PEOPLES BANCORP OF NORTH CAROLINA INC
Form DEF 14A
April 03, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14A

(Rule 14a-101)

Proxy Statement Pursuant to Section 14(a)
of the Securities Exchange Act of 1934

Filed by the Registrant	[X]
Filed by a Party other than the Registrant	[ ]

Check the appropriate box:

[ ]	Preliminary Proxy Statement	[ ]	Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
[X]	Definitive Proxy Statement		
[ ]	Definitive Additional Materials		
[ ]	Soliciting Material Pursuant to §240.14a-12		

Peoples Bancorp of North Carolina, Inc.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

[X]		No fee required.
[ ]		Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.
	(1)	Title of each class of securities to which transaction applies:
	(2)	Aggregate number of securities to which transaction applies:
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PEOPLES BANCORP
OF NORTH CAROLINA, INC.

Notice of 2006 Annual Meeting,
Proxy Statement and
Annual Report

PEOPLES BANCORP OF NORTH CAROLINA, INC.

PROXY STATEMENT

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PEOPLES BANCORP OF NORTH CAROLINA, INC.
Post Office Box 467
518 West C Street
Newton, North Carolina 28658-0467
(828) 464-5620

NOTICE OF 2006 ANNUAL MEETING OF SHAREHOLDERS
To Be Held on May 4, 2006

NOTICE IS HEREBY GIVEN that the 2006 Annual Meeting of Shareholders (the "Meeting") of Peoples Bancorp of North Carolina, Inc. (the "Company") will be held on Thursday, May 4, 2006, at 11:00 a.m., Eastern Time, at the Catawba Country Club, 1154 Country Club Road, Newton, North Carolina.

The Meeting is for the purpose of considering and voting upon the following matters:

1. To elect four persons who will serve as directors of the Company for a three-year term expiring in 2009, or until their successors are duly elected and qualified;

2. To ratify the appointment of Porter Keadle Moore, LLP ("PKM") as the independent auditor for the Company for the fiscal year ending December 31, 2006; and

3. To transact such other business as may properly come before the Meeting or any adjournments thereof. The board of directors of the Company (the "Board of Directors") is not aware of any other business to be considered at the Meeting.

The Board of Directors has established March 6, 2006 as the record date for the determination of shareholders entitled to notice of and to vote at the Meeting and at any adjournments thereof. In the event there are not sufficient shares present in person or by proxy to constitute a quorum at the time of the Meeting, the Meeting may be adjourned in order to permit further solicitation of proxies by the Company.

By Order of the Board of Directors,

/s/ Tony W. Wolfe

Tony W. Wolfe
President and Chief Executive Officer

Newton, North Carolina
April 3, 2006

A form of proxy is enclosed to enable you to vote your shares at the Meeting. You are urged, regardless of the number of shares you hold, to complete, sign, date and return the proxy promptly. A return envelope, which requires no postage if mailed in the United States, is enclosed for your convenience.

PEOPLES BANCORP OF NORTH CAROLINA, INC.

PROXY STATEMENT
2006 ANNUAL MEETING OF SHAREHOLDERS
May 4, 2006

SOLICITATION, VOTING AND REVOCABILITY OF PROXIES

General

This Proxy Statement is being furnished to shareholders of the Company in connection with the solicitation by the Board of Directors of the Company of proxies to be used at the Meeting to be held on Thursday, May 4, 2006, at 11:00 a.m., Eastern Time, at the Catawba Country Club, 1154 Country Club Road, Newton, North Carolina, and at any adjournments thereof. This Proxy Statement and the accompanying form of proxy were first mailed to shareholders on April 3, 2006.

The Company's principal executive offices are located at 518 West C Street, Newton, North Carolina 28658, and its telephone number is (828) 464-5620.

Other than the matters listed on the attached Notice of 2006 Annual Meeting of Shareholders, the Board of Directors knows of no matters that will be presented for consideration at the Meeting. Execution of a proxy, however, confers on the designated proxyholders discretionary authority to vote the shares represented thereby in accordance with their best judgment on such other business, if any, that may properly come before the Meeting or any adjournments thereof.

Revocability of Proxy

A proxy may be revoked at any time prior to its exercise by the filing of a written notice of revocation with the Secretary of the Company, by delivering to the Company a duly executed proxy bearing a later date, or by attending the Meeting and voting in person. However, if you are a shareholder whose shares are not registered in your own name, you will need appropriate documentation from your recordholder to vote personally at the Meeting.

Solicitation

The cost of solicitation of proxies on behalf of the Board of Directors will be borne by the Company. Proxies may be solicited personally or by telephone by directors, officers and regular employees of the Company, without additional compensation therefor. The Company will also request persons, firms and corporations holding shares in their names, or in the name of their nominees, which are beneficially owned by others to send proxy material to, and obtain proxies from, such beneficial owners and will reimburse such holders, upon request, for their reasonable out-of-pocket expenses in doing so.

Voting Securities and Vote Required for Approval

Regardless of the number of shares of the Company's common stock (the "Common Stock") owned, it is important that shareholders be represented by proxy or be present in person at the Meeting. Shareholders are requested to vote by completing the enclosed form of proxy and returning it signed and dated in the enclosed postage-paid envelope. Any shareholder may vote for, against, or withhold authority to vote on any matter to come before the Meeting. If the enclosed proxy is properly completed, signed, dated and returned, and not revoked, it will be voted in accordance with the instructions therein. If no instructions are given, the proxy will be voted "FOR" the nominees for election to the Board of Directors named in this Proxy Statement and "FOR" the ratification of PKM as the Company's independent auditor for the fiscal year ending December 31, 2006. If instructions are given with respect to one but not

1

both proposals, (i) such instructions as are given will be followed, and (ii) the proxy will be voted "FOR" the proposal on which no instructions are given.

The securities which may be voted at the Meeting consist of shares of Common Stock. The close of business on March 6, 2006 has been fixed by the Board of Directors as the record date (the "Record Date") for the determination of shareholders of record entitled to notice of and to vote at the Meeting and any adjournments thereof. The total number of shares of Common Stock outstanding on the Record Date was 3,454,501.

The presence, in person or by proxy, of the holders of at least a majority of the total number of shares of Common Stock entitled to vote at the Meeting is necessary to constitute a quorum at the Meeting. Since many of our shareholders cannot attend the Meeting, it is necessary that a large number be represented by proxy. Accordingly, the Board of Directors has designated proxies to represent those shareholders who cannot be present in person and who desire to be so represented. In the event there are not sufficient votes for a quorum or to approve or ratify any proposal at the time of the Meeting, the Meeting may be adjourned in order to permit the further solicitation of proxies.

In the election of directors, persons must be nominated and elected for a term to expire at the 2009 Annual Meeting of Shareholders. Each share of Common Stock shall entitle its owner to one vote, and a nominee need only receive a plurality of the votes cast in the election of directors in order to be elected. As a result, those persons nominated who receive the largest number of votes will be elected as directors. No shareholder has the right to cumulatively vote his or her shares in the election of directors.

As to the ratification of the independent auditor, each share of Common Stock shall entitle its owner to one vote and the affirmative vote of the holders of a majority of the shares of Common Stock present at the Meeting, in person or by proxy and entitled to vote, is required to constitute shareholder approval of the proposal.

Proxies solicited hereby will be returned to the Board of Directors, and will be tabulated by one or more inspectors of election designated by the Board of Directors. Abstentions will be counted for purposes of determining whether a quorum is present at the Meeting. Abstentions will not be counted in tabulating the votes cast on any proposal submitted to the shareholders. Broker non-votes will be counted for determining the existence of a quorum but will not be counted for tabulating votes cast on any proposal.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The Securities Exchange Act of 1934, as amended (the "Exchange Act"), requires that any person who acquires the beneficial ownership of more than five percent of the Common Stock notify the Securities and Exchange Commission (the "SEC") and the Company. Following is certain information, as of the Record Date, regarding those persons or groups who held of record or who are known to the Company to own beneficially, more than five percent of the outstanding Common Stock.

Name and Address of Beneficial Owner	**Amount and Nature of** Beneficial Ownership[1]	**Percent of Class**[2]
Christine S. Abernethy P.O. Box 820 Newton, NC 28658	385,005[3]	11.15%
Banc Funds Company, LLC 208 South LaSalle St.	193,922	5.61%

Suite 1680 Chicago, IL 60604		
Tontine Partners, LP 55 Railroad Ave., 3rd Floor Greenwich, CT 06830-6378	314,793	9.11%

2

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

2 Based upon a total of 3,454,501 shares of Common Stock outstanding as of the Record Date.

3 Carolina Glove Company, Inc. owns 65,215 shares of Common Stock. These shares are included in the calculation of Ms. Abernethy's total beneficial ownership interest. Ms. Abernethy owns approximately 50% of the stock of Carolina Glove Company, Inc. The business is operated by a family committee. Ms. Abernethy has no active day-to-day participation in the business affairs of Carolina Glove Company, Inc.

Set forth below is certain information, as of the Record Date, regarding those shares of Common Stock owned beneficially by each of the persons who currently serves as a member of the Board of Directors, is a nominee for election to the Board at the Meeting, or is a named executive officer of the Company. Also shown is the number of shares of Common Stock owned by the directors and executive officers of the Company as a group.

Name and Address	**Amount and Nature of Beneficial Ownership**[1]	**Percentage of Class**[2]
James S. Abernethy Post Office Box 327 Newton, NC 28658	108,907[3]	3.06%
Robert C. Abernethy Post Office Box 366 Newton, NC 28658	124,624[4]	3.50%
Joseph F. Beaman, Jr. Post Office Box 467 Newton, NC 28658	23,447[5]	*
William D. Cable Post Office Box 467 Newton, NC 28658	17,463[6]	*
Douglas S. Howard P. O. Box 587 Denver, NC 28037	4,434[7]	*
A. Joseph Lampron Post Office Box 467 Newton, NC 28658	11,647[8]	*

John W. Lineberger, Jr. 6154 Vesuvius Furnace Road Iron Station, NC 28080	563	*
Gary E. Matthews 210 First Avenue South Conover, NC 28613	8,900	*
Billy L. Price, Jr., M.D. 540 11th Ave. Place NW Hickory, NC 28601	598	*
Larry E. Robinson Post Office Box 723 Newton, NC 28658	27,125[9]	*

Name and Address	**Amount and Nature of Beneficial Ownership**[1]	**Percentage of Class**[2]
Lance A. Sellers Post Office Box 467 Newton, NC 28658	20,971[10]	*
William Gregory Terry 706 South College Ave Newton, NC 28658	3,276[11]	*
Dan Ray Timmerman, Sr. Post Office Box 1148 Conover, NC 28613	35,302[12]	*
Tony W. Wolfe Post Office Box 467 Newton, NC 28658	43,570[13]	1.22%
Benjamin I. Zachary Post Office Box 277 Taylorsville, NC 28681	45,311[14]	1.27%
All current directors and nominees and executive officers as a group (17 people)	435,985 [15,16]	12.24%

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

1

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

2

Based upon a total of 3,454,501 shares of Common Stock outstanding as of the Record Date and 107,421 stock options exercisable within 60 days with respect to the designated recipient(s).

3

Includes 38,811 shares of Common Stock owned by Alexander Railroad Company. Mr. J. Abernethy is Vice President, Secretary and Chairman of the Board of Directors of Alexander Railroad Company.

4

Includes 2,961 shares of Common Stock owned by Mr. R. Abernethy's spouse, for which Mr. R. Abernethy disclaims beneficial ownership.

5

Includes 20,945 shares of Common Stock in which Mr. Beaman has the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

6

Includes 14,248 shares of Common Stock in which Mr. Cable has the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

7

Includes 1,000 shares of Common Stock owned by Mr. Howard's mother over which Mr. Howard holds a power of attorney. Includes 500 shares of Common Stock owned by Howard Ventures, Inc. Mr. Howard is Vice President of Howard Ventures, Inc.

8

Includes 11,152 shares of Common Stock in which Mr. Lampron has the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

9

Includes 4,143 shares of Common Stock owned by Mr. Robinson's spouse, for which Mr. Robinson disclaims beneficial ownership.

[10] Includes 20,848 shares of Common Stock in which Mr. Sellers has the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

11

Includes 1,000 shares of Common Stock owned by Drum Funeral Home, LLC. Mr. Terry is Executive Vice-President of Drum Funeral Home, LLC.

12

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

13

Includes 40,228 shares of Common Stock in which Mr. Wolfe has the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

14

Includes 38,811 shares of Common Stock owned by Alexander Railroad Company. Mr. Zachary is President, Treasurer, General Manager and a Director of Alexander Railroad Company.

15

The 38,811 shares owned by Alexander Railroad Company and attributed to Mr. J. Abernethy and Mr. Zachary are only included once in calculating this total.

16

Includes 107,421 shares of Common Stock in which the executive officers, as a group, have the right to acquire beneficial interest within 60 days by the exercise of stock options granted under the Omnibus Stock Ownership and Long Term Incentive Plan.

Directors James S. Abernethy and Robert C. Abernethy are brothers and are sons of Christine S. Abernethy, who owns in excess of 10% of the Common Stock.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires the Company's executive officers and directors, and persons who own more than ten percent of the Common Stock, to file reports of ownership and changes in ownership with the SEC. Executive officers, directors and greater than ten percent beneficial owners are required by SEC regulations to furnish the Company with copies of all Section 16(a) forms they file.

Based solely on a review of the copies of such forms furnished to the Company and written representations from the Company's executive officers and directors, the Company believes that during the fiscal year ended December 31, 2005, its executive officers and directors and greater than ten percent beneficial owners complied with all applicable Section 16(a) filing requirements.

PROPOSAL 1

ELECTION OF DIRECTORS

Nominees

The Bylaws of the Company provide that the number of directors of the Company shall not be less than five nor more than fifteen. The exact number of directors is determined by the Board of Directors. The Board of Directors has set the size of the Board at ten members following the election of directors at the 2006 Annual Meeting of Shareholders.

The Board of Directors has nominated the four persons named below for election as directors to serve for a three-year term to expire at the 2009 Annual Meeting of Shareholders or until their earlier death, resignation, retirement, removal or disqualification or until their successors shall be elected and shall qualify.

The persons named in the accompanying form of proxy intend to vote any shares of Common Stock represented by valid proxies received by them to elect the four nominees listed below as directors for the term specified, unless authority to vote is withheld or such proxies are duly revoked. All of the nominees for election are currently members of the Board of Directors whose terms expire in 2006. In the event that any of the nominees should become unavailable to accept nomination or election, it is intended that the proxyholders will vote to elect in his stead such other person as the present Board of Directors may recommend. The Board of Directors has no reason to believe that any of the nominees named herein will be unable to serve if elected to office.

The Company's Bylaws provide that, in order to be eligible for consideration at the Annual Meeting of Shareholders, all nominations of directors, other than those made by the Board of Directors, must be made in writing and must be delivered to the Secretary of the Company not less than 50 days nor more than 90 days prior to the meeting at which such nominations will be made; provided, however, if less than 60 days notice of the meeting is given to shareholders, such nominations must be delivered to the Secretary of the Company not later than the close of business on the tenth day following the day on which the notice of meeting was mailed.

The following table sets forth as to each nominee, his name, age, principal occupation during the last five years, and the year he was first elected as a director.

Name	Age on December 31, 2005	Principal Occupation During Last Five Years	Director Since
Robert C. Abernethy	55	President, Secretary and Treasurer, Carolina Glove Company, Inc. (glove manufacturer); Secretary and Assistant Treasurer, Midstate Contractors, Inc (paving company)	1976
James S. Abernethy	51	Vice President, Carolina Glove Company, Inc (glove manufacturer); President and Assistant Secretary, Midstate Contractors, Inc (paving company); Vice President, Secretary and Chairman of the Board of Directors, Alexander Railroad Company	1992
Larry E. Robinson	60	President and Chief Executive Officer, The Blue Ridge Distributing Company, Inc (beer and wine distributor)	1993
William Gregory Terry	38	Executive Vice President, Drum & Willis-Reynolds Funeral Homes and Crematory	2004

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR ALL OF THE ABOVE-LISTED NOMINEES FOR ELECTION AS DIRECTORS. THE FOUR NOMINEES RECEIVING THE HIGHEST NUMBER OF VOTES SHALL BE DEEMED TO HAVE BEEN ELECTED.

The following table sets forth as to each continuing director of the Bank, his name, age, principal occupation during the last five years, the year he was first elected as a director, and the year his current term expires.

	Age on	Principal Occupation	Director	Term

Name	December 31, 2005	During Last Five Years	Since	Expires
John W. Lineberger, Jr.	55	President, Lincoln Bonded Warehouse Company (commercial warehousing facility)	2004	2007
Gary E. Matthews	50	President and Director, Matthews Construction Company, Inc.	2001	2007
Dan Ray Timmerman, Sr.	58	President, Timmerman Manufacturing, Inc. (wrought iron furniture manufacturer)	1995	2007

Name	Age on December 31, 2005	Principal Occupation During Last Five Years	Director Since	Term Expires
Benjamin I. Zachary	49	President, Treasurer, and member of the Board of Directors, Alexander Railroad	1995	2007
Douglas S. Howard	46	Vice President, Howard Ventures, Inc.; Secretary/Treasurer, Denver Equipment of Charlotte, Inc	2004	2008
Billy L. Price, Jr., M D	49	Practicing Internist and Partner in Catawba Valley Internal Medicine, P.A.; Clinical Instructor, Wake Forest University School of Medicine	2004	2008

Board of Directors of the Bank

Peoples Bank (the "Bank") also will have ten directors currently serving on its board of directors, comprised of all the same people who are currently directors of the Company.

Meetings of the Board

The Board of Directors and/or the Bank's board of directors met a total of fifteen (15) times during the fiscal year ended December 31, 2005. During the year ended December 31, 2005, all members of the Board of Directors attended at least 75% of the aggregate number of meetings of the Board of Directors, the Bank's board of directors and committees of both boards on which they served.

Committees of the Board

The Board of Directors of the Company has three standing committees - the Governance Committee, the Executive Committee, and the Audit Committee. These committees are described below.

Governance Committee. The Governance Committee is comprised entirely of independent Directors, as defined in Rule 4200(a)(15) of the NASD's listing standards. It currently consists of Directors R. Abernethy, J. Abernethy, Lineberger, Robinson, Terry, Timmerman and Zachary. The Governance Committee is responsible for developing and maintaining the corporate governance policy, as well as acting as the nominating committee for the Board. The Company has adopted a written charter for the Governance Committee, which was attached as an exhibit to the Company's Notice of 2004 Annual Meeting, Proxy Statement and Annual Report.

The Governance Committee interviews candidates for membership to the Board of Directors, recommends candidates to the full Board, slates candidates for Director and shareholder votes, and fills any vacancies on the Board of Directors which occur between shareholder meetings. The Governance Committee's identification of candidates for Director typically results from the business interactions of the members of the Governance Committee or from recommendations received by the committee from other Directors or from Company management. The Governance Committee currently has no written policy with regard to the consideration of director candidates recommended by security holders. If a security holder recommends a director candidate to the Governance Committee, however, the Governance Committee will consider the candidate and apply the same considerations that it would to its own candidates. The recommendation of a candidate by a security holder should be made in writing, addressed to the attention of the Governance Committee at the Company's corporate headquarters. The recommendation should include a description of the candidate's background, his or her contact information, and any other information the security holder considers useful and appropriate for the Governance Committee's consideration of the candidate. The criteria which have been established by the Governance Committee as bearing on the consideration of a candidate's qualification to serve as a Director include the following: the candidate's ethics, integrity, involvement in the community, success in business, relationship with the Bank, investment in the Company, place of residence (i.e., proximity to the Bank's market area), and financial expertise.

The Governance Committee met five (5) times during fiscal year 2005.

Executive Committee. The Executive Committee performs duties as assigned by the full Board of Directors. Actions taken by the Executive Committee must be approved by the full Board. The Executive Committee consists of Directors R. Abernethy, J. Abernethy, and Timmerman, as well as Mr. Wolfe, the President and Chief Executive Officer of the Company. It meets on an "as needed" basis.

Audit Committee. The Audit Committee consists of Directors R. Abernethy, Howard, Matthews, Price, Robinson, Timmerman and Zachary. The Board of Directors has determined that these members are independent as that term is defined in Rule 4200(a)(15) of the NASD's listing standards.

The Audit Committee meets at least quarterly and, among other responsibilities, oversees (i) the independent auditing of the Company; (ii) the system of internal controls that management has established; and (iii) the quarterly and annual financial information to be provided to shareholders and the Securities and Exchange Commission. The Audit Committee met eight (8) times during the fiscal year ended December 31, 2005.

Communications Between Shareholders and Members of the Board of Directors

The Company does not have a formal procedure for shareholder communication with the Board of Directors. In general, however, the directors and executive officers of the Company are easily accessible by telephone, postal mail or electronic mail. Any matter intended for the Board of Directors, or for any individual member or members of the Board, can be directed to the Company's Chief Executive Officer, Mr. Wolfe, or Chief Financial Officer, Mr. Lampron, with a request to forward the same to the intended recipient. Alternatively, shareholders can direct correspondence to the Board, or any of its members, in care of the Company at the Company's address. All such communications will be forwarded to the intended recipient unopened.

Director Attendance at Annual Meetings

Although it is customary for all members of the Board of Directors to attend, the Company has no formal policy in place with regard to Directors' attendance at the Annual Meeting of Shareholders. All members of the Company's Board of Directors attended the 2005 Annual Meeting of Shareholders.

Bank Board Committees

The Bank's board of directors has the same three committees as the Company's Board of Directors, the Governance Committee, the Audit Committee and the Executive Committee. The membership of the Bank's standing committees and the committees' responsibilities are identical to those performed by their counterpart committees on the Company level.

The Bank's Executive Committee currently has four members, Directors J. Abernethy, R. Abernethy, Wolfe, and Timmerman. The Committee performs duties as assigned by the full board of directors of the Bank. Any action taken by the Executive Committee must be ratified by the full board. The Committee meets on an "as needed" basis.

The Governance Committee has seven (7) members, Directors J. Abernethy, R. Abernethy, Lineberger, Robinson, Terry, Timmerman and Zachary. The Bank's Governance Committee performs the same duties as the Company's Governance Committee. In addition, the Bank's Governance Committee oversees the investigation of and makes recommendations for future branching sites. It also is responsible for discussion of matters of general, strategic corporate direction, discussion of capital expenses associated with technology, and recommendations for director nominations to the full Board of Directors.

The Governance Committee reviews for approval the recommendations of the President and Chief Executive Officer for the compensation of the executive officers, and makes recommendations to the Board of Directors for the compensation of the President and Chief Executive Officer, and makes recommendations to the Board of Directors regarding the adoption of and amendments to employee benefit plans and amendments to the salary administration plan. The Governance Committee met five (5) times during fiscal year ended December 31, 2005.

The Bank's Audit Committee performs the same duties as the Company's Audit Committee. It consists of Directors R. Abernethy, Howard, Matthews, Price, Robinson, Timmerman and Zachary. The Bank's Audit Committee met eight (8) times during fiscal year ended December 31, 2005.

Director Compensation

Directors' Fees. Members of the Board of Directors receive no fees or compensation for their service. However, all members of the Board of Directors are also directors of the Bank and are compensated for that service. Directors receive a fee of $750 for each Bank board of directors meeting attended. An additional fee of $500 is paid to committee members for each committee meeting attended. In addition to these meeting fees, each director also received an annual retainer of $9,000.

The Bank maintains a Service Recognition Program, under which directors, officers and employees are eligible for awards. Under this Program, directors, officers and employees are awarded a combination of Common Stock of the Company and cash, with the amount of the award based upon the length of service to the Bank. Any Common Stock awarded under the Program is purchased by the Bank on the open market, and no new shares are issued by the Company under the Service Recognition Program.

Directors' Stock Benefits Plan. Members of the Board of Directors are eligible to participate in the Company's Omnibus Stock Ownership and Long Term Incentive Plan (the "Stock Benefits Plan"). Each director has been awarded 5,901 book value shares (adjusted to reflect 10% stock dividends on April 24, 2000 and March 16, 2005, as appropriate) under the Stock Benefits Plan. Directors J. Abernethy, R. Abernethy, Robinson, Timmerman and Zachary were awarded book value shares on September 28, 1999. The book value of the Common Stock on September 28, 1999, was $10.41 (as adjusted). The book value shares then awarded vest 20% annually, with the first 20% vesting on September 28, 2000, and the final 20% vesting on September 28, 2004. Director Matthews was awarded book value shares upon his election to the Board of Directors on May 3, 2001. The book value of the Common Stock on May 3, 2001, was $12.68 (as adjusted). Mr. Matthews' book value shares vest at a rate of 25% annually with the first 25% having vested on May 3, 2002, and the final 25% vesting on May 3, 2005. Directors Howard, Lineberger, Price and Terry were awarded book value shares on May 6, 2004. The book value of the Common Stock on May 6, 2004, was $14.26 (as adjusted). Their shares vest at a rate of 20% annually, with the first 20% vesting on May 6, 2005, and the final 20% vesting on May 6, 2009. See "-- Management Compensation - Stock Benefits Plan" for a description of the plan.

Directors' Deferred Compensation Plan. In January 2002, the Bank established a non-qualified deferred compensation plan for all of its directors. The Bank's directors are also directors of the Company. Under this plan, each director may defer all or a portion of his fees to the plan each year. The director may elect to invest the deferred compensation in a restricted list of eleven investment funds. The Bank may make matching contributions to the plan for the benefit of the director from time to time at the discretion of the Bank. Directors are fully vested in all amounts they contribute to the plan and in any amounts contributed by the Bank.

Benefits under the plan are payable in the event of the director's death, resignation, removal, failure to be re-elected, retirement or in cases of hardship. Directors may elect to receive deferred compensation payments in one lump sum or in installments.

Effective December 6, 2001, the Bank established a Rabbi Trust to hold the directors' accrued benefits under the plan. The Directors' Deferred Compensation Plan was made effective January 1, 2002.

Directors' Supplemental Retirement Plan. Effective January 1, 2002, the Bank implemented a non-qualified supplemental retirement benefits plan for all its directors. The plan is designed to provide a retirement benefit to the directors while at the same time minimizing the financial impact on the Bank's earnings. The plan provides retirement benefits based on an index formula. This formula consists of the earnings on a specific life insurance policy, reduced by an amount equal to the Bank's opportunity cost. Following a director's retirement, the Bank pays the earnings in excess of the opportunity cost to the director annually. These payments continue for fifteen years following the director's retirement. The Bank has purchased life insurance policies on each insurable director that are actuarially designed to offset the annual expense associated with the indexed formula benefit. The Bank is the sole owner of all the policies.

Executive Officers

The following table sets forth certain information with respect to the persons who are executive officers of either the Company or the Bank, or both.

Name	Age on December 31, 2005	Positions and Occupations During Last Five Years	Employed By the Company or the Bank Since
Tony W. Wolfe	59	President and Chief Executive Officer of the Company and the Bank	1990
Joseph F. Beaman, Jr.	56	Executive Vice President and Corporate Secretary of the Company; Executive Vice President, Chief Administrative Officer and Secretary of the Bank	1977
William D. Cable	37	Executive Vice President and Assistant Corporate Treasurer of the Company; Executive Vice President and Chief Operations Officer of the Bank; Prior to 2002, Bank Senior Vice President - Information Services	1995
Lance A. Sellers	43	Executive Vice President and Assistant Corporate Secretary of the Company; Executive Vice President and Chief Credit Officer of the Bank	1998
A. Joseph Lampron	51	Executive Vice President, Chief Financial Officer and Corporate	2001

Treasurer of the Company;
Executive
Vice President and Chief Financial
Officer of the Bank. Prior to
December
2001, Vice President/Senior Change
Manager at a large North Carolina
bank

Management Compensation

The executive officers of the Company are not paid any cash compensation by the Company. However, the executive officers of the Company also are executive officers of the Bank and receive compensation from the Bank.

The table on the following page shows, for the fiscal years ended December 31, 2005, 2004 and 2003, the cash compensation received by, as well as certain other compensation paid or accrued for those years, the Bank's Chief Executive Officer and the Bank's executive officers whose total annual salary and bonus exceeded $100,000.

		Annual Compensation			Long Term Compensation Awards		All Other
Name and Principal Position	Year	Salary	Bonus	Other Annual Compensation[1]	Restricted Stock Awards	Securities Underlying Options/Stock Appreciation Rights ("SARS") (in shares)	Compensation[2,3,4,5,6]
Tony W. Wolfe	2005	$ 224,560	$ 50,593	$--	$--	$0/0	$ 13,660
President and Chief Executive	2004	$ 212,949	$0	$--	$--	$0/0	$ 12,832
Officer of the Company and the Bank	2003	$ 206,828	$0	$--	$--	$0/0	$ 13,814
Joseph F. Beaman, Jr.	2005	$ 117,386	$ 27,042	$--	$--	$0/0	$ 6,937
Executive Vice President and	2004	$ 139,222	$0	$--	$--	$0/0	$ 8,098
Corporate Secretary of the Company; Executive Vice President, Chief Administrative Officer and Secretary of the Bank	2003	$ 152,214	$0	$--	$--	$0/0	$ 7,963
Lance A. Sellers	2005	$ 160,676	$ 32,636	$--	$--	$0/0	$ 8,326
Executive Vice President and	2004	$ 156,205	$0	$--	$--	$0/0	$ 8,201
Assistant Corporate Secretary of the Company; Executive Vice President and Chief Credit Officer of the Bank	2003	$ 150,031	$0	$--	$--	$0/0	$ 7,648
A. Joseph Lampron	2005	$ 125,865	$ 27,924	$--	$--	$0/0	$ 6,946
Executive Vice President, Chief	2004	$ 131,067	$0	$--	$--	$0/0	$ 6,608
Financial Officer and Corporate Treasurer of the Company;	2003	$ 111,593	$0	$--	$--	$0/0	$ 6,089

Executive Vice President and Chief Financial Officer of the Bank							
William D. Cable	2005	$ 130,602	$ 27,924	$--	$--	$0/0	$ 6,638
Executive Vice President and	2004	$ 123,689	$0	$--	$--	$0/0	$ 6,342
Assistant Corporate Treasurer of the Company; Executive Vice President and Chief Operations Officer of the Bank	2003	$ 118,135	$0	$--	$--	$0/0	$ 6,046

Footnotes on the following page

1

Perquisites for the fiscal year did not exceed the lesser of $50,000, or 10% of salary and bonus as reported for the named employee.

2

For Mr. Wolfe, includes for 2005 $10,000 under the 401(k) plan, $1,992 premium paid for group term life insurance in excess of $50,000 and $1,668 paid for the Split Dollar Benefit; 2004: $9,324 under the 401(k) plan, a $1,899 premium paid for group term life insurance in excess of $50,000 and $1,609 paid for the Split Dollar Death Benefit; 2003: $10,410 under the 401(k) plan, a $1,827 premium paid for group term life insurance in excess of $50,000 and $1,577 paid for the Split Dollar Benefit;

3

For Mr. Beaman, includes for 2005 $5,711 under the 401(k) plan, $918 premium paid for group term life insurance in excess of $50,000 and $308 paid for the Split Dollar Death Benefit; 2004: $6,816 under the 401(k) plan, a $991 premium paid for group term life insurance in excess of $50,000 and $291 paid for the Split Dollar Death Benefit; 2003: $7,296 under the 401(k) plan, a $667 premium paid for group term life insurance in excess of $50,000 and $282 paid for the Split Dollar Death Benefit.

4

For Mr. Sellers, includes for 2005 $7,869 under the 401(k) plan, $319 premium paid for group term life insurance in excess of $50,000 and $138 paid for the Split Dollar Death Benefit; 2004: $7,643 under the 401(k) plan, a $307 premium paid for group term life insurance in excess of $50,000 and $251 paid for the Split Dollar Death Benefit; 2003: $7,355 under the 401(k) plan, a $293 premium paid for group term life insurance in excess of $50,000 and $130 paid for the Split Dollar Death Benefit.

5

For Mr. Lampron, includes for 2005 $6,109 under the 401(k) plan, $541 premium paid for group term life insurance in excess of $50,000 and $296 paid for the Split Dollar Death Benefit; 2004: $5,819 under the 401(k) plan, a $508 premium paid for group term life insurance in excess of $50,000 and $281 paid for the Split Dollar Death Benefit; 2003: $5,561 under the 401(k) plan, a $310 premium paid for group term life insurance in excess of $50,000 and $218 paid for the Split Dollar Death Benefit.

6

For Mr. Cable, includes for 2005 $6,343 under the 401(k) plan, $222 premium paid for group term life insurance in excess of $50,000 and $73 paid for the Split Dollar Death Benefit; 2004: $6,043 under the 401(k) plan, a $207 premium paid for group term life insurance in excess of $50,000 and $92 paid for the Split Dollar Death Benefit; 2003: $5,780 under the 401(k) plan, a $197 premium paid for group term life insurance in excess of $50,000 and $69 paid for the Split Dollar Death Benefit.

Employment Agreements

The Bank has entered into employment agreements with Tony W. Wolfe, President and Chief Executive Officer; Joseph F. Beaman, Jr., Executive Vice President, Chief Administrative Officer and Corporate Secretary; Lance A. Sellers, Executive Vice President, Chief Credit Officer and Assistant Corporate Secretary; A. Joseph Lampron, Executive Vice President, Chief Financial Officer and Corporate Treasurer; and William D. Cable, Executive Vice President, Chief Operations Officer and Assistant Corporate Treasurer, in order to establish their duties and compensation and to provide for their continued employment with the Bank. The agreements provide for an initial term of employment of three years. Commencing on the first anniversary date and continuing on each anniversary date thereafter, unless notice of a non-extension is given by either party, each agreement is automatically extended for an additional year so that the remaining term shall always be no less than two and no more than three years. The agreements also provide that the base salary shall be reviewed by the Board of Directors not less often than annually. In addition, the employment agreements provide for discretionary bonuses and participation in other management incentive, pension, profit-sharing, medical or retirement plans maintained by the Bank, as well as fringe benefits normally associated with such employee's office. Mr. Wolfe's agreement provides for a company automobile. The employment agreements provide that they may be terminated by the Bank for cause, as defined in the agreements, and that they may otherwise be terminated by the Bank (subject to vested rights) or by the employee.

In the event of a change in control, the term of the employment agreements shall be automatically extended for three years from the date of the change of control. For purposes of the employment agreement, a change in control generally will occur if (i) any "person" (as such term is used in Section 13(d) and 14(d) of the Exchange Act), other than a person who beneficially owned as of January 1, 1998, more than 5% of the Bank's securities, acquires beneficial ownership of voting stock and irrevocable proxies representing 20% or more of any class of voting securities of either the Company or the Bank, (ii) the election of directors constituting more than one-half of the Board of Directors of the Company or the Bank who, prior to their election, were not nominated for election or approved by at least three-fourths of the Board of Directors of the Company as then constituted; (iii) either the Company or the Bank consolidates or merges with or into another corporation, association or entity or is otherwise reorganized, where neither the Company nor the Bank, respectively, is the surviving corporation in the transaction; or (iv) all or substantially all of the assets of either the Company or the Bank are sold or otherwise transferred to or acquired by any other entity or group.

In addition, the employee may voluntarily terminate his employment at any time following a change in control and continue to receive his base salary for the remainder of the term of the employment agreement, if, after the change in control, (i) the employee is assigned duties and/or responsibilities that are inconsistent with his position prior to the change in control or that are inconsistent with his reporting responsibilities at that time, (ii) the employee's compensation or benefits are reduced, or (iii) the employee is transferred, without his consent, to a location which is an unreasonable distance from his current principal work location.

An additional thirteen (13) middle management officers had employment agreements during 2005. The term of these agreements is until December 1, 2006, renewed annually and the agreements contain provisions similar to those discussed above.

Equity Compensation Plan Information

The following table presents the number of shares of Company stock to be issued upon the exercise of outstanding options; the weighted-average price of the outstanding options and the number of options remaining that may be issued under the Company's stock option plans described above.

Plan Category	**Number of securities to be issued upon exercise of outstanding options, warrants and rights**	**Weighted-average exercise price of outstanding options, warrants and rights**	**Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))**
	(a)	**(b)**	**(c)**
Equity compensation plans approved by security holders	193,743[1]	$13.41[2]	33,154
Equity compensation plans not approved by security holders	0	$0	0
Total	193,743	$13.41	33,154

[1] Of the 193,743 stock options issued under the Omnibus Plan, a total of 190,809 of those stock options have vested or are exercisable within 60 days. Of the outstanding stock options, options to purchase a total of 28,126 shares of the Common Stock were granted on September 28, 1999; 48,237 options were granted on September 25, 2000; 55,510 options were granted on October 30, 2001; 4,552 options were granted on December 18, 2001; 70,345 options were

granted on December 17, 2003; 2,200 options were granted on May 6, 2004; and 2,200 options were granted on December 16, 2004.

[2] The exercise prices for the grants of stock options under the Omnibus Plan on September 28, 1999; September 25, 2000; October 30, 2001; December 18, 2001; December 17, 2002; May 6, 2004 and December 16, 2004 are: $14.88 (as adjusted due to a 10% stock dividend granted on April 24, 2000); $11.53; $14.49; $13.36; $12.82; $17.01; and $17.44, respectively. All prices and shares have been adjusted for the 10% stock dividend paid March 16, 2005.

Stock Benefits Plan

General. The Board of Directors has implemented the Omnibus Stock Ownership and Long Term Incentive Plan (the "Omnibus Plan") which was approved by the Company's shareholders on May 13, 1999. The purpose of the Omnibus Plan is to promote the interests of the Company by attracting and retaining directors and employees of outstanding ability and to provide executive and other key employees of the Company and its subsidiaries greater incentive to make material contributions to the success of the Company by providing them with stock-based compensation which will increase in value based upon the market performance of the Common Stock and/or the corporate achievement of financial and other performance objectives.

The Omnibus Plan is administered by the Governance Committee of Board of Directors (the "Committee"). Subject to the terms of the Omnibus Plan, the Committee and the Board of Directors have authority to construe and interpret, for eligible employees and eligible directors, respectively, the Omnibus Plan, to determine the terms and provisions of Rights (as defined below) to be granted under the Omnibus Plan, to define the terms used in the Omnibus Plan and in the Rights granted thereunder, to prescribe, amend and rescind rules and regulations relating to the Omnibus Plan, to determine the individuals to whom and the times at which Rights shall be granted and the number of shares to be subject to, or to underlie, each Right awarded, and to make all other determinations necessary or advisable for the administration of the Omnibus Plan.

Rights Which May Be Granted. Under the Omnibus Plan, the Committee may grant or award eligible participants Options, rights to receive restricted shares of Common Stock, long term incentive units (each equivalent to one share of Common Stock), SARs, and/or Book Value Shares. These grants and awards are referred to herein as the "Rights." All Rights must be granted or awarded by March 30, 2009, the tenth anniversary of the date the Board of Directors adopted the Omnibus Plan. As of December 31, 2005, Rights representing 33,154 shares of Common Stock (adjusted to reflect the April 24, 2000 10% stock dividend and the March 16, 2005 10% stock dividend) were eligible to be awarded under the Omnibus Plan.

Options. Options granted under the Omnibus Plan to eligible directors and employees may be either incentive stock options ("ISOs") or non-qualified stock options ("NSOs"). The exercise price of an Option may not be less than 100% of the last-transaction price for the Common Stock quoted by the Nasdaq National Market on the date of grant.

The Committee shall determine the expiration date of each Option granted, up to a maximum of ten years from the date of grant. In the Committee's discretion, it may specify the period or periods of time within which each Option will first become exercisable, which period or periods may be accelerated or shortened by the Committee.

Each Option granted will terminate upon the expiration date established by the Committee or upon the earlier of (i) twelve months after the holder ceases to be an eligible employee or director by reason of death or disability, and (ii) immediately as of the date the holder is no longer an eligible employee or director for any reason other than death or disability. In the event of a change in control (as that term is defined in the Omnibus Plan), any unvested options granted under the Omnibus Plan will immediately and automatically vest.

Restricted Stock. The Committee may award Rights to acquire shares of Common Stock subject to certain transfer restrictions ("Restricted Stock") to eligible participants under the Omnibus Plan for such purchase price per share, if any, as the Committee, in its discretion, may determine appropriate. The Committee shall determine the expiration date for each Restricted Stock award, up to a maximum of ten years from the date of grant. In the Committee's discretion, it may specify the period or periods of time within which each Restricted Stock award will first become exercisable, which period or periods may be accelerated or shortened by the Committee.

Awards of Restricted Stock shall terminate in the same manner as described above in connection with the termination of Options.

Units. Under the Omnibus Plan, the Committee may grant to eligible directors and employees awards of long term incentive units, each equivalent in value to one share of Common Stock ("Units"). Except as otherwise provided, Units awarded may be distributed only after the end of a performance period of two or more years, as determined by the Committee, beginning with the year in which the awards are granted.

The percentage of the Units awarded that are to be distributed will depend on the level of financial and other performance goals achieved by the Company during the performance period. The Committee may adopt one or more performance categories in addition to, or in substitution for, a performance category or may eliminate all performance categories other than financial performance. All performance categories other than financial performance may not be applied in the aggregate as a factor of more than one against financial performance.

As soon as practicable after each performance period, the percentage of Units awarded that are to be distributed, based on the levels of performance achieved, will be determined and distributed to the recipients of such awards in the form of a

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

In the event of the death or disability of a Unit recipient prior to the end of any performance period, the number of Units awarded for such performance period will be reduced in proportion to the number of months remaining in the performance period after the date of death or disability; and the remaining portion of the award, if any, may, in the discretion of the Committee, be adjusted based upon the levels of performance achieved prior to the date of death or disability, and distributed within a reasonable time after death or disability. In the event a recipient of Units ceases to be an eligible director or employee for any reason other than death or disability, all Units awarded, but not yet distributed, will be cancelled.

In the event of a change in control (as that term is defined in the Omnibus Plan), any outstanding Units will immediately and automatically be reduced as appropriate to reflect a shorter performance period.

An amount equal to the dividend payable on one share of Common Stock (a "dividend equivalent credit") will be determined and credited on the payment date to each Unit recipient's account for each Unit awarded and not yet distributed or cancelled. Such amount will be converted within the account to an additional number of Units equal to the number of shares of Common Stock which could be purchased at the last-transaction price of the Common Stock on the Nasdaq National Market on the dividend payment date.

No dividend equivalent credits or distribution of Units may be credited or made if, at the time of crediting or distribution, (i) the regular quarterly dividend on the Common Stock has been omitted and not subsequently paid or there exists any default in payment of dividends on any such outstanding shares of Common Stock; (ii) the rate of dividends on the Common Stock is lower than at the time the Units to which the dividend equivalent credit relates were awarded, adjusted for certain changes; (iii) estimated consolidated net income of the Company for the twelve-month period preceding the month the dividend equivalent credit or distribution would otherwise have been made is less than the sum of the amount of the dividend equivalent credits and Units eligible for distribution under the Omnibus Plan in that month plus all dividends applicable to such period on an accrual basis, either paid, declared or accrued at the most recently paid rate, on all outstanding shares of Common Stock; or (iv) the dividend equivalent credit or distribution would result in a default in any agreement by which the Company is bound.

If an extraordinary event occurs during a performance period which significantly alters the basis upon which the performance levels were established, the Committee may make adjustments which it deems appropriate in the performance levels. Such events may include changes in accounting practices, tax, financial institution laws or regulations or other laws or regulations, economic changes not in the ordinary course of business cycles, or compliance with judicial decrees or other legal requirements.

Stock Appreciation Rights. The Omnibus Plan provides that the Committee may award to eligible directors and employees Rights to receive cash based upon increases in the market price of Common Stock over the last transaction price of the Common Stock on the Nasdaq National Market (the "Base Price") on the date of the award. The Committee may adjust the Base Price of a SAR based upon the market value performance of the Common Stock in comparison with the aggregate market value performance of a selected index or at a stated annual percentage rate. The expiration date of a SAR may be no more than ten years from the date of award.

Each SAR awarded by the Committee may be exercisable immediately or may become vested over such period or periods as the Committee may establish, which periods may be accelerated or shortened in the Committee's discretion.

Each SAR awarded will terminate upon the expiration date established by the Committee, termination of the employment or directorship of the SAR recipient, or in the event of a change in control, as described above in connection with the termination of Options.

Book Value Shares. The Omnibus Plan provides that the Committee may award to eligible directors and eligible employees long term incentive units, each equivalent in value to the book value of one share of Common Stock on the date of award ("Book Value Shares"). The Committee shall specify the period or periods of time within which each Book Value Share will vest, which period or periods may be accelerated or shortened by the Committee. Upon redemption, the holder of a Book

Value Share will receive an amount equal to the difference between the book value of the Common Stock at the time the Book Value Share is awarded and the book value of the Common Stock at the time the Book Value Share is redeemed, adjusted for the effects of dividends, new share issuances, and mark-to-market valuations of the Company's investment securities portfolio in accordance with FASB 115.

The expiration date of each Book Value Share awarded shall be established by the Committee, up to a maximum of ten years from the date of award. However, awards of Book Value Shares shall earlier terminate in the same manner as described above in connection with the termination of Options.

Adjustments. In the event the outstanding shares of the Common Stock are increased, decreased, changed into or exchanged for a different number or kind of securities as a result of a stock split, reverse stock split, stock dividend, recapitalization, merger, share exchange acquisition, or reclassification, appropriate proportionate adjustments will be made in (i) the aggregate number or kind of shares which may be issued pursuant to exercise of, or which underlie, Rights; (ii) the exercise or other purchase price, or Base Price, and the number and/or kind of shares acquirable under, or underlying, Rights; (iii) and rights and matters determined on a per share basis under the Omnibus Plan. Any such adjustment will be made by the Committee, subject to ratification by the Board of Directors. As described above, the Base Price of a SAR may also be adjusted by the Committee to reflect changes in a selected index. Except with regard to Units and Book Value Shares awarded under the Omnibus Plan, no adjustment in the Rights will be required by reason of the issuance of Common Stock, or securities convertible into Common Stock, by the Company for cash or the issuance of shares of Common Stock by the Company in exchange for shares of the capital stock of any corporation, financial institution or other organization acquired by the Company or a subsidiary thereof in connection therewith.

Any shares of Common Stock allocated to Rights granted under the Omnibus Plan, which Rights are subsequently cancelled or forfeited, will be available for further allocation upon such cancellation or forfeiture.

Federal Income Tax Consequences.

Options. Under current provisions of the Code, the federal income tax treatment of ISOs and NSOs is different. Options granted to employees under the Omnibus Plan may be ISOs which are designed to result in beneficial tax treatment to the employee but not a tax deduction to the Company.

The holder of an ISO generally is not taxed for federal income tax purposes on either the grant or the exercise of the option. However, the optionee must include in his or her federal alternative minimum tax income any excess (the "Bargain Element") of the acquired common stock's fair market value at the time of exercise over the exercise price paid by the optionee. Furthermore, if the optionee sells, exchanges, gives or otherwise disposes of such common stock (other than in certain types of transactions) either within two years after the option was granted or within one year after the option was exercised (an "Early Disposition"), the optionee generally must recognize the Bargain Element as compensation income for regular federal income tax purposes. Any gain realized on the disposition in excess of the Bargain Element is subject to recognition under the usual rules applying to dispositions of property. If a taxable sale or exchange is made after such holding periods are satisfied, the difference between the exercise price and the amount realized upon the disposition of the common stock generally will constitute a capital gain or loss for tax purposes.

Options granted to directors under the Omnibus Plan would be "NSOs". In general, the holder of an NSO will recognize at the time of exercise of the NSO, compensation income equal to the amount by which the fair market value of the common stock received on the date of exercise exceeds the sum of the exercise price and any amount paid for the NSO.

If an optionee exercises an ISO or NSO and delivers shares of common stock as payment for part or all of the exercise price of the stock purchased (the "Payment Stock"), no gain or loss generally will be recognized with respect to the Payment Stock; provided, however, if the Payment Stock was acquired pursuant to the exercise of an ISO, the optionee will be subject to recognizing as compensation income the Bargain Element on the Payment Stock as an

Early Disposition if the exchange for the new shares occurs prior to the expiration of the holding periods for the Payment Stock.

The Company generally would not recognize gain or loss or be entitled to a deduction upon either the grant of an ISO or NSO or the optionee's exercise of an ISO. The Company generally will recognize gain or loss or be entitled to a deduction upon the exercise of an NSO. If there is an Early Disposition, the Company generally would be entitled to deduct the Bargain Element as compensation paid to the optionee.

The above and other descriptions of federal income tax consequences are necessarily general in nature and do not purport to be complete. Moreover, statutory provisions are subject to change, as are their interpretations, and their application may vary in individual circumstances. Such descriptions may not be used to avoid any federal tax penalty. Such descriptions are written to support this proxy statement. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. Finally, the consequences under applicable state and local income tax laws may not be the same as under the federal income tax laws

Restricted Stock. Pursuant to Section 83 of the Code, recipients of Restricted Stock awards under the Omnibus Plan will recognize ordinary income in an amount equal to the fair market value of the shares of Common Stock granted to them at the time that the shares vest and become transferable. The Company will be entitled to deduct as a compensation expense for tax purposes the same amounts recognized as income by recipients of Restricted Stock awards in the year in which such amounts are included in income.

Units. The Company expects that participants generally will not be taxed on the award of Units. Instead, any cash and the then fair market value of any Common Stock received by the participants upon the distribution of a Unit generally will be taxable to the participants as compensation income upon such distribution. At that time, the Company generally will be entitled to claim a deduction in an amount equal to the compensation income.

SARs. Pursuant to Section 83 of the code, recipients of SARs under the Omnibus Plan will recognize, at the time a SAR award is exercised, ordinary income in an amount equal to the difference between the fair market value of the Common Stock at the time of award of the SAR and the fair market value of the Common Stock at the time that the SAR is exercised. The Company will be entitled to deduct as a compensation expense for tax purposes the same amounts recognized as income by recipients of SAR awards in the year in which such amounts are included in income.

Book Value Shares. The Company expects that participants generally will not be taxed on the award of Book Value Shares. Instead, any cash received by the participants upon redemption of the Book Value Shares generally will be taxable to the participant as compensation income upon distribution. At that time, the Company generally will be entitled to claim a deduction in an amount equal to the compensation income.

Grants and Awards Made During the Fiscal Year Ended December 31, 2005. The table below shows the number and value of options of the Company's named executive officers at the end of fiscal year 2005.

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

Name	Shares Acquired on Exercise #	Value Realized ($)	Number of Securities Underlying Unexercised Options/SARs at Fiscal Year End[1,2]		Value of Unexercised In-the-Money Options/SARs at Fiscal Year End[3]	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Tony W. Wolfe	0	$0	40,228/0	0/0	$370,177.46/$0	$0/$0

Joseph F. Beaman, Jr	0	$0	20,945/0	0/0	$192,055.68/$0	$0/$0
Lance A. Sellers	0	$0	20,848/0	0/0	$193,179.70/$0	$0/$0

Name	Shares Acquired on Exercise #	Value Realized ($)	Number of Securities Underlying Unexercised Options/SARs at Fiscal Year End[1,2]		Value of Unexercised In-the-Money Options/SARs at Fiscal Year End[3]	
			Exercisable	Unexercisable	Exercisable	Unexercisable
A. Joseph Lampron	0	$0	11,152/0	0/0	$105,488.73/$0	$0/$0
William D. Cable	0	$0	14,248/0	0/0	$132,734.30/$0	$0/$0

1

Options to purchase 16,627 shares of Common Stock (adjusted to reflect the April 24, 2000 10% stock dividend and the 10% stock dividend on March 16, 2005) were granted to Messrs. Wolfe, Beaman, Sellers and Cable as of September 28, 1999. Pursuant to an amendment to the Stock Option Grant Agreements dated September 25, 2000 these options vest 20% each year over a five-year period beginning on September 28, 2000, with the last 20% vesting on September 28, 2004. Options to purchase 24,953 shares of Common Stock were granted to the Messr. Wolfe, Beaman, Sellers and Cable as of September 25, 2000. One-third of these options vested on September 25, 2001, one-third vested on September 25, 2002 and one-third vested on September 25, 2003. Options to purchase 24,984 shares of Common Stock were granted to Messr. Wolfe, Beaman, Sellers and Cable as of October 30, 2001. One-third vested on October 30, 2002, one-third vested on October 30, 2003, and one-third vested on October 30, 2004. Options to purchase 36,300 shares of Common Stock were granted to all the named persons (including Mr. Lampron) as of December 17, 2002. One-third vested on December 17, 2003, one-third vested on December 17, 2004, and one-third vested on December 17, 2005.

2

Options to purchase 4,551 shares of Common Stock were granted to Mr. Lampron as of December 18, 2001. One-third vested on December 18, 2002, one-third vested on December 18, 2003 and one-third vested on December 18, 2004.

3

The exercise price of the stock options granted to Messr. Wolfe, Beaman, Sellers and Cable on September 28, 1999 is $14.88 (adjusted to reflect the April 24, 2000 10% stock dividend). The exercise price of the stock options granted to them on September 25, 2000 is $11.53. The exercise price of the stock options granted to them on October 30, 2001 is $14.49. The exercise price of stock options granted to Mr. Lampron on December 18, 2001 is $13.36. The exercise price of stock options granted to all named persons on December 17, 2002 is $12.82. On December 31, 2005, the closing market price for the Common Stock as reported on the Nasdaq National Market was $22.50.

Incentive Compensation Plans

The Bank also has a Management Incentive Plan for officers and an Employee Incentive Plan for employees of the Bank. Eligibility under the Employee Incentive Plan is granted to all employees upon ninety (90) days of service with the Bank. Participants in the Employee Incentive Plan are entitled to receive quarterly cash incentives based upon a graduated schedule indexed to attainment of corporate budget. Participants in the Management Incentive Plan are recommended annually by the President and Chief Executive Officer to the Bank's Board of Directors. Each individual's incentive pool is determined by a formula which links attainment of corporate budget with attainment of individual goals and objectives. Incentives under the Management Incentive Plan are paid annually.

Profit Sharing Plan and 401(k) Plan

The Bank has a Profit Sharing Plan and 401(k) Plan for all eligible employees. The Bank made no contribution to the Profit Sharing Plan for the year ended December 31, 2005. No investments in Bank stock have been made by the plan.

Under the Bank's 401(k) plan, the Bank matches employee contributions to a maximum of five percent of annual compensation. The Bank's 2005 contribution to the 401(k) Plan pursuant to this formula was approximately $360,000. All contributions to the 401(k) Plan are tax deferred.

The Profit Sharing Plan and 401(k) Plan permit participants to choose from ten investment funds which are selected by a committee comprised of selected directors and senior management. Both the 401(k) Plan and Profit Sharing Plan were amended in 2000 to permit participation in the plans beginning in the second month of employment. As of December 31, 2003, both plans provide for vesting of 20% of the benefit after two years employment and 20% each year thereafter until participants are 100% vested after six years employment.

Deferred Compensation Plan

In January 2002, the Bank established a non-qualified deferred compensation plan for directors and certain officers. Eligible officers selected by the Bank's board of directors may elect to contribute a percentage of their compensation to the plan. The Bank may make matching or other contributions to the plan as well, in amounts determined at the discretion of the Bank. Participants are fully vested in all amounts contributed to the plan by them or on their behalf.

Benefits under the plan are payable in the event of the participant's retirement, death, termination, or as a result of hardship. Benefit payments may be made in a lump sum or in installments, as selected by the participant.

Effective December 6, 2001, the Bank established a Rabbi Trust to hold the accrued benefits of the participants under the plan.

Supplemental Retirement Plan

Effective January 1, 2002, the Bank implemented a non-qualified supplemental retirement benefits plan for certain officers. The plan is designed to provide a retirement benefit to the officers while at the same time minimizing the financial impact on the Bank's earnings. The plan provides retirement benefits based on an index formula. The index formula consists of the earnings on a specific life insurance policy, reduced by an amount equal to the Bank's opportunity cost. Following an officer's retirement, the Bank pays the earnings in excess of the opportunity cost to the officer annually. These payments continue for a period between ten years and the life of the officer. The Bank has purchased life insurance policies on the participating officers that are actuarially designed to offset the annual expenses associated with the index formula benefit. The Bank is the sole owner of all of the policies.

Discretionary Bonuses and Service Awards

In the past, the Bank has paid bonuses to its employees in amounts determined in the discretion of the Bank's board of directors. The Bank anticipates that discretionary bonuses will continue to be paid to its employees in the future.

Indebtedness of and Transactions with Management and Directors

Certain directors and executive officers of the Bank and their immediate families and associates were customers of and had transactions with the Bank in the ordinary course of business during 2005. All outstanding loans, extensions of credit or overdrafts, endorsements and guarantees outstanding at any time during 2005 (i) were made in the ordinary course of business, (ii) were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons, and (iii) were transactions which in the opinion of management of the Bank did not involve more than the normal risk of collectibility or present other unfavorable features.

The Bank leases two of its facilities from Shortgrass Associates, L.L.C ("Shortgrass"). Director John W. Lineberger, Jr., owns 25% of the membership interests in Shortgrass. Pursuant to the terms of the leases for the two facilities leased by the Bank, the Bank paid to Shortgrass monthly rent in the amount of $15,613 during 2005, resulting in total annual lease payments for these facilities of $187,360. Each of the facilities is subject to a twenty year lease between the Bank and Shortgrass.

REPORT OF GOVERNANCE COMMITTEE WITH RESPECT TO COMPENSATION

The Company does not have a Compensation Committee. Review of the Bank's salary programs and recommendations to the Bank's board of directors regarding compensation of the executive officers are duties of the Bank's Governance Committee. The Bank's board of directors ultimately determines such compensation. The salary of each of the executive officers is determined based upon the executive officer's contributions to the Bank's overall profitability, maintenance of regulatory compliance standards, professional leadership, and management effectiveness in meeting the needs of day-to-day operations. The Governance Committee also compares the compensation of the executive officers with compensation paid to executives of other businesses in the Bank's market area, as well as to appropriate state and national salary data. These factors were considered in establishing the compensation of Tony W. Wolfe, President and Chief Executive Officer; Joseph F. Beaman, Jr., Executive Vice President, Chief Administrative Officer and Corporate Secretary; Lance A. Sellers, Executive Vice President, Chief Credit Officer and Assistant Corporate Secretary; A. Joseph Lampron, Executive Vice President, Chief Financial Officer and Corporate Treasurer; and William D. Cable, Executive Vice President, Chief Operations Officer and Assistant Corporate Treasurer, during the 2005 fiscal year. In addition, all of the executive officers of the Bank are eligible to receive discretionary bonuses declared by the Bank's board of directors. The amount of such bonuses and incentive payments is based upon the net income of the Bank in comparison to attainment of corporate budget and attainment of corporate goals and objectives.

Robert C. Abernethy	John W. Lineberger, Jr.
Larry E. Robinson	James S. Abernethy
William G. Terry	Dan Ray Timmerman, Sr.
Benjamin I. Zachary	

GOVERNANCE COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

No member of the Governance Committee is now, or formerly was, an officer or employee of the Company or the Bank. Tony W. Wolfe, President and Chief Executive Officer of the Bank, makes recommendations to the Committee regarding compensation of the executive officers. Mr. Wolfe participates in the deliberations, but not the decisions, of the Committee regarding compensation of executive officers other than himself. He does not participate in the Committee's discussions or decisions regarding his own compensation.

REPORT OF AUDIT COMMITTEE

The Company has adopted a written charter for the Audit Committee which is reviewed annually, and amended as needed, by the Committee. The Audit Committee has reviewed and discussed the audited financial statements with management of the Company and has discussed with the independent auditors the matters required to be discussed by SAS 61. In addition, the Committee has received the written disclosures and the letter from the independent accountants required by Independence Standards Board Standard No. 1, and has discussed with the independent accountant the independent accountant's independence. Based upon these reviews and discussions, the Committee recommended to the Board of Directors that the audited financial statements be included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

Robert C. Abernethy	Douglas S. Howard
Larry E. Robinson	Dan Ray Timmerman, Sr.
Gary E. Matthews	Dr. Billy L. Price, Jr.
Benjamin I. Zachary	

PERFORMANCE GRAPH

The following graph compares the Company's cumulative shareholder return on its Common Stock with a NASDAQ index and with a southeastern bank index. The graph was prepared by SNL Securities, L.C., Charlottesville, Virginia, using data as of December 31, 2005.

COMPARISON OF SIX-YEAR CUMULATIVE TOTAL RETURNS
Performance Report for
Peoples Bancorp of North Carolina, Inc.

	Period Ending					
Index	**12/31/00**	**12/31/01**	**12/31/02**	**12/31/03**	**12/31/04**	**12/31/05**
Peoples Bancorp of North Carolina, Inc.	100.00	109.10	113.32	114.67	156.57	163.45
NASDAQ - Total US*	100.00	79.18	54.44	82.09	89.59	91.54
SNL Southeast Bank Index	100.00	124.58	137.62	172.81	204.94	209.78

*Source: CRSP, Center for Research in Security Prices, Graduate School of Business, The University of Chicago 2005.
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SNL Financial LC, Charlottesville, VA **(434) 977-1600**
@ 2006

PROPOSAL 2

RATIFICATION OF SELECTION OF INDEPENDENT AUDITOR

Porter Keadle Moore, LLP, of Atlanta, Georgia ("PKM"), has been selected by the Audit Committee as the Company's and the Bank's independent auditor for the year ending December 31, 2006. Such selection is being submitted to the Company's shareholders for ratification. Representatives of PKM are expected to attend the Meeting and will be afforded an opportunity to make a statement, if they so desire, and to respond to appropriate questions from shareholders.

Audit Fees

The aggregate fees billed by PKM for professional services rendered in connection with the (i) audit of the Company's annual financial statements for 2005 and 2004, and (ii) review of the financial statements included in the Company's quarterly filings on Form 10-Q during those fiscal years were approximately $127,000 and $125,000, respectively.

Audit Related Fees

The aggregate fees billed by PKM in 2005 and 2004 for professional services rendered for assurance and related services that are reasonably related to the performance of the audit or review of the Company's financial statements and not included in "Audit Fees" above were approximately $12,000 and $21,000, respectively. These fees were primarily related to the audit of the Company's profit sharing and 401(k) plan and the testing of management's assertions regarding internal controls in accordance with the Federal Deposit Insurance Corporation Improvement Act.

Tax Fees

The aggregate fees billed in each of the last two fiscal years for professional services rendered by PKM for tax compliance, tax advice, and tax planning were approximately $24,000 and $18,000 in 2005 and 2004, respectively. These fees were primarily related to the preparation of the Company's income tax returns, assistance with quarterly income tax estimates and preparation of Forms 5500 for various benefit plans.

All Other Fees

PKM did not bill the Company for any other fees during 2005 or 2004.

The fees billed by PKM are pre-approved by the Audit Committee of the Company in accordance with the policies and procedures for the Audit Committee set forth in the committee's charter. The Audit Committee typically pre-approves all audit and non-audit services provided by the Company's independent auditors and may not engage the independent auditors to perform any prohibited non-audit services. For 2005, one hundred percent (100%) of the total fees paid for audit, audit related and tax services were pre-approved. For 2004, one hundred percent (100%) of the fees for audit, audit related, and tax were pre-approved. The Audit Committee has determined that the rendering of non-audit professional services by PKM, as identified above, is compatible with maintaining PKM's independence.

THE BOARD OF DIRECTORS RECOMMENDS THAT THE SHAREHOLDERS VOTE FOR RATIFICATION OF THE APPOINTMENT OF PKM AS INDEPENDENT AUDITOR FOR THE COMPANY AND THE BANK FOR THE FISCAL YEAR ENDING DECEMBER 31, 2006.

DATE FOR RECEIPT OF SHAREHOLDER PROPOSALS

It is presently anticipated that the 2007 Annual Meeting of Shareholders of the Company will be held on May 3, 2007. In order for shareholder proposals to be included in the Company's proxy materials for that meeting, such proposals must be received by the Secretary of the Company at the Company's principal executive office no later than December 14, 2006 and meet all other applicable requirements for inclusion in the proxy statement.

In the alternative, a shareholder may commence his or her own proxy solicitation and present a proposal from the floor at the 2007 Annual Meeting of Shareholders of the Company. In order to do so, the shareholder must notify the Secretary of the Company in writing, at the Company's principal executive office no later than February 19, 2007, of his or her proposal. If the Secretary of the Company is not notified of the shareholder's proposal by February 19, 2007, the Board of Directors may vote on the proposal pursuant to the discretionary authority granted by the proxies solicited by the Board of Directors for the 2007 Annual Meeting.

OTHER MATTERS

Management knows of no other matters to be presented for consideration at the Meeting or any adjournments thereof. If any other matters shall properly come before the Meeting, it is intended that the proxyholders named in the enclosed form of proxy will vote the shares represented thereby in accordance with their judgment, pursuant to the discretionary authority granted therein.

MISCELLANEOUS

The Annual Report of the Company for the year ended December 31, 2005, which includes financial statements audited and reported upon by the Company's independent auditor, is being mailed as Appendix A to this Proxy Statement; however, it is not intended that the Annual Report be deemed a part of this Proxy Statement or a solicitation of proxies.

THE FORM 10-K FILED BY THE COMPANY WITH THE SEC, INCLUDING THE FINANCIAL STATEMENTS AND SCHEDULES THERETO, WILL BE PROVIDED FREE OF CHARGE UPON WRITTEN REQUEST DIRECTED TO: PEOPLES BANCORP OF NORTH CAROLINA, INC., POST OFFICE BOX 467, 518 WEST C STREET, NEWTON, NORTH CAROLINA 28658-0467, ATTENTION: A. JOSEPH LAMPRON.

By Order of the Board of Directors,

/s/ Tony W. Wolfe

Tony W. Wolfe
President and Chief Executive Officer

Newton, North Carolina
April 3, 2006

APPENDIX A

PEOPLES BANCORP OF NORTH CAROLINA, INC.

General Description of Business

Peoples Bancorp of North Carolina, Inc. (the "Company"), was formed in 1999 to serve as the holding company for Peoples Bank (the "Bank"). The Company is a bank holding company registered with the Board of Governors of the Federal Reserve System (the "Federal Reserve") under the Bank Holding Company Act of 1956, as amended (the "BHCA"). The Company's sole activity consists of owning the Bank. The Company's principal source of income is any dividends which are declared and paid by the Bank on its capital stock. The Company has no operations and conducts no business of its own other than owning the Bank. Accordingly, the discussion of the business which follows concerns the business conducted by the Bank, unless otherwise indicated.

The Bank, founded in 1912, is a state-chartered commercial bank serving the citizens and business interests of the Catawba Valley and surrounding communities through 17 banking offices located in Lincolnton, Newton, Denver, Catawba, Conover, Maiden, Claremont, Hiddenite, Hickory and Charlotte, North Carolina. The Bank also operates a Loan Production Office in Davidson, North Carolina. At December 31, 2005, the Company had total assets of $730.3 million, net loans of $559.2 million, deposits of $582.9 million, investment securities of $115.2 million, and shareholders' equity of $54.4 million.

The Bank has a diversified loan portfolio, with no foreign loans and few agricultural loans. Real estate loans are predominately variable rate commercial property loans. Commercial loans are spread throughout a variety of industries with no one particular industry or group of related industries accounting for a significant portion of the commercial loan portfolio. The majority of the Bank's deposit and loan customers are individuals and small to medium-sized businesses located in the Bank's market area.

The operations of the Bank and depository institutions in general are significantly influenced by general economic conditions and by related monetary and fiscal policies of depository institution regulatory agencies, including the Federal Reserve, the Federal Deposit Insurance Corporation (the "FDIC") and the North Carolina Commissioner of Banks (the "Commissioner").

At December 31, 2005, the Bank employed 222 full-time equivalent employees.

The Bank is a subsidiary of the Company. The Bank has two subsidiaries, Peoples Investment Services, Inc. and Real Estate Advisory Services, Inc. Through a relationship with Raymond James Financial Services, Inc., Peoples Investment Services, Inc. provides the Bank's customers access to investment counseling and non-deposit investment products such as stocks, bonds, mutual funds, tax deferred annuities, and related brokerage services. Real Estate Advisory Services, Inc., provides real estate appraisal and real estate brokerage services.

In December 2001 the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust I ("PEBK Trust"), which issued $14.0 million of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures that qualify as Tier I capital under Federal Reserve Board guidelines. All of the common securities of PEBK Trust are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust to purchase $14.4 million of junior subordinated debentures of the Company, which pay interest at a floating rate equal to the prime rate plus 50 basis points. The proceeds received by the Company from the sale of the junior subordinated debentures were used for general purposes, primarily to provide capital to the Bank. The debentures represent the sole asset of PEBK Trust. As discussed under the heading entitled "Recent Accounting Pronouncements" in note 1 to the consolidated financial statements included in the 2005 Annual Report of Peoples Bancorp, Inc., attached hereto as Exhibit 13, PEBK Trust was deconsolidated by the Company under FIN 46 as of December 31, 2003.

This report contains certain forward-looking statements with respect to the financial condition, results of operations and business of Peoples Bancorp of North Carolina, Inc. (the "Company"). These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Company and on the information available to management at the time that these disclosures were prepared. These statements can be identified by the use of words like "expect," "anticipate," "estimate" and "believe," variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by Peoples Bank (the "Bank"), (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environment and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in the Company's other filings with the Securities and Exchange Commission. The Company undertakes no obligation to update any forward-looking statements.

SELECTED FINANCIAL DATA

Dollars in Thousands Except Per Share Amounts

	2005	2004	2003	2002	2001
Summary of Operations					
Interest income	$ 43,371	36,292	34,935	36,649	41,932
Interest expense	15,429	12,335	12,749	15,777	23,027
Net interest income	27,942	23,957	22,186	20,872	18,905
Provision for loan losses	3,110	3,256	6,744	5,432	3,545
Net interest income after provision for loan losses	24,832	20,701	15,442	15,440	15,360
Non-interest income	6,696	6,020	5,845	6,466	8,229
Non-interest expense	21,816	20,057	18,228	16,758	16,752
Income before taxes	9,712	6,664	3,059	5,148	6,837
Income taxes	3,381	2,233	1,055	1,712	2,262
Net income	$ 6,331	4,431	2,004	3,436	4,575
Selected Year-End Balances					
Assets	$ 730,280	686,348	674,032	645,638	619,505
Available for sale securities	115,158	105,598	79,460	71,736	84,286
Loans, net	559,239	527,419	542,404	519,122	484,517
Mortgage loans held for sale	2,248	3,783	587	5,065	5,339
Interest-earning assets	692,402	652,678	639,501	608,619	586,496
Deposits	582,854	556,522	549,802	515,739	490,223
Interest-bearing liabilities	576,681	553,135	550,357	527,525	516,422
Shareholders' equity	$ 54,353	50,938	48,554	48,605	45,401
Shares outstanding*	3,440,805	3,448,341	3,448,722	3,446,902	3,540,585
Selected Average Balances					
Assets	$ 706,843	684,385	661,077	625,227	575,142
Available for sale securities	108,690	93,770	72,072	77,414	84,549
Loans	550,545	547,753	539,559	507,879	454,371
Interest-earning assets	668,181	650,095	625,764	592,947	545,945
Deposits	570,997	558,142	533,703	499,224	481,289
Interest-bearing liabilities	563,210	553,880	540,676	516,747	472,435
Shareholders' equity	$ 55,989	51,978	49,971	48,257	47,432
Shares outstanding*	3,449,873	3,459,379	3,447,056	3,467,173	3,540,585
Profitability Ratios					
Return on average total assets	0.90%	0.65%	0.30%	0.55%	0.80%
Return on average shareholders' equity	11.31%	8.52%	4.01%	7.12%	9.65%

Dividend payout ratio		22.34%	28.37%	62.56%	36.58%	28.14%
Liquidity and Capital Ratios (averages)						
Loan to deposit		96.42%	98.14%	101.10%	101.73%	94.41%
Shareholders' equity to total assets		7.92%	7.59%	7.56%	7.72%	8.25%
Per share of common stock*						
Basic net income	$	1.84	1.28	0.58	0.99	1.29
Diluted net income	$	1.80	1.26	0.58	0.99	1.29
Cash dividends	$	0.41	0.36	0.36	0.36	0.36
Book value	$	15.80	14.77	14.08	14.10	12.83

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

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Introduction

Management's discussion and analysis of earnings and related data are presented to assist in understanding the consolidated financial condition and results of operations of Peoples Bancorp of North Carolina, Inc. (the "Company"), for the years ended December 31, 2005, 2004 and 2003. The Company is a registered bank holding company operating under the supervision of the Federal Reserve Board and the parent company of Peoples Bank (the "Bank"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg and Iredell Counties, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation (the "FDIC").

Overview

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

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

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

During 2005 the Federal Reserve has increased the Federal Funds Rate a total of 2.00%, with the rate set at 4.25% as of December 31, 2005. These increases had a positive impact on 2005 earnings and should continue to have a positive impact on the Bank's net interest income in future periods. The positive impact from the increase in the Federal Funds

Rate has been partially offset by the decrease in earnings realized on interest rate swaps utilized by the Company to convert some variable rate loans to fixed rate. These swaps were put in place during the time that the Federal Funds Rate approached 1.00% and helped to offset the decline in income experienced in 2003 and 2004 because of the reductions in the Federal Funds Rate that the Federal Reserve implemented from January 2001 to June 2003.

Summary of Significant Accounting Policies

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

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. The following is a summary of some of the more subjective and complex accounting policies of the Company. A more complete description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2006 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 4, 2006 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 collectability of loans is reflected through the Company's estimate of the allowance for loan losses. The Company performs periodic and systematic detailed reviews of its lending portfolio to assess overall collectability. In addition, certain assets and liabilities are reflected at their estimated fair value in the consolidated financial statements. Such amounts are based on either quoted market prices or estimated values derived from dealer quotes used by the Company, market comparisons or internally generated modeling techniques. The Company's internal models generally involve present value of cash flow techniques. The various techniques are discussed in greater detail elsewhere in management's discussion and analysis and the notes to consolidated financial statements.

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

In December 2004, the FASB revised SFAS No. 123 ("SFAS No. 123 (R)"). SFAS No. 123 (R), "Share-Based Payment," requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Pro forma disclosure is no longer an alternative to financial statement recognition. SFAS No. 123 (R) is effective for periods beginning after December 31, 2005. The Company will adopt in the first quarter of 2006. The financial statement impact of adopting this change in accounting principle is not expected to be material due to the small number of unvested shares at December 31, 2005.

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

The remainder of management's discussion and analysis of the Company's results of operations and financial position should be read in conjunction with the consolidated financial statements and related notes presented on pages A-25 through A-48.

Results of Operations

Summary. The Company reported earnings of $6.3 million in 2005, or $1.84 basic net earnings per share and $1.80 diluted net earnings per share, a 43% increase as compared to $4.4 million, or $1.28 basic net earnings per share and $1.26 diluted net earnings per share, for 2004. Net earnings from recurring operations for 2005 were $6.8 million, or $1.98 basic net earnings per share and $1.94 diluted net earnings per share, representing a 48% increase over net earnings from recurring operations of $4.6 million, or $1.33 basic net earnings per share and $1.31 diluted net earnings per share in 2004. Net non-recurring losses on disposition of assets in 2005 amounted to $746,000, primarily due to a $730,000 loss on sale of securities. This is an increase over net non-recurring losses on disposition of assets for the year ended December 31, 2004, which amounted to $248,000. The Company's increase in recurring earnings for 2005 is primarily attributable to an increase in net interest income, an increase in non-interest income and a decrease in the provision for loan losses, which were partially offset by an increase in non-interest expense.

Net earnings for 2004 represented an increase of 121% as compared to 2003 net earnings of $2.0 million. Net earnings from recurring operations for 2004 increased 106% when compared to $2.2 million, or $0.65 basic net earnings per share and $0.64 diluted net earnings per share for 2003. Net earnings for 2003 included non-recurring losses on the sale of securities of $53,000. The increase in 2004 recurring earnings was primarily attributable to a decrease in the provision for loan losses and an increase in net interest income, which were partially offset by an increase in non-interest expense.

The annualized return on average assets in 2005 was 0.90%, compared to 0.65% in 2004 and 0.30% in 2003. Excluding non-recurring gains and losses on disposition of assets, the annualized return on average assets was 0.96%, 0.67% and 0.34% in 2005, 2004 and 2003, respectively. Annualized return on average shareholders' equity was 11.31% in 2005 compared to 8.52% in 2004 and 4.01% in 2003. Excluding non-recurring gains and losses on disposition of assets, the annualized return on average shareholders' equity was 12.07%, 8.81% and 4.46% in 2005, 2004 and 2003, respectively.

Net Interest Income. Net interest income, the major component of the Company's net income, is the amount by which interest and fees generated by interest-earning assets exceed the total cost of funds used to carry them. Net interest income is affected by changes in the volume and mix of interest-earning assets and interest-bearing liabilities, as well as changes in the yields earned and rates paid. Net interest margin is calculated by dividing tax-equivalent net interest income by average interest-earning assets, and represents the Company's net yield on its interest-earning assets.

Net interest income was $27.9 million for 2005, or 17% over net interest income of $24.0 million in 2004. The increase was attributable to an increase in interest income due to an increase in the prime rate resulting from Federal Reserve interest rate increases combined with an increase in the average outstanding balance of available for sale securities. Net interest income increased 8% in 2004 from $22.2 million in 2003.

Table 1 sets forth for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest incurred on such amounts and the average rate earned or incurred for the years ended December 31, 2005, 2004 and 2003. The table also sets forth the average rate earned on total interest-earning assets, the average rate paid on total interest-bearing liabilities, and the net yield on average total interest-earning assets for the same periods. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields and interest income on tax-exempt investments have been adjusted to tax equivalent basis using an effective tax rate 34% for securities that are both federal and state tax exempt and an effective tax rate of 6.90% for state tax exempt securities. Non-accrual loans and the interest income that was recorded on these loans, if any, are included in the yield calculations for loans in all periods reported.

Table 1- Average Balance Table

		December 31, 2005			December 31, 2004			December 31, 2003		
(Dollars in Thousands)		**Average Balance**	**Interest**	**Yield / Rate**	**Average Balance**	**Interest**	**Yield / Rate**	**Average Balance**	**Interest**	**Yield / Rate**
Interest-earning assets:										
Loans	$	550,545	37,234	6.76%	547,753	29,826	5.45%	539,559	28,700	5.32%
Interest rate swap agreements		-	(575)	-0.14%	-	1,056	2.21%	-	1,522	3.22%
Loan fees		-	1,951	0.29%	-	1,409	0.26%	-	1,390	0.26%
Total loans		550,545	38,610	7.01%	547,753	32,291	5.90%	539,559	31,612	5.86%
Investments - taxable		37,487	1,597	4.26%	35,920	1,545	4.30%	49,082	2,186	4.45%
Investments - nontaxable*		71,203	3,389	4.76%	57,850	2,741	4.74%	22,990	1,228	5.34%
Federal funds sold		2,272	73	3.21%	3,363	35	1.05%	5,981	58	0.98%
Other		6,674	238	3.57%	5,209	141	2.70%	8,152	174	2.14%
Total interest-earning assets		668,181	43,907	6.57%	650,095	36,753	5.65%	625,764	35,258	5.63%
Cash and due from banks		15,149			13,058			12,587		
Other assets		31,324			30,601			31,008		
		(7,811)			(9,369)			(8,282)		

Allowance for loan losses									
Total assets	$ 706,843			684,385			661,077		
Interest-bearing liabilities:									
NOW accounts	$ 110,852	1,468	1.32%	106,832	1,292	1.21%	75,757	688	0.91%
Regular savings accounts	21,205	65	0.31%	21,845	72	0.33%	21,131	75	0.35%
Money market accounts	56,858	1,112	1.96%	51,069	535	1.05%	58,134	556	0.96%
Time deposits	292,807	8,923	3.05%	300,175	7,145	2.38%	310,991	8,157	2.62%
FHLB borrowings	65,934	2,889	4.38%	58,656	2,603	4.44%	59,305	2,597	4.38%
Demand notes payable to U.S. Treasury	702	21	3.02%	678	8	1.14%	710	7	0.99%
Trust preferred securities	14,433	938	6.50%	14,433	677	4.69%	14,433	668	4.62%
Other	419	13	3.00%	192	3	1.46%	215	1	0.47%
Total interest-bearing liabilities	563,210	15,429	2.74%	553,880	12,335	2.23%	540,676	12,749	2.36%
Demand deposits	89,275			78,221			67,690		
Other liabilities	1,275			2,137			2,800		
Shareholders' equity	55,989			51,978			49,971		
Total liabilities and shareholder's equity	$ 709,749			686,216			661,137		
Net interest spread		$ 28,478	3.83%		24,418	3.43%		22,509	3.27%
Net yield on interest-earning assets			4.26%			3.76%			3.60%
Taxable equivalent adjustment									
Investment securities		$ 536			460			323	
Net interest income		$ 27,942			23,958			22,186	

*Includes U.S. government agency securities that are non-taxable for state income tax purposes of $50.7 million in 2005, $40.4 million in 2004 and $9.4 million in 2003. An effective tax rate of 6.90% was used to calculate the tax equivalent yield on these securities.

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

Table 2 - Rate/Volume Analysis-Tax Equivalent Basis

	December 31, 2005			December 31, 2004		
(Dollars in Thousands)	**Changes in average volume**	**Changes in average rates**	**Total Increase (Decrease)**	**Changes in average volume**	**Changes in average rates**	**Total Increase (Decrease)**
Interest Income:						
Loans: Net of unearned income	$ 180	6,139	6,319	481	198	679
Investments - taxable	67	(15)	52	(603)	(38)	(641)
Investments - nontaxable	634	14	648	1,756	(243)	1,513
Federal funds sold	(23)	61	38	(26)	3	(23)
Other	45	52	97	(73)	40	(33)
Total interest income	903	6,251	7,154	1,535	(40)	1,495
Interest expense:						
NOW accounts	51	125	176	329	275	604
Regular savings accounts	(2)	(5)	(7)	2	(5)	(3)
Money market accounts	87	490	577	(71)	50	(21)
Time deposits	(200)	1,978	1,778	(271)	(741)	(1,012)
FHLB Borrowings	321	(35)	286	(28)	34	6
Demand notes payable to U.S. Treasury	-	13	13	-	1	1
Trust Preferred Securities	24	237	261	-	9	9
Other	5	5	10	-	2	2
Total interest expense	286	2,808	3,094	(39)	(375)	(414)
Net interest income	$ 617	3,443	4,060	1,574	335	1,909

Net interest income on a tax equivalent basis totaled $28.5 million in 2005, increasing 17% or $4.1 million from 2004. This increase was primarily attributable to an increase in the yield on interest-earning assets partially offset by an increase in the cost of funds. The interest rate spread, which represents the rate earned on interest-earning assets less the rate paid on interest-bearing liabilities, was 3.83% in 2005, an increase from the 2004 net interest spread of 3.43%. The net yield on interest-earning assets in 2005 increased to 4.26% from the 2004 net interest margin of 3.76%.

Tax equivalent interest income increased $7.2 million or 19% in 2005 primarily due to an increase in the Bank's prime lending rate from an average rate of 4.34% in 2004 to 6.19% in 2005. The increase in rates combined with a $17.4 million increase in average interest-earning assets resulted in an increase in the yield on interest-earning assets to 6.57% in 2005 as compared to 5.65% in 2004. The $18.1 million increase in average interest-earning assets was attributable primarily to a $14.9 million increase in average investment securities. Average loans in 2005 increased

1% to $550.5 million when compared to 2004. All other interest-earning assets including federal funds sold increased to $8.9 million in 2005 from $8.6 million in 2004.

Interest expense increased $3.1 million or 25% in 2005 due to an increase in the average rate paid on interest-bearing liabilities combined with a $9.3 million increase in volume of interest-bearing liabilities. The cost of funds increased to 2.74% in 2005 from 2.23% in 2004. This increase in the cost of funds was primarily attributable to increases in the average rate paid on interest-bearing checking and savings accounts and certificates of deposit. The $9.3 million growth in average interest-bearing liabilities was primarily attributable to an increase in FHLB borrowings of $7.2 million to $65.9 million in 2005 from $58.7 million in 2004.

In 2004 net interest income on a tax equivalent basis increased $1.9 million or 8% to $24.4 million in 2004 from $22.5 million in 2003. The interest rate spread was 3.43% in 2004, an increase from the 2003 net interest spread of 3.27%. The net yield on interest-earning assets in 2004 increased to 3.76% from the 2003 net interest margin of 3.60%.

Provision for Loan Losses. Provision for loan losses are charged to income in order to bring the total allowance for loan losses to a level deemed appropriate by management of the Company based on factors such as management's judgment as to losses within the Company's loan portfolio, including the valuation of impaired loans in accordance with Statement of Financial Accounting Standards ("SFAS") No. 114 and No. 118, loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies and management's assessment of the quality of the loan portfolio and general economic climate.

The provision for loan losses was $3.1 million, $3.3 million, and $6.7 million for the years ended December 31, 2005, 2004 and 2003, respectively. The decrease in the provision for loan losses for 2005 reflects a decrease in classified loans of $5.3 million as of December 31, 2005 when compared to December 31, 2004, netted against the effect of a 6% growth in gross loans during 2005. Please see the section below entitled "Allowance for Loan Losses" for a more complete discussion of the Bank's policy for addressing possible loan losses

Non-Interest Income. Non-interest income for 2005 totaled $6.7 million, an increase of $676,000 or 11% from non-interest income of $6.0 million for 2004. The increases in non-interest income for 2005 are primarily due to an increase in fee income from the Bank's Banco de la Gente branches, which were in operation for the first full year in 2005, increases in debit card fee income and an increase in mortgage banking income. Non-interest income for 2004 increased $175,000 or 3% from non-interest income of $5.8 million for 2003. The increase in non-interest income for 2004 is primarily due to an increase in service charge fee income associated with deposit growth, which were partially offset by a decrease in mortgage banking income. Excluding non-recurring gains or losses on the disposition of assets, non-interest income for 2005 increased 19% to $7.4 million as compared to $6.2 million in 2004. Non-interest income, excluding non-recurring gains or losses on the disposition of assets, totaled $6.2 million for 2003.

Service charges on deposit accounts totaled $3.8 million during 2005, an increase of $345,000, or 10% over 2004. Service charge income increased $168,000, or 5% in 2004 compared to 2003. These increases are primarily attributable to growth in the deposit base coupled with normal pricing changes, which resulted in an increase in account maintenance fees.

Other service charges and fees increased 69% to $1.1 million for the year ended December 31, 2005 as compared to $677,000 for the same period one year ago. This increase is primarily attributable to fee income from the Bank's Banco de la Gente branches, which were in operation for the first full year in 2005.

The Company reported net losses on sale of securities of $730,000, $64,000 and $53,000 in 2005, 2004 and 2003, respectively. Losses on the sale of securities were primarily due to the sale of $20 million in callable U.S. Government Agency securities, which were reinvested in fixed term U.S. Government Agency securities in order to reduce the exposure to a decrease in interest rates in the Bank's investment portfolio.

Mortgage banking income increased to $469,000 in 2005 from $357,000 in 2004. During 2004 mortgage banking income decreased $248,000 from the $605,000 reported in 2003. The decrease in mortgage banking income for 2004 was primarily attributable to an increase in mortgage interest rates during 2004.

Net losses on repossessed assets were $38,000 for 2005 compared to net losses on repossessed assets of $180,000 for 2004. During 2003 a net loss on repossessed assets of $747,000 was recognized.

The Company recognized a $479,000 gain on the sale of loans during 2003 as a result of the sale of the Bank's $3.7 million credit card portfolio in 2003. There were no gains on the sale of loans recognized in 2005 and 2004.

Miscellaneous income for 2005 totaled $1.7 million, an increase of 24% from $1.4 million for 2004. The increase in miscellaneous income was primarily attributable to an increase in debit card fee income primarily associated with increased card usage due to an increased number of demand accounts. During 2003, miscellaneous income increased 18% primarily due to an increase in debit card fee income.

Table 3 presents a summary of non-interest income for the years ended December 31, 2005, 2004 and 2003.

Table 3 - Non-Interest Income

(Dollars in Thousands)		**2005**	**2004**	**2003**
Service charges	$	3,780	3,435	3,267
Other service charges and fees		1,142	677	611
Gain (loss) on sale of securities		(730)	(64)	(53)
Mortgage banking income		469	356	604
Insurance and brokerage commissions		387	430	421
Loss on foreclosed and repossessed assets		(38)	(179)	(747)
Gain on sale of loans		-	-	479
Miscellaneous		1,686	1,365	1,263
Total non-interest income	$	6,696	6,020	5,845

Non-Interest Expense. Total non-interest expense amounted to $21.8 million for 2005, an increase of 9% from 2004. Non-interest expense for 2004 increased 10% to $20.1 million from non-interest expense of $18.2 million for 2003.

Salary and employee benefit expense was $12.4 million in 2005, compared to $11.5 million during 2004, an increase of $873,000 or 8%, following a $1.4 million or 14% increase in salary and employee benefit expense in 2004 over 2003. The 2005 increase in salary and employee benefits is primarily due to normal salary increases and increased incentive expense. The increase during 2004 is attributable to normal salary increases, increased incentive expense and increased employee insurance costs.

The Company recorded occupancy expenses of $3.9 million in 2005, compared to $3.7 million during 2004, an increase of $277,000 or 8%, following an increase of $282,000 or 8% in occupancy expenses in 2004 over 2003. The increase in 2005 is primarily due to an increase in furniture and equipment expense and lease expense. Increases in 2004 are attributable to an increase in repairs and maintenance expense and an increase in lease expense resulting from lease agreements for branch facilities entered into during 2003 and 2004. During 2003, the Company sold two branch locations with net book values of approximately $3.1 million and is currently leasing the facilities from the buyers. As a result of the sales, the Company deferred a gain of approximately $633,000 and is recognizing the gain over the lease term. Approximately $22,000 of the deferred gain was recognized for the years ended December 31, 2005 and 2004. During 2003 approximately $18,000 of the deferred gain was recognized. Annual rent expense related to these two locations is $237,000.

The total of all other operating expenses increased $610,000 or 12% during 2005. Other operating expense increased $170,000 or 4% in 2004 over 2003. The increase in other expense for 2005 is primarily attributable to increases of $219,000 in fraud and forgery and processing adjustments on transactional accounts, $99,000 in professional fees, $74,000 in deposit program expense and $73,000 in debit card expense.

Table 4 presents a summary of non-interest expense for the years ended December 31, 2005, 2004 and 2003.

Table 4 - Non-Interest Expense

(Dollars in Thousands)		**2005**	**2004**	**2003**
Salaries and wages	$	8,648	8,240	7,733
Employee benefits		3,702	3,237	2,367
Total personnel expense		12,350	11,477	10,100
Occupancy expense		3,949	3,672	3,390
Office supplies		314	314	270
FDIC deposit insurance		76	81	82
Professional services		389	290	333

Postage		264	211	217
Telephone		403	337	333
Director fees and expense		334	351	234
Marketing and public relations		656	620	541
Consulting fees		233	306	280
Taxes and licenses		218	200	443
Other operating expense		2,631	2,198	2,005
Total non-interest expense	$	21,817	20,057	18,228

Income Taxes. Total income tax expense was $3.4 million in 2005 compared with $2.2 million in 2004 and $1.1 million in 2003. The primary reason for the increase in taxes for 2005 as compared to 2004 and 2003 was the increase in pretax income. The Company's effective tax rates were 34.81%, 33.51% and 34.50% in 2005, 2004 and 2003, respectively.

Liquidity. The objectives of the Company's liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company's liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of December 31, 2005 such unfunded commitments to extend credit were $133.4 million, while commitments in the form of standby letters of credit totaled $2.7 million.

The Company uses several sources to meet its liquidity requirements. The primary source is core deposits, which includes demand deposits, savings accounts and certificates of deposits of denominations less than $100,000. The Company considers these to be a stable portion of the Company's liability mix and the result of on-going consumer and commercial banking relationships. As of December 31, 2005, the Company's core deposits totaled $430.4 million, or 74% of total deposits.

The other sources of funding for the Company are through large denomination certificates of deposit, including brokered deposits, federal funds purchased and FHLB advances. The Bank is also able to borrow from the Federal Reserve System on a short-term basis.

At December 31, 2005, the Bank had a significant amount of deposits in amounts greater than $100,000, including brokered deposits of $40.3 million, which mature over the next two years. The balance and cost of these deposits are more susceptible to changes in the interest rate environment than other deposits. For additional information, please see the section below entitled "Deposits".

The Bank has a line of credit with the FHLB equal to 20% of the Bank's total assets, with an outstanding balance of $71.6 million at December 31, 2005. The remaining availability at FHLB was $49.3 million at December 31, 2005. The Bank also had the ability to borrow up to $26.5 million for the purchase of overnight federal funds from three correspondent financial institutions as of December 31, 2005.

The liquidity ratio for the Bank, which is defined as net cash, interest bearing deposits with banks, federal funds sold, certain investment securities and certain FHLB advances available under the line of credit, as a percentage of net deposits (adjusted for deposit runoff projections) and short-term liabilities was 36.81% at December 31, 2005, 34.82% at December 31, 2004 and 26.83% at December 31, 2003. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy is 20%.

As disclosed in the Company's Consolidated Statements of Cash Flows included elsewhere herein, net cash provided by operating activities was approximately $14.3 million during 2005. Net cash used in investing activities of $49.8 million consisted primarily of a net increase in loans of $35.1 million. Net cash provided by financing activities amounted to $38.6 million, primarily from $26.3 million net increase in deposits.

Asset Liability and Interest Rate Risk Management. The objective of the Company's Asset Liability and Interest Rate Risk strategies is to identify and manage the sensitivity of net interest income to changing interest rates and to minimize the interest rate risk between interest-earning assets and interest-bearing liabilities at various maturities. This is to be done in conjunction with the need to maintain adequate liquidity and the overall goal of maximizing net interest income. Table 5 presents an interest rate sensitivity analysis for the interest-earning assets and interest-bearing liabilities for the year ended December 31, 2005.

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Table 5 - Interest Sensitivity Analysis

(Dollars in Thousands)	Immediate	1-3 Months	4-12 Months	Total Within One year	Over One year & Non-sensitive	Total
Interest-earning assets:						
Loans	$ 427,716	17,536	8,697	453,949	112,714	$ 566,663
Mortgage loans available for sale	2,248	-	-	2,248	-	2,248
Investment securities	-	1,753	-	1,753	113,405	115,158
Federal funds sold	1,347	-	-	1,347	-	1,347
Interest-bearing deposit accounts	1,480	-	-	1,480	-	1,480
Other interest-earning assets	-	-	-	-	5,506	5,506
Total interest-earning assets	432,791	19,289	8,697	460,777	231,625	$ 692,402
Interest-bearing liabilities:						
NOW, savings, and money market deposits	183,249	-	-	183,249	-	$ 183,249
Time deposits	69,697	42,161	130,078	241,936	63,008	304,944
Other short term borrowings	1,474	-	-	1,474	-	1,474
FHLB borrowings	4,600	2,500	-	7,100	64,500	71,600
Securities sold under agreement to repurchase	981	-	-	981	-	981
Trust preferred securities	-	14,433	-	14,433	-	14,433
Total interest-bearing liabilities	260,001	59,094	130,078	449,173	127,508	$ 576,681
Interest-sensitive gap	$ 172,790	(39,805)	(121,381)	11,604	104,117	$ 115,721
Cumulative interest-sensitive gap	$ 172,790	132,985	11,604	11,604	115,721	
Interest-earning assets as a percentage of interest-bearing liabilities	166.46 %	32.64 %	6.69 %	102.58 %		

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

The Company's rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available for sale securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits and borrowed funds. As shown in table 5, the Company's balance sheet is asset-sensitive, meaning that in a given period there will be more assets than liabilities subject to immediate repricing as interest rates change in the market. Because most of the Company's loans are tied to the prime rate, they reprice more rapidly than rate sensitive interest-bearing deposits. During periods of rising rates, this results in increased net interest income. The opposite occurs during periods of declining rates. Rate sensitive assets at December 31, 2005 totaled $692.4 million, exceeding rate sensitive liabilities of $576.7 million by $115.7 million.

In order to assist in achieving a desired level of interest rate sensitivity, the Company entered into off-balance sheet contracts that are considered derivative financial instruments. As of December 31, 2005, the Company had cash flow hedges with a notional amount of $70.0 million. These derivative instruments consist of two interest rate floor contracts that are used to hedge future cash flows of the first $70.0 million of certain variable rate commercial loans against the downward effects of their repricing in the event of a decreasing rate environment for a period of three years ending in July 2008 and November 2008. If the prime rate falls below 6.25% during the term of the contract on the first floor, the Company will receive payments based on the $35.0 million notional amount times the difference between 6.25% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate is 6.25% or higher. The Company paid a premium of $161,000 on this contact. On the second floor if the prime rate falls below 7.00% during the term of the contract, the Company will receive payments based on the $35.0 million notional amount times the difference between 7.00% and the weighted average prime rate for the quarter. No payments will be received by the Company if the weighted average prime rate is 7.00% or higher. The Company paid a premium of $203,000 on this contract.

The Company settled two previously outstanding interest rate swap agreements during 2005. The first swap with a notional amount of $25.0 million and scheduled to mature in April 2006 was sold for a loss of $318,000. The second swap with a notional amount of $30.0 million and scheduled to mature in September 2006 was sold for a loss of $552,000. The losses realized upon settlement are being recognized over the original term of the agreements, and during the year ended December 31, 2005, losses of approximately $484,000 were recognized.

The Bank also utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At December 31, 2005, the Bank had $90.5 million in loans with interest rate floors; however, none of the floors were in effect pursuant to the terms of the promissory notes on these loans.

An analysis of the Company's financial condition and growth can be made be examining the changes and trends in interest-earning assets and interest-bearing liabilities, and a discussion of these changes and trends follows.

Analysis of Financial Condition

Investment Securities. All of the Company's investment securities are held in the available-for-sale ("AFS") category. At December 31, 2005 the market value of AFS securities totaled $115.2 million, compared to $105.6 million and $79.5 million at December 31, 2004 and 2003, respectively. The increase in 2005 investment securities is attributable to additional securities purchases, which were partially offset by paydowns on mortgage-backed securities and maturities during 2005. This increase in AFS securities reflects management's directed effort to increase investment securities as a percentage of total assets in an effort to reduce the credit risk in the balance sheet. Table 6 presents the market value of the AFS securities held at December 31, 2005, 2004 and 2003.

Table 6 - Summary of Investment Portfolio

(Dollars in Thousands)		**2005**	**2004**	**2003**
Obligations of United States government agencies and corporations	$	60,243	46,570	34,517
Obligations of states and political subdivisions		21,609	20,649	14,950
Mortgage backed securities		31,004	36,543	24,920
Trust preferred securities		1,750	1,750	5,000
Equity securities		552	86	73
Total securities	$	115,158	105,598	79,460

The composition of the investment securities portfolio reflects the Company's investment strategy of maintaining an appropriate level of liquidity while providing a relatively stable source of income. The investment portfolio also provides a balance to interest rate risk and credit risk in other categories of the balance sheet while providing a vehicle for the investment of available funds, furnishing liquidity, and supplying securities to pledge as required collateral for certain deposits.

The Company's investment portfolio consists of U.S. government agency securities, municipal securities, U.S. government agency sponsored mortgage-backed securities, trust preferred securities and equity securities. AFS securities averaged $108.7 million in 2005, $93.8 million in 2004 and $72.1 million in 2003. Table 7 presents the amortized cost of AFS securities held by the Company by maturity category at December 31, 2005. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity and yields are calculated on a tax equivalent basis. Yields and interest income on tax-exempt investments have been adjusted to tax equivalent basis using an effective tax rate 34% for securities that are both federal and state tax exempt and an effective tax rate of 6.90% for state tax exempt securities.

Table 7 - Maturity Distribution and Weighted Average Yield on Investments

(Dollars in Thousands)	One Year or Less		After One Year Through 5 Years		After 5 Years Through 10 Years		After 10 Years		Totals	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Book value:										
United States Government agencies	$ -	-	36,433	4.27%	24,318	4.80%	-	-	$ 60,751	4.48%
States and political subdivisions	200	7.21%	8,341	5.08%	9,329	4.88%	3,878	7.04%	21,748	5.36%
Mortgage backed securities	-	-	432	3.74%	12,371	3.99%	19,063	4.53%	31,866	4.31%
Trust preferred securities	-	-	-	-	-	-	1,750	7.16%	1,750	7.16%
Equity securities	-	-	-	-	-	-	815	0.21%	815	0.21%
Total securities	$ 200	7.21%	45,206	4.42%	46,018	4.60%	25,506	4.95%	$ 116,930	4.61%

Loans. The loan portfolio is the largest category of the Company's earning assets and is comprised of commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. The Company grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg County. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by real estate, which is dependent upon the real estate market. Non-real estate loans also can be affected by local economic conditions. In management's opinion, there are no significant concentrations of credit with particular borrowers engaged in similar activities.

The composition of the Company's loan portfolio is presented in table 8.

Table 8 - Loan Portfolio

(Dollars in Thousands)	2005		2004		2003		2002		2001	
	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans
Breakdown of loan receivables:										
Commercial	$ 79,902	14.10%	79,189	14.79%	90,558	16.41%	92,141	17.51%	102,409	20.87%

Real estate - mortgage	330,227	58.28%	312,988	58.45%	332,730	60.26%	322,987	61.36%	277,737	56.61%
Real estate - construction	141,420	24.96%	127,042	23.73%	110,392	19.99%	80,552	15.30%	82,791	16.88%
Consumer	15,115	2.66%	16,249	3.03%	18,446	3.34%	30,690	5.83%	27,671	5.64%
Total loans	$ 566,664	100.00%	535,468	100.00%	552,126	100.00%	526,370	100.00%	490,608	100.00%
Less: Allowance for loan losses	7,425		8,049		9,722		7,248		6,091	
Net loans	$ 559,239		527,419		542,404		519,122		484,517	

As of December 31, 2005, gross loans outstanding were $566.7 million, an increase of $31.2 million or 6% from the December 31, 2004 balance of $535.5 million. Commercial loans increased $713,000 in 2005. Real estate mortgage loans grew $17.2 million when compared to 2004 due to an increase in commercial real estate loans. Real estate construction loans increased $14.4 million in 2005 as a result of an increase in real estate development loans. Consumer loans decreased $1.1 million in 2005.

Mortgage loans held for sale were $2.2 million at December 31, 2005, a decrease of $1.5 million from the December 31, 2004 balance of $3.8 million which represented an increase of $3.2 million from the December 31, 2003 balance of $587,000

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Table 9 identifies the maturities of all loans as of December 31, 2005 and addresses the sensitivity of these loans to changes in interest rates.

Table 9 - Maturity and Repricing Data for Loans

(Dollars in Thousands)	Within One Year or Less	After One Year Through Five Years	After Five Years	Total Loans
Commercial	$ 70,761	8,572	569	$ 79,902
Real estate - mortgage	245,454	51,624	33,149	330,227
Real estate - construction	131,110	9,373	937	141,420
Consumer	6,624	7,215	1,275	15,114
Total loans	$ 453,949	76,784	35,930	$ 566,663
Total fixed rate loans	$ 11,316	63,882	35,930	$ 111,128
Total floating rate loans	442,633	12,902	-	455,535
Total loans	$ 453,949	76,784	35,930	$ 566,663

In the normal course of business, there are various commitments outstanding to extend credit that are not reflected in the financial statements. At December 31, 2005, outstanding loan commitments totaled $133.4 million. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Additional information regarding commitments is provided below in the section entitled “Contractual Obligations” and in Note 10 to the Consolidated Financial Statements.

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

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

An analysis of the credit quality of the loan portfolio and the adequacy of the allowance for loan losses is prepared by the Bank’s credit administration personnel and presented to the Bank’s Board of Directors on a monthly basis. The allowance is the total of specific reserves allocated to significant individual loans plus a general reserve. After individual loans with specific allocations have been deducted, the general reserve is calculated by applying general reserve percentages to the nine risk grades within the portfolio. Loans are categorized as one of nine risk grades based on management’s assessment of the overall credit quality of the loan, including payment history, financial position of the borrower, underlying collateral and internal credit review. The general reserve percentages are determined by management based on its evaluation of losses inherent in the various risk grades of loans. The allowance for loan losses is established through charges to expense in the form of a provision for loan losses. Loan losses and recoveries are charged and credited directly to the allowance.

An allowance for loan losses is also established, as necessary, for individual loans considered to be impaired in accordance with Statement of Financial Accounting Standards ("SFAS") No. 114. A loan is considered impaired when, based on current information and events, it is probable that all amounts due according to the contractual terms of the loan will not be collected. Impaired loans are measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or at the loan's observable market price, or the fair value of collateral if the loan is collateral dependent. At December 31, 2005 and 2004, the recorded investment in loans that were considered to be impaired under SFAS No. 114 was approximately $3.5 million and $5.1 million, respectively, with related allowance for loan losses of approximately $478,000 and $773,000, respectively.

The Bank’s allowance for loan losses is also subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance for loan losses and the size of the allowance for loan losses compared to a group of peer banks identified by the regulators. During their routine examinations of banks, the FDIC and the North Carolina Commissioner of Banks may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

While it is the Bank's policy to charge off in the current period loans for which a loss is considered probable, there are additional risks of future losses which cannot be quantified precisely or attributed to particular loans or classes of loans. Because these risks include the state of the economy, management’s judgment as to the adequacy of the allowance is necessarily approximate and imprecise. After review of all relevant matters affecting loan collectability, management believes that the allowance for loan losses is appropriate.

As described above, the Company grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg County. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by real estate, which is dependent upon the real estate market. Non-real estate loans also can be affected by local economic conditions. At December 31, 2005, approximately 5% of the Company’s portfolio was not secured by any type of collateral. Unsecured loans generally involve higher credit risk than secured loans, and in the event of customer default, the Company has a higher exposure to potential loan losses.

Net charge-offs for 2005 were $3.7 million. The ratio of net charge-offs to average total loans was 0.68% in 2005, 0.90% in 2004 and 0.79% in 2003. Charge-offs in 2004 included charges of $1.0 million and $550,000 related to loans to customers that were formerly directors of the Company. The allowance for loan losses decreased to $7.4 million or 1.31% of total loans outstanding at December 31, 2005. This decrease in the allowance for loan losses was the result of a reduction in classified loans. For December 31, 2004 and 2003, the allowance for loan losses amounted to $8.0 million, or 1.50% of total loans outstanding and $9.7 million, or 1.76% of total loans outstanding, respectively.

Table 10 presents the percentage of loans assigned to each risk grade along with the general reserve percentage applied to loans in each risk grade at December 31, 2005 and 2004.

Table 10 - Loan Risk Grade Analysis

	Percentage of Loans By Risk Grade		**General Reserve Percentage**	
Risk Grade	**2005**	**2004**	**2005**	**2004**
Risk 1 (Excellent Quality)	14.28%	13.44%	0.15%	0.15%
Risk 2 (High Quality)	18.16%	23.03%	0.50%	0.50%
Risk 3 (Good Quality)	56.40%	53.89%	1.00%	1.00%
Risk 4 (Management Attention)	8.38%	5.67%	2.50%	2.50%
Risk 5 (Watch)	0.88%	0.95%	7.00%	7.00%
Risk 6 (Substandard)	0.42%	0.61%	12.00%	12.00%
Risk 7 (Low Substandard)	0.86%	1.46%	25.00%	25.00%
Risk 8 (Doubtful)	0.00%	0.00%	50.00%	50.00%
Risk 9 (Loss)	0.00%	0.00%	100.00%	100.00%

At December 31, 2005, there were two relationships which exceeded $1.0 million (totaling $2.7 million) in the Watch risk grade, no relationships that exceeded $1.0 million in the Substandard risk grade and two relationships which exceed $1.0 million (totaling $4.5 million) in the Low Substandard risk grade. Balances of individual relationships exceeding $1.0 million in these risk grades ranged from $1.1 million to $3.2 million. These customers continue to meet payment requirements and these relationships would not become non-performing assets unless they are unable to meet those requirements.

Table 11 presents an analysis of the allowance for loan losses, including charge-off activity.

Table 11 - Analysis of Allowance for Loan Losses

(Dollars in Thousands)		**2005**	**2004**	**2003**	**2002**	**2001**
Reserve for loan losses at beginning	$	8,049	9,722	7,248	6,091	4,713
Loans charged off:						
Commercial		293	1,004	1,179	3,737	842
Real estate - mortgage		2,141	3,842	2,422	158	790
Real estate - construction		1,250	4	251	-	51
Consumer		516	535	630	546	675
Total loans charged off		4,200	5,385	4,482	4,441	2,358
Recoveries of losses previously charged off:						
Commercial		144	162	36	40	84
Real estate - mortgage		162	144	18	-	-
Real estate - construction		-	-	1	4	6
Consumer		160	150	157	122	101
Total recoveries		466	456	212	166	191
Net loans charged off		3,734	4,929	4,270	4,275	2,167
Provision for loan losses		3,110	3,256	6,744	5,432	3,545
Reserve for loan losses at end of year	$	7,425	8,049	9,722	7,248	6,091
Loans charged off net of recoveries, as a percent of average loans outstanding		0.68%	0.90%	0.79%	0.84%	0.48%

Non-performing Assets. Non-performing assets, comprised of non-accrual loans, other real estate owned, other repossessed assets and loans for which payments are more than 90 days past due totaled $5.0 million at December 31, 2005 compared to $6.0 million at December 31, 2004. Non-accrual loans were $3.5 million at December 31, 2005, a decrease of $1.6 million from non-accruals of $5.1 million at December 31, 2004. As a percentage of loans outstanding, non-accrual loans were 0.62% and 0.95% at December 31, 2005 and 2004, respectively. The Bank had loans ninety days past due and still accruing at December 31, 2005 of $946,000 as compared to $245,000 for the same period in 2004. Other real estate owned totaled $531,000 and $682,000 as of December 31, 2005 and 2004, respectively. The Bank had no repossessed assets as of December 31, 2005 and 2004.

At December 31, 2005 the Company had non-performing loans, defined as non-accrual and accruing loans past due more than 90 days, of $4.4 million or 0.79% of total loans. Non-performing loans for 2004 were $5.3 million, or 1.00% of total loans and $4.6 million, or 0.84% of total loans for 2003. Interest that would have been recorded on non-accrual loans for the years ended December 31, 2005, 2004 and 2003, had they performed in accordance with their original terms, amounted to approximately $507,000, $264,000 and $400,000 respectively. Interest income on impaired loans included in the results of operations for 2005, 2004, and 2003 amounted to approximately $77,000, $123,000 and $67,000, respectively.

Management continually monitors the loan portfolio to ensure that all loans potentially having a material adverse impact on future operating results, liquidity or capital resources have been classified as non-performing. Should economic conditions deteriorate, the inability of distressed customers to service their existing debt could cause higher levels of non-performing loans.

It is the general policy of the Company to stop accruing interest income and place the recognition of interest on a cash basis when a loan is placed on non-accrual status and any interest previously accrued but not collected is reversed against current income. Generally a loan is placed on non-accrual status when it is over 90 days past due and there is reasonable doubt that all principal will be collected.

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

Table 12 - Non-performing Assets

(Dollars in Thousands)		**2005**	**2004**	**2003**	**2002**	**2001**
Non-accrual loans	$	3,492	5,097	4,343	4,602	3,756
Loans 90 days or more past due and still accruing		946	245	271	239	655
Total non-performing loans		4,438	5,342	4,614	4,841	4,411
All other real estate owned		531	682	1,447	240	256
All other repossessed assets		-	-	206	1,538	4
Total non-performing assets	$	4,969	6,024	6,267	6,619	4,671
As a percent of total loans at year end						
Non-accrual loans		0.62%	0.95%	0.79%	0.87%	0.77%
Loans 90 days or more past due and still accruing		0.17%	0.05%	0.05%	0.05%	0.13%
Total non-performing assets		0.88%	1.12%	1.14%	1.26%	0.95%

Deposits. The Company primarily uses deposits to fund its loan and investment portfolios. The Company offers a variety of deposit accounts to individuals and businesses. Deposit accounts include checking, savings, money market and time deposits. As of December 31, 2005, total deposits were $582.9 million, an increase of $26.4 million or 5% increase over the December 31, 2004 balance of $556.5 million. The increase in deposits is primarily attributable to growth in core deposits, which include demand deposits, savings accounts and certificates of deposits of denominations less than $100,000, to $430.4 million at December 31, 2005 from $402.2 million at December 31, 2004. The increase in core deposits resulted primarily from an increase in the Bank's certificates of deposits of denominations less than $100,000, due to a change in certificate of deposit pricing strategies implemented in 2005.

Time deposits in amounts of $100,000 or more totaled $152.4 million at December 31, 2005, $154.3 million and $171.6 million at December 31, 2004 and 2003, respectively. The decrease in 2005 is due to a reduction in brokered deposits that were replaced with core deposits. At December 31, 2005, brokered deposits amounted to $40.3 million as compared to $39.4 million at December 31, 2004. Brokered deposits are generally considered to be more susceptible to withdrawal as a result of interest rate changes and to be a less stable source of funds, as compared to deposits from the local market. Brokered deposits outstanding as of December 31, 2005 have a weighted average rate of 3.64% with a weighted average original term of 18 months.

Table 13 is a summary of the maturity distribution of time deposits in amounts of $100,000 or more as of December 31, 2005.

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

(Dollars in Thousands)		**2005**
Three months or less	$	33,040
Over three months through six months		28,730
Over six months through twelve months		38,760
Over twelve months		51,881
Total	$	152,411

Borrowed Funds. The Company has access to various short-term borrowings, including the purchase of federal funds and borrowing arrangements from the FHLB and other financial institutions. At December 31, 2005, FHLB borrowings totaled $71.6 million compared to $59.0 million at December 31, 2004 and $58.0 million at December 31, 2003. Average FHLB borrowings for 2005 were $65.9 million, compared to average balances of $58.7 million for 2004 and $59.3 million for 2003. The maximum amount of outstanding FHLB borrowings was $77.6 million in 2005, and $70.7 in 2004 and $75.1 in 2003. The FHLB advances outstanding at December 31, 2005 had both fixed and adjustable interest rates ranging from 3.28% to 6.49%. Currently $7.1 million of the FHLB advances outstanding have contractual maturities prior to December 31, 2006. The FHLB has the option to convert $52.0 million of the total advances to a floating rate and, if converted, the Bank may repay advances without prepayment of a prepayment fee. The Company also has an additional $10.0 million in variable rate convertible advances, which may be repaid without a prepayment fee if converted by the FHLB. Additional information regarding FHLB advances is provided in Note 6 to the Consolidated Financial Statements.

Demand notes payable to the U. S. Treasury, which represent treasury tax and loan payments received from customers, amounted to approximately $1.5 million, $1.2 million and $443,000 at December 31, 2005, 2004 and 2003, respectively.

Securities sold under agreements to repurchase amounted to $981,000 as of December 31, 2005. The Company had no securities sold under agreements to repurchase as of December 21, 2004 and 2003.

The Company had no federal funds purchased as of December 31, 2005, 2004 or 2003.

Junior Subordinated Debentures (related to Trust Preferred Securities). In December 2001 the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust I ("PEBK Trust"), which issued $14.0 million of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures that qualify as Tier 1 capital under Federal Reserve Board guidelines. All of the common securities of PEBK Trust are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust to purchase $14.4 million of junior subordinated debentures of the Company, which pay a floating rate equal to prime plus 50 basis points. The proceeds received by the Company from the sale of the junior subordinated debentures were used for general purposes, primarily to provide capital to the Bank. The debentures represent the sole asset of PEBK Trust. PEBK Trust is not included in the consolidated financial statements at December 31, 2005, 2004 or 2003.

The trust preferred securities accrue and pay quarterly distributions based on the liquidation value of $50,000 per capital security at a floating rate of prime plus 50 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust has funds with which to make the distributions and other payments. The net combined effect of all the documents entered into in connection with the trust preferred securities is that the Company is liable to make the distributions and other payments required on the trust preferred securities.

The trust preferred securities are mandatorily redeemable upon maturity of the debentures on December 31, 2031, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust, in whole or in part, on or after December 31, 2006. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount and any accrued but unpaid interest.

Contractual Obligations and Off-Balance Sheet Arrangements. The Company's contractual obligations and other commitments as of December 31, 2005 are summarized in Table 14 below. The Company's contractual obligations include the repayment of principal and interest related to FHLB advances and junior subordinated debentures, as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.

Table 14 - Contractual Obligations and Other Commitments

(Dollars in Thousands)	**Within One year**	**One to Three Years**	**Three to Five Years**	**Five Years or More**	**Total**
Contractual Cash Obligations					
Long-term borrowings*	$ 2,500	2,500	17,000	45,000	$ 67,000
Junior subordinated debentures	-	-	-	14,433	14,433
Operating lease obligations	985	1,935	1,447	4,232	8,599

Total	$	3,485	4,435	18,447	63,665	$	90,032
Other Commitments							
Commitments to extend credit	$	46,450	23,217	9,472	54,270	$	133,409
Standby letters of credit and financial guarantees written		2,607	85	-	-		2,692
Total	$	49,057	23,302	9,472	54,270	$	136,101

*Excludes $4.6 million adjustable rate credit due to the FHLB, which matured in February 2006.

The Company enters into derivative contracts to manage various financial risks. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or referenced interest rate. Derivative contracts are carried at fair value on the consolidated balance sheet with the fair value representing the net present value of expected future cash receipts or payments based on market interest rates as of the balance sheet date. Derivative contracts are written in amounts referred to as notional amounts, which only provide the basis for calculating payments between counterparties and are not a measure of financial risk. Therefore, the derivative amounts recorded on the balance sheet do not represent the amounts that may ultimately be paid under these contracts. Further discussions of derivative instruments are included above in the section entitled “Asset Liability and Interest Rate Risk Management” beginning on page A-10 and in Notes 1, 10, 11 and 16 to the Consolidated Financial Statements.

Capital Resources. Shareholders’ equity at December 31, 2005 was $54.4 million compared to $50.9 million at December 31, 2004 and $48.6 million at December 31, 2003. At December 31, 2005 and 2004, unrealized gains and losses, net of taxes, amounted to losses of $1.4 million and $121,000, respectively. For the year ended December 31, 2003, unrealized gains and losses, net of taxes, amounted to a gain of $588,000. Average shareholders’ equity as a percentage of total average assets is one measure used to determine capital strength. Average shareholders’ equity as a percentage of total average assets was 7.92%, 7.59% and 7.56% for 2005, 2004 and 2003. The return on average shareholders’ equity was 11.31% at December 31, 2005 as compared to 8.52% and 4.01% as of December 31, 2004 and December 31, 2003, respectively. Total cash dividends paid during 2005 amounted to $1.4 million. Cash dividends totaling $1.3 million were paid during 2004 and 2003.

In November 2004, the Company’s Board of Directors authorized the repurchase of up to $3.0 million in common shares of the Company’s outstanding common stock effective through the end of November 2005. During 2005, the Company repurchased a total of 15,000 shares at a total price of $315,000. During 2004, the Company repurchased a total of 15,100 shares at a total price of $291,000.

In November 2005, the Company’s Board of Directors authorized the repurchase of up to $2.0 million in common shares of the Company’s outstanding common stock effective through the end of November 2006. No shares have been repurchased under the current plan.

Under regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 4.0% or greater. Tier 1 capital is generally defined as shareholders' equity and trust preferred securities less all intangible assets and goodwill. Tier 1 capital at December 31, 2005, 2004 and 2003 includes $14.0 million in trust preferred securities. The Company’s Tier 1 capital ratio was 11.02%, 10.97% and 10.50% at December 31, 2005, 2004 and 2003, respectively. Total risk-based capital is defined as Tier 1 capital plus supplementary capital. Supplementary capital, or Tier 2 capital, consists of the Company's allowance for loan losses, not exceeding 1.25% of the Company's risk-weighted assets. Total risk-based capital ratio is therefore defined as the ratio of total capital (Tier 1 capital and Tier 2 capital) to risk-weighted assets. The Company’s total risk-based capital ratio was 12.19%, 12.22% and 11.75% at December 31, 2005, 2004 and 2003, 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 9.84%, 9.50% and 9.37% at December 31, 2005, 2004 and 2003, respectively.

The Bank’s Tier 1 risk-based capital ratio was 10.46%, 10.35% and 9.87% at December 31, 2005, 2004 and 2003, respectively. The total risk-based capital ratio for the Bank was 11.64%, 11.60% and 11.13% at December 31, 2005, 2004 and December 31, 2003, respectively. The Bank’s Tier 1 leverage capital ratio was 9.33%, 8.95% and 8.80% at December 31, 2005, 2004 and 2003 respectively.

A bank is considered to be "well capitalized" if it has a total risk-based capital ratio of 10.0 % or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and has a leverage ratio of 5.0% or greater. Based upon these guidelines, the Bank was considered to be "well capitalized" at December 31, 2005, 2004 and 2003.

The capital treatment of trust preferred securities has been reviewed recently by the Federal Reserve Bank. The Federal Reserve Bank's proposal for capital treatment of trust preferred securities, released May 4, 2004, would continue to permit the inclusion of trust preferred securities in Tier 1 capital of bank holding companies. Further discussions of FIN 46 are included under "Recent Accounting Pronouncements" in Note 1 of the Notes to Consolidated Financial Statements.

The Company’s key equity ratios as of December 31, 2005, 2004 and 2003 are presented in Table 15.

Table 15 - Equity Ratios

	2005	2004	2003
Return on average assets	0.90%	0.65%	0.30%
Return on average equity	11.31%	8.52%	4.01%
Dividend payout ratio	22.34%	28.37%	62.56%
Average equity to average assets	7.92%	7.59%	7.56%

Quarterly Financial Data. The Company’s consolidated quarterly operating results for the years ended December 31, 2005 and 2004 are presented in table 16.

Table 16 - Quarterly Financial Data

	2005				2004			
(Dollars in thousands, except per share amounts)	**First**	**Second**	**Third**	**Fourth**	**First**	**Second**	**Third**	**Fourth**
Total interest income	$ 9,581	10,349	11,352	12,089	8,936	8,847	9,135	9,374
Total interest expense	3,346	3,686	3,978	4,418	3,066	3,002	3,103	3,164
Net interest income	6,235	6,663	7,374	7,671	5,870	5,845	6,032	6,210
Provision for loan losses	690	723	930	767	859	868	931	598
Other income	1,638	1,842	1,795	1,421	1,500	1,531	1,549	1,440
Other expense	5,259	5,301	5,388	5,869	4,720	4,873	4,990	5,474
Income before income taxes	1,924	2,481	2,851	2,456	1,791	1,635	1,660	1,578
Income taxes	647	873	1,010	851	613	547	552	521
Net earnings	$ 1,277	1,608	1,841	1,605	1,178	1,088	1,108	1,057
Basic earnings per share	$ 0.37	0.47	0.53	0.47	0.34	0.31	0.32	0.31
Diluted earnings per share	$ 0.36	0.46	0.52	0.46	0.34	0.31	0.32	0.30

QUANTATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk reflects the risk of economic loss resulting from adverse changes in market prices and interest rates. This risk of loss can be reflected in either diminished current market values or reduced potential net interest income in future periods.

The Company's market risk arises primarily from interest rate risk inherent in its lending and deposit taking activities. The structure of the Company's loan and deposit portfolios is such that a significant decline (increase) in interest rates may adversely impact net market values and interest income. Management seeks to manage the risk through the utilization of its investment securities and off-balance sheet derivative instruments. During the years ended December 31, 2005, 2004 and 2003, the Company used interest rate contracts to manage market risk as discussed above in the section entitled "Asset Liability and Interest Rate Risk Management."

Table 17 presents in tabular form the contractual balances and the estimated fair value of the Company's on-balance sheet financial instruments and the notional amount and estimated fair value of the Company's off-balance sheet derivative instruments at their expected maturity dates for the period ended December 31, 2005. The expected maturity categories take into consideration historical prepayment experience as well as management's expectations based on the interest rate environment at December 31, 2005. As of December 31, 2005, all fixed rate advances are callable at the option of FHLB. For core deposits without contractual maturity (i.e. interest bearing checking, savings, and money market accounts), the table presents principal cash flows based on management's judgment concerning their most likely runoff or repricing behaviors.

Table 17 - Market Risk Table

(Dollars In Thousands)	Principal/Notional Amount Maturing in Year Ended December 31,						
Loans Receivable	**2006**	**2007**	**2008**	**2009 & 2010**	**Thereafter**	**Total**	**Fair Value**
Fixed rate	$ 19,131	16,117	14,695	31,070	30,114	$ 111,128	$ 111,049
Average interest rate	7.93%	7.28%	6.80%	6.83%	6.92%		
Variable rate	$ 169,488	66,448	38,876	74,198	106,526	$ 455,535	$ 455,498
Average interest rate	7.82%	7.97%	8.05%	7.89%	7.65%		
						$ 566,663	$ 566,547
Investment Securities	.						
Interest bearing cash	$ -	-	-	-	1,480	$ 1,480	$ 1,480
Average interest rate	-	-	-	-	3.64%		
Federal funds sold	$ 1,347	-	-	-	-	$ 1,347	$ 1,347
Average interest rate	3.80%	-	-	-	-		
Securities available for sale	$ 1,535	5,485	16,725	25,708	65,705	$ 115,158	$ 115,158
Average interest rate	4.41%	4.57%	4.29%	4.18%	3.88%		
Nonmarketable equity securities	$ -	-	-	-	3,735	$ 3,735	$ 5,506
Average interest rate	-	-	-	-	3.97%		
Debt Obligations							
Deposits	$ 230,683	101,307	46,232	37,888	166,744	$ 582,854	$ 583,312
Average interest rate	3.36%	4.10%	4.05%	3.77%	1.05%		
Advances from FHLB	$ 47,100	7,500	-	17,000	-	$ 71,600	$ 71,843
Average interest rate	3.62%	3.99%	-	5.35%	-		

Demand notes payable to U.S. Treasury	$ 1,474	-	-	-	-	$ 1,474	$ 1,474
Average interest rate	3.79%	-	-	-	-		
Securities sold under agreement to repurchase	$ 981	-	-	-	-	$ 981	$ 981
Average interest rate	3.14%	-	-	-	-		
Junior subordinated debentures	$ -	-	-	-	14,433	$ 14,433	$ 14,433
Average interest rate	-	-	-	-	7.11%		
Derivative Instruments (notional amount)							
Interest rate floor contracts	$ -	-	70,000	-	-	$ 70,000	$ 176
Average interest rate	-	-	6.63%	-	-		

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Table 18 presents the simulated impact to net interest income under varying interest rate scenarios and the theoretical impact of rate changes over a twelve-month period referred to as “rate ramps.” The table shows the estimated theoretical impact on the Company’s tax equivalent net interest income from hypothetical rate changes of plus and minus 1% and 2% as compared to the estimated theoretical impact of rates remaining unchanged. The table also shows the simulated impact to market value of equity under varying interest rate scenarios and the theoretical impact of immediate and sustained rate changes referred to as “rate shocks” of plus and minus 1% and 2% compared to the theoretical impact of rates remaining unchanged. The prospective effects of the hypothetical interest rate changes are based upon various assumptions, including relative and estimated levels of key interest rates. This type of modeling has limited usefulness because it does not allow for the strategies management would utilize in response to sudden and sustained rate changes. Also, management does not believe that rate changes of the magnitude presented are likely in the forecast period presented.

Table 18 - Interest Rate Risk
(Dollars in thousands)

Hypothetical rate change (ramp over 12 months)	Estimated Resulting Theoretical Net Interest Income		
		Amount	% Change
+2%	$	33,409	7.68%
+1%	$	32,216	3.83%
0%	$	31,028	0.00%
-1%	$	29,952	-3.47%
-2%	$	29,052	-6.37%

Hypothetical rate change (immediate shock)	Estimated Resulting Theoretical Market Value of Equity		
		Amount	% Change
+2%	$	48,424	-8.63%
+1%	$	50,588	-4.54%
0%	$	52,995	0.00%
-1%	$	55,686	5.08%
-2%	$	58,725	10.81%

MARKET FOR THE COMPANY'S COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

Peoples Bancorp common stock is traded on the over-the-counter (OTC) market and quoted on the Nasdaq National Market, under the symbol "PEBK." Scott and Stringfellow, Inc., Ryan, Beck & Co. and Sterne Agee & Leach, Inc. are market makers for the Company's shares.

Although the payment of dividends by the Company is subject to certain requirements and limitations of North Carolina corporate law, neither the Commissioner nor the FDIC have promulgated any regulations specifically limiting the right of the Company to pay dividends and repurchase shares. However, the ability of the Company to pay dividends and repurchase shares may be dependent upon the Company's receipt of dividends from the Bank. The Bank's ability to pay dividends is limited. North Carolina commercial banks, such as the Bank, are subject to legal limitations on the amounts of dividends they are permitted to pay. Dividends may be paid by the Bank from undivided profits, which are determined by deducting and charging certain items against actual profits, including any contributions to surplus required by North Carolina law. Also, an insured depository institution, such as the Bank, is prohibited from making capital distributions, including the payment of dividends, if, after making such distribution, the institution would become "undercapitalized" (as such term is defined in the applicable law and regulations). Based on its current financial condition, the Bank does not expect that this provision will have any impact on the Bank's ability to pay dividends.

As of March 6, 2006, the Company had 702 shareholders of record, not including the number of persons or entities whose stock is held in nominee or street name through various brokerage firms or banks. The market price for the Company's common stock was $23.82 on March 6, 2006.

Table 19 presents certain market and dividend information for the last two fiscal years. Over-the-counter quotations reflect inter-dealer prices, without retail mark-up, mark down or commission and may not necessarily represent actual transactions.

Table 19 - Market and Dividend Data

2005		**Low Bid**	**High Bid**	**Cash Dividend Per Share**
First Quarter	$	17.75	22.27	0.10
Second Quarter	$	17.25	22.00	0.10
Third Quarter	$	18.16	22.27	0.10
Fourth Quarter	$	19.47	24.00	0.11