

PEOPLES BANCORP OF NORTH CAROLINA INC  
Form 10-Q  
November 07, 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: September 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 October 31, 2014.

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## INDEX

PART I.	FINANCIAL INFORMATION	PAGE(S)
Item 1.	Financial Statements	
	Consolidated Balance Sheets at September 30, 2014 (Unaudited) and December 31, 2013 (Audited)	3
	Consolidated Statements of Earnings for the three and nine months ended September 30, 2014 and 2013 (Unaudited)	4
	Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2014 and 2013 (Unaudited)	5
	Consolidated Statements of Cash Flows for the nine months ended September 30, 2014 and 2013 (Unaudited)	6-7
	Notes to Consolidated Financial Statements (Unaudited)	8-23
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	24-36
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	37
Item 4T.	Controls and Procedures	38
<b>PART II. OTHER INFORMATION</b>		
Item 1.	Legal Proceedings	39
Item 1A.	Risk Factors	39
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	39
Item 3.	Defaults upon Senior Securities	39
Item 5.	Other Information	39
Item 6.	Exhibits	39-42
Signatures		43
Certifications		44-46

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 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 1. Financial Statements

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

## Consolidated Balance Sheets

September 30, 2014 and December 31, 2013

(Dollars in thousands)

Assets	September 30, 2014 (Unaudited)	December 31, 2013 (Audited)
Cash and due from banks, including reserve requirements of \$13,041 and \$11,472, respectively	\$ 34,887	49,902
Interest-bearing deposits	50,636	26,871
Cash and cash equivalents	85,523	76,773
Investment securities available for sale	279,787	297,890
Other investments	4,706	4,990
Total securities	284,493	302,880
Mortgage loans held for sale	887	497
Loans	650,550	620,960
Less allowance for loan losses	(12,343 )	(13,501 )
Net loans	638,207	607,459
Premises and equipment, net	17,482	16,358
Cash surrender value of life insurance	14,020	13,706
Other real estate	1,840	1,679
Accrued interest receivable and other assets	11,483	15,332
Total assets	\$ 1,053,935	1,034,684
<b>Liabilities and Shareholders' Equity</b>		
<b>Deposits:</b>		
Noninterest-bearing demand	\$ 211,832	195,265
NOW, MMDA & savings	403,240	386,893
Time, \$100,000 or more	109,489	115,268
Other time	92,234	101,935
Total deposits	816,795	799,361
Securities sold under agreements to repurchase	47,020	45,396

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FHLB borrowings	65,000	65,000
Junior subordinated debentures	20,619	20,619
Accrued interest payable and other liabilities	8,294	20,589
Total liabilities	957,728	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	43,648	36,758
Accumulated other comprehensive income (loss)	4,389	(1,172 )
Total shareholders' equity	96,207	83,719
Total liabilities and shareholders' equity	\$ 1,053,935	1,034,684

See accompanying Notes to Consolidated Financial Statements.

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

## Consolidated Statements of Earnings

Three and Nine Months Ended September 30, 2014 and 2013

(Dollars in thousands, except per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
<b>Interest income:</b>				
Interest and fees on loans	\$ 7,664	7,592	22,556	22,671
Interest on due from banks	18	22	42	62
<b>Interest on investment securities:</b>				
U.S. Government sponsored enterprises	646	307	2,298	970
States and political subdivisions	1,168	1,179	3,514	3,233
Other	87	88	294	264
Total interest income	9,583	9,188	28,704	27,200
<b>Interest expense:</b>				
NOW, MMDA & savings deposits	124	160	375	578
Time deposits	287	396	924	1,285
FHLB borrowings	556	618	1,650	1,914
Junior subordinated debentures	98	100	291	299
Other	11	11	33	43
Total interest expense	1,076	1,285	3,273	4,119
Net interest income	8,507	7,903	25,431	23,081
Provision for loan losses	256	337	(27 )	2,164
Net interest income after provision for loan losses	8,251	7,566	25,458	20,917
<b>Non-interest income:</b>				
Service charges	1,303	1,189	3,655	3,333
Other service charges and fees	213	258	892	900
Gain on sale of securities	240	-	266	614
Mortgage banking income	256	301	548	1,000
Insurance and brokerage commissions	161	161	521	478
Gain/(loss) on sale and write-down of other real estate	(234 )	(111 )	(384 )	(284 )
Miscellaneous	1,268	1,313	3,660	3,806
Total non-interest income	3,207	3,111	9,158	9,847
<b>Non-interest expense:</b>				

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Salaries and employee benefits	4,301	4,183	12,784	12,614
Occupancy	1,489	1,357	4,476	3,988
Other	2,751	2,349	7,471	7,004
Total non-interest expense	8,541	7,889	24,731	23,606
Earnings before income taxes	2,917	2,788	9,885	7,158
Income tax expense	475	870	2,313	1,848
Net earnings	2,442	1,918	7,572	5,310
Dividends and accretion on preferred stock	-	156	-	470
Net earnings available to common shareholders	\$ 2,442	1,762	7,572	4,840
Basic net earnings per common share	\$ 0.43	0.31	1.35	0.86
Diluted net earnings per common share	\$ 0.43	0.31	1.34	0.86
Cash dividends declared per common share	\$ 0.04	0.03	0.12	0.09

See accompanying Notes to Consolidated Financial Statements.



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

## Consolidated Statements of Comprehensive Income (Loss)

Three and Nine Months Ended September 30, 2014 and 2013

(Dollars in thousands)

	Three months ended September 30,		Nine months ended September 30,	
	2014 (Unaudited)	2013 (Unaudited)	2014 (Unaudited)	2013 (Unaudited)
Net earnings	\$ 2,442	1,918	7,572	5,310
Other comprehensive income (loss):				
Unrealized holding gains (losses) on securities available for sale	1,788	(2,084 )	9,374	(9,881 )
Reclassification adjustment for gains on securities available for sale included in net earnings	(240 )	-	(266 )	(614 )
Total other comprehensive income (loss), before income taxes	1,548	(2,084 )	9,108	(10,495 )
Income tax (benefit) expense related to other comprehensive (loss) income:				
Unrealized holding gains (losses) on securities available for sale	696	(812 )	3,651	(3,849 )
Reclassification adjustment for gains on securities available for sale included in net earnings	(93 )	-	(104 )	(239 )
Total income tax expense (benefit) related to other comprehensive income (loss)	603	(812 )	3,547	(4,088 )
Total other comprehensive income (loss), net of tax	945	(1,272 )	5,561	(6,407 )
Total comprehensive income (loss)	\$ 3,387	646	13,133	(1,097 )

See accompanying Notes to Consolidated Financial Statements.

5

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

## Consolidated Statements of Cash Flows

Nine Months Ended September 30, 2014 and 2013

(Dollars in thousands)

	2014 (Unaudited)	2013 (Unaudited)
Cash flows from operating activities:		
Net earnings	\$ 7,572	5,310
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation, amortization and accretion	5,254	6,099
Provision for loan losses	(27 )	2,164
Gain on sale of investment securities	(266 )	(614 )
Gain on sale of other real estate	(43 )	(86 )
Write-down of other real estate	427	370
Restricted stock expense	272	104
Change in:		
Mortgage loans held for sale	(390 )	4,721
Cash surrender value of life insurance	(315 )	(324 )
Other assets	(254 )	897
Other liabilities	229	938
Net cash provided by operating activities	12,459	19,579
Cash flows from investing activities:		
Purchases of investment securities available for sale	(25,439 )	(89,169 )
Proceeds from calls, maturities and paydowns of investment securities available for sale	29,263	52,666
Proceeds from sales of investment securities available for sale	20,202	17,463
FHLB stock redemption	284	384
Net change in loans	(34,213 )	(1,448 )
Purchases of premises and equipment	(2,927 )	(1,575 )
Proceeds from sales of other real estate and repossessions	3,230	4,823
Net cash used by investing activities	(9,600 )	(16,856 )
Cash flows from financing activities:		
Net change in deposits	17,434	16,766
Net change in securities sold under agreements to repurchase	1,624	13,596

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Proceeds from FHLB borrowings	-	15,000
Repayments of FHLB borrowings	-	(15,000 )
Preferred stock repurchase	(12,524 )	-
Proceeds from stock options exercised	38	-
Cash dividends paid on preferred stock	-	(470 )
Cash dividends paid on common stock	(681 )	(508 )
Net cash provided by financing activities	5,891	29,384
Net change in cash and cash equivalents	8,750	32,107
Cash and cash equivalents at beginning of period	76,773	48,843
Cash and cash equivalents at end of period	\$ 85,523	80,950

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

## Consolidated Statements of Cash Flows, continued

Nine Months Ended September 30, 2014 and 2013

(Dollars in thousands)

	2014 (Unaudited)	2013 (Unaudited)
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid during the period for:		
Interest	\$ 3,290	4,179
Income taxes	\$ 1,637	1,937
Noncash investing and financing activities:		
Change in unrealized gain (loss) on investment securities available for sale, net		
	\$ 5,561	(6,407 )
Transfers of loans to other real estate and repossessions	\$ 3,774	2,153
Financed portion of sales of other real estate	\$ 282	525
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, 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, 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. 2014-11 (a) requires entities to account for repurchase-to-maturity transactions as secured borrowings

(rather than as sales with forward repurchase agreements), (b) eliminates accounting guidance on linked repurchase financing transactions, and (c) 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.

In August 2014, FASB issued ASU No. 2014-14, (Subtopic 310-40): Receivables – Troubled debt Restructurings by Creditors. ASU No. 2014-14 provides guidance on the classification and measurement of certain government-guaranteed mortgage loans upon foreclosure by a creditor. ASU No. 2014-14 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 September 30, 2014 and December 31, 2013 are as follows:

(Dollars in thousands)

	September 30, 2014			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Mortgage-backed securities	\$ 94,571	1,591	141	96,021
U.S. Government sponsored enterprises	27,939	185	147	27,977
State and political subdivisions	146,108	5,612	711	151,009
Corporate bonds	2,482	14	22	2,474
Trust preferred securities	750	-	-	750
Equity securities	748	808	-	1,556
Total	\$ 272,598	8,210	1,021	279,787

(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 September 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)

	September 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	\$ 11,266	14	8,126	127	19,392	141
U.S. Government sponsored enterprises	8,113	74	3,926	73	12,039	147
State and political subdivisions	-	-	31,377	711	31,377	711
Corporate bonds	-	-	527	22	527	22
Total	\$ 19,379	88	43,956	933	63,335	1,021

(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 September 30, 2014, unrealized losses in the investment securities portfolio relating to debt securities totaled \$1.0 million. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the September 30, 2014 tables above, 35 out of 175 securities issued by state and political subdivisions contained unrealized losses, 14 out of 79 securities issued by U.S. Government sponsored enterprises, including mortgage-backed securities, contained unrealized losses, and one out of four securities issued by corporations contained unrealized losses. These unrealized losses are considered temporary because of acceptable financial condition and results of operations of entities that issued 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 September 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.

September 30, 2014

(Dollars in thousands)

	Amortized Cost	Estimated Fair Value
Due within one year	\$ 5,362	5,393
Due from one to five years	41,153	43,023
Due from five to ten years	113,866	116,443
Due after ten years	16,898	17,351
Mortgage-backed securities	94,571	96,021

Equity securities	748	1,556
Total	\$ 272,598	279,787

Proceeds from sales of securities available for sale during the nine months ended September 30, 2014 were \$20.2 million and resulted in gross gains of \$291,000 and gross losses of \$25,000. Proceeds from sales of securities available for sale during the nine months ended September 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 \$103.0 million and \$86.0 million at September 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 September 30, 2014 and December 31, 2013 are summarized as follows:

(Dollars in thousands)

	September 30, 2014	December 31, 2013
Real estate loans		
Construction and land development	\$ 56,959	63,742
Single-family residential	202,797	195,975
Single-family residential - Banco de la Gente stated income	47,665	49,463
Commercial	227,183	209,287
Multifamily and farmland	10,887	11,801
Total real estate loans	545,491	530,268
Loans not secured by real estate		
Commercial loans	78,139	68,047
Farm loans	10	19
Consumer loans	10,210	9,593
All other loans	16,700	13,033
Total loans	650,550	620,960
Less allowance for loan losses	12,343	13,501
Total net loans	\$ 638,207	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 September 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 September 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 7% of the Bank's total loan portfolio.
-

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 September 30, 2014, commercial real estate loans comprised approximately 35% 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 September 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 September 30, 2014 and December 31, 2013:

September 30, 2014  
(Dollars in thousands)

	Loans 30 to 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	\$ 231	3,546	3,777	53,182	56,959	-
Single-family residential	2,663	973	3,636	199,161	202,797	120
Single-family residential - Banco de la Gente stated income	1,155	1,006	2,161	45,504	47,665	-
Commercial	1,864	416	2,280	224,903	227,183	-
Multifamily and farmland	-	167	167	10,720	10,887	-
Total real estate loans	5,913	6,108	12,021	533,470	545,491	120
<b>Loans not secured by real estate</b>						
Commercial loans	444	256	700	77,439	78,139	-
Farm loans	-	-	-	10	10	-
Consumer loans	148	11	159	10,051	10,210	-
All other loans	-	-	-	16,700	16,700	-
Total loans	\$ 6,505	6,375	12,880	637,670	650,550	120

December 31, 2013  
(Dollars in thousands)

	Loans 30 to 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	-
Single-family residential -						

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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 September 30, 2014 and December 31, 2013:

(Dollars in thousands)

	September 30, 2014	December 31, 2013
Real estate loans		
Construction and land development	\$ 3,888	6,546
Single-family residential	2,325	2,980
Single-family residential - Banco de la Gente stated income	1,955	1,990
Commercial	1,818	2,043
Multifamily and farmland	166	-
Total real estate loans	10,152	13,559
Loans not secured by real estate		
Commercial loans	421	250
Consumer loans	61	27
Total	\$ 10,634	13,836

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 \$26.8 million, \$27.6 million and \$27.1 million at September 30, 2014, December 31, 2013 and September 30, 2013, respectively. Interest income recognized on accruing impaired loans was \$992,000, \$916,000 and \$1.3 million for the nine months ended September 30, 2014, the nine months ended September 30, 2013 and the year ended December 31, 2013, respectively. Interest income recognized on accruing impaired loans was \$311,000 and \$337,000 for the three months ended September 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 September 30, 2014 and December 31, 2013:

September 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
Real estate loans						

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Construction and land development	\$ 5,704	3,808	645	4,453	40	5,990
Single-family residential	6,520	941	5,360	6,301	139	7,690
Single-family residential -						
Banco de la Gente stated income	21,706	-	21,129	21,129	1,210	19,998
Commercial	4,733	2,845	1,548	4,393	192	4,445
Multifamily and farmland	166	-	166	166	1	171
Total impaired real estate loans	38,829	7,594	28,848	36,442	1,582	38,294
Loans not secured by real estate						
Commercial loans	760	-	659	659	13	836
Consumer loans	311	-	307	307	5	305
Total impaired loans	\$ 39,900	7,594	29,814	37,408	1,600	39,435



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 nine months ended September 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 Farm	Consumer and All Other	Unallocated		
<b>Nine months ended</b>											
<b>September 30, 2014</b>											
<b>Allowance</b>											
<b>for loan</b>											
<b>losses:</b>											
<b>Beginning</b>											
balance	\$3,218	3,123	-	1,863	2,219	37	1,069	-	245	1,727	13,501
Charge-offs	(772)	(223)	(148)	(181)	-	(197)	(399)	(399)	(399)	(399)	(1,920)
Recoveries	389	64	17	165	-	42	-	112	-	-	789
Provision	239	(230)	(60)	(435)	(29)	240	-	282	(34)	(27)	(27)
<b>Ending</b>											
balance	\$3,074	2,734	-	1,672	1,768	8	1,154	-	240	1,693	12,343

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Three months ended  
September 30, 2014

Allowance  
for loan  
losses:

Beginning

balance	\$3,387	2,848	1,708	1,839	7	1,081	-	253	1,552	12,675
Charge-offs	(513)	(30)	(7)	(51)	-	(4)	-	(144)	-	(749)
Recoveries	107	2	-	4	-	15	-	33	-	161
Provision	93	(86)	(29)	(24)	1	62	-	98	141	256
Ending balance	\$3,074	2,734	1,672	1,768	8	1,154	-	240	1,693	12,343

Allowance for loan losses at  
September 30, 2014:

Ending  
balance:

individually  
evaluated

for impairment	\$-	67	1,164	182	-	-	-	-	-	1,413
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Ending  
balance:

collectively  
evaluated

for impairment	3,074	2,667	508	1,586	8	1,154	-	240	1,693	10,930
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Ending

balance	\$3,074	2,734	1,672	1,768	8	1,154	-	240	1,693	12,343
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Loans at  
September  
30, 2014:

Ending

balance	\$56,959	202,797	47,665	227,183	10,887	78,139	10	26,910	-	650,550
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Ending  
balance:

individually  
evaluated

for impairment	\$3,808	2,312	19,083	3,563	-	-	-	-	-	28,766
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Ending  
balance:

collectively  
evaluated

for impairment	\$53,151	200,485	28,582	223,620	10,887	78,139	10	26,910	-	621,784
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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	
Nine months ended										
September 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	(732)	(1,204)	(252)	(327)	-	(483)	-	(485)	-	(3,483)
Recoveries	374	75	101	50	-	39	-	111	-	750
Provision	99	864	67	240	8	140	-	379	367	2,164
Ending balance	\$4,140	2,966	1,914	2,012	36	784	-	250	1,752	13,854
Three months ended										
September 30, 2013										
Allowance for loan losses:										
Beginning										
balance	\$4,725	3,304	1,924	1,858	34	822	-	229	1,133	14,029
Charge-offs	(17)	(569)	(28)	(51)	-	(101)	-	(204)	-	(970)
Recoveries	348	31	31	-	-	14	-	34	-	458
Provision	(916)	200	(13)	(205)	2	49	-	191	619	337
Ending balance	\$4,140	2,966	1,914	2,012	36	784	-	250	1,752	13,854
Allowance for loan losses at September 30, 2013:										
Ending balance: individually evaluated for impairment										
\$1	60	1,233	-	-	-	-	-	-	-	1,294
Ending balance: collectively										

evaluated for impairment	4,139	2,906	681	2,012	36	784	-	250	1,752	12,560
Ending balance	\$4,140	2,966	1,914	2,012	36	784	-	250	1,752	13,854

Loans at  
September  
30, 2013:

Ending balance	\$67,870	191,338	50,035	205,911	11,541	64,957	22	25,387	-	617,061
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Ending  
balance:  
individually  
evaluated

for impairment	\$6,790	3,079	19,803	3,100	-	-	-	272	-	33,044
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Ending  
balance:  
collectively  
evaluated

for impairment	\$61,080	188,259	30,232	202,811	11,541	64,957	22	25,115	-	584,017
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The provision for loan losses for the three months ended September 30, 2014 was \$256,000, as compared to \$337,000 for the same period one year ago. The decrease in the provision for loan losses is primarily attributable to a \$3.5 million reduction in non-accrual loans from September 30, 2013 to September 30, 2014.

The provision for loan losses for the nine months ended September 30, 2014 was a credit of \$27,000, as compared to an expense of \$2.2 million for the same period one year ago. The decrease in the provision for loan losses is primarily attributable to a \$1.6 million decrease in net charge-offs during the nine months ended September 30, 2014 compared to the same period one year ago and a \$3.5 million reduction in non-accrual loans from September 30, 2013 to September 30, 2014. The credit to provision for loan losses in the nine months ended September 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 September 30, 2014 to \$12.3 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 as 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 September 30, 2014 and December 31, 2013:

September 30, 2014  
(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	\$-	13,925	-	-	-	1,240	-	1,311	-	16,476
2- High Quality	6,926	71,916	-	37,429	251	17,708	-	3,599	1,947	139,776
3- Good Quality	23,647	74,571	21,165	145,065	6,753	46,624	10	4,598	12,558	334,991
4- Management Attention	12,867	30,167	8,134	34,165	1,026	11,442	-	576	2,195	100,572
5- Watch	6,617	6,624	6,848	6,541	2,690	388	-	42	-	29,750
6- Substandard	6,902	5,594	11,518	3,983	167	727	-	84	-	28,975
7- Doubtful	-	-	-	-	-	-	-	-	-	-
8- Loss	-	-	-	-	-	10	-	-	-	10
<b>Total</b>	<b>\$56,959</b>	<b>202,797</b>	<b>47,665</b>	<b>227,183</b>	<b>10,887</b>	<b>78,139</b>	<b>10</b>	<b>10,210</b>	<b>16,700</b>	<b>650,550</b>

December 31, 2013  
(Dollars in thousands)

	Real Estate Loans									Total
	Construction and Land Development	Single- Family Residential	Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial Farm	Consumer	All Other		
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
<b>Total</b>	<b>\$63,742</b>	<b>195,975</b>	<b>49,463</b>	<b>209,287</b>	<b>11,801</b>	<b>68,047</b>	<b>19</b>	<b>9,593</b>	<b>13,033</b>	<b>620,960</b>

Total TDR loans amounted to \$10.2 million and \$21.9 million at September 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 \$1.7 million and \$335,000 in performing loans classified as TDR loans at September 30, 2014 and December 31, 2013, respectively.



The following tables present an analysis of loan modifications during the nine months ended September 30, 2014 and 2013:

Nine months ended September 30, 2014  
(Dollars in thousands)

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans			
Construction and land development	1	\$ 291	291
Single-family residential	2	849	849
Single-family residential - Banco de la Gente stated income	7	594	594
Total real estate TDR loans	10	1,734	1,734
Total TDR loans	10	\$ 1,734	1,734

Nine months ended September 30, 2013  
(Dollars in thousands)

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans			
Construction and land development	2	\$ 825	825
Single-family residential	-	-	-
Single-family residential - Banco de la Gente stated income	4	466	466
Total real estate TDR loans	6	1,291	1,291
Total TDR loans	6	\$ 1,291	1,291

(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 nine months ended September 30, 2014 and 2013 is as follows:

For the three months ended September 30, 2014

Net Earnings Available to Common	Common Shares	Per Share Amount
---	------------------	------------------------

	Shareholders (Dollars in thousands)			
Basic earnings per common share	\$ 2,442	5,617,125	\$	0.43
Effect of dilutive securities:				
Stock options	-	27,599		
Diluted earnings per common share	\$ 2,442	5,644,724	\$	0.43

For the nine months ended September 30, 2014

	Net Earnings Available to Common Shareholders		Per Share Amount
	(Dollars in thousands)	Common Shares	
Basic earnings per common share	\$ 7,572	5,615,556	\$ 1.35
Effect of dilutive securities:			
Stock options	-	24,173	
Diluted earnings per common share	\$ 7,572	5,639,729	\$ 1.34

For the three months ended September 30, 2013

	Net Earnings Available to Common Shareholders		Per Share Amount
	(Dollars in thousands)	Common Shares	
Basic earnings per common share	\$ 1,762	5,613,495	\$ 0.31
Effect of dilutive securities:			
Stock options	-	15,180	
Diluted earnings per common share	\$ 1,762	5,628,675	\$ 0.31

For the nine months ended September 30, 2013

	Net Earnings Available to Common Shareholders		Per Share Amount
	(Dollars in thousands)	Common Shares	
Basic earnings per common share	\$ 4,840	5,613,495	\$ 0.86
Effect of dilutive securities:			
Stock options	-	8,554	
Diluted earnings per common share	\$ 4,840	5,622,049	\$ 0.86

(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 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. As of September 30, 2014, there were no outstanding options under the 1999 Plan.

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.

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 recognized compensation expense on the restricted stock units over the period of time the restrictions were 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 in each period reflected the changes in the Company's stock price during such period. As of September 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 stock-based rights under the 2009 Plan must be granted or awarded by May 7, 2019 (or ten years from the 2009 Plan effective date).

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 such period. As of September 30, 2014, the total unrecognized compensation expense related to the restricted stock unit grants under the 2009 Plan was \$808,000.

The Company recognized compensation expense for restricted stock unit awards granted under the 2009 Plan of \$272,000 and \$104,000 for the nine months ended September 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.

#### 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.

#### 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 September 30, 2014 and December 31, 2013.

(Dollars in thousands)

	September 30, 2014			
	Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 96,021	-	96,021	-
U.S. Government sponsored enterprises	27,977	-	27,977	-
State and political subdivisions	151,009	-	151,009	-
Corporate bonds	2,474	-	2,474	-
Trust preferred securities	750	-	-	750
Equity securities	1,556	1,556	-	-

(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 nine months ended September 30, 2014.

(Dollars in thousands)

	Investment Securities Available for Sale Level 3 Valuation
Balance, beginning of period	\$ 750
Change in book value	-
Change in gain/(loss) realized and unrealized	-
Purchases/(sales and calls)	-
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 September 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 September 30, 2014	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Nine Months Ended September 30, 2014
Impaired loans	\$ 35,808	-	-	35,808	(931 )
Other real estate	1,840	-	-	1,840	(384 )

(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 September 30, 2014 and December 31, 2013 are as follows:

(Dollars in thousands)

	Fair Value Measurements at September 30, 2014				
	Carrying Amount	Level 1	Level 2	Level 3	Total
<b>Assets:</b>					
Cash and cash equivalents	\$ 85,523	85,523	-	-	85,523
Investment securities available for sale	279,787	1,556	277,481	750	279,787
Other investments	4,706	-	-	4,706	4,706
Mortgage loans held for sale	887	-	-	887	887
Loans, net	638,207	-	-	641,923	641,923
Cash surrender value of life insurance	14,020	-	14,020	-	14,020
<b>Liabilities:</b>					
Deposits	\$ 816,795	-	815,640	-	815,640
Securities sold under agreements to repurchase	47,020	-	47,020	-	47,020
FHLB borrowings	65,000	-	64,594	-	64,594
Junior subordinated debentures	20,619	-	20,619	-	20,619

(Dollars in thousands)

	Fair Value Measurements at December 31, 2013			
	Carrying	Level 2	Level 3	Total

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Amount Level  
1

Assets:					
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
Liabilities:					
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 September 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 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. 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 UST sold all of the Company's Series A preferred stock in a public auction in June 2012. 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. Remaining Series A preferred shares were redeemable at any time at par. Also, 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 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. Fair value of the Company's financial instruments is discussed in Note (6) of the Notes to Consolidated Financial Statements (Unaudited) included in this Quarterly Report.



## Results of Operations

Summary. Net earnings were \$2.4 million or \$0.43 basic and diluted net earnings per share for the three months ended September 30, 2014, as compared to \$1.9 million or \$0.34 basic and diluted net earnings per share, before adjustment for preferred stock dividends and accretion, for the same period one year ago. Net earnings available to common shareholders were \$2.4 million or \$0.43 basic and diluted net earnings per common share for the three months ended September 30, 2014, as compared to \$1.8 million or \$0.31 basic and diluted net earnings per common share for the same period one year ago. The increase in third quarter earnings is attributable to an increase in net interest income, a decrease in the provision for loan losses and an increase in non-interest income, which were partially offset by an increase in non-interest expense.

The annualized return on average assets was 0.93% for the three months ended September 30, 2014, compared to 0.74% for the same period one year ago, and annualized return on average shareholders' equity was 10.09% for the three months ended September 30, 2014, compared to 8.02% for the same period one year ago.

Year-to-date net earnings as of September 30, 2014 were \$7.6 million, or \$1.35 basic net earnings per share and \$1.34 diluted net earnings per share, as compared to \$5.3 million or \$0.95 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 nine months ended September 30, 2014 were \$7.6 million or \$1.35 basic net earnings per common share and \$1.34 diluted net earnings per common share, as compared to \$4.8 million or \$0.86 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 an increase in net interest income and a decrease in the provision for loan losses, which were partially offset by an increase in non-interest expense and a decrease in non-interest income, as discussed below.

The annualized return on average assets was 0.98% for the nine months ended September 30, 2014, compared to 0.70% for the same period one year ago, and annualized return on average shareholders' equity was 10.71% for the nine months ended September 30, 2014, compared to 7.11% 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 September 30, 2014, compared to \$7.9 million for the same period one year ago. This increase was primarily due to an increase in interest income resulting from an increase in the yield on investment securities and an increase in the average outstanding principal balance of loans and was augmented by a decrease in interest expense resulting primarily from a reduction in the cost of funds.

Interest income increased \$395,000 or 4% for the three months ended September 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 principal balance of loans. The average yield on investment securities available for sale for the quarters ended September 30, 2014 and 2013 was 3.44% and 2.86%, respectively. The average yield on earning assets for the quarters ended September 30, 2014 and 2013 was 4.22% and 4.08%, respectively. During the quarter ended September 30, 2014, average investment securities available for sale decreased \$13.5 million to \$283.4 million from \$296.9 million for the quarter ended September 30, 2013. During the quarter ended September 30, 2014, average loans increased \$25.5 million to \$638.2 million from \$612.7 million for the quarter ended September 30, 2013.

Interest expense decreased \$209,000 or 16% for the three months ended September 30, 2014, compared to the same period one year ago. This decrease was the result of lower cost of funds and a reduction in certificates of deposit. The average rate paid on interest-bearing checking and savings accounts was 0.12% for the quarter ended September 30, 2014, as compared to 0.17% for the same period one year ago. The average rate paid on certificates of deposit was 0.56% for the quarter ended September 30, 2014, as compared to 0.69% for the same period one year ago. During the quarter ended September 30, 2014, average certificates of deposit decreased \$23.2 million to \$204.1 million from \$227.3 million for the quarter ended September 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 September 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 a 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 September 30, 2014			Three months ended September 30, 2013		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Loans receivable	\$ 638,192	7,664	4.76%	612,716	7,592	4.92%
Investments - taxable	117,216	656	2.22%	134,447	296	0.87%
Investments - nontaxable*	171,467	1,829	4.23%	168,324	1,863	4.39%
Other	28,024	18	0.25%	35,641	22	0.24%
<b>Total interest-earning assets</b>	<b>954,899</b>	<b>10,167</b>	<b>4.22%</b>	<b>951,128</b>	<b>9,773</b>	<b>4.08%</b>
Cash and due from banks	49,541			43,281		
Other assets	54,897			47,582		
Allowance for loan losses	(12,658 )			(13,868 )		
<b>Total assets</b>	<b>\$ 1,046,679</b>			<b>1,028,123</b>		
<b>Interest-bearing liabilities:</b>						
NOW, MMDA & savings deposits	\$ 392,767	123	0.12%	380,564	160	0.17%
Time deposits	204,120	287	0.56%	227,276	396	0.69%
FHLB borrowings	65,000	556	3.39%	70,000	618	3.50%
Trust preferred securities	20,619	98	1.89%	20,619	100	1.92%
Other	48,736	12	0.10%	46,270	11	0.09%
<b>Total interest-bearing liabilities</b>	<b>731,242</b>	<b>1,076</b>	<b>0.58%</b>	<b>744,729</b>	<b>1,285</b>	<b>0.68%</b>
Demand deposits	215,551			184,151		
Other liabilities	3,866			4,341		
Shareholders' equity	96,020			94,902		
<b>Total liabilities and shareholder's equity</b>	<b>\$ 1,046,679</b>			<b>1,028,123</b>		
<b>Net interest spread</b>		<b>\$ 9,091</b>	<b>3.64%</b>		<b>8,488</b>	<b>3.39%</b>
<b>Net yield on interest-earning assets</b>			<b>3.78%</b>			<b>3.54%</b>
<b>Taxable equivalent adjustment</b>						
Investment securities		\$ 584			585	
<b>Net interest income</b>		<b>\$ 8,507</b>			<b>7,903</b>	

\*Includes U.S. Government agency securities that are non-taxable for state income tax purposes of \$25.2 million in 2014 and \$19.9 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 September 30, 2014 increased 10% to \$25.4 million compared to \$23.1 million for the same period one year ago. This increase was primarily due to an increase in interest income resulting from an increase in the yield on investment securities and an increase in the average outstanding principal balance of loans and was augmented by a decrease in interest expense resulting primarily from a reduction in the cost of funds.

Interest income increased \$1.5 million or 6% for the nine months ended September 30, 2014 to \$28.7 million, compared to \$27.2 million for the same period in 2013. This increase was primarily due to an increase in interest income resulting from an increase in the yield on investment securities and an increase in the average outstanding principal balance of loans. The average yield on investment securities available for sale for the nine months ended September 30, 2014 and 2013 was 3.52% and 2.73%, respectively. The average yield on earning assets for the nine months ended September 30, 2014 and 2013 was 4.31% and 4.07%, respectively. During the nine months ended September 30, 2014, average investment securities available for sale increased \$1.0 million to \$292.5 million from \$291.5 million for the nine months ended September 30, 2013. During the nine months ended September 30, 2014, average loans increased \$11.5 million to \$625.2 million from \$613.7 million for the nine months ended September 30, 2013.

Interest expense decreased \$846,000 or 21% for the nine months ended September 30, 2014, compared to the same period in 2013. This decrease was 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 nine months ended September 30, 2014, as compared to 0.21% for the same period one year ago. The average rate paid on certificates of deposits was 0.58% for the nine months ended September 30, 2014, as compared to 0.73% for the same period one year ago. Average certificates of deposit decreased \$22.9 million to \$211.2 million for the nine months ended September 30, 2014 from \$234.1 million for the nine months ended September 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 nine months ended September 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 a 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)	Nine months ended September 30, 2014			Nine months ended September 30, 2013		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Loans receivable	\$ 625,185	22,556	4.82%	613,727	22,671	4.94%
Investments - taxable	126,682	2,243	2.37%	143,062	902	0.84%
Investments - nontaxable*	171,188	5,624	4.39%	154,409	5,167	4.47%
Other	22,279	42	0.25%	35,803	62	0.23%
<b>Total interest-earning assets</b>	<b>945,334</b>	<b>30,465</b>	<b>4.31%</b>	<b>947,001</b>	<b>28,802</b>	<b>4.07%</b>
Cash and due from banks	46,798			32,410		
Other assets	51,371			52,768		
Allowance for loan losses	(13,089 )			(14,284 )		
<b>Total assets</b>	<b>\$ 1,030,414</b>			<b>1,017,895</b>		
<b>Interest-bearing liabilities:</b>						
NOW, MMDA & savings deposits	\$ 390,434	375	0.13%	374,556	578	0.21%
Time deposits	211,217	924	0.58%	234,131	1,285	0.73%
FHLB borrowings	65,000	1,650	3.39%	70,000	1,914	3.66%
Trust preferred securities	20,619	291	1.89%	20,619	299	1.94%
Other	45,982	33	0.10%	41,696	43	0.14%
<b>Total interest-bearing liabilities</b>	<b>733,252</b>	<b>3,273</b>	<b>0.60%</b>	<b>741,002</b>	<b>4,119</b>	<b>0.74%</b>
Demand deposits	201,253			174,716		

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Other liabilities	1,379		2,271	
Shareholders' equity	94,530		99,906	
Total liabilities and shareholder's equity \$	1,030,414		1,017,895	
Net interest spread		\$ 27,192	3.71%	24,683 3.33%
Net yield on interest-earning assets			3.85%	3.48%
Taxable equivalent adjustment				
Investment securities		\$ 1,761		1,602
Net interest income		\$ 25,431		23,081

\*Includes U.S. Government agency securities that are non-taxable for state income tax purposes of \$24.5 million in 2014 and \$19.5 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.

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

(Dollars in thousands)	Three months ended September 30, 2014 compared to three months ended September 30, 2013			Nine months ended September 30, 2014 compared to nine months ended September 30, 2013		
	Changes in average volume	Changes in average rates	Total Increase (Decrease)	Changes in average volume	Changes in average rates	Total Increase (Decrease)
	<b>Interest income:</b>					
Loans: Net of unearned income	\$ 311	(239 )	72	418	(533 )	(115 )
Investments - taxable	(67 )	427	360	(197 )	1,538	1,341
Investments - nontaxable	34	(68 )	(34 )	556	(99 )	457
Other	(5 )	1	(4 )	(25 )	5	(20 )
<b>Total interest income</b>	<b>273</b>	<b>121</b>	<b>394</b>	<b>752</b>	<b>911</b>	<b>1,663</b>
<b>Interest expense:</b>						
NOW, MMDA & savings deposits	4	(41 )	(37 )	20	(223 )	(203 )
Time deposits	(36 )	(73 )	(109 )	(113 )	(248 )	(361 )
FHLB borrowings	(43 )	(19 )	(62 )	(132 )	(132 )	(264 )
Trust preferred securities	-	(2 )	(2 )	-	(8 )	(8 )
Other	1	-	1	4	(14 )	(10 )
<b>Total interest expense</b>	<b>(74 )</b>	<b>(135 )</b>	<b>(209 )</b>	<b>(221 )</b>	<b>(625 )</b>	<b>(846 )</b>
<b>Taxable equivalent net interest income</b>	<b>\$ 347</b>	<b>256</b>	<b>603</b>	<b>973</b>	<b>1,536</b>	<b>2,509</b>

Provision for Loan Losses. The provision for loan losses for the three months ended September 30, 2014 was \$256,000, as compared to \$337,000 for the same period one year ago. The decrease in the provision for loan losses is primarily attributable to a \$3.5 million reduction in non-accrual loans from September 30, 2013 to September 30, 2014.

The provision for loan losses for the nine months ended September 30, 2014 was a credit of \$27,000, as compared to an expense of \$2.2 million for the same period one year ago. The decrease in the provision for loan losses is primarily attributable to a \$1.6 million decrease in net charge-offs during the nine months ended September 30, 2014, compared to the same period one year ago and a \$3.5 million reduction in non-accrual loans from September 30, 2013 to September 30, 2014. The credit to provision for loan losses in the nine months ended September 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 September 30, 2014 to \$12.3 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 since 2010, as shown below:



(Dollars in thousands)

	Net charge-offs						Net charge-offs as a percent of average loans outstanding					
	Nine months ended		Years ended December 31,				Nine months ended		Years ended December 31,			
	September 30, 2014	2013	2013	2012	2011	2010	September 30, 2014	2013	2013	2012	2011	2010
Real estate loans												
Construction and land development	\$ 383	358	400	4,201	6,923	10,135	0.65%	0.51%	0.58%	4.99%	6.40%	6.84%
Single-family residential	159	1,129	1,613	814	2,049	2,853	0.08%	0.57%	0.82%	0.39%	0.91%	1.15%
Single-family residential - Banco de la Gente stated income	131	151	132	668	675	425	0.27%	0.29%	0.26%	1.25%	1.23%	0.98%
Commercial	16	277	395	563	1,247	753	0.01%	0.14%	0.20%	0.27%	0.59%	0.43%
Multifamily and farmland	-	-	-	-	-	-	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Total real estate loans	689	1,915	2,540	6,246	10,894	14,166	0.13%	0.36%	0.48%	1.12%	1.80%	2.14%
	-	-	-	-	-	-						
Loans not secured by real estate												
Commercial loans	155	444	458	451	193	1,668	0.22%	0.71%	0.73%	0.75%	0.34%	3.41%
Farm loans	-	-	-	-	-	-	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Consumer loans (1)	287	374	508	408	434	524	2.92%	3.86%	5.27%	4.00%	4.05%	4.73%
All other loans	-	-	-	-	-	-	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Total loans	\$ 1,131	2,733	3,506	7,105	11,521	16,358	0.18%	0.45%	0.57%	1.10%	1.65%	2.16%
Provision for loan losses for the period	\$ (27	) 2,164	2,584	4,924	12,632	16,438						
Allowance for loan losses at end of period	\$ 12,343	13,854	13,501	14,423	16,604	15,493						
Total loans at end of period	\$ 650,550	617,061	620,960	619,974	670,497	726,160						

Non-accrual loans at end of period	\$ 10,634	14,144	13,836	17,630	21,785	40,062
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Allowance for loan losses as a percent of total loans outstanding at end of period	1.90%	2.25%	2.17%	2.33%	2.48%	2.13%
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Non-accrual loans as a percent of total loans outstanding at end of period	1.63%	2.29%	2.23%	2.84%	3.25%	5.52%
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(1) The loss ratio for Consumer loans is elevated because overdraft charge-offs related to DDA and NOW accounts are reported in Consumer Loan charge-offs and recoveries. The net overdraft charge-offs are not considered material and are therefore not shown separately.

Another factor considered in taking a credit to provision expense in the nine months ended September 30, 2014 was the continuing decline in the construction and land development portfolio. This portfolio has experienced the highest percentage of loss from 2010 through 2012 as shown in the table above. The balance outstanding declined to \$57.0 million at September 30, 2014 from \$63.7 million at December 31, 2013, continuing the decline in this portfolio from the maximum balance of \$213.7 million at December 31, 2008.

Non-Interest Income. Total non-interest income was \$3.2 million for the three months ended September 30, 2014, compared to \$3.1 million for the same period one year ago. This increase is primarily attributable to a \$240,000 increase in gains on the sale of securities, which was partially offset by a \$45,000 decrease in miscellaneous non-interest income resulting primarily from a \$110,000 reduction in vendor commissions for the three months ended September 30, 2014, as compared to the same period one year ago.

Non-interest income was \$9.2 million for the nine months ended September 30, 2014, compared to \$9.8 million for the same period one year ago. This decrease is primarily attributable to a \$348,000 decrease in gains on the sale of securities, a \$452,000 decrease in mortgage banking income due to a reduction in mortgage banking activity associated with an increase in mortgage rates and a \$146,000 decrease in miscellaneous non-interest income primarily due to an increase in losses and write-downs on other real estate, which were partially offset by a \$314,000 increase in service charges and fees primarily due to an increase in commercial checking service charges for the nine months ended September 30, 2014, as compared to the same period one year ago.

Non-Interest Expense. Total non-interest expense was \$8.5 million for the three months ended September 30, 2014, compared to \$7.9 million for the same period one year ago. This increase in non-interest expense included: (1) a \$118,000 increase in salaries and benefits expense primarily due to an increase in the number of full-time equivalent employees, (2) a \$132,000 increase in occupancy expense primarily due to a \$73,000 increase in furniture and equipment depreciation expense and (3) a \$402,000 increase in non-interest expenses other than salary, employee benefits and occupancy expenses primarily due to a \$218,000 amortization expense associated with North Carolina income tax credits purchased during the three months ended September 30, 2014, as compared to the same period one year ago.

Non-interest expense was \$24.7 million for the nine months ended September 30, 2014, as compared to \$23.6 million for the same period one year ago. This increase in non-interest expense included: (1) a \$170,000 increase in salaries and benefits expense primarily due to an increase in the number of full-time equivalent employees, (2) a \$488,000 increase in occupancy expense primarily due to a \$329,000 increase in furniture and equipment depreciation expense and (3) a \$467,000 increase in non-interest expenses other than salary, employee benefits and occupancy expenses primarily due to a \$218,000 amortization expense associated with North Carolina income tax credits purchased, a \$67,000 increase in consulting fees and a \$61,000 increase in advertising expense during the nine months ended September 30, 2014, as compared to the same period one year ago.

Income Taxes. The Company reported income tax expense of \$475,000 and \$870,000 for the three months ended September 30, 2014 and 2013, respectively. This represented an effective tax rate of 16% and 31% for the respective periods. The lower effective tax rate for 2014 is primarily due to North Carolina income tax credits purchased during the third quarter of 2014.

The Company reported income taxes of \$2.3 million and \$1.8 million for the nine months ended September 30, 2014 and 2013, respectively. This represented an effective tax rate of 23% and 26% for the respective periods. The lower effective tax rate for 2014 is primarily due to North Carolina income tax credits purchased during the third quarter of 2014.

#### Analysis of Financial Condition

Investment Securities. Available for sale securities were \$279.8 million at September 30, 2014, compared to \$297.9 million at December 31, 2013. This decrease is primarily attributable to \$19.5 million securities sold during the third quarter of 2014. Average investment securities available for sale for the nine months ended September 30, 2014 were \$292.5 million compared to \$293.8 million for the year ended December 31, 2013.

Loans. At September 30, 2014, loans were \$650.6 million, compared to \$621.0 million at December 31, 2013. This increase is primarily attributable to a \$17.9 million increase in commercial real estate loans and a \$10.1 million increase in commercial loans not secured by real estate. Loans originated or renewed during the nine months ended September 30, 2014, of approximately \$152.3 million, were offset by paydowns and payoffs of existing loans. Average loans represented 66% and 65% of average earning assets for the nine months ended September 30, 2014 and the year ended December 31, 2013, respectively. The Company had \$887,000 and \$497,000 in mortgage loans held for sale as of September 30, 2014 and December 31, 2013, respectively.

Although the Company has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by real estate, which is dependent upon the real estate market. Real estate mortgage loans include both commercial and residential mortgage loans. At September 30, 2014, the Company had \$106.8 million in residential mortgage loans, \$87.3 million in home equity loans and \$293.1 million in commercial mortgage loans, which include \$237.0 million secured by commercial property and \$56.1 million secured by residential property. Residential mortgage loans include \$58.8 million made to customers in the Company's traditional banking offices and \$48.0 million in mortgage loans originated in the Company's Latino banking offices. All residential mortgage loans are originated as fully amortizing loans, with no negative amortization.

At September 30, 2014, the Company had \$57.0 million in construction and land development loans. The following table presents a breakout of these loans.

(Dollars in thousands)

	Number of Loans	Balance Outstanding	Non-accrual Balance
Land acquisition and development - commercial purposes	61	\$ 12,716	\$ 29
Land acquisition and development - residential purposes	281	34,387	3,859
1 to 4 family residential construction	46	7,570	-
Commercial construction	6	2,286	-
Total construction and land development	394	\$ 56,959	\$ 3,888

Total TDR loans amounted to \$10.2 million and \$21.9 million at September 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 \$1.7

million and \$335,000 in performing loans classified as TDR loans at September 30, 2014 and December 31, 2013, respectively.

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

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

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

As an additional measure, the Bank engages an independent third party to review the underwriting, documentation and risk grading analyses. This independent third party reviews and evaluates loan relationships greater than \$1.0 million, excluding loans in default, and loans in process of litigation or liquidation. The third party's evaluation and report is shared with management and the Bank's Board of Directors.

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

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

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Bank's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below.

The general allowance reflects reserves established under GAAP for collective loan impairment. These reserves are based upon historical net charge-offs using the greater of the last two, three, four or five years' loss experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends in establishing reserves.

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

Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Bank's loan portfolio as of the date of the financial statements. Management believes it has established the allowance in

accordance with GAAP and in consideration of the current economic environment. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

Various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require adjustments to the allowance based on their judgments of information available to them at the time of their examinations. Management believes it has established the allowance for credit losses pursuant to GAAP, and has taken into account the views of its regulators and the current economic environment.

The allowance for loan losses at September 30, 2014 was \$12.3 million or 1.90% of total loans, compared to \$13.5 million or 2.17% of total loans at December 31, 2013.

The following table presents the percentage of loans assigned to each risk grade at September 30, 2014 and December 31, 2013.

Risk Grade	Percentage of Loans By Risk Grade	
	9/30/2014	12/31/2013
Risk Grade 1 (Excellent Quality)	2.15%	2.40%
Risk Grade 2 (High Quality)	21.49%	18.82%
Risk Grade 3 (Good Quality)	51.65%	49.49%
Risk Grade 4 (Management Attention)	15.40%	18.69%
Risk Grade 5 (Watch)	4.57%	5.05%
Risk Grade 6 (Substandard)	4.43%	5.25%
Risk Grade 7 (Doubtful)	0.00%	0.00%
Risk Grade 8 (Loss)	0.00%	0.00%

At September 30, 2014, including non-accrual loans, there were five relationships exceeding \$1.0 million in the Watch risk grade (which totaled \$11.5 million) and four relationships exceeding \$1.0 million in the Substandard risk grade (which totaled \$8.8 million).

**Non-performing Assets.** Non-performing assets totaled \$12.6 million at September 30, 2014 or 1.19% of total assets, compared to \$16.4 million or 1.58% of total assets at December 31, 2013. Non-accrual loans were \$10.6 million at September 30, 2014 and \$13.8 million at December 31, 2013. As a percentage of total loans outstanding, non-accrual loans were 1.63% at September 30, 2014, compared to 2.23% at December 31, 2013. Non-accrual loans include \$3.9 million in construction and land development loans, \$6.3 million in commercial and residential mortgage loans and \$482,000 in other loans at September 30, 2014, compared to \$6.5 million in construction and land development loans, \$7.0 million in commercial and residential mortgage loans and \$277,000 in other loans at December 31, 2013. The Bank had loans 90 days past due and still accruing totaling \$120,000 and \$882,000 as of September 30, 2014 and December 31, 2013, respectively. Other real estate totaled \$1.8 million at September 30, 2014, compared to \$1.7 million at December 31, 2013.

**Deposits.** Total deposits at September 30, 2014 were \$816.8 million compared to \$799.4 million at December 31, 2013. Core deposits, which include non-interest bearing demand deposits, NOW, MMDA, savings and non-brokered certificates of deposit of denominations less than \$100,000, were \$707.2 million at September 30, 2014 as compared to \$683.9 million at December 31, 2013. Certificates of deposit in amounts of \$100,000 or more totaled \$109.5 million at September 30, 2014 as compared to \$115.3 million at December 31, 2013. At September 30, 2014, brokered deposits were \$10.9 million as compared to \$15.1 million at December 31, 2013. Brokered deposits outstanding as of September 30, 2014 had a weighted average rate of 0.12% with a weighted average original term of ten months as compared to brokered deposits outstanding at December 31, 2013, which had a weighted average rate of 0.14% with a weighted average original term of eight months.

**Borrowed Funds.** Borrowings from the FHLB totaled \$65.0 million at September 30, 2014 and December 31, 2013. The average balance of FHLB borrowings for the three months ended September 30, 2014 was \$65.0 million, compared to \$69.7 million for the year ended December 31, 2013. The FHLB borrowings outstanding at September 30, 2014 had interest rates ranging from 1.79% to 4.26% and maturity dates ranging from 2014 to 2019.



Securities sold under agreements to repurchase were \$47.0 million at September 30, 2014 compared to \$45.4 million at December 31, 2013.

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

The trust preferred securities issued by PEBK Trust II accrue and pay quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II does not have funds with which to make the distributions and other payments. The net combined effect of the trust preferred securities transaction is that the Company is obligated to make the distributions and other payments required on the trust preferred securities.

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

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

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

The Company's rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available for sale securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits and borrowed funds. Average rate sensitive assets for the nine months ended September 30, 2014 totaled \$945.3 million, exceeding average rate sensitive liabilities of \$733.2 million by \$212.1 million.

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 September 30, 2014.

Included in the rate sensitive assets are \$285.3 million in variable rate loans indexed to prime rate subject to immediate repricing upon changes by the Federal Open Market Committee ("FOMC"). The Company utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At September 30, 2014, the Company had \$195.7 million in loans with interest rate floors. The floors were in effect on \$192.7 million of these loans pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 0.97% higher than the indexed rate on the promissory notes without interest rate floors.

**Liquidity.** The objectives of the Company's liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory

requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company's liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of September 30, 2014, such unfunded commitments to extend credit were \$168.1 million, while commitments in the form of standby letters of credit totaled \$3.3 million.

The Company uses several sources to meet its liquidity requirements. The primary source is core deposits, which includes demand deposits, savings accounts and non-brokered certificates of deposit of denominations less than \$100,000. The Company considers these to be a stable portion of the Company's liability mix and the result of on-going consumer and commercial banking relationships. As of September 30, 2014, the Company's core deposits totaled \$707.2 million, or 87% of total deposits.

The other sources of funding for the Company are through large denomination certificates of deposit, including brokered deposits, federal funds purchased, securities under agreements to repurchase and FHLB borrowings. The Bank is also able to borrow from the Federal Reserve Bank (“FRB”) on a short-term basis. The Company’s policies include the ability to access wholesale funding of up to 40% of total assets. The Company’s wholesale funding includes FHLB borrowings, FRB borrowings, brokered deposits, internet certificates of deposit and certificates of deposit issued to the State of North Carolina. The Company’s ratio of wholesale funding to total assets was 7.22% as of September 30, 2014.

At September 30, 2014, the Bank had a significant amount of deposits in amounts greater than \$100,000. The cost of these deposits is more susceptible to changes in the interest rate environment than other deposits. Access to the brokered deposit market could be restricted if the Bank were to fall below the well capitalized level.

The Bank has a line of credit with the FHLB equal to 20% of the Bank’s total assets, with an outstanding balance of \$65.0 million at September 30, 2014 and December 31, 2013. At September 30, 2014, the carrying value of loans pledged as collateral to the FHLB totaled \$125.5 million compared to \$132.9 million at December 31, 2013. As additional collateral, the Bank has pledged securities to the FHLB. At September 30, 2014, the market value of securities pledged to the FHLB totaled \$14.6 million compared to \$17.3 million at December 31, 2013. The remaining availability under the line of credit with the FHLB was \$25.4 million at September 30, 2014 compared to \$21.6 million at December 31, 2013. The Bank had no borrowings from the FRB at September 30, 2014 or December 31, 2013. FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At September 30, 2014, the carrying value of loans pledged as collateral to the FRB totaled \$340.4 million compared to \$315.2 million at December 31, 2013.

The Bank also had the ability to borrow up to \$54.5 million for the purchase of overnight federal funds from five correspondent financial institutions as of September 30, 2014.

The liquidity ratio for the Bank, which is defined as net cash, interest-bearing deposits, federal funds sold and certain investment securities, as a percentage of net deposits and short-term liabilities was 32.46% at September 30, 2014 and 35.65% at December 31, 2013. The minimum required liquidity ratio as defined in the Bank’s Asset/Liability and Interest Rate Risk Management Policy is 10%.

Contractual Obligations and Off-Balance Sheet Arrangements. The Company’s contractual obligations and other commitments as of September 30, 2014 and December 31, 2013 are summarized in the table below. The Company’s contractual obligations include the repayment of principal and interest related to FHLB advances and junior subordinated debentures, as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.

(Dollars in thousands)

	September 30, 2014	December 31, 2013
<b>Contractual Cash Obligations</b>		
Long-term borrowings	\$ 65,000	65,000
Junior subordinated debentures	20,619	20,619
Operating lease obligations	4,780	3,743
<b>Total</b>	<b>\$ 90,399</b>	<b>89,362</b>
<b>Other Commitments</b>		
Commitments to extend credit	\$ 168,054	146,243
Standby letters of credit and financial guarantees written	3,319	4,361

Total	\$	171,373	150,604
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The Company enters into derivative contracts to manage various financial risks. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or referenced interest rate. Derivative contracts are carried at fair value on the consolidated balance sheet with the fair value representing the net present value of expected future cash receipts or payments based on market interest rates as of the balance sheet date. Derivative contracts are written in amounts referred to as notional amounts, which only provide the basis for calculating payments between counterparties and are not a measure of financial risk. Further discussions of derivative instruments are included above in the section entitled "Asset Liability and Interest Rate Risk Management".

Capital Resources. Shareholders' equity was \$96.2 million or 9.1% of total assets, as of September 30, 2014, compared to \$83.7 million or 8.1% of total assets as of December 31, 2013. This increase reflects an increase in retained earnings and an increase in accumulated other comprehensive income resulting from an increase in the unrealized gain on investment securities.

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.

Annualized return on average equity for the nine months ended September 30, 2014 was 10.71% compared to 7.11% for the nine months ended September 30, 2013. Total cash dividends paid on common stock were \$681,000 and \$505,000 for the nine months ended September 30, 2014 and 2013, respectively.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights. The Board of Directors does not currently anticipate issuing any additional series of preferred stock.

In September 2014, the Company's Board of Directors authorized a stock repurchase program, pursuant to which up to \$2 million will be allocated to repurchase the Company's common stock. Any purchases under the Company's stock repurchase program may be made periodically as permitted by securities laws and other legal requirements in the open market or in privately negotiated transactions. The timing and amount of any repurchase of shares will be determined by the Company's management, based on its evaluation of market conditions and other factors. The repurchase program may be suspended at any time or from time-to-time without prior notice. The Company had not repurchased any of its common stock under this program as of September 30, 2014.

Under the regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 4.0% or greater. Tier 1 capital is generally defined as shareholders' equity and trust preferred securities less all intangible assets and goodwill. Tier 1 capital at September 30, 2014 and December 31, 2013 includes \$20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 15.13% and 14.83% at September 30, 2014 and December 31, 2013, respectively. Total risk-based capital is defined as Tier 1 capital plus supplementary capital. Supplementary capital, or Tier 2 capital, consists of the Company's allowance for loan losses, not exceeding 1.25% of the Company's risk-weighted assets. Total risk-based capital ratio is therefore defined as the ratio of total capital (Tier 1 capital and Tier 2 capital) to risk-weighted assets. The Company's total risk-based capital ratio was 16.43% and 16.14% at September 30, 2014 and December 31, 2013, respectively. In addition to the Tier 1 and total risk-based capital requirements, financial institutions are also required to maintain a leverage ratio of Tier 1 capital to total average assets of 4.0% or greater. The Company's Tier 1 leverage capital ratio was 10.68% and 10.08% at September 30, 2014 and December 31, 2013, respectively.

The Bank's Tier 1 risk-based capital ratio was 14.51% and 14.43% at September 30, 2014 and December 31, 2013, respectively. The total risk-based capital ratio for the Bank was 15.80% and 15.73% at September 30, 2014 and December 31, 2013, respectively. The Bank's Tier 1 leverage capital ratio was 10.23% and 9.79% at September 30, 2014 and December 31, 2013, respectively.

A bank is considered to be "well capitalized" if it has a total risk-based capital ratio of 10.0 % or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater. Based upon these guidelines, the Bank was considered to be "well capitalized" at September 30, 2014.

On July 2, 2013, the Federal Reserve Board approved its final rule on the Basel III capital standards, which implement changes to the regulatory capital framework for banking organizations. Capital levels at the Company and the Bank currently exceed the new capital requirements, which will be effective on January 1, 2015.



Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not required for smaller reporting companies.

37

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Item 4T. Controls and Procedures

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

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

PART OTHER INFORMATION

II.

Item 1. Legal Proceedings

On April 2, 2013, the Bank received notice that a lawsuit was filed against it in the General Court of Justice, Superior Court Division, Lincoln County, North Carolina. The complaint alleges (i) breach of contract and the covenants of good faith and fair dealing by the Bank, (ii) conversion, (iii) unjust enrichment and (iv) violations of the North Carolina Unfair and Deceptive Trade Practices Act in its assessment and collection of overdraft fees. It seeks the refund of overdraft fees, treble damages, attorneys' fees and injunctive relief. The Plaintiff seeks to have the lawsuit certified as a class action. On June 6, 2013, the Bank filed a motion for judgment on the pleadings, which was heard in the North Carolina Business Court on October 1, 2013. On April 15, 2014, the North Carolina Business Court denied the Bank's motion for judgment on the pleadings. The effect of the court's ruling, which is not a determination on the merits, is to allow the case to proceed to the next stages of the legal process, including discovery and determination as to whether class certification is appropriate or not. That discovery is now underway. The Bank believes that the allegations in the complaint are without merit and intends to vigorously defend the lawsuit, including the request that the lawsuit be certified as a class action.

Item Risk Factors

1A.

Not required for smaller reporting companies.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Total Number of Shares	Average Price Paid	Total Number of Shares Purchased as Part of Publicly Announced Plans or	Maximum Number of Shares that May Yet Be Purchased
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Period	Purchased	per Share	Programs	Under the Plans or Programs
July 1 - 31, 2014	569	\$ 16.98	-	-
August 1 - 31, 2014	588	16.71	-	-
September 1 - 30, 2014	-	-	-	-
Total	1,157	(1) \$ 16.84	-	-

(1) The Company purchased 1,157 shares on the open market in the three months ended September 30, 2014 for its deferred compensation plan. All purchases were funded by participant contributions to the plan.

### Item 3.Defaults Upon Senior Securities

Not applicable

### Item 5.Other Information

Not applicable

Item 6. Exhibits

- Exhibit (3)(1) Articles of Amendment dated December 19, 2008, regarding the Series A Preferred Stock, incorporated by reference to Exhibit (3)(1) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (3)(2) Articles of Amendment dated February 26, 2010, incorporated by reference to Exhibit (3)(2) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010
- Exhibit (3)(i) Articles of Incorporation of the Registrant, incorporated by reference to Exhibit (3)(i) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999
- Exhibit (3)(ii) Amended and Restated Bylaws of the Registrant, incorporated by reference to Exhibit (3)(ii) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010
- Exhibit (4) Specimen Stock Certificate, incorporated by reference to Exhibit (4) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999
- Exhibit (4)(1) Form of Certificate for the Series A Preferred Stock, incorporated by reference to Exhibit (4)(1) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(a)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Tony W. Wolfe dated December 18, 2008, incorporated by reference to Exhibit (10)(a)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(b)(i) Employment Letter Agreement dated December 23, 2008 between the Registrant and Joseph F. Beaman, Jr., incorporated by reference to Exhibit (10)(b)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(b)(ii) Amendment to Employment Agreement between Peoples Bank and Joseph F. Beaman, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(b)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008

- Exhibit (10)(b)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Joseph F. Beaman, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(b)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(c)(i) Employment Letter Agreement dated December 23, 2008 between the Registrant and William D. Cable, Sr., incorporated by reference to Exhibit (10)(c)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(c)(ii) Amendment to Employment Agreement between Peoples Bank and William D. Cable, Sr. dated December 18, 2008, incorporated by reference to Exhibit (10)(c)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(c)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and William D. Cable, Sr. dated December 18, 2008, incorporated by reference to Exhibit (10)(c)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008

- Exhibit (10)(d)(i) Employment Letter Agreement dated December 23, 2008 between the Registrant and Lance A. Sellers, incorporated by reference to Exhibit (10)(d)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(d)(ii) Amendment to Employment Agreement between Peoples Bank and Lance A. Sellers dated December 18, 2008, incorporated by reference to Exhibit (10)(d)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(d)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Lance A. Sellers dated December 18, 2008, incorporated by reference to Exhibit (10)(d)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(e) Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(f) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(e)(i) Amendment No. 1 to the Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(e)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 15, 2007
- Exhibit (10)(f)(i) Employment Letter Agreement dated December 23, 2008 between the Registrant and A. Joseph Lampron, Jr., incorporated by reference to Exhibit (10)(f)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(f)(ii) Amendment to Employment Agreement between Peoples Bank and A. Joseph Lampron, Jr. dated March 18, 2010 incorporated by reference to Exhibit (10)(f)(ii) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010
- Exhibit (10)(f)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and A. Joseph Lampron, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(f)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(g) Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference

to Exhibit (10)(h) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002

- Exhibit (10)(h) Rabbi Trust for the Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002
- Exhibit (10)(i) Description of Service Recognition Program maintained by Peoples Bank, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 27, 2003
- Exhibit (10)(j) Capital Securities Purchase Agreement dated as of June 26, 2006, by and among the Registrant, PEBK Capital Trust II and Bear, Sterns Securities Corp., incorporated by reference to Exhibit (10)(j) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(k) Amended and Restated Trust Agreement of PEBK Capital Trust II, dated as of June 28, 2006, incorporated by reference to Exhibit (10)(k) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(l) Guarantee Agreement of the Registrant dated as of June 28, 2006, incorporated by reference to Exhibit (10)(l) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006

- Exhibit (10)(m) Indenture, dated as of June 28, 2006, by and between the Registrant and LaSalle Bank National Association, as Trustee, relating to Junior Subordinated Debt Securities Due September 15, 2036, incorporated by reference to Exhibit (10)(m) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(n) Form of Amended and Restated Director Supplemental Retirement Agreement between Peoples Bank and Directors Robert C. Abernethy, James S. Abernethy, Douglas S. Howard, John W. Lineberger, Jr., Gary E. Matthews, Dr. Billy L. Price, Jr., Larry E. Robinson, W. Gregory Terry, Dan Ray Timmerman, Sr. and Benjamin I. Zachary, incorporated by reference to Exhibit (10)(n) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(o) 2009 Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(o) to the Form 10-K filed with the Securities and Exchange Commission on March 20, 2009
- Exhibit (10)(p) Underwriting Agreement with Merrill Lynch, Pierce, Fenner & Smith Incorporated and Sandler O'Neill & Partners, L.P., as representatives of the several underwriters listed on Schedule A thereto and the UST incorporated by reference to Exhibit 1.1 to the Form 8-K filed with the Securities and Exchange Commission on June 29, 2012
- Exhibit (14) Code of Business Conduct and Ethics of Peoples Bancorp of North Carolina, Inc., incorporated by reference to Exhibit (14) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2005
- Exhibit (31)(a) Certification of principal executive officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit (31)(b) Certification of principal financial officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit (32) Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- Exhibit (101) The following materials from the Company's 10-Q Report for the quarterly period ended September 30, 2014, formatted in XBRL: (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Income, (iii) the



Condensed Consolidated Statements of Changes in Shareholders' Equity, (iv) the Condensed Consolidated Statements of Cash Flows, and (v) the Notes to the Condensed Consolidated Financial Statements, tagged as blocks of text.\*

\*Furnished, not filed.

SIGNATURES

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

Peoples Bancorp of North Carolina, Inc.

November 7, 2014  
Date

/s/ Lance A. Sellers  
Lance A. Sellers  
President and Chief Executive Officer  
(Principal Executive Officer)

November 7, 2014  
Date

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

