

PEOPLES BANCORP OF NORTH CAROLINA INC  
Form 10-Q  
August 08, 2007

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

**FORM 10-Q**

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

For the quarterly period ended: **June 30, 2007**

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

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

(Exact name of registrant as specified in its charter)

**North Carolina**

(State or other jurisdiction of incorporation or organization)

**000-27205**

(Commission File No.)

**56-2132396**

(IRS Employer Identification No.)

**518 West C Street, Newton, North Carolina**

(Address of principal executive offices)

**28658**

(Zip Code)

**(828) 464-5620**

(Registrant's telephone number, including area code)

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

Yes      X      No

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

Large Accelerate  
Filer

Accelerated Filer

Non-Accelerated Filer

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

Yes

No

X

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

**5,665,143 shares of common stock, outstanding at July 31, 2007.**

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Statements made in this Form 10-Q, other than those concerning historical information, should be considered forward-looking statements pursuant to the safe harbor provisions of the Securities Exchange Act of 1934 and the Private Securities Litigation Act of 1995. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management and on the information available to management at the time that this Form 10-Q was prepared. These statements can be identified by the use of words like “expect,” “anticipate,” “estimate,” and “believe,” variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by Peoples Bank, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environments and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in the Company’s other filings with the Securities and Exchange Commission, including but not limited to those described in Peoples Bancorp of North Carolina, Inc.’s annual report on Form 10-K for the year ended December 31, 2006

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

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

<u>Assets</u>	June 30, 2007 <i>(Unaudited)</i>	December 31, 2006
Cash and due from banks	\$ 26,888,694	18,860,318
Federal funds sold	2,757,000	2,640,000
Cash and cash equivalents	29,645,694	21,500,318
Investment securities available for sale	118,308,573	117,581,000
Other investments	5,961,447	7,295,449
Total securities	124,270,020	124,876,449
Loans	663,125,684	651,381,129
Less allowance for loan losses	(8,514,417)	(8,303,432)
Net loans	654,611,267	643,077,697
Premises and equipment, net	14,421,165	12,816,385
Cash surrender value of life insurance	6,651,597	6,532,406
Accrued interest receivable and other assets	10,074,654	10,144,283
Total assets	\$ 839,674,397	818,947,538
<u>Liabilities and Shareholders' Equity</u>		
Deposits:		
Non-interest bearing demand	\$ 117,701,167	101,393,142
NOW, MMDA & savings	183,721,294	174,577,641
Time, \$100,000 or more	177,739,130	194,176,291
Other time	174,942,640	163,673,215
Total deposits	654,104,231	633,820,289
Demand notes payable to U.S. Treasury	1,092,438	1,600,000
Securities sold under agreement to repurchase	17,236,961	6,417,803
FHLB borrowings	77,000,000	89,300,000
Junior subordinated debentures	20,619,000	20,619,000
Accrued interest payable and other liabilities	4,228,148	4,355,073
Total liabilities	774,280,778	756,112,165
Shareholders' equity:		

Preferred stock, no par value; authorized 5,000,000 shares; no shares issued and outstanding	-	-
Common stock, no par value; authorized 20,000,000 shares; issued and outstanding 5,710,143 shares in 2007 and 3,830,634 shares in 2006	50,272,682	51,122,147
Retained earnings	16,882,082	12,484,463
Accumulated other comprehensive loss	(1,761,145)	(771,237)
Total shareholders' equity	65,393,619	62,835,373
 Total liabilities and shareholders' equity	 \$ 839,674,397	 818,947,538

See accompanying notes to consolidated financial statements.

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Earnings

	Three months ended June 30,		Six months ended June 30,	
	<u>2007</u> (Unaudited)	<u>2006</u> (Unaudited)	<u>2007</u> (Unaudited)	<u>2006</u> (Unaudited)
<b>Interest income:</b>				
Interest and fees on loans	\$ 13,771,019	12,148,601	27,371,208	23,280,785
Interest on federal funds sold	209,202	17,060	334,697	21,202
<b>Interest on investment securities:</b>				
U.S. Government agencies	1,130,857	1,070,334	2,260,936	2,092,008
States and political subdivisions	221,698	193,411	441,192	386,161
Other	112,993	129,354	237,962	262,907
<b>Total interest income</b>	<b>15,445,769</b>	<b>13,558,760</b>	<b>30,645,995</b>	<b>26,043,063</b>
<b>Interest expense:</b>				
NOW, MMDA & savings deposits	985,198	681,623	1,897,641	1,356,360
Time deposits	4,318,455	3,432,723	8,604,858	6,420,454
FHLB borrowings	893,523	968,265	1,817,013	1,853,955
Junior subordinated debentures	364,148	297,681	724,347	577,320
Other	173,193	48,300	297,471	83,843
<b>Total interest expense</b>	<b>6,734,517</b>	<b>5,428,592</b>	<b>13,341,330</b>	<b>10,291,932</b>
<b>Net interest income</b>	<b>8,711,252</b>	<b>8,130,168</b>	<b>17,304,665</b>	<b>15,751,131</b>
<b>Provision for loans losses</b>	<b>634,000</b>	<b>413,000</b>	<b>957,000</b>	<b>1,172,000</b>
<b>Net interest income after provision for loan losses</b>	<b>8,077,252</b>	<b>7,717,168</b>	<b>16,347,665</b>	<b>14,579,131</b>
<b>Non-interest income:</b>				
Service charges	1,023,105	1,016,930	1,935,673	1,941,875
Other service charges and fees	447,177	363,013	934,724	759,029
Loss on sale of securities	(194,402)	(91,951)	(194,402)	(173,751)
Mortgage banking income	187,771	119,268	299,612	239,876
Insurance and brokerage commissions	130,907	109,783	231,564	213,683
Miscellaneous	544,082	499,940	1,053,353	965,760
<b>Total non-interest income</b>	<b>2,138,640</b>	<b>2,016,983</b>	<b>4,260,524</b>	<b>3,946,472</b>

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Non-interest expense:				
Salaries and employee benefits	3,298,737	2,869,737	6,671,903	5,713,212
Occupancy	1,210,294	1,017,425	2,314,533	2,005,821
Other	1,670,833	1,660,957	3,214,474	3,136,269
Total non-interest expenses	6,179,864	5,548,119	12,200,910	10,855,302
Earnings before income taxes	4,036,028	4,186,032	8,407,279	7,670,301
Income taxes	1,445,915	1,524,600	3,030,041	2,773,800
Net earnings	\$ 2,590,113	2,661,432	5,377,238	4,896,501
Basic earnings per share	\$ 0.45	0.47	0.94	0.86
Diluted earnings per share	\$ 0.44	0.46	0.92	0.85
Cash dividends declared per share	\$ 0.09	0.07	0.17	0.14

See accompanying notes to consolidated financial statements.



## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

	Three months ended June 30,		Six months ended June 30,	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Net earnings	\$ 2,590,113	2,661,432	5,377,238	4,896,501
Other comprehensive income (loss):				
Unrealized holding losses on securities available for sale	(1,648,535)	(1,668,016)	(1,756,930)	(2,346,369)
Reclassification adjustment for losses on sales of securities available for sale included in net earnings	194,402	91,951	194,402	173,751
Unrealized holding losses on derivative financial instruments qualifying as cash flow hedges	(315,185)	(220,198)	(192,174)	(666,903)
Reclassification adjustment for losses on derivative financial instruments qualifying as cash flow hedges included in net earnings	-	105,530	-	301,630
Total other comprehensive loss, before income taxes	(1,769,318)	(1,690,733)	(1,754,702)	(2,537,891)
Income tax expense (benefit) related to other comprehensive income:				
Unrealized holding losses on securities available for sale	(642,104)	(649,692)	(684,324)	(913,911)
Reclassification adjustment for losses on sales of securities available for sale included in net earnings	75,720	35,815	75,720	67,676
Unrealized holding losses on derivative financial instruments qualifying as cash flow hedges	(164,759)	(114,513)	(156,190)	(310,626)
Reclassification adjustment for losses on derivative financial instruments qualifying as cash flow hedges included in net earnings	-	41,103	-	117,485
Total income tax expense related to other comprehensive income	(731,143)	(687,287)	(764,794)	(1,039,376)
Total other comprehensive loss, net of tax	(1,038,175)	(1,003,446)	(989,908)	(1,498,515)

Total comprehensive income	\$ 1,551,938	1,657,986	4,387,330	3,397,986
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See accompanying notes to consolidated financial statements.

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## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

Six months ended June 30, 2007 and 2006

	<u>2007</u> <i>(Unaudited)</i>	<u>2006</u> <i>(Unaudited)</i>
Cash flows from operating activities:		
Net earnings	\$ 5,377,238	4,896,501
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation, amortization and accretion	753,394	859,573
Provision for loan losses	957,000	1,172,000
Loss on sale of investment securities	194,402	173,751
Recognition of loss on sale of derivative instruments	-	301,630
Gain on sale of premises and equipment	(11,842)	(10,448)
Loss (gain) on sale of repossessed assets	76,802	(13,453)
Amortization of deferred issuance costs on trust preferred securities	-	156,723
Stock option compensation expense	2,418	1,757
Change in:		
Mortgage loans held for sale	-	(1,192,675)
Cash surrender value of life insurance	(119,191)	(103,454)
Other assets	644,637	(1,571,650)
Other liabilities	(126,925)	(685,493)
Net cash provided by operating activities	7,747,933	3,984,762
Cash flows from investing activities:		
Purchases of investment securities available for sale	(5,685,477)	(10,759,635)
Proceeds from calls and maturities of investment securities available for sale	4,048,527	4,055,529
Proceeds from sales of investment securities available for sale	-	6,325,544
Purchases of other investments	(2,461,900)	(7,282,450)
Proceeds from sale of other investments	3,001,500	7,038,000
Net change in loans	(12,910,994)	(41,520,523)
Purchases of premises and equipment	(2,411,325)	(837,418)
Proceeds from sale of repossessed assets	353,075	443,123
Purchases of derivative financial instruments	-	(961,500)
Net cash used by investing activities	(16,066,594)	(43,499,330)
Cash flows from financing activities:		
Net change in deposits	20,283,942	27,935,324
Net change in demand notes payable to U.S. Treasury	(507,562)	(1,295,842)
Net change in securities sold under agreement to repurchase	10,819,158	1,887,060
Proceeds from FHLB borrowings	134,300,000	397,500,000
Repayments of FHLB borrowings	(146,600,000)	(395,000,000)
Proceeds from issuance of trust preferred securities	-	20,619,000
Proceeds from exercise of stock options	236,367	281,042

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Common stock repurchased	(1,088,250)	(425,000)
Cash paid in lieu of fractional shares	(3,354)	(6,426)
Cash dividends paid	(976,264)	(796,706)
Net cash provided by financing activities	16,464,037	50,698,452
Net change in cash and cash equivalent	8,145,376	11,183,884
Cash and cash equivalents at beginning of period	21,500,318	19,815,999
Cash and cash equivalents at end of period	\$ 29,645,694	30,999,883

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows, continued

Six months ended June 30, 2007 and 2006

	<u>2007</u> <i>(Unaudited)</i>	<u>2006</u> <i>(Unaudited)</i>
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest	\$ 13,230,576	10,544,350
Income taxes	\$ 2,974,000	3,087,600
Noncash investing and financing activities:		
Change in unrealized gain (loss) on investment securities available for sale, net	\$ (953,924)	(1,326,383)
Change in unrealized gain (loss) on derivative financial instruments, net	\$ (35,984)	(172,132)
Transfer of loans to other real estate and repossessions	\$ 420,424	278,954
Reclassification of an investment from other assets to securities available for sale	\$ 499,995	-
Reclassification of an investment from other investments to securities available for sale	\$ 600,000	-
Transfer of retained earnings to common stock for issuance of stock dividend	\$ -	9,430,532

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (*Unaudited*)

(1) Summary of Significant Accounting Policies

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

The consolidated financial statements in this report are unaudited. In the opinion of management, all adjustments (none of which were other than normal accruals) necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Management of the Company has made a number of estimates and assumptions relating to reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in conformity with generally accepted accounting principles. Actual results could differ from those estimates.

The Company’s accounting policies are fundamental to understanding management’s discussion and analysis of results of operations and financial condition. Many of the Company’s accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of the specific accounting guidance. A description of the Company’s significant accounting policies can be found in Note 1 of the notes to consolidated financial statements in the Company’s 2006 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 3, 2007 Annual Meeting of Shareholders.

*Recently Issued Accounting Pronouncements*

In June 2006, the Financial Accounting Standard Board (“FASB”) issued Financial Interpretation No. 48 (“FIN 48”) “Accounting for Uncertainty in Income Taxes” – an interpretation of SFAS No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements and prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This interpretation was effective for the Company beginning in January of 2007. The Company has assessed the impact of FIN 48 and has determined that there are no significant positions taken in the preparation of its tax return that create any uncertainties and therefore FIN 48 will not have a material impact on its financial position or its results of operations.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements. This standard is not expected to have a material effect on the Company’s financial position, results of operations or disclosures.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (SFAS 159), which permits entities to choose to measure financial instruments and certain other instruments at fair value. SFAS 159 is effective as of the beginning of fiscal years that begin in November 15, 2007; however, it includes an early adoption provision allowing entities to adopt within 120 days of their most recent fiscal year-end. The Company has decided not to implement SFAS 159 until January of 2008.

(2) Allowance for Loan Losses

The following is an analysis of the allowance for loan losses for the three months ended June 30, 2007 and 2006:

	2007	2006
Balance, beginning of period	\$ 8,303,432	7,424,782
Provision for loan losses	957,000	1,172,000
Less:		
Charge-offs	(954,015)	(900,487)
Recoveries	208,000	226,124
Net charge-offs	(746,015)	(674,363)
Balance, end of period	\$ 8,514,417	7,922,419

(3)

Net Earnings Per Share

Net earnings per common share is based on the weighted average number of common shares outstanding during the period while the effects of potential common shares outstanding during the period are included in diluted earnings per share. The average market price during the year is used to compute equivalent shares. All previously reported per share amounts have been restated to reflect a 3-for-2 stock split which occurred during second quarter 2007.

The reconciliation of the amounts used in the computation of both “basic earnings per share” and “diluted earnings per share” for the three and six months ended June 30, 2007 is as follows:

For the three months ended June 30, 2007

	Net Earnings	Weighted Average Common Shares	Per Share Amount
Basic earnings per share	\$ 2,590,113	5,746,837	\$ 0.45
Effect of dilutive securities:			
Stock options	-	115,683	
Diluted earnings per share	\$ 2,590,113	5,862,520	\$ 0.44

For the six months ended June 30, 2007

	Net Earnings	Weighted Average Common Shares	Per Share Amount
Basic earnings per share	\$ 5,377,238	5,747,458	\$ 0.94
Effect of dilutive securities:			
Stock options	-	117,287	
Diluted earnings per share	\$ 5,377,238	5,864,745	\$ 0.92

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

For the three months ended June 30, 2006

	Net Earnings	Weighted Average Common Shares	Per Share Amount
Basic earnings per share	\$ 2,661,432	5,677,673	\$ 0.47
Effect of dilutive securities:			
Stock options	-	85,588	
Diluted earnings per share	\$ 2,661,432	5,763,261	\$ 0.46

For the six months ended June 30, 2006



	Net Earnings	Weighted Average Common Shares	Per Share Amount
Basic earnings per share	\$ 4,896,501	5,682,472	\$ 0.86
Effect of dilutive securities:			
Stock options	-	85,536	
Diluted earnings per share	\$ 4,896,501	5,768,008	\$ 0.85

(4) Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan (the "Plan") whereby certain stock-based rights, such as stock options, restricted stock, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees. A total of 389,450 shares were reserved for possible issuance under this Plan. All rights must be granted or awarded within ten years from the 1999 effective date.

Under the Plan, the Company granted incentive stock options to certain eligible employees in order that they may purchase Company stock at a price equal to the fair market value on the date of the grant. The options granted in 1999 vest over a five-year period. Options granted subsequent to 1999 vest over a three-year period. All options expire ten years after issuance. The Company did not grant any options during the three and six months ended June 30, 2007 and 2006.

Shareholders approved an amendment to the Plan at the Annual Meeting of Shareholders on May 3, 2007 to include an additional 390,000 shares of authorized but unissued Common Stock in the Plan, which will be available for future awards.

(5) Stock Split

On April 19, 2007, the Board of Directors of the Company authorized a 3-for-2 stock split that was paid in conjunction with the Company's regular cash dividend for the second quarter of 2007. As a result of the stock split, each shareholder received three new shares of stock for every two 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 split. The cash dividend was paid based on the number of shares held by shareholders as adjusted by the stock split. All previously reported per share amounts have been restated to reflect this stock split.

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

*The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors and the Company's consolidated financial statements and notes thereto on pages A-26 through A-56 of the Company's 2006 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 3, 2007 Annual Meeting of Shareholders.*

**Introduction**

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

**Overview**

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

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

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

senior management team.

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

The Bank opened a new office in Mecklenburg County, in Cornelius, North Carolina in June 2007. The Bank plans to open a new Banco de la Gente office in Raleigh in 2007 in a continuing effort to serve the Latino community. The Bank also plans to open a new traditional banking office in Iredell County, North Carolina in Mooresville during late 2007. Management expects to continue to open at least one new traditional office in Mecklenburg or Iredell counties in each of the next two to three years and additional Banco de la Gente offices in other metropolitan areas in North Carolina.

### **Summary of Significant Accounting Policies**

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

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. 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 3, 2007 Annual Meeting of Shareholders. The following is a summary of the more subjective and complex accounting policies of the Company.

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

There are other complex accounting standards that require the Company to employ significant judgment in interpreting and applying certain of the principles prescribed by those standards. These judgments include, but are not limited to, the determination of whether a financial instrument or other contract meets the definition of a derivative in accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities." For a more complete discussion of policies, see the notes to the consolidated financial statements.

In June 2006, the Financial Accounting Standard Board ("FASB") issued Financial Interpretation No. 48 ("FIN 48") "Accounting for Uncertainty in Income Taxes" – an interpretation of SFAS No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements and prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This interpretation was effective for the Company beginning in January of 2007. The Company has assessed the impact of FIN 48 and has determined that there are no significant positions taken in the preparation of its tax return that create any uncertainties and therefore FIN 48 will not have a material impact on its financial position or its results of operations.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements. This standard is not expected to have a material effect on the Company's financial position, results of operations or disclosures.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159), which permits entities to choose to measure financial instruments and certain other instruments at fair value. SFAS 159 is effective as of the beginning of fiscal years that begin in November 15, 2007; however, it includes an early adoption provision allowing entities to adopt within 120 days of their most recent fiscal

year-end. The Company has decided not to implement SFAS 159 until January of 2008.

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

### **Results of Operations**

*Summary.* Net earnings for the second quarter of 2007 were \$2.6 million, or \$0.45 basic net earnings per share and \$0.44 diluted net earnings per share as compared to \$2.7 million, or \$0.47 basic net earnings per share and \$0.46 diluted net earnings per for the same period one year ago. The decrease in net earnings is primarily attributable to increases in the provision for loan losses and non-interest expense, which were partially offset by increases in net interest income and non-interest income.

The annualized return on average assets was 1.24% for the three months ended June 30, 2007 compared to 1.40% for the same period in 2006, and annualized return on average shareholders' equity was 15.42% for the three months ended June 30, 2007 compared to 18.52% for the same period in 2006.

Net earnings for the six months ended June 30, 2007 were \$5.4 million, or \$0.94 basic net earnings per share and \$0.92 diluted net earnings per share. The increase in net earnings for the six-month period ended June 30, 2007 is primarily attributable to growth in interest-earning assets, which contributed to increases in net interest income, and non-interest income. In addition the Company had a decrease in the provision for loan losses. The increases in net interest income and non-interest income and the decrease in the provision for loan losses were partially offset by an increase in non-interest expense.

The annualized return on average assets was 1.31% for the six months ended June 30, 2007 and 2006, and annualized return on average shareholders' equity was 16.03% for the six months ended June 30, 2007 compared to 16.91% for the same period in 2006.

*Net Interest Income.* Net interest income, the major component of the Company's net earnings, was \$8.7 million for the three months ended June 30, 2007, an increase of 7% over the \$8.1 million earned in the same period in 2006. This increase is attributable to Federal Reserve interest rate increases, which resulted in increases to the prime rate. In addition, the average outstanding balances of loans and investment securities available-for-sale increased for the three months ended June 30, 2007 compared to the three months ended June 30, 2006.

Interest income increased \$1.9 million or 14% for the three months ended June 30, 2007 compared with the same period in 2006. The increase was due to an increase in the average yield received on loans resulting from Federal Reserve interest rate increases combined with an increase in the average outstanding balance of loans and investment securities available-for-sale. During the quarter ended June 30, 2007, average loans increased \$50.4 million to \$646.6 million from \$596.2 million for the three months ended June 30, 2006. During the quarter ended June 30, 2007, average investment securities available-for-sale increased \$2.5 million to \$120.3 million from \$117.8 million for the three months ended June 30, 2006.

Interest expense increased \$1.3 million or 24% for the three months ended June 30, 2007 compared with the same period in 2006. The increase in interest expense was due to an increase in the cost of funds to 4.14% for the three months ended June 30, 2007 from 3.58% for the same period in 2006, combined with an increase in volume of interest-bearing liabilities. The increase in the cost of funds is primarily attributable to increases in the average rate paid on interest-bearing checking and savings accounts and certificates of deposit. The average rate paid on interest-bearing checking and savings accounts was 2.15% for the three months ended June 30, 2007 as compared to 1.61% for the same period of 2006. The average rate paid on certificates of deposits was 4.86% for the three months ended June 30, 2007 compared to 4.05% for the same period one year ago.

Net interest income for the six-month period ended June 30, 2007 was \$17.3 million, an increase of 10% over net interest income of \$15.8 million for the six months ended June 30, 2006. This increase is attributable to an increase in interest income due to increases in the prime rate combined with increases in the average outstanding balances of loans and investment securities available-for-sale.

Interest income increased \$4.6 million or 18% to \$30.6 million for the six months ended June 30, 2007 compared to \$26.0 million for the same period in 2006. The increase was primarily due to an increase in the average yield received on loans resulting from Federal Reserve interest rate increases combined with an increase in the average outstanding balance of investment securities available for sale. The average yield earned on loans, including fees, was 8.56% for the six months ended June 30, 2007 as compared to 7.98% for the same period of 2006. During the six months ended June 30, 2007, average loans increased \$56.5 million to \$644.9 million from \$588.4 million for the same period in 2006. Average investment securities available for sale increased 3% to \$120.3 million in the six months ended June

30, 2007 compared to the same period in 2006. All other interest-earning assets including federal funds sold increased to an average of \$21.0 million in the six months ended June 30, 2007 from \$8.9 million in the same period in 2006. The tax equivalent yield on average earning assets increased to 7.97% for the six months ended June 30, 2007 from 7.45% for the six months ended June 30, 2006.

Interest expense increased 30% to \$13.3 million for the six months ended June 30, 2007 compared to \$10.3 million for the corresponding period in 2006. The increase in interest expense was due to an increase in the cost of funds to 4.13% for the six months ended June 30, 2007 from 3.45% for the same period in 2006, combined with an increase in the volume of interest bearing liabilities. The increase in the cost of funds is primarily attributable to increases in the average rate paid on interest-bearing deposits. The average rate paid on interest-bearing checking and savings accounts was 2.12% for the six months ended June 30, 2007 as compared to 1.59% for the same period in 2006. The average rate paid on



certificates of deposits was 4.82% for the six months ended June 30, 2007 from 3.91% for the same period one year ago.

*Provision for Loan Losses.* For the three months ended June 30, 2007, a contribution of \$634,000 was made to the provision for loan losses compared to \$413,000 for the same period one year ago. The increase in provision for loan losses is primarily attributable to an increase in net charge-offs of \$600,000. Charge-offs during the three months ended June 30, 2007 consisted primarily of charge-offs on three small loans with the largest charge-off being \$300,000.

For the six months ended June 30, 2007 a contribution of \$957,000 was made to the provision for loan losses compared to a \$1.2 million contribution to the provision for loan losses for the six months ended June 30, 2006. The decrease in the provision for loan losses is primarily attributable to slower growth in loan balances for the first six months of 2007 when compared to the same period in 2006.

*Non-Interest Income.* Total non-interest income was \$2.1 million in the second quarter of 2007, a 6% increase over the \$2.0 million for the same period in 2006. This increase is primarily due to an increase in other service charges and fees, mortgage banking income and miscellaneous other income. Other service charges and fees increased 23% to \$447,000 for the three-month period ended June 30, 2007 when compared to the same period one year ago. This increase is primarily attributable to an increase of \$60,000 in check cashing fee income. Mortgage banking income increased \$69,000 during the three months ended June 30, 2007 as compared to the corresponding period in 2006. Miscellaneous income was \$544,000 for the three months ended June 30, 2007, a 9% increase from \$500,000 for the same period in 2006. This increase in miscellaneous income was partially attributable to an increase of \$62,000 in debit card fee income primarily associated with increased card usage due to an increased number of demand accounts. These increases were partially offset by a \$102,000 increase in losses on the sale of securities. The \$194,000 in the loss on the sale of securities for the three months ended June 30, 2007 is due to a write-down of an asset classified as other investments. Management determined the market value of this investment had decreased significantly and was not a temporary impairment therefore a write-down was appropriate during second quarter 2007.

Total non-interest income was \$4.3 million for the six months ended June 30, 2007, an 8% increase over the \$3.9 million for the same period in 2006. This increase is primarily due to an increase in fee income and other miscellaneous income resulting from activity in new branches. Service charges were \$1.9 million for the six months ended June 30, 2007 and 2006. Other service charges and fees increased 23% to \$935,000 for the six months ended June 30, 2007 when compared to the same period one year ago. This increase is primarily attributable to an increase of \$108,000 in check cashing fee income and an increase of \$88,000 in miscellaneous fee income. Mortgage banking income increased 25% to \$300,000 for the six months ended June 30, 2007 when compared to the same period in 2006 due to an increase in mortgage broker activity. Miscellaneous income increased 9% to \$1.1 million for the six months ended June 30, 2007. This increase in miscellaneous income was partially attributable to an increase of \$110,000 in debit card fee income primarily associated with increased card usage due to an increased number of demand accounts.

*Non-Interest Expense.* Total non-interest expense increased 11% to \$6.2 million for the second quarter of 2007 as compared to \$5.5 million for the corresponding period in 2006. Salary and employee benefits totaled \$3.3 million for the three months ended June 30, 2007, an increase of 15% from the same period in 2006. The increase in salary and employee benefits is due to normal salary increases and expense associated with additional staff for new branches. Occupancy expense increased 19% for the quarter ended June 30, 2007 due to an increase in furniture and equipment expense and lease expense associated with new branches and new sales and lending platform system implementations. Other non-interest expense increased 1% to \$1.7 million for the three months ended June 30, 2007 as compared to the same period in 2006. This increase in other non-interest expense is attributable to an increase of \$66,000 in professional fees, an increase of \$51,000 in advertising expense, an increase of \$35,000 in office supplies

and an increase of \$21,000 in debit card expense. These increases in non-interest expense other than salary, benefits and occupancy expenses were partially offset by a \$152,000 decrease in amortization of trust preferred securities issuance costs.

Total non-interest expense was \$12.2 million for the six months ended June 30, 2007, an increase of 12% over the same period in 2006. Salary and employee benefits totaled \$6.7 million for the six months ended June 30, 2007, an increase of 17% over the same period in 2006. The increase in salary and employee benefits is primarily due normal salary increases and expenses associated with additional staff for new branches. Occupancy expense increased 15% for the six months ended June 30, 2007 due to an increase in furniture and equipment expense and lease expense associated with new branches and new sales and lending platform system implementations. Other non-interest expense increased 2% to \$3.2 million for the six months ended June 30, 2007 as compared to the same period in 2006. This increase in other non-interest expense is primarily attributable to an increase of \$125,000 in professional fees, an increase of \$90,000 in advertising expense and an increase of \$59,000 in debit card expense. These increases in non-interest expense other than salary, benefits and occupancy expenses were partially offset by a \$157,000 decrease in amortization of trust preferred securities issuance costs. The Company paid a \$178,000 prepayment fee in the first quarter of 2006 on the early termination of a \$5.0 million Federal Home Loan Bank of Atlanta ("FHLB") advance. This fee was included in other non-interest expense.

*Income Taxes.* The Company reported income taxes of \$1.4 million and \$1.5 million for the second quarters of 2007 and 2006, respectively. This represented an effective tax rate of 36% for the respective periods.

The Company reported income taxes of \$3.0 million and \$2.8 million for the six months ended June 30, 2007 and 2006, respectively. This represented an effective tax rate of 36% for the respective periods.

### **Analysis of Financial Condition**

*Investment Securities.* Available-for-sale securities amounted to \$117.7 million at June 30, 2007 compared to \$117.6 million at December 31, 2006. Average investment securities available for sale for the six months ended June 30, 2007 amounted to \$120.3 million compared to \$118.1 million for the year ended December 31, 2006.

*Loans.* At June 30, 2007, loans amounted to \$663.1 million compared to \$651.4 million at December 31, 2006, an increase of \$11.7 million. Average loans represented 82% of total earning assets for the six months ended June 30, 2007 as compared to 83% for the year ended December 31, 2006.

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

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

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

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

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

matters related to credit risk.

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

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment in accordance with SFAS No. 114, "Accounting By Creditors for Impairment of a Loan. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Company's loss exposure for each credit, given the payment status, financial condition of the borrower, and value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below. At June 30,

2007 and December 31, 2006, the recorded investment in loans that were considered to be impaired under SFAS No. 114 was approximately \$6.7 million and \$7.6 million, respectively, with related allowance for loan losses of approximately \$1.1 million and \$1.2 million, respectively.

The general allowance reflects reserves established under the provisions of SFAS No. 5, "Accounting for Contingencies" for collective loan impairment. These reserves are based upon historical net charge-offs using the last three years' experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends.

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

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

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the six months ended June 30, 2007 as compared to the year ended December 31, 2006. Such revisions, estimates and assumptions are made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

Additionally, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowances for loan losses. Such agencies may require adjustments to the allowances based on their judgments of information available to them at the time of their examinations.

The allowance for loan losses at June 30, 2007 amounted to \$8.5 million or 1.28% of total loans compared to \$8.0 million or 1.27% of total loans at December 31, 2006.

*Non-performing Assets.* Non-performing assets totaled \$7.2 million at June 30, 2007 or 0.86% of total assets, compared to \$8.0 million at December 31, 2006, or 0.97% of total assets. Non-accrual loans were \$6.7 million at June 30, 2007 and \$7.6 million at December 31, 2006. As a percentage of total loans outstanding, non-accrual loans were 1.01% at June 30, 2007 compared to 1.16% at December 31, 2006. Non-accrual balances at June 30, 2007 and December 31, 2006 include one classified loan relationship that was moved to non-accrual status in fourth quarter 2006. This relationship totals \$4.2 million at June 30, 2007 and has been appropriately reserved in the Bank's allowance for loan losses. The Bank had loans ninety days past due and still accruing at June 30, 2007 and December 31, 2006 of \$181,000 and \$78,000, respectively. Other real estate owned totaled \$335,000 as of June 30, 2007 as compared to \$344,000 at December 31, 2006. The Bank had no repossessed assets as of June 30, 2007 and December 31, 2006.

Total non-performing loans, which include non-accrual loans and loans ninety days past due and still accruing, were \$6.9 million and \$7.6 million at June 30, 2007 and December 31, 2006, respectively. The ratio of non-performing loans to total loans was 1.03% at June 30, 2007, as compared to 1.17% at December 31, 2006.

*Deposits.* Total deposits at June 30, 2007 were \$654.1 million, an increase of \$20.3 million over deposits of \$633.8 million at December 31, 2006. Core deposits, which include non-interest bearing demand deposits, NOW, MMDA, savings and certificates of deposits of denominations less than \$100,000, increased \$36.8 million to \$476.4 million at June 30, 2007 as compared to \$439.6 million at December 31, 2006 due to concerted efforts to attract additional deposits from existing customers and to attract new customers in our existing offices along with deposits gathered in two new offices opened since June 2006. Certificates of deposit in amounts greater than \$100,000 or more totaled \$177.8 million at June 30, 2007 as compared to \$194.2 million at December 31, 2006. At June 30, 2007, brokered deposits amounted to \$42.3 million as compared to \$60.0 million at December 31, 2006. The decrease in brokered deposits reflects maturing brokered certificates of deposit that were not replaced due to an increase in core deposits. Brokered deposits outstanding as of June 30, 2007 had a weighted average rate of 5.34% with a weighted average original term of 9 months.

*Borrowed Funds.* Borrowings from the FHLB totaled \$77.0 million at June 30, 2007 compared to \$89.3 million at December 31, 2006. The average balance of FHLB borrowings for the six months ended June 30, 2007 was \$78.9 million compared to \$74.1 million for the year ended December 31, 2006. At June 30, 2007, all FHLB borrowings had maturities exceeding one year. The FHLB has the option to convert \$67.0 million of the total advances to a floating rate and, if converted, the Bank may repay advances without 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 Company had no federal funds purchased as of June 30, 2007 or December 31, 2006.

Securities sold under agreements to repurchase increased \$10.8 million to \$17.2 million at June 30, 2007 as compared to \$6.4 million at December 31, 2006 as concerted efforts to promote cash management services has increased customer usage of securities sold under agreements to repurchase.

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

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

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

*Asset Liability and Interest Rate Risk Management.* The objective of the Company’s Asset Liability and Interest Rate Risk strategies is to identify and manage the sensitivity of net interest income to changing interest rates and to minimize the interest rate risk between interest-earning assets and interest-bearing liabilities at various maturities. This is to be done in conjunction with the need to maintain adequate liquidity and the overall goal of maximizing net interest income.

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

The Company's rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available-for-sale securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits and borrowed funds. The Company's balance sheet is asset-sensitive, meaning that in a given period there will be more assets than liabilities subject to immediate repricing as interest rates change in the market. Because most of the Company's loans are tied to the prime rate, they reprice more rapidly than rate sensitive interest-bearing deposits. During periods of rising rates, this results in increased net interest income. The opposite occurs during periods of declining rates. Average rate sensitive assets for the six months ended June 30, 2007 totaled \$786.2 million, exceeding average rate sensitive liabilities of \$651.9 million by \$134.3 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 June 30, 2007, the Company had cash flow hedges with a notional amount of \$150.0 million. These derivative instruments consist of four interest rate floor contracts that are used to hedge future cash flows from payments on the first \$150.0 million of certain variable rate commercial,



construction and home equity loans against the downward effects of their repricing in the event of a decreasing rate environment for a period of three years ending in July 2008, November 2008, January 2009 and June 2009. If the prime rate falls below 6.25% during the term of the contract on the first floor, the Company will receive payments based on the \$35.0 million notional amount times the difference between 6.25% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate is 6.25% or higher. The Company paid a premium of \$161,000 on this contract. On the second floor if the prime rate falls below 7.00% during the term of the contract, the Company will receive payments based on the \$35.0 million notional amount times the difference between 7.00% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate is 7.00% or higher. The Company paid a premium of \$203,000 on this contract. On the third floor if the prime rate falls below 7.50% during the term of the contract, the Company will receive payments based on the \$45.0 million notional amount times the difference between 7.50% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate is 7.50% or higher. The Company paid a premium of \$562,500 on this contract. On the fourth floor if the prime rate falls below 8.00% during the term of the contract, the Company will receive payments based on the \$35.0 million notional amount times the difference between 8.00% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate is 8.00% or higher. The Company paid a premium of \$399,000 on this contract.

The Bank also utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At June 30, 2007, the Bank had \$68.3 million in loans with interest rate floors; however, none of the floors were in effect pursuant to the terms of the promissory notes on these loans.

The Bank also had \$16.0 million in loans that are tied to the prime rate and had interest rate caps in effect pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 1.26% lower than the indexed rate on the promissory notes without the interest rate caps.

*Liquidity.* The objectives of the Company's liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company's liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of June 30, 2007 such unfunded commitments to extend credit were \$182.5 million, while commitments in the form of standby letters of credit totaled \$4.0 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 June 30, 2007, the Company's core deposits totaled \$476.4 million, or 73% 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 on a short-term basis.

At June 30, 2007, the Bank had a significant amount of deposits in amounts greater than \$100,000, including brokered deposits of \$42.3 million, which mature over the next nine months. The balance and cost of these deposits are more susceptible to changes in the interest rate environment than other deposits.

The Bank had a line of credit with the FHLB equal to 20% of the Bank's total assets, with an outstanding balance of \$77.0 million at June 30, 2007. The remaining availability at FHLB was \$63.5 million at June 30, 2007. The Bank also had the ability to borrow up to \$35.0 million for the purchase of overnight federal funds from three correspondent financial institutions as of June 30, 2007.

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 34.85% at June 30, 2007 and 31.15% at December 31, 2006. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy is 20%.

*Contractual Obligations and Off-Balance Sheet Arrangements.* The Company's contractual obligations and other commitments as of June 30, 2007 and December 31, 2006 are summarized in the table below. The Company's contractual obligations include the repayment of principal and interest related to FHLB advances and junior subordinated debentures,

as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.

**CONTRACTUAL OBLIGATIONS AND OTHER COMMITMENTS:**  
(Dollars in Thousands)

	June 30, 2007	December 31, 2006
<b>Contractual Cash Obligations</b>		
Long-term borrowings	\$ 77,000	69,500
Junior subordinated debentures	20,619	20,619
Operating lease obligations	7,575	8,009
<b>Total</b>	<b>\$ 105,194</b>	<b>98,128</b>
<b>Other Commitments</b>		
Commitments to extend credit	\$ 182,482	151,697
Standby letters of credit and financial guarantees written	3,999	4,574
<b>Total</b>	<b>\$ 186,481</b>	<b>156,271</b>

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

*Capital Resources.* Shareholders' equity at June 30, 2007 was \$65.4 million compared to \$62.8 million at December 31, 2006. At June 30, 2007 and December 31, 2006, unrealized losses, net of taxes, amounted to \$1.8 million and \$771,000, respectively. The increase in unrealized losses at June 30, 2007 is primarily attributable to a decrease in the market value of available for sale securities and derivative instruments. Management expects that accumulated comprehensive income (loss) will continue to fluctuate due to changes in the market value of available for sale investments securities and derivative instruments caused by changes in market interest rates. Annualized return on average equity for the six months ended June 30, 2007 was 16.03% compared to 14.68% for the year ended December 31, 2006. Total cash dividends paid during the six months ended June 30, 2007 amounted to \$976,000 as compared to total cash dividends of \$797,000 paid for the first six months of 2006.

In November 2006, 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 2007. The Company has repurchased \$1.1 million, or 55,000 shares, of its common stock under this plan as of June 30, 2007.

Under the regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 4.0% or greater. Tier 1 capital is generally defined as shareholders' equity and Trust Preferred Securities less all intangible assets and goodwill. Tier 1 capital at

June 30, 2007 and December 31, 2006 includes \$20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 11.77% and 11.70% at June 30, 2007 and December 31, 2006, 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 12.92% and 12.86% at June 30, 2007 and December 31, 2006, respectively. In addition to the Tier 1 and total risk-based capital requirements, financial institutions are also required to maintain a leverage ratio of Tier 1 capital to total average assets of 4.0% or greater. The Company's Tier 1 leverage capital ratio was 10.50% and 10.80% at June 30, 2007 and December 31, 2006, respectively.

The Bank's Tier 1 risk-based capital ratio was 10.38% and 10.21% at June 30, 2007 and December 31, 2006, respectively. The total risk-based capital ratio for the Bank was 11.54% and 11.37% at June 30, 2007 and December 31, 2006, respectively. The Bank's Tier 1 leverage capital ratio was 9.25% and 9.41% at June 30, 2007 and December 31, 2006, 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 June 30, 2007.

**Item Quantitative and Qualitative Disclosures About Market**

**3. Risk**

There have been no material changes in the quantitative and qualitative disclosures about market risks as of June 30, 2007 from that presented in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

**Item Controls and Procedures**

**4.**

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

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

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

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

**Item Risk Factors****1A.**

There are no material changes from the risk factors as previously disclosed in the Company's Form 10-K in response to Item 1A. to Part I to Form 10-K, filed with Securities and Exchange Commission on March 15, 2007.

**Item Unregistered Sales of Equity Securities and Use of Proceeds****2.****ISSUER PURCHASES OF EQUITY SECURITIES**

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs</b>
April 1 - 30, 2007	2,070	\$ 19.51	-	\$ 2,000,000
May 1 - 31, 2007	30,824	19.41	30,000	1,418,000
June 1 - 30, 2007	25,000	20.25	25,000	911,750
<b>Total</b>	<b>57,894</b>	<b>\$ 19.77</b>	<b>55,000</b>	<b>\$ 911,750</b>

**Item Defaults Upon Senior Securities****3.**

Not applicable

**Item Submission of Matters to a Vote of Security Holders****4.**

- (a) Annual Shareholders' Meeting – May 3, 2007

(b) Directors elected at the meeting are as follows: John W. Lineberger, Jr., Gary E. Matthews, Dan Ray Timmerman, Sr. and Benjamin I. Zachary.

(c) At the May 3, 2007 Annual Shareholders Meeting the following items were submitted to a vote of shareholders:

1) Election of Directors:

	<b>Vote For</b>	<b>Withhold Authority</b>
John W. Lineberger, Jr.	3,540,960	51,826
Gary E. Matthews	3,573,623	19,163
Dan Ray Timmerman, Sr.	3,573,637	19,149
Benjamin I. Zachary	3,551,500	41,286

2) Approval of Amendment No. 1 to the Company's Omnibus Stock Ownership and Long Term Incentive Plan which provided for the addition of 390,000 shares of authorized, but unissued, common stock of the Company to the Plan

Votes For – 2,404,838, Votes Against – 553,399, Votes Abstained – 21,707



3) Ratification of appointment of Independent Registered Public Accountants – Porter Keadle Moore, LLP

Votes For – 3,572,688, Votes Against – 15,502, Votes Abstained – 8,071

(d) Not applicable

**Item Other Information**

**5.**

Not applicable

**Item 6. Exhibits**

- Exhibit (3)(i) Articles of Incorporation of Peoples Bancorp of North Carolina, Inc., incorporated by reference to Exhibit (3)(i) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999
- Exhibit (3)(ii) Amended and Restated Bylaws of Peoples Bancorp of North Carolina, Inc., incorporated by reference to Exhibit (3)(ii) to the Form 10-K filed with the Securities and Exchange Commission on March 26, 2004
- Exhibit (4) Specimen Stock Certificate, incorporated by reference to Exhibit (4) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999
- Exhibit (10)(a) Employment Agreement between Peoples Bank and Tony W. Wolfe incorporated by reference to Exhibit (10)(a) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(b) Employment Agreement between Peoples Bank and Joseph F. Beaman, Jr. incorporated by reference to Exhibit (10)(b) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(c) Employment Agreement between Peoples Bank and William D. Cable incorporated by reference to Exhibit (10)(d) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(d) Employment Agreement between Peoples Bank and Lance A. Sellers incorporated by reference to Exhibit (10)(e) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(e) Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long

Term Incentive Plan incorporated by reference to Exhibit (10)(f) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000

Exhibit (10)(e)(i) Amendment No. 1 to the Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(e)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 15, 2007

Exhibit (10)(f) Employment Agreement between Peoples Bank and A. Joseph Lampron incorporated by reference to Exhibit (10)(g) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002

Exhibit (10)(g) Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(h) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002

Exhibit (10)(h) Rabbi Trust for the Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002

- Exhibit (10)(i) Description of Service Recognition Program maintained by Peoples Bank, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 27, 2003
- Exhibit (10)(j) Capital Securities Purchase Agreement dated as of June 26, 2006, by and among Peoples Bancorp of North Carolina, Inc., PEBK Capital Trust II and Bear, Sterns Securities Corp. incorporated by reference to Exhibit (10)(j) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(k) Amended and Restated Trust Agreement of PEBK Capital Trust II, dated as of June 28, 2006 incorporated by reference to Exhibit (10)(k) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(l) Guarantee Agreement of Peoples Bancorp of North Carolina, Inc. dated as of June 28, 2006 incorporated by reference to Exhibit (10)(l) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(m) Indenture, dated as of June 28, 2006, by and between Peoples Bancorp of North Carolina, Inc. and LaSalle Bank National Association, as Trustee, relating to Junior Subordinated Debt Securities Due September 15, 2036 incorporated by reference to Exhibit (10)(m) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (14) Code of Business Conduct and Ethics of Peoples Bancorp of North Carolina, Inc., incorporated by reference to Exhibit (14) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2005
- Exhibit (31)(a) Certification of principal executive officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit (31)(b) Certification of principal financial officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit (32) Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002



**SIGNATURES**

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

Peoples Bancorp of North Carolina, Inc.

August 8, 2007  
Date

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

August 8, 2007  
Date

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

