PEOPLES BANCORP OF NORTH CAROLINA INC
Form 10-Q
November 12, 2009

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

FORM 10-Q

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

For the quarterly period ended: September 30, 2009

OR

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

For the transition period from __________ to __________

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

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

000-27205 (Commission File No.)	56-2132396 (IRS Employer Identification No.)
518 West C Street, Newton, North Carolina (Address of principal executive offices)	28658 (Zip Code)

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

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

Yes X No

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

Large Accelerate Filer	Accelerated Filer	Non-Accelerated Filer

Smaller Reporting Company	X

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

Yes No X

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.
5,539,056 shares of common stock, outstanding at October 31, 2009.

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Statements made in this Form 10-Q, other than those concerning historical information, should be considered forward-looking statements pursuant to the safe harbor provisions of the Securities Exchange Act of 1934 and the Private Securities Litigation Act of 1995. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management and on the information available to management at the time that this Form 10-Q was prepared. These statements can be identified by the use of words like "expect," "anticipate," "estimate," and "believe," variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by Peoples Bank, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environments and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in the Company's other filings with the Securities and Exchange Commission, including but not limited to those described in Peoples Bancorp of North Carolina, Inc.'s annual report on Form 10-K for the year ended December 31, 2008.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(Dollars in thousands)

Assets	September 30, 2009 (Unaudited)	December 31, 2008
Cash and due from banks	$ 35,775	19,743
Interest bearing deposits	1,412	1,453
Federal funds sold	-	6,733
Cash and cash equivalents	37,187	27,929
Investment securities available for sale	188,352	124,916
Other investments	6,117	6,303
Total securities	194,469	131,219
Mortgage loans held for sale	1,577	-
Loans	782,272	781,188
Less allowance for loan losses	(15,474)	(11,025)
Net loans	766,798	770,163
Premises and equipment, net	17,539	18,297
Cash surrender value of life insurance	7,216	7,019
Accrued interest receivable and other assets	16,445	14,135
Total assets	$ 1,041,231	968,762
Liabilities and Shareholders' Equity		
Deposits:		
Non-interest bearing demand	$ 111,578	104,448
NOW, MMDA & savings	272,865	210,058
Time, $100,000 or more	240,440	220,374
Other time	169,435	186,182
Total deposits	794,318	721,062
Demand notes payable to U.S. Treasury	444	1,600
Securities sold under agreement to repurchase	31,911	37,501
Short-term Federal Reserve Bank borrowings	12,500	5,000
FHLB borrowings	77,000	77,000
Junior subordinated debentures	20,619	20,619
Accrued interest payable and other liabilities	4,940	4,852
Total liabilities	941,732	867,634

Shareholders' equity:			
Series A preferred stock, $1,000 stated value; authorized			
5,000,000 shares; issued and outstanding			
25,054 shares in 2009 and 2008		24,441	24,350
Common stock, no par value; authorized			
20,000,000 shares; issued and outstanding			
5,539,056 shares in 2009 and 2008		48,269	48,269
Retained earnings		23,043	22,985
Accumulated other comprehensive income		3,746	5,524
Total shareholders' equity		99,499	101,128
Total liabilities and shareholders' equity	$	1,041,231	968,762

See accompanying notes to consolidated financial statements.

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

(Dollars in thousands, except per share amounts)

	Three months ended September 30, 2009 (Unaudited)	Three months ended September 30, 2008 (Unaudited)	Nine months ended September 30, 2009 (Unaudited)	Nine months ended September 30, 2008 (Unaudited)
Interest income:				
Interest and fees on loans	$ 10,662	12,734	32,603	38,407
Interest on federal funds sold	-	17	1	52
Interest on investment securities:				
U.S. Government agencies	1,385	1,065	3,947	3,305
States and political subdivisions	325	225	866	668
Other	31	80	90	315
Total interest income	12,403	14,121	37,507	42,747
Interest expense:				
NOW, MMDA & savings deposits	789	807	2,066	2,514
Time deposits	2,213	3,536	7,669	11,467
FHLB borrowings	911	891	2,666	2,722
Junior subordinated debentures	116	233	445	790
Other	103	159	312	513
Total interest expense	4,132	5,626	13,158	18,006
Net interest income	8,271	8,495	24,349	24,741
Provision for loans losses	3,139	1,035	7,156	2,107
Net interest income after provision for loan losses	5,132	7,460	17,193	22,634
Non-interest income:				
Service charges	1,511	1,411	4,094	3,814
Other service charges and fees	472	575	1,568	1,842
Gain (loss) on sale and write-down of securities	(79)	(140)	1,072	(140)
Mortgage banking income	129	165	633	526
Insurance and brokerage commissions	87	104	286	330
Miscellaneous	383	391	1,287	1,542
Total non-interest income	2,503	2,506	8,940	7,914
Non-interest expense:				
Salaries and employee benefits	3,596	3,890	11,231	11,435
Occupancy	1,357	1,228	3,990	3,652
Other	2,391	2,160	7,421	6,234
Total non-interest expense	7,344	7,278	22,642	21,321

Earnings before income taxes		291		2,688	3,491	9,227
Income taxes		(9	)	942	1,206	3,234
Net earnings		300		1,746	2,285	5,993
Dividends and accretion on preferred stock		348		-	898	-
Net earnings (loss) available to common shareholders	$	(48	)	1,746	1,387	5,993
Basic earnings (loss) per share	$	(0.01	)	0.31	0.25	1.07
Diluted earnings (loss) per share	$	(0.01	)	0.31	0.25	1.06
Cash dividends declared per share	$	0.07		0.12	0.24	0.36

See accompanying notes to consolidated financial statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Loss)

(Dollars in thousands)

		Three months ended September 30,		Nine months ended September 30,	
		2009 (Unaudited)	2008 (Unaudited)	2009 (Unaudited)	2008 (Unaudited)
Net earnings	$	300	1,746	2,285	5,993
Other comprehensive income (loss):					
Unrealized holding gains (losses) on securities available for sale		2,560	(636)	839	(1,087)
Reclassification adjustment for (gains) losses on sale and write-downs of securities available for sale included in net earnings		79	140	(1,072)	140
Unrealized holding gains (losses) on derivative financial instruments qualifying as cash flow hedges		(304)	263	(2,294)	876
Reclassification adjustment for gains on derivative financial instruments qualifying as cash flow hedges included in net earnings		(25)	-	(25)	-
Total other comprehensive income (loss), before income taxes		2,310	(233)	(2,552)	(71)
Income tax expense (benefit) related to other comprehensive income:					
Unrealized holding gains (losses) on securities available for sale		997	(248)	327	(423)
Reclassification adjustment for (gains) losses on sale and write-downs of securities available for sale					

included in net earnings		30	55	(418)	55
Unrealized holding gains (losses) on derivative financial instruments qualifying as cash flow hedges		(158)	19	(683)	174
Total income tax (expense) benefit related to other comprehensive income		869	(174)	(774)	(194)
Total other comprehensive income (loss), net of tax		1,441	(59)	(1,778)	123
Total comprehensive income	$	1,741	1,687	507	6,116

See accompanying notes to consolidated financial statements.

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Nine months ended September 30, 2009 and 2008

(Dollars in thousands)

		2009 (Unaudited)		2008 (Unaudited)	
Cash flows from operating activities:					
Net earnings	$	2,285		5,993	
Adjustments to reconcile net earnings to net cash provided by operating activities:					
Depreciation, amortization and accretion		2,033		1,214	
Provision for loan losses		7,156		2,107	
Gain on sale of investment securities		(1,795	)	(160	)
Write-down of investment securities		723		300	
Gain on ineffective portion of derivative financial instruments		(25	)	-	
Loss (gain) on sale of repossessed assets		44		(38	)
Write-down of other real estate and repossessions		477		172	
Origination of mortgage loans held for sale		(1,577	)	-	
Change in:					
Cash surrender value of life insurance		(197	)	(182	)
Other assets		(2,853	)	(1,204	)
Other liabilities		88		(1,258	)
Net cash provided by operating activities		6,359		6,944	
Cash flows from investing activities:					
Purchases of investment securities available for sale		(128,710	)	(33,485	)
Proceeds from calls, paydowns and maturities of investment securities available for sale		35,361		14,142	
Proceeds from sales of investment securities available for sale		30,743		23,445	
Purchases of other investments		(1,176	)	(2,978	)
Proceeds from sale of other investments		788		3,110	
Net change in loans		(6,361	)	(46,601	)
Purchases of premises and equipment		(693	)	(1,613	)
Proceeds from sale of premises and equipment		1		34	
Proceeds from sale of repossessed assets		1,072		1,560	
Net cash used by investing activities		(68,975	)	(42,386	)
Cash flows from financing activities:					
Net change in deposits		73,256		60,229	
Net change in demand notes payable to U.S. Treasury		(1,156	)	-	
		(5,590	)	4,647	

Net change in securities sold under agreement to repurchase					
Proceeds from FHLB borrowings		24,100		68,600	
Repayments of FHLB borrowings		(24,100	)	(79,100	)
Proceeds from FRB borrowings		45,000		-	
Repayments of FRB borrowings		(37,500	)	-	
Proceeds from exercise of stock options		-		44	
Common stock repurchased		-		(549	)
Cash dividends paid on Series A preferred stock		(807	)	-	
Cash dividends paid on common stock		(1,329	)	(2,015	)
Net cash provided by financing activities		71,874		51,856	
Net change in cash and cash equivalent		9,258		16,414	
Cash and cash equivalents at beginning of period		27,929		29,800	
Cash and cash equivalents at end of period	$	37,187		46,214	

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows, continued

Nine months ended September 30, 2009 and 2008

(Dollars in thousands)

		2009 (Unaudited)		2008 (Unaudited)	
Supplemental disclosures of cash flow information:					
Cash paid during the year for:					
Interest	$	13,434		18,221	
Income taxes	$	1,483		3,262	
Noncash investing and financing activities:					
Change in unrealized gain (loss) on investment securities available for sale, net	$	(142	)	(578	)
Change in unrealized gain (loss) on derivative financial instruments, net	$	(1,636	)	702	
Transfer of loans to other real estate and repossessions	$	3,387		3,209	
Financed portion of sale of other real estate	$	818		883	
Accretion of Series A preferred stock discount	$	91		-	
Cumulative effect of adoption of EITF 06-4	$	-		467	

See accompanying notes to consolidated financial statements.

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1) Summary of Significant Accounting Policies

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

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

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of the specific accounting guidance. A description of the Company's significant accounting policies can be found in Note 1 of the notes to consolidated financial statements in the Company's 2008 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 7, 2009 Annual Meeting of Shareholders.

Recently Issued Accounting Pronouncements

In April 2009, the Financial Accounting Standards Board ("FASB") issued new authoritative guidance under the following three ASC's intended to provide additional guidance and enhance disclosures regarding fair value measurements and impairment of securities:

ASC Topic 820 (formerly FASB Staff Position (FSP) FAS 157-4), "Fair Value Measurements and Disclosures," provides additional guidance for estimating fair value in accordance with ASC Topic 820 when the volume and level of activity for the asset or liability have decreased significantly. ASC Topic 820 also provides guidance on identifying circumstances that indicate a transaction is not orderly. The provisions of ASC Topic 820 was effective for the period ended June 30, 2009 and did not have a significant effect on the Company's condensed consolidated financial statements.

ASC Topic 825 (formerly FSP FAS 107-1 and APB 28-1), "Financial Instruments," requires disclosures about fair value of financial instruments in interim reporting periods of publicly traded companies that were previously only required to be disclosed in annual financial statements. The provisions of ASC Topic 825 were effective for the Company's interim period ending on June 30, 2009. The new interim disclosures are included in Note 5 - Fair Value.

ASC Topic 320 (formerly FSP FAS 115-2 and FAS 124-2), "Investments – Debt and Equity Securities," amends current other-than-temporary impairment guidance in GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. This ASC Topic 320 does not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. The provisions of ASC Topic 320 were effective for the Company's interim period ending on June 30, 2009. The Company adopted the provisions of ASC

Topic 320 as of June 30, 2009 and it did not have a significant effect on the Company's condensed consolidated financial statements.

In June 2009, the FASB issued new authoritative guidance under ASC Topic 860 (formerly Statement No. 166) "Transfers and Servicing," to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. ASC Topic 860 eliminates the concept of a "qualifying special-purpose entity" and changes the requirements for derecognizing financial assets. ASC Topic 860 also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The new authoritative guidance under ASC Topic 860 will be effective January 1, 2010 and is not expected to have a significant impact on the Company's condensed consolidated financial statements.

In June 2009, the FASB issued SFAS No. 167, "Amendments to FASB Interpretation No. 46(R)" (SFAS 167) to amend certain requirements of FASB Interpretation No. 46 (revised December 2003), "Consolidation of Variable Interest Entities" to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements. Under FASB's Codification at ASC 105-10-65-1-d, SFAS 167 will remain authoritative until integrated into FASB Codification. SFAS 167 is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. SFAS 167 is not expected to have any effect on the Company's financial position, results of operations or disclosures.

In June 2009, the FASB issued Accounting Standards Update No. 2009-01 ("ASU 2009-01"), "Topic 105 – Generally Accepted Accounting Principles amendments based on Statement of Financial Accounting Standards No. 168 – The FASB Accounting Standards Codification TM and the Hierarchy of Generally Accepted Accounting Principles." ASU 2009-01 amends the FASB Accounting Standards Codification for the issuance of FASB Statement No. 168 ("SFAS 168"), "The FASB Accounting Standards Codification TM and the Hierarchy of Generally Accepted Accounting Principles." ASU 2009-1 includes SFAS 168 in its entirety, including the accounting standards update instructions contained in Appendix B of the Statement. The FASB Accounting Standards Codification TM ("Codification") became the source of authoritative U.S. generally accepted accounting principles ("GAAP") recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission ("SEC") under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of this Statement, the Codification will supersede all then-existing non-SEC accounting and reporting standards. All other non-grandfathered non-SEC accounting literature not included in the Codification will become non-authoritative. This Statement is effective for the Company's financial statements beginning in the interim period ended September 30, 2009.

Following this Statement, the FASB will not issue new standards in the form of Statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates. The FASB does not consider Accounting Standards Updates as authoritative in their own right. Accounting Standards Updates serve only to update the Codification, provide background information about the guidance, and provide the basis for conclusions on the change(s) in the Codification. FASB Statement No. 162, "The Hierarchy of Generally Accepted Accounting Principles", which became effective on November 13, 2008, identified the sources of accounting principles and the framework for selecting the principles used in preparing the financial statements of nongovernmental entities that are presented in conformity with GAAP. Statement 162 arranged these sources of GAAP in a hierarchy for users to apply accordingly. Upon becoming effective, all of the content of the Codification carries the same level of authority, effectively superseding Statement 162. In other words, the GAAP hierarchy has been modified to include only two levels of GAAP: authoritative and non-authoritative. As a result, this Statement replaces Statement 162 to indicate this change to the GAAP hierarchy. The adoption of the Codification and ASU 2009-01 did not have any effect on the Company's results of operations or financial position. All references to accounting literature included in the notes to the financial statements have been changed to reference the appropriate sections of the Codification.

In June 2009, the FASB issued Accounting Standards Update No. 2009-02 ("ASU 2009-02"), "Omnibus Update – Amendments to Various Topics for Technical Corrections." The adoption of ASU 2009-02 did not have a material effect on the Company's results of operations, financial position or disclosures.

In August 2009, the FASB issued Accounting Standards Update No. 2009-03 ("ASU 2009-03"), "SEC Update – Amendments to Various Topics Containing SEC Staff Accounting Bulletins." ASU 2009-03 represents technical corrections to various topics containing SEC Staff Accounting Bulletins to update cross-references to Codification text. This ASU did not have a material effect on the Company's results of operations, financial position or disclosures.

In August 2009, the FASB issued Accounting Standards Update No. 2009-04 ("ASU 2009-04"), "Accounting for Redeemable Equity Instruments – Amendment to Section 480-10-S99." ASU 2009-04 represents an update to Section

480-10-S99, Distinguishing Liabilities from Equity, per Emerging Issues Task Force ("EITF") Topic D-98, Classification and Measurement of Redeemable Securities. ASU 2009-04 did not have a material effect on the Company's results of operations, financial position or disclosures.

In August 2009, the FASB issued Accounting Standards Update No. 2009-05 ("ASU 2009-05"), "Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value." ASU 2009-05 applies to all entities that measure liabilities at fair value within the scope of ASC Topic 820. ASU 2009-05 provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the following techniques:

1) A valuation technique that uses:
   a. The quoted price of the identical liability when traded as an asset
   b. Quoted prices for similar liabilities or similar liabilities when traded as assets.
2) Another valuation technique that is consistent with the principles of ASC Topic 820. Two examples would be an income approach, such as a technique that is based on the amount at the measurement date that the reporting entity would pay to transfer the identical liability or would receive to enter into the identical liability.

The amendments in ASU 2009-5 also clarify that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. It also clarifies that both a quoted price in an active market for the identical liability at the measurement date and the quoted price for the identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements. The guidance provided in ASU 2009-5 is effective for the Company in the fourth quarter of 2009. Because the Company does not currently have any liabilities that are recorded at fair value, the adoption of this guidance will not have any impact on results of operations, financial position or disclosures.

ASU 2009-12, "Fair Value Measurements and Disclosures (Topic 820) - Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)," issued in September, 2009, allows a company to measure the fair value of an investment that has no readily determinable fair market value on the basis of the investee's net asset value per share as provided by the investee. This allowance assumes that the investee has calculated net asset value in accordance with the GAAP measurement principles of Topic 946 as of the reporting entity's measurement date. Examples of such investments include investments in hedge funds, private equity funds, real estate funds and venture capital funds. The update also provides guidance on how the investment should be classified within the fair value hierarchy based on the value for which the investment can be redeemed. The amendment is effective for interim and annual periods ending after December 15, 2009 with early adoption permitted. The Company does not have investments in such entities and, therefore, there will be no impact to our financial statements.

ASU 2009-13, "Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements – a consensus of the FASB Emerging Issues Task Force" was issued in October, 2009 and provides guidance on accounting for products or services (deliverables) separately rather than as a combined unit utilizing a selling price hierarchy to determine the selling price of a deliverable. The selling price is based on vendor-specific evidence, third-party evidence or estimated selling price. The amendments in the Update are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 with early adoption permitted. The Company does not expect the update to have an impact on its financial statements.

Issued October, 2009, ASU 2009-15, "Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing" amends ASC Topic 470 and provides guidance for accounting and reporting for own-share lending arrangements issued in contemplation of a convertible debt issuance. At the date of issuance, a share-lending arrangement entered into on an entity's own shares should be measured at fair value in accordance with Topic 820 and recognized as an issuance cost, with an offset to additional paid-in capital. Loaned shares are excluded from basic and diluted earnings per share unless default of the share-lending arrangement occurs. The amendments also require several disclosures including a description and the terms of the arrangement and the reason for entering into the arrangement. The effective dates of the amendments are dependent upon the date the share-lending arrangement was entered into and include retrospective application for arrangements outstanding as of the beginning of fiscal years beginning on or after December 15, 2009. The Company has no plans to issue convertible debt and, therefore, does not expect the update to have an impact on its financial statements.

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

(2) Allowance for Loan Losses

The following is an analysis of the allowance for loan losses for the nine months ended September 30, 2009 and 2008:

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(Dollars in thousands)		2009	2008
Balance, beginning of period	$	11,026	9,103
Provision for loan losses		7,156	2,107
Less:			
Charge-offs		(3,166)	(1,667)
Recoveries		458	220
Net charge-offs		(2,708)	(1,447)
Balance, end of period	$	15,474	9,763

(3) Net Earnings Per Common Share

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

The reconciliation of the amounts used in the computation of both "basic earnings per common share" and "diluted earnings per common share" for the three and nine months ended September 30, 2009 and 2008 is as follows:

For the three months ended September 30, 2009

		Net Earnings (Loss) Available to Common Shareholders (Dollars in thousands)	Common Shares		Per Share Amount
Basic (loss) per common share	$	(48)	5,539,056	$	(0.01)
Effect of dilutive securities:					
Stock options		-	3,526		
Diluted (loss) per common share	$	(48)	5,542,582	$	(0.01)

For the nine months ended September 30, 2009

		Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares		Per Share Amount
Basic earnings per common share	$	1,387	5,539,056	$	0.25
Effect of dilutive securities:					
Stock options		-	3,346		
Diluted earnings per common share	$	1,387	5,542,402	$	0.25

For the three months ended September 30, 2008

		Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares		Per Share Amount
Basic earnings per common share	$	1,746	5,589,056	$	0.31
Effect of dilutive securities:					
Stock options		-	46,726		
Diluted earnings per common share	$	1,746	5,635,782	$	0.31

For the nine months ended September 30, 2008

		Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares		Per Share Amount
Basic earnings per common share	$	5,993	5,600,109	$	1.07
Effect of dilutive securities:					
Stock options		-	64,544		
Diluted earnings per common share	$	5,993	5,664,653	$	1.06

(4) Stock-Based Compensation

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

Under the 1999 Plan, the Company granted incentive stock options to certain eligible employees in order that they may purchase Company stock at a price equal to the fair market value on the date of the grant. The options granted in 1999 vest over a five-year period. Options granted subsequent to 1999 vest over a three-year period. All options expire ten years after issuance. The Company did not grant any options during the nine months ended September 30, 2009 and 2008.

The Company granted 3,000 shares of restricted stock in 2007 at a grant date fair value of $17.40 per share. The Company granted 1,750 shares of restricted stock during the third quarter 2008 at a grant date fair value of $12.80 per share during third quarter 2008 and 2,000 shares of restricted stock at a fair value of $11.37 per share during fourth quarter 2008. The Company recognizes compensation expense on the restricted stock over the period of time the restrictions are in place (three years from the grant date for the grants to date). The amount of expense recorded each period reflects the changes in the Company’s stock price during the period. As of September 30, 2009 there was $23,000 of total unrecognized compensation cost related to restricted stock grants, respectively, which is expected to be recognized over a period of three years.

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

(5) Fair Value

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. FASB establishes a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The Company's fair value measurements for items measured at fair value at September 30, 2009 included:

(Dollars in thousands)		Fair Value Measurements September 30, 2009	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Investment securities available for sale	$	188,352	852	186,250	1,250
Mortgage loans held for sale	$	1,577	-	1,577	-
Market value of derivatives (in other assets)	$	2,265	-	2,265	-

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

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the nine months ended September 30, 2009:

(Dollars in thousands)	Investment Securities Available for Sale