOPLES BANCORP OF NORTH CAROLINA, INC.

PROXY STATEMENT

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PEOPLES BANCORP OF NORTH CAROLINA, INC.

**Post Office Box 467
518 West C Street
Newton, North Carolina 28658-0467
(828) 464-5620**

NOTICE OF 2006 ANNUAL MEETING OF SHAREHOLDERS

To Be Held on May 4, 2006

NOTICE IS HEREBY GIVEN that the 2006 Annual Meeting of Shareholders (the "Meeting") of Peoples Bancorp of North Carolina, Inc. (the "Company") will be held on Thursday, May 4, 2006, at 11:00 a.m., Eastern Time, at the Catawba Country Club, 1154 Country Club Road, Newton, North Carolina.

The Meeting is for the purpose of considering and voting upon the following matters:

1. To elect four persons who will serve as directors of the Company for a three-year term expiring in 2009, or until their successors are duly elected and qualified;
2. To ratify the appointment of Porter Keadle Moore, LLP ("PKM") as the independent auditor for the Company for the fiscal year ending December 31, 2006; and
3. To transact such other business as may properly come before the Meeting or any adjournments thereof. The board of directors of the Company (the "Board of Directors") is not aware of any other business to be considered at the Meeting.

The Board of Directors has established March 6, 2006 as the record date for the determination of shareholders entitled to notice of and to vote at the Meeting and at any adjournments thereof. In the event there are not sufficient shares present in person or by proxy to constitute a quorum at the time of the Meeting, the Meeting may be adjourned in order to permit further solicitation of proxies by the Company.

By Order of the Board of Directors,

/s/ Tony W. Wolfe

Tony W. Wolfe
President and Chief Executive Officer

Newton, North Carolina
April 3, 2006

A form of proxy is enclosed to enable you to vote your shares at the Meeting. You are urged, regardless of the number of shares you hold, to complete, sign, date and return the proxy promptly. A return envelope, which requires no postage if mailed in the United States, is enclosed for your convenience.

PEOPLES BANCORP OF NORTH CAROLINA, INC.

**PROXY STATEMENT
2006 ANNUAL MEETING OF SHAREHOLDERS
May 4, 2006**

SOLICITATION, VOTING AND REVOCABILITY OF PROXIES

General

This Proxy Statement is being furnished to shareholders of the Company in connection with the solicitation by the Board of Directors of the Company of proxies to be used at the Meeting to be held on Thursday, May 4, 2006, at 11:00 a.m., Eastern Time, at the Catawba Country Club, 1154 Country Club Road, Newton, North Carolina, and at any adjournments thereof. This Proxy Statement and the accompanying form of proxy were first mailed to shareholders on April 3, 2006.

The Company's principal executive offices are located at 518 West C Street, Newton, North Carolina 28658, and its telephone number is (828) 464-5620.

Other than the matters listed on the attached Notice of 2006 Annual Meeting of Shareholders, the Board of Directors knows of no matters that will be presented for consideration at the Meeting. Execution of a proxy, however, confers on the designated proxyholders discretionary authority to vote the shares represented thereby in accordance with their best judgment on such other business, if any, that may properly come before the Meeting or any adjournments thereof.

Revocability of Proxy

A proxy may be revoked at any time prior to its exercise by the filing of a written notice of revocation with the Secretary of the Company, by delivering to the Company a duly executed proxy bearing a later date, or by attending the Meeting and voting in person. However, if you are a shareholder whose shares are not registered in your own name, you will need appropriate documentation from your recordholder to vote personally at the Meeting.

Solicitation

The cost of solicitation of proxies on behalf of the Board of Directors will be borne by the Company. Proxies may be solicited personally or by telephone by directors, officers and regular employees of the Company, without additional compensation therefor. The Company will also request persons, firms and corporations holding shares in their names, or in the name of their nominees, which are beneficially owned by others to send proxy material to, and obtain proxies from, such beneficial owners and will reimburse such holders, upon request, for their reasonable out-of-pocket expenses in doing so.

Voting Securities and Vote Required for Approval

Regardless of the number of shares of the Company's common stock (the "Common Stock") owned, it is important that shareholders be represented by proxy or be present in person at the Meeting. Shareholders are requested to vote by completing the enclosed form of proxy and returning it signed and dated in the enclosed postage-paid envelope. Any shareholder may vote for, against, or withhold authority to vote on any matter to come before the Meeting. If the enclosed proxy is properly completed, signed, dated and returned, and not revoked, it will be voted in accordance with

the instructions therein. If no instructions are given, the proxy will be voted "FOR" the nominees for election to the Board of Directors named in this Proxy Statement and "FOR" the ratification of PKM as the Company's independent auditor for the fiscal year ending December 31, 2006. If instructions are given with respect to one but not

both proposals, (i) such instructions as are given will be followed, and (ii) the proxy will be voted "FOR" the proposal on which no instructions are given.

The securities which may be voted at the Meeting consist of shares of Common Stock. The close of business on March 6, 2006 has been fixed by the Board of Directors as the record date (the "Record Date") for the determination of shareholders of record entitled to notice of and to vote at the Meeting and any adjournments thereof. The total number of shares of Common Stock outstanding on the Record Date was 3,454,501.

The presence, in person or by proxy, of the holders of at least a majority of the total number of shares of Common Stock entitled to vote at the Meeting is necessary to constitute a quorum at the Meeting. Since many of our shareholders cannot attend the Meeting, it is necessary that a large number be represented by proxy. Accordingly, the Board of Directors has designated proxies to represent those shareholders who cannot be present in person and who desire to be so represented. In the event there are not sufficient votes for a quorum or to approve or ratify any proposal at the time of the Meeting, the Meeting may be adjourned in order to permit the further solicitation of proxies.

In the election of directors, persons must be nominated and elected for a term to expire at the 2009 Annual Meeting of Shareholders. Each share of Common Stock shall entitle its owner to one vote, and a nominee need only receive a plurality of the votes cast in the election of directors in order to be elected. As a result, those persons nominated who receive the largest number of votes will be elected as directors. No shareholder has the right to cumulatively vote his or her shares in the election of directors.

As to the ratification of the independent auditor, each share of Common Stock shall entitle its owner to one vote and the affirmative vote of the holders of a majority of the shares of Common Stock present at the Meeting, in person or by proxy and entitled to vote, is required to constitute shareholder approval of the proposal.

Proxies solicited hereby will be returned to the Board of Directors, and will be tabulated by one or more inspectors of election designated by the Board of Directors. Abstentions will be counted for purposes of determining whether a quorum is present at the Meeting. Abstentions will not be counted in tabulating the votes cast on any proposal submitted to the shareholders. Broker non-votes will be counted for determining the existence of a quorum but will not be counted for tabulating votes cast on any proposal.

**SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS
AND MANAGEMENT**

The Securities Exchange Act of 1934, as amended (the "Exchange Act"), requires that any person who acquires the beneficial ownership of more than five percent of the Common Stock notify the Securities and Exchange Commission (the "SEC") and the Company. Following is certain information, as of the Record Date, regarding those persons or groups who held of record or who are known to the Company to own beneficially, more than five percent of the outstanding Common Stock.

| <u>Name and Address of Beneficial Owner</u> | <u>Amount and Nature of Beneficial Ownership</u> ¹ | <u>Percent of Class</u> ² |
|--|--|---|
| Christine S. Abernethy P.O. Box 820 Newton, NC 28658 | 385,005 ³ | 11.15% |
| Banc Funds Company, LLC 208 South LaSalle St. | 193,922 | 5.61% |

Suite 1680
Chicago, IL 60604

Tontine Partners, LP
55 Railroad Ave., 3rd Floor
Greenwich, CT 06830-6378

314,793

9.11%

2

1

Unless otherwise noted, all shares are owned directly of record by the named individuals, by their spouses and minor children, or by other entities controlled by the named individuals. Voting and investment power is not shared unless otherwise indicated.

2

Based upon a total of 3,454,501 shares of Common Stock outstanding as of the Record Date.

3

Carolina Glove Company, Inc. owns 65,215 shares of Common Stock. These shares are included in the calculation of Ms. Abernethy's total beneficial ownership interest. Ms. Abernethy owns approximately 50% of the stock of Carolina Glove Company, Inc. The business is operated by a family committee. Ms. Abernethy has no active day-to-day participation in the business affairs of Carolina Glove Company, Inc.

Set forth below is certain information, as of the Record Date, regarding those shares of Common Stock owned beneficially by each of the persons who currently serves as a member of the Board of Directors, is a nominee for election to the Board at the Meeting, or is a named executive officer of the Company. Also shown is the number of shares of Common Stock owned by the directors and executive officers of the Company as a group.

| <u>Name and Address</u> | <u>Amount and Nature of Beneficial Ownership¹</u> | <u>Percentage of Class²</u> |
|--|--|--|
| James S. Abernethy Post Office Box 327 Newton, NC 28658 | 108,907 ³ | 3.06% |
| Robert C. Abernethy Post Office Box 366 Newton, NC 28658 | 124,624 ⁴ | 3.50% |
| Joseph F. Beaman, Jr. Post Office Box 467 Newton, NC 28658 | 23,447 ⁵ | * |
| William D. Cable Post Office Box 467 Newton, NC 28658 | 17,463 ⁶ | * |
| Douglas S. Howard P. O. Box 587 Denver, NC 28037 | 4,434 ⁷ | * |
| A. Joseph Lampron Post Office Box 467 Newton, NC 28658 | 11,647 ⁸ | * |

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| | | |
|--|---------------------|---|
| John W. Lineberger, Jr. 6154 Vesuvius Furnace Road Iron Station, NC 28080 | 563 | * |
| Gary E. Matthews 210 First Avenue South Conover, NC 28613 | 8,900 | * |
| Billy L. Price, Jr., M.D. 540 11th Ave. Place NW Hickory, NC 28601 | 598 | * |
| Larry E. Robinson Post Office Box 723 Newton, NC 28658 | 27,125 ⁹ | * |

| <u>Name and Address</u> | <u>Amount and Nature of Beneficial Ownership¹</u> | <u>Percentage of Class²</u> |
|--|--|--|
| Lance A. Sellers Post Office Box 467 Newton, NC 28658 | 20,971 ¹⁰ | * |
| William Gregory Terry 706 South College Ave Newton, NC 28658 | 3,276 ¹¹ | * |
| Dan Ray Timmerman, Sr. Post Office Box 1148 Conover, NC 28613 | 35,302 ¹² | * |
| Tony W. Wolfe Post Office Box 467 Newton, NC 28658 | 43,570 ¹³ | 1.22% |
| Benjamin I. Zachary Post Office Box 277 Taylorsville, NC 28681 | 45,311 ¹⁴ | 1.27% |
| All current directors and nominees and executive officers as a group (17 people) | 435,985 15,16 | 12.24% |

*Does not exceed one percent of the Common Stock outstanding.

1

Unless otherwise noted, all shares are owned directly of record by the named individuals, by their spouses and minor children, or by other entities controlled by the named individuals. Voting and investment power is not shared unless otherwise indicated.

2

Based upon a total of 3,454,501 shares of Common Stock outstanding as of the Record Date and 107,421 stock options exercisable within 60 days with respect to the designated recipient(s).

3

Includes 38,811 shares of Common Stock owned by Alexander Railroad Company. Mr. J. Abernethy is Vice President, Secretary and Chairman of the Board of Directors of Alexander Railroad Company.

4

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Includes 2,961 shares of Common Stock owned by Mr. R. Abernethy's spouse, for which Mr. R. Abernethy disclaims beneficial ownership.

5

Includes 20,945 shares of Common Stock in which Mr. Beaman has the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

6

Includes 14,248 shares of Common Stock in which Mr. Cable has the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

7

Includes 1,000 shares of Common Stock owned by Mr. Howard's mother over which Mr. Howard holds a power of attorney. Includes 500 shares of Common Stock owned by Howard Ventures, Inc. Mr. Howard is Vice President of Howard Ventures, Inc.

8

Includes 11,152 shares of Common Stock in which Mr. Lampron has the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

9

Includes 4,143 shares of Common Stock owned by Mr. Robinson's spouse, for which Mr. Robinson disclaims beneficial ownership.

¹⁰ Includes 20,848 shares of Common Stock in which Mr. Sellers has the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

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11

Includes 1,000 shares of Common Stock owned by Drum Funeral Home, LLC. Mr. Terry is Executive Vice-President of Drum Funeral Home, LLC.

12

Includes 1,650 shares of Common Stock owned by Timmerman Manufacturing, Inc. Mr. Timmerman is President and a Director of Timmerman Manufacturing, Inc.

13

Includes 40,228 shares of Common Stock in which Mr. Wolfe has the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

14

Includes 38,811 shares of Common Stock owned by Alexander Railroad Company. Mr. Zachary is President, Treasurer, General Manager and a Director of Alexander Railroad Company.

15

The 38,811 shares owned by Alexander Railroad Company and attributed to Mr. J. Abernethy and Mr. Zachary are only included once in calculating this total.

16

Includes 107,421 shares of Common Stock in which the executive officers, as a group, have the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

Directors James S. Abernethy and Robert C. Abernethy are brothers and are sons of Christine S. Abernethy, who owns in excess of 10% of the Common Stock.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires the Company's executive officers and directors, and persons who own more than ten percent of the Common Stock, to file reports of ownership and changes in ownership with the SEC. Executive officers, directors and greater than ten percent beneficial owners are required by SEC regulations to furnish the Company with copies of all Section 16(a) forms they file.

Based solely on a review of the copies of such forms furnished to the Company and written representations from the Company's executive officers and directors, the Company believes that during the fiscal year ended December 31, 2005, its executive officers and directors and greater than ten percent beneficial owners complied with all applicable Section 16(a) filing requirements.

PROPOSAL 1

ELECTION OF DIRECTORS

Nominees

The Bylaws of the Company provide that the number of directors of the Company shall not be less than five nor more than fifteen. The exact number of directors is determined by the Board of Directors. The Board of Directors has set the size of the Board at ten members following the election of directors at the 2006 Annual Meeting of Shareholders.

The Board of Directors has nominated the four persons named below for election as directors to serve for a three-year term to expire at the 2009 Annual Meeting of Shareholders or until their earlier death, resignation, retirement, removal or disqualification or until their successors shall be elected and shall qualify.

The persons named in the accompanying form of proxy intend to vote any shares of Common Stock represented by valid proxies received by them to elect the four nominees listed below as directors for the term specified, unless authority to vote is withheld or such proxies are duly revoked. All of the nominees for election are currently members of the Board of Directors whose terms expire in 2006. In the event that any of the nominees should become unavailable to accept nomination or election, it is intended that the proxyholders will vote to elect in his stead such other person as the present Board of Directors may recommend. The Board of Directors has no reason to believe that any of the nominees named herein will be unable to serve if elected to office.

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The Company's Bylaws provide that, in order to be eligible for consideration at the Annual Meeting of Shareholders, all nominations of directors, other than those made by the Board of Directors, must be made in writing and must be delivered to the Secretary of the Company not less than 50 days nor more than 90 days prior to the meeting at which such nominations will be made; provided, however, if less than 60 days notice of the meeting is given to shareholders, such nominations must be delivered to the Secretary of the Company not later than the close of business on the tenth day following the day on which the notice of meeting was mailed.

The following table sets forth as to each nominee, his name, age, principal occupation during the last five years, and the year he was first elected as a director.

| <u>Name</u> | <u>Age on December 31, 2005</u> | <u>Principal Occupation During Last Five Years</u> | <u>Director Since</u> |
|-----------------------|-------------------------------------|---|---------------------------|
| Robert C. Abernethy | 55 | President, Secretary and Treasurer, Carolina Glove Company, Inc. (glove manufacturer); Secretary and Assistant Treasurer, Midstate Contractors, Inc (paving company) | 1976 |
| James S. Abernethy | 51 | Vice President, Carolina Glove Company, Inc (glove manufacturer); President and Assistant Secretary, Midstate Contractors, Inc (paving company); Vice President, Secretary and Chairman of the Board of Directors, Alexander Railroad Company | 1992 |
| Larry E. Robinson | 60 | President and Chief Executive Officer, The Blue Ridge Distributing Company, Inc (beer and wine distributor) | 1993 |
| William Gregory Terry | 38 | Executive Vice President, Drum & Willis-Reynolds Funeral Homes and Crematory | 2004 |

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR ALL OF THE ABOVE-LISTED NOMINEES FOR ELECTION AS DIRECTORS. THE FOUR NOMINEES RECEIVING THE HIGHEST NUMBER OF VOTES SHALL BE DEEMED TO HAVE BEEN ELECTED.

The following table sets forth as to each continuing director of the Bank, his name, age, principal occupation during the last five years, the year he was first elected as a director, and the year his current term expires.

| <u>Age on</u> | <u>Principal Occupation</u> | <u>Director</u> | <u>Term</u> |
|---------------|-----------------------------|-----------------|-------------|
|---------------|-----------------------------|-----------------|-------------|

| <u>Name</u> | <u>December 31,</u> <u>2005</u> | <u>During Last Five Years</u> | <u>Since</u> | <u>Expires</u> |
|----------------------------|------------------------------------|--|--------------|----------------|
| John W. Lineberger, Jr. | 55 | President, Lincoln Bonded Warehouse Company (commercial warehousing facility) | 2004 | 2007 |
| Gary E. Matthews | 50 | President and Director, Matthews Construction Company, Inc. | 2001 | 2007 |
| Dan Ray Timmerman, Sr. | 58 | President, Timmerman Manufacturing, Inc. (wrought iron furniture manufacturer) | 1995 | 2007 |

| <u>Name</u> | <u>Age on December 31, 2005</u> | <u>Principal Occupation During Last Five Years</u> | <u>Director Since</u> | <u>Term Expires</u> |
|-----------------------------|---|---|---------------------------|-------------------------|
| Benjamin I. Zachary | 49 | President, Treasurer, and member of the Board of Directors, Alexander Railroad | 1995 | 2007 |
| Douglas S. Howard | 46 | Vice President, Howard Ventures, Inc.; Secretary/Treasurer, Denver Equipment of Charlotte, Inc | 2004 | 2008 |
| Billy L. Price, Jr., M D | 49 | Practicing Internist and Partner in Catawba Valley Internal Medicine, P.A.; Clinical Instructor, Wake Forest University School of Medicine | 2004 | 2008 |

Board of Directors of the Bank

Peoples Bank (the "Bank") also will have ten directors currently serving on its board of directors, comprised of all the same people who are currently directors of the Company.

Meetings of the Board

The Board of Directors and/or the Bank's board of directors met a total of fifteen (15) times during the fiscal year ended December 31, 2005. During the year ended December 31, 2005, all members of the Board of Directors attended at least 75% of the aggregate number of meetings of the Board of Directors, the Bank's board of directors and committees of both boards on which they served.

Committees of the Board

The Board of Directors of the Company has three standing committees - the Governance Committee, the Executive Committee, and the Audit Committee. These committees are described below.

Governance Committee. The Governance Committee is comprised entirely of independent Directors, as defined in Rule 4200(a)(15) of the NASD's listing standards. It currently consists of Directors R. Abernethy, J. Abernethy, Lineberger, Robinson, Terry, Timmerman and Zachary. The Governance Committee is responsible for developing and maintaining the corporate governance policy, as well as acting as the nominating committee for the Board. The Company has adopted a written charter for the Governance Committee, which was attached as an exhibit to the Company's Notice of 2004 Annual Meeting, Proxy Statement and Annual Report.

The Governance Committee interviews candidates for membership to the Board of Directors, recommends candidates to the full Board, slates candidates for Director and shareholder votes, and fills any vacancies on the Board of Directors which occur between shareholder meetings. The Governance Committee's identification of candidates for Director typically results from the business interactions of the members of the Governance Committee or from recommendations received by the committee from other Directors or from Company management. The Governance Committee currently has no written policy with regard to the consideration of director candidates recommended by security holders. If a security holder recommends a director candidate to the Governance Committee, however, the Governance Committee will consider the candidate and apply the same considerations that it would to its own

candidates. The recommendation of a candidate by a security holder should be made in writing, addressed to the attention of the Governance Committee at the Company's corporate headquarters. The recommendation should include a description of the candidate's background, his or her contact information, and any other information the security holder considers useful and appropriate for the Governance Committee's consideration of the candidate. The criteria which have been established by the Governance Committee as bearing on the consideration of a candidate's qualification to serve as a Director include

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the following: the candidate's ethics, integrity, involvement in the community, success in business, relationship with the Bank, investment in the Company, place of residence (i.e., proximity to the Bank's market area), and financial expertise.

The Governance Committee met five (5) times during fiscal year 2005.

Executive Committee. The Executive Committee performs duties as assigned by the full Board of Directors. Actions taken by the Executive Committee must be approved by the full Board. The Executive Committee consists of Directors R. Abernethy, J. Abernethy, and Timmerman, as well as Mr. Wolfe, the President and Chief Executive Officer of the Company. It meets on an "as needed" basis.

Audit Committee. The Audit Committee consists of Directors R. Abernethy, Howard, Matthews, Price, Robinson, Timmerman and Zachary. The Board of Directors has determined that these members are independent as that term is defined in Rule 4200(a)(15) of the NASD's listing standards.

The Audit Committee meets at least quarterly and, among other responsibilities, oversees (i) the independent auditing of the Company; (ii) the system of internal controls that management has established; and (iii) the quarterly and annual financial information to be provided to shareholders and the Securities and Exchange Commission. The Audit Committee met eight (8) times during the fiscal year ended December 31, 2005.

Communications Between Shareholders and Members of the Board of Directors

The Company does not have a formal procedure for shareholder communication with the Board of Directors. In general, however, the directors and executive officers of the Company are easily accessible by telephone, postal mail or electronic mail. Any matter intended for the Board of Directors, or for any individual member or members of the Board, can be directed to the Company's Chief Executive Officer, Mr. Wolfe, or Chief Financial Officer, Mr. Lampron, with a request to forward the same to the intended recipient. Alternatively, shareholders can direct correspondence to the Board, or any of its members, in care of the Company at the Company's address. All such communications will be forwarded to the intended recipient unopened.

Director Attendance at Annual Meetings

Although it is customary for all members of the Board of Directors to attend, the Company has no formal policy in place with regard to Directors' attendance at the Annual Meeting of Shareholders. All members of the Company's Board of Directors attended the 2005 Annual Meeting of Shareholders.

Bank Board Committees

The Bank's board of directors has the same three committees as the Company's Board of Directors, the Governance Committee, the Audit Committee and the Executive Committee. The membership of the Bank's standing committees and the committees' responsibilities are identical to those performed by their counterpart committees on the Company level.

The Bank's Executive Committee currently has four members, Directors J. Abernethy, R. Abernethy, Wolfe, and Timmerman. The Committee performs duties as assigned by the full board of directors of the Bank. Any action taken by the Executive Committee must be ratified by the full board. The Committee meets on an "as needed" basis.

The Governance Committee has seven (7) members, Directors J. Abernethy, R. Abernethy, Lineberger, Robinson, Terry, Timmerman and Zachary. The Bank's Governance Committee performs the same duties as the Company's Governance Committee. In addition, the Bank's Governance Committee oversees the investigation of and makes

recommendations for future branching sites. It also is responsible for discussion of matters of general, strategic corporate direction, discussion of capital expenses associated with technology, and recommendations for director nominations to the full Board of Directors.

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The Governance Committee reviews for approval the recommendations of the President and Chief Executive Officer for the compensation of the executive officers, and makes recommendations to the Board of Directors for the compensation of the President and Chief Executive Officer, and makes recommendations to the Board of Directors regarding the adoption of and amendments to employee benefit plans and amendments to the salary administration plan. The Governance Committee met five (5) times during fiscal year ended December 31, 2005.

The Bank's Audit Committee performs the same duties as the Company's Audit Committee. It consists of Directors R. Abernethy, Howard, Matthews, Price, Robinson, Timmerman and Zachary. The Bank's Audit Committee met eight (8) times during fiscal year ended December 31, 2005.

Director Compensation

Directors' Fees. Members of the Board of Directors receive no fees or compensation for their service. However, all members of the Board of Directors are also directors of the Bank and are compensated for that service. Directors receive a fee of \$750 for each Bank board of directors meeting attended. An additional fee of \$500 is paid to committee members for each committee meeting attended. In addition to these meeting fees, each director also received an annual retainer of \$9,000.

The Bank maintains a Service Recognition Program, under which directors, officers and employees are eligible for awards. Under this Program, directors, officers and employees are awarded a combination of Common Stock of the Company and cash, with the amount of the award based upon the length of service to the Bank. Any Common Stock awarded under the Program is purchased by the Bank on the open market, and no new shares are issued by the Company under the Service Recognition Program.

Directors' Stock Benefits Plan. Members of the Board of Directors are eligible to participate in the Company's Omnibus Stock Ownership and Long Term Incentive Plan (the "Stock Benefits Plan"). Each director has been awarded 5,901 book value shares (adjusted to reflect 10% stock dividends on April 24, 2000 and March 16, 2005, as appropriate) under the Stock Benefits Plan. Directors J. Abernethy, R. Abernethy, Robinson, Timmerman and Zachary were awarded book value shares on September 28, 1999. The book value of the Common Stock on September 28, 1999, was \$10.41 (as adjusted). The book value shares then awarded vest 20% annually, with the first 20% vesting on September 28, 2000, and the final 20% vesting on September 28, 2004. Director Matthews was awarded book value shares upon his election to the Board of Directors on May 3, 2001. The book value of the Common Stock on May 3, 2001, was \$12.68 (as adjusted). Mr. Matthews' book value shares vest at a rate of 25% annually with the first 25% having vested on May 3, 2002, and the final 25% vesting on May 3, 2005. Directors Howard, Lineberger, Price and Terry were awarded book value shares on May 6, 2004. The book value of the Common Stock on May 6, 2004, was \$14.26 (as adjusted). Their shares vest at a rate of 20% annually, with the first 20% vesting on May 6, 2005, and the final 20% vesting on May 6, 2009. See "-- Management Compensation - Stock Benefits Plan" for a description of the plan.

Directors' Deferred Compensation Plan. In January 2002, the Bank established a non-qualified deferred compensation plan for all of its directors. The Bank's directors are also directors of the Company. Under this plan, each director may defer all or a portion of his fees to the plan each year. The director may elect to invest the deferred compensation in a restricted list of eleven investment funds. The Bank may make matching contributions to the plan for the benefit of the director from time to time at the discretion of the Bank. Directors are fully vested in all amounts they contribute to the plan and in any amounts contributed by the Bank.

Benefits under the plan are payable in the event of the director's death, resignation, removal, failure to be re-elected, retirement or in cases of hardship. Directors may elect to receive deferred compensation payments in one lump sum or in installments.

Effective December 6, 2001, the Bank established a Rabbi Trust to hold the directors' accrued benefits under the plan. The Directors' Deferred Compensation Plan was made effective January 1, 2002.

Directors' Supplemental Retirement Plan. Effective January 1, 2002, the Bank implemented a non-qualified supplemental retirement benefits plan for all its directors. The plan is designed to provide a retirement benefit to the

directors while at the same time minimizing the financial impact on the Bank's earnings. The plan provides retirement benefits based on an index formula. This formula consists of the earnings on a specific life insurance policy, reduced by an amount equal to the Bank's opportunity cost. Following a director's retirement, the Bank pays the earnings in excess of the opportunity cost to the director annually. These payments continue for fifteen years following the director's retirement. The Bank has purchased life insurance policies on each insurable director that are actuarially designed to offset the annual expense associated with the indexed formula benefit. The Bank is the sole owner of all the policies.

Executive Officers

The following table sets forth certain information with respect to the persons who are executive officers of either the Company or the Bank, or both.

| <u>Name</u> | <u>Age on December 31, 2005</u> | <u>Positions and Occupations During Last Five Years</u> | <u>Employed By the Company or the Bank Since</u> |
|-----------------------|---|--|--|
| Tony W. Wolfe | 59 | President and Chief Executive Officer of the Company and the Bank | 1990 |
| Joseph F. Beaman, Jr. | 56 | Executive Vice President and Corporate Secretary of the Company; Executive Vice President, Chief Administrative Officer and Secretary of the Bank | 1977 |
| William D. Cable | 37 | Executive Vice President and Assistant Corporate Treasurer of the Company; Executive Vice President and Chief Operations Officer of the Bank; Prior to 2002, Bank Senior Vice President - Information Services | 1995 |
| Lance A. Sellers | 43 | Executive Vice President and Assistant Corporate Secretary of the Company; Executive Vice President and Chief Credit Officer of the Bank | 1998 |
| A. Joseph Lampron | 51 | Executive Vice President, Chief Financial Officer and Corporate | 2001 |

Treasurer of the Company;
Executive
Vice President and Chief Financial
Officer of the Bank. Prior to
December
2001, Vice President/Senior Change
Manager at a large North Carolina
bank

Management Compensation

The executive officers of the Company are not paid any cash compensation by the Company. However, the executive officers of the Company also are executive officers of the Bank and receive compensation from the Bank.

The table on the following page shows, for the fiscal years ended December 31, 2005, 2004 and 2003, the cash compensation received by, as well as certain other compensation paid or accrued for those years, the Bank's Chief Executive Officer and the Bank's executive officers whose total annual salary and bonus exceeded \$100,000.

| Name and Principal Position | Year | <u>Annual Compensation</u> | | Other Annual Compensation ¹ | <u>Long Term Compensation Awards</u> | | <u>All Other Compensation</u> ^{2,3,4,5,6} |
|---|------|----------------------------|--------------|---|--|---|--|
| | | <u>Salary</u> | <u>Bonus</u> | | <u>Restricted Stock Awards</u> | <u>Securities Underlying Options/Stock Appreciation Rights ("SARS") (in shares)</u> | |
| Tony W. Wolfe President and Chief Executive Officer of the Company and the Bank | 2005 | \$ 224,560 | \$ 50,593 | \$-- | \$-- | \$0/0 | \$ 13,660 |
| | 2004 | \$ 212,949 | \$ 0 | \$-- | \$-- | \$0/0 | \$ 12,832 |
| | 2003 | \$ 206,828 | \$ 0 | \$-- | \$-- | \$0/0 | \$ 13,814 |
| Joseph F. Beaman, Jr. Executive Vice President and Corporate Secretary of the Company; Executive Vice President, Chief Administrative Officer and Secretary of the Bank | 2005 | \$ 117,386 | \$ 27,042 | \$-- | \$-- | \$0/0 | \$ 6,937 |
| | 2004 | \$ 139,222 | \$ 0 | \$-- | \$-- | \$0/0 | \$ 8,098 |
| | 2003 | \$ 152,214 | \$ 0 | \$-- | \$-- | \$0/0 | \$ 7,963 |
| Lance A. Sellers Executive Vice President and Assistant Corporate Secretary of the Company; Executive Vice President and Chief Credit Officer of the Bank | 2005 | \$ 160,676 | \$ 32,636 | \$-- | \$-- | \$0/0 | \$ 8,326 |
| | 2004 | \$ 156,205 | \$ 0 | \$-- | \$-- | \$0/0 | \$ 8,201 |
| | 2003 | \$ 150,031 | \$ 0 | \$-- | \$-- | \$0/0 | \$ 7,648 |
| A. Joseph Lampron Executive Vice President, Chief Financial Officer and Corporate Treasurer of the Company; | 2005 | \$ 125,865 | \$ 27,924 | \$-- | \$-- | \$0/0 | \$ 6,946 |
| | 2004 | \$ 131,067 | \$ 0 | \$-- | \$-- | \$0/0 | \$ 6,608 |
| | 2003 | \$ 111,593 | \$ 0 | \$-- | \$-- | \$0/0 | \$ 6,089 |

Executive Vice President
and Chief
Financial Officer of the
Bank

| | | | | | | | |
|--|------|------------|-----------|------|------|-------|----------|
| William D. Cable | 2005 | \$ 130,602 | \$ 27,924 | \$-- | \$-- | \$0/0 | \$ 6,638 |
| Executive Vice President and Assistant Corporate Treasurer of the Company; Executive Vice President and Chief Operations Officer of the Bank | 2004 | \$ 123,689 | \$0 | \$-- | \$-- | \$0/0 | \$ 6,342 |
| | 2003 | \$ 118,135 | \$0 | \$-- | \$-- | \$0/0 | \$ 6,046 |

Footnotes on the following page

1

Perquisites for the fiscal year did not exceed the lesser of \$50,000, or 10% of salary and bonus as reported for the named employee.

2

For Mr. Wolfe, includes for 2005 \$10,000 under the 401(k) plan, \$1,992 premium paid for group term life insurance in excess of \$50,000 and \$1,668 paid for the Split Dollar Benefit; 2004: \$9,324 under the 401(k) plan, a \$1,899 premium paid for group term life insurance in excess of \$50,000 and \$1,609 paid for the Split Dollar Death Benefit; 2003: \$10,410 under the 401(k) plan, a \$1,827 premium paid for group term life insurance in excess of \$50,000 and \$1,577 paid for the Split Dollar Benefit;

3

For Mr. Beaman, includes for 2005 \$5,711 under the 401(k) plan, \$918 premium paid for group term life insurance in excess of \$50,000 and \$308 paid for the Split Dollar Death Benefit; 2004: \$6,816 under the 401(k) plan, a \$991 premium paid for group term life insurance in excess of \$50,000 and \$291 paid for the Split Dollar Death Benefit; 2003: \$7,296 under the 401(k) plan, a \$667 premium paid for group term life insurance in excess of \$50,000 and \$282 paid for the Split Dollar Death Benefit.

4

For Mr. Sellers, includes for 2005 \$7,869 under the 401(k) plan, \$319 premium paid for group term life insurance in excess of \$50,000 and \$138 paid for the Split Dollar Death Benefit; 2004: \$7,643 under the 401(k) plan, a \$307 premium paid for group term life insurance in excess of \$50,000 and \$251 paid for the Split Dollar Death Benefit; 2003: \$7,355 under the 401(k) plan, a \$293 premium paid for group term life insurance in excess of \$50,000 and \$130 paid for the Split Dollar Death Benefit.

5

For Mr. Lampron, includes for 2005 \$6,109 under the 401(k) plan, \$541 premium paid for group term life insurance in excess of \$50,000 and \$296 paid for the Split Dollar Death Benefit; 2004: \$5,819 under the 401(k) plan, a \$508 premium paid for group term life insurance in excess of \$50,000 and \$281 paid for the Split Dollar Death Benefit; 2003: \$5,561 under the 401(k) plan, a \$310 premium paid for group term life insurance in excess of \$50,000 and \$218 paid for the Split Dollar Death Benefit.

6

For Mr. Cable, includes for 2005 \$6,343 under the 401(k) plan, \$222 premium paid for group term life insurance in excess of \$50,000 and \$73 paid for the Split Dollar Death Benefit; 2004: \$6,043 under the 401(k) plan, a \$207 premium paid for group term life insurance in excess of \$50,000 and \$92 paid for the Split Dollar Death Benefit; 2003: \$5,780 under the 401(k) plan, a \$197 premium paid for group term life insurance in excess of \$50,000 and \$69 paid for the Split Dollar Death Benefit.

Employment Agreements

The Bank has entered into employment agreements with Tony W. Wolfe, President and Chief Executive Officer; Joseph F. Beaman, Jr., Executive Vice President, Chief Administrative Officer and Corporate Secretary; Lance A. Sellers, Executive Vice President, Chief Credit Officer and Assistant Corporate Secretary; A. Joseph Lampron, Executive Vice President, Chief Financial Officer and Corporate Treasurer; and William D. Cable, Executive Vice President, Chief Operations Officer and Assistant Corporate Treasurer, in order to establish their duties and compensation and to provide for their continued employment with the Bank. The agreements provide for an initial term of employment of three years. Commencing on the first anniversary date and continuing on each anniversary

date thereafter, unless notice of a non-extension is given by either party, each agreement is automatically extended for an additional year so that the remaining term shall always be no less than two and no more than three years. The agreements also provide that the base salary shall be reviewed by the Board of Directors not less often than annually. In addition, the employment agreements provide for discretionary bonuses and participation in other management incentive, pension, profit-sharing, medical or retirement plans maintained by the Bank, as well as fringe benefits normally associated with such employee's office. Mr. Wolfe's agreement provides for a company automobile. The employment agreements provide that they may be terminated by the Bank for cause, as defined in the agreements, and that they may otherwise be terminated by the Bank (subject to vested rights) or by the employee.

In the event of a change in control, the term of the employment agreements shall be automatically extended for three years from the date of the change of control. For purposes of the employment agreement, a change in control generally will occur if (i) any "person" (as such term is used in Section 13(d) and 14(d) of the Exchange Act), other than a person who beneficially owned as of January 1, 1998, more than 5% of the Bank's securities, acquires beneficial ownership of voting stock and irrevocable proxies representing 20% or more of any class of voting securities of either the Company or the Bank, (ii) the election of directors constituting more than one-half of the Board of Directors of the Company or the Bank who, prior to their election, were not nominated for election or approved by at least three-fourths of the Board of Directors of the Company as then constituted; (iii) either the Company or the Bank consolidates or merges with or into another corporation, association or entity or is otherwise reorganized, where neither the Company nor the Bank, respectively, is the surviving corporation in the transaction; or (iv) all or substantially all of the assets of either the Company or the Bank are sold or otherwise transferred to or acquired by any other entity or group.

In addition, the employee may voluntarily terminate his employment at any time following a change in control and continue to receive his base salary for the remainder of the term of the employment agreement, if, after the change in control, (i) the employee is assigned duties and/or responsibilities that are inconsistent with his position prior to the change in control or that are inconsistent with his reporting responsibilities at that time, (ii) the employee's compensation or benefits are reduced, or (iii) the employee is transferred, without his consent, to a location which is an unreasonable distance from his current principal work location.

An additional thirteen (13) middle management officers had employment agreements during 2005. The term of these agreements is until December 1, 2006, renewed annually and the agreements contain provisions similar to those discussed above.

Equity Compensation Plan Information

The following table presents the number of shares of Company stock to be issued upon the exercise of outstanding options; the weighted-average price of the outstanding options and the number of options remaining that may be issued under the Company's stock option plans described above.

| Plan Category | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
|---|--|--|--|
| | (a) | (b) | (c) |
| Equity compensation plans approved by security holders | 193,743 ¹ | \$13.41 ² | 33,154 |
| Equity compensation plans not approved by security holders | 0 | \$0 | 0 |
| Total | 193,743 | \$13.41 | 33,154 |

¹ Of the 193,743 stock options issued under the Omnibus Plan, a total of 190,809 of those stock options have vested or are exercisable within 60 days. Of the outstanding stock options, options to purchase a total of 28,126 shares of the Common Stock were granted on September 28, 1999; 48,237 options were granted on September 25, 2000; 55,510 options were granted on October 30, 2001; 4,552 options were granted on December 18, 2001; 70,345 options were

granted on December 17, 2003; 2,200 options were granted on May 6, 2004; and 2,200 options were granted on December 16, 2004.

² The exercise prices for the grants of stock options under the Omnibus Plan on September 28, 1999; September 25, 2000; October 30, 2001; December 18, 2001; December 17, 2002; May 6, 2004 and December 16, 2004 are: \$14.88 (as adjusted due to a 10% stock dividend granted on April 24, 2000); \$11.53; \$14.49; \$13.36; \$12.82; \$17.01; and \$17.44, respectively. All prices and shares have been adjusted for the 10% stock dividend paid March 16, 2005.

Stock Benefits Plan

General. The Board of Directors has implemented the Omnibus Stock Ownership and Long Term Incentive Plan (the "Omnibus Plan") which was approved by the Company's shareholders on May 13, 1999. The purpose of the Omnibus Plan is to promote the interests of the Company by attracting and retaining directors and employees of outstanding ability and to provide executive and other key employees of the Company and its subsidiaries greater incentive to make material contributions to the success of the Company by providing them with stock-based compensation which will increase in value based upon the market performance of the Common Stock and/or the corporate achievement of financial and other performance objectives.

The Omnibus Plan is administered by the Governance Committee of Board of Directors (the "Committee"). Subject to the terms of the Omnibus Plan, the Committee and the Board of Directors have authority to construe and interpret, for eligible employees and eligible directors, respectively, the Omnibus Plan, to determine the terms and provisions of Rights (as defined below) to be granted under the Omnibus Plan, to define the terms used in the Omnibus Plan and in the Rights granted thereunder, to prescribe, amend and rescind rules and regulations relating to the Omnibus Plan, to determine the individuals to whom and the times at which Rights shall be granted and the number of shares to be subject to, or to underlie, each Right awarded, and to make all other determinations necessary or advisable for the administration of the Omnibus Plan.

Rights Which May Be Granted. Under the Omnibus Plan, the Committee may grant or award eligible participants Options, rights to receive restricted shares of Common Stock, long term incentive units (each equivalent to one share of Common Stock), SARs, and/or Book Value Shares. These grants and awards are referred to herein as the "Rights." All Rights must be granted or awarded by March 30, 2009, the tenth anniversary of the date the Board of Directors adopted the Omnibus Plan. As of December 31, 2005, Rights representing 33,154 shares of Common Stock (adjusted to reflect the April 24, 2000 10% stock dividend and the March 16, 2005 10% stock dividend) were eligible to be awarded under the Omnibus Plan.

Options. Options granted under the Omnibus Plan to eligible directors and employees may be either incentive stock options ("ISOs") or non-qualified stock options ("NSOs"). The exercise price of an Option may not be less than 100% of the last-transaction price for the Common Stock quoted by the Nasdaq National Market on the date of grant.

The Committee shall determine the expiration date of each Option granted, up to a maximum of ten years from the date of grant. In the Committee's discretion, it may specify the period or periods of time within which each Option will first become exercisable, which period or periods may be accelerated or shortened by the Committee.

Each Option granted will terminate upon the expiration date established by the Committee or upon the earlier of (i) twelve months after the holder ceases to be an eligible employee or director by reason of death or disability, and (ii) immediately as of the date the holder is no longer an eligible employee or director for any reason other than death or disability. In the event of a change in control (as that term is defined in the Omnibus Plan), any unvested options granted under the Omnibus Plan will immediately and automatically vest.

Restricted Stock. The Committee may award Rights to acquire shares of Common Stock subject to certain transfer restrictions ("Restricted Stock") to eligible participants under the Omnibus Plan for such purchase price per share, if any, as the Committee, in its discretion, may determine appropriate. The Committee shall determine the expiration date for each Restricted Stock award, up to a maximum of ten years from the date of grant. In the Committee's discretion, it may specify the period or periods of time within which each Restricted Stock award will first become exercisable, which period or periods may be accelerated or shortened by the Committee.

Awards of Restricted Stock shall terminate in the same manner as described above in connection with the termination of Options.

Units. Under the Omnibus Plan, the Committee may grant to eligible directors and employees awards of long term incentive units, each equivalent in value to one share of Common Stock ("Units"). Except as otherwise provided, Units awarded may be distributed only after the end of a performance period of two or more years, as determined by the Committee, beginning with the year in which the awards are granted.

The percentage of the Units awarded that are to be distributed will depend on the level of financial and other performance goals achieved by the Company during the performance period. The Committee may adopt one or more performance categories in addition to, or in substitution for, a performance category or may eliminate all performance categories other than financial performance. All performance categories other than financial performance may not be

applied in the aggregate as a factor of more than one against financial performance.

As soon as practicable after each performance period, the percentage of Units awarded that are to be distributed, based on the levels of performance achieved, will be determined and distributed to the recipients of such awards in the form of a

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combination of shares of Common Stock and cash. Units awarded, but which the recipients are not entitled to receive, will be cancelled.

In the event of the death or disability of a Unit recipient prior to the end of any performance period, the number of Units awarded for such performance period will be reduced in proportion to the number of months remaining in the performance period after the date of death or disability; and the remaining portion of the award, if any, may, in the discretion of the Committee, be adjusted based upon the levels of performance achieved prior to the date of death or disability, and distributed within a reasonable time after death or disability. In the event a recipient of Units ceases to be an eligible director or employee for any reason other than death or disability, all Units awarded, but not yet distributed, will be cancelled.

In the event of a change in control (as that term is defined in the Omnibus Plan), any outstanding Units will immediately and automatically be reduced as appropriate to reflect a shorter performance period.

An amount equal to the dividend payable on one share of Common Stock (a "dividend equivalent credit") will be determined and credited on the payment date to each Unit recipient's account for each Unit awarded and not yet distributed or cancelled. Such amount will be converted within the account to an additional number of Units equal to the number of shares of Common Stock which could be purchased at the last-transaction price of the Common Stock on the Nasdaq National Market on the dividend payment date.

No dividend equivalent credits or distribution of Units may be credited or made if, at the time of crediting or distribution, (i) the regular quarterly dividend on the Common Stock has been omitted and not subsequently paid or there exists any default in payment of dividends on any such outstanding shares of Common Stock; (ii) the rate of dividends on the Common Stock is lower than at the time the Units to which the dividend equivalent credit relates were awarded, adjusted for certain changes; (iii) estimated consolidated net income of the Company for the twelve-month period preceding the month the dividend equivalent credit or distribution would otherwise have been made is less than the sum of the amount of the dividend equivalent credits and Units eligible for distribution under the Omnibus Plan in that month plus all dividends applicable to such period on an accrual basis, either paid, declared or accrued at the most recently paid rate, on all outstanding shares of Common Stock; or (iv) the dividend equivalent credit or distribution would result in a default in any agreement by which the Company is bound.

If an extraordinary event occurs during a performance period which significantly alters the basis upon which the performance levels were established, the Committee may make adjustments which it deems appropriate in the performance levels. Such events may include changes in accounting practices, tax, financial institution laws or regulations or other laws or regulations, economic changes not in the ordinary course of business cycles, or compliance with judicial decrees or other legal requirements.

Stock Appreciation Rights. The Omnibus Plan provides that the Committee may award to eligible directors and employees Rights to receive cash based upon increases in the market price of Common Stock over the last transaction price of the Common Stock on the Nasdaq National Market (the "Base Price") on the date of the award. The Committee may adjust the Base Price of a SAR based upon the market value performance of the Common Stock in comparison with the aggregate market value performance of a selected index or at a stated annual percentage rate. The expiration date of a SAR may be no more than ten years from the date of award.

Each SAR awarded by the Committee may be exercisable immediately or may become vested over such period or periods as the Committee may establish, which periods may be accelerated or shortened in the Committee's discretion.

Each SAR awarded will terminate upon the expiration date established by the Committee, termination of the employment or directorship of the SAR recipient, or in the event of a change in control, as described above in connection with the termination of Options.

Book Value Shares. The Omnibus Plan provides that the Committee may award to eligible directors and eligible employees long term incentive units, each equivalent in value to the book value of one share of Common Stock on the date of award ("Book Value Shares"). The Committee shall specify the period or periods of time within which each Book Value Share will vest, which period or periods may be accelerated or shortened by the Committee. Upon redemption, the holder of a Book

Value Share will receive an amount equal to the difference between the book value of the Common Stock at the time the Book Value Share is awarded and the book value of the Common Stock at the time the Book Value Share is redeemed, adjusted for the effects of dividends, new share issuances, and mark-to-market valuations of the Company's investment securities portfolio in accordance with FASB 115.

The expiration date of each Book Value Share awarded shall be established by the Committee, up to a maximum of ten years from the date of award. However, awards of Book Value Shares shall earlier terminate in the same manner as described above in connection with the termination of Options.

Adjustments. In the event the outstanding shares of the Common Stock are increased, decreased, changed into or exchanged for a different number or kind of securities as a result of a stock split, reverse stock split, stock dividend, recapitalization, merger, share exchange acquisition, or reclassification, appropriate proportionate adjustments will be made in (i) the aggregate number or kind of shares which may be issued pursuant to exercise of, or which underlie, Rights; (ii) the exercise or other purchase price, or Base Price, and the number and/or kind of shares acquirable under, or underlying, Rights; (iii) and rights and matters determined on a per share basis under the Omnibus Plan. Any such adjustment will be made by the Committee, subject to ratification by the Board of Directors. As described above, the Base Price of a SAR may also be adjusted by the Committee to reflect changes in a selected index. Except with regard to Units and Book Value Shares awarded under the Omnibus Plan, no adjustment in the Rights will be required by reason of the issuance of Common Stock, or securities convertible into Common Stock, by the Company for cash or the issuance of shares of Common Stock by the Company in exchange for shares of the capital stock of any corporation, financial institution or other organization acquired by the Company or a subsidiary thereof in connection therewith.

Any shares of Common Stock allocated to Rights granted under the Omnibus Plan, which Rights are subsequently cancelled or forfeited, will be available for further allocation upon such cancellation or forfeiture.

Federal Income Tax Consequences.

Options. Under current provisions of the Code, the federal income tax treatment of ISOs and NSOs is different. Options granted to employees under the Omnibus Plan may be ISOs which are designed to result in beneficial tax treatment to the employee but not a tax deduction to the Company.

The holder of an ISO generally is not taxed for federal income tax purposes on either the grant or the exercise of the option. However, the optionee must include in his or her federal alternative minimum tax income any excess (the "Bargain Element") of the acquired common stock's fair market value at the time of exercise over the exercise price paid by the optionee. Furthermore, if the optionee sells, exchanges, gives or otherwise disposes of such common stock (other than in certain types of transactions) either within two years after the option was granted or within one year after the option was exercised (an "Early Disposition"), the optionee generally must recognize the Bargain Element as compensation income for regular federal income tax purposes. Any gain realized on the disposition in excess of the Bargain Element is subject to recognition under the usual rules applying to dispositions of property. If a taxable sale or exchange is made after such holding periods are satisfied, the difference between the exercise price and the amount realized upon the disposition of the common stock generally will constitute a capital gain or loss for tax purposes.

Options granted to directors under the Omnibus Plan would be "NSOs". In general, the holder of an NSO will recognize at the time of exercise of the NSO, compensation income equal to the amount by which the fair market value of the common stock received on the date of exercise exceeds the sum of the exercise price and any amount paid for the NSO.

If an optionee exercises an ISO or NSO and delivers shares of common stock as payment for part or all of the exercise price of the stock purchased (the "Payment Stock"), no gain or loss generally will be recognized with respect to the Payment Stock; provided, however, if the Payment Stock was acquired pursuant to the exercise of an ISO, the optionee will be subject to recognizing as compensation income the Bargain Element on the Payment Stock as an

Early Disposition if the exchange for the new shares occurs prior to the expiration of the holding periods for the Payment Stock.

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The Company generally would not recognize gain or loss or be entitled to a deduction upon either the grant of an ISO or NSO or the optionee's exercise of an ISO. The Company generally will recognize gain or loss or be entitled to a deduction upon the exercise of an NSO. If there is an Early Disposition, the Company generally would be entitled to deduct the Bargain Element as compensation paid to the optionee.

The above and other descriptions of federal income tax consequences are necessarily general in nature and do not purport to be complete. Moreover, statutory provisions are subject to change, as are their interpretations, and their application may vary in individual circumstances. Such descriptions may not be used to avoid any federal tax penalty. Such descriptions are written to support this proxy statement. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. Finally, the consequences under applicable state and local income tax laws may not be the same as under the federal income tax laws

Restricted Stock. Pursuant to Section 83 of the Code, recipients of Restricted Stock awards under the Omnibus Plan will recognize ordinary income in an amount equal to the fair market value of the shares of Common Stock granted to them at the time that the shares vest and become transferable. The Company will be entitled to deduct as a compensation expense for tax purposes the same amounts recognized as income by recipients of Restricted Stock awards in the year in which such amounts are included in income.

Units. The Company expects that participants generally will not be taxed on the award of Units. Instead, any cash and the then fair market value of any Common Stock received by the participants upon the distribution of a Unit generally will be taxable to the participants as compensation income upon such distribution. At that time, the Company generally will be entitled to claim a deduction in an amount equal to the compensation income.

SARs. Pursuant to Section 83 of the code, recipients of SARs under the Omnibus Plan will recognize, at the time a SAR award is exercised, ordinary income in an amount equal to the difference between the fair market value of the Common Stock at the time of award of the SAR and the fair market value of the Common Stock at the time that the SAR is exercised. The Company will be entitled to deduct as a compensation expense for tax purposes the same amounts recognized as income by recipients of SAR awards in the year in which such amounts are included in income.

Book Value Shares. The Company expects that participants generally will not be taxed on the award of Book Value Shares. Instead, any cash received by the participants upon redemption of the Book Value Shares generally will be taxable to the participant as compensation income upon distribution. At that time, the Company generally will be entitled to claim a deduction in an amount equal to the compensation income.

Grants and Awards Made During the Fiscal Year Ended December 31, 2005. The table below shows the number and value of options of the Company's named executive officers at the end of fiscal year 2005.

**Aggregated Option/SAR Exercises in Last Fiscal Year
and Fiscal Year-End Option/SAR Values**

| <u>Name</u> | <u>Shares Acquired on Exercise #</u> | <u>Value Realized (\$)</u> | <u>Number of Securities Underlying Unexercised Options/SARs at Fiscal Year End^{1,2}</u> | | <u>Value of Unexercised In-the-Money Options/SARs at Fiscal Year End³</u> | |
|---------------|--|------------------------------------|--|----------------------|--|----------------------|
| | | | <u>Exercisable</u> | <u>Unexercisable</u> | <u>Exercisable</u> | <u>Unexercisable</u> |
| Tony W. Wolfe | 0 | \$0 | 40,228/0 | 0/0 | \$370,177.46/\$0 | \$0/\$0 |

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| | | | | | | |
|-------------------------|---|-----|----------|-----|------------------|---------|
| Joseph F. Beaman, Jr | 0 | \$0 | 20,945/0 | 0/0 | \$192,055.68/\$0 | \$0/\$0 |
| Lance A. Sellers | 0 | \$0 | 20,848/0 | 0/0 | \$193,179.70/\$0 | \$0/\$0 |

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| <u>Name</u> | <u>Shares Acquired on Exercise #</u> | <u>Value Realized (\$)</u> | <u>Number of Securities Underlying Unexercised Options/SARs at Fiscal Year End^{1,2}</u> | | <u>Value of Unexercised In-the-Money Options/SARs at Fiscal Year End³</u> | |
|-------------------|--|------------------------------------|--|----------------------|--|----------------------|
| | | | <u>Exercisable</u> | <u>Unexercisable</u> | <u>Exercisable</u> | <u>Unexercisable</u> |
| A. Joseph Lampron | 0 | \$0 | 11,152/0 | 0/0 | \$105,488.73/\$0 | \$0/\$0 |
| William D. Cable | 0 | \$0 | 14,248/0 | 0/0 | \$132,734.30/\$0 | \$0/\$0 |

1

Options to purchase 16,627 shares of Common Stock (adjusted to reflect the April 24, 2000 10% stock dividend and the 10% stock dividend on March 16, 2005) were granted to Messrs. Wolfe, Beaman, Sellers and Cable as of September 28, 1999. Pursuant to an amendment to the Stock Option Grant Agreements dated September 25, 2000 these options vest 20% each year over a five-year period beginning on September 28, 2000, with the last 20% vesting on September 28, 2004. Options to purchase 24,953 shares of Common Stock were granted to the Messrs. Wolfe, Beaman, Sellers and Cable as of September 25, 2000. One-third of these options vested on September 25, 2001, one-third vested on September 25, 2002 and one-third vested on September 25, 2003. Options to purchase 24,984 shares of Common Stock were granted to Messrs. Wolfe, Beaman, Sellers and Cable as of October 30, 2001. One-third vested on October 30, 2002, one-third vested on October 30, 2003, and one-third vested on October 30, 2004. Options to purchase 36,300 shares of Common Stock were granted to all the named persons (including Mr. Lampron) as of December 17, 2002. One-third vested on December 17, 2003, one-third vested on December 17, 2004, and one-third vested on December 17, 2005.

2

Options to purchase 4,551 shares of Common Stock were granted to Mr. Lampron as of December 18, 2001. One-third vested on December 18, 2002, one-third vested on December 18, 2003 and one-third vested on December 18, 2004.

3

The exercise price of the stock options granted to Messrs. Wolfe, Beaman, Sellers and Cable on September 28, 1999 is \$14.88 (adjusted to reflect the April 24, 2000 10% stock dividend). The exercise price of the stock options granted to them on September 25, 2000 is \$11.53. The exercise price of the stock options granted to them on October 30, 2001 is \$14.49. The exercise price of stock options granted to Mr. Lampron on December 18, 2001 is \$13.36. The exercise price of stock options granted to all named persons on December 17, 2002 is \$12.82. On December 31, 2005, the closing market price for the Common Stock as reported on the Nasdaq National Market was \$22.50.

Incentive Compensation Plans

The Bank also has a Management Incentive Plan for officers and an Employee Incentive Plan for employees of the Bank. Eligibility under the Employee Incentive Plan is granted to all employees upon ninety (90) days of service with the Bank. Participants in the Employee Incentive Plan are entitled to receive quarterly cash incentives based upon a graduated schedule indexed to attainment of corporate budget. Participants in the Management Incentive Plan are recommended annually by the President and Chief Executive Officer to the Bank's Board of Directors. Each individual's incentive pool is determined by a formula which links attainment of corporate budget with attainment of individual goals and objectives. Incentives under the Management Incentive Plan are paid annually.

Profit Sharing Plan and 401(k) Plan

The Bank has a Profit Sharing Plan and 401(k) Plan for all eligible employees. The Bank made no contribution to the Profit Sharing Plan for the year ended December 31, 2005. No investments in Bank stock have been made by the plan.

Under the Bank's 401(k) plan, the Bank matches employee contributions to a maximum of five percent of annual compensation. The Bank's 2005 contribution to the 401(k) Plan pursuant to this formula was approximately \$360,000. All contributions to the 401(k) Plan are tax deferred.

The Profit Sharing Plan and 401(k) Plan permit participants to choose from ten investment funds which are selected by a committee comprised of selected directors and senior management. Both the 401(k) Plan and Profit Sharing Plan were amended in 2000 to permit participation in the plans beginning in the second month of employment. As of December 31, 2003, both plans provide for vesting of 20% of the benefit after two years employment and 20% each year thereafter until participants are 100% vested after six years employment.

Deferred Compensation Plan

In January 2002, the Bank established a non-qualified deferred compensation plan for directors and certain officers. Eligible officers selected by the Bank's board of directors may elect to contribute a percentage of their compensation to the plan. The Bank may make matching or other contributions to the plan as well, in amounts determined at the discretion of the Bank. Participants are fully vested in all amounts contributed to the plan by them or on their behalf.

Benefits under the plan are payable in the event of the participant's retirement, death, termination, or as a result of hardship. Benefit payments may be made in a lump sum or in installments, as selected by the participant.

Effective December 6, 2001, the Bank established a Rabbi Trust to hold the accrued benefits of the participants under the plan.

Supplemental Retirement Plan

Effective January 1, 2002, the Bank implemented a non-qualified supplemental retirement benefits plan for certain officers. The plan is designed to provide a retirement benefit to the officers while at the same time minimizing the financial impact on the Bank's earnings. The plan provides retirement benefits based on an index formula. The index formula consists of the earnings on a specific life insurance policy, reduced by an amount equal to the Bank's opportunity cost. Following an officer's retirement, the Bank pays the earnings in excess of the opportunity cost to the officer annually. These payments continue for a period between ten years and the life of the officer. The Bank has purchased life insurance policies on the participating officers that are actuarially designed to offset the annual expenses associated with the index formula benefit. The Bank is the sole owner of all of the policies.

Discretionary Bonuses and Service Awards

In the past, the Bank has paid bonuses to its employees in amounts determined in the discretion of the Bank's board of directors. The Bank anticipates that discretionary bonuses will continue to be paid to its employees in the future.

Indebtedness of and Transactions with Management and Directors

Certain directors and executive officers of the Bank and their immediate families and associates were customers of and had transactions with the Bank in the ordinary course of business during 2005. All outstanding loans, extensions of credit or overdrafts, endorsements and guarantees outstanding at any time during 2005 (i) were made in the ordinary course of business, (ii) were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons, and (iii) were transactions which in the opinion of management of the Bank did not involve more than the normal risk of collectibility or present other unfavorable features.

The Bank leases two of its facilities from Shortgrass Associates, L.L.C ("Shortgrass"). Director John W. Lineberger, Jr., owns 25% of the membership interests in Shortgrass. Pursuant to the terms of the leases for the two facilities leased by the Bank, the Bank paid to Shortgrass monthly rent in the amount of \$15,613 during 2005, resulting in total annual lease payments for these facilities of \$187,360. Each of the facilities is subject to a twenty year lease between the Bank and Shortgrass.

REPORT OF GOVERNANCE COMMITTEE WITH RESPECT TO COMPENSATION

The Company does not have a Compensation Committee. Review of the Bank's salary programs and recommendations to the Bank's board of directors regarding compensation of the executive officers are duties of the Bank's Governance Committee. The Bank's board of directors ultimately determines such compensation. The salary of each of the executive officers is determined based upon the executive officer's contributions to the Bank's overall profitability, maintenance of regulatory compliance standards, professional leadership, and management effectiveness in meeting the needs of day-to-day operations. The Governance Committee also compares the compensation of the executive officers with compensation paid to executives of other businesses in the Bank's market area, as well as to appropriate state and national salary data. These factors were considered in establishing the compensation of Tony W. Wolfe, President and Chief Executive Officer; Joseph F. Beaman, Jr., Executive Vice President, Chief Administrative Officer and Corporate Secretary; Lance A. Sellers, Executive Vice President, Chief Credit Officer and Assistant Corporate Secretary; A. Joseph Lampron, Executive Vice President, Chief Financial Officer and Corporate Treasurer; and William D. Cable, Executive Vice President, Chief Operations Officer and Assistant Corporate Treasurer, during the 2005 fiscal year. In addition, all of the executive officers of the Bank are eligible to receive discretionary bonuses declared by the Bank's board of directors. The amount of such bonuses and incentive payments is based upon the net income of the Bank in comparison to attainment of corporate budget and attainment of corporate goals and objectives.

Robert C. John W. Lineberger, Jr.
Abernethy

Larry E. James S. Abernethy
Robinson

William G. Dan Ray Timmerman, Sr.
Terry

Benjamin
I. Zachary

GOVERNANCE COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

No member of the Governance Committee is now, or formerly was, an officer or employee of the Company or the Bank. Tony W. Wolfe, President and Chief Executive Officer of the Bank, makes recommendations to the Committee regarding compensation of the executive officers. Mr. Wolfe participates in the deliberations, but not the decisions, of the Committee regarding compensation of executive officers other than himself. He does not participate in the Committee's discussions or decisions regarding his own compensation.

REPORT OF AUDIT COMMITTEE

The Company has adopted a written charter for the Audit Committee which is reviewed annually, and amended as needed, by the Committee. The Audit Committee has reviewed and discussed the audited financial statements with management of the Company and has discussed with the independent auditors the matters required to be discussed by SAS 61. In addition, the Committee has received the written disclosures and the letter from the independent accountants required by Independence Standards Board Standard No. 1, and has discussed with the independent accountant the independent accountant's independence. Based upon these reviews and discussions, the Committee

recommended to the Board of Directors that the audited financial statements be included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

Robert C. Douglas S. Howard
Abernethy

Larry E. Dan Ray Timmerman, Sr.
Robinson

Gary E. Dr. Billy L. Price, Jr.
Matthews

Benjamin
I. Zachary

PERFORMANCE GRAPH

The following graph compares the Company's cumulative shareholder return on its Common Stock with a NASDAQ index and with a southeastern bank index. The graph was prepared by SNL Securities, L.C., Charlottesville, Virginia, using data as of December 31, 2005.

COMPARISON OF SIX-YEAR CUMULATIVE TOTAL RETURNS
 Performance Report for
 Peoples Bancorp of North Carolina, Inc.

Period Ending

| <i>Index</i> | 12/31/00 | 12/31/01 | 12/31/02 | 12/31/03 | 12/31/04 | 12/31/05 |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Peoples Bancorp of North Carolina, Inc. | 100.00 | 109.10 | 113.32 | 114.67 | 156.57 | 163.45 |
| NASDAQ - Total US* | 100.00 | 79.18 | 54.44 | 82.09 | 89.59 | 91.54 |
| SNL Southeast Bank Index | 100.00 | 124.58 | 137.62 | 172.81 | 204.94 | 209.78 |

*Source: CRSP, Center for Research in Security Prices, Graduate School of Business, The University of Chicago 2005.

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**SNL Financial LC, Charlottesville,
 VA
 @ 2006**

(434) 977-1600

PROPOSAL 2

RATIFICATION OF SELECTION OF INDEPENDENT AUDITOR

Porter Keadle Moore, LLP, of Atlanta, Georgia ("PKM"), has been selected by the Audit Committee as the Company's and the Bank's independent auditor for the year ending December 31, 2006. Such selection is being submitted to the Company's shareholders for ratification. Representatives of PKM are expected to attend the Meeting and will be afforded an opportunity to make a statement, if they so desire, and to respond to appropriate questions from shareholders.

Audit Fees

The aggregate fees billed by PKM for professional services rendered in connection with the (i) audit of the Company's annual financial statements for 2005 and 2004, and (ii) review of the financial statements included in the Company's quarterly filings on Form 10-Q during those fiscal years were approximately \$127,000 and \$125,000, respectively.

Audit Related Fees

The aggregate fees billed by PKM in 2005 and 2004 for professional services rendered for assurance and related services that are reasonably related to the performance of the audit or review of the Company's financial statements and not included in "Audit Fees" above were approximately \$12,000 and \$21,000, respectively. These fees were primarily related to the audit of the Company's profit sharing and 401(k) plan and the testing of management's assertions regarding internal controls in accordance with the Federal Deposit Insurance Corporation Improvement Act.

Tax Fees

The aggregate fees billed in each of the last two fiscal years for professional services rendered by PKM for tax compliance, tax advice, and tax planning were approximately \$24,000 and \$18,000 in 2005 and 2004, respectively. These fees were primarily related to the preparation of the Company's income tax returns, assistance with quarterly income tax estimates and preparation of Forms 5500 for various benefit plans.

All Other Fees

PKM did not bill the Company for any other fees during 2005 or 2004.

The fees billed by PKM are pre-approved by the Audit Committee of the Company in accordance with the policies and procedures for the Audit Committee set forth in the committee's charter. The Audit Committee typically pre-approves all audit and non-audit services provided by the Company's independent auditors and may not engage the independent auditors to perform any prohibited non-audit services. For 2005, one hundred percent (100%) of the total fees paid for audit, audit related and tax services were pre-approved. For 2004, one hundred percent (100%) of the fees for audit, audit related, and tax were pre-approved. The Audit Committee has determined that the rendering of non-audit professional services by PKM, as identified above, is compatible with maintaining PKM's independence.

THE BOARD OF DIRECTORS RECOMMENDS THAT THE SHAREHOLDERS VOTE FOR RATIFICATION OF THE APPOINTMENT OF PKM AS INDEPENDENT AUDITOR FOR THE COMPANY AND THE BANK FOR THE FISCAL YEAR ENDING DECEMBER 31, 2006.

DATE FOR RECEIPT OF SHAREHOLDER PROPOSALS

It is presently anticipated that the 2007 Annual Meeting of Shareholders of the Company will be held on May 3, 2007. In order for shareholder proposals to be included in the Company's proxy materials for that meeting, such proposals must be received by the Secretary of the Company at the Company's principal executive office no later than December 14, 2006 and meet all other applicable requirements for inclusion in the proxy statement.

In the alternative, a shareholder may commence his or her own proxy solicitation and present a proposal from the floor at the 2007 Annual Meeting of Shareholders of the Company. In order to do so, the shareholder must notify the Secretary of the Company in writing, at the Company's principal executive office no later than February 19, 2007, of his or her proposal. If the Secretary of the Company is not notified of the shareholder's proposal by February 19, 2007, the Board of Directors may vote on the proposal pursuant to the discretionary authority granted by the proxies solicited by the Board of Directors for the 2007 Annual Meeting.

OTHER MATTERS

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

MISCELLANEOUS

The Annual Report of the Company for the year ended December 31, 2005, which includes financial statements audited and reported upon by the Company's independent auditor, is being mailed as Appendix A to this Proxy Statement; however, it is not intended that the Annual Report be deemed a part of this Proxy Statement or a solicitation of proxies.

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

By Order of the Board of Directors,

/s/ Tony W. Wolfe

Tony W. Wolfe
President and Chief Executive Officer

Newton, North Carolina
April 3, 2006

APPENDIX A

PEOPLES BANCORP OF NORTH CAROLINA, INC.

General Description of Business

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

The Bank, founded in 1912, is a state-chartered commercial bank serving the citizens and business interests of the Catawba Valley and surrounding communities through 17 banking offices located in Lincolnton, Newton, Denver, Catawba, Conover, Maiden, Claremont, Hiddenite, Hickory and Charlotte, North Carolina. The Bank also operates a Loan Production Office in Davidson, North Carolina. At December 31, 2005, the Company had total assets of \$730.3 million, net loans of \$559.2 million, deposits of \$582.9 million, investment securities of \$115.2 million, and shareholders' equity of \$54.4 million.

The Bank has a diversified loan portfolio, with no foreign loans and few agricultural loans. Real estate loans are predominately variable rate commercial property loans. Commercial loans are spread throughout a variety of industries with no one particular industry or group of related industries accounting for a significant portion of the commercial loan portfolio. The majority of the Bank's deposit and loan customers are individuals and small to medium-sized businesses located in the Bank's market area.

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

At December 31, 2005, the Bank employed 222 full-time equivalent employees.

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

In 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 I 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 interest at a floating rate equal to the prime rate 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. As discussed under the heading entitled "Recent Accounting Pronouncements" in note 1 to the consolidated financial statements included in the 2005 Annual Report of Peoples Bancorp, Inc., attached hereto as Exhibit 13, PEBK Trust was deconsolidated by the Company under FIN 46 as of December 31, 2003.

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

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SELECTED FINANCIAL DATA*Dollars in Thousands Except Per Share Amounts*

| | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|-----------|--------|--------|--------|--------|
| Summary of Operations | | | | | |
| Interest income | \$ 43,371 | 36,292 | 34,935 | 36,649 | 41,932 |
| Interest expense | 15,429 | 12,335 | 12,749 | 15,777 | 23,027 |
| Net interest income | 27,942 | 23,957 | 22,186 | 20,872 | 18,905 |
| Provision for loan losses | 3,110 | 3,256 | 6,744 | 5,432 | 3,545 |
| Net interest income after provision for loan losses | 24,832 | 20,701 | 15,442 | 15,440 | 15,360 |
| Non-interest income | 6,696 | 6,020 | 5,845 | 6,466 | 8,229 |
| Non-interest expense | 21,816 | 20,057 | 18,228 | 16,758 | 16,752 |
| Income before taxes | 9,712 | 6,664 | 3,059 | 5,148 | 6,837 |
| Income taxes | 3,381 | 2,233 | 1,055 | 1,712 | 2,262 |
| Net income | \$ 6,331 | 4,431 | 2,004 | 3,436 | 4,575 |

Selected Year-End Balances

| | | | | | |
|-------------------------------|------------|-----------|-----------|-----------|-----------|
| Assets | \$ 730,280 | 686,348 | 674,032 | 645,638 | 619,505 |
| Available for sale securities | 115,158 | 105,598 | 79,460 | 71,736 | 84,286 |
| Loans, net | 559,239 | 527,419 | 542,404 | 519,122 | 484,517 |
| Mortgage loans held for sale | 2,248 | 3,783 | 587 | 5,065 | 5,339 |
| Interest-earning assets | 692,402 | 652,678 | 639,501 | 608,619 | 586,496 |
| Deposits | 582,854 | 556,522 | 549,802 | 515,739 | 490,223 |
| Interest-bearing liabilities | 576,681 | 553,135 | 550,357 | 527,525 | 516,422 |
| Shareholders' equity | \$ 54,353 | 50,938 | 48,554 | 48,605 | 45,401 |
| Shares outstanding* | 3,440,805 | 3,448,341 | 3,448,722 | 3,446,902 | 3,540,585 |

Selected Average Balances

| | | | | | |
|-------------------------------|------------|-----------|-----------|-----------|-----------|
| Assets | \$ 706,843 | 684,385 | 661,077 | 625,227 | 575,142 |
| Available for sale securities | 108,690 | 93,770 | 72,072 | 77,414 | 84,549 |
| Loans | 550,545 | 547,753 | 539,559 | 507,879 | 454,371 |
| Interest-earning assets | 668,181 | 650,095 | 625,764 | 592,947 | 545,945 |
| Deposits | 570,997 | 558,142 | 533,703 | 499,224 | 481,289 |
| Interest-bearing liabilities | 563,210 | 553,880 | 540,676 | 516,747 | 472,435 |
| Shareholders' equity | \$ 55,989 | 51,978 | 49,971 | 48,257 | 47,432 |
| Shares outstanding* | 3,449,873 | 3,459,379 | 3,447,056 | 3,467,173 | 3,540,585 |

Profitability Ratios

| | | | | | |
|--|--------|-------|-------|-------|-------|
| Return on average total assets | 0.90% | 0.65% | 0.30% | 0.55% | 0.80% |
| Return on average shareholders' equity | 11.31% | 8.52% | 4.01% | 7.12% | 9.65% |

| | | | | | |
|-----------------------|--------|--------|--------|--------|--------|
| Dividend payout ratio | 22.34% | 28.37% | 62.56% | 36.58% | 28.14% |
|-----------------------|--------|--------|--------|--------|--------|

Liquidity and Capital Ratios (averages)

| | | | | | |
|--------------------------------------|--------|--------|---------|---------|--------|
| Loan to deposit | 96.42% | 98.14% | 101.10% | 101.73% | 94.41% |
| Shareholders' equity to total assets | 7.92% | 7.59% | 7.56% | 7.72% | 8.25% |

Per share of common stock*

| | | | | | | |
|--------------------|----|-------|-------|-------|-------|-------|
| Basic net income | \$ | 1.84 | 1.28 | 0.58 | 0.99 | 1.29 |
| Diluted net income | \$ | 1.80 | 1.26 | 0.58 | 0.99 | 1.29 |
| Cash dividends | \$ | 0.41 | 0.36 | 0.36 | 0.36 | 0.36 |
| Book value | \$ | 15.80 | 14.77 | 14.08 | 14.10 | 12.83 |

*Shares outstanding and per share computations have been retroactively restated to reflect a 10% stock dividend during first quarter 2005.

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. (the "Company"), for the years ended December 31, 2005, 2004 and 2003. The Company is a registered bank holding company operating under the supervision of the Federal Reserve Board and the parent company of Peoples Bank (the "Bank"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg and Iredell 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 loans and consumer loans. Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment securities portfolios and our cost of funds, which consists of interest paid on deposits and borrowed funds. Net interest income also is affected by the relative amounts of 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 serving our customers than many of our non-local competitors because of our ability to quickly and effectively provide senior management responses to customer needs and inquiries. Our ability to provide these services is enhanced by the stability of our senior management team.

During 2005 the Federal Reserve has increased the Federal Funds Rate a total of 2.00%, with the rate set at 4.25% as of December 31, 2005. These increases had a positive impact on 2005 earnings and should continue to have a positive impact on the Bank's net interest income in 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 swaps utilized by the Company to convert some variable rate loans to fixed rate. These 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.

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 its 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

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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.

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

There are other complex accounting standards that require the Company to employ significant judgment in interpreting and applying certain of the principles prescribed by those standards. These judgments include, but are not limited to, the determination of whether a financial instrument or other contract meets the definition of a derivative in accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133). For a more complete discussion of policies, see the notes to 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 will adopt in the first quarter of 2006. The financial statement impact of adopting this change in accounting principle is not expected to be material due to the small number of unvested shares at December 31, 2005.

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

The remainder of management's discussion and analysis of the Company's results of operations and financial position should be read in conjunction with the consolidated financial statements and related notes presented on pages A-25 through A-48.

Results of Operations

Summary. The Company reported earnings of \$6.3 million in 2005, or \$1.84 basic net earnings per share and \$1.80 diluted net earnings per share, a 43% increase as compared to \$4.4 million, or \$1.28 basic net earnings per share and \$1.26 diluted net earnings per share, for 2004. Net earnings from recurring operations for 2005 were \$6.8 million, or \$1.98 basic net earnings per share and \$1.94 diluted net earnings per share, representing a 48% increase over net earnings from recurring operations of \$4.6 million, or \$1.33 basic net earnings per share and \$1.31 diluted net earnings per share in 2004. Net non-recurring losses on disposition of assets in 2005 amounted to \$746,000, primarily due to a \$730,000 loss on sale of securities. This is an increase over net non-recurring losses on disposition of assets for the year ended December 31, 2004, which amounted to \$248,000. The Company's increase in recurring earnings for 2005 is primarily attributable to an increase in net interest income, an increase in non-interest income and a decrease in the provision for loan losses, which were partially offset by an increase in non-interest expense.

Net earnings for 2004 represented an increase of 121% as compared to 2003 net earnings of \$2.0 million. Net earnings from recurring operations for 2004 increased 106% when compared to \$2.2 million, or \$0.65 basic net earnings per

share and \$0.64 diluted net earnings per share for 2003. Net earnings for 2003 included non-recurring losses on the sale of securities of \$53,000. The increase in 2004 recurring earnings was primarily attributable to a decrease in the provision for loan losses and an increase in net interest income, which were partially offset by an increase in non-interest expense.

The annualized return on average assets in 2005 was 0.90%, compared to 0.65% in 2004 and 0.30% in 2003. Excluding non-recurring gains and losses on disposition of assets, the annualized return on average assets was 0.96%, 0.67% and 0.34% in 2005, 2004 and 2003, respectively. Annualized return on average shareholders' equity was 11.31% in 2005 compared to 8.52% in 2004 and 4.01% in 2003. Excluding non-recurring gains and losses on disposition of assets, the annualized return on average shareholders' equity was 12.07%, 8.81% and 4.46% in 2005, 2004 and 2003, respectively.

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

Net interest income was \$27.9 million for 2005, or 17% over net interest income of \$24.0 million in 2004. The increase was attributable to an increase in interest income due to an increase in the prime rate resulting from Federal Reserve interest rate increases combined with an increase in the average outstanding balance of available for sale securities. Net interest income increased 8% in 2004 from \$22.2 million in 2003.

Table 1 sets forth for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest incurred on such amounts and the average rate earned or incurred for the years ended December 31, 2005, 2004 and 2003. The table also sets forth the average rate earned on total interest-earning assets, the average rate paid on total interest-bearing liabilities, and the net yield on average total interest-earning assets for the same periods. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields and interest income on tax-exempt investments have been adjusted to tax equivalent basis using an effective tax rate 34% for securities that are both federal and state tax exempt and an effective tax rate of 6.90% for state tax exempt securities. Non-accrual loans and the interest income that was recorded on these loans, if any, are included in the yield calculations for loans in all periods reported.

Table 1- Average Balance Table

| (Dollars in Thousands) | December 31, 2005 | | | December 31, 2004 | | | December 31, 2003 | | |
|--------------------------------------|-------------------|---------------|--------------|-------------------|---------------|--------------|-------------------|---------------|--------------|
| | Average Balance | Interest | Yield / Rate | Average Balance | Interest | Yield / Rate | Average Balance | Interest | Yield / Rate |
| Interest-earning assets: | | | | | | | | | |
| Loans | \$ 550,545 | 37,234 | 6.76% | 547,753 | 29,826 | 5.45% | 539,559 | 28,700 | 5.32% |
| Interest rate swap agreements | - | (575) | -0.14% | - | 1,056 | 2.21% | - | 1,522 | 3.22% |
| Loan fees | - | 1,951 | 0.29% | - | 1,409 | 0.26% | - | 1,390 | 0.26% |
| Total loans | 550,545 | 38,610 | 7.01% | 547,753 | 32,291 | 5.90% | 539,559 | 31,612 | 5.86% |
| Investments - taxable | 37,487 | 1,597 | 4.26% | 35,920 | 1,545 | 4.30% | 49,082 | 2,186 | 4.45% |
| Investments - nontaxable* | 71,203 | 3,389 | 4.76% | 57,850 | 2,741 | 4.74% | 22,990 | 1,228 | 5.34% |
| Federal funds sold | 2,272 | 73 | 3.21% | 3,363 | 35 | 1.05% | 5,981 | 58 | 0.98% |
| Other | 6,674 | 238 | 3.57% | 5,209 | 141 | 2.70% | 8,152 | 174 | 2.14% |
| Total interest-earning assets | 668,181 | 43,907 | 6.57% | 650,095 | 36,753 | 5.65% | 625,764 | 35,258 | 5.63% |
| Cash and due from banks | 15,149 | | | 13,058 | | | 12,587 | | |
| Other assets | 31,324 | | | 30,601 | | | 31,008 | | |
| | (7,811) | | | (9,369) | | | (8,282) | | |

| | | | | | | | | | |
|---|------------|--------|-------|---------|--------|-------|---------|--------|-------|
| Allowance for loan losses | | | | | | | | | |
| Total assets | \$ 706,843 | | | 684,385 | | | 661,077 | | |
| Interest-bearing liabilities: | | | | | | | | | |
| NOW accounts | \$ 110,852 | 1,468 | 1.32% | 106,832 | 1,292 | 1.21% | 75,757 | 688 | 0.91% |
| Regular savings accounts | 21,205 | 65 | 0.31% | 21,845 | 72 | 0.33% | 21,131 | 75 | 0.35% |
| Money market accounts | 56,858 | 1,112 | 1.96% | 51,069 | 535 | 1.05% | 58,134 | 556 | 0.96% |
| Time deposits | 292,807 | 8,923 | 3.05% | 300,175 | 7,145 | 2.38% | 310,991 | 8,157 | 2.62% |
| FHLB borrowings | 65,934 | 2,889 | 4.38% | 58,656 | 2,603 | 4.44% | 59,305 | 2,597 | 4.38% |
| Demand notes payable to U.S. Treasury | 702 | 21 | 3.02% | 678 | 8 | 1.14% | 710 | 7 | 0.99% |
| Trust preferred securities | 14,433 | 938 | 6.50% | 14,433 | 677 | 4.69% | 14,433 | 668 | 4.62% |
| Other | 419 | 13 | 3.00% | 192 | 3 | 1.46% | 215 | 1 | 0.47% |
| Total interest-bearing liabilities | 563,210 | 15,429 | 2.74% | 553,880 | 12,335 | 2.23% | 540,676 | 12,749 | 2.36% |
| Demand deposits | 89,275 | | | 78,221 | | | 67,690 | | |
| Other liabilities | 1,275 | | | 2,137 | | | 2,800 | | |
| Shareholders' equity | 55,989 | | | 51,978 | | | 49,971 | | |
| Total liabilities and shareholder's equity | \$ 709,749 | | | 686,216 | | | 661,137 | | |
| Net interest spread | \$ 28,478 | 3.83% | | 24,418 | 3.43% | | 22,509 | 3.27% | |
| Net yield on interest-earning assets | | | 4.26% | | | 3.76% | | | 3.60% |
| Taxable equivalent adjustment | | | | | | | | | |
| Investment securities | \$ 536 | | | 460 | | | 323 | | |
| Net interest income | \$ 27,942 | | | 23,958 | | | 22,186 | | |

*Includes U.S. government agency securities that are non-taxable for state income tax purposes of \$50.7 million in 2005, \$40.4 million in 2004 and \$9.4 million in 2003. An effective tax rate of 6.90% was used to calculate the tax equivalent yield on these securities.

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

Table 2 - Rate/Volume Analysis-Tax Equivalent Basis

| (Dollars in Thousands) | December 31, 2005 | | | December 31, 2004 | | |
|---------------------------------------|---------------------------|--------------------------|---------------------------|---------------------------|--------------------------|---------------------------|
| | Changes in average volume | Changes in average rates | Total Increase (Decrease) | Changes in average volume | Changes in average rates | Total Increase (Decrease) |
| Interest Income: | | | | | | |
| Loans: Net of unearned income | \$ 180 | 6,139 | 6,319 | 481 | 198 | 679 |
| Investments - taxable | 67 | (15) | 52 | (603) | (38) | (641) |
| Investments - nontaxable | 634 | 14 | 648 | 1,756 | (243) | 1,513 |
| Federal funds sold | (23) | 61 | 38 | (26) | 3 | (23) |
| Other | 45 | 52 | 97 | (73) | 40 | (33) |
| Total interest income | 903 | 6,251 | 7,154 | 1,535 | (40) | 1,495 |
| Interest expense: | | | | | | |
| NOW accounts | 51 | 125 | 176 | 329 | 275 | 604 |
| Regular savings accounts | (2) | (5) | (7) | 2 | (5) | (3) |
| Money market accounts | 87 | 490 | 577 | (71) | 50 | (21) |
| Time deposits | (200) | 1,978 | 1,778 | (271) | (741) | (1,012) |
| FHLB Borrowings | 321 | (35) | 286 | (28) | 34 | 6 |
| Demand notes payable to U.S. Treasury | - | 13 | 13 | - | 1 | 1 |
| Trust Preferred Securities | 24 | 237 | 261 | - | 9 | 9 |
| Other | 5 | 5 | 10 | - | 2 | 2 |
| Total interest expense | 286 | 2,808 | 3,094 | (39) | (375) | (414) |
| Net interest income | \$ 617 | 3,443 | 4,060 | 1,574 | 335 | 1,909 |

Net interest income on a tax equivalent basis totaled \$28.5 million in 2005, increasing 17% or \$4.1 million from 2004. This increase was primarily attributable to an increase in the yield on interest-earning assets partially offset by an increase in the cost of funds. The interest rate spread, which represents the rate earned on interest-earning assets less the rate paid on interest-bearing liabilities, was 3.83% in 2005, an increase from the 2004 net interest spread of 3.43%. The net yield on interest-earning assets in 2005 increased to 4.26% from the 2004 net interest margin of 3.76%.

Tax equivalent interest income increased \$7.2 million or 19% in 2005 primarily due to an increase in the Bank's prime lending rate from an average rate of 4.34% in 2004 to 6.19% in 2005. The increase in rates combined with a \$17.4 million increase in average interest-earning assets resulted in an increase in the yield on interest-earning assets to 6.57% in 2005 as compared to 5.65% in 2004. The \$18.1 million increase in average interest-earning assets was attributable primarily to a \$14.9 million increase in average investment securities. Average loans in 2005 increased

1% to \$550.5 million when compared to 2004. All other interest-earning assets including federal funds sold increased to \$8.9 million in 2005 from \$8.6 million in 2004.

Interest expense increased \$3.1 million or 25% in 2005 due to an increase in the average rate paid on interest-bearing liabilities combined with a \$9.3 million increase in volume of interest-bearing liabilities. The cost of funds increased to 2.74% in 2005 from 2.23% in 2004. This increase in the cost of funds was primarily attributable to increases in the average rate paid on interest-bearing checking and savings accounts and certificates of deposit. The \$9.3 million growth in average interest-bearing liabilities was primarily attributable to an increase in FHLB borrowings of \$7.2 million to \$65.9 million in 2005 from \$58.7 million in 2004.

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In 2004 net interest income on a tax equivalent basis increased \$1.9 million or 8% to \$24.4 million in 2004 from \$22.5 million in 2003. The interest rate spread was 3.43% in 2004, an increase from the 2003 net interest spread of 3.27%. The net yield on interest-earning assets in 2004 increased to 3.76% from the 2003 net interest margin of 3.60%.

Provision for Loan Losses. Provision for loan losses are charged to income in order to bring the total allowance for loan losses to a level deemed appropriate by management of the Company based on factors such as management's judgment as to losses within the Company's loan portfolio, including the valuation of impaired loans in accordance with Statement of Financial Accounting Standards ("SFAS") No. 114 and No. 118, loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies and management's assessment of the quality of the loan portfolio and general economic climate.

The provision for loan losses was \$3.1 million, \$3.3 million, and \$6.7 million for the years ended December 31, 2005, 2004 and 2003, respectively. The decrease in the provision for loan losses for 2005 reflects a decrease in classified loans of \$5.3 million as of December 31, 2005 when compared to December 31, 2004, netted against the effect of a 6% growth in gross loans during 2005. Please see the section below entitled "Allowance for Loan Losses" for a more complete discussion of the Bank's policy for addressing possible loan losses

Non-Interest Income. Non-interest income for 2005 totaled \$6.7 million, an increase of \$676,000 or 11% from non-interest income of \$6.0 million for 2004. The increases in non-interest income for 2005 are primarily due to an increase in fee income from the Bank's Banco de la Gente branches, which were in operation for the first full year in 2005, increases in debit card fee income and an increase in mortgage banking income. Non-interest income for 2004 increased \$175,000 or 3% from non-interest income of \$5.8 million for 2003. The increase in non-interest income for 2004 is primarily due to an increase in service charge fee income associated with deposit growth, which were partially offset by a decrease in mortgage banking income. Excluding non-recurring gains or losses on the disposition of assets, non-interest income for 2005 increased 19% to \$7.4 million as compared to \$6.2 million in 2004. Non-interest income, excluding non-recurring gains or losses on the disposition of assets, totaled \$6.2 million for 2003.

Service charges on deposit accounts totaled \$3.8 million during 2005, an increase of \$345,000, or 10% over 2004. Service charge income increased \$168,000, or 5% in 2004 compared to 2003. These increases are primarily attributable to growth in the deposit base coupled with normal pricing changes, which resulted in an increase in account maintenance fees.

Other service charges and fees increased 69% to \$1.1 million for the year ended December 31, 2005 as compared to \$677,000 for the same period one year ago. This increase is primarily attributable to fee income from the Bank's Banco de la Gente branches, which were in operation for the first full year in 2005.

The Company reported net losses on sale of securities of \$730,000, \$64,000 and \$53,000 in 2005, 2004 and 2003, respectively. Losses on the sale of securities were primarily due to the sale of \$20 million in callable U.S. Government Agency securities, which were reinvested in fixed term U.S. Government Agency securities in order to reduce the exposure to a decrease in interest rates in the Bank's investment portfolio.

Mortgage banking income increased to \$469,000 in 2005 from \$357,000 in 2004. During 2004 mortgage banking income decreased \$248,000 from the \$605,000 reported in 2003. The decrease in mortgage banking income for 2004 was primarily attributable to an increase in mortgage interest rates during 2004.

Net losses on repossessed assets were \$38,000 for 2005 compared to net losses on repossessed assets of \$180,000 for 2004. During 2003 a net loss on repossessed assets of \$747,000 was recognized.

The Company recognized a \$479,000 gain on the sale of loans during 2003 as a result of the sale of the Bank's \$3.7 million credit card portfolio in 2003. There were no gains on the sale of loans recognized in 2005 and 2004.

Miscellaneous income for 2005 totaled \$1.7 million, an increase of 24% from \$1.4 million for 2004. The increase in miscellaneous income was primarily attributable to an increase in debit card fee income primarily associated with increased card usage due to an increased number of demand accounts. During 2003, miscellaneous income increased 18% primarily due to an increase in debit card fee income.

Table 3 presents a summary of non-interest income for the years ended December 31, 2005, 2004 and 2003.

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Table 3 - Non-Interest Income

| (Dollars in Thousands) | 2005 | 2004 | 2003 |
|---|-----------------|--------------|--------------|
| Service charges | \$ 3,780 | 3,435 | 3,267 |
| Other service charges and fees | 1,142 | 677 | 611 |
| Gain (loss) on sale of securities | (730) | (64) | (53) |
| Mortgage banking income | 469 | 356 | 604 |
| Insurance and brokerage commissions | 387 | 430 | 421 |
| Loss on foreclosed and repossessed assets | (38) | (179) | (747) |
| Gain on sale of loans | - | - | 479 |
| Miscellaneous | 1,686 | 1,365 | 1,263 |
| Total non-interest income | \$ 6,696 | 6,020 | 5,845 |

Non-Interest Expense. Total non-interest expense amounted to \$21.8 million for 2005, an increase of 9% from 2004. Non-interest expense for 2004 increased 10% to \$20.1 million from non-interest expense of \$18.2 million for 2003.

Salary and employee benefit expense was \$12.4 million in 2005, compared to \$11.5 million during 2004, an increase of \$873,000 or 8%, following a \$1.4 million or 14% increase in salary and employee benefit expense in 2004 over 2003. The 2005 increase in salary and employee benefits is primarily due to normal salary increases and increased incentive expense. The increase during 2004 is attributable to normal salary increases, increased incentive expense and increased employee insurance costs.

The Company recorded occupancy expenses of \$3.9 million in 2005, compared to \$3.7 million during 2004, an increase of \$277,000 or 8%, following an increase of \$282,000 or 8% in occupancy expenses in 2004 over 2003. The increase in 2005 is primarily due to an increase in furniture and equipment expense and lease expense. Increases in 2004 are attributable to an increase in repairs and maintenance expense and an increase in lease expense resulting from lease agreements for branch facilities entered into during 2003 and 2004. During 2003, the Company sold two branch locations with net book values of approximately \$3.1 million and is currently leasing the facilities from the buyers. As a result of the sales, the Company deferred a gain of approximately \$633,000 and is recognizing the gain over the lease term. Approximately \$22,000 of the deferred gain was recognized for the years ended December 31, 2005 and 2004. During 2003 approximately \$18,000 of the deferred gain was recognized. Annual rent expense related to these two locations is \$237,000.

The total of all other operating expenses increased \$610,000 or 12% during 2005. Other operating expense increased \$170,000 or 4% in 2004 over 2003. The increase in other expense for 2005 is primarily attributable to increases of \$219,000 in fraud and forgery and processing adjustments on transactional accounts, \$99,000 in professional fees, \$74,000 in deposit program expense and \$73,000 in debit card expense.

Table 4 presents a summary of non-interest expense for the years ended December 31, 2005, 2004 and 2003.

Table 4 - Non-Interest Expense

| (Dollars in Thousands) | 2005 | 2004 | 2003 |
|--------------------------------|---------------|---------------|---------------|
| Salaries and wages | \$ 8,648 | 8,240 | 7,733 |
| Employee benefits | 3,702 | 3,237 | 2,367 |
| Total personnel expense | 12,350 | 11,477 | 10,100 |
| Occupancy expense | 3,949 | 3,672 | 3,390 |
| Office supplies | 314 | 314 | 270 |
| FDIC deposit insurance | 76 | 81 | 82 |
| Professional services | 389 | 290 | 333 |

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| | | | |
|-----------------------------------|------------------|---------------|---------------|
| Postage | 264 | 211 | 217 |
| Telephone | 403 | 337 | 333 |
| Director fees and expense | 334 | 351 | 234 |
| Marketing and public relations | 656 | 620 | 541 |
| Consulting fees | 233 | 306 | 280 |
| Taxes and licenses | 218 | 200 | 443 |
| Other operating expense | 2,631 | 2,198 | 2,005 |
| Total non-interest expense | \$ 21,817 | 20,057 | 18,228 |

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Income Taxes. Total income tax expense was \$3.4 million in 2005 compared with \$2.2 million in 2004 and \$1.1 million in 2003. The primary reason for the increase in taxes for 2005 as compared to 2004 and 2003 was the increase in pretax income. The Company's effective tax rates were 34.81%, 33.51% and 34.50% in 2005, 2004 and 2003, respectively.

Liquidity. The objectives of the Company's liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company's liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of December 31, 2005 such unfunded commitments to extend credit were \$133.4 million, while commitments in the form of standby letters of credit totaled \$2.7 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 December 31, 2005, the Company's core deposits totaled \$430.4 million, or 74% 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 December 31, 2005, the Bank had a significant amount of deposits in amounts greater than \$100,000, including brokered deposits of \$40.3 million, which mature over the next two years. The balance and cost of these deposits are more susceptible to changes in the interest rate environment than other deposits. For additional information, please see the section below entitled "Deposits".

The Bank has a line of credit with the FHLB equal to 20% of the Bank's total assets, with an outstanding balance of \$71.6 million at December 31, 2005. The remaining availability at FHLB was \$49.3 million at December 31, 2005. The Bank also had the ability to borrow up to \$26.5 million for the purchase of overnight federal funds from three correspondent financial institutions as of December 31, 2005.

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 36.81% at December 31, 2005, 34.82% at December 31, 2004 and 26.83% at December 31, 2003. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy is 20%.

As disclosed in the Company's Consolidated Statements of Cash Flows included elsewhere herein, net cash provided by operating activities was approximately \$14.3 million during 2005. Net cash used in investing activities of \$49.8 million consisted primarily of a net increase in loans of \$35.1 million. Net cash provided by financing activities amounted to \$38.6 million, primarily from \$26.3 million net increase in deposits.

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. Table 5 presents an interest rate sensitivity analysis for the interest-earning assets and interest-bearing liabilities for the year ended December 31, 2005.

Table 5 - Interest Sensitivity Analysis

| (Dollars in Thousands) | Immediate | 1-3 Months | 4-12 Months | Total Within One year | Over One year & Non-sensitive | Total |
|--|-------------------|-------------------|--------------------|------------------------------|--|-------------------|
| Interest-earning assets: | | | | | | |
| Loans | \$ 427,716 | 17,536 | 8,697 | 453,949 | 112,714 | \$ 566,663 |
| Mortgage loans available for sale | 2,248 | - | - | 2,248 | - | 2,248 |
| Investment securities | - | 1,753 | - | 1,753 | 113,405 | 115,158 |
| Federal funds sold | 1,347 | - | - | 1,347 | - | 1,347 |
| Interest-bearing deposit accounts | 1,480 | - | - | 1,480 | - | 1,480 |
| Other interest-earning assets | - | - | - | - | 5,506 | 5,506 |
| Total interest-earning assets | 432,791 | 19,289 | 8,697 | 460,777 | 231,625 | \$ 692,402 |
| Interest-bearing liabilities: | | | | | | |
| NOW, savings, and money market deposits | 183,249 | - | - | 183,249 | - | \$ 183,249 |
| Time deposits | 69,697 | 42,161 | 130,078 | 241,936 | 63,008 | 304,944 |
| Other short term borrowings | 1,474 | - | - | 1,474 | - | 1,474 |
| FHLB borrowings | 4,600 | 2,500 | - | 7,100 | 64,500 | 71,600 |
| Securities sold under agreement to repurchase | 981 | - | - | 981 | - | 981 |
| Trust preferred securities | - | 14,433 | - | 14,433 | - | 14,433 |
| Total interest-bearing liabilities | 260,001 | 59,094 | 130,078 | 449,173 | 127,508 | \$ 576,681 |
| Interest-sensitive gap | \$ 172,790 | (39,805) | (121,381) | 11,604 | 104,117 | \$ 115,721 |
| Cumulative interest-sensitive gap | \$ 172,790 | 132,985 | 11,604 | 11,604 | 115,721 | |
| Interest-earning assets as a percentage of interest-bearing liabilities | 166.46 % | 32.64 % | 6.69 % | 102.58 % | | |

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

The Company’s rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available for sale securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits and borrowed funds. As shown in table 5, the Company’s balance sheet is asset-sensitive, meaning that in a given period there will be more assets than liabilities subject to immediate repricing as interest rates change in the market. Because most of the Company’s loans are tied to the prime rate, they reprice more rapidly than rate sensitive interest-bearing deposits. During periods of rising rates, this results in increased net interest income. The opposite occurs during periods of declining rates. Rate sensitive assets at December 31, 2005 totaled \$692.4 million, exceeding rate sensitive liabilities of \$576.7 million by \$115.7 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 December 31, 2005, the Company had cash flow hedges with a notional amount of \$70.0 million. These derivative instruments consist of two interest rate floor contracts that are used to hedge future cash flows of the first \$70.0 million of certain variable rate commercial 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 and November 2008. 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.

The Company settled two previously outstanding interest rate swap agreements during 2005. The first swap with a notional amount of \$25.0 million and scheduled to mature in April 2006 was sold for a loss of \$318,000. The second swap with a notional amount of \$30.0 million and scheduled to mature in September 2006 was sold for a loss of \$552,000. The losses realized upon settlement are being recognized over the original term of the agreements, and during the year ended December 31, 2005, losses of approximately \$484,000 were recognized.

The Bank also utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At December 31, 2005, the Bank had \$90.5 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.

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

Analysis of Financial Condition

Investment Securities. All of the Company's investment securities are held in the available-for-sale ("AFS") category. At December 31, 2005 the market value of AFS securities totaled \$115.2 million, compared to \$105.6 million and \$79.5 million at December 31, 2004 and 2003, respectively. The increase in 2005 investment securities is attributable to additional securities purchases, which were partially offset by paydowns on mortgage-backed securities and maturities during 2005. This increase in AFS securities reflects management's directed effort to increase investment securities as a percentage of total assets in an effort to reduce the credit risk in the balance sheet. Table 6 presents the market value of the AFS securities held at December 31, 2005, 2004 and 2003.

Table 6 - Summary of Investment Portfolio

| (Dollars in Thousands) | 2005 | 2004 | 2003 |
|---|-------------------|----------------|---------------|
| Obligations of United States government agencies and corporations | \$ 60,243 | 46,570 | 34,517 |
| Obligations of states and political subdivisions | 21,609 | 20,649 | 14,950 |
| Mortgage backed securities | 31,004 | 36,543 | 24,920 |
| Trust preferred securities | 1,750 | 1,750 | 5,000 |
| Equity securities | 552 | 86 | 73 |
| Total securities | \$ 115,158 | 105,598 | 79,460 |

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

The Company's investment portfolio consists of U.S. government agency securities, municipal securities, U.S. government agency sponsored mortgage-backed securities, trust preferred securities and equity securities. AFS securities averaged \$108.7 million in 2005, \$93.8 million in 2004 and \$72.1 million in 2003. Table 7 presents the

amortized cost of AFS securities held by the Company by maturity category at December 31, 2005. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity and yields are calculated on a tax equivalent basis. Yields and interest income on tax-exempt investments have been adjusted to tax equivalent basis using an effective tax rate 34% for securities that are both federal and state tax exempt and an effective tax rate of 6.90% for state tax exempt securities.

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Table 7 - Maturity Distribution and Weighted Average Yield on Investments

| (Dollars in Thousands) Book value: | One Year or Less | | After One Year Through 5 Years | | After 5 Years Through 10 Years | | After 10 Years | | Totals | |
|---------------------------------------|------------------|--------------|--------------------------------|--------------|--------------------------------|--------------|----------------|--------------|-------------------|--------------|
| | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield |
| United States Government agencies | \$ - | - | 36,433 | 4.27% | 24,318 | 4.80% | - | - | \$ 60,751 | 4.48% |
| States and political subdivisions | 200 | 7.21% | 8,341 | 5.08% | 9,329 | 4.88% | 3,878 | 7.04% | 21,748 | 5.36% |
| Mortgage backed securities | - | - | 432 | 3.74% | 12,371 | 3.99% | 19,063 | 4.53% | 31,866 | 4.31% |
| Trust preferred securities | - | - | - | - | - | - | 1,750 | 7.16% | 1,750 | 7.16% |
| Equity securities | - | - | - | - | - | - | 815 | 0.21% | 815 | 0.21% |
| Total securities | \$ 200 | 7.21% | 45,206 | 4.42% | 46,018 | 4.60% | 25,506 | 4.95% | \$ 116,930 | 4.61% |

Loans. The loan portfolio is the largest category of the Company's earning assets and is comprised of commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. The Company grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg 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. In management's opinion, there are no significant concentrations of credit with particular borrowers engaged in similar activities.

The composition of the Company's loan portfolio is presented in table 8.

Table 8 - Loan Portfolio

| (Dollars in Thousands) Breakdown of loan receivables: | 2005 | | 2004 | | 2003 | | 2002 | | 2001 | |
|--|-----------|------------|--------|------------|--------|------------|--------|------------|---------|------------|
| | Amount | % of Loans | Amount | % of Loans | Amount | % of Loans | Amount | % of Loans | Amount | % of Loans |
| Commercial | \$ 79,902 | 14.10% | 79,189 | 14.79% | 90,558 | 16.41% | 92,141 | 17.51% | 102,409 | 20.87% |

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| | | | | | | | | | | |
|----------------------------|-------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Real estate - mortgage | 330,227 | 58.28% | 312,988 | 58.45% | 332,730 | 60.26% | 322,987 | 61.36% | 277,737 | 56.61% |
| Real estate - construction | 141,420 | 24.96% | 127,042 | 23.73% | 110,392 | 19.99% | 80,552 | 15.30% | 82,791 | 16.88% |
| Consumer | 15,115 | 2.66% | 16,249 | 3.03% | 18,446 | 3.34% | 30,690 | 5.83% | 27,671 | 5.64% |
| Total loans | \$ 566,664 | 100.00% | 535,468 | 100.00% | 552,126 | 100.00% | 526,370 | 100.00% | 490,608 | 100.00% |
| Less: | | | | | | | | | | |
| Allowance for loan losses | 7,425 | | 8,049 | | 9,722 | | 7,248 | | 6,091 | |
| Net loans | \$ 559,239 | | 527,419 | | 542,404 | | 519,122 | | 484,517 | |

As of December 31, 2005, gross loans outstanding were \$566.7 million, an increase of \$31.2 million or 6% from the December 31, 2004 balance of \$535.5 million. Commercial loans increased \$713,000 in 2005. Real estate mortgage loans grew \$17.2 million when compared to 2004 due to an increase in commercial real estate loans. Real estate construction loans increased \$14.4 million in 2005 as a result of an increase in real estate development loans. Consumer loans decreased \$1.1 million in 2005.

Mortgage loans held for sale were \$2.2 million at December 31, 2005, a decrease of \$1.5 million from the December 31, 2004 balance of \$3.8 million which represented an increase of \$3.2 million from the December 31, 2003 balance of \$587,000

Table 9 identifies the maturities of all loans as of December 31, 2005 and addresses the sensitivity of these loans to changes in interest rates.

Table 9 - Maturity and Repricing Data for Loans

| (Dollars in Thousands) | Within One Year or Less | After One Year Through Five Years | After Five Years | Total Loans |
|----------------------------|----------------------------|---|---------------------|-------------------|
| Commercial | \$ 70,761 | 8,572 | 569 | \$ 79,902 |
| Real estate - mortgage | 245,454 | 51,624 | 33,149 | 330,227 |
| Real estate - construction | 131,110 | 9,373 | 937 | 141,420 |
| Consumer | 6,624 | 7,215 | 1,275 | 15,114 |
| Total loans | \$ 453,949 | 76,784 | 35,930 | \$ 566,663 |
| Total fixed rate loans | \$ 11,316 | 63,882 | 35,930 | \$ 111,128 |
| Total floating rate loans | 442,633 | 12,902 | - | 455,535 |
| Total loans | \$ 453,949 | 76,784 | 35,930 | \$ 566,663 |

In the normal course of business, there are various commitments outstanding to extend credit that are not reflected in the financial statements. At December 31, 2005, outstanding loan commitments totaled \$133.4 million. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Additional information regarding commitments is provided below in the section entitled "Contractual Obligations" and in Note 10 to the Consolidated Financial Statements.

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

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

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 monthly 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 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.

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 December 31, 2005 and 2004, the recorded investment in loans that were considered to be

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impaired under SFAS No. 114 was approximately \$3.5 million and \$5.1 million, respectively, with related allowance for loan losses of approximately \$478,000 and \$773,000, respectively.

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.

As described above, 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 December 31, 2005, 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.

Net charge-offs for 2005 were \$3.7 million. The ratio of net charge-offs to average total loans was 0.68% in 2005, 0.90% in 2004 and 0.79% in 2003. Charge-offs in 2004 included charges of \$1.0 million and \$550,000 related to loans to customers that were formerly directors of the Company. The allowance for loan losses decreased to \$7.4 million or 1.31% of total loans outstanding at December 31, 2005. This decrease in the allowance for loan losses was the result of a reduction in classified loans. For December 31, 2004 and 2003, the allowance for loan losses amounted to \$8.0 million, or 1.50% of total loans outstanding and \$9.7 million, or 1.76% of total loans outstanding, respectively.

Table 10 presents the percentage of loans assigned to each risk grade along with the general reserve percentage applied to loans in each risk grade at December 31, 2005 and 2004.

Table 10 - Loan Risk Grade Analysis

| Risk Grade | Percentage of Loans By Risk Grade | | General Reserve Percentage | |
|-------------------------------|--------------------------------------|--------|-------------------------------|---------|
| | 2005 | 2004 | 2005 | 2004 |
| Risk 1 (Excellent Quality) | 14.28% | 13.44% | 0.15% | 0.15% |
| Risk 2 (High Quality) | 18.16% | 23.03% | 0.50% | 0.50% |
| Risk 3 (Good Quality) | 56.40% | 53.89% | 1.00% | 1.00% |
| Risk 4 (Management Attention) | 8.38% | 5.67% | 2.50% | 2.50% |
| Risk 5 (Watch) | 0.88% | 0.95% | 7.00% | 7.00% |
| Risk 6 (Substandard) | 0.42% | 0.61% | 12.00% | 12.00% |
| Risk 7 (Low Substandard) | 0.86% | 1.46% | 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% |

At December 31, 2005, there were two relationships which exceeded \$1.0 million (totaling \$2.7 million) in the Watch risk grade, no relationships that exceeded \$1.0 million in the Substandard risk grade and two relationships which exceed \$1.0 million (totaling \$4.5 million) in the Low Substandard risk grade. Balances of individual relationships exceeding \$1.0 million in these risk grades ranged from \$1.1 million to \$3.2 million. These customers continue to meet payment requirements and these relationships would not become non-performing assets unless they are unable to meet those requirements.

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Table 11 presents an analysis of the allowance for loan losses, including charge-off activity.

Table 11 - Analysis of Allowance for Loan Losses

| (Dollars in Thousands) | 2005 | 2004 | 2003 | 2002 | 2001 |
|--|-----------------|--------------|--------------|--------------|--------------|
| Reserve for loan losses at beginning | \$ 8,049 | 9,722 | 7,248 | 6,091 | 4,713 |
| Loans charged off: | | | | | |
| Commercial | 293 | 1,004 | 1,179 | 3,737 | 842 |
| Real estate - mortgage | 2,141 | 3,842 | 2,422 | 158 | 790 |
| Real estate - construction | 1,250 | 4 | 251 | - | 51 |
| Consumer | 516 | 535 | 630 | 546 | 675 |
| Total loans charged off | 4,200 | 5,385 | 4,482 | 4,441 | 2,358 |
| Recoveries of losses previously charged off: | | | | | |
| Commercial | 144 | 162 | 36 | 40 | 84 |
| Real estate - mortgage | 162 | 144 | 18 | - | - |
| Real estate - construction | - | - | 1 | 4 | 6 |
| Consumer | 160 | 150 | 157 | 122 | 101 |
| Total recoveries | 466 | 456 | 212 | 166 | 191 |
| Net loans charged off | 3,734 | 4,929 | 4,270 | 4,275 | 2,167 |
| Provision for loan losses | 3,110 | 3,256 | 6,744 | 5,432 | 3,545 |
| Reserve for loan losses at end of year | \$ 7,425 | 8,049 | 9,722 | 7,248 | 6,091 |
| Loans charged off net of recoveries, as a percent of average loans outstanding | | | | | |
| | 0.68% | 0.90% | 0.79% | 0.84% | 0.48% |

Non-performing Assets. Non-performing assets, comprised of non-accrual loans, other real estate owned, other repossessed assets and loans for which payments are more than 90 days past due totaled \$5.0 million at December 31, 2005 compared to \$6.0 million at December 31, 2004. Non-accrual loans were \$3.5 million at December 31, 2005, a decrease of \$1.6 million from non-accruals of \$5.1 million at December 31, 2004. As a percentage of loans outstanding, non-accrual loans were 0.62% and 0.95% at December 31, 2005 and 2004, respectively. The Bank had loans ninety days past due and still accruing at December 31, 2005 of \$946,000 as compared to \$245,000 for the same period in 2004. Other real estate owned totaled \$531,000 and \$682,000 as of December 31, 2005 and 2004, respectively. The Bank had no repossessed assets as of December 31, 2005 and 2004.

At December 31, 2005 the Company had non-performing loans, defined as non-accrual and accruing loans past due more than 90 days, of \$4.4 million or 0.79% of total loans. Non-performing loans for 2004 were \$5.3 million, or 1.00% of total loans and \$4.6 million, or 0.84% of total loans for 2003. Interest that would have been recorded on

non-accrual loans for the years ended December 31, 2005, 2004 and 2003, had they performed in accordance with their original terms, amounted to approximately \$507,000, \$264,000 and \$400,000 respectively. Interest income on impaired loans included in the results of operations for 2005, 2004, and 2003 amounted to approximately \$77,000, \$123,000 and \$67,000, respectively.

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

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

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A summary of non-performing assets at December 31 for each of the years presented is shown in Table 12.

Table 12 - Non-performing Assets

| (Dollars in Thousands) | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|-----------------|--------------|--------------|--------------|--------------|
| Non-accrual loans | \$ 3,492 | 5,097 | 4,343 | 4,602 | 3,756 |
| Loans 90 days or more past due and still accruing | 946 | 245 | 271 | 239 | 655 |
| Total non-performing loans | 4,438 | 5,342 | 4,614 | 4,841 | 4,411 |
| All other real estate owned | 531 | 682 | 1,447 | 240 | 256 |
| All other repossessed assets | - | - | 206 | 1,538 | 4 |
| Total non-performing assets | \$ 4,969 | 6,024 | 6,267 | 6,619 | 4,671 |
| As a percent of total loans at year end | | | | | |
| Non-accrual loans | 0.62% | 0.95% | 0.79% | 0.87% | 0.77% |
| Loans 90 days or more past due and still accruing | 0.17% | 0.05% | 0.05% | 0.05% | 0.13% |
| Total non-performing assets | 0.88% | 1.12% | 1.14% | 1.26% | 0.95% |

Deposits. The Company primarily uses deposits to fund its loan and investment portfolios. The Company offers a variety of deposit accounts to individuals and businesses. Deposit accounts include checking, savings, money market and time deposits. As of December 31, 2005, total deposits were \$582.9 million, an increase of \$26.4 million or 5% increase over the December 31, 2004 balance of \$556.5 million. The increase in deposits is primarily attributable to growth in core deposits, which include demand deposits, savings accounts and certificates of deposits of denominations less than \$100,000, to \$430.4 million at December 31, 2005 from \$402.2 million at December 31, 2004. The increase in core deposits resulted primarily from an increase in the Bank's certificates of deposits of denominations less than \$100,000, due to a change in certificate of deposit pricing strategies implemented in 2005.

Time deposits in amounts of \$100,000 or more totaled \$152.4 million at December 31, 2005, \$154.3 million and \$171.6 million at December 31, 2004 and 2003, respectively. The decrease in 2005 is due to a reduction in brokered deposits that were replaced with core deposits. At December 31, 2005, brokered deposits amounted to \$40.3 million as compared to \$39.4 million at December 31, 2004. Brokered deposits are generally considered to be more susceptible to withdrawal as a result of interest rate changes and to be a less stable source of funds, as compared to deposits from the local market. Brokered deposits outstanding as of December 31, 2005 have a weighted average rate of 3.64% with a weighted average original term of 18 months.

Table 13 is a summary of the maturity distribution of time deposits in amounts of \$100,000 or more as of December 31, 2005.

Table 13 - Maturities of Time Deposits over \$100,000

| (Dollars in Thousands) | 2005 |
|---------------------------------------|-------------------|
| Three months or less | \$ 33,040 |
| Over three months through six months | 28,730 |
| Over six months through twelve months | 38,760 |
| Over twelve months | 51,881 |
| Total | \$ 152,411 |

Borrowed Funds. The Company has access to various short-term borrowings, including the purchase of federal funds and borrowing arrangements from the FHLB and other financial institutions. At December 31, 2005, FHLB borrowings totaled \$71.6 million compared to \$59.0 million at December 31, 2004 and \$58.0 million at December 31, 2003. Average FHLB borrowings for 2005 were \$65.9 million, compared to average balances of \$58.7 million for 2004 and \$59.3 million for 2003. The maximum amount of outstanding FHLB borrowings was \$77.6 million in 2005, and \$70.7 in 2004 and \$75.1 in 2003. The FHLB advances outstanding at December 31, 2005 had both fixed and adjustable interest rates ranging from 3.28% to 6.49%. Currently \$7.1 million of the FHLB advances outstanding have contractual maturities prior to December 31, 2006. The FHLB has the option to convert \$52.0 million of the total advances to a floating rate and, if converted, the Bank may repay advances without prepayment 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. Additional information regarding FHLB advances is provided in Note 6 to the Consolidated Financial Statements.

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Demand notes payable to the U. S. Treasury, which represent treasury tax and loan payments received from customers, amounted to approximately \$1.5 million, \$1.2 million and \$443,000 at December 31, 2005, 2004 and 2003, respectively.

Securities sold under agreements to repurchase amounted to \$981,000 as of December 31, 2005. The Company had no securities sold under agreements to repurchase as of December 21, 2004 and 2003.

The Company had no federal funds purchased as of December 31, 2005, 2004 or 2003.

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 at December 31, 2005, 2004 or 2003.

The trust preferred securities 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.

The 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.

Contractual Obligations and Off-Balance Sheet Arrangements. The Company’s contractual obligations and other commitments as of December 31, 2005 are summarized in Table 14 below. The Company’s contractual obligations include the repayment of principal and interest related to FHLB advances and junior subordinated debentures, as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.

Table 14 - Contractual Obligations and Other Commitments

| (Dollars in Thousands) | Within One year | One to Three Years | Three to Five Years | Five Years or More | Total |
|-------------------------------------|-----------------|--------------------------|------------------------|--------------------------|-----------|
| Contractual Cash Obligations | | | | | |
| Long-term borrowings* | \$ 2,500 | 2,500 | 17,000 | 45,000 | \$ 67,000 |
| Junior subordinated debentures | - | - | - | 14,433 | 14,433 |
| Operating lease obligations | 985 | 1,935 | 1,447 | 4,232 | 8,599 |

| | | | | | | | |
|--|----|--------|--------|--------|--------|----|---------|
| Total | \$ | 3,485 | 4,435 | 18,447 | 63,665 | \$ | 90,032 |
| Other Commitments | | | | | | | |
| Commitments to extend credit | \$ | 46,450 | 23,217 | 9,472 | 54,270 | \$ | 133,409 |
| Standby letters of credit and financial guarantees written | | 2,607 | 85 | - | - | | 2,692 |
| Total | \$ | 49,057 | 23,302 | 9,472 | 54,270 | \$ | 136,101 |

*Excludes \$4.6 million adjustable rate credit due to the FHLB, which matured in February 2006.

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The Company enters into derivative contracts to manage various financial risks. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or referenced interest rate. Derivative contracts are carried at fair value on the consolidated balance sheet with the fair value representing the net present value of expected future cash receipts or payments based on market interest rates as of the balance sheet date. Derivative contracts are written in amounts referred to as notional amounts, which only provide the basis for calculating payments between counterparties and are not a measure of financial risk. Therefore, the derivative amounts recorded on the balance sheet do not represent the amounts that may ultimately be paid under these contracts. Further discussions of derivative instruments are included above in the section entitled "Asset Liability and Interest Rate Risk Management" beginning on page A-10 and in Notes 1, 10, 11 and 16 to the Consolidated Financial Statements.

Capital Resources. Shareholders' equity at December 31, 2005 was \$54.4 million compared to \$50.9 million at December 31, 2004 and \$48.6 million at December 31, 2003. At December 31, 2005 and 2004, unrealized gains and losses, net of taxes, amounted to losses of \$1.4 million and \$121,000, respectively. For the year ended December 31, 2003, unrealized gains and losses, net of taxes, amounted to a gain of \$588,000. Average shareholders' equity as a percentage of total average assets is one measure used to determine capital strength. Average shareholders' equity as a percentage of total average assets was 7.92%, 7.59% and 7.56% for 2005, 2004 and 2003. The return on average shareholders' equity was 11.31% at December 31, 2005 as compared to 8.52% and 4.01% as of December 31, 2004 and December 31, 2003, respectively. Total cash dividends paid during 2005 amounted to \$1.4 million. Cash dividends totaling \$1.3 million were paid during 2004 and 2003.

In November 2004, the Company's Board of Directors authorized the repurchase of up to \$3.0 million in common shares of the Company's outstanding common stock effective through the end of November 2005. During 2005, the Company repurchased a total of 15,000 shares at a total price of \$315,000. During 2004, the Company repurchased a total of 15,100 shares at a total price of \$291,000.

In November 2005, the Company's Board of Directors authorized the repurchase of up to \$2.0 million in common shares of the Company's outstanding common stock effective through the end of November 2006. No shares have been repurchased under the current plan.

Under regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 4.0% or greater. Tier 1 capital is generally defined as shareholders' equity and trust preferred securities less all intangible assets and goodwill. Tier 1 capital at December 31, 2005, 2004 and 2003 includes \$14.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 11.02%, 10.97% and 10.50% at December 31, 2005, 2004 and 2003, 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 12.19%, 12.22% and 11.75% at December 31, 2005, 2004 and 2003, 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 9.84%, 9.50% and 9.37% at December 31, 2005, 2004 and 2003, respectively.

The Bank's Tier 1 risk-based capital ratio was 10.46%, 10.35% and 9.87% at December 31, 2005, 2004 and 2003, respectively. The total risk-based capital ratio for the Bank was 11.64%, 11.60% and 11.13% at December 31, 2005, 2004 and December 31, 2003, respectively. The Bank's Tier 1 leverage capital ratio was 9.33%, 8.95% and 8.80% at December 31, 2005, 2004 and 2003 respectively.

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

the Bank was considered to be "well capitalized" at December 31, 2005, 2004 and 2003.

The capital treatment of trust preferred securities has been reviewed recently by the Federal Reserve Bank. The Federal Reserve Bank's proposal for capital treatment of trust preferred securities, released May 4, 2004, would continue to permit the inclusion of trust preferred securities in Tier 1 capital of bank holding companies. Further discussions of FIN 46 are included under "Recent Accounting Pronouncements" in Note 1 of the Notes to Consolidated Financial Statements.

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The Company's key equity ratios as of December 31, 2005, 2004 and 2003 are presented in Table 15.

Table 15 - Equity Ratios

| | 2005 | 2004 | 2003 |
|----------------------------------|--------|--------|--------|
| Return on average assets | 0.90% | 0.65% | 0.30% |
| Return on average equity | 11.31% | 8.52% | 4.01% |
| Dividend payout ratio | 22.34% | 28.37% | 62.56% |
| Average equity to average assets | 7.92% | 7.59% | 7.56% |

Quarterly Financial Data. The Company's consolidated quarterly operating results for the years ended December 31, 2005 and 2004 are presented in table 16.

**Table 16 - Quarterly
Financial Data**

| (Dollars in thousands, except per share amounts) | 2005 | | | | 2004 | | | |
|---|----------|--------|--------|--------|-------|--------|-------|--------|
| | First | Second | Third | Fourth | First | Second | Third | Fourth |
| Total interest income | \$ 9,581 | 10,349 | 11,352 | 12,089 | 8,936 | 8,847 | 9,135 | 9,374 |
| Total interest expense | 3,346 | 3,686 | 3,978 | 4,418 | 3,066 | 3,002 | 3,103 | 3,164 |
| Net interest income | 6,235 | 6,663 | 7,374 | 7,671 | 5,870 | 5,845 | 6,032 | 6,210 |
| Provision for loan losses | 690 | 723 | 930 | 767 | 859 | 868 | 931 | 598 |
| Other income | 1,638 | 1,842 | 1,795 | 1,421 | 1,500 | 1,531 | 1,549 | 1,440 |
| Other expense | 5,259 | 5,301 | 5,388 | 5,869 | 4,720 | 4,873 | 4,990 | 5,474 |
| Income before income taxes | 1,924 | 2,481 | 2,851 | 2,456 | 1,791 | 1,635 | 1,660 | 1,578 |
| Income taxes | 647 | 873 | 1,010 | 851 | 613 | 547 | 552 | 521 |
| Net earnings | \$ 1,277 | 1,608 | 1,841 | 1,605 | 1,178 | 1,088 | 1,108 | 1,057 |
| Basic earnings per share | \$ 0.37 | 0.47 | 0.53 | 0.47 | 0.34 | 0.31 | 0.32 | 0.31 |
| Diluted earnings per share | \$ 0.36 | 0.46 | 0.52 | 0.46 | 0.34 | 0.31 | 0.32 | 0.30 |

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QUANTATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

The Company's market risk arises primarily from interest rate risk inherent in its lending and deposit taking activities. The structure of the Company's loan and deposit portfolios is such that a significant decline (increase) in interest rates may adversely impact net market values and interest income. Management seeks to manage the risk through the utilization of its investment securities and off-balance sheet derivative instruments. During the years ended December 31, 2005, 2004 and 2003, the Company used interest rate contracts to manage market risk as discussed above in the section entitled "Asset Liability and Interest Rate Risk Management."

Table 17 presents in tabular form the contractual balances and the estimated fair value of the Company's on-balance sheet financial instruments and the notional amount and estimated fair value of the Company's off-balance sheet derivative instruments at their expected maturity dates for the period ended December 31, 2005. The expected maturity categories take into consideration historical prepayment experience as well as management's expectations based on the interest rate environment at December 31, 2005. As of December 31, 2005, all fixed rate advances are callable at the option of FHLB. For core deposits without contractual maturity (i.e. interest bearing checking, savings, and money market accounts), the table presents principal cash flows based on management's judgment concerning their most likely runoff or repricing behaviors.

Table 17 - Market Risk Table

| (Dollars In Thousands) | Principal/Notional Amount Maturing in Year Ended December 31, | | | | | | Fair Value |
|---------------------------------|---|---------|--------|-------------|------------|------------|------------|
| | 2006 | 2007 | 2008 | 2009 & 2010 | Thereafter | Total | |
| Loans Receivable | | | | | | | |
| Fixed rate | \$ 19,131 | 16,117 | 14,695 | 31,070 | 30,114 | \$ 111,128 | \$ 111,049 |
| Average interest rate | 7.93% | 7.28% | 6.80% | 6.83% | 6.92% | | |
| Variable rate | \$ 169,488 | 66,448 | 38,876 | 74,198 | 106,526 | \$ 455,535 | \$ 455,498 |
| Average interest rate | 7.82% | 7.97% | 8.05% | 7.89% | 7.65% | | |
| | | | | | | \$ 566,663 | \$ 566,547 |
| Investment Securities | | | | | | | |
| Interest bearing cash | \$ - | - | - | - | 1,480 | \$ 1,480 | \$ 1,480 |
| Average interest rate | - | - | - | - | 3.64% | | |
| Federal funds sold | \$ 1,347 | - | - | - | - | \$ 1,347 | \$ 1,347 |
| Average interest rate | 3.80% | - | - | - | - | | |
| Securities available for sale | \$ 1,535 | 5,485 | 16,725 | 25,708 | 65,705 | \$ 115,158 | \$ 115,158 |
| Average interest rate | 4.41% | 4.57% | 4.29% | 4.18% | 3.88% | | |
| Nonmarketable equity securities | \$ - | - | - | - | 3,735 | \$ 3,735 | \$ 5,506 |
| Average interest rate | - | - | - | - | 3.97% | | |
| Debt Obligations | | | | | | | |
| Deposits | \$ 230,683 | 101,307 | 46,232 | 37,888 | 166,744 | \$ 582,854 | \$ 583,312 |
| Average interest rate | 3.36% | 4.10% | 4.05% | 3.77% | 1.05% | | |
| Advances from FHLB | \$ 47,100 | 7,500 | - | 17,000 | - | \$ 71,600 | \$ 71,843 |
| Average interest rate | 3.62% | 3.99% | - | 5.35% | - | | |

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| | | | | | | | |
|---|----------|---|---|---|--------|-----------|-----------|
| Demand notes payable to U.S. Treasury | \$ 1,474 | - | - | - | - | \$ 1,474 | \$ 1,474 |
| Average interest rate | 3.79% | - | - | - | - | | |
| Securities sold under agreement to repurchase | \$ 981 | - | - | - | - | \$ 981 | \$ 981 |
| Average interest rate | 3.14% | - | - | - | - | | |
| Junior subordinated debentures | \$ - | - | - | - | 14,433 | \$ 14,433 | \$ 14,433 |
| Average interest rate | - | - | - | - | 7.11% | | |

Derivative Instruments (notional amount)

| | | | | | | | |
|-------------------------------|------|---|--------|---|---|-----------|--------|
| Interest rate floor contracts | \$ - | - | 70,000 | - | - | \$ 70,000 | \$ 176 |
| Average interest rate | - | - | 6.63% | - | - | | |

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Table 18 presents the simulated impact to net interest income under varying interest rate scenarios and the theoretical impact of rate changes over a twelve-month period referred to as “rate ramps.” The table shows the estimated theoretical impact on the Company’s tax equivalent net interest income from hypothetical rate changes of plus and minus 1% and 2% as compared to the estimated theoretical impact of rates remaining unchanged. The table also shows the simulated impact to market value of equity under varying interest rate scenarios and the theoretical impact of immediate and sustained rate changes referred to as “rate shocks” of plus and minus 1% and 2% compared to the theoretical impact of rates remaining unchanged. The prospective effects of the hypothetical interest rate changes are based upon various assumptions, including relative and estimated levels of key interest rates. This type of modeling has limited usefulness because it does not allow for the strategies management would utilize in response to sudden and sustained rate changes. Also, management does not believe that rate changes of the magnitude presented are likely in the forecast period presented.

Table 18 - Interest Rate Risk
(Dollars in thousands)

| Hypothetical rate change (ramp over 12 months) | Estimated Resulting Theoretical Net Interest Income | |
|---|--|----------|
| | Amount | % Change |
| +2% | \$ 33,409 | 7.68% |
| +1% | \$ 32,216 | 3.83% |
| 0% | \$ 31,028 | 0.00% |
| -1% | \$ 29,952 | -3.47% |
| -2% | \$ 29,052 | -6.37% |

| Hypothetical rate change (immediate shock) | Estimated Resulting Theoretical Market Value of Equity | |
|---|---|----------|
| | Amount | % Change |
| +2% | \$ 48,424 | -8.63% |
| +1% | \$ 50,588 | -4.54% |
| 0% | \$ 52,995 | 0.00% |
| -1% | \$ 55,686 | 5.08% |
| -2% | \$ 58,725 | 10.81% |

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**MARKET FOR THE COMPANY'S COMMON EQUITY
AND RELATED SHAREHOLDER MATTERS**

Peoples Bancorp common stock is traded on the over-the-counter (OTC) market and quoted on the Nasdaq National Market, under the symbol "PEBK." Scott and Stringfellow, Inc., Ryan, Beck & Co. and Sterne Agee & Leach, Inc. are market makers for the Company's shares.

Although the payment of dividends by the Company is subject to certain requirements and limitations of North Carolina corporate law, neither the Commissioner nor the FDIC have promulgated any regulations specifically limiting the right of the Company to pay dividends and repurchase shares. However, the ability of the Company to pay dividends and repurchase shares may be dependent upon the Company's receipt of dividends from the Bank. The Bank's ability to pay dividends is limited. North Carolina commercial banks, such as the Bank, are subject to legal limitations on the amounts of dividends they are permitted to pay. Dividends may be paid by the Bank from undivided profits, which are determined by deducting and charging certain items against actual profits, including any contributions to surplus required by North Carolina law. Also, an insured depository institution, such as the Bank, is prohibited from making capital distributions, including the payment of dividends, if, after making such distribution, the institution would become "undercapitalized" (as such term is defined in the applicable law and regulations). Based on its current financial condition, the Bank does not expect that this provision will have any impact on the Bank's ability to pay dividends.

As of March 6, 2006, the Company had 702 shareholders of record, not including the number of persons or entities whose stock is held in nominee or street name through various brokerage firms or banks. The market price for the Company's common stock was \$23.82 on March 6, 2006.

Table 19 presents certain market and dividend information for the last two fiscal years. Over-the-counter quotations reflect inter-dealer prices, without retail mark-up, mark down or commission and may not necessarily represent actual transactions.

Table 19 - Market and Dividend Data

| | Low Bid | High Bid | Cash Dividend Per Share |
|----------------|----------------|-----------------|--|
| 2005 | | | |
| First Quarter | \$ 17.75 | 22.27 | 0.10 |
| Second Quarter | \$ 17.25 | 22.00 | 0.10 |
| Third Quarter | \$ 18.16 | 22.27 | 0.10 |
| Fourth Quarter | \$ 19.47 | 24.00 | 0.11 |
| 2004 | | | |
| First Quarter | \$ 15.84 | 18.25 | 0.09 |
| Second Quarter | \$ 16.09 | 17.95 | 0.09 |
| Third Quarter | \$ 16.54 | 18.09 | 0.09 |

| | | | | |
|----------------|----|-------|-------|------|
| Fourth Quarter | \$ | 16.39 | 18.18 | 0.09 |
|----------------|----|-------|-------|------|

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DIRECTORS AND OFFICERS OF THE COMPANY

DIRECTORS

Robert C. Abernethy - Chairman

Chairman of the Board, Peoples Bancorp of North Carolina, Inc. and Peoples Bank;
President, Secretary and Treasurer, Carolina Glove Company, Inc. (glove manufacturer)

James S. Abernethy

President and Assistant Secretary, Midstate Contractors, Inc. (paving company)

Douglas S. Howard

Vice President, Howard Ventures, Inc.

John W. Lineberger, Jr.

President, Lincoln Bonded Warehouse Company (commercial warehousing and distribution facility)

Gary E. Matthews

President and Director, Matthews Construction Company, Inc.

Billy L. Price, Jr. MD

Practicing Internist and Partner, Catawba Valley Internal Medicine, P.A.

Larry E. Robinson

President and Chief Executive Officer, The Blue Ridge Distributing Co., Inc. (beer and wine distributor)

William Gregory (Greg) Terry

Executive Vice President, Drum & Willis-Reynolds Funeral Homes and Crematory

Dan Ray Timmerman, Sr.

President, Timmerman Manufacturing, Inc. (wrought iron furniture manufacturer)

Benjamin I. Zachary

President, Treasurer and Member of the Board of Directors,
Alexander Railroad Company

OFFICERS

Tony W. Wolfe

President and Chief Executive Officer

Joseph F. Beaman, Jr.

Executive Vice President and Corporate Secretary

Lance A. Sellers

Executive Vice President and Assistant Corporate Secretary

William D. Cable

Executive Vice President and Assistant Corporate Treasurer

A. Joseph Lampron

Executive Vice President, Chief Financial Officer and Corporate Treasurer

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Porter Keadle Moore, LLP

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the consolidated balance sheets of Peoples Bancorp of North Carolina, Inc. as of December 31, 2005 and 2004, and the related consolidated statements of earnings, changes in shareholders' equity, comprehensive income and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Peoples Bancorp of North Carolina, Inc. as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

/s/ Porter Keadle Moore, LLP

Atlanta, Georgia
March 4, 2006

Certified Public Accountants

Suite 1800 * 235 Peachtree Street NE * Atlanta, Georgia 30303 * Phone 404-588-4200 * Fax 404-588-4222 *
www.pkm.com

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

December 31, 2005 and 2004

| <u>Assets</u> | <u>2005</u> | <u>2004</u> |
|--|----------------|-------------|
| Cash and due from banks, including reserve requirements of \$5,229,000 and \$4,643,000 | \$ 18,468,999 | 15,067,871 |
| Federal funds sold | 1,347,000 | 1,723,000 |
| Cash and cash equivalents | 19,815,999 | 16,790,871 |
| Investment securities available for sale | 115,158,184 | 105,598,106 |
| Other investments | 5,810,749 | 5,396,959 |
| Total securities | 120,968,933 | 110,995,065 |
| Mortgage loans held for sale | 2,247,900 | 3,783,175 |
| Loans | 566,663,416 | 535,467,733 |
| Less allowance for loan losses | (7,424,782) | (8,048,627) |
| Net loans | 559,238,634 | 527,419,106 |
| Premises and equipment, net | 12,662,153 | 12,742,730 |
| Cash surrender value of life insurance | 6,311,757 | 6,034,188 |
| Accrued interest receivable and other assets | 9,034,239 | 8,582,937 |
| Total assets | \$ 730,279,615 | 686,348,072 |

Liabilities and Shareholders' Equity

| | | |
|--|---------------|-------------|
| Deposits: | | |
| Non-interest bearing demand | \$ 94,660,721 | 78,024,194 |
| NOW, MMDA & savings | 183,248,699 | 193,917,507 |
| Time, \$100,000 or more | 152,410,976 | 154,300,926 |
| Other time | 152,533,265 | 130,279,446 |
| Total deposits | 582,853,661 | 556,522,073 |
| Demand notes payable to U.S. Treasury | 1,473,693 | 1,184,392 |
| Securities sold under agreement to repurchase | 981,050 | - |
| FHLB borrowings | 71,600,000 | 59,000,000 |
| Junior subordinated debentures | 14,433,000 | 14,433,000 |
| Accrued interest payable and other liabilities | 4,585,217 | 4,270,755 |
| Total liabilities | 675,926,621 | 635,410,220 |

Shareholders' equity:

Preferred stock, no par value; authorized

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| | | |
|---|----------------|-------------|
| 5,000,000 shares; no shares issued and outstanding | - | - |
| Common stock, no par value; authorized 20,000,000 shares; issued and outstanding 3,440,805 shares in 2005 and 3,135,074 shares in 2004 | 41,096,500 | 35,040,390 |
| Retained earnings | 14,656,160 | 16,018,206 |
| Accumulated other comprehensive income (loss) | (1,399,666) | (120,744) |
| Total shareholders' equity | 54,352,994 | 50,937,852 |
| Total liabilities and shareholders' equity | \$ 730,279,615 | 686,348,072 |

See accompanying notes to consolidated financial statements.

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

For the Years Ended December 31, 2005, 2004 and 2003

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|--|-------------------|-------------------|-------------------|
| Interest income: | | | |
| Interest and fees on loans | \$ 38,609,667 | 32,290,835 | 31,612,448 |
| Interest on federal funds sold | 72,578 | 35,236 | 58,384 |
| Interest on investment securities: | | | |
| U.S. Government agencies | 3,584,755 | 2,903,865 | 2,244,375 |
| States and political subdivisions | 735,892 | 660,227 | 577,339 |
| Other | 367,875 | 402,080 | 441,958 |
| Total interest income | 43,370,767 | 36,292,243 | 34,934,504 |
| Interest expense: | | | |
| NOW, MMDA & savings deposits | 2,644,413 | 1,899,249 | 1,318,820 |
| Time deposits | 8,923,488 | 7,145,486 | 8,157,388 |
| FHLB borrowings | 2,888,785 | 2,602,866 | 2,597,043 |
| Junior subordinated debentures | 938,145 | 676,547 | 667,526 |
| Other | 33,790 | 10,518 | 7,891 |
| Total interest expense | 15,428,621 | 12,334,666 | 12,748,668 |
| Net interest income | 27,942,146 | 23,957,577 | 22,185,836 |
| Provision for loans losses | 3,110,000 | 3,256,000 | 6,743,900 |
| Net interest income after provision for loan losses | 24,832,146 | 20,701,577 | 15,441,936 |
| Other income: | | | |
| Service charges | 3,779,933 | 3,434,544 | 3,266,949 |
| Other service charges and fees | 1,141,879 | 677,191 | 610,591 |
| Loss on sale of securities | (729,727) | (63,688) | (52,855) |
| Mortgage banking income | 469,109 | 356,782 | 604,568 |
| Insurance and brokerage commissions | 386,662 | 429,788 | 420,762 |
| Loss on sale of repossessed assets | (37,811) | (179,886) | (746,543) |
| Gain on sale of loans | - | - | 478,759 |
| Miscellaneous | 1,686,334 | 1,365,397 | 1,262,883 |
| Total other income | 6,696,379 | 6,020,128 | 5,845,114 |
| Other expense: | | | |
| Salaries and employee benefits | 12,350,119 | 11,477,495 | 10,099,811 |
| Occupancy | 3,948,694 | 3,672,051 | 3,389,857 |
| Other | 5,517,832 | 4,907,923 | 4,738,253 |
| Total other expenses | 21,816,645 | 20,057,469 | 18,227,921 |

| | | | |
|-----------------------------------|--------------|-----------|-----------|
| Earnings before income taxes | 9,711,880 | 6,664,236 | 3,059,129 |
| Income taxes | 3,380,900 | 2,233,300 | 1,055,538 |
| Net earnings | \$ 6,330,980 | 4,430,936 | 2,003,591 |
| Basic earnings per share | \$ 1.84 | 1.28 | 0.58 |
| Diluted earnings per share | \$ 1.80 | 1.26 | 0.58 |
| Cash dividends declared per share | \$ 0.41 | 0.36 | 0.36 |

See accompanying notes to consolidated financial statements.

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PEOPLES BANCORP OF NORTH CAROLINA, INC.

Consolidated Statements of Changes in Shareholders' Equity

For the Years Ended December 31, 2005, 2004 and 2003

| | <u>Common Stock</u> | | <u>Retained</u> | <u>Accumulated</u> <u>Other</u> <u>Comprehensive</u> | <u>Total</u> |
|--|---------------------|---------------|-----------------|--|--------------|
| | <u>Shares</u> | <u>Amount</u> | <u>Earnings</u> | <u>Income (Loss)</u> | |
| Balance, December 31, 2002 | 3,133,547 | \$ 35,097,773 | 12,094,363 | 1,412,597 | 48,604,733 |
| Cash dividends declared | - | - | (1,253,430) | - | (1,253,430) |
| Exercise of stock options | 1,655 | 23,737 | - | - | 23,737 |
| Net earnings | - | - | 2,003,591 | - | 2,003,591 |
| Change in accumulated other comprehensive income (loss), net of tax | - | - | - | (824,735) | (824,735) |
| Balance, December 31, 2003 | 3,135,202 | 35,121,510 | 12,844,524 | 587,862 | 48,553,896 |
| Cash dividends declared | - | - | (1,257,254) | - | (1,257,254) |
| Repurchase and retirement of common stock | (15,100) | (290,826) | - | - | (290,826) |
| Exercise of stock options | 14,972 | 209,706 | - | - | 209,706 |
| Net earnings | - | - | 4,430,936 | - | 4,430,936 |
| Change in accumulated other comprehensive income (loss), net of tax | - | - | - | (708,606) | (708,606) |
| Balance, December 31, 2004 | 3,135,074 | 35,040,390 | 16,018,206 | (120,744) | 50,937,852 |

| | | | | | |
|---|-----------|---------------|-------------|-------------|-------------|
| 10% stock dividend | 313,546 | 6,274,087 | (6,274,087) | - | - |
| Cash paid in lieu of fractional shares | - | - | (4,700) | - | (4,700) |
| Cash dividends declared | - | - | (1,414,239) | - | (1,414,239) |
| Repurchase and retirement of common stock | (15,000) | (314,750) | - | - | (314,750) |
| Exercise of stock options | 7,185 | 96,773 | - | - | 96,773 |
| Net earnings | - | - | 6,330,980 | - | 6,330,980 |
| Change in accumulated other comprehensive income (loss), net of tax | - | - | - | (1,278,922) | (1,278,922) |
| Balance, December 31, 2005 | 3,440,805 | \$ 41,096,500 | 14,656,160 | (1,399,666) | 54,352,994 |

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

For the Years Ended December 31, 2005, 2004 and 2003

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|--|--------------|-------------|-------------|
| Net earnings | \$ 6,330,980 | 4,430,936 | 2,003,591 |
| Other comprehensive income (loss): | | | |
| Unrealized holding gains (losses) on securities | | | |
| available for sale | (3,045,565) | 30,988 | (419,147) |
| Reclassification adjustment for losses on sales of securities available for sale included in net earnings | | | |
| | 729,727 | 63,688 | 52,855 |
| Unrealized holding losses on derivative financial instruments qualifying as cash flow hedges | | | |
| | (283,493) | (702,000) | (284,000) |
| Reclassification adjustment for losses (gains) on derivative financial instruments qualifying as cash flow hedges included in net earnings | | | |
| | 483,715 | (553,375) | (700,626) |
| Total other comprehensive income (loss), before income taxes | (2,115,616) | (1,160,699) | (1,350,918) |
| Income tax expense (benefit) related to other comprehensive income: | | | |
| Unrealized holding gains (losses) on securities | | | |
| available for sale | (1,186,248) | 12,070 | (163,258) |
| Reclassification adjustment for losses on sales of securities available for sale included in net earnings | | | |
| | 284,229 | 24,806 | 20,587 |
| Unrealized holding losses on derivative financial instruments qualifying as cash flow hedges | | | |
| | (123,082) | (273,429) | (110,618) |

| | | | |
|---|--------------|-----------|-----------|
| Reclassification adjustment for losses (gains) on derivative financial instruments qualifying as cash flow hedges included in net earnings | 188,407 | (215,540) | (272,894) |
| Total income tax expense (benefit) related to other comprehensive income | (836,694) | (452,093) | (526,183) |
| Total other comprehensive income (loss), net of tax | (1,278,922) | (708,606) | (824,735) |
| Total comprehensive income | \$ 5,052,058 | 3,722,330 | 1,178,856 |

See accompanying notes to consolidated
financial statements.

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PEOPLES BANCORP OF NORTH CAROLINA, INC.

Consolidated Statements of Cash Flows

For the Years Ended December 31, 2005, 2004 and 2003

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|---|--------------|--------------|--------------|
| Cash flows from operating activities: | | | |
| Net earnings | \$ 6,330,980 | 4,430,936 | 2,003,591 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | | |
| Depreciation, amortization and accretion | 1,643,459 | 1,563,245 | 1,963,995 |
| Provision for loan losses | 3,110,000 | 3,256,000 | 6,743,900 |
| Deferred income taxes | 332,806 | 341,441 | (1,526,062) |
| Loss on sale of investment securities | 729,727 | 63,688 | 52,855 |
| Recognition of gain (loss) on sale of derivative instruments | 483,715 | (553,375) | (700,626) |
| Gain on sale of loans | - | - | (478,759) |
| Amortization of deferred gain on sale of premises | (21,984) | (22,412) | - |
| Loss (gain) on sale of repossessed assets | (2,189) | 15,412 | 262,840 |
| Writedown of other real estate and repossessions | 40,000 | 164,474 | 483,703 |
| Change in: | | | |
| Mortgage loans held for sale | 1,535,275 | (3,195,680) | 4,477,140 |
| Cash surrender value of life insurance | (277,569) | (988,739) | (216,741) |
| Other assets | 462,686 | (3,442,472) | 377,900 |
| Other liabilities | 651,204 | 1,470,823 | (4,582) |
| Net cash provided by operating activities | 15,018,110 | 3,103,341 | 13,439,154 |
| Cash flows from investing activities: | | | |
| Purchases of investment securities available for sale | (49,431,813) | (48,667,610) | (55,439,455) |
| Proceeds from calls and maturities of investment securities available for sale | 9,655,995 | 19,413,975 | 27,158,675 |
| Proceeds from sales of investment securities available for sale | 27,768,392 | 2,986,313 | 19,896,324 |
| Purchases of other investments | (5,367,790) | (4,822,500) | (925,000) |
| Proceeds from sale of other investments | 4,239,000 | 3,642,514 | 953,600 |
| Net change in loans | (35,062,738) | 12,578,820 | (31,533,937) |

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| | | | |
|---|---------------|--------------|--------------|
| Proceeds from sale of loans | - | - | 4,207,206 |
| Purchases of premises and equipment | (1,373,019) | (1,502,346) | (1,913,876) |
| Proceeds from sale of premises and equipment | 1,750 | - | - |
| Proceeds from sale of repossessed assets | 246,218 | 2,153,103 | 1,502,891 |
| Purchases of derivative financial instruments | (364,000) | - | - |
| Proceeds from (payment on) settlement of derivative financial instruments | (870,000) | - | 1,254,000 |
| Net cash used by investing activities | (50,558,005) | (14,217,731) | (34,839,572) |
| Cash flows from financing activities: | | | |
| Net change in deposits | 26,331,588 | 6,719,841 | 34,063,277 |
| Net change in demand notes payable to U.S. Treasury | 289,301 | 741,008 | (1,156,616) |
| Net change in securities sold under agreement to repurchase | 981,050 | - | - |
| Proceeds from FHLB borrowings | 162,300,000 | 95,850,000 | 46,650,000 |
| Repayments of FHLB borrowings | (149,700,000) | (94,850,000) | (51,721,429) |
| Proceeds from exercise of stock options | 96,773 | 209,706 | 23,737 |
| Common stock repurchased | (314,750) | (290,826) | - |
| Cash paid in lieu of fractional shares | (4,700) | - | - |
| Cash dividends paid | (1,414,239) | (1,257,254) | (1,253,430) |
| Net cash provided by financing activities | 38,565,023 | 7,122,475 | 26,605,539 |
| Net change in cash and cash equivalent | 3,025,128 | (3,991,915) | 5,205,121 |
| Cash and cash equivalents at beginning of period | 16,790,871 | 20,782,786 | 15,577,665 |
| Cash and cash equivalents at end of period | \$ 19,815,999 | 16,790,871 | 20,782,786 |

PEOPLES BANCORP OF NORTH CAROLINA, INC.**Consolidated Statements of Cash Flows, continued****For the Years ended December 31, 2005, 2004 and 2003**

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|--|----------------|-------------|-------------|
| Supplemental disclosures of cash flow information: | | | |
| Cash paid during the year for: | | | |
| Interest | \$ 15,189,559 | 11,833,234 | 12,975,587 |
| Income taxes | \$ 2,245,000 | 2,483,394 | 2,093,000 |
| Noncash investing and financing activities: | | | |
| Change in unrealized gain (loss) on investment securities available for sale, net | \$ (1,413,819) | 57,800 | (223,621) |
| Change in unrealized gain (loss) on derivative financial instruments, net | \$ 134,897 | (766,406) | (601,114) |
| Transfer of loans to other real estate and repossessions | \$ 133,210 | 1,362,138 | 3,382,633 |
| Financed portion of sale of other real estate | \$ - | 2,212,142 | 1,258,500 |
| Financed portion of sale of premises and equipment | \$ - | - | 3,729,932 |
| 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.

Notes to Consolidated Financial Statements

(1) Summary of Significant Accounting Policies

Organization

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

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

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

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

Principles of Consolidation

The consolidated financial statements include the financial statements of Peoples Bancorp of North Carolina, Inc. and its wholly owned subsidiary 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.

Basis of Presentation

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

Cash and Cash Equivalents

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

Investment Securities

The Company classifies its securities in one of three categories: trading, available for sale, or held to maturity. Trading securities are bought and held principally for sale in the near term. Held to maturity securities are those securities for which the Company has the ability and intent to hold until maturity. All other securities not included in trading or held to maturity are classified as available for sale. At December 31, 2005 and 2004, the Company had classified all of its investment securities as available for sale.

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

A decline in the market value of any available for sale investment below cost that is deemed other than temporary is charged to earnings and establishes a new cost basis for the security.

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

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Other Investments

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

Mortgage Loan Held for Sale

Mortgage loans held for sale are carried at the lower of aggregate cost or market value. At December 31, 2005 and 2004, the cost of mortgage loans held for sale approximates the market value.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are reported at the principal amount outstanding, net of the allowance for loan losses. Interest on loans is calculated by using the simple interest method on daily balances of the principal amount outstanding. Loan origination fees and direct origination costs of loans are recognized at the time the loan is recorded on the books. Because the loan origination fee approximates the cost to originate most loans, the effect on net income is immaterial.

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

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

Allowance for Loan Losses

The allowance for loan losses is established through a provision for loan losses charged to earnings. Loans are charged against the allowance for loan losses when management believes the collectability of the principal is unlikely. The allowance represents an amount, which, in management's judgment, will be adequate to absorb probable losses on existing loans that may become uncollectible.

Management's judgment in determining the adequacy of the allowance is based on evaluations of the collectability of loans. These evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, current economic conditions that may affect the borrower's ability to pay, overall portfolio quality, and review of specific problem loans. In determining the adequacy of the allowance for loan losses, management uses a loan grading system that rates individual loans into nine risk classifications. These risk categories are assigned allocations of loss based on management's estimate of potential loss, which is generally based on an analysis of historical loss experience, current economic conditions, performance trends, and discounted collateral deficiencies. The combination of these results is compared monthly to the recorded allowance for loan losses and material differences are adjusted by increasing or decreasing the provision for loan losses. Management uses an independent external loan reviewer to challenge and corroborate the loan grading system and provide additional analysis in determining the adequacy of the allowance for loan losses and the future provisions for estimated losses.

While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on judgments different than those of management.

Mortgage Banking Activities

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

Mortgage servicing rights represent the unamortized cost of purchased and originated contractual rights to service mortgages for others in exchange for a servicing fee. Mortgage servicing rights are amortized over the period of estimated net servicing income and are periodically adjusted for actual prepayments of the underlying mortgage loans. The Company amortized approximately \$56,000, \$88,000, and \$338,000 during 2005, 2004 and 2003, respectively. No new servicing assets were recognized during 2005, 2004 and 2003.

Mortgage loans serviced for others are not included in the accompanying balance sheets. The unpaid principal balances of mortgage loans serviced for others was approximately \$18.1 million, \$22.6 million and \$29.7 million at December 31, 2005, 2004 and 2003, respectively.

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

Premises and Equipment

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

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

Foreclosed Assets

Foreclosed assets include all assets received in full or partial satisfaction of a loan and include real and personal property. Foreclosed assets are reported at the lower of carrying amount or net realizable value, and are included in other assets on the balance sheet.

Income Taxes

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

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

Derivative Financial Instruments and Hedging Activities

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

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

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

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

Advertising Costs

The costs of advertising costs are expensed as incurred.

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Accumulated Other Comprehensive Income

At December 31, 2005, accumulated other comprehensive income consisted of net unrealized losses on securities available for sale of \$1.1 million and net unrealized losses on derivatives of \$318,000. At December 31, 2004, accumulated other comprehensive income (loss) consisted of net unrealized gains on securities available for sale of \$332,000 and net unrealized losses on derivatives of \$453,000.

Stock-Based Compensation

The Company's stock-based compensation plan is accounted for under Accounting Principles Board Opinion No. 25 and related interpretations. No compensation expense has been recognized related to the grant of the incentive stock options. Had compensation cost been determined based upon the fair value of the options at the grant dates, the Company's net earnings and net earnings per share would have been reduced to the proforma amounts indicated below.

| | | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|----------------------------|-----------------------|--------------|-------------|-------------|
| Net earnings | As reported | \$ 6,330,980 | 4,430,936 | 2,003,591 |
| | Effect of grants | (143,747) | (312,444) | - |
| | Effect of forfeitures | 5,253 | 14,092 | - |
| | Proforma | \$ 6,192,486 | 4,132,584 | 2,003,591 |
| Basic earnings per share | As reported | \$ 1.84 | 1.28 | 0.58 |
| | Proforma | \$ 1.79 | 1.19 | 0.58 |
| Diluted earnings per share | As reported | \$ 1.80 | 1.26 | 0.58 |
| | Proforma | \$ 1.76 | 1.18 | 0.58 |

The weighted average fair value of options at grant date in 2004 was \$4.27. The fair value of each option is estimated on the date of grant using the Black-Scholes options-pricing model with the following weighted average assumptions used for grants in 2004 - dividend yield of 2.14%; risk free interest rate of 4.22%; expected volatility of 0.153; and an expected life of 10 years.

Net Earnings Per Share

Net earnings per 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. For the year ended December 31, 2003 net earnings per share equaled diluted earnings per share, as the potential common shares outstanding during the period had no effect on the computation.

The reconciliations of the amounts used in the computation of both "basic earnings per share" and "diluted earnings per share" for the years ended December 31, 2005, 2004 and 2003 are as follows:

| | | | |
|--|--------------|-----------|---------|
| For the year ended December 31, 2005: | Net | Common | Per |
| | Earnings | Shares | Share |
| | | | Amount |
| Basic earnings per share | \$ 6,330,980 | 3,449,873 | \$ 1.84 |
| Effect of dilutive securities: | | | |
| Stock options | - | 60,655 | |
| Diluted earnings per share | \$ 6,330,980 | 3,510,528 | \$ 1.80 |

| For the year ended December 31, 2004: | Net Earnings | Common Shares | Per Share Amount |
|--|-----------------|------------------|------------------------|
| Basic earnings per share | \$ 4,430,936 | 3,459,379 | \$ 1.28 |
| Effect of dilutive securities: | | | |
| Stock options | - | 47,604 | |
| Diluted earnings per share | \$ 4,430,936 | 3,506,983 | \$ 1.26 |

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| | | | |
|--|--------------|-----------|---------|
| For the year ended December 31, 2003: | | Common | Per |
| | Net | Shares | Share |
| | Earnings | | Amount |
| Basic earnings per share | \$ 2,003,591 | 3,447,056 | \$ 0.58 |
| Effect of dilutive securities: | | | |
| Stock options | - | 29,703 | |
| Diluted earnings per share | \$ 2,003,591 | 3,476,759 | \$ 0.58 |

On February 17, 2005, the Board of Directors of the Company authorized a 10% stock dividend and a \$0.10 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. The stock and cash dividends were paid on March 16, 2005 to shareholders of record on March 3, 2005. All previously reported per share amounts have been restated to reflect this stock dividend.

Recent Accounting Pronouncements

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 as of the beginning of fiscal years beginning after June 15, 2005. The Company will adopt in the first quarter of 2006. The financial statement impact of adopting this change in accounting principle is not expected to be material due to the small number of unvested shares at December 31, 2005.

(2) Investment Securities

Investment securities available for sale at December 31, 2005 and 2004 are as follows:

| | December 31, 2005 | | | |
|----------------------------------|-----------------------|---------------------|---------------------|----------------------------|
| | Amortized Cost | Gross Unrealized | Gross Unrealized | Estimated Fair Value |
| | | Gains | Losses | |
| Mortgage-backed securities | \$ 31,865,547 | - | 861,583 | 31,003,964 |
| U.S. government agencies | 60,751,179 | 83,410 | 591,506 | 60,243,083 |
| State and political subdivisions | 21,748,079 | 268,720 | 407,307 | 21,609,492 |
| Trust preferred securities | 1,750,000 | - | - | 1,750,000 |
| Equity securities | 814,995 | - | 263,350 | 551,645 |
| Total | \$ 116,929,800 | 352,130 | 2,123,746 | 115,158,184 |

| | December 31, 2004 | | | |
|--|-------------------|---------------------|---------------------|----------------------------|
| | Amortized Cost | Gross Unrealized | Gross Unrealized | Estimated Fair Value |
| | | Gains | Losses | |

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| | | | | |
|----------------------------------|----------------|---------|---------|-------------|
| Mortgage-backed securities | \$ 36,492,826 | 188,816 | 138,443 | 36,543,199 |
| U.S. government agencies | 46,498,958 | 170,574 | 99,195 | 46,570,337 |
| State and political subdivisions | 20,212,105 | 546,905 | 110,189 | 20,648,821 |
| Trust preferred securities | 1,750,000 | - | - | 1,750,000 |
| Equity securities | 99,995 | - | 14,246 | 85,749 |
| Total | \$ 105,053,884 | 906,295 | 362,073 | 105,598,106 |

The current fair value and associated unrealized losses on investments in debt securities with unrealized losses at December 31, 2005 are summarized in the table below, with the length of time the individual securities have been in a continuous loss position.

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| | Less than 12 Months | | December 31, 2005 12 Months or More | | Total | |
|----------------------------------|----------------------|------------------|--|------------------|-------------------|------------------|
| | Fair Value | Unrealized | Fair Value | Unrealized | Fair Value | Unrealized |
| | | Losses | | Losses | | Losses |
| Mortgage-backed securities | \$ 19,267,931 | 436,110 | 11,725,154 | 425,473 | 30,993,085 | 861,583 |
| U.S. government agencies | 27,541,468 | 313,598 | 11,221,262 | 277,908 | 38,762,730 | 591,506 |
| State and political subdivisions | 5,986,444 | 106,833 | 6,546,483 | 300,474 | 12,532,927 | 407,307 |
| Equity securities | 479,050 | 235,950 | 72,595 | 27,400 | 551,645 | 263,350 |
| Total | \$ 53,274,893 | 1,092,491 | 29,565,494 | 1,031,255 | 82,840,387 | 2,123,746 |

| | Less than 12 Months | | December 31, 2004 12 Months or More | | Total | |
|----------------------------------|----------------------|----------------|--|---------------|-------------------|----------------|
| | Fair Value | Unrealized | Fair Value | Unrealized | Fair Value | Unrealized |
| | | Losses | | Losses | | Losses |
| Mortgage-backed securities | \$ 9,706,756 | 100,854 | 2,625,755 | 37,589 | 12,332,511 | 138,443 |
| U.S. government agencies | 14,910,156 | 85,488 | 2,986,293 | 13,707 | 17,896,449 | 99,195 |
| State and political subdivisions | 7,118,463 | 110,189 | - | - | 7,118,463 | 110,189 |
| Equity securities | - | - | 85,749 | 14,246 | 85,749 | 14,246 |
| Total | \$ 31,735,375 | 296,531 | 5,697,797 | 65,542 | 37,433,172 | 362,073 |

At December 31, 2005, unrealized losses in the investment securities portfolio related to debt securities totaled \$1.9 million. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the December 31, 2005 tables above, 34 out of 66 securities issued by state and political subdivisions contained unrealized losses and 67 out of 70 securities issued by U.S. government agencies and government sponsored corporations, including mortgage-backed securities, contained unrealized losses. These unrealized losses are considered temporary because of acceptable investment grades on each security and the repayment sources of principal and interest are government backed.

The amortized cost and estimated fair value of investment securities available for sale at December 31, 2005, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

| | Amortized Cost | Estimated Fair Value |
|----------------------------|-------------------|----------------------------|
| Due within one year | \$ 200,172 | 201,026 |
| Due from one to five years | 44,773,905 | 44,213,108 |

| | | |
|----------------------------|----------------|-------------|
| Due from five to ten years | 33,646,742 | 33,398,366 |
| Due after ten years | 5,628,439 | 5,790,075 |
| Mortgage-backed securities | 31,865,547 | 31,003,964 |
| Equity securities | 814,995 | 551,645 |
| Total | \$ 116,929,800 | 115,158,184 |

Proceeds from sales of securities available for sale during 2005, 2004 and 2003 were \$27.8 million, \$3.0 million and \$19.9 million, respectively. Gross losses of \$730,000, \$64,000 and \$53,000 for 2005, 2004 and 2003, respectively, were realized on those sales.

Securities with a carrying value of approximately \$25.7 million and \$23.7 million at December 31, 2005 and 2004, respectively, were pledged to secure public deposits and for other purposes as required by law.

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(3) Loans

Major classifications of loans at December 31, 2005 and 2004 are summarized as follows:

| | 2005 | 2004 |
|--------------------------------|-----------------------|--------------------|
| Commercial | \$ 79,902,157 | 79,189,073 |
| Real estate - mortgage | 330,226,315 | 312,988,293 |
| Real estate - construction | 141,420,338 | 127,041,980 |
| Consumer | 15,114,606 | 16,248,387 |
| Total loans | 566,663,416 | 535,467,733 |
| Less allowance for loan losses | 7,424,782 | 8,048,627 |
| Total net loans | \$ 559,238,634 | 527,419,106 |

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 improved and unimproved real estate, the value of which is dependent upon the real estate market.

At December 31, 2005 and 2004, the recorded investment in loans that were considered to be impaired was approximately \$3.5 million and \$5.1 million, respectively. In addition, the Company had approximately \$946,000 and \$245,000 in loans past due more than ninety days and still accruing interest at December 31, 2005 and 2004, respectively. The related allowance for loan losses on impaired loans was approximately \$478,000 and \$773,000 at December 31, 2005 and 2004, respectively. The average recorded investment in impaired loans for the twelve months ended December 31, 2005 and 2004 was approximately \$6.2 million and \$5.3 million, respectively. For the years ended December 31, 2005, 2004 and 2003, the Company recognized approximately \$77,000, \$123,000 and \$67,000, respectively, of interest income on impaired loans.

Changes in the allowance for loan losses were as follows:

| | 2005 | 2004 | 2003 |
|--|---------------------|------------------|------------------|
| Balance at beginning of year | \$ 8,048,627 | 9,722,267 | 7,247,906 |
| Amounts charged off | (4,199,650) | (5,385,199) | (4,481,548) |
| Recoveries on amounts previously charged off | 465,805 | 455,559 | 212,009 |
| Provision for loan losses | 3,110,000 | 3,256,000 | 6,743,900 |
| Balance at end of year | \$ 7,424,782 | 8,048,627 | 9,722,267 |

(4) Premises and Equipment

Major classifications of premises and equipment are summarized as follows:

| | 2005 | 2004 |
|------|--------------|-----------|
| Land | \$ 2,187,254 | 2,170,514 |

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| | | |
|----------------------------------|---------------|------------|
| Buildings and improvements | 10,405,684 | 10,138,526 |
| Furniture and equipment | 12,743,224 | 11,679,698 |
| Total premises and equipment | 25,336,162 | 23,988,738 |
| Less accumulated depreciation | 12,674,009 | 11,246,008 |
| Total net premises and equipment | \$ 12,662,153 | 12,742,730 |

Depreciation expense was approximately \$1.5 million for the year ended December 31, 2005 and \$1.3 million for the years ended December 31, 2004 and 2003.

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During 2003, the Company sold two branch locations with net book values of approximately \$3,115,000 and is currently leasing the facilities from the buyer. As a result of the sales, the Company deferred a gain of approximately \$633,000 and is recognizing the gain over the lease term. For the periods ended December 31, 2005 and 2004, the Company recognized approximately \$22,000 of the deferred gain and for the period ended December 31, 2003 approximately \$18,000 of the deferred gain was recognized.

(5) Time Deposits

At December 31, 2005, the scheduled maturities of time deposits are as follows:

| | |
|---------------------|-----------------------|
| 2006 | \$ 241,930,881 |
| 2007 | 46,248,980 |
| 2008 | 6,666,780 |
| 2009 | 7,034,324 |
| 2010 and thereafter | 3,063,276 |
| Total | \$ 304,944,241 |

At December 31, 2005 and 2004, the Company has approximately \$40.3 million and \$39.4 million, respectively, in time deposits purchased through third party brokers. The weighted average rate of brokered deposits as of December 31, 2005 and 2004 was 3.64% and 2.38%, respectively.

(6) Federal Home Loan Bank Advances

The Bank has advances from the Federal Home Loan Bank of Atlanta ("FHLB") with monthly interest payments at various maturity dates and interest rates ranging from 3.28% to 6.49% at December 31, 2005. The FHLB advances are collateralized by a blanket assignment on all residential first mortgage loans, commercial real estate loans, home equity lines of credit and loans secured by multi-family real estate that the Bank owns. At December 31, 2005, the carrying value of loans pledged as collateral totaled approximately \$200.9 million.

Advances from the FHLB outstanding at December 31, 2005 consist of the following:

| <u>Maturity Date</u> | <u>Call Date</u> | <u>Rate</u> | <u>Rate Type</u> | <u>Amount</u> |
|----------------------|--|-------------|------------------|---------------|
| February 5, 2006 | N/A | 4.440% | Daily Rate | \$ 4,600,000 |
| March 30, 2010 | March 30, 2001 and every three months thereafter | 6.020% | Convertible | 5,000,000 |
| March 30, 2010 | September 30, 2000 and every three months thereafter | 5.880% | Convertible | 5,000,000 |
| May 24, 2010 | May 24, 2001 and every three months thereafter | 6.490% | Convertible | 2,000,000 |
| January 10, 2011 | January 10, 2002 and every three months thereafter | 4.200% | Convertible | 5,000,000 |

| | | | | |
|------------------|---|--------|-------------|---------------|
| May 2, 2011 | May 2, 2002 and every three months thereafter | 4.055% | Convertible | 30,000,000 |
| January 26, 2006 | N/A | 3.280% | Adjustable | 2,500,000 |
| January 25, 2007 | N/A | 4.220% | Adjustable | 2,500,000 |
| June 24, 2015 | June 24, 2010 | 3.710% | Convertible | 5,000,000 |
| June 24, 2010 | June 24, 2006 | 3.879% | Convertible | 5,000,000 |
| July 23, 2012 | July 23, 2007 | 3.870% | Convertible | 5,000,000 |
| | | | | \$ 71,600,000 |

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The FHLB has the option to convert \$52.0 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.

The Bank is required to purchase and hold certain amounts of FHLB stock in order to obtain FHLB borrowings. No ready market exists for the FHLB stock, and it has no quoted market value. The stock is redeemable at \$100 per share subject to certain limitations set by the FHLB. At December 31, 2005 and 2004, the Bank owned FHLB stock amounting to \$4.6 million and \$4.0 million, respectively.

(7) Junior Subordinated Debentures

In December 2001, the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust I (“PEBK Trust”), which issued \$14 million of guaranteed preferred beneficial interests in the Company’s junior subordinated deferrable interest debentures that qualify as Tier I 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 interest at 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. As discussed in note 1, PEBK Trust was deconsolidated by the Company under FIN 46 (Revised).

The trust preferred securities 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.

The 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.

(8) Income Taxes

The provision for income taxes is summarized as follows:

| | 2005 | 2004 | 2003 |
|----------|--------------|-----------|-------------|
| Current | \$ 3,048,094 | 1,891,859 | 2,581,600 |
| Deferred | 332,806 | 341,441 | (1,526,062) |
| Total | \$ 3,380,900 | 2,233,300 | 1,055,538 |

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

| | 2005 | 2004 | 2003 |
|--|--------------|-----------|-----------|
| Pre-tax income at statutory rates (34%) | \$ 3,302,039 | 2,265,840 | 1,040,104 |
| Differences: | | | |
| Tax exempt interest income | (263,555) | (243,346) | (216,431) |
| Nondeductible interest and other expense | 30,511 | 21,588 | 18,668 |

| | | | |
|--|--------------|-----------|-----------|
| Cash surrender value of life insurance | (73,973) | (65,871) | (73,692) |
| State taxes, net of federal benefits | 363,264 | 236,544 | 270,493 |
| Other, net | 22,614 | 18,545 | 16,396 |
| Total | \$ 3,380,900 | 2,233,300 | 1,055,538 |

The following summarized the tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities. The net deferred tax asset is included as a component of other assets at December 31, 2005 and 2004.

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| | 2005 | 2004 |
|---|--------------|-----------|
| Deferred tax assets: | | |
| Allowance for loan losses | \$ 2,862,550 | 3,103,068 |
| Amortizable intangible assets | 141,010 | 173,548 |
| Accrued retirement expense | 533,155 | 454,446 |
| Income from non-accrual loans | 9,639 | 23,309 |
| Deferred gain on sale of premises | 220,876 | 228,932 |
| Unrealized loss on cash flow hedges | 223,684 | 289,009 |
| Unrealized loss on available for sale securities | 690,044 | - |
| Other | 33,578 | 28,965 |
| Total gross deferred tax assets | 4,714,536 | 4,301,277 |
| Deferred tax liabilities: | | |
| Unrealized gains on available for sale securities | - | 211,974 |
| Deferred loan fees | 1,135,448 | 1,060,798 |
| Premises and equipment | 545,570 | 477,285 |
| Deferred income from servicing rights | 87,330 | 108,920 |
| Total gross deferred tax liabilities | 1,768,348 | 1,858,977 |
| Net deferred tax asset | \$ 2,946,188 | 2,442,300 |

(9) Related Party Transactions

The Company conducts transactions with its directors and executive officers, including companies in which they have beneficial interests, in the normal course of business. It is the policy of the Company that loan transactions with directors and officers be made on substantially the same terms as those prevailing at the time made for comparable loans to other persons. The following is a summary of activity for related party loans for 2005:

| | |
|-------------------|--------------|
| Beginning balance | \$ 8,404,828 |
| New loans | 2,229,878 |
| Repayments | 3,413,977 |
| Ending balance | \$ 7,220,729 |

During 2005, an individual formerly considered a related party resigned as a director of the Company and as a result approximately \$160,000 in loans to this individual and his affiliates have been removed from the beginning balance of the summary of related party loan activity.

At December 31, 2005 and 2004, the Company had deposit relationships with related parties of approximately \$8.9 million and \$13.1 million, respectively.

The Company also enters into contracts from time to time with certain directors for the construction of bank facilities. At December 31, 2005 and 2004, the Company had no outstanding construction contracts with these directors. During the year ended December 31, 2005, 2004 and 2003, total costs for construction, remodeling and repair for bank facilities paid to directors were approximately \$0, \$44,000 and \$531,000, respectively.

(10) Commitments and Contingencies

The Company leases various office spaces for banking and operational facilities and equipment under operating lease arrangements. Future minimum lease payments required for all operating leases having a remaining term in excess of one year at December 31, 2005 are as follows:

| <u>Year</u> | |
|--------------------------|--------------|
| 2006 | \$ 984,858 |
| 2007 | 983,386 |
| 2008 | 952,257 |
| 2009 | 793,700 |
| 2010 | 652,643 |
| Thereafter | 4,232,256 |
| | |
| Total minimum obligation | \$ 8,599,100 |

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Total rent expense was approximately \$956,000, \$873,000 and \$789,000 for 2005, 2004 and 2003, respectively.

The Company is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and financial guarantees. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

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

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

| | Contractual Amount | |
|--|--------------------|-------------|
| | 2005 | 2004 |
| Financial instruments whose contract amount represent credit risk: | | |
| Commitments to extend credit | \$ 133,409,227 | 123,093,680 |
| Standby letters of credit and financial guarantees written | \$ 2,692,192 | 3,278,326 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and because they may expire without being drawn upon, the total commitment amount of \$136.1 million does not necessarily represent future cash requirements. Standby letters of credit and financial guarantees written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party.

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

The Company has an overall interest rate-risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company attempts to minimize the credit risk in derivative instruments by entering into transactions with counterparties that are reviewed periodically by the Company and are believed to be of high quality.

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

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

The Company has \$26.5 million available for the purchase of overnight federal funds from three correspondent financial institutions.

(11) Derivative Financial Instruments and Hedging Transactions

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company.

As of December 31, 2005, the Company had cash flow hedges with a notional amount of \$70.0 million. These derivative instruments consist of two interest rate floor contracts that are used to hedge future cash flows of the first \$70.0 million of certain variable rate loans against the downward effects of their repricing in the event of a

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decreasing rate environment for a period of three years ending in July 2008 and November 2008. 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.

The Company settled two previously outstanding interest rate swap agreements during 2005. The first swap with a notional amount of \$25.0 million and scheduled to mature in April 2006 was sold for a loss of \$318,000. The second swap with a notional amount of \$30.0 million and scheduled to mature in September 2006 was sold for a loss of \$552,000. The losses realized upon settlement are being recognized over the original term of the agreements, and during the year ended December 31, 2005, losses of approximately \$484,000 were recognized.

(12) Employer and Director Benefit Programs

The Company has a profit sharing and 401(k) plan for the benefit of substantially all employees subject to certain minimum age and service requirements. Under this plan, the Company matches employee contributions to a maximum of five percent of annual compensation. The Company's contribution pursuant to this formula was approximately \$360,000, \$363,000 and \$306,000 for the years of 2005, 2004 and 2003, respectively. Investments of the plan are determined by the compensation committee consisting of selected outside directors and senior executive officers. No investments in Company stock have been made by the plan. The vesting schedule for the plan begins at 20 percent after two years of employment and graduates 20 percent each year until reaching 100 percent after six years of employment.

In December 2002, the Company initiated a postretirement benefit plan to provide retirement benefits to key officers and its Board of Directors and to provide death benefits for their designated beneficiaries. Under the plan, the Company purchased life insurance contracts on the lives of the key officers and each director. The increase in cash surrender value of the contracts, less the Company's cost of funds, constitutes the Company's contribution to the plan each year. Plan participants are to be paid annual benefits for a specified number of years commencing upon retirement. Expenses incurred for benefits relating to this plan were approximately \$245,000, \$223,000 and \$264,000 during 2005, 2004 and 2003, respectively.

The Company is currently paying medical benefits for certain retired employees. Postretirement benefits expense, including amortization of the transition obligation, as applicable, was approximately \$23,000, \$47,000 and \$16,000, for the years ended December 31, 2005, 2004 and 2003, respectively. The following table sets forth the accumulated postretirement benefit obligation as of December 31, 2005 and 2004, which represents the liability for accrued postretirement benefit costs:

| | 2005 | 2004 |
|---|------------|----------|
| Accumulated postretirement benefit obligation | \$ 244,304 | 215,985 |
| Unrecognized gain (loss) | (80,495) | (49,038) |
| Net liability recognized | \$ 163,809 | 166,947 |

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 effective date.

Under the Plan, the Company has 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 after ten years. A summary of the activity in the Plan is presented below:

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| | 2005 | | 2004 | | 2003 | |
|----------------------------------|---------|---|----------|---|---------|---|
| | Shares | Weighted Average Option Price Per Share | Shares | Weighted Average Option Price Per Share | Shares | Weighted Average Option Price Per Share |
| Outstanding, beginning of period | 202,401 | \$ 13.39 | 216,726 | 13.26 | 218,545 | 13.25 |
| Granted during the period | - | \$ - | 4,400 | 17.22 | - | - |
| Forfeited during the period | (1,194) | \$ 12.82 | (2,260) | 13.19 | - | - |
| Exercised during the period | (7,464) | \$ 12.97 | (16,465) | 12.73 | (1,819) | 13.04 |
| Outstanding, end of period | 193,743 | \$ 13.41 | 202,401 | 13.39 | 216,726 | 13.26 |
| Number of shares exercisable | 190,809 | \$ 13.35 | 173,609 | 13.37 | 140,035 | 13.17 |

Options outstanding at December 31, 2005 are exercisable at option prices ranging from \$11.53 to \$17.44, as presented in the table above. Such options have a weighted average remaining contractual life of approximately seven years.

Members of the Board of Directors are eligible to participate in the Company's Omnibus Stock Ownership and Long Term Incentive Plan (the "Stock Benefits Plan"). Each director has been awarded 5,365 book value shares under the Stock Benefits Plan. Nine directors were awarded book value shares on September 28, 1999. The book value of the common stock on September 28, 1999 was \$11.45 and has been adjusted to reflect a 10% stock dividend on April 24, 2000 and a 10% stock dividend on March 16, 2005. The book value shares awarded vest 20% annually, with the first 20% vesting on September 28, 2000 and the final 20% vesting on September 28, 2004. One director was awarded 5,365 book value shares upon his election to the Board of Directors on May 3, 2001. The book value of the common stock on May 3, 2002 was \$13.95. These book value shares vest at a rate of 25% annually with the first 25% having vested on May 3, 2002, and the final 25% vesting on May 3, 2005. Four directors were awarded 5,365 book value shares on May 6, 2004. The book value of the common stock on May 6, 2004 was \$15.68. Their shares vest at a rate of 20% annually, with the first 20% vesting on May 6, 2005, and the final 20% vesting on May 6, 2009. The Company recorded expenses of approximately \$102,000, \$92,000 and \$47,000 associated with the benefits of this plan in the years ended December 31, 2005, 2004 and 2003, respectively.

A summary of book value shares activity under the Stock Benefits Plan for the years ended December 31, 2005, 2004 and 2003 is presented below.

| | 2005 | 2004 | 2003 |
|--|---------------------------------|---------------------------------|---------------------------------|
| | Weighted Average Price of | Weighted Average Price of | Weighted Average Price of |

| | Shares | Book Value Shares | Shares | Book Value Shares | Shares | Book Value Shares |
|----------------------------------|----------|----------------------|---------|----------------------|---------|----------------------|
| Outstanding, beginning of period | 70,819 | \$ 11.88 | 53,114 | 10.67 | 59,015 | 10.64 |
| Granted during the period | - | \$ - | 23,606 | 14.25 | - | - |
| Forfeited during the period | - | \$ - | (1,180) | 10.41 | (5,902) | 10.41 |
| Exercised during the period | (11,802) | \$ 10.41 | (4,721) | 10.41 | - | - |
| Outstanding, end of period | 59,017 | \$ 12.18 | 70,819 | 11.88 | 53,114 | 10.67 |
| Number of shares exercisable | 40,127 | \$ 11.20 | 45,733 | 10.63 | 40,717 | 10.58 |

(13) Regulatory Matters

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

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios of capital in relation to both on- and off-balance sheet items at various risk weights. Total capital consists of two tiers of capital. Tier 1 Capital includes common shareholders' equity and trust preferred securities less adjustments for intangible assets. Tier 2 Capital consists of the allowance for loan losses up to 1.25% of risk-weighted assets and other adjustments. Management believes, as of December 31, 2005, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

The capital treatment of trust preferred securities has been reviewed recently by the Federal Reserve Bank. The Federal Reserve Bank's proposal for capital treatment of trust preferred securities, released May 4, 2004, would continue to permit the inclusion of trust preferred securities in Tier 1 capital of bank holding companies.

As of December 31, 2005, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

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

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|--|-----------|--------|-------------------------------|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | | | <i>(dollars in thousands)</i> | | | |
| As of December 31, 2005: | | | | | | |
| Total Capital (to Risk-Weighted Assets) | | | | | | |
| Consolidated | \$ 76,993 | 12.19% | 50,514 | 8.00% | N/A | N/A |
| Bank | \$ 73,265 | 11.64% | 50,360 | 8.00% | 62,951 | 10.00% |
| Tier 1 Capital (to Risk-Weighted Assets) | | | | | | |
| Consolidated | \$ 69,568 | 11.02% | 25,257 | 4.00% | N/A | N/A |
| Bank | \$ 65,840 | 10.46% | 25,180 | 4.00% | 37,770 | 6.00% |
| Tier 1 Capital (to Average Assets) | | | | | | |
| Consolidated | \$ 69,568 | 9.84% | 28,273 | 4.00% | N/A | N/A |
| Bank | \$ 65,840 | 9.33% | 28,217 | 4.00% | 35,272 | 5.00% |

As of December 31, 2004:

Total Capital (to Risk-Weighted Assets)

| | | | | | | |
|--|--------|--------|--------|-------|--------|--------|
| Consolidated | \$ | 12.22% | 47,407 | 8.00% | N/A | N/A |
| | 72,410 | | | | | |
| Bank | \$ | 11.60% | 47,240 | 8.00% | 59,050 | 10.00% |
| | 68,503 | | | | | |
| Tier 1 Capital (to Risk-Weighted Assets) | | | | | | |
| Consolidated | \$ | 10.97% | 23,704 | 4.00% | N/A | N/A |
| | 65,021 | | | | | |
| Bank | \$ | 10.35% | 23,620 | 4.00% | 35,430 | 6.00% |
| | 61,114 | | | | | |
| Tier 1 Capital (to Average Assets) | | | | | | |
| Consolidated | \$ | 9.50% | 27,374 | 4.00% | N/A | N/A |
| | 65,021 | | | | | |
| Bank | \$ | 8.95% | 27,328 | 4.00% | 34,161 | 5.00% |
| | 61,114 | | | | | |

(14) Shareholders' Equity

In November 2004, the Company's Board of Directors authorized the repurchase of up to \$3.0 million in common shares of the Company's outstanding common stock effective through the end of November 2005. During 2005, the Company repurchased a total of 15,000 shares at a total price of \$315,000. During 2004, the Company repurchased a total of 15,100 shares at a total price of \$291,000.

In November 2005, the Company's Board of Directors authorized the repurchase of up to \$2.0 million in common shares of the Company's outstanding common stock effective through the end of November 2006. No shares have been repurchased under the current plan.

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

The Board of Directors of the Bank may declare a dividend of all of its retained earnings as it may deem appropriate, subject to the requirements of the General Statutes of North Carolina, without prior approval from the requisite regulatory authorities. As of December 31, 2005, this amount was approximately \$14.7 million.

(15) Other Operating Expense

Other operating expense for the years ended December 31 included the following items that exceeded one percent of total revenues:

| | 2005 | 2004 | 2003 |
|-------------|------------|---------|---------|
| Advertising | \$ 656,184 | 619,731 | 540,970 |

(16) Fair Value of Financial Instruments

The Company is required to disclose fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company's financial instruments are detailed below. Where quoted prices are not available, fair values are based on estimates using discounted cash flows and other valuation techniques. The use of discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following disclosures should not be considered a surrogate of the liquidation value of the Company, but rather a good faith estimate of the increase or decrease in value of financial instruments held by the Company since purchase, origination, or issuance.

Cash and Cash Equivalents

For cash, due from banks and federal funds sold, the carrying amount is a reasonable estimate of fair value.

Investment Securities Available for Sale

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

Other Investments

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

Loans and Mortgage Loans Held for Sale

The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. For variable rate loans, the carrying amount is a reasonable estimate of fair value. Mortgage loans held for sale are valued based on the current price at which these loans could be sold into the secondary market.

Cash Surrender Value of Life Insurance

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

Mortgage Servicing Rights

Fair value of mortgage servicing rights is determined by estimating the present value of the future net servicing income, on a disaggregated basis, using anticipated prepayment assumptions.

Deposits and Demand Notes Payable

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

FHLB Advances

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

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Junior Subordinated Debentures

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

Derivative Instruments

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

Commitments to Extend Credit and Standby Letters of Credit

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

Limitations

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

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

The carrying amount and estimated fair value of the Company's financial instruments at December 31, 2005 and 2004 are as follows:

| | 2005 | | 2004 | |
|---|-------------------------------|----------------------------|--------------------|----------------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| | <i>(dollars in thousands)</i> | | | |
| Assets: | | | | |
| Cash and cash equivalents | \$ 19,816 | 19,816 | 16,791 | 16,791 |
| Investment securities available for sale | \$ 115,158 | 115,158 | 105,598 | 105,598 |
| Other investments | \$ 5,811 | 5,811 | 5,397 | 5,397 |
| Mortgage loans held for sale | \$ 2,248 | 2,248 | 3,783 | 3,783 |
| Loans, net | \$ 559,239 | 559,122 | 527,419 | 525,818 |
| Cash surrender value of life insurance | \$ 6,312 | 6,312 | 6,034 | 6,034 |
| Mortgage servicing rights | \$ 227 | 227 | 283 | 283 |
| Derivative instruments | \$ 176 | 176 | - | - |
| Liabilities: | | | | |
| Deposits and demand notes payable | \$ 584,327 | 584,786 | 557,706 | 556,993 |
| FHLB advances | \$ 71,600 | 71,804 | 59,000 | 61,637 |

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| | | | | | |
|--------------------------------|----|--------|--------|--------|--------|
| Junior subordinated debentures | \$ | 14,433 | 14,433 | 14,433 | 14,433 |
| Derivative instruments | \$ | - | - | 742 | 742 |

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(17) Peoples Bancorp of North Carolina, Inc. (Parent Company Only) Condensed Financial Statements**Balance Sheets****December 31, 2005 and 2004**

| <u>Assets</u> | <u>2005</u> | <u>2004</u> |
|---|----------------------|-------------------|
| Cash | \$ 519,089 | 517,652 |
| Interest-bearing time deposit | 2,000,000 | 2,000,000 |
| Investment in subsidiaries | 65,057,096 | 61,463,299 |
| Investment securities available for sale | 451,651 | - |
| Other investments | 349,994 | 1,050,749 |
| Other assets | 683,493 | 613,727 |
| Total assets | \$ 69,061,323 | 65,645,427 |
| <u>Liabilities and Shareholders' Equity</u> | | |
| Accrued expenses | \$ 275,329 | 274,575 |
| Junior subordinated debentures | 14,433,000 | 14,433,000 |
| Shareholders' equity | 54,352,994 | 50,937,852 |
| Total liabilities and shareholders' equity | \$ 69,061,323 | 65,645,427 |

Statements of Earnings**For the Years Ended December 31, 2005, 2004 and 2003**

| Revenues: | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|---|------------------|------------------|------------------|
| Dividends from subsidiaries | \$ 2,375,042 | 1,962,551 | 3,948,455 |
| Interest and dividend income | 83,632 | 63,875 | 43,684 |
| Total revenues | 2,458,674 | 2,026,426 | 3,992,139 |
| Expenses: | | | |
| Interest | 938,145 | 676,547 | 667,526 |
| Other operating expenses | 289,691 | 280,002 | 211,788 |
| Total expenses | 1,227,836 | 956,549 | 879,314 |
| Earnings before income tax benefit and equity in | | | |

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| | | | |
|--|--------------|-----------|-------------|
| undistributed earnings of subsidiaries | 1,230,838 | 1,069,877 | 3,112,825 |
| Income tax benefit | 379,500 | 296,700 | 277,200 |
| Earnings before undistributed earnings in subsidiaries | 1,610,338 | 1,366,577 | 3,390,025 |
| Equity in undistributed earnings in subsidiaries | 4,720,642 | 3,064,359 | - |
| Dividends paid in excess in earnings | - | - | (1,386,434) |
| Net earnings | \$ 6,330,980 | 4,430,936 | 2,003,591 |

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Statements of Cash Flows

For the Years Ended December 31, 2005, 2004 and 2003

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|---|--------------------|--------------------|--------------------|
| Cash flows from operating activities: | | | |
| Net earnings | \$ 6,330,980 | 4,430,936 | 2,003,591 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | | |
| Amortization | 17,742 | 17,742 | 17,742 |
| Book value shares accrual | 21,818 | 66,933 | 47,078 |
| Equity in undistributed earnings of subsidiaries | (4,720,642) | (3,064,359) | 1,386,434 |
| Deferred income tax benefit | (8,412) | (25,806) | (19,173) |
| Change in: | | | |
| Accrued income | 17,930 | (9,033) | - |
| Accrued expense | (21,063) | - | 7,814 |
| Net cash provided by operating activities | 1,638,353 | 1,416,413 | 3,443,486 |
| Cash flows from investing activities: | | | |
| Net change in interest-bearing time deposit | - | - | (2,000,000) |
| Purchases of investment securities available for sale | - | (250,000) | - |
| Net cash used by investing activities | - | (250,000) | (2,000,000) |
| Cash flows from financing activities: | | | |
| Cash dividends paid | (1,414,239) | (1,257,254) | (1,253,430) |
| Cash paid in lieu of fractional shares | (4,700) | - | - |
| Common stock repurchased | (314,750) | (290,826) | - |
| Proceeds from exercise of stock options | 96,773 | 209,706 | 23,737 |
| Net cash provided (used) by financing activities | (1,636,916) | (1,338,374) | (1,229,693) |
| Net change in cash | 1,437 | (171,961) | 213,793 |
| Cash at beginning of year | 517,652 | 689,613 | 475,820 |
| Cash at end of year | \$ 519,089 | 517,652 | 689,613 |

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**xPLEASE MARK VOTES
AS IN THIS EXAMPLE**

**REVOCABLE PROXY
PEOPLES BANCORP OF NORTH CAROLINA, INC.**

**Annual Meeting of Shareholders
May 4, 2006 11:00a.m.
(Solicited on behalf of the Board of Directors)**

The undersigned holder of Common Stock of Peoples Bancorp of North Carolina, Inc. (the "Company"), revoking all proxies heretofore given, hereby constitutes and appoints the official proxy committee of the Company, comprised of all of the members of the Board of Directors of the Company, each with full power of substitution, for the undersigned and in the name, place and stead of the undersigned to vote all of the undersigned's shares of said stock, according to the number of votes and with all the powers the undersigned would possess if personally present, at the 2006 Annual Meeting of Shareholders of Peoples Bancorp of North Carolina, Inc. (the "Meeting") to be held at the Catawba Country Club, 1154 Country Club Road, Newton, North Carolina, on May 4, 2006 at 11:00 A.M., Eastern Time, and at any adjournments or postponements thereof.

**For With- For All
hold Except**

1. The approval of the election of the following named directors: o o o

Robert C. Abernethy, James S. Abernethy, Larry E. Robinson and William Gregory Terry to serve as directors until the 2009 Annual Meeting of Shareholders or until their successors are duly elected and qualified.

INSTRUCTIONS: To withhold authority to vote for any individual nominee, mark "For All Except" and write that nominee's name in the space provided below.

For Against Abstain

2. The ratification and approval of the appointment of Porter o o o
Keadle Moore, LLP as the Company's independent auditor for the fiscal year ending December 31, 2006.

3. The proxy committee of the Company is authorized to vote in their discretion upon such other matters as may properly come before the
Meeting.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE "FOR" EACH OF THE LISTED PROPOSALS.

The shares represented by this proxy will be voted in the manner directed. In the absence of any direction, the shares will be voted FOR each nominee listed above, FOR the ratification and approval of the appointment of Porter Keadle Moore, LLP as the Company's independent auditors for the fiscal year ending December 31, 2006, and in accordance with the discretion of the proxy committee of the Company on such other matters as may properly come before the Meeting. If instructions are given with respect to one but not all proposals, such instructions as are given will be followed and the proxy will be voted as indicated above on the proposal(s) for which no instructions are given.

Signature(s) should conform to names as registered. For jointly owned shares, each owner should sign. When signing as attorney, executor, administrator, trustee, guardian or officer of a corporation, please give full title.

| | |
|--|------|
| Please be sure to sign and date this Proxy in the box below. | Date |
| | |

Shareholder sign above

Co-holder (if any) sign above

Detach above card, sign, date and mail in postage paid envelope provided.

PEOPLES BANCORP OF NORTH CAROLINA, Inc.

THIS PROXY IS SOLICITED BY THE BOARD OF DIRECTORS

The above signed hereby acknowledges receipt of the Notice of Meeting and Proxy Statement each dated April 3, 2006, relating to the Meeting and hereby revokes any proxy or proxies heretofore given.

Each properly executed proxy will be voted in accordance with the specifications made above and in the discretion of the proxy committee of the Company on any other matter that come before the Meeting. Where no choice is specified, this proxy will be voted (i) FOR all listed nominees to serve as directors, (ii) FOR the ratification and approval of the appointment of Porter Keadle Moore, LLP as the Company's independent auditors for the fiscal year ending December 31, 2006, and (iii) in accordance with the discretion of the proxy committee of the Company on such other matters as may properly come before the Meeting.

PLEASE ACT PROMPTLY

SIGN, DATE & MAIL YOUR PROXY CARD TODAY

IF YOUR ADDRESS HAS CHANGED, PLEASE CORRECT THE ADDRESS IN THE SPACE PROVIDED BELOW AND RETURN THIS PORTION WITH THE PROXY IN THE ENVELOPE PROVIDED.

