

PEOPLES BANCORP OF NORTH CAROLINA INC
Form DEF 14A
April 06, 2005

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 []

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| <input type="checkbox"/> Preliminary Proxy Statement | <input type="checkbox"/> Confidential, for Use of the Commission |
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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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Date Filed:

PEOPLES BANCORP
OF NORTH CAROLINA, INC.

Notice of 2005 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 2005 ANNUAL MEETING OF SHAREHOLDERS
To Be Held on May 5, 2005**

NOTICE IS HEREBY GIVEN that the 2005 Annual Meeting of Shareholders (the "Meeting") of Peoples Bancorp of North Carolina, Inc. (the "Company") will be held on Thursday, May 5, 2005, 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 three persons who will serve as directors of the Company for a three-year term expiring in 2008, 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, 2005; 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 11, 2005 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 6, 2005

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
2005 ANNUAL MEETING OF SHAREHOLDERS
May 5, 2005**

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 5, 2005, 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 6, 2005.

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 2005 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, 2005. 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 11, 2005 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 3,451,406.

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 2008 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. The number of shares has been adjusted for the 10% stock dividend paid on March 16, 2005 to shareholders of record as of March 3, 2005.

<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	379,732 ³	11.00%
Banc Funds Company, LLC 208 South LaSalle St. Suite 1680	201,363	5.83%

Chicago, IL 60604

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

311,065

9.01%

2

¹Unless otherwise noted, all shares are owned directly of record by the named individuals, by their spouses and minor children, or by other entities by the named individuals. Voting and investment power is not shared unless otherwise indicated.

²Based upon a total of 3,451,406 shares of Common Stock outstanding as of the Record Date.

³Carolina Glove Company, Inc. owns 63,116 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 or who served as one during fiscal year 2004 and each of the named executive officers of the Company, nominees for election at the Meeting, and the directors and executive officers of the Company as a group.

<u>Name and Address</u>	<u>Amount and Nature of Beneficial Ownership</u> 1	<u>Percentage of Class</u> 2
James S. Abernethy Post Office Box 327 Newton, NC 28658	108,908 ³	3.07%
Robert C. Abernethy Post Office Box 366 Newton, NC 28658	123,577 ⁴	3.48%
Joseph F. Beaman, Jr. Post Office Box 467 Newton, NC 28658	22,193 ⁵	*
William D. Cable Post Office Box 467 Newton, NC 28658	14,563 ⁶	*
Douglas S. Howard P.O. Box 587 Denver, NC 28037	2,012 ⁷	*
A. Joseph Lampron Post Office Box 467 Newton, NC 28658	9,246 ⁸	*
John W. Lineberger, Jr.	363	*

6154 Vesuvius Furnace
Road
Iron Station, NC 28080

Gary E. Matthews
210 First Avenue South
Conover, NC 28613

6,455

*

Charles F. Murray
Post Office Box 1118
Claremont, NC 28610

62,492⁹

1.76%

Billy L. Price, Jr., M.D.
540 11th Ave. Place NW
Hickory, NC 28601

398

*

Larry E. Robinson
Post Office 723
Newton, NC 28658

26,907¹⁰

*

<u>Name and Address</u>	<u>Amount and Nature of Beneficial Ownership</u> ¹	<u>Percentage of Class</u> ²
Lance A. Sellers Post Office Box 467 Newton, NC 28658	18,403 ¹¹	*
Fred L. Sherrill, Jr. Post Office Box 816 Conover, NC 28613	15,796 ¹²	*
William Gregory Terry 706 South College Ave. Newton, NC 28658	1,369	*
Dan Ray Timmerman, Sr. Post Office Box 1148 Conover, NC 28613	34,712 ¹³	*
Tony W. Wolfe Post Office Box 467 Newton, NC 28658	39,722 ¹⁴	1.12%
Benjamin I. Zachary Post Office Box 277 Taylorsville, NC 28681	45,160 ¹⁵	1.27%
All current directors and nominees and executive officers as a group (17 people)	497,480 ^{16,17}	14.03%

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

¹Unless 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.

²Based upon a total of 3,451,406 shares of Common Stock outstanding as of the Record Date and 95,312 stock options exercisable within 60 days with respect to the designated recipient(s).

³Includes 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.

⁴Includes 2,902 shares of Common Stock owned by Mr. R. Abernethy's spouse, for which Mr. R. Abernethy disclaims beneficial ownership.

⁵Includes 19,476 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.

⁶Includes 12,045 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.

⁷Includes 550 shares of Common Stock owned by Mr. Howard's mother over which Mr. Howard holds a power of attorney.

⁸Includes 8,951 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.

⁹Includes 970 shares of Common Stock owned by Mr. Murray's spouse, for which Mr. Murray disclaims beneficial ownership. Also includes 1,815 shares owned by Murray's Hatchery, Inc. Mr. Murray is President of Murray's Hatchery, Inc.

¹⁰Includes 4,043 shares of Common Stock owned by Mr. Robinson's spouse, for which Mr. Robinson disclaims beneficial ownership.

¹¹Includes 18,280 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.

¹²Includes 6,259 shares of Common Stock owned by Mr. Sherrill's spouse, for which Mr. Sherrill disclaims beneficial ownership.

¹³Includes 1,650 shares of Common Stock owned by Timmerman Manufacturing, Inc. Mr. Timmerman is President and a Director of Timmerman Manufacturing, Inc.

¹⁴Includes 36,560 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.

¹⁵ 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.

¹⁶The 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.

¹⁷Includes 95,312 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, 2004, 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 eleven members following the election of directors at the 2005 Annual Meeting of Shareholders.

The Board of Directors has nominated the three persons named below for election as directors to serve for a three-year term to expire at the 2008 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 three 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 2005. 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.

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, 2004</u>	<u>Principal Occupation During Last Five Years</u>	<u>Director Since</u>
Charles F. Murray	61	President, Murray's Hatchery, Inc.	1990
Douglas S. Howard	45	Vice President, Howard Ventures, Inc.; Secretary/Treasurer, Denver Equipment of Charlotte, Inc.	2004
Billy L. Price, Jr., M.D.	48	Practicing Internist and Partner in Catawba Valley Internal Medicine, P.A.; Clinical Instructor, Wake Forest University School of Medicine	2004

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR ALL OF THE ABOVE-LISTED NOMINEES FOR ELECTION AS DIRECTORS. THE THREE 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>Name</u>	<u>Age on December 31, 2004</u>	<u>Principal Occupation During Last Five Years</u>	<u>Director Since</u>	<u>Term Expires</u>
Robert C. Abernethy	54	President, Secretary and Treasurer, Carolina Glove Company, Inc. (glove manufacturer); Secretary and Assistant Treasurer, Midstate Contractors, Inc. (paving company)	1976	2006
James S. Abernethy	50	Vice President, Carolina Glove	1992	2006

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

Larry E. Robinson	59	President and Chief Executive Officer, The Blue Ridge Distributing, Inc. (beer and wine distributor)	1993	2006
William Gregory Terry	37	Executive Vice President, Drum & Willis-Reynolds Funeral Homes and Crematory	2004	2006
John W. Lineberger, Jr.	54	President, Lincoln Bonded Warehouse Company (commercial warehousing facility)	2004	2007

<u>Name</u>	<u>Age on December 31, 2004</u>	<u>Principal Occupation During Last Five Years</u>	<u>Director Since</u>	<u>Term Expires</u>
Gary E. Matthews	49	President and Director, Matthews Construction Company, Inc.	2001	2007
Dan Ray Timmerman, Sr.	57	President, Timmerman Manufacturing, Inc. (wrought iron furniture manufacturer)	1995	2007
Benjamin I. Zachary	48	President, Treasurer, and member of the Board of Directors, Alexander Railroad Company	1995	2007

Mr. Fred. L. Sherrill, Jr., a member of the Company's Board of Directors since 1989, has reached the Board's mandatory retirement age and is retiring from the Board effective as of May 5, 2005, the date of the 2005 Annual Meeting of Shareholders.

Board of Directors of the Bank

Peoples Bank (the "Bank") also will have eleven 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, 2004. During the year ended December 31, 2004, 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

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Director include 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 eight (8) times during fiscal year 2004.

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, Murray, Price, Robinson, Sherrill, 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 internal 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 seven (7) times during the fiscal year ended December 31, 2004.

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 2004 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 eight (8) times during fiscal year ended December 31, 2004.

The Bank's Audit Committee performs the same duties as the Company's Audit Committee. It consists of Directors R. Abernethy, Howard, Matthews, Murray, Price, Robinson, Sherrill, Timmerman and Zachary. The Bank's Audit Committee met seven (7) times during fiscal year ended December 31, 2004.

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 \$600 for each Bank board of directors meeting attended. An additional fee of \$300 is paid to committee members for each committee meeting attended. In addition to these meeting fees, each director also received an annual retainer of \$7,200.

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, Murray, Robinson, Sherrill, 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, 2004</u>	<u>Positions and Occupations During Last Five Years</u>	<u>Employed By the Company or the Bank Since</u>
Tony W. Wolfe	58	President and Chief Executive Officer of the Company and the Bank	1990
Joseph F. Beaman, Jr.	55	Executive Vice President and Corporate Secretary of the Company; Executive Vice President, Chief Administrative Officer and Secretary of the Bank; Prior to 2001, Chief Financial Officer of the Company and the Bank	1977
William D. Cable	36	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	42	Executive Vice President and Assistant Corporate Secretary of the Company; Executive Vice President and Chief Banking Officer of the Bank; Prior to 2001, Bank Executive Vice President -	1998

Credit Administration, Mortgage
Lending and Commercial Banking.

A. Joseph Lampron	50	Executive Vice President, Chief Financial Officer and Corporate 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.	2001
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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, 2004, 2003 and 2002, 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.

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Name and Principal Position	Year	Salary	Bonus	Annual Compensation	Long Term Compensation Awards		All Other Compensation 2,3,4,5,6
					Restricted Stock Awards	Securities Underlying Options/Stock Appreciation Rights ("SARS") (in shares)	
Tony W. Wolfe President and Chief Executive Officer of the Company and the Bank	2004	\$212,949	\$0	\$--	--	\$0/0	\$11,223
	2003	206,828	0	--	--	0/0	12,237
	2002	207,840	0	--	--	11,000/0 ⁷	11,827
Joseph F. Beaman, Jr. Executive Vice President and Corporate Secretary of the Company; Executive Vice President, Chief Administrative Officer and Secretary of the Bank	2004	\$139,222	\$0	\$--	--	\$0/0	\$7,807
	2003	152,214	0	--	--	0/0	7,963
	2002	148,509	3,750	--	--	4,400/0 ⁷	7,963
Lance A. Sellers Executive Vice President and Assistant Corporate Secretary of the Company; Executive Vice President and Chief Banking Officer of the Bank	2004	\$156,205	\$0	\$--	--	\$0/0	\$7,950
	2003	150,031	0	--	--	0/0	7,648
	2002	140,994	0	--	--	7,700/0 ⁷	7,164
A. Joseph Lampron Executive Vice President, Chief Financial Officer and Corporate Treasurer of the Company; Executive Vice President and Chief	2004	\$131,067	\$0	\$--	--	\$0/0	\$6,327
	2003	111,593	0	--	--	0/0	5,871
	2002	101,751	10,000	--	--	6,600/0 ⁷	5,283

Financial Officer of the
Bank

William D. Cable	2004	\$123,689	\$0	\$--	--	\$0/0	\$6,250
Executive Vice President and	2003	118,135	0	--	--	0/0	5,977
Assistant Corporate Treasurer of the Company; Executive Vice President and Chief Operations Officer of the Bank	2002	110,814	0	--	--	6,600/0 ⁷	5,572

Footnotes on the following page
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- 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 2004, \$9,324 under the 401(k) plan and a \$1,899 premium paid for group term life insurance in excess of \$50,000; for 2003, \$10,410 under the 401(k) plan and a \$1,827 premium paid for group term life insurance in excess of \$50,000; and for 2002, \$10,000 under the 401(k) plan and a \$1,827 premium paid for group life insurance in excess of \$50,000.
- 3 For Mr. Beaman, includes: for 2004, \$6,816 under the 401(k) plan and a \$991 premium paid for group term life insurance in excess of \$50,000; for 2003, \$7,296 under the 401(k) plan and a \$667 premium paid for group term life insurance in excess of \$50,000; for 2002, \$7,296 under the 401(k) plan and a \$667 premium paid for group life insurance in excess of \$50,000.
- 4 For Mr. Sellers, includes: for: 2004, \$7,643 under the 401(k) plan and a \$307 premium paid for group term life insurance in excess of \$50,000; for 2003, \$7,355 under the 401(k) plan and a \$293 premium paid for group term life insurance in excess of \$50,000; for 2002, \$6,893 under the 401(k) plan and a \$271 premium paid for group life insurance in excess of \$50,000.
- 5 For Mr. Lampron, includes: for 2004, \$5,819 under the 401(k) plan and a \$508 premium paid for group term life insurance in excess of \$50,000; for 2003, \$5,561 under the 401(k) plan and a \$310 premium paid for group term life insurance in excess of \$50,000; for 2002: \$5,013 under the 401(k) plan and a \$270 premium paid for group life insurance in excess of \$50,000.
- 6 For Mr. Cable, includes: for 2004, \$6,043 under the 401(k) plan and a \$207 premium paid for group term life insurance in excess of \$50,000; for 2003, \$5,780 under the 401(k) plan and a \$197 premium paid for group term life insurance in excess of \$50,000; for 2002: \$5,411 under the 401(k) plan and a \$161 premium paid for group life insurance in excess of \$50,000.
- 7 Includes 11,000; 4,400; 7,700; 6,600 and 6,600 shares subject to option granted on December 17, 2002, to Mr. Wolfe, Mr. Beaman, Mr. Sellers, Mr. Lampron, and Mr. Cable respectively. These options, granted pursuant to the Omnibus Plan, entitle Messrs. Wolfe, Beaman, Sellers, Lampron and Cable to purchase at any time after vesting and before December 17, 2012, shares of Common Stock in exchange for an exercise price of \$12.82 per share, which was the fair market per share value of the Common Stock on the date of grant. Of these options granted to Messrs. Wolfe, Beaman, Sellers, Lampron and Cable, one-third of the options vested on December 17, 2003, one-third vested on December 17, 2004, and the final third will vest on December 17, 2005. All options become 100% vested upon death, disability or a change in control of the Bank.

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 Banking 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 and Mr. Beaman's agreement provides for a monthly automobile allowance. 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.

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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 twelve (12) middle management officers had employment agreements during 2004. The term of these agreements is until December 1, 2005, 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	219,110 ¹	\$13.34 ²	33,168
Equity compensation plans not approved by security holders	0	0	0
Total	219,110	\$13.34	33,168

¹ Of the 219,110 stock options issued under the Omnibus Plan, a total of 190,331 of those stock options have vested or are exercisable within 60 days. Of the outstanding stock options, options to purchase a total of 29,086 shares of the Common Stock were granted on September 28, 1999; 50,104 options were granted on September 25, 2000; 57,874 options were granted on October 30, 2001; 4,551 options were granted on December 18, 2001; 73,095 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; \$13.37; \$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.

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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, 2004, Rights representing 33,168 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 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 combination of shares of Common Stock and cash. Units awarded, but which the recipients are not entitled to receive, will be cancelled.

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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.

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.

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.

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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.

The above description of tax consequences under federal law is necessarily general in nature and does not purport to be complete. Moreover, statutory provisions are subject to change, as are their interpretations, and their application may vary in individual circumstances. Finally, the consequences under applicable state and local income tax laws may not be the same as under the federal income tax laws.

Grants and Awards Made During the Fiscal Year Ended December 31, 2004. The table below shows the number and value of options of the Company's named executive officers at the end of fiscal year 2004.

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

Name	Shares Acquired on Exercise (#)	Value Realized (\$)	Number of Securities Underlying Unexercised Options/SARs at Fiscal Year End ^{1, 2}		Value of Unexercised In-the-Money Options/SARs at Fiscal Year End ³	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Tony W. Wolfe	0	\$0	36,560/0	3,668/0	\$597,996.94/\$0	\$59,976.01/\$0
Joseph F. Beaman, Jr.	0	\$0	19,476/0	1,467/0	\$318,555.08/\$0	\$24,007.68/\$0
Lance A. Sellers	0	\$0	18,280/0	2,568/0	\$298,998.47/\$0	\$41,999.04/\$0
	0	\$0	8,951/0	2,200/0	\$79,264.12/\$0	\$19,480.00/\$0

A. Joseph
Lampron

William D. Cable 0 \$0 12,045/0 2,200/0 \$197,041.41/\$0 \$35,980.93/\$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 Messr. 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 Messr. 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 will vest 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.

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³The 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 \$13.37. The exercise price of stock options granted to all named persons on December 17, 2002 is \$12.82. On December 31, 2004, the closing market price for the Common Stock as reported on the Nasdaq National Market was \$17.52.

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, 2004. 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 2004 contribution to the 401(k) Plan pursuant to this formula was approximately \$363,000. 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 2004. All outstanding loans, extensions of credit or overdrafts, endorsements and guarantees outstanding at any time during 2004 (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 lease 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 \$15,608.33 during 2004, resulting in total annual lease payments for these facilities of \$187,299.96. 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 Banking 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 2004 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. Abernethy	John W. Lineberger, Jr.
Larry E. Robinson	James S. Abernethy
William G. Terry	Dan Ray Timmerman, Sr.
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, 2004.

Robert C. Abernethy	Douglas S. Howard
Charles F. Murray	Billy L. Price, Jr., M.D.
Larry E. Robinson	Dan Ray Timmerman, Sr.
Fred L. Sherrill, Jr.	Benjamin I. Zachary
Gary E. Matthews	

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, 2004.

COMPARISON OF SIX-YEAR CUMULATIVE TOTAL RETURNS

Performance Report for
Peoples Bancorp of North Carolina, Inc.

Index	Period Ending					
	12/31/99	12/31/00	12/31/01	12/31/02	12/31/03	12/31/04
Peoples Bancorp of North Carolina, Inc.	100.00	103.87	113.32	114.67	156.57	163.45
NASDAQ - Total US*	100.00	60.82	48.16	33.11	49.93	54.49
SNL Southeast Bank Index	100.00	100.41	125.09	138.18	173.52	205.78

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

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SNL Financial
LC
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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, 2005. 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 2004 and 2003, and (ii) review of the financial statements included in the Company’s quarterly filings on Form 10-Q during those fiscal years were approximately \$125,000 and \$120,000, respectively.

Audit Related Fees

The aggregate fees billed by PKM in 2004 and 2003 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 \$21,000 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 \$18,000 and \$15,000 in 2004 and 2003, respectively. These fees were primarily related to the preparation of the Company’s income tax returns and Forms 5500 for various benefit plans.

All Other Fees

In addition to the fees outlined above, PKM billed fees in the amounts of approximately \$0 and \$2,000 in fiscal years 2004 and 2003, respectively, for additional services rendered during each of those years. These fees were primarily related to collateral verification testing and consultation on various accounting matters.

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 2004, one hundred percent (100%) of the total fees paid for audit, audit related, tax and other non-audit services were pre-approved. For 2003, one hundred percent (100%) of the fees for audit services were pre-approved; ninety percent (90%) of the total fees for audit related, tax and other non-audit services 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, 2005.

DATE FOR RECEIPT OF SHAREHOLDER PROPOSALS

It is presently anticipated that the 2006 Annual Meeting of Shareholders of the Company will be held on May 4, 2006. In order for shareholder proposals to be included in the Company's proxy materials for that meeting, such proposals must be received by the Secretary of the Company at the Company's principal executive office no later than December 7, 2005 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 2006 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 21, 2006, of his or her proposal. If the Secretary of the Company is not notified of the shareholder's proposal by February 21, 2006, 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 2006 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, 2004, 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 6, 2005

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 16 offices located in Lincolnton, Newton, Denver, Catawba, Conover, Maiden, Claremont, Hiddenite, Hickory and Charlotte, North Carolina. At December 31, 2004, the Company had total assets of \$686.3 million, net loans of \$527.4 million, deposits of \$556.5 million, investment securities of \$105.6 million, and shareholders' equity of \$50.9 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, 2004, the Bank employed 209 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 2004 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

	2004	2003	2002	2001	2000
Summary of Operations					
Interest income	\$ 36,255	34,854	36,624	41,898	40,859
Interest expense	12,335	12,749	15,777	23,027	19,432
Net interest income	23,920	22,105	20,847	18,871	21,427
Provision for loan losses	3,256	6,744	5,432	3,545	1,879
Net interest income after provision for loan losses	20,664	15,361	15,415	15,326	19,548
Non-interest income	6,057	5,926	6,491	8,263	3,915
Non-interest expense	20,057	18,228	16,758	16,752	15,509
Income before taxes	6,664	3,059	5,148	6,837	7,954
Income taxes	2,233	1,055	1,712	2,262	2,576
Net income	\$ 4,431	2,004	3,436	4,575	5,378
Selected Year-End Balances					
Assets	\$ 686,348	674,032	645,638	619,505	519,002
Available for sale securities	105,598	79,460	71,736	84,286	71,565
Loans, net	527,419	542,404	519,122	484,517	406,226
Mortgage loans held for sale	3,783	587	5,065	5,339	1,564
Interest-earning assets	652,678	639,501	608,619	586,496	490,449
Deposits	556,522	549,802	515,739	490,223	450,073
Interest-bearing liabilities	553,135	550,357	527,525	516,422	420,594
Shareholders' equity	\$ 50,938	48,554	48,605	45,401	43,039
Shares outstanding*	3,448,581	3,448,722	3,446,902	3,540,585	3,540,585
Selected Average Balances					
Assets	\$ 684,384	660,644	624,796	575,142	469,536
Available for sale securities	93,770	72,072	77,414	84,549	66,218
Loans	547,753	539,559	507,879	454,371	374,226
Interest-earning assets	650,095	625,764	592,947	545,945	447,645
Deposits	558,141	533,704	499,224	481,289	408,210
Interest-bearing liabilities	553,880	540,676	516,747	472,868	373,167
Shareholders' equity	\$ 51,978	49,914	48,257	47,432	42,852
Shares outstanding*	3,459,379	3,447,056	3,467,173	3,540,585	3,540,585
Profitability Ratios					
Return on average total assets	0.65%	0.30%	0.55%	0.80%	1.15%
Return on average shareholders' equity	8.52%	4.01%	7.12%	9.65%	12.55%
Dividend payout ratio	28.37%	62.56%	36.58%	28.14%	23.39%

**Liquidity and Capital Ratios
(averages)**

Loan to deposit	98.14%	101.10%	101.73%	94.41%	91.67%
Shareholders' equity to total assets	7.59%	7.56%	7.72%	8.25%	9.13%

Per share of common stock*

Basic net income	\$	1.28	0.58	0.99	1.29	1.52
Diluted net income	\$	1.26	0.58	0.99	1.29	1.52
Cash dividends	\$	0.36	0.36	0.36	0.36	0.32
Book value	\$	14.77	14.08	14.10	12.83	11.05

*Shares outstanding and per share computations have been retroactively restated to reflect a 10% stock dividend during first quarter 2005 and a 10% stock dividend during second quarter 2000.

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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, 2004, 2003 and 2002. 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 and Mecklenburg 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 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.

With the general slowdown in the economy that began in 2000, the Federal Reserve provided a stimulus through a series of interest rate reductions that lowered the prime rate from 9.50% in January 2001 to 4.00% in June 2003. These reductions in prime rate negatively impacted the Company's net interest margin and net interest spread in 2002 and 2003, which resulted in lower net interest income for the Company. The Company's asset growth has been slower as a

result of heavy refinancing as customers have taken advantage of these attractive interest rates. The fee income associated with the heavy refinancing volume replaced some of the lost net interest income. The Company utilized interest rate swaps to convert some variable rate loans to fixed rate in order to offset some of the reduced earnings because of the decreases in the prime rate.

Between June and December 31, 2004, the Federal Reserve increased the federal funds rate a total of 1.25%, with the rate set at 2.25% as of December 31, 2004. These increases had a positive impact on 2004 earnings and should continue to have a positive impact on the Bank's net interest income in the future periods.

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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 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 2005 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 5, 2005 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 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 January 2003, the Financial Accounting Standards Board (“FASB”) issued FASB Interpretation No. 46, “Consolidation of Variable Interest Entities - An Interpretation of Accounting Research Bulletin No. 51” (“FIN 46”). In December 2003, the FASB issued a revised version of FIN 46 to resolve certain questions and confusion related to the application of the original FIN 46. The Company adopted FIN 46 (Revised) as of December 31, 2003, and as a result, the Company’s wholly owned subsidiary, PEBK Capital Trust I, is no longer included in these consolidated financial statements. The consolidated financial statements have been restated for all periods presented to reflect this change in accounting, and the adoption of FIN 46 (Revised) had no impact on the Company’s reported results of operations or shareholders’ equity.

In January 2004, the FASB issued as tentative guidance, Derivatives Implementation Group Issue G25, “Cash Flow Hedges: Hedging the Variable Interest Payments on a Group of Prime-Rate-Based Interest-Bearing Loans.” Issue G25 provides guidance for entities wishing to hedge the variability in loan interest receipts that are tied to the prime rate and other issues associated with cash flow hedges. Issue G25 was revised and was cleared by the FASB in July 2004. The revised guidance does allow for hedging a pool of non-benchmark-rate assets or liabilities by entering into an interest rate swap whose floating leg is also based on the prime rate or another non-benchmark-rate. Therefore, management expects that the interest rate swaps hedging prime-rate based loans discussed in the section below entitled “Asset Liability and Interest Rate Risk Management” will continue to be treated as cash flow hedges and that the Company will not have to record changes in value as a component of current earnings nor terminate the swaps as long as the hedge is effective.

In November 2003, the Emerging Issues Task Force (“EITF”) of the Financial Accounting Standards Board (“FASB”) reached a consensus on EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.” EITF 03-1 provides guidance on determining other-than-temporary impairments and its application to marketable equity securities and debt securities accounted for under SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities.” In September 2004, the FASB issued FASB Staff Position (“FSP”) EITF Issue 03-1-1, which delayed the effective date for the measurement and recognition guidance contained in the EITF 03-1 pending finalization of the draft FSP EITF Issue 03-1-a, “Implementation Guidance for the Application of Paragraph 16 of EITF 03-1.” The disclosure requirements of EITF 03-1 remain in effect. The Company adopted the disclosure requirements of EITF 03-1 as of September 30, 2004. The adoption of the recognition and measurement provisions of EITF 03-1 are not expected to have a material impact on the Company’s results of operations, financial position or cash flows.

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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 June 15, 2005. The Company is still evaluating the transition provisions allowed by SFAS No. 123 (R) and expects to adopt in the third quarter of 2005. The financial statement impact is not expected to be materially different from that shown in the existing pro forma disclosure required under the original SFAS No. 123.

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-49.

Results of Operations

Summary. The Company reported earnings of \$4.4 million in 2004, or \$1.41 basic net earnings per share and \$1.39 diluted net earnings per share, a 121% increase as compared to \$2.0 million, or \$0.64 basic net earnings per share and \$0.63 diluted net earnings per share, for 2003. Net earnings from recurring operations for 2004 were \$4.6 million, or \$1.46 basic net earnings per share and \$1.44 diluted net earnings per share, representing a 106% increase over net earnings from recurring operations of \$2.2 million, or \$0.71 basic and diluted net earnings per share in 2003. Net non-recurring losses on disposition of assets in 2004 amounted to \$248,000. This is a reduction from net non-recurring losses on disposition of assets for the year ended December 31, 2003, which amounted to \$355,000 and were comprised of a \$747,000 net loss on repossessed assets and a \$53,000 loss on sale of securities, which was partially offset by a \$479,000 gain associated with the sale of the Bank's \$3.7 million credit card portfolio during 2003. The Company's increase in recurring earnings for 2004 is 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.

Net earnings for 2003 represented a decrease of 42% as compared to 2002 net earnings of \$3.4 million. Net earnings from recurring operations for 2003 decreased 26% when compared to \$3.0 million, or \$0.96 basic net earnings per share and \$0.95 diluted net earnings per share for 2002. Net earnings for 2002 included non-recurring gains on the sale of securities of \$626,000. The decline in 2003 year-to-date recurring earnings was primarily attributable to an increase in the provision for loan losses and an increase in non-interest expense.

The annualized return on average assets in 2004 was 0.65%, compared to 0.30% in 2003 and 0.55% in 2002. Excluding non-recurring gains and losses on disposition of assets, the annualized return on average assets was 0.67%, 0.34% and 0.48% in 2004, 2003 and 2002, respectively. Annualized return on average shareholders' equity was 8.52% in 2004 compared to 4.01% in 2003 and 7.12% in 2002. Excluding non-recurring gains and losses on disposition of assets, the annualized return on average shareholders' equity was 8.81%, 4.46% and 6.30% in 2004, 2003 and 2002, respectively.

Net Interest Income. Net interest income, the major component of the Company's net income, is the amount by which interest and fees are 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 \$23.9 million for 2004, or 8% over net interest income of \$22.1 million in 2003. The increase was attributable to an increase in interest income due to an increase in the prime rate, as well as an increase in the average outstanding balance of available for sale securities and loans combined with a reduction in interest expense resulting from a decrease in the cost of funds. Net interest income increased 6% in 2003 from \$20.8 million in 2002.

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, 2004, 2003 and 2002. 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, 2004			December 31, 2003			December 31, 2002		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
Interest-earning assets:									
Loans	\$ 547,753	29,826	5.45%	539,559	28,700	5.32%	507,879	30,256	5.96%
Interest rate swap agreements	-	1,056	2.21%	-	1,522	3.22%	-	509	1.16%
Loan fees	-	1,371	0.29%	-	1,310	0.28%	-	1,274	0.29%
Total loans	547,753	32,252	5.89%	539,559	31,532	5.84%	507,879	32,039	6.31%
Investments - taxable	35,920	1,545	4.30%	49,082	2,186	4.45%	63,792	3,726	5.84%
Investments - nontaxable*	57,850	2,741	4.74%	22,990	1,228	5.34%	13,622	929	6.82%
Federal funds sold	3,363	35	1.05%	5,981	58	0.98%	3,356	45	1.34%
Other	5,209	141	2.70%	8,152	174	2.14%	4,298	201	4.68%
Total interest-earning assets	650,095	36,714	5.65%	625,764	35,178	5.62%	592,947	36,940	6.23%
Cash and due from banks	13,058			12,587			11,351		
Other assets	30,601			31,008			27,536		
Allowance for loan losses	(9,369)			(8,282)			(6,607)		
Total assets	\$ 684,384			661,077			625,227		
Interest-bearing liabilities:									
NOW accounts	\$ 106,832	1,292	1.21%	75,757	688	0.91%	60,757	628	1.03%
Regular savings accounts	21,845	72	0.33%	21,131	75	0.35%	21,908	95	0.44%
Money market accounts	51,069	535	1.05%	58,134	556	0.96%	72,170	1,282	1.78%
Time deposits	300,175	7,145	2.38%	310,991	8,157	2.62%	285,133	10,358	3.63%
FHLB borrowings	58,656	2,603	4.44%	59,305	2,597	4.38%	60,956	2,659	4.36%
Demand notes payable to U.S. Treasury	678	8	1.14%	710	7	0.99%	811	12	1.46%
Trust preferred securities	14,433	677	4.69%	14,433	668	4.62%	14,433	735	5.09%
Other	192	3	1.46%	215	1	0.47%	579	8	1.38%
Total interest-bearing liabilities	553,880	12,335	2.23%	540,676	12,749	2.36%	516,747	15,777	3.05%
Demand deposits	78,221			67,690			59,256		
Other liabilities	2,137			2,800			2,326		
Shareholders' equity	51,978			49,971			48,257		
Total liabilities and shareholder's equity	\$ 686,216			661,137			626,586		
Net interest spread		\$ 24,379	3.42%		22,430	3.26%		21,163	3.18%
Net yield on interest-earning assets			3.75%			3.58%			3.57%
Taxable equivalent adjustment									
Investment securities		\$ 459			324			316	

Net interest income	\$ 23,920	22,106	20,847
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*Includes \$40.4 million of U.S. government agency securities that are non-taxable for state income tax purposes. An effective tax rate of 6.90% was used to calculate the tax equivalent yield on these securities.

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

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

(Dollars in Thousands)	December 31, 2004			December 31, 2003		
	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	\$ 480	241	721	1,925	(2,432)	(507)
Investments - taxable	(575)	(66)	(641)	(757)	(783)	(1,540)
Investments - nontaxable	1,756	(243)	1,513	570	(271)	299
Federal funds sold	(26)	3	(23)	30	(17)	13
Other	(73)	40	(33)	34	(61)	(27)
Total interest income	\$ 1,562	(25)	1,537	1,802	(3,564)	(1,762)
Interest expense:						
NOW accounts	\$ 329	275	604	146	(86)	60
Regular savings accounts	2	(5)	(3)	(3)	(17)	(20)
Money market accounts	(71)	50	(21)	(192)	(534)	(726)
Time deposits	(271)	(741)	(1,012)	809	(3,010)	(2,201)
FHLB borrowings	(28)	34	6	(72)	10	(62)
Demand notes payable to U.S. Treasury	-	1	1	(1)	(4)	(5)
Junior subordinated debentures	-	9	9	-	(67)	(67)
Other	-	2	2	(3)	(4)	(7)
Total interest expense	\$ (39)	(375)	(414)	684	(3,712)	(3,028)
Net interest income	\$ 1,601	350	1,951	1,118	147	1,266

Net interest income on a tax equivalent basis totaled \$24.4 million in 2004, increasing 9% or \$2.0 million from 2003. This increase was primarily attributable to an increase in the yield on interest-earning assets combined with a decrease 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 3.42% in 2004, an increase from the 2003 net interest spread of 3.26%. The net yield on interest-earning assets in 2004 increased to 3.75% from the 2003 net interest margin of 3.58%.

Tax equivalent interest income increased \$1.5 million or 4% in 2004 primarily due to an increase in the Bank's prime lending rate from an average rate of 4.12% in 2003 to 4.34% in 2004. The increase in rates combined with a \$24.3 million increase in average interest-earning assets resulted in an increase in the yield on interest-earning assets to 5.65% in 2004 as compared to 5.62% in 2003. The \$24.3 million increase in average interest-earning assets was attributable primarily to a \$21.7 million increase in average investment securities. Average loans in 2004 increased 2% to \$547.8 million when compared to 2003. All other interest-earning assets including federal funds sold decreased to \$8.6 million in 2004 from \$14.1 million in 2003.

Interest expense decreased \$414,000 or 3% in 2004 due to a decrease in the average rate paid on interest-bearing liabilities, partially offset by an increase in volume of interest-bearing liabilities. The cost of funds decreased to 2.23% in 2004 from 2.36% in 2003. This decrease in the cost of funds was primarily attributable to a decrease in the average rate paid on certificates of deposit to 2.38% in 2004 from 2.62% in 2003. This decrease in cost was offset by growth in average interest-bearing liabilities, which increased by \$13.2 million to \$553.9 million in 2004 from \$540.7 million in 2003. This growth in average interest-bearing liabilities was attributable to an increase in average interest-bearing deposits, which increased by \$13.9 million, to \$479.9 million in 2004 from \$466.0 million in 2003.

In 2003 net interest income on a tax equivalent basis increased \$1.3 million or 6% to \$22.4 million in 2003 from \$21.2 million in 2002. The interest rate spread was 3.26% in 2003, an increase from the 2002 net interest spread of 3.18%. The net yield on interest-earning assets in 2003 increased to 3.58% from the 2002 net interest margin of 3.57%.

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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 \$3.3 million, \$6.7 million, and \$5.4 million for the years ended December 31, 2004, 2003 and 2002, respectively. The decrease in the provision for loan losses for 2004 reflects a decrease in classified loans of \$10.0 million. 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 2004 totaled \$6.1 million, an increase of \$132,000 or 2% from non-interest income of \$5.9 million for 2003. The increases in non-interest income for 2004 are primarily due to an increase in service charge fee income associated with deposit growth. These increases were partially offset by a decrease in mortgage banking income. Non-interest income for 2003 decreased \$565,000 or 9% from non-interest income of \$6.5 million for 2002. The decrease in non-interest income for 2003 reflected reductions in gains on sales of securities and increased losses on repossessed assets. These decreases were partially offset by an increase in service charges. Excluding non-recurring gains or losses on the disposition of assets, non-interest income for 2004 and 2003 totaled \$6.3 million. Non-interest income, excluding non-recurring gains or losses on the disposition of assets, increased 7% for 2003 when compared to 2002.

Service charges on deposit accounts totaled \$3.4 million during 2004, an increase of \$168,000, or 5% over 2003. Service charge income increased \$206,000, or 7% in 2003 compared to 2002. 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.

The Company reported a net loss on sale of securities of \$64,000 in 2004, compared to a net loss on sale of securities of \$53,000 during 2003. During 2002 a net gain on sale of securities of approximately \$626,000 was recognized.

Mortgage banking income decreased to \$394,000 in 2004 from \$685,000 in 2003. Management expects that mortgage banking income will continue to be less than prior periods due to a reduction in refinancing activity and expected interest rate increases. In 2004 and 2003 the Company recognized no gains on sale of mortgage loans as compared to a \$29,000 gain on sale of mortgage loans recognized during 2002. During 2003 mortgage banking income decreased \$17,000 from the \$702,000 reported in 2002. The decrease in mortgage banking income for 2003 was primarily attributable to a reduction in net gains recognized on the sale of mortgage loans.

Net losses on repossessed assets were \$180,000 for 2004 compared to net losses on repossessed assets of \$747,000 for 2003. During 2002 a net loss on repossessed assets of \$600 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 2004 and 2002.

Miscellaneous income for 2004 totaled \$1.4 million, an increase of 8% from \$1.3 million for 2003. The increase in miscellaneous income was primarily attributable to an increase in debit card fee income. During 2003, miscellaneous income increased 13% primarily due to an increase in vendor commissions.

Table 3 presents a summary of non-interest income for the years ended December 31, 2004, 2003 and 2002.

Table 3 - Non-Interest Income

(Dollars in Thousands)	2004	2003	2002
Service charges	\$ 3,435	3,267	3,061
Other service charges and fees	677	611	503
Gain (loss) on sale of securities	(64)	(53)	626
Mortgage banking income	394	685	702
Insurance and brokerage commissions	430	421	478
Loss on foreclosed and repossessed assets	(179)	(747)	(1)
Gain on sale of loans	-	479	-
Miscellaneous	1,365	1,263	1,122
Total non-interest income	\$ 6,058	5,926	6,491

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Non-Interest Expense. Total non-interest expense amounted to \$20.1 million for 2004, an increase of 10% from 2003. Non-interest expense for 2003 increased 9% to \$18.2 million from non-interest expense of \$16.8 million for 2002.

Salary and employee benefit expense was \$11.5 million in 2004, compared to \$10.1 million during 2003, an increase of \$1.4 million or 14%, following a \$531,000 or 6% increase in salary and employee benefit expense in 2003 over 2002. The 2004 increase in salary and employee benefits is due to normal salary increases, increased incentive expense and increased employee insurance costs. The increase during 2003 is attributable to normal salary increases and increased employee insurance costs.

The Company recorded occupancy expenses of \$3.7 million in 2004, compared to \$3.4 million during 2003, an increase of \$282,000 or 8%, following an increase of \$247,000 or 8% in occupancy expenses in 2003 over 2002. The increase in 2004 is primarily due 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. Increases in 2003 are attributable to an increase in overhead expense associated with the Bank's growth and expansion of its branch network. 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 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. Approximately \$22,000 and \$18,000 of the deferred gain was recognized for the years ended December 31, 2004 and 2003, respectively. Annual rent expense related to these two locations is \$237,000.

The total of all other operating expenses increased \$170,000 or 4% during 2004. Other operating expense increased \$692,000 or 17% in 2003 over 2002. The increase in other expense for 2003 is primarily attributable an increase of \$440,000 in consulting and advertising expense due to an aggressive marketing campaign started by the Bank in 2003 and an increase of \$403,000 in non-income taxes primarily due to state franchise taxes.

Table 4 presents a summary of non-interest expense for the years ended December 31, 2004, 2003 and 2002.

Table 4 - Non-Interest Expense

(Dollars in Thousands)	2004	2003	2002
Salaries and wages	\$ 8,240	7,733	7,376
Employee benefits	3,237	2,367	2,193
Total personnel expense	11,477	10,100	9,569
Occupancy expense	3,672	3,390	3,143
Office supplies	314	270	283
FDIC deposit insurance	81	82	157
Professional services	290	333	264
Postage	211	217	221
Telephone	337	333	315
Director fees and expense	351	234	352
Marketing and public relations	620	541	219
Merchant processing expense	-	-	78
Consulting fees	306	280	160
Taxes and licenses	200	443	40
Other operating expense	2,198	2,005	1,957
Total non-interest expense	\$ 20,057	18,228	16,758

Income Taxes. Total income tax expense was \$2.2 million in 2004 compared with \$1.1 million in 2003 and \$1.7 million in 2002. The primary reason for the increase in taxes for 2004 as compared to 2003 and 2002 was the increase in pretax income. The Company's effective tax rates were 33.51%, 34.50% and 33.26% in 2004, 2003 and 2002,

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, 2004 such unfunded commitments to extend credit were \$123.1 million, while commitments in the form of standby letters of credit totaled \$3.3 million.

The Company uses several sources to meet its liquidity requirements. The primary source is core deposits, which

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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, 2004, the Company's core deposits totaled \$402.2 million, or 72% 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, 2004, the Bank had a significant amount of deposits in amounts greater than \$100,000, including brokered deposits of \$39.4 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 \$59.0 million at December 31, 2004. The remaining availability at FHLB was \$41.7 million at December 31, 2004. 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, 2004.

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 34.82% at December 31, 2004, 26.83% at December 31, 2003 and 17.85% at December 31, 2002. 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 \$3.1 million during 2004. Net cash used in investing activities of \$14.2 million consisted primarily of securities purchased of \$48.7 million funded by sales, maturities and paydowns of investment securities of \$22.4 million. Net cash provided by financing activities amounted to \$7.1 million, consisting of a \$6.7 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, 2004.

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	\$ 422,746	14,944	9,009	446,699	88,769	\$ 535,468
Mortgage loans available for sale	3,783	-	-	3,783	-	3,783
Investment securities	-	2,076	-	2,076	103,522	105,598
Federal funds sold	1,723	-	-	1,723	-	1,723
Interest-bearing deposit accounts	1,729	-	-	1,729	-	1,729
Other interest-earning assets	-	-	-	-	4,377	4,377
Total interest-earning assets	\$ 429,981	17,020	9,009	456,010	196,668	\$ 652,678
Interest-bearing liabilities:						
NOW, savings, and money market deposits	\$ 193,918	-	-	193,918	-	\$ 193,918
Time deposits	59,182	57,023	105,738	221,943	62,637	284,580
Other short term borrowings	1,204	-	-	1,204	-	1,204
FHLB borrowings	7,000	-	5,000	12,000	47,000	59,000
Trust preferred securities	-	14,433	-	14,433	-	14,433
Total interest-bearing liabilities	\$ 261,304	71,456	110,738	443,498	109,637	\$ 553,135
Interest-sensitive gap	\$ 168,677	(54,436)	(101,729)	12,512	87,031	\$ 99,543
Cumulative interest-sensitive gap	\$ 168,677	114,241	12,512	12,512	99,543	
Interest-earning assets as a percentage of interest-bearing liabilities	164.55 %	23.82 %	8.14 %	102.82 %		

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. Average rate sensitive assets at December 31, 2004 totaled \$652.7 million, exceeding average rate sensitive liabilities of \$553.1 million by \$99.6 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. These contracts consist of interest rate swap agreements under which the Company converted \$55.0 million of variable rate loans to a fixed rate. At December 31, 2004, the Company had two interest rate swap contracts outstanding. These swaps are accounted for as cash flow hedges. Under the first swap agreement, the Company receives a fixed rate of 5.22% and pays a variable rate based on the current prime rate (5.25% at December 31, 2004) on a notional amount of \$25.0 million. The swap agreement matures in April 2006. Under the second swap agreement, the Company receives a rate of 5.41% and pays a variable rate based on the current prime rate (5.25% at December 31, 2004) on a notional amount of \$30.0 million. The swap agreement matures in September 2006. Management believes that the risk associated with using this type of derivative financial instrument to mitigate interest rate risk should not have any material unintended impact on the Company's financial condition or results of operations.

During 2003, the Company settled two previously outstanding interest rate swap agreements. The first swap, with a notional amount of \$40.0 million and scheduled to mature in June 2004 was sold for a gain of \$860,000. The second swap with a notional amount of \$20.0 million and scheduled to mature in July 2004 was sold for a gain of \$394,000. The

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gains realized upon settlement are being recognized over the original term of the agreements and during the year ended December 31, 2004, gains of approximately \$553,000 were realized. For the year ended December 31, 2003, gains of approximately \$701,000 were realized.

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, 2004, there were \$3.6 million in loans that are tied to the prime rate and had interest rate floors in effect pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 0.43% higher than the indexed rate on the promissory notes without the interest rate floors.

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, 2004 the market value of AFS securities totaled \$105.6 million, compared to \$79.5 million and \$71.7 million at December 31, 2003 and 2002, respectively. The increase in 2004 investment securities is attributable to additional securities purchases, which were partially offset by paydowns on mortgage-backed securities and maturities during 2004. 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, 2004, 2003 and 2002.

Table 6 - Summary of Investment Portfolio

(Dollars in Thousands)	2004	2003	2002
Obligations of United States government agencies and corporations	\$ 46,570	34,517	-
Obligations of states and political subdivisions	20,649	14,950	14,350
Mortgage backed securities	36,543	24,920	52,386
Trust preferred securities	1,750	5,000	5,000
Equity securities	86	73	-
Total securities	\$ 105,598	79,460	71,736

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 \$93.8 million in 2004, \$72.1 million in 2003 and \$77.4 million in 2002. Table 7 presents the amortized cost of AFS securities held by the Company by maturity category at December 31, 2004. 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	\$ -	-	21,500	3.48%	24,999	4.47%	-	-	\$ 46,499	4.01%
States and political subdivisions	981	7.07%	4,687	6.06%	10,620	4.46%	3,924	7.08%	20,212	5.47%
Mortgage backed securities	-	-	-	-	14,998	3.93%	21,495	4.37%	36,493	4.19%
Trust preferred securities	-	-	-	-	-	-	1,750	5.50%	1,750	5.50%
Equity securities	-	-	-	-	-	-	100	1.58%	100	1.58%
Total securities	\$ 981	7.07%	26,187	3.94%	50,617	4.31%	27,269	4.82%	\$ 105,054	4.38%

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:	2004		2003		2002		2001		2000	
	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans
Commercial	\$ 79,189	14.79%	90,558	16.41%	92,141	17.51%	102,409	20.87%	96,882	23.58%
	312,988	58.45%	332,730	60.26%	322,987	61.36%	277,737	56.61%	229,260	55.79%

Real estate - mortgage										
Real estate - construction	127,042	23.73%	110,392	19.99%	80,552	15.30%	82,791	16.88%	58,939	14.34%
Consumer	16,249	3.03%	18,446	3.34%	30,690	5.83%	27,671	5.64%	25,858	6.29%
Total loans	\$ 535,468	100.00%	552,126	100.00%	526,370	100.00%	490,608	100.00%	410,939	100.00%
Less:										
Allowance for loan losses	\$ 8,049		9,722		7,248		6,091		4,713	
Net loans	\$ 527,419		542,404		519,122		484,517		406,226	

As of December 31, 2004, gross loans outstanding were \$535.5 million, a decrease of \$16.7 million or 3% from the December 31, 2003 balance of \$552.1 million. Commercial loans declined \$11.3 million in 2004 primarily due to payoffs of several large commercial loans. Real estate mortgage loans decreased \$19.7 million when compared to 2003 due to a decrease in commercial real estate loans. Real estate construction loans grew \$16.7 million in 2004 as a result of an increase in real estate development loans. Consumer loans decreased \$2.2 million in 2004.

Mortgage loans held for sale were \$3.8 million at December 31, 2004, an increase of \$3.2 million from the December 31, 2003 balance of \$587,000 which represented a decrease of \$4.5 million from the December 31, 2002 balance of \$5.1 million.

Table 9 identifies the maturities of all loans as of December 31, 2004 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	\$ 73,727	4,249	1,213	\$ 79,189
Real estate - mortgage	246,341	34,265	32,382	312,988
Real estate - construction	119,732	6,962	348	127,042
Consumer	6,899	8,351	999	16,249
Total loans	\$ 446,699	53,827	34,942	\$ 535,468
Total fixed rate loans	\$ 13,514	53,040	34,942	\$ 101,496
Total floating rate loans	433,185	787	-	433,972
Total loans	\$ 446,699	53,827	34,942	\$ 535,468

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, 2004, outstanding loan commitments totaled \$123.1 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, 2004 and 2003, the recorded investment in loans that were considered to be impaired under SFAS No. 114 was approximately \$5.3 million and \$4.6 million, respectively, with related allowance for

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loan losses of \$787,000 and \$1.5 million, 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.

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, 2004, approximately 6% 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 2004 were \$4.9 million. The ratio of net charge-offs to average total loans was 0.90% in 2004, 0.79% in 2003 and 0.84% in 2002. 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 \$8.0 million or 1.50% of total loans outstanding at December 31, 2004. This decrease in the allowance for loan losses was the result of a reduction in classified loans. For December 31, 2003 and 2002, the allowance for loan losses amounted to \$9.7 million, or 1.76% of total loans outstanding and \$7.2 million, or 1.38% 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, 2004 and 2003.

Table 10 - Loan Risk Grade Analysis

Risk Grade	Percentage of Loans By Risk Grade		General Reserve Percentage	
	2004	2003	2004	2003
Risk 1 (Excellent Quality)	13.44%	11.36%	0.15%	0.15%
Risk 2 (High Quality)	23.03%	24.03%	0.50%	0.50%
Risk 3 (Good Quality)	53.89%	53.80%	1.00%	1.00%
Risk 4 (Management Attention)	5.67%	5.11%	2.50%	2.50%
Risk 5 (Watch)	0.95%	1.15%	7.00%	7.00%
Risk 6 (Substandard)	0.61%	2.43%	12.00%	12.00%
Risk 7 (Low Substandard)	1.46%	1.33%	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, 2004, there was one relationship which exceeded \$1.0 million totaling \$1.2 million in the Watch risk grade, three relationships that exceeded \$1.0 million each totaling \$4.1 million in the Substandard risk grade and three relationships which exceed \$1.0 million each totaling \$8.7 million in the Low Substandard risk grade. Balances of individual relationships exceeding \$1.0 million in these risk grades ranged from \$1.2 million to \$3.9 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)	2004				
		2003	2002	2001	2000
Reserve for loan losses at beginning	\$ 9,722	7,248	6,091	4,713	3,924
Loans charged off:					
Commercial	1,004	1,179	3,737	842	857
Real estate - mortgage	3,842	2,422	158	790	10
Real estate - construction	4	251	-	51	36
Consumer	535	630	546	675	255
Total loans charged off	5,385	4,482	4,441	2,358	1,158
Recoveries of losses previously charged off:					
Commercial	162	36	40	84	20
Real estate - mortgage	144	18	-	-	-
Real estate - construction	-	1	4	6	-
Consumer	150	157	122	101	48
Total recoveries	456	212	166	191	68
Net loans charged off	4,929	4,270	4,275	2,167	1,090
Provision for loan losses	3,256	6,744	5,432	3,545	1,879
Reserve for loan losses at end of year	\$ 8,049	9,722	7,248	6,091	4,713
Loans charged off net of recoveries, as a percent of average loans outstanding	0.90%	0.79%	0.84%	0.48%	0.29%

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 \$6.0 million at December 31, 2004 compared to \$6.3 million at December 31, 2003. Non-accrual loans were \$5.1 million at December 31, 2004, an increase of \$755,000 from non-accruals of \$4.3 million at December 31, 2003. As a percentage of loans outstanding, non-accrual loans were 0.95% and 0.79% at December 31, 2004 and 2003, respectively. The Bank had loans ninety days past due and still accruing at December 31, 2004 of \$245,000 as compared to \$271,000 for the same period in 2003. Other real estate owned totaled \$682,000 and \$1.4 million as of December 31, 2004 and 2003, respectively. Repossessed assets, primarily consisting of aircraft taken in collection of loans, totaled \$206,000 as of December 31, 2003. The Bank had no repossessed assets as of December 31, 2004.

At December 31, 2004 the Company had non-performing loans, defined as non-accrual and accruing loans past due more than 90 days, of \$5.3 million or 1.00% of total loans. Non-performing loans for 2003 were \$4.6 million, or 0.84% of total loans and \$4.8 million, or 0.92% of total loans for 2002. Interest that would have been recorded on non-accrual loans for the years ended December 31, 2004, 2003 and 2002, had they performed in accordance with

their original terms, amounted to approximately \$264,000, \$400,000 and \$484,000 respectively. Interest income on impaired loans included in the results of operations for 2004, 2003, and 2002 amounted to approximately \$130,000, \$82,000 and \$22,000, 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

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against current income. Generally a loan is placed on non-accrual status when it is over 90 days past due and there is reasonable doubt that all principal will be collected.

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

Table 12 - Non-performing Assets

(Dollars in Thousands)	2004	2003	2002	2001	2000
Non-accrual loans	\$ 5,097	4,343	4,602	3,756	5,421
Loans 90 days or more past due and still accruing	245	271	239	655	545
Total non-performing loans	5,342	4,614	4,841	4,411	5,966
All other real estate owned	682	1,447	240	256	112
All other repossessed assets	-	206	1,538	4	3
Total non-performing assets	\$ 6,024	6,267	6,619	4,671	6,081
As a percent of total loans at year end					
Non-accrual loans	0.95%	0.79%	0.87%	0.77%	1.32%
Loans 90 days or more past due and still accruing	0.05%	0.05%	0.05%	0.13%	0.13%
Total non-performing assets	1.12%	1.14%	1.26%	0.95%	1.48%

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, 2004, total deposits were \$556.5 million, an increase of \$6.7 million or 1% increase over the December 31, 2003 balance of \$549.8 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 \$402.2 million at December 31, 2004 from \$378.2 million at December 31, 2003. The increase in core deposits resulted primarily from an increase in the Bank's Investment Checking product. The Company chose to price the Investment Checking product at a level which attracted new deposits but was more cost effective than brokered deposits.

Time deposits in amounts of \$100,000 or more totaled \$154.3 million at December 31, 2004, \$171.6 million and \$160.8 million at December 31, 2003 and 2002, respectively. This decrease is due to a reduction in brokered deposits that were replaced with core deposits. At December 31, 2004, brokered deposits amounted to \$39.4 million as compared to \$55.5 million at December 31, 2003. 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, 2004 have a weighted average rate of 2.38% with a weighted average original term of 23 months.

Table 13 is a summary of the maturity distribution of time deposits in amounts of \$100,000 or more as of December 31, 2004.

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

(Dollars in Thousands)	2004
Three months or less	\$ 52,243
Over three months through six months	19,933
Over six months through twelve months	31,784

Over twelve months	50,341
Total	\$ 154,301

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, 2004, FHLB borrowings totaled \$59.0 million compared to \$58.0 million at December 31, 2003 and \$63.1 million at December 31, 2002. Average FHLB borrowings for 2004 were \$58.7 million, compared to average balances of \$59.3 million for 2003 and \$61.0 million for 2002. The maximum amount of outstanding FHLB borrowings was \$70.7 million in 2004, and \$75.1 in 2003 and \$74.2 in 2002. The FHLB advances outstanding at December 31, 2004 had both fixed and adjustable interest rates ranging from 2.19% to 6.49%. Currently \$12.0 million of the FHLB advances outstanding have contractual maturities prior to December 31, 2005. As of December 31, 2004, the Company had \$52.0 million in convertible FHLB advances. Additional information regarding FHLB advances is provided in note 6 to the consolidated financial statements.

Demand notes payable to the U. S. Treasury, which represent treasury tax and loan payments received from

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customers, amounted to approximately \$1.2 million, \$443,000 and \$1.6 million at December 31, 2004, 2003 and 2002, respectively.

The Company had no federal funds purchased as of December 31, 2004, 2003 or 2002.

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, 2004, 2003 or 2002.

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, 2004 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*	\$ 10,000	-	-	47,000	\$ 57,000
Junior subordinated debentures	-	-	-	14,433	14,433
Operating lease obligations	811,653	1,324,960	1,316,550	4,826,917	8,280,080
Total	\$ 821,653	1,324,960	1,316,550	4,888,350	\$ 8,351,513
Other Commitments					
	\$ 48,441	12,070	15,354	47,229	\$ 123,094

Commitments to extend
credit

Standby letters of credit and financial guarantees written	3,144	134	-	-	3,278
Total	\$ 51,585	12,204	15,354	47,229	\$ 126,372

*Excludes \$2.0 million adjustable rate credit due to the FHLB, which matured in February 2005.

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 liabilities recorded on the balance sheet under "Accrued interest payable and other liabilities" as of December 31, 2004 do not represent the amounts that may ultimately be paid under these contracts. Further discussions of derivative instruments are

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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, 2004 was \$50.9 million compared to \$48.6 million at December 31, 2003 and 2002. At December 31, 2004, unrealized gains and losses, net of taxes, amounted to a loss of \$121,000. For the years ended December 31, 2003 and 2002, unrealized gains and losses, net of taxes, amounted to gains of \$588,000 and \$1.4 million, respectively. Average shareholders' equity as a percentage of total average assets is one measure used to determine capital strength. Average shareholders' equity as a percentage of total average assets was 7.59%, 7.56% and 7.72% for 2004, 2003 and 2002. The return on average shareholders' equity was 8.52% at December 31, 2004 as compared to 4.01% and 7.12% as of December 31, 2003 and December 31, 2002, respectively. Total cash dividends paid during 2004, 2003 and 2002 amounted to \$1.3 million.

In 2004, the Company repurchased \$291,000, or 15,100 shares of its common stock as part of the stock repurchase plan implemented in November 2004, which expires in November 2005. The Company repurchased \$1.3 million, or 85,500 shares of its common stock in 2002 as part of the stock repurchase plan implemented in February 2002, which expired in February 2003.

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, 2004, 2003 and 2002 includes \$14.0 million in trust preferred securities. The Company's Tier I capital ratio was 10.97%, 10.50% and 10.76% at December 31, 2004, 2003 and 2002, 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 12.22%, 11.75% and 12.01% at December 31, 2004, 2003 and 2002, respectively. In addition to the Tier I 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 I leverage capital ratio was 9.50%, 9.37% and 9.78% at December 31, 2004, 2003 and 2002, respectively.

The Bank's Tier 1 risk-based capital ratio was 10.35%, 9.87% and 10.48% at December 31, 2004, 2003 and 2002, respectively. The total risk-based capital ratio for the Bank was 11.60%, 11.13% and 11.73% at December 31, 2004, 2003 and December 31, 2002, respectively. The Bank's Tier 1 leverage capital ratio was 8.95%, 8.80% and 9.52% at December 31, 2004, 2003 and 2002 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, 2004, 2003 and 2002.

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.

The Company's key equity ratios as of December 31, 2004, 2003 and 2002 are presented in Table 15.

Table 15 - Equity Ratios

	2004	2003	2002
Return on average assets	0.65%	0.30%	0.55%

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Return on average equity	8.52%	4.01%	7.12%
Dividend payout ratio	28.37%	62.56%	36.58%
Average equity to average assets	7.59%	7.56%	7.72%

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Quarterly Financial Data. The Company's consolidated quarterly operating results for the years ended December 31, 2004 and 2003 are presented in table 16.

**Table 16 -
Quarterly Financial
Data**

(Dollars in thousands, except per share amounts)	2004				2003			
	First	Second	Third	Fourth	First	Second	Third	Fourth
Total interest income	\$ 8,928	8,841	9,125	9,361	\$ 8,694	8,651	8,610	8,899
Total interest expense	3,066	3,002	3,103	3,164	3,238	3,216	3,193	3,101
Net interest income	5,862	5,839	6,022	6,197	5,456	5,435	5,417	5,798
Provision for loan losses	859	868	931	598	793	2,277	1,560	2,114
Other income	1,508	1,536	1,559	1,455	1,984	1,056	1,590	1,295
Other expense	4,720	4,873	4,990	5,474	4,447	4,175	4,821	4,785
Income before income taxes	1,791	1,634	1,660	1,580	2,200	39	626	194
Income taxes	613	547	552	522	782	(52)	307	18
Net earnings	\$ 1,178	1,087	1,108	1,058	\$ 1,418	91	319	176
Basic earnings per share	\$ 0.38	0.35	0.35	0.34	\$ 0.45	0.03	0.10	0.06
Diluted earnings per share	\$ 0.37	0.34	0.35	0.33	\$ 0.45	0.03	0.10	0.06

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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, 2004, 2003 and 2002, 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, 2004. 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, 2004. As of December 31, 2004, 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, 2008						Fair Value
	2005	2006	2007	2009	Thereafter	Total	
Loans Receivable							
Fixed rate	\$ 21,608	14,883	13,375	24,393	27,237	\$ 101,496	\$ 99,895
Average interest rate	6.78%	7.09%	7.08%	6.51%	6.44%		
Variable rate	\$ 164,485	58,032	47,387	69,035	95,033	\$ 433,972	\$ 433,972
Average interest rate	6.04%	5.97%	6.03%	6.11%	5.89%		
						\$ 535,468	\$ 533,867
Investment Securities							
Interest-bearing cash	\$ -	-	-	-	1,729	\$ 1,729	\$ 1,729
Average interest rate	-	-	-	-	2.13%		
Federal funds sold	\$ 1,723	-	-	-	-	\$ 1,723	\$ 1,723
Average interest rate	2.09%	-	-	-	-		
Securities available for sale	\$ 23,132	2,433	1,633	28,948	49,452	\$ 105,598	\$ 105,598
Average interest rate	4.64%	3.40%	6.15%	3.18%	4.48%		
Nonmarketable equity securities	\$ -	-	-	-	4,377	\$ 4,377	\$ 4,377
Average interest rate	-	-	-	-	3.42%		
Debt Obligations							
Deposits	\$ 192,910	37,496	43,025	13,782	269,309	\$ 556,522	\$ 555,808

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Average interest rate		2.04%	2.73%	3.58%	3.57%	0.90%		
Advances from FHLB	\$	12,000	35,000	-	12,000	-	\$ 59,000	\$ 61,637
Average interest rate		4.22%	4.08%	-	6.04%	-		
Demand notes payable to U.S. Treasury	\$	1,184	-	-	-	-	\$ 1,184	\$ 1,184
Average interest rate		2.19%	-	-	-	-		
Junior subordinated debentures	\$	-	-	-	-	14,433	\$ 14,433	\$ 14,433
Average interest rate		-	-	-	-	5.47%		

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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%	\$ 28,572	7.66%
+1%	\$ 27,591	3.96%
0%	\$ 26,540	0.00%
-1%	\$ 25,501	-3.91%
-2%	\$ 24,619	-7.24%

Hypothetical rate change (immediate shock)	Estimated Resulting Theoretical Market Value of Equity	
	Amount	% Change
+2%	\$ 48,415	-8.31%
+1%	\$ 51,097	-3.23%
0%	\$ 52,801	0.00%
-1%	\$ 52,629	-0.33%
-2%	\$ 51,181	-3.07%

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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., Sterne Agee & Leach, Inc. and Trident Securities, 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 11, 2005, the Company had 704 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 \$18.69 on March 11, 2005.

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
2004					
First Quarter	\$	17.42	\$	20.07	\$ 0.10
Second Quarter	\$	17.70	\$	19.74	\$ 0.10
Third Quarter	\$	18.19	\$	19.90	\$ 0.10
Fourth Quarter	\$	18.03	\$	20.00	\$ 0.10
					Cash Dividend Per Share
2003					
First Quarter	\$	13.91	\$	15.10	\$ 0.10
Second Quarter	\$	14.75	\$	18.25	\$ 0.10
Third Quarter	\$	16.38	\$	19.00	\$ 0.10

Fourth Quarter	\$	16.91	\$	20.82	\$	0.10
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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.

Charles F. Murray

President, Murray's Hatchery, 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)

Fred L. Sherrill, Jr.

Retired (furniture manufacturing executive)

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

General Manager, Treasurer, Secretary 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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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, 2004 and 2003, 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, 2004. 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 provided 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, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

/s/ Porter Keadle Moore, LLP

Atlanta, Georgia
January 13, 2005

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PEOPLES BANCORP OF NORTH CAROLINA, INC.

Consolidated Balance Sheets

December 31, 2004 and 2003

<u>Assets</u>	<u>2004</u>	<u>2003</u>
Cash and due from banks, including reserve requirements of \$4,643,000 and \$3,262,000	\$ 15,067,871	18,413,786
Federal funds sold	1,723,000	2,369,000
Cash and cash equivalents	16,790,871	20,782,786
Investment securities available for sale	105,598,106	79,460,452
Other investments	5,396,959	4,216,973
Total securities	110,995,065	83,677,425
Mortgage loans held for sale	3,783,175	587,495
Loans	535,467,733	552,126,189
Less allowance for loan losses	(8,048,627)	(9,722,267)
Net loans	527,419,106	542,403,922
Premises and equipment, net	12,742,730	12,537,230
Cash surrender value of life insurance	6,034,188	5,045,449
Accrued interest receivable and other assets	8,582,937	8,998,137
Total assets	\$ 686,348,072	674,032,444
<u>Liabilities and Shareholders' Equity</u>		
Deposits:		
Non interest-bearing demand	\$ 78,024,194	72,420,923
NOW, MMDA and savings	193,917,507	158,677,445
Time, \$100,000 or more	154,300,926	171,596,789
Other time	130,279,446	147,107,075
Total deposits	556,522,073	549,802,232
Demand notes payable to U.S. Treasury	1,184,392	443,384
FHLB borrowings	59,000,000	58,000,000
Junior subordinated debentures	14,433,000	14,433,000
Accrued interest payable and other liabilities	4,270,755	2,799,932
Total liabilities	635,410,220	625,478,548
Shareholders' equity:		
Preferred stock, no par value; authorized 5,000,000 shares; no shares issued and outstanding	-	-

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Common stock, no par value; authorized 20,000,000 shares; issued and outstanding 3,135,074 shares in 2004 and 3,135,202 shares in 2003	35,040,390	35,121,510
Retained earnings	16,018,206	12,844,524
Accumulated other comprehensive income	(120,744)	587,862
Total shareholders' equity	50,937,852	48,553,896
 Total liabilities and shareholders' equity	 \$ 686,348,072	 674,032,444

See accompanying notes to consolidated financial statements.

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PEOPLES BANCORP OF NORTH CAROLINA, INC.**Consolidated Statements of Earnings****For the Years Ended December 31, 2004, 2003 and 2002**

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Interest income:			
Interest and fees on loans	\$ 32,253,161	31,531,673	32,038,359
Interest on federal funds sold	35,236	58,384	45,271
Interest on investment securities:			
U.S. Government agencies	2,903,865	2,244,375	3,439,814
States and political subdivisions	660,227	577,339	613,219
Other	402,080	441,958	487,284
Total interest income	36,254,569	34,853,729	36,623,947
Interest expense:			
NOW, MMDA and savings deposits	1,899,249	1,318,820	2,006,077
Time deposits	7,145,486	8,157,388	10,358,168
FHLB borrowings	2,602,866	2,597,043	2,658,742
Junior subordinated debentures	676,547	667,526	735,000
Other	10,518	7,891	19,344
Total interest expense	12,334,666	12,748,668	15,777,331
Net interest income	23,919,903	22,105,061	20,846,616
Provision for loans losses	3,256,000	6,743,900	5,431,600
Net interest income after provision for loan losses	20,663,903	15,361,161	15,415,016
Other income:			
Service charges	3,434,544	3,266,949	3,060,581
Other service charges and fees	677,191	610,591	503,165
Gain (loss) on sale of securities	(63,688)	(52,855)	625,616
Mortgage banking income	394,456	685,343	702,290
Insurance and brokerage commissions	429,788	420,762	477,765
Gain (loss) on sale of repossessed assets	(179,886)	(746,543)	(564)
Gain on sale of loans	-	478,759	-
Miscellaneous	1,365,397	1,262,883	1,121,762
Total other income	6,057,802	5,925,889	6,490,615
Other expense:			
Salaries and employee benefits	11,477,495	10,099,811	9,569,016
Occupancy	3,672,051	3,389,857	3,142,712
Other	4,907,923	4,738,253	4,046,347
Total other expenses	20,057,469	18,227,921	16,758,075
Earnings before income taxes	6,664,236	3,059,129	5,147,556

Income taxes		2,233,300	1,055,538	1,712,000
Net earnings	\$	4,430,936	2,003,591	3,435,556
Basic earnings per share	\$	1.28	0.58	0.99
Diluted earnings per share	\$	1.26	0.58	0.99
Cash dividends per share	\$	0.36	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, 2004, 2003 and 2002**

	<u>Common Stock</u>		<u>Retained Earnings</u>	Accumulated Other	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>		<u>Comprehensive Income (Loss)</u>	
Balance, December 31, 2001	3,218,714	\$ 36,407,798	9,915,399	(922,094)	45,401,103
Cash dividends declared	-	-	(1,256,592)	-	(1,256,592)
Repurchase and retirement of common stock	(85,500)	(1,314,250)	-	-	(1,314,250)
Exercise of stock options	333	4,225	-	-	4,225
Net earnings	-	-	3,435,556	-	3,435,556
Change in accumulated other comprehensive income (loss), net of tax	-	-	-	2,334,691	2,334,691
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

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC.**Consolidated Statements of Comprehensive Income****For the Years Ended December 31, 2004, 2003 and 2002**

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Net earnings	\$ 4,430,936	2,003,591	3,435,556
Other comprehensive income (loss):			
Unrealized holding gains (losses) on securities available for sale arising during the year	30,988	(419,147)	2,951,843
Reclassification adjustment for gains (losses) on sales of securities available for sale included in net earnings	63,688	52,855	(625,616)
Unrealized holding gains (losses) on derivative financial instruments qualifying as cash flow hedges arising during the year	(702,000)	(284,000)	1,498,000
Reclassification adjustment for gains on derivative financial instruments qualifying as cash flow hedges included in net earnings	(553,375)	(700,626)	-
Total other comprehensive income (loss), before income taxes	(1,160,699)	(1,350,918)	3,824,227
Income tax expense (benefit) related to other comprehensive income:			
Unrealized holding gains (losses) on securities available for sale arising during the year	12,070	(163,258)	1,149,742
Reclassification adjustment for gains (losses) on sales of securities available for sale included in net earnings	24,806	20,587	(243,677)
Unrealized holding gains (losses) on derivative			

financial instruments qualifying as cash flow			
hedges arising during the year	(273,429)	(110,618)	583,471
Reclassification adjustment for gains on derivative			
financial instruments qualifying as cash flow			
hedges included in net earnings	(215,540)	(272,894)	-
Total income tax expense (benefit) related to			
other comprehensive income	(452,093)	(526,183)	1,489,536
Total other comprehensive income (loss), net of tax	(708,606)	(824,735)	2,334,691
Total comprehensive income	\$ 3,722,330	1,178,856	5,770,247

See accompanying notes to consolidate financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC.

Consolidated Statements of Cash Flows

For the Years Ended December 31, 2004, 2003 and 2002

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Cash flows from operating activities:	\$ 4,430,936	2,003,591	3,435,556
Net earnings			
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation, amortization and accretion	1,563,245	1,963,995	1,685,715
Provision for loan losses	3,256,000	6,743,900	5,431,600
Deferred income taxes	341,441	(1,526,062)	(318,921)
Loss (gain) on sale of investment securities	63,688	52,855	(625,616)
Recognition of gain on sale of derivative instruments	(553,375)	(700,626)	-
Gain on sale of loans	-	(478,759)	-
Amortization of deferred gain on sale of premises	(22,412)	-	-
Loss (gain) on sale of repossessed assets	15,412	262,840	(19,981)
Writedown of other real estate and repossessions	164,474	483,703	-
Change in:			
Mortgage loans held for sale	(3,195,680)	4,477,140	274,296
Cash surrender value of life insurance	(988,739)	(216,741)	(245,708)
Other assets	(3,442,472)	377,900	(595,240)
Other liabilities	1,470,823	(4,582)	178,282
Net cash provided by operating activities	3,103,341	13,439,154	9,199,983
Cash flows from investing activities:			
Purchases of investment securities available for sale	(48,667,610)	(55,439,455)	(48,339,951)
Proceeds from calls and maturities of investment securities available for sale	19,413,975	27,158,675	28,609,785
Proceeds from sales of investment securities available for sale	2,986,313	19,896,324	35,191,263
Purchases of other investments	(4,822,500)	(925,000)	(300,000)
Proceeds from sale of other investments	3,642,514	953,600	557,200
Net change in loans	12,578,820	(31,533,937)	(42,113,346)
Proceeds from sale of loans	-	4,207,206	-
Purchases of premises and equipment	(1,502,346)	(1,913,876)	(2,614,380)
Proceeds from sale of premises and equipment	-	-	412,289

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Proceeds from sale of repossessed assets	2,153,103	1,502,891	488,647
Proceeds from sale of derivative financial instruments	-	1,254,000	-
Net cash used by investing activities	(14,217,731)	(34,839,572)	(28,108,493)
Cash flows from financing activities:			
Net change in deposits	6,719,841	34,063,277	25,515,766
Net change in demand notes payable to U.S. Treasury	741,008	(1,156,616)	1,482,013
Proceeds from FHLB borrowings	95,850,000	46,650,000	68,100,000
Repayments of FHLB borrowings	(94,850,000)	(51,721,429)	(73,242,857)
Transaction costs associated with junior subordinated debentures	-	-	(105,450)
Proceeds from exercise of stock options	209,706	23,737	4,225
Common stock repurchased	(290,826)	-	(1,314,250)
Cash dividends paid	(1,257,254)	(1,253,430)	(1,256,592)
Net cash provided by financing activities	7,122,475	26,605,539	19,182,855
Net change in cash and cash equivalent	(3,991,915)	5,205,121	274,345
Cash and cash equivalents at beginning of period	20,782,786	15,577,665	15,303,320
Cash and cash equivalents at end of period	\$ 16,790,871	20,782,786	15,577,665

PEOPLES BANCORP OF NORTH CAROLINA, INC.**Consolidated Statements of Cash Flows, continued****For the Years ended December 31, 2004, 2003 and 2002**

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Supplemental disclosures of cash flow information:			
Cash paid during the year for:			
Interest	\$ 11,833,234	12,975,587	16,006,155
Income taxes	\$ 2,483,394	2,093,000	2,235,500
Noncash investing and financing activities:			
Change in unrealized gain (loss) on investment securities available for sale, net	\$ 57,800	(223,621)	2,334,691
Change in unrealized gain (loss) on derivative financial instruments, net	\$ (766,406)	(173,382)	-
Transfer of loans to other real estate and repossessions	\$ 1,362,138	3,382,633	2,077,057
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	-

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, 2004 and 2003, 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, 2004 and 2003, 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 of 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 nonaccrual 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 recognized new servicing assets of approximately \$37,600 during 2002 and amortized approximately \$88,000, \$338,000 and \$310,000 during 2004, 2003 and 2002, respectively. No new servicing assets were recognized during 2004 and 2003.

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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 \$22.6 million, \$29.7 million and \$56.7 million at December 31, 2004, 2003 and 2002, respectively.

The Company originates certain fixed rate mortgage loans and commits these loans for sale. The commitments to originate fixed rate mortgage loans and the commitments to sell these loans to a third party are both derivative contracts. These derivative contracts, which exactly and equally offset each other, are entered into simultaneously and therefore 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 which 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.

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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.

Accumulated Other Comprehensive Income

At December 31, 2004, accumulated other comprehensive income consisted of net unrealized gains on securities available for sale of \$332,000 and net unrealized losses on derivatives of \$453,000. At December 31, 2003, accumulated other comprehensive income (loss) consisted of net unrealized gains on securities available for sale of \$274,000, net unrealized losses on derivatives of \$24,000 and net deferred gains on the sale of derivative financial instruments of \$338,000.

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>2004</u>	<u>2003</u>	<u>2002</u>
Net earnings	As reported	\$	4,430,936	2,003,591	3,435,556
	Effect of grants, net of tax		(190,747)	-	(276,415)
	Effect of forfeitures, net of tax		8,603	-	42,982
	Proforma	\$	4,248,792	2,003,591	3,202,123
Basic earnings per share	As reported	\$	1.28	0.58	0.99
	Proforma	\$	1.23	0.58	0.92
Diluted earnings per share	As reported	\$	1.26	0.58	0.99
	Proforma	\$	1.21	0.58	0.92

The weighted average fair value of options at grant date in 2004 and 2002 was \$4.27 and \$6.60, respectively. 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 and 2002, respectively - dividend yield of 2.14% and 2.8%, respectively; risk free interest rate of 4.22% and 4.00%, respectively; expected volatility of 0.153 and 0.53, respectively; 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, 2002 net earnings per share equaled diluted earnings per share, as the potential common shares outstanding during the period had no effect on the computation.

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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, 2004, 2003 and 2002 are as follows:

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:	Net Earnings	Common Shares	Per Share 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

For the year ended December 31, 2002:	Net Earnings	Common Shares	Per Share Amount
Basic earnings per share	\$ 3,435,556	3,467,173	\$ 0.99
Effect of dilutive securities:			
Stock options	-	8,023	
Diluted earnings per share	\$ 3,435,556	3,475,196	\$ 0.99

At December 31, 2002 a total of 93,023 potential common shares related to stock options were not included in the computation of diluted earnings per share because they would have been antidilutive.

During first quarter 2005, the Company declared and distributed a 10% stock dividend to its shareholders. All previously reported per share amounts have been restated to reflect the stock dividend.

Recent Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board (“FASB”) issued FASB Interpretation No. 46, “Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51” (“FIN 46”). In December 2003, the FASB issued a revised version of FIN 46 to resolve certain questions and confusion related to the application of the original FIN 46. The Company adopted FIN 46 (Revised) as of December 31, 2003, and as a result, the Company’s wholly owned subsidiary, PEBK Capital Trust I, is no longer included in these consolidated financial statements. The consolidated financial statements have been restated for all periods presented to reflect this change in accounting, and the adoption of FIN 46 (Revised) had no impact on the Company’s reported results of operations or stockholders’ equity.

In January 2004, the FASB issued as tentative guidance, Derivatives Implementation Group Issue G25, “Cash Flow Hedges: Hedging the Variable Interest Payments on a Group of Prime-Rate-Based Interest-Bearing Loans.” Issue G25 provides guidance for entities wishing to hedge the variability in loan interest receipts that are tied to the prime rate and other issues associated with cash flow hedges. Issue G25 was revised and was cleared by the FASB in July 2004. The revised guidance does allow for hedging a pool of non-benchmark-rate assets or liabilities by entering into an interest rate swap whose floating leg is also based on the prime rate or another non-benchmark-rate. Therefore, management expects that the interest rate swaps hedging prime-rate based loans discussed in note 11 to the consolidated financial statements will continue to be treated as cash flow hedges and that the Company will not have to record changes in value as a component of current earnings nor terminate the swaps as long as the hedge is effective

In November 2003, the Emerging Issues Task Force (“EITF”) of the Financial Accounting Standards Board (“FASB”) reached a consensus on EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.” EITF 03-1 provides guidance on determining other-than-temporary impairments and its application to marketable equity securities and debt securities accounted for under SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities.” In September 2004, the FASB issued FASB Staff Position (“FSP”) EITF Issue 03-1-1 which delayed the effective date for the measurement and recognition guidance contained in the EITF 03-1 pending finalization of the draft FSP EITF Issue 03-1-a, “Implementation Guidance for the Application of

Paragraph 16 of EITF 03-1.” The disclosure requirements of EITF 03-1 remain in effect. The Company adopted the disclosure requirements of EITF 03-1 as of December 31, 2003. The adoption of the recognition and measurement provisions of EITF 03-1 are not expected to have a material impact on the Company’s results of operations, financial position or cash flows.

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 June 15, 2005. The Company is still evaluating the transition provisions allowed by SFAS No. 123 (R) and expects to adopt in the third quarter of 2005. The financial statement impact is not expected to be materially different from that shown in the existing pro forma disclosure required under the original SFAS No. 123.

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(2) Investment Securities

Investment securities available for sale at December 31, 2004 and 2003 are as follows:

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

	Amortized Cost	December 31, 2003		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Mortgage-backed securities	\$ 24,911,000	96,142	87,282	24,919,860
U.S. government agencies	34,545,774	107,847	136,375	34,517,246
State and political subdivisions	14,454,137	559,907	64,137	14,949,907
Trust preferred securities	5,000,000	-	-	5,000,000
Equity securities	99,995	-	26,556	73,439
Total	\$ 79,010,906	763,896	314,350	79,460,452

The current fair value and associated unrealized losses on investments in debt securities with unrealized losses at December 31, 2004 are summarized in the table below, with the length of time the individual securities have been in a continuous loss position.

	Less than 12 Months		December 31, 2004 12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized 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

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	Less than 12 Months		December 31, 2003 12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	\$ 11,510,389	87,282	-	-	11,510,389	87,282
U.S. government agencies	7,911,840	136,375	-	-	7,911,840	136,375
State and political subdivisions	2,267,965	64,137	-	-	2,267,965	64,137
Equity securities	73,439	26,556	-	-	73,439	26,556
Total	\$ 21,763,633	314,350	-	-	21,763,633	314,350

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At December 31, 2004, unrealized losses in the investment securities portfolio related to debt securities totaled \$347,827. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the December 31, 2004 tables above, 19 out of 67 securities issued by state and political subdivisions contained unrealized losses and 25 out of 51 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, 2004, 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	\$ 981,041	990,079
Due from one to five years	26,186,619	26,351,012
Due from five to ten years	35,619,670	35,725,854
Due after ten years	5,673,733	5,902,213
Mortgage-backed securities	36,492,826	36,543,199
Equity securities	99,995	85,749
Total	\$ 105,053,884	105,598,106

Proceeds from sales of securities available for sale during 2004, 2003 and 2002 were \$3.0 million, \$19.9 million and \$35.2 million, respectively. Gross gains of \$626,000 for 2002, along with gross losses of \$64,000 and \$53,000 for 2004 and 2003, respectively, were realized on those sales.

Securities with a carrying value of approximately \$23.7 million and \$20.1 million at December 31, 2004 and 2003, respectively, were pledged to secure public deposits and for other purposes as required by law.

(3) Loans

Major classifications of loans at December 31, 2004 and 2003 are summarized as follows:

	2004	2003
Commercial	\$ 79,189,073	90,557,643
Real estate - mortgage	312,988,293	332,729,979
Real estate - construction	127,041,980	110,392,005
Consumer	16,248,387	18,446,562
Total loans	535,467,733	552,126,189
Less allowance for loan losses	8,048,627	9,722,267
Total net loans	\$ 527,419,106	542,403,922

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 which is dependent upon the real estate market.

At December 31, 2004 and 2003, the recorded investment in loans that were considered to be impaired was approximately \$5.3 million and \$4.6 million, respectively, of which approximately \$5.1 million at December 31, 2004 and \$4.3 million at December 31, 2003 was on nonaccrual. In addition, the Company had approximately \$245,000 and \$271,000 in loans past due more than ninety days and still accruing interest at December 31, 2004 and 2003, respectively. The related allowance for loan losses on impaired loans was approximately \$787,000 and \$1.5 million at December 31, 2004 and 2003, respectively. The average recorded investment in impaired loans for

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the twelve months ended December 31, 2004 and 2003 was approximately \$5.3 million and \$7.7 million, respectively. For the years ended December 31, 2004, 2003 and 2002, the Company recognized approximately \$130,000, \$82,000 and \$22,000, respectively, of interest income on impaired loans.

Changes in the allowance for loan losses were as follows:

	2004	2003	2002
Balance at beginning of year	\$ 9,722,267	7,247,906	6,090,570
Amounts charged off	(5,385,199)	(4,481,548)	(4,441,007)
Recoveries on amounts previously charged off	455,559	212,009	166,743
Provision for loan losses	3,256,000	6,743,900	5,431,600
Balance at end of year	\$ 8,048,627	9,722,267	7,247,906

(4) Premises and Equipment

Major classifications of premises and equipment are summarized as follows:

	2004	2003
Land	\$ 2,170,514	1,915,954
Buildings and improvements	10,138,526	9,982,688
Furniture and equipment	11,679,698	10,618,908
Total premises and equipment	23,988,738	22,517,550
Less accumulated depreciation	11,246,008	9,980,320
Total net premises and equipment	\$ 12,742,730	12,537,230

Depreciation expense was approximately \$1.3 million for the years ended December 31, 2004, 2003 and 2002.

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, 2004 and 2003, the Company recognized approximately \$22,000 and \$18,000 of the deferred gain, respectively.

(5) Time Deposits

At December 31, 2004, the scheduled maturities of time deposits are as follows:

2005	\$ 221,940,040
2006	30,697,184
2007	18,161,287
2008	6,660,115
2009 and thereafter	7,121,746

Total	\$ 284,580,372
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At December 31, 2004 and 2003, the Company has approximately \$39.4 million and \$55.5 million, respectively, in time deposits purchased through third party brokers. The weighted average rate of brokered deposits as of December 31, 2004 was 2.38%.

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(6) Federal Home Loan Bank Advances

The Bank has advances from the Federal Home Loan Bank (“FHLB”) with monthly interest payments at various maturity dates and interest rates ranging from 2.19% to 6.49% at December 31, 2004. 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, 2004, the carrying value of loans pledged as collateral totaled approximately \$169.9 million.

Advances from the FHLB outstanding at December 31, 2004 consist of the following:

<u>Maturity Date</u>	<u>Call Date</u>	<u>Rate</u>	<u>Rate Type</u>	<u>Amount</u>
February 5, 2005	N/A	2.440%	Daily Rate	\$ 2,000,000
July 5, 2005	October 5, 2000 and every three months thereafter	6.160%	Convertible	5,000,000
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, 2005	N/A	2.190%	Adjustable	5,000,000
				\$59,000,000

The FHLB has the option to convert \$52.0 million of the total advances outstanding into three month LIBOR-based floating rate advances. If the FHLB elects to convert the advances, the Bank may terminate the transaction without payment of a prepayment fee.

The Bank is required to purchase and hold certain amounts of FHLB stock in order to obtain FHLB borrowings. No ready market exists for the FHLB stock, and it has no quoted market value. The stock is redeemable at \$100 per share subject to certain limitations set by the FHLB. At December 31, 2004 and 2003, the Bank owned FHLB stock amounting to \$4.0 million and \$3.1 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

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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:

	2004	2003	2002
Current	\$1,891,859	2,581,600	2,030,921
Deferred	341,441	(1,526,062)	(318,921)
Total	\$2,233,300	1,055,538	1,712,000

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:

	2004	2003	2002
Pre-tax income at statutory rates (34%)	\$ 2,265,840	1,040,104	1,750,169
Differences:			
Tax exempt interest income	(243,346)	(216,431)	(231,395)
Nondeductible interest and other expense	21,588	18,668	24,088
Cash surrender value of life insurance	(65,871)	(73,692)	(83,541)
State taxes, net of federal benefits	236,544	270,493	230,088
Other, net	18,545	16,396	22,591
Total	\$ 2,233,300	1,055,538	1,712,000

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, 2004 and 2003.

	2004	2003
Deferred tax assets:		
Allowance for loan losses	\$ 3,103,068	3,566,467
Amortizable intangible assets	173,548	209,849
Accrued retirement expense	454,446	332,575
Income from non-accrual loans	23,309	23,309
Deferred gain on sale of premises	228,932	-
Deferred gain on sale of cash flow hedges	-	217,284
Unrealized loss on cash flow hedges	289,009	15,580
Other	28,965	25,047
Total gross deferred tax assets	4,301,277	4,390,111

Deferred tax liabilities:

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Unrealized gains on available for sale securities	211,974	175,098
Unrealized gains on sale of cash flow hedges	-	215,540
Deferred loan fees	1,060,798	1,103,661
Premises and equipment	477,285	421,316
Deferred income from servicing rights	108,920	142,848
Total gross deferred tax liabilities	1,858,977	2,058,463
Net deferred tax asset	\$ 2,442,300	2,331,648

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(9) Related Party Transactions

The Company conducts transactions with its directors and executive officers, including companies in which they have beneficial interests, in the normal course of business. It is the policy of the Company that loan transactions with directors and officers 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 2004:

Beginning balance	\$ 9,945,349
New loans	3,734,875
Repayments	5,115,079
Ending balance	\$ 8,565,145

At December 31, 2003, the Company had approximately \$3.7 million in potential problem loans to related parties, with an allowance for loan losses of approximately \$918,000. There were no potential problem loans to related parties at December 31, 2004.

During 2004, an individual formerly considered a related party resigned as a director of the Company and as a result approximately \$3.8 million 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, 2003, approximately \$3.7 million in loans to this individual were considered to be potential problem loans.

The Company elected four new directors in 2004. Approximately \$5.7 million in loans to these directors and their affiliates have been added to the beginning balance of the summary of related party loan activity.

At December 31, 2004 and 2003, the Company had deposit relationships with related parties of approximately \$13.1 million and \$10.2 million, respectively.

The Company also enters into contracts from time to time with certain directors for the construction of bank facilities. At December 31, 2004, the Company had no outstanding construction contracts with these directors as compared to approximately \$31,000 in construction contracts at December 31, 2003.. During the year ended December 31, 2004, 2003 and 2002, total costs for construction, remodeling and repair for bank facilities paid to directors were approximately \$44,000, \$531,000 and \$1.5 million, respectively.

(10) Commitments and Contingencies

The Company leases various office spaces for banking and operational facilities 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, 2004 are as follows:

<u>Year</u>	
2005	\$ 811,653
2006	650,845
2007	674,115
2008	685,603
2009	630,947
Thereafter	4,826,917

Total minimum obligation	\$ 8,280,080
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Total rent expense was approximately \$577,000, \$481,000 and \$326,000 for 2004, 2003 and 2002, 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

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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	
	2004	2003
Financial instruments whose contract amount represent credit risk:		
Commitments to extend credit	\$ 124,674,707	104,729,455
Standby letters of credit and financial guarantees written	\$ 3,278,326	3,876,430

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 \$128.0 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) Derivatives 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, 2004 and 2003, the Company had cash flow hedges with a notional amount of \$55.0 million. These derivative instruments consist of two interest rate swap agreements that were used to convert floating rate loans to fixed rate for a period of three years ending in April 2006 and September 2006. Interest rate swap agreements generally involve the exchange of fixed and variable rate interest payments between two parties, based on a common notional principal amount and maturity date. The terms of the swaps are determined based on management's assessment of future interest rates and other factors. Accrued expenses and other liabilities includes \$742,000 and \$40,000, which represent the adjusted fair value of these cash flow hedges resulting in an after-tax decrease in accumulated other comprehensive income of \$453,000 and \$24,000 as of December 31, 2004 and 2003, respectively. As of December 31, 2004, no ineffectiveness was recorded in earnings.

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The Company settled two previously outstanding interest rate swap agreements during 2003. The first swap with a notional amount of \$40.0 million and scheduled to mature in June 2004 was sold for a gain of \$860,000. The second swap with a notional amount of \$20.0 million and scheduled to mature in July 2004 was sold for a gain of \$394,000. The gains realized upon settlement were recognized over the original terms of the agreements, and during the year ended December 31, 2003, net gains of approximately \$428,000 had been realized. The remaining net gain of approximately \$338,000 was recognized during the year ended December 31, 2004.

(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 \$363,000, \$306,000 and \$339,000 for the years of 2004, 2003 and 2002, 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 \$223,000 and \$264,000 during 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 \$47,000, \$16,000 and \$33,000, for the years ended December 31, 2004, 2003 and 2002, respectively. The following table sets forth the accumulated postretirement benefit obligation as of December 31, 2004 and 2003, which represents the liability for accrued postretirement benefit costs:

	2004	2003
Accumulated postretirement benefit obligation	\$ 215,985	222,541
Unrecognized gain (loss)	(49,038)	(52,203)
Net liability recognized	\$ 166,947	170,338

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 321,860 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:

2004	2003	2002
Weighted	Weighted	Weighted

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	Shares	Average Option Price Per Share	Shares	Average Option Price Per Share	Shares	Average Option Price Per Share
Outstanding, beginning of period	197,024	\$ 14.59	198,679	\$ 14.58	139,703	\$ 14.82
Granted during the period	4,000	\$ 18.95	-	-	67,550	\$ 14.10