

PEOPLES BANCORP OF NORTH CAROLINA INC  
Form 10-Q  
August 08, 2014

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

FORM 10-Q

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

For the quarterly period ended: June 30, 2014

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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  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.

5,617,125 shares of common stock, outstanding at July 31, 2014.

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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 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, 2013.

## PART FINANCIAL INFORMATION

## I.

## Item I. Financial Statements

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

## Consolidated Balance Sheets

June 30, 2014 and December 31, 2013

(Dollars in thousands)

Assets	June 30, 2014 (Unaudited)	December 31, 2013 (Audited)
Cash and due from banks, including reserve requirements of \$10,561 and \$11,472, respectively	\$ 54,522	49,902
Interest-bearing deposits	20,546	26,871
Cash and cash equivalents	75,068	76,773
Investment securities available for sale	297,165	297,890
Other investments	4,706	4,990
Total securities	301,871	302,880
Mortgage loans held for sale	2,048	497
Loans	633,336	620,960
Less allowance for loan losses	(12,675 )	(13,501 )
Net loans	620,661	607,459
Premises and equipment, net	16,762	16,358
Cash surrender value of life insurance	13,914	13,706
Other real estate	3,532	1,679
Accrued interest receivable and other assets	13,996	15,332
Total assets	\$ 1,047,852	1,034,684
Liabilities and Shareholders' Equity		
Deposits:		
Noninterest-bearing demand	\$ 206,655	195,265
NOW, MMDA & savings	397,305	386,893
Time, \$100,000 or more	112,201	115,268
Other time	95,318	101,935
Total deposits	811,479	799,361

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Securities sold under agreements to repurchase	46,764	45,396
FHLB borrowings	65,000	65,000
Junior subordinated debentures	20,619	20,619
Accrued interest payable and other liabilities	10,943	20,589
Total liabilities	954,805	950,965

Commitments

Shareholders' equity:

Common stock, no par value; authorized 20,000,000 shares; issued and outstanding 5,617,125 and 5,613,495 shares, respectively	48,170	48,133
Retained earnings	41,433	36,758
Accumulated other comprehensive income (loss)	3,444	(1,172 )
Total shareholders' equity	93,047	83,719
Total liabilities and shareholders' equity	\$ 1,047,852	1,034,684

See accompanying Notes to Consolidated Financial Statements.

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

## Consolidated Statements of Earnings

Three and Six Months Ended June 30, 2014 and 2013

(Dollars in thousands, except per share amounts)

	Three months ended June 30,		Six months ended June 30,	
	2014 (Unaudited)	2013 (Unaudited)	2014 (Unaudited)	2013 (Unaudited)
<b>Interest income:</b>				
Interest and fees on loans	\$ 7,491	7,439	14,893	15,079
Interest on due from banks	12	28	24	40
<b>Interest on investment securities:</b>				
U.S. Government sponsored enterprises	804	286	1,651	664
States and political subdivisions	1,169	1,069	2,346	2,053
Other	100	87	207	176
Total interest income	9,576	8,909	19,121	18,012
<b>Interest expense:</b>				
NOW, MMDA & savings deposits	125	200	251	418
Time deposits	303	422	637	889
FHLB borrowings	549	635	1,094	1,296
Junior subordinated debentures	97	100	193	199
Other	11	15	21	32
Total interest expense	1,085	1,372	2,196	2,834
Net interest income	8,491	7,537	16,925	15,178
Provision for loan losses	67	773	(282 )	1,827
Net interest income after provision for loan losses	8,424	6,764	17,207	13,351
<b>Non-interest income:</b>				
Service charges	1,223	1,104	2,352	2,143
Other service charges and fees	260	268	679	642
Gain on sale of securities	-	352	26	614
Mortgage banking income	188	315	292	699
Insurance and brokerage commissions	162	178	361	317
Gain/(loss) on sale and write-down of other real estate	12	(184 )	(150 )	(173 )
Miscellaneous	1,265	1,276	2,392	2,494

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Total non-interest income		3,110	3,309	5,952	6,736
Non-interest expense:					
Salaries and employee benefits		4,207	4,240	8,483	8,430
Occupancy		1,466	1,320	2,988	2,632
Other		2,394	2,419	4,720	4,655
Total non-interest expense		8,067	7,979	16,191	15,717
Earnings before income taxes		3,467	2,094	6,968	4,370
Income tax expense		916	461	1,838	979
Net earnings		2,551	1,633	5,130	3,391
Dividends and accretion on preferred stock		-	156	-	313
Net earnings available to common shareholders	\$	2,551	1,477	5,130	3,078
Basic and diluted net earnings per common share	\$	0.45	0.26	0.91	0.55
Cash dividends declared per common share	\$	0.04	0.03	0.08	0.06

See accompanying Notes to Consolidated Financial Statements.



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

## Consolidated Statements of Comprehensive (Loss) Income

Three and Six Months Ended June 30, 2014 and 2013

(Dollars in thousands)

	Three months ended June 30,		Six months ended June 30,	
	2014 (Unaudited)	2013 (Unaudited)	2014 (Unaudited)	2013 (Unaudited)
Net earnings	\$ 2,551	1,633	5,130	3,391
Other comprehensive income (loss):				
Unrealized holding gains (losses) on securities available for sale	3,726	(6,583 )	7,586	(7,798 )
Reclassification adjustment for gains on securities available for sale included in net earnings	-	(352 )	(26)	(614 )
Total other comprehensive income (loss), before income taxes	3,726	(6,935 )	7,560	(8,412 )
Income tax (benefit) expense related to other comprehensive (loss) income:				
Unrealized holding gains (losses) on securities available for sale	1,451	(2,564 )	2,954	(3,038 )
Reclassification adjustment for gains on securities available for sale included in net earnings	-	(137 )	(10)	(239 )
Total income tax expense (benefit) related to other comprehensive income (loss)	1,451	(2,701 )	2,944	(3,277 )
Total other comprehensive income (loss), net of tax	2,275	(4,234 )	4,616	(5,135 )
Total comprehensive income (loss)	\$ 4,826	(2,601 )	9,746	(1,744 )

See accompanying Notes to Consolidated Financial Statements.

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

## Consolidated Statements of Cash Flows

Six Months Ended June 30, 2014 and 2013

(Dollars in thousands)

	2014 (Unaudited)	2013 (Unaudited)
Cash flows from operating activities:		
Net earnings	\$ 5,130	3,391
Adjustments to reconcile net earnings to net cash (used) provided by operating activities:		
Depreciation, amortization and accretion	3,258	4,438
Provision for loan losses	(282 )	1,827
Gain on sale of investment securities	(26 )	(614 )
Gain on sale of other real estate	(2 )	(86 )
Write-down of other real estate	152	259
Restricted stock expense	167	70
Change in:		
Mortgage loans held for sale	(1,552 )	920
Cash surrender value of life insurance	(208 )	(214 )
Other assets	(2,274 )	2,217
Other liabilities	2,877	(1,381 )
Net cash provided by operating activities	7,240	10,827
Cash flows from investing activities:		
Purchases of investment securities available for sale	(13,070 )	(59,154 )
Proceeds from calls, maturities and paydowns of investment securities available for sale	18,415	35,031
Proceeds from sales of investment securities available for sale	677	17,463
FHLB stock redemption	284	384
Net change in loans	(15,978 )	7,718
Purchases of premises and equipment	(1,372 )	(1,666 )
Proceeds from sales of other real estate and repossessions	1,554	3,619
Net cash (used) provided by investing activities	(9,490 )	3,395
Cash flows from financing activities:		
Net change in deposits	12,118	6,908
Net change in securities sold under agreements to repurchase	1,368	11,393
Proceeds from FHLB borrowings	-	15,000

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Repayments of FHLB borrowings	-	(15,000 )
Preferred stock repurchase	(12,524 )	
Proceeds from stock options exercised	37	-
Cash dividends paid on preferred stock	-	(313 )
Cash dividends paid on common stock	(454 )	(337 )
Net cash provided by financing activities	545	17,651
Net change in cash and cash equivalent	(1,705 )	31,873
Cash and cash equivalents at beginning of period	76,773	48,843
Cash and cash equivalents at end of period	\$ 75,068	80,716

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

## Consolidated Statements of Cash Flows, continued

Six Months Ended June 30, 2014 and 2013

(Dollars in thousands)

	2014 (Unaudited)	2013 (Unaudited)
<b>Supplemental disclosures of cash flow information:</b>		
<b>Cash paid during the period for:</b>		
Interest	\$ 2,217	2,889
Income taxes	\$ 837	1,112
<b>Noncash investing and financing activities:</b>		
<b>Change in unrealized gain on investment securities</b>		
available for sale, net	\$ 4,616	(5,135 )
Transfers of loans to other real estate and repossessions	\$ 3,288	2,003
Financed portion of sales of other real estate	\$ 230	40

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1) Summary of Significant Accounting Policies

The consolidated financial statements include the financial statements of Peoples Bancorp of North Carolina, Inc. and its wholly owned 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. (“REAS”) (collectively called the “Company”). All significant intercompany balances and transactions have been eliminated in consolidation.

The consolidated financial statements in this report (other than the Consolidated Balance Sheet at December 31, 2013) 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 the 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 in the United States (“GAAP”). 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 2013 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 1, 2014 Annual Meeting of Shareholders.

Recently Issued Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-04, (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. ASU No. 2014-04 provides additional guidance to clarify when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan should be derecognized and the real estate property recognized. ASU No. 2014-04 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The adoption of this guidance is not expected to have a material impact on the Company’s results of operations, financial position or disclosures.

In May 2014, the FASB issued ASU No. 2014-09, (Topic 606): Revenue from Contracts with Customers. ASU No. 2014-09 provides guidance on the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. ASU No. 2014-09 is effective for reporting periods beginning after December 15, 2016. The adoption of this guidance is not expected to have a material impact on the Company’s results of operations, financial position or disclosures.

In June 2014, the FASB issued ASU No. 2014-11, (Subtopic 860-10): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures. ASU No. 2014-11 makes limited amendments to the guidance in FASB Accounting Standards Codification (“ASC”) 860, Transfers and Servicing, on accounting for certain repurchase agreements (repos). ASU No. 2014-1 (1) requires entities to account for repurchase-to-maturity transactions as secured borrowings (rather than as sales with forward repurchase agreements), (2) eliminates accounting guidance on

linked repurchase financing transactions, and (3) expands disclosure requirements related to certain transfers of financial assets that are accounted for as sales and certain transfers (specifically, repos, securities lending transactions, and repurchase-to-maturity transactions) accounted for as secured borrowings. ASU 2014-11 also amends FASB ASC 860 to clarify that repos and securities lending transactions that do not meet all of the derecognition criteria should be accounted for as secured borrowings. In addition, ASU No. 2014-11 provides examples of repurchase and securities lending arrangements that illustrate whether a transferor has maintained effective control over the transferred financial assets. ASU No. 2014-11 is effective for reporting periods beginning the first interim or annual period after December 15, 2014. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

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

(2) Investment Securities

Investment securities available for sale at June 30, 2014 and December 31, 2013 are as follows:

(Dollars in thousands)

	June 30, 2014			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Mortgage-backed securities	\$ 115,747	1,937	170	117,514
U.S. Government sponsored enterprises	25,211	107	217	25,101
State and political subdivisions	145,573	4,398	1,342	148,629
Corporate bonds	3,495	14	22	3,487
Trust preferred securities	750	-	-	750
Equity securities	748	936	-	1,684
Total	\$ 291,524	7,392	1,751	297,165

(Dollars in thousands)

	December 31, 2013			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Mortgage-backed securities	\$ 123,706	1,040	769	123,977
U.S. Government sponsored enterprises	22,115	97	69	22,143
State and political subdivisions	148,468	1,987	5,087	145,368
Corporate bonds	3,522	11	70	3,463
Trust preferred securities	1,250	-	-	1,250
Equity securities	748	941	-	1,689
Total	\$ 299,809	4,076	5,995	297,890

The current fair value and associated unrealized losses on investments in securities with unrealized losses at June 30, 2014 and December 31, 2013 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

	June 30, 2014					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	\$ 8,550	6	18,386	164	26,936	170
U.S. Government sponsored enterprises	16,483	217	-	-	16,483	217
State and political subdivisions	12,495	40	38,905	1,302	51,400	1,342
Corporate bonds	1,000	-	533	22	1,533	22



Total	\$ 38,528	263	57,824	1,488	96,352	1,751
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(Dollars in thousands)

	December 31, 2013					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	\$ 40,857	691	10,128	78	50,985	769
U.S. Government sponsored enterprises	9,714	69	-	-	9,714	69
State and political subdivisions	77,187	4,863	1,824	224	79,011	5,087
Corporate bonds	1,984	16	511	54	2,495	70
Total	\$ 129,742	5,639	12,463	356	142,205	5,995

At June 30, 2014, unrealized losses in the investment securities portfolio relating to debt securities totaled \$1.8 million. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the June 30, 2014 tables above, 50 out of 175 securities issued by state and political subdivisions contained unrealized losses, 17 out of 95 securities issued by U.S. Government sponsored enterprises, including mortgage-backed securities, contained unrealized losses, and two out of five securities issued by corporations contained unrealized losses. These unrealized losses are considered temporary because of acceptable financial condition and results of operations on each security and the repayment sources of principal and interest on U.S. Government sponsored enterprises, including mortgage-backed securities, are government backed.

The amortized cost and estimated fair value of investment securities available for sale at June 30, 2014, 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.

June 30, 2014

(Dollars in thousands)

	Amortized Cost	Estimated Fair Value
Due within one year	\$ 4,392	4,401
Due from one to five years	37,594	38,956
Due from five to ten years	114,940	116,246
Due after ten years	18,103	18,364
Mortgage-backed securities	115,747	117,514
Equity securities	748	1,684
Total	\$ 291,524	297,165

Proceeds from sales of securities available for sale during the six months ended June 30, 2014 were \$677,000 and resulted in gross gains of \$26,000. Proceeds from sales of securities available for sale during the six months ended June 30, 2013 were \$17.5 million and resulted in gross gains of \$738,000 and gross losses of \$124,000.

Securities with a fair value of approximately \$83.9 million and \$86.0 million at June 30, 2014 and December 31, 2013, respectively, were pledged to secure public deposits and for other purposes as required by law.

## (3) Loans

Major classifications of loans at June 30, 2014 and December 31, 2013 are summarized as follows:

(Dollars in thousands)

	June 30, 2014	December 31, 2013
Real estate loans		
Construction and land development	\$ 59,843	63,742
Single-family residential	196,192	195,975
Single-family residential - Banco de la Gente stated income	48,165	49,463
Commercial	214,378	209,287
Multifamily and farmland	11,821	11,801
Total real estate loans	530,399	530,268
Loans not secured by real estate		
Commercial loans	78,056	68,047
Farm loans	93	19
Consumer loans	10,143	9,593
All other loans	14,645	13,033
Total loans	633,336	620,960
Less allowance for loan losses	12,675	13,501
Total net loans	\$ 620,661	607,459

The Bank 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, Union and Wake counties of North Carolina. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by improved and unimproved real estate, the value of which is dependent upon the real estate market. Risk characteristics of the major components of the Bank's loan portfolio are discussed below:

- Construction and land development loans – The risk of loss is largely dependent on the initial estimate of whether the property's value at completion equals or exceeds the cost of property construction and the availability of take-out financing. During the construction phase, a number of factors can result in delays or cost overruns. If the estimate is inaccurate or if actual construction costs exceed estimates, the value of the property securing the loan may be insufficient to ensure full repayment when completed through a permanent loan, sale of the property, or by seizure of collateral. As of June 30, 2014, construction and land development loans comprised approximately 9% of the Bank's total loan portfolio.
- Single-family residential loans – Declining home sales volumes, decreased real estate values and higher than normal levels of unemployment could contribute to losses on these loans. As of June 30, 2014, single-family residential loans comprised approximately 39% of the Bank's total loan portfolio, and include Banco de la Gente single-family residential stated income loans, which were approximately 8% of the Bank's total loan portfolio.

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Commercial real estate loans – Repayment is dependent on income being generated in amounts sufficient to cover operating expenses and debt service. These loans also involve greater risk because they are generally not fully amortizing over a loan period, but rather have a balloon payment due at maturity. A borrower’s ability to make a balloon payment typically will depend on being able to either refinance the loan or timely sell the underlying property. As of June 30, 2014, commercial real estate loans comprised approximately 34% of the Bank’s total loan portfolio.

- Commercial loans – Repayment is generally dependent upon the successful operation of the borrower’s business. In addition, the collateral securing the loans may depreciate over time, be difficult to appraise, be illiquid, or fluctuate in value based on the success of the business. As of June 30, 2014, commercial loans comprised approximately 12% of the Bank’s total loan portfolio.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The following tables present an age analysis of past due loans, by loan type, as of June 30, 2014 and December 31, 2013:

June 30, 2014

(Dollars in thousands)

	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Total Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
<b>Real estate loans</b>						
Construction and land development	\$ 830	4,862	5,692	54,151	59,843	-
Single-family residential	1,453	667	2,120	194,072	196,192	392
Single-family residential - Banco de la Gente stated income	1,874	719	2,593	45,572	48,165	-
Commercial	1,652	289	1,941	212,437	214,378	-
Multifamily and farmland	169	-	169	11,652	11,821	-
<b>Total real estate loans</b>	<b>5,978</b>	<b>6,537</b>	<b>12,515</b>	<b>517,884</b>	<b>530,399</b>	<b>392</b>
<b>Loans not secured by real estate</b>						
Commercial loans	1,001	49	1,050	77,006	78,056	-
Farm loans	-	-	-	93	93	-
Consumer loans	129	-	129	10,014	10,143	-
All other loans	-	-	-	14,645	14,645	-
<b>Total loans</b>	<b>\$ 7,108</b>	<b>6,586</b>	<b>13,694</b>	<b>619,642</b>	<b>633,336</b>	<b>392</b>

December 31, 2013

(Dollars in thousands)

	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Total Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
<b>Real estate loans</b>						
Construction and land development	\$ 3,416	5,426	8,842	54,900	63,742	-
Single-family residential	4,518	1,555	6,073	189,902	195,975	-

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Single-family residential -

Banco de la Gente stated income	9,833	1,952	11,785	37,678	49,463	881
Commercial	1,643	486	2,129	207,158	209,287	-
Multifamily and farmland	177	-	177	11,624	11,801	-
Total real estate loans	19,587	9,419	29,006	501,262	530,268	881

Loans not secured by real estate

Commercial loans	424	29	453	67,594	68,047	-
Farm loans	-	-	-	19	19	-
Consumer loans	181	3	184	9,409	9,593	1
All other loans	-	-	-	13,033	13,033	-
Total loans	\$ 20,192	9,451	29,643	591,317	620,960	882

The following table presents the Company's non-accrual loans as of June 30, 2014 and December 31, 2013:

(Dollars in thousands)

	June 30, 2014	December 31, 2013
<b>Real estate loans</b>		
Construction and land development	\$ 5,216	6,546
Single-family residential	1,563	2,980
Single-family residential - Banco de la Gente stated income	1,780	1,990
Commercial	1,804	2,043
<b>Total real estate loans</b>	<b>10,363</b>	<b>13,559</b>
<b>Loans not secured by real estate</b>		
Commercial loans	511	250
Consumer loans	47	27
<b>Total</b>	<b>\$ 10,921</b>	<b>13,836</b>

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan that is collateral-dependent is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform appraisals for other companies. Factors including the assumptions and techniques utilized by the appraiser are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. An allowance for each impaired loan that is non-collateral dependent is calculated based on the present value of projected cash flows. If the recorded investment in the impaired loan exceeds the present value of projected cash flows, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under \$250,000 are not individually evaluated for impairment, with the exception of the Bank's troubled debt restructured ("TDR") loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Accruing impaired loans were \$27.7 million, \$27.6 million and \$26.2 million at June 30, 2014, December 31, 2013 and June 30, 2013, respectively. Interest income recognized on accruing impaired loans was \$681,000, \$579,000 and \$1.3 million for the six months ended June 30, 2014, the six months ended June 30, 2013 and the year ended December 31, 2013, respectively. Interest income recognized on accruing impaired loans was \$325,000 and \$286,000 for the three months ended June 30, 2014 and 2013, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as non-accrual.

The following tables present the Company's impaired loans as of June 30, 2014 and December 31, 2013:

June 30, 2014

(Dollars in thousands)

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Recorded Investment in Impaired Loans	Related Allowance	Average Outstanding Impaired Loans
<b>Real estate loans</b>						
Construction and land development	\$ 6,963	3,784	2,355	6,139	56	6,502

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Single-family residential	5,972	947	4,827	5,774	132	7,507
Single-family residential -						
Banco de la Gente stated income	21,758	-	21,129	21,129	1,217	20,303
Commercial	4,665	2,251	2,145	4,396	256	4,463
Multifamily and farmland	169	-	169	169	1	172
Total impaired real estate loans	39,527	6,982	30,625	37,607	1,662	38,947
Loans not secured by real estate						
Commercial loans	849	-	755	755	16	895
Consumer loans	303	249	51	300	1	305
Total impaired loans	\$ 40,679	7,231	31,431	38,662	1,679	40,147



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December 31, 2013  
(Dollars in thousands)

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Recorded Investment in Impaired Loans	Related Allowance	Average Outstanding Impaired Loans
<b>Real estate loans</b>						
Construction and land development	\$ 9,861	6,293	868	7,161	53	8,289
Single-family residential	7,853	1,428	5,633	7,061	123	7,859
Single-family residential - Banco de la Gente stated income	22,034	-	21,242	21,242	1,300	21,242
Commercial	5,079	3,045	1,489	4,534	182	4,171
Multifamily and farmland	177	-	177	177	1	184
Total impaired real estate loans	45,004	10,766	29,409	40,175	1,659	41,745
<b>Loans not secured by real estate</b>						
Commercial loans	999	257	724	981	15	826
Consumer loans	302	264	35	299	1	247
Total impaired loans	\$ 46,305	11,287	30,168	41,455	1,675	42,818

Changes in the allowance for loan losses for the three and six months ended June 30, 2014 and 2013 were as follows:

(Dollars in thousands)

	Real Estate Loans									Total
	Construction and Land Development	Single- Family Residential	Single- Family Residential -	Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial Commercial	Farm	Consumer and All Other	
Six months ended June 30, 2014										
Allowance for loan losses:										
Beginning balance	\$3,218	3,123	1,863	2,219	37	1,069	-	245	1,727	13,501
Charge-offs	(260)	(194)	(140)	(131)	-	(193)	-	(254)	-	(1,172)
Recoveries	282	60	17	161	-	26	-	82	-	628
Provision	147	(141)	(32)	(410)	(30)	179	-	180	(175)	(282)
Ending balance	\$3,387	2,848	1,708	1,839	7	1,081	-	253	1,552	12,675

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Three months ended  
June 30, 2014

Allowance  
for loan  
losses:

Beginning

balance	\$3,133	3,132	1,767	2,196	36	945	-	230	1,539	12,978
Charge-offs	-	(171)	(108)	(20)	-	(181)	-	(117)	-	(597)
Recoveries	3	52	5	101	-	21	-	45	-	227
Provision	251	(165)	44	(438)	(29)	296	-	95	13	67
Ending balance	\$3,387	2,848	1,708	1,839	7	1,081	-	253	1,552	12,675

Allowance for loan  
losses June 30, 2014:

Ending  
balance:

individually  
evaluated

for impairment	\$-	67	1,175	-	-	242	-	-	-	1,484
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Ending  
balance:

collectively  
evaluated

for impairment	3,387	2,781	533	1,839	7	839	-	253	1,552	11,191
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Ending

balance	\$3,387	2,848	1,708	1,839	7	1,081	-	253	1,552	12,675
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Loans June  
30, 2014:

Ending

balance	\$59,843	196,192	48,165	214,378	11,821	78,056	93	24,788	-	633,336
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Ending  
balance:

individually  
evaluated

for impairment	\$5,297	2,325	19,287	-	-	3,307	-	250	-	30,466
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Ending  
balance:

collectively  
evaluated

for impairment	\$54,546	193,867	28,878	214,378	11,821	74,749	93	24,538	-	602,870
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(Dollars in thousands)

	Construction and Land Development	Single- Family Residential	Real Estate Loans Single- Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial Farm	Consumer and All Other	Unallocated	Total	
Six months ended										
June 30, 2013										
Allowance for loan losses:										
Beginning										
balance	\$4,399	3,231	1,998	2,049	28	1,088	-	245	1,385	14,423
Charge-offs	(715)	(636)	(224)	(275)	-	(382)	-	(281)	-	(2,513)
Recoveries	26	43	70	50	-	25	-	78	-	292
Provision	1,015	666	80	34	6	91	-	187	(252)	1,827
Ending balance	\$4,725	3,304	1,924	1,858	34	822	-	229	1,133	14,029
Three months ended										
June 30, 2013										
Allowance for loan losses:										
Beginning										
balance	\$4,785	3,182	1,976	1,811	30	1,209	-	232	1,187	14,412
Charge-offs	(218)	(274)	(72)	(275)	-	(361)	-	(134)	-	(1,334)
Recoveries	25	24	70	2	-	14	-	43	-	178
Provision	133	372	(50)	320	4	(40)	-	88	(54)	773
Ending balance	\$4,725	3,304	1,924	1,858	34	822	-	229	1,133	14,029
Allowance for loan losses June 30, 2013:										
Ending balance: individually evaluated for impairment										
\$6	343	1,234	-	-	-	-	-	-	-	1,583
Ending balance: collectively										

evaluated for impairment	4,719	2,961	690	1,858	34	822	-	229	1,133	12,446
Ending balance	\$4,725	3,304	1,924	1,858	34	822	-	229	1,133	14,029

Loans June  
30, 2013:

Ending balance	\$70,112	192,601	50,454	191,368	10,918	66,161	24	26,434	-	608,072
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Ending  
balance:  
individually  
evaluated  
for  
impairment

Ending  
balance:  
collectively  
evaluated  
for  
impairment

\$7,626	3,480	19,912	3,125	-	-	-	279	-	34,422
\$62,486	189,121	30,542	188,243	10,918	66,161	24	26,155	-	573,650

The provision for loan losses for the three months ended June 30, 2014 was \$67,000, as compared to \$773,000 for the same period one year ago. The decrease in the provision for loan losses is primarily attributable to a \$5.2 million reduction in non-accrual loans from June 30, 2013 to June 30, 2014 and a reduction in net charge-offs of \$786,000 during the three months ended June 30, 2014, as compared to the same period one year ago.

The provision for loan losses for the six months ended June 30, 2014 was a credit of \$282,000, as compared to an expense of \$1.8 million for the same period one year ago. The decrease in the provision for loan losses is primarily attributable to a \$1.7 million decrease in net charge-offs during the six months ended June 30, 2014 compared to the same period one year ago and a \$5.2 million reduction in non-accrual loans from June 30, 2013 to June 30, 2014. The credit to provision for loan losses in the six months ended June 30, 2014 resulted from, and was considered appropriate as part of, management's assessment and estimate of the risks in the total loan portfolio and determination of the total allowance for loan losses. The primary factors contributing to the decrease in the allowance for loan losses at June 30, 2014 to \$12.7 million from \$13.5 million at December 31, 2013 were the continuing positive trends in indicators of potential losses on loans, primarily non-accrual loans and the reduction in net charge-offs.

The Company utilizes an internal risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 1 to 8. These risk grades are evaluated on an ongoing basis. A description of the general characteristics of the eight risk grades is as follows:

- Risk Grade 1 – Excellent Quality: Loans are well above average quality and a minimal amount of credit risk exists. CD or cash secured loans or properly margined actively traded stock or bond secured loans would fall in this grade.
- Risk Grade 2 – High Quality: Loans are of good quality with risk levels well within the Company's range of acceptability. The organization or individual is established with a history of successful performance though somewhat susceptible to economic changes.
- Risk Grade 3 – Good Quality: Loans of average quality with risk levels within the Company's range of acceptability but higher than normal. This may be a new organization or an existing organization in a transitional phase (e.g.

expansion, acquisition, market change).

- Risk Grade 4 – Management Attention: These loans have higher risk and servicing needs but still are acceptable. Evidence of marginal performance or deteriorating trends is observed. These are not problem credits presently, but may be in the future if the borrower is unable to change its present course.

- Risk Grade 5 – Watch: These loans are currently performing satisfactorily, but there has been some recent past due history on repayment and there are potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Company’s position at some future date.
- Risk Grade 6 – Substandard: A Substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or the collateral pledged (if there is any). There is a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.
- Risk Grade 7 – Doubtful: Loans classified as Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.
- Risk Grade 8 – Loss: Loans classified as Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be realized in the future. Loss is a temporary grade until the appropriate authority is obtained to charge the loan off.

The following tables present the credit risk profile of each loan type based on internally assigned risk grades as of June 30, 2014 and December 31, 2013:

June 30, 2014

(Dollars in thousands)

	Real Estate Loans									
	Construction and Land Development		Single-Family Residential	Banco de la Gente Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer	All Other
1- Excellent Quality	\$-	15,376	-	-	-	720	-	1,386	-	17,482
2- High Quality	8,224	66,361	-	37,883	682	11,404	-	3,659	1,972	130,185
3- Good Quality	23,249	71,086	21,528	129,951	6,621	51,697	93	4,424	10,439	319,088
4- Management Attention	12,949	32,416	8,293	35,900	1,643	12,452	-	575	2,234	106,462
5- Watch	7,355	5,914	7,040	6,661	2,706	944	-	20	-	30,640
6- Substandard	8,066	5,039	11,304	3,983	169	770	-	77	-	29,408
7- Doubtful	-	-	-	-	-	-	-	-	-	-
8- Loss	-	-	-	-	-	69	-	2	-	71

Total	\$59,843	196,192	48,165	214,378	11,821	78,056	93	10,143	14,645	633,336
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December 31, 2013

(Dollars in thousands)

	Real Estate Loans										
	Construction and Land Development		Single-Family Residential	Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer	All Other	Total
1- Excellent Quality	\$7	15,036	-	-	-	365	-	1,270	-	-	16,678
2- High Quality	7,852	60,882	-	33,340	715	8,442	-	3,519	2,139	-	116,889
3- Good Quality	22,899	73,118	22,255	123,604	7,882	44,353	19	4,061	8,565	-	306,756
4- Management Attention	14,464	34,090	8,369	42,914	286	13,704	-	358	2,329	-	116,514
5- Watch	8,163	6,806	8,113	5,190	2,741	320	-	50	-	-	31,383
6- Substandard	10,357	6,043	10,726	4,239	177	863	-	330	-	-	32,735
7- Doubtful	-	-	-	-	-	-	-	-	-	-	-
8- Loss	-	-	-	-	-	-	-	5	-	-	5
Total	\$63,742	195,975	49,463	209,287	11,801	68,047	19	9,593	13,033	-	620,960

Total TDR loans amounted to \$11.7 million and \$21.9 million at June 30, 2014 and December 31, 2013, respectively. The terms of these loans have been renegotiated to provide a concession to original terms, including a reduction in principal or interest as a result of the deteriorating financial position of the borrower. There were \$1.5 million and \$335,000 in performing loans classified as TDR loans at June 30, 2014 and December 31, 2013, respectively.



The Bank did not enter into any new TDR loan modifications during the three months ended June 30, 2014. The following table presents an analysis of loan modifications during the six months ended June 30, 2014:

Six months ended June 30, 2014  
(Dollars in thousands)

		Pre-Modification	Post-Modification
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
<b>Real estate loans</b>			
Construction and land development	1	\$ 316	316
Single-family residential	1	734	734
Single-family residential - Banco de la Gente stated income	6	494	494
Total real estate TDR loans	8	1,544	1,544
Total TDR loans	8	\$ 1,544	1,544

The following tables present an analysis of loan modifications during the three and six months ended June 30, 2013:

Three months ended June 30, 2013  
(Dollars in thousands)

		Pre-Modification	Post-Modification
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
<b>Real estate loans</b>			
Construction and land development	1	\$ 724	712
Single-family residential	2	78	78
Single-family residential - Banco de la Gente stated income	1	140	138
Total real estate TDR loans	4	942	928
Total TDR loans	4	\$ 942	928

Six months ended June 30, 2013  
(Dollars in thousands)

		Pre-Modification	Post-Modification
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
<b>Real estate loans</b>			
Construction and land development	2	\$ 841	829
Single-family residential	2	78	78
Single-family residential - Banco de la Gente stated income	4	472	469
Total real estate TDR loans	8	1,391	1,376
Total TDR loans	8	\$ 1,391	1,376

(4)

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 six months ended June 30, 2014 and 2013 is as follows:

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For the three months ended June 30, 2014

	Net Earnings Available to Common Shareholders		
	(Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	\$ 2,551	5,616,008	\$ 0.45
Effect of dilutive securities:			
Stock options	-	25,471	
Diluted earnings per common share	\$ 2,551	5,641,479	\$ 0.45

For the six months ended June 30, 2014

	Net Earnings Available to Common Shareholders		
	(Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	\$ 5,130	5,614,758	\$ 0.91
Effect of dilutive securities:			
Stock options	-	22,432	
Diluted earnings per common share	\$ 5,130	5,637,190	\$ 0.91

For the three months ended June 30, 2013

	Net Earnings Available to Common Shareholders		
	(Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	\$ 1,477	5,613,495	\$ 0.26
Effect of dilutive securities:			
Stock options	-	5,589	
Diluted earnings per common share	\$ 1,477	5,619,084	\$ 0.26

For the six months ended June 30, 2013

	Net Earnings Available to Common Shareholders		
	(Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	\$ 3,078	5,613,495	\$ 0.55
Effect of dilutive securities:			
Stock options	-	5,185	
Diluted earnings per common share	\$ 3,078	5,618,680	\$ 0.55

(5)

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 and restricted stock units were granted to eligible directors and employees. The 1999 Plan expired on May 13, 2009 but still governs the rights and obligations of the parties for grants made thereunder.

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 vested over a five-year period. Options granted subsequent to 1999 vested over a three-year period. All options expire ten years after issuance.

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In addition, under the 1999 Plan, the Company granted 3,000 restricted stock units in 2007 at a grant date fair value of \$17.40 per share. The Company granted 1,750 restricted stock units at a grant date fair value of \$12.80 per share during the third quarter of 2008 and 2,000 restricted stock units at a grant date fair value of \$11.37 per share during the fourth quarter of 2008. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (three years from the grant date for the grants of restricted stock units to date under the 1999 Plan). The amount of expense recorded each period reflects the changes in the Company's stock price during the period. As of June 30, 2014, there was no unrecognized compensation expense related to the 2007 and 2008 restricted stock unit grants granted under the 1999 Plan.

The Company also has an Omnibus Stock Ownership and Long Term Incentive Plan that was approved by shareholders on May 7, 2009 (the "2009 Plan") whereby certain stock-based rights, such as stock options, restricted stock, restricted stock units, performance units, stock appreciation rights or book value shares, may be granted to eligible directors and employees. A total of 282,635 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 granted 29,514 restricted stock units under the 2009 Plan at a grant date fair value of \$7.90 per share during the first quarter of 2012. 5,355 restricted stock units were forfeited by the executive officers of the Company as required by the agreement with the U.S. Department of the Treasury ("UST") in conjunction with the Company's participation in the Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP"). In July 2012, the Company granted 5,355 restricted stock units at a grant date fair value of \$8.25 per share. The Company granted 26,795 restricted stock units under the 2009 Plan at a grant date fair value of \$11.90 per share during the second quarter of 2013. The Company granted 21,056 restricted stock units under the 2009 Plan at a grant date fair value of \$15.70 per share during the first quarter of 2014. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (five years from the grant date for the 2012 grants, four years from the grant date for the 2013 grants and three years from the grant date for the 2014 grants). The amount of expense recorded each period reflects the changes in the Company's stock price during the period. As of June 30, 2014, the total unrecognized compensation expense related to the restricted stock unit grants under the 2009 Plan was \$840,000.

The Company recognized compensation expense for restricted stock awards granted under the 2009 Plan of \$167,000 and \$70,000 for the six months ended June 30, 2014 and 2013, respectively.

(6) Fair Value

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

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

- Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

#### Cash and Cash Equivalents

For cash, due from banks and interest-bearing deposits, the carrying amount is a reasonable estimate of fair value. Cash and cash equivalents are reported in the Level 1 fair value category.

#### Investment Securities Available for Sale

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 for investment securities with quoted market prices are reported in the Level 1 fair value category. Fair value measurements obtained from independent pricing services are reported in the Level 2 fair value category. All other fair value measurements are reported in the Level 3 fair value category.

#### Other Investments

For other investments, the carrying value is a reasonable estimate of fair value. Other investments are reported in the Level 3 fair value category.

#### Mortgage Loans Held for Sale

Mortgage loans held for sale are carried at the lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value. Mortgage loans held for sale are reported in the Level 3 fair value category.

#### Loans

The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. For variable rate loans, the carrying amount is a reasonable estimate of fair value. Loans are reported in the Level 3 fair value category, as the pricing of loans is more subjective than the pricing of other financial instruments.

#### Cash Surrender Value of Life Insurance

For cash surrender value of life insurance, the carrying value is a reasonable estimate of fair value. Cash surrender value of life insurance is reported in the Level 2 fair value category.

#### Other Real Estate

The fair value of other real estate is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. Other real estate is reported in the Level 3 fair value category.

#### Deposits

The fair value of demand deposits, interest-bearing demand deposits and savings is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. Deposits are reported in the Level 2 fair value category.

#### Securities Sold Under Agreements to Repurchase

For securities sold under agreements to repurchase, the carrying value is a reasonable estimate of fair value. Securities sold under agreements to repurchase are reported in the Level 2 fair value category.

#### Federal Home Loan Bank ("FHLB") Borrowings

The fair value of FHLB borrowings is estimated based upon discounted future cash flows using a discount rate comparable to the current market rate for such borrowings. FHLB borrowings are reported in the Level 2 fair value category.

category.

#### Junior Subordinated Debentures

Because the Company's junior subordinated debentures were issued at a floating rate, the carrying amount is a reasonable estimate of fair value. Junior subordinated debentures are reported in the Level 2 fair value category.

#### Commitments to Extend Credit and Standby Letters of Credit

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

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### Limitations

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

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

The table below presents the balance of securities available for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy, as of June 30, 2014 and December 31, 2013.

(Dollars in thousands)

	June 30, 2014			
	Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 117,514	-	117,514	-
U.S. Government sponsored enterprises	\$ 25,101	-	25,101	-
State and political subdivisions	\$ 148,629	-	148,629	-
Corporate bonds	\$ 3,487	-	3,487	-
Trust preferred securities	\$ 750	-	-	750
Equity securities	\$ 1,684	1,684	-	-

(Dollars in thousands)

	December 31, 2013			
	Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 123,977	-	123,977	-
U.S. Government sponsored enterprises	\$ 22,143	-	22,143	-
State and political subdivisions	\$ 145,368	-	145,368	-
Corporate bonds	\$ 3,463	-	3,463	-
Trust preferred securities	\$ 1,250	-	-	1,250
Equity securities	\$ 1,689	1,689	-	-

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the six months ended June 30, 2014.

(Dollars in thousands)

Investment  
Securities  
Available for  
Sale

	Level 3 Valuation
Balance, beginning of period	\$ 1,250
Change in book value	-
Change in gain/(loss) realized and unrealized	-
Purchases/(sales and calls)	(500 )
Transfers in and/or (out) of Level 3	-
Balance, end of period	\$ 750
Change in unrealized gain/(loss) for assets still held in Level 3	\$ -

The fair value measurements for impaired loans and other real estate on a non-recurring basis at June 30, 2014 and December 31, 2013 are presented below. The fair value measurement process uses certified appraisals and other market-based information; however, in many cases, it also requires significant input based on management's knowledge of, and judgment about, current market conditions, specific issues relating to the collateral, and other matters. As a result, all fair value measurements for impaired loans and other real estate are considered Level 3.

(Dollars in thousands)

		Fair Value Measurements June 30, 2014	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Six Months Ended June 30, 2014
Impaired loans	\$	36,983	-	-	36,983	(433 )
Other real estate	\$	3,532	-	-	3,532	(150 )

(Dollars in thousands)

		Fair Value Measurements December 31, 2013	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2013
Impaired loans	\$	39,780	-	-	39,780	(3,207 )
Other real estate	\$	1,679	-	-	1,679	(581 )

The carrying amount and estimated fair value of financial instruments at June 30, 2014 and December 31, 2013 are as follows:

(Dollars in thousands)

	Carrying Amount	Fair Value Measurements at June 30, 2014			
		Level 1	Level 2	Level 3	Total
<b>Assets:</b>					
Cash and cash equivalents	\$ 75,068	75,068	-	-	75,068
Investment securities available for sale	297,165	1,684	294,731	750	297,165
Other investments	4,706	-	-	4,706	4,706
Mortgage loans held for sale	2,048	-	-	2,048	2,048
Loans, net	620,661	-	-	623,799	623,799
Cash surrender value of life insurance	13,914	-	13,914	-	13,914
<b>Liabilities:</b>					
Deposits	\$ 811,479	-	810,415	-	810,415
Securities sold under agreements to repurchase	46,764	-	46,764	-	46,764
FHLB borrowings	65,000	-	65,984	-	65,984
Junior subordinated debentures	20,619	-	20,619	-	20,619



(Dollars in thousands)

	Carrying Amount	Fair Value Measurements at December 31, 2013			Total
		Level 1	Level 2	Level 3	
<b>Assets:</b>					
Cash and cash equivalents	\$ 76,773	76,773	-	-	76,773
Investment securities available for sale	297,890	1,689	294,951	1,250	297,890
Other investments	4,990	-	-	4,990	4,990
Mortgage loans held for sale	497	-	-	497	497
Loans, net	607,459	-	-	612,132	612,132
Cash surrender value of life insurance	13,706	-	13,706	-	13,706
<b>Liabilities:</b>					
Deposits	\$ 799,361	-	798,460	-	798,460
Securities sold under agreements to repurchase	45,396	-	45,396	-	45,396
FHLB borrowings	65,000	-	65,891	-	65,891
Junior subordinated debentures	20,619	-	20,619	-	20,619

## (7) Derivative Instruments and Hedging Activities

## Accounting Policy for Derivative Instruments and Hedging Activities

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

## Risk Management Objective of Using Derivatives

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. The Company did not have any interest rate derivatives outstanding as of June 30, 2014 or December 31, 2013.

(8) Subsequent Events

The Company has reviewed and evaluated subsequent events and transactions for material subsequent events through the date the financial statements are issued. Management has concluded that there were no material subsequent events.

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

The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors and the Company's Consolidated Financial Statements and Notes thereto on pages A-28 through A-64 of the Company's 2013 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 1, 2014 Annual Meeting of Shareholders.

### Introduction

Management's discussion and analysis of earnings and related data are presented to assist in understanding the consolidated financial condition and results of operations of the Company. The Company is the parent company of the Bank and a registered bank holding company operating under the supervision of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg, Iredell, Union and Wake 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 commercial loans, real estate mortgage loans, real estate construction 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 our interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, a positive interest rate spread will generate net interest income. Our profitability is also affected by the level of other income and operating expenses. Other income consists primarily of miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds. Operating expenses consist of compensation and benefits, occupancy related expenses, federal deposit and other insurance premiums, data processing, advertising and other expenses.

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

Economic conditions in 2014 continue to demonstrate signs of improvement. While the general trends are positive, the lack of significant recoveries in the housing and job markets continue to stress various segments of our customer base and therefore limit the impact of the economic recovery to our financial condition and results of operations. With the unemployment rate continuing to be higher than historical norms and home prices well below pre-crisis levels, the primary indicators of economic activity for our markets continue to point to challenging business conditions that have slowed our return to pre-crisis levels of earnings. This is also reflected in our local markets, as the unemployment rate in our primary markets remains above the national and state unemployment rates.

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) into law. This legislation made extensive changes to the laws regulating financial products and services as well as firms and companies offering financial products and services. The Dodd-Frank Act also altered certain corporate governance matters affecting public companies. The legislation requires substantial rulemaking and mandates numerous additional studies, the results of which could impact future legislative and regulatory action. We continue to evaluate this legislation including its related rules and regulations, and we continue to assess the extent to which it will impact our current and future operations.

While we are unable to determine all ramifications of the Dodd-Frank Act at this time, we expect that many of the requirements called for in the Dodd-Frank Act will be implemented over time, and most will be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies, the full extent of the impact of such requirements will have on financial institutions’ operations is unclear. The changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make necessary changes in order to comply with new statutory and regulatory requirements.



Although we are unable to control the external factors that influence our business, by maintaining high levels of balance sheet liquidity, managing our interest rate exposures and by actively monitoring asset quality, we seek to minimize the potentially adverse risks of unforeseen and unfavorable economic trends.

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. While we continue to focus our resources in and around our current footprint, we do consider other avenues of growth that could add shareholder value.

The Federal Reserve has maintained the Federal Funds Rate at 0.25% since December 2008. This historically low rate has had a negative impact on earnings and will continue to have a negative impact on our net interest income in future periods. The negative impact of low interest rates has been partially offset by earnings realized on interest rate contracts utilized by the Bank. Additional information regarding the Bank's interest rate contracts is provided below in the section entitled "Asset Liability and Interest Rate Risk Management."

On December 23, 2008, the Company entered into a Securities Purchase Agreement ("Purchase Agreement") with the U.S. Department of the Treasury ("UST") pursuant to the Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP"). Under the Purchase Agreement, the Company agreed to issue and sell 25,054 shares of Series A preferred stock and a Warrant to purchase 357,234 shares of the Company's common stock. Proceeds from this issuance of Series A preferred shares were allocated between preferred stock and the Warrant based on their relative fair values at the time of the sale. Of the \$25.1 million in proceeds, \$24.4 million was allocated to the Series A preferred stock and \$704,000 was allocated to the Warrant. The discount recorded on the Series A preferred stock that resulted from allocating a portion of the proceeds to the Warrant was being accreted directly to retained earnings over a five-year period applying a level yield.

The Series A preferred stock qualified as Tier 1 capital and paid cumulative dividends at a rate of 5% per annum for the first five years (i.e., through December 23, 2013) and 9% per annum thereafter. The Series A preferred stock was redeemable at the stated amount of \$1,000 per share plus any accrued and unpaid dividends. Under the terms of the original Purchase Agreement, the Company could not redeem the Series A preferred shares until December 23, 2011 unless the total amount of the issuance, \$25.1 million, was replaced with the same amount of other forms of capital that would qualify as Tier 1 capital. However, with the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA"), the Company could redeem the Series A preferred shares at any time, if approved by the Company's primary regulator. The Series A preferred stock was non-voting except for class voting rights on matters that would adversely affect the rights of the holders of the Series A preferred stock.

The UST sold all of its Series A preferred stock in a public auction in June 2012, and, as a result, the Company is no longer subject to the executive compensation and corporate governance standards imposed by TARP. The Company purchased 12,530 shares of the 25,054 outstanding shares of Series A preferred stock from the UST. The shares were purchased for \$933.36 per share, for a total purchase price of \$11,778,576, including \$83,575 accrued and unpaid dividends on the Series A preferred stock. The Company retired the 12,530 shares purchased. The \$834,999 difference between the \$12,530,000 face value of the Series A preferred stock retired and the \$11,695,001 purchase price of the Series A preferred stock retired was credited to retained earnings effective June 30, 2012. Remaining Series A preferred shares were redeemable at any time at par.

During 2012, the Company completed its repurchase of the Warrant to purchase 357,234 shares of the Company's common stock. The Company repurchased the Warrant for a total price of \$425,000. The exercise price of the Warrant was \$10.52 per common share and was exercisable at anytime on or before December 18, 2018. The

Company is no longer accreting the discount associated with the Warrant, as the discount remaining at the time of repurchase was included in the cost of the Warrant. As of December 31, 2013, the Company had accreted a total of \$478,000 of the discount related to the Series A preferred stock.

The Company received regulatory approval in December 2013 to repurchase and redeem the remaining 12,524 outstanding shares of its Series A preferred stock. The repurchase and redemption was completed on January 17, 2014 and was reflected on the Company's Consolidated Balance Sheets as of December 31, 2013. "Accrued interest payable and other liabilities" at December 31, 2013 includes \$12.6 million for the payment to preferred shareholders of principal and accrued dividends on January 17, 2014.

### Summary of Significant Accounting Policies

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. A more complete description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2013 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 1, 2014 Annual Meeting of Shareholders.

Many of the Company's assets and liabilities are recorded using various techniques that require significant judgment as to recoverability. The collectibility 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 collectibility. 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 this management's discussion and analysis and the Notes to the Consolidated Financial Statements.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is 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 table below presents the balance of securities available for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of June 30, 2014 and December 31, 2013.

(Dollars in thousands)

	Fair Value Measurements	June 30, 2014		
		Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 117,514	-	117,514	-
U.S. Government sponsored enterprises	\$ 25,101	-	25,101	-
State and political subdivisions	\$ 148,629	-	148,629	-
Corporate bonds	\$ 3,487	-	3,487	-
Trust preferred securities	\$ 750	-	-	750
Equity securities	\$ 1,684	1,684	-	-

(Dollars in thousands)

	Fair Value Measurements	December 31, 2013		
		Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 123,977	-	123,977	-
U.S. Government sponsored enterprises	\$ 22,143	-	22,143	-
State and political subdivisions	\$ 145,368	-	145,368	-
Corporate bonds	\$ 3,463	-	3,463	-
Trust preferred securities	\$ 1,250	-	-	1,250
Equity securities	\$ 1,689	1,689	-	-

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.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the six months ended June 30, 2014:

(Dollars in thousands)

	Investment Securities Available for Sale Level 3 Valuation
Balance, beginning of period	\$ 1,250
Change in book value	-
Change in gain/(loss) realized and unrealized	-
Purchases/(sales and calls)	(500 )
Transfers in and/or (out) of Level 3	-
Balance, end of period	\$ 750
Change in unrealized gain/(loss) for assets still held in Level 3	\$ -

The Bank's June 30, 2014 and December 31, 2013 fair value measurements for impaired loans and other real estate on a non-recurring basis are presented below. The fair value measurement process uses certified appraisals and other market-based information; however, in many cases, it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral, and other matters. As a result, all fair value measurements for impaired loans and other real estate are considered Level 3.

(Dollars in thousands)

	Fair Value Measurements June 30, 2014	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Six Months Ended June 30, 2014
Impaired loans	\$ 36,983	-	-	36,983	(433 )
Other real estate	\$ 3,532	-	-	3,532	(150 )

(Dollars in thousands)

	Fair Value Measurements December 31, 2013	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2013
Impaired loans	\$ 39,780	-	-	39,780	(3,207 )
Other real estate	\$ 1,679	-	-	1,679	(581 )

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan that is collateral-dependent is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform

appraisals for other companies. Factors, including the assumptions and techniques utilized by the appraiser, are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. An allowance for each impaired loan that is non-collateral dependent is calculated based on the present value of projected cash flows. If the recorded investment in the impaired loan exceeds the present value of projected cash flows, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under \$250,000 are not individually evaluated for impairment, with the exception of the Bank's TDR loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Accruing impaired loans were \$27.7 million, \$27.6 million and \$26.2 million at June 30, 2014, December 31, 2013 and June 30, 2013, respectively. Interest income recognized on accruing impaired loans was \$681,000, \$579,000 and \$1.3 million for the six months ended June 30, 2014, the six months ended June 30, 2013 and the year ended December 31, 2013, respectively. Interest income recognized on accruing impaired loans was \$325,000 and \$286,000 for the three months ended June 30, 2014 and 2013, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as non-accrual.

## Results of Operations

Summary. Net earnings were \$2.6 million or \$0.45 basic and diluted net earnings per share for the three months ended June 30, 2014, as compared to \$1.6 million or \$0.29 basic and diluted net earnings per share, before adjustment for preferred stock dividends and accretion, for the same period one year ago. After adjusting for dividends and accretion on preferred stock, net earnings available to common shareholders were \$2.6 million or \$0.45 basic and diluted net earnings per common share for the three months ended June 30, 2014, as compared to \$1.5 million or \$0.26 basic and diluted net earnings per common share, for the same period one year ago. The increase in second quarter earnings is attributable to a decrease in the provision for loan losses and an increase in net interest income, which were partially offset by a decrease in non-interest income.

The annualized return on average assets was 1.00% for the three months ended June 30, 2014 compared to 0.64% for the same period one year ago, and annualized return on average shareholders' equity was 11.08% for the three months ended June 30, 2014 compared to 6.55% for the same period one year ago.

Year-to-date net earnings as of June 30, 2014 were \$5.1 million or \$0.91 basic and diluted net earnings per share, as compared to \$3.4 million or \$0.60 basic and diluted net earnings per share, before adjustment for preferred stock dividends and accretion, for the same period one year ago. After adjusting for dividends and accretion on preferred stock, net earnings available to common shareholders for the six months ended June 30, 2014 were \$5.1 million or \$0.91 basic and diluted net earnings per common share, as compared to \$3.1 million or \$0.55 basic and diluted net earnings per common share, for the same period one year ago. The increase in year-to-date earnings is primarily attributable to a decrease in the provision for loan losses and an increase in net interest income, which were partially offset by a decrease in non-interest income and an increase in non-interest expense, as discussed below.

The annualized return on average assets was 1.01% for the six months ended June 30, 2014 compared to 0.68% for the same period one year ago, and annualized return on average shareholders' equity was 11.33% for the six months ended June 30, 2014 compared to 6.80% for the same period one year ago.

Net Interest Income. Net interest income, the major component of the Company's net earnings, was \$8.5 million for the three months ended June 30, 2014, compared to \$7.5 million for the same period one year ago. This increase was primarily due to an increase in interest income due to an increase in the yield on investment securities and an increase in the average outstanding balance of investment securities combined with a decrease in interest expense due to a reduction in the cost of funds.

Interest income increased \$667,000 or 7% for the three months ended June 30, 2014 compared to the same period one year ago. The increase was primarily due to an increase in the yield on investment securities and an increase in the average outstanding balance of investment securities. The average yield on investment securities available for sale for the quarters ended June 30, 2014 and 2013 was 3.55% and 2.67%, respectively. The average yield on earning assets for the quarters ended June 30, 2014 and 2013 was 4.34% and 3.97%, respectively. During the quarter ended June 30, 2014, average investment securities available for sale increased \$4.2 million to \$295.2 million from \$291.0 million for the three months ended June 30, 2013. During the quarter ended June 30, 2014, average loans increased \$12.2 million to \$619.7 million from \$607.5 million for the three months ended June 30, 2013.

Interest expense decreased \$287,000 or 21% for the three months ended June 30, 2014 compared with the same period one year ago due to lower cost of funds and a reduction in certificates of deposit. The average rate paid on interest-bearing checking and savings accounts was 0.13% for the three months ended June 30, 2014 as compared to 0.21% for the same period one year ago. The average rate paid on certificates of deposit was 0.58% for the three months ended June 30, 2014 compared to 0.73% for the same period one year ago. During the quarter ended June 30, 2014, average certificates of deposit decreased \$22.6 million to \$210.3 million from \$232.9 million for the three months ended June 30, 2013.

The following table 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 three months ended June 30, 2014 and 2013. 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 total average 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 of 37.96% for securities that are both federal and state tax exempt and an effective tax rate of 31.96% for federal 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.



(Dollars in thousands)	Three months ended June 30, 2014			Three months ended June 30, 2013		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Loans receivable	\$ 619,675	7,491	4.85%	607,481	7,439	4.91%
Investments - taxable	125,403	758	2.42%	139,546	225	0.65%
Investments - nontaxable*	175,107	1,901	4.38%	157,283	1,747	4.46%
Other	18,060	12	0.26%	48,588	28	0.23%
<b>Total interest-earning assets</b>	<b>938,245</b>	<b>10,162</b>	<b>4.34%</b>	<b>952,898</b>	<b>9,439</b>	<b>3.97%</b>
Cash and due from banks	47,399			28,002		
Other assets	52,362			54,430		
Allowance for loan losses	(13,018 )			(14,286 )		
<b>Total assets</b>	<b>\$ 1,024,988</b>			<b>1,021,044</b>		
<b>Interest-bearing liabilities:</b>						
NOW, MMDA & savings deposits	\$ 392,186	125	0.13%	374,531	200	0.21%
Time deposits	210,251	303	0.58%	232,868	422	0.73%
FHLB borrowings	65,000	549	3.39%	70,000	635	3.64%
Trust preferred securities	20,619	97	1.89%	20,619	100	1.96%
Other	45,597	11	0.09%	41,965	15	0.14%
<b>Total interest-bearing liabilities</b>	<b>733,653</b>	<b>1,085</b>	<b>0.59%</b>	<b>739,983</b>	<b>1,372</b>	<b>0.74%</b>
Demand deposits	195,383			176,974		
Other liabilities	4,786			4,714		
Shareholders' equity	92,388			100,054		
<b>Total liabilities and shareholder's equity</b>	<b>\$ 1,026,210</b>			<b>1,021,725</b>		
<b>Net interest spread</b>		<b>\$ 9,077</b>	<b>3.75%</b>		<b>8,067</b>	<b>3.23%</b>
<b>Net yield on interest-earning assets</b>			<b>3.88%</b>			<b>3.40%</b>
<b>Taxable equivalent adjustment</b>						
Investment securities		\$ 586			530	
<b>Net interest income</b>		<b>\$ 8,491</b>			<b>7,537</b>	

\*Includes U.S. Government agency securities that are non-taxable for state income tax purposes of \$25.4 million in 2014 and \$19.3 million in 2013. Tax rates of 6.00% and 6.90% were used to calculate the tax equivalent yield on these securities in 2014 and 2013, respectively.

Year-to-date net interest income as of June 30, 2014 increased 11.5% to \$16.9 million compared to \$15.2 million for the same period one year ago. This increase was primarily due to an increase in interest income due to an increase in the yield on investment securities and an increase in the average outstanding balance of investment securities combined with a decrease in interest expense due to a reduction in the cost of funds.

Interest income increased \$1.1 million or 6% for the six months ended June 30, 2014 compared with the same period in 2013. This increase was primarily due to an increase in the yield on investment securities and an increase in the average outstanding balance of investment securities. The average yield on investment securities available for sale for the six months ended June 30, 2014 and 2013 was 3.56% and 2.66%, respectively. The average yield on earning assets for the six months ended June 30, 2014 and 2013 was 4.35% and 4.06%, respectively. During the six months ended June 30, 2014, average investment securities available for sale increased \$8.3 million to \$297.1 million from \$288.8 million for the six months ended June 30, 2013. During the six months ended June 30, 2014, average loans increased \$4.3 million to \$618.6 million from \$614.3 million for the six months ended June 30, 2013.

Interest expense decreased \$638,000 or 23% for the six months ended June 30, 2014 compared with the same period in 2013 primarily due to lower cost of funds and a reduction in certificates of deposit. The average rate paid on interest-bearing checking and savings accounts was 0.13% for the six months ended June 30, 2014 as compared to 0.23% for the same period one year ago. The average rate paid on certificates of deposits was 0.60% for the six months ended June 30, 2014 compared to 0.75% for the same period one year ago. Average certificates of deposit decreased \$22.8 million to \$214.8 million for the six months ended June 30, 2014 from \$237.6 million for the six months ended June 30, 2013.

The following table 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 six months ended June 30, 2014 and 2013. 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 total average 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 of 37.96% for securities that are both federal and state tax exempt and an effective tax rate of 31.96% for federal 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.

(Dollars in thousands)	Six months ended June 30, 2014			Six months ended June 30, 2013		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Loans receivable	\$ 618,574	14,893	4.86%	614,241	15,079	4.95%
Investments - taxable	127,983	1,549	2.44%	144,278	567	0.79%
Investments - nontaxable*	174,556	3,833	4.43%	150,499	3,342	4.48%
Other	19,359	24	0.25%	35,885	40	0.22%
<b>Total interest-earning assets</b>	<b>940,472</b>	<b>20,299</b>	<b>4.35%</b>	<b>944,903</b>	<b>19,028</b>	<b>4.06%</b>
Cash and due from banks	45,403			26,884		
Other assets	49,579			55,406		
Allowance for loan losses	(13,307 )			(14,496 )		
<b>Total assets</b>	<b>\$ 1,022,147</b>			<b>1,012,697</b>		
<b>Interest-bearing liabilities:</b>						
NOW, MMDA & savings deposits	\$ 389,248	251	0.13%	371,502	418	0.23%
Time deposits	214,825	637	0.60%	237,615	889	0.75%
FHLB borrowings	65,000	1,094	3.40%	70,000	1,296	3.73%
Trust preferred securities	20,619	193	1.89%	20,619	199	1.96%
Other	44,582	21	0.10%	39,371	32	0.16%
<b>Total interest-bearing liabilities</b>	<b>734,274</b>	<b>2,196</b>	<b>0.60%</b>	<b>739,107</b>	<b>2,834</b>	<b>0.77%</b>
Demand deposits	193,985			169,921		