

PEOPLES BANCORP OF NORTH CAROLINA INC  
Form DEF 14A  
March 25, 2014

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  
 [X] Definitive Proxy Statement Only (as permitted by Rule 14a-6(e)(2))  
 [ ] 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)

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[X] No fee required.

[ ] Fee computed on table below per Exchange Act Rules 14a-6(i)(1)  
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(3)

Filing Party:

(4)

Date Filed:

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PEOPLES BANCORP  
OF NORTH CAROLINA, INC.

Notice of 2014 Annual Meeting,  
Proxy Statement and  
Annual Report

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## 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 2014 ANNUAL MEETING OF  
SHAREHOLDERS  
To Be Held On May 1, 2014

NOTICE IS HEREBY GIVEN that the 2014 Annual Meeting of Shareholders of Peoples Bancorp of North Carolina, Inc. (the "Company") will be held as follows:

Place: Catawba Country Club  
1154 Country Club Road  
Newton, North Carolina

Date: May 1, 2014

Time: 11:00 a.m., Eastern Time

The purposes of the Annual Meeting are to consider and vote upon the following matters:

- To elect ten persons who will serve as members of the Board of Directors until the 2015 Annual Meeting of Shareholders or until their successors are duly elected and qualified;
- To ratify the appointment of Porter Keadle Moore, LLC ("PKM") as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2014; and
- To consider and act on any other matters that may properly come before the Annual Meeting or any adjournment.

The Board of Directors has established March 18, 2014, as the record date for the determination of shareholders entitled to notice of and to vote at the Annual Meeting. If an insufficient number of shares is present in person or by proxy to constitute a quorum at the time of the Annual Meeting, the Annual Meeting may be adjourned in order to permit further solicitation of proxies by the Company.

Your vote is important. We urge you to vote as soon as possible so that your shares may be voted in accordance with your wishes. You may vote by executing and returning your proxy card in the accompanying envelope, or by voting electronically over the Internet or by telephone. Please refer to the proxy card enclosed for information on voting electronically. If you attend the Annual Meeting, you may vote in person and the proxy will not be used.

By Order of the Board of Directors,

/s/ Lance A. Sellers  
Lance A. Sellers  
President and Chief Executive Officer

Newton, North Carolina  
March 25, 2014

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PEOPLES BANCORP OF NORTH CAROLINA, INC.

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PROXY STATEMENT

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Annual Meeting of Shareholders  
To Be Held On May 1, 2014

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This Proxy Statement is being mailed to our shareholders on or about March 25, 2014, for solicitation of proxies by the Board of Directors of Peoples Bancorp of North Carolina, Inc. Our principal executive offices are located at 518 West C Street, Newton, North Carolina 28658. Our telephone number is (828) 464-5620.

In this Proxy Statement, the terms “we,” “us,” “our” and the “Company” refer to Peoples Bancorp of North Carolina, Inc. The term “Bank” means Peoples Bank, our wholly-owned, North Carolina-chartered bank subsidiary. The terms “you” and “your” refer to the shareholders of the Company.

Important Notice Regarding the Availability of Proxy Materials for the Shareholder Meeting to Be Held on May 1, 2014. The Notice, Proxy Statement and the Annual Report to Shareholders for the year ended December 31, 2013 are also available at <https://www.sn1.com/IRWebLinkX/GenPage.aspx?IID=4050385&GKP=202713>

You may also access the above off-site website by going to [www.peoplesbanknc.com](http://www.peoplesbanknc.com) and click on the link.

INFORMATION ABOUT THE ANNUAL MEETING

Your vote is very important. For this reason, our Board of Directors is requesting that you allow your common stock to be represented at the 2014 Annual Meeting of Shareholders by the proxies named on the enclosed proxy card.

When is the Annual Meeting? May 1, 2014, at 11 a.m., Eastern Time.

Where will the Annual Meeting be held? At the Catawba Country Club, 1154 Country Club Road, Newton, North Carolina.

What items will be voted on at the Annual Meeting?

1. ELECTION OF DIRECTORS. To elect ten directors to serve until the 2015 Annual Meeting of Shareholders;
2. RATIFICATION OF SELECTION OF INDEPENDENT AUDITOR. To ratify the appointment of Porter Keadle Moore, LLC ("PKM") as the Company's independent registered public accounting firm for fiscal year 2014.
- 3.



OTHER BUSINESS. To consider any other business as may properly come before the Annual Meeting or any adjournment.

Who can vote?

Only holders of record of our common stock at the close of business on March 18, 2014 (the "Record Date") will be entitled to notice of and to vote at the Annual Meeting and any adjournment of the Annual Meeting. On the Record Date, there were 5,613,495 shares of our common stock outstanding and entitled to vote and 714 shareholders of record.

How do I vote by proxy?

You may vote your shares by marking, signing and dating the enclosed proxy card and returning it in the enclosed postage-paid envelope or by voting electronically over the Internet or by telephone using the information on the proxy card. If you return your signed proxy card before the Annual Meeting, the proxies will vote your shares as you direct. The Board of Directors has appointed proxies to represent shareholders who cannot attend the Annual Meeting in person.

For the election of directors, you may vote for (1) all of the nominees, (2) none of the nominees, or (3) all of the nominees except those you designate. If a nominee for election as a director becomes unavailable for election at any time at or before the Annual Meeting, the proxies will vote your shares for a substitute nominee. For each other item of business, you may vote "FOR" or "AGAINST" or you may "ABSTAIN" from voting.

If you return your signed proxy card but do not specify how you want to vote your shares, the proxies will vote them "FOR" the election of all of our nominees for directors and "FOR" all other proposals presented in this Proxy Statement in accordance with recommendations from the Board of Directors.

If your shares are held in the name of a broker or other nominee (i.e., held in "street name"), you will need to obtain a proxy instruction card from the broker holding your shares and return the card as directed by your broker. Your broker is not permitted to vote on your behalf on the election of directors unless you provide specific instructions by following the instructions from your broker about voting your shares by telephone or Internet or completing and returning the voting instruction card provided by your broker. For your vote to be counted in the election of directors you now will need to communicate your voting decision to your bank, broker or other holder of record before the date of the Annual Meeting.

We are not aware of any other matters to be brought before the Annual Meeting. If matters other than those discussed above are properly brought before the Annual Meeting, the proxies may vote your shares in accordance with their best judgment.

How do I change or revoke my proxy?

You can change or revoke your proxy at any time before it is voted at the Annual Meeting in any of three ways: (1) by delivering a written notice of revocation to the Secretary of the Company; (2) by delivering another properly signed proxy card to the Secretary of the Company with a more recent date than your first proxy card or by changing your vote by telephone or the Internet; or (3) by attending the Annual Meeting and voting in person. You should deliver your written notice or superseding proxy to the Secretary of the Company

at our principal executive offices listed above.

How many votes can I cast?

You are entitled to one vote for each share held as of the Record Date on each nominee for election and each other matter presented for a vote at the Annual Meeting. You may not vote your shares cumulatively in the election of directors.

How many votes are required to approve the proposals?

If a quorum is present at the Annual Meeting, each director nominee will be elected by a plurality of the votes cast in person or by proxy. If you withhold your vote on a nominee, your shares will not be counted as having voted for that nominee.

The proposal to ratify the appointment of the Company's independent registered public accounting firm for 2014 will be approved if the votes cast in favor exceed the votes cast in opposition.

Any other matters properly coming before the Annual Meeting for a vote will require the affirmative vote of the holders of a majority of the shares represented in person or by proxy at the Annual Meeting and entitled to vote on that matter.

Abstentions and broker non-votes are not treated as votes cast on any proposal. As a result, neither will have an effect on the vote for the election of any director or the ratification of our independent registered public accounting firm.

A broker non-vote occurs when a broker does not vote on a particular matter because the broker does not have discretionary authority on that matter and has not received instructions from the owner of the shares.

In the event there are insufficient votes present at the Annual Meeting for a quorum or to approve or ratify any proposal, the Annual Meeting may be adjourned in order to permit the further solicitation of proxies.

What constitutes a "quorum" for the Annual Meeting?

A majority of the outstanding shares of our common stock entitled to vote at the Annual Meeting, present in person or represented by proxy, constitutes a quorum (a quorum is necessary to conduct business at the Annual Meeting). Your shares will be considered part of the quorum if you have voted your shares by proxy or by telephone or Internet. Abstentions, broker non-votes and votes withheld from any director nominee count as shares present at the Annual Meeting for purposes of determining a quorum.

Who pays for the solicitation of proxies?

We will pay the cost of preparing, printing and mailing materials in connection with this solicitation of proxies. In addition to solicitation by mail, our officers, directors and regular employees, as well as those of the Bank, may make solicitations personally, by telephone or otherwise without additional compensation for doing so. We reserve

the right to engage a proxy solicitation firm to assist in the solicitation of proxies for the Annual Meeting. We will, upon request, reimburse

brokerage firms, banks and others for their reasonable out-of-pocket expenses in forwarding proxy materials to beneficial owners of stock or otherwise in connection with this solicitation of proxies.

When are proposals for the 2015 Annual Meeting due?

To be considered either for inclusion in the proxy materials solicited by the Board of Directors for the 2015 Annual Meeting, proposals must be received by the Secretary of the Company at our principal executive offices at 518 West C Street, Newton, North Carolina 28658 (or at P.O. Box 467, Newton, North Carolina 28658-0467) no later than December 26, 2014. To be included in the proxy materials, a proposal must comply with our Bylaws, Rule 14a-8 and all other applicable provisions of Regulation 14A under the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Any proposal not intended to be included in the Company's proxy statement for the 2015 Annual Meeting, but intended to be presented at the 2015 Annual Meeting, must be received by us at our principal executive offices listed above no later than February 9, 2015.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS  
AND MANAGEMENT

The Exchange Act requires that any person who acquires the beneficial ownership of more than five percent (5%) of the Company's 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 (5%) of the Company's outstanding common stock.

| Name and Address of Beneficial Owner                                                              | Amount and Nature of Beneficial Ownership <sup>1</sup> | Percent of Class <sup>2</sup> |
|---------------------------------------------------------------------------------------------------|--------------------------------------------------------|-------------------------------|
| Christine S. Abernethy<br>P.O. Box 386<br>Newton, NC 28658                                        | 660,4953                                               | 11.77%                        |
| Tontine Financial Partners,<br>LP<br>55 Railroad Avenue, 3rd<br>Floor<br>Greenwich, CT 06830-6378 | 371,6044                                               | 6.62%                         |
| Tontine Management, LLC<br>55 Railroad Avenue<br>Greenwich, CT 06830                              | 371,6044                                               | 6.62%                         |
| Tontine Asset Associates,<br>LLC<br>55 Railroad Avenue<br>Greenwich, CT 06830                     | 141,3614                                               | 2.52%                         |
| Jeffrey L. Gendell<br>55 Railroad Avenue<br>Greenwich, CT 06830                                   | 512,9654                                               | 9.14%                         |

<sup>1</sup> 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.

<sup>2</sup> Based upon a total of 5,613,495 shares of common stock outstanding as of the Record Date.

<sup>3</sup> Carolina Glove Company, Inc. owns 107,604 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.

<sup>4</sup> Based on a Schedule 13G/A (Amendment No. 5) filed by Tontine Financial Partners, LP, Tontine Management, LLC, Tontine Overseas Associates, LLC, Tontine Asset Associates, LLC and Jeffrey L. Gendell with the SEC on February 14, 2014 and represents the total number of shares controlled by Jeffrey Gendell and the related Tontine

entities.

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Set forth below is certain information, as of the Record Date (unless otherwise indicated), 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 of Directors at the Annual Meeting, or is a named executive officer (“NEO”) 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<br>of Beneficial<br>Ownership <sup>1</sup> | Percentage<br>of<br>Class <sup>2</sup> |
|--------------------------------------------------------------------------|--------------------------------------------------------------|----------------------------------------|
| James S. Abernethy<br>Post Office Box 327<br>Newton, NC 28658            | 171,6043                                                     | 3.06%                                  |
| Robert C. Abernethy<br>Post Office Box 366<br>Newton, NC 28658           | 156,4264                                                     | 2.79%                                  |
| Joseph F. Beaman, Jr.<br>Post Office Box 467<br>Newton, NC 28658         | 8,241                                                        | *                                      |
| William D. Cable, Sr.<br>Post Office Box 467<br>Newton, NC 28658         | 19,094                                                       | *                                      |
| Douglas S. Howard<br>Post Office Box 587<br>Denver, NC 28037             | 12,5375                                                      | *                                      |
| A. Joseph Lampron, Jr.<br>Post Office Box 467<br>Newton, NC 28658        | 6,752                                                        | *                                      |
| John W. Lineberger, Jr.<br>Post Office Box 481<br>Lincolnton, NC 28092   | 2,299                                                        | *                                      |
| Gary E. Matthews<br>210 First Avenue South<br>Conover, NC 28613          | 21,586                                                       | *                                      |
| Billy L. Price, Jr., M.D.<br>540 11th Ave. Place NW<br>Hickory, NC 28601 | 5,853                                                        | *                                      |
| Larry E. Robinson<br>Post Office Box 723                                 | 49,9016                                                      | *                                      |

|                        |         |       |
|------------------------|---------|-------|
| Newton, NC 28658       |         |       |
| Lance A. Sellers       | 10,516  | *     |
| Post Office Box 467    |         |       |
| Newton, NC 28658       |         |       |
| William Gregory Terry  | 16,592  | *     |
| Post Office Box 395    |         |       |
| Conover, NC 28613      |         |       |
| Dan Ray Timmerman, Sr. | 87,1477 | 1.55% |
| Post Office Box 1148   |         |       |
| Conover, NC 28613      |         |       |
| Benjamin I. Zachary    | 88,1758 | 1.57% |
| Post Office Box 277    |         |       |
| Taylorsville, NC 28681 |         |       |

|                                                                                  |          |        |
|----------------------------------------------------------------------------------|----------|--------|
| All current directors and nominees and executive officers as a group (14 people) | 592,6859 | 10.56% |
|----------------------------------------------------------------------------------|----------|--------|

\*Does not exceed one percent of the common stock outstanding.

\*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 5,613,495 shares of common stock outstanding as of the Record Date.

3 Includes 64,038 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 5,868 shares of common stock owned by Mr. R. Abernethy's spouse, for which Mr. R. Abernethy disclaims beneficial ownership.

5 Includes 450 shares of common stock owned by Mr. Howard's spouse, for which Mr. Howard disclaims beneficial ownership.

6 Includes 8,835 shares of common stock owned by Mr. Robinson's spouse, for which Mr. Robinson disclaims beneficial ownership.

7 Includes 2,722 shares of common stock owned by Timmerman Manufacturing, Inc. Mr. Timmerman is a shareholder, director, Chairman of the Board and the Chief Executive Officer of Timmerman Manufacturing, Inc.

8 Includes 64,038 shares of common stock owned by Alexander Railroad Company. Mr. Zachary is President, Treasurer, General Manager and a Director of Alexander Railroad Company.

9 The 64,038 shares owned by Alexander Railroad Company and attributed to Mr. J. Abernethy and Mr. Zachary are only included once in calculating this total.

Directors James S. Abernethy and Robert C. Abernethy are brothers and are sons of Christine S. Abernethy, who owns in excess of ten percent (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 (10%) of the common stock, to file reports of ownership and changes in ownership with the SEC. Executive officers, directors and greater than ten percent (10%) 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, 2013, its executive officers and directors and greater than ten percent (10%) beneficial owners complied with all applicable Section 16(a) filing requirements.

## PROPOSAL 1

### ELECTION OF DIRECTORS

Our Board of Directors has set its number at ten members. Our current 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 Governance Committee or the Board of Directors, must be 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, that if less than 60 days' notice of the meeting is given to the 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.

Information about the nominees for election to the Board of Directors for a one-year term until the 2015 Annual Meeting of Shareholders appears below. All of the nominees are currently serving on the Board of Directors.

#### Director Nominees

James S. Abernethy, age 59 (as of March 1, 2014), is employed by Carolina Glove Company, Inc., a glove manufacturing company as its Vice President. Mr. Abernethy continues to serve as President and Assistant Secretary of Midstate Contractors, Inc., a paving company and also as Vice President, Secretary and Chairman of the Board of Directors of Alexander Railroad Company. Mr. Abernethy is also a director of Burke Mills, a public company. He has served as a director of the Company since 1992. Mr. Abernethy has a total of 21 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the North Carolina Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Abernethy earned a business administration degree from Gardner Webb University in North Carolina. Over his 21 years of service on the Board of Directors, Mr. Abernethy has served on all the Bank's and the Company's committees.

Robert C. Abernethy, age 63 (as of March 1, 2014), is employed by Carolina Glove Company, Inc., a glove manufacturing company, as its President, Secretary and Treasurer. Mr. Abernethy continues to serve as Secretary and Assistant Treasurer of Midstate Contractors, Inc., a paving company. He has served as a director of the Company since 1976 and as Chairman since 1991. Mr. Abernethy has a total of 37 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the North Carolina Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Abernethy earned a B.S. degree from Gardner Webb University in North Carolina. He serves on the Finance Committee and Investment Committee of Grace United Church of Christ. Mr. Abernethy also serves on the board of directors of Carolina Glove Company, Inc. and Midstate Contractors, Inc. both privately held companies.

Douglas S. Howard, age 55 (as of March 1, 2014), is employed by Denver Equipment of Charlotte, Inc. as Vice President, Secretary and Treasurer. Mr. Howard is currently serving as the Chairman of the Endowment Committee of Eastern Catawba Cooperative Christian Ministry. He has served as a director of the Company since 2004. Mr. Howard has a total of 15 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. He also serves on the Western NC Methodist Church Board of Finance. Mr. Howard also serves on the boards of Catawba Valley Medical Center and other privately-held companies.

John W. Lineberger, Jr., age 63 (as of March 1, 2014), is employed by Lincoln Bonded Warehouse Company, a commercial warehousing facility, as President. He has served as a director of the Company since 2004. Mr. Lineberger has a total of nine years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Lineberger earned a B.S. degree in business administration from Western Carolina University.

Gary E. Matthews, age 58 (as of March 1, 2014), is employed by Matthews Construction Company, Inc. as its President and a Director. He has served as a director of the Company since 2001. Mr. Matthews has a total of 12 years of banking experience, is a graduate of the North Carolina Bank Directors' College, and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Matthews is also a director of Conover Metal Products, a privately held company. Mr. Matthews earned a B.S. degree in civil engineering/construction from North Carolina

State University.

Billy L. Price, Jr., M.D., age 57 (as of March 1, 2014), is the Managing Partner and Practitioner of Internal Medicine at Catawba Valley Internal Medicine, PA. Dr. Price also serves on the Board of Trustees of Catawba Valley Medical Center. He has served as a director of the Company since 2004. Dr. Price has a total of nine years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Dr. Price was previously the owner/pharmacist of Conover Drug Company. He is also a

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director of Primary Physician Care, a private company. Dr. Price earned a B.S. degree in pharmacy from the University of North Carolina at Chapel Hill and his MD from East Carolina University School of Medicine.

Larry E. Robinson, age 68 (as of March 1, 2014), is employed by The Blue Ridge Distributing Company, Inc., a beer and wine distributor, as the President and Chief Executive Officer. He is a partner and Chief Operating Officer of United Beverages of North Carolina, LLC, a beer distributor. He has served as a director of the Company since 1993. Mr. Robinson has a total of 20 years of banking experience and is a graduate of the North Carolina Bank Directors' College. Mr. Robinson attended Western Carolina University and received an Associate Degree in Business and Accounting from Catawba Valley Community College in North Carolina.

William Gregory Terry, age 46 (as of March 1, 2014), is employed by Drum & Willis-Reynolds Funeral Homes and Crematory as General Manager. He has served as a director of the Company since 2004. Mr. Terry has a total of nine years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Terry graduated with a B.S. degree in business management from Clemson University in South Carolina. Mr. Terry serves on numerous civic and community boards.

Dan Ray Timmerman, Sr., age 66 (as of March 1, 2014), is a shareholder, director, Chairman of the Board and the Chief Executive Officer of Timmerman Manufacturing, Inc., a wrought iron furniture, railings and gates manufacturer. He has served as a director of the Company since 1995. Mr. Timmerman has a total of 18 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Timmerman earned a B.S. degree in business administration with a concentration in accounting from Lenoir-Rhyne University in North Carolina.

Benjamin I. Zachary, age 58 (as of March 1, 2014), is employed by Alexander Railroad Company as its President, Treasurer, General Manager and Director. He has served as a director of the Company since 1995. Mr. Zachary has a total of 18 years of banking experience and is a graduate of the North Carolina Bank Directors' College. Mr. Zachary earned a B.S. degree in business administration with a concentration in accounting from the University of North Carolina at Chapel Hill. He worked as a CPA for a national accounting firm for eight years following graduation where his assignments included financial statement audits of several banks. He formerly served as Treasurer and a member of the Finance Committee of First United Methodist Church of Taylorsville for many years. Mr. Zachary is a member of the Taylorsville Rotary Club and also serves as Treasurer.

We have no reason to believe that any of the nominees for election will be unable or will decline to serve if elected. In the event of death or disqualification of any nominee or the refusal or inability of any nominee to serve as a director, however, the proxies will vote for the election of another person as they determine in their discretion or may allow the vacancy to remain open until filled by the Board of Directors. In no circumstance will any proxy be voted for more than two nominees who are not named in this proxy statement. Properly executed and returned proxies, unless revoked, will be voted as directed by you or, in the absence of direction, will be voted in favor of the election of the recommended nominees. An affirmative vote of a plurality of votes cast at the Annual Meeting is necessary to elect a nominee as a director.

**THE BOARD OF DIRECTORS RECOMMENDS YOU VOTE "FOR" ALL OF THE NOMINEES NAMED ABOVE  
AS DIRECTORS**

**OUR BOARD OF DIRECTORS  
AND ITS COMMITTEES**

How often did our Board of Directors meet during 2013?

Our Board of Directors held 14 meetings during 2013. All incumbent directors attended more than 75% of the total number of meetings of the Board of Directors and its committees on which they served during the year.

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What committees does our Board of Directors have?

During 2013, our Board of Directors had five standing committees, the Audit and Enterprise Risk Committee, the Governance Committee, the Compensation Committee, the Loan Sub-Committee and the Executive Committee. The voting members of these Committees are appointed by the Board of Directors annually from among its members. Certain of our executive officers also serve as non-voting, advisory members of these committees.

**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 of Directors. The Executive Committee consists of Directors R. Abernethy, J. Abernethy, Lineberger, Matthews and Howard, as well as the President and Chief Executive Officer of the Company. It meets on an “as needed” basis and did not meet during 2013.

**Governance Committee.** The Governance Committee is comprised entirely of independent directors, as defined in the applicable NASDAQ listing standards. The Board of Directors determines on an annual basis each director’s independence. During 2013 the following persons served on the Committee: Directors R. Abernethy, J. Abernethy, Lineberger, Robinson, Terry, and Timmerman. The Governance Committee is responsible for developing and maintaining the corporate governance policy, as well as acting as the nominating committee for the Board of Directors.

The Governance Committee, serving as the nominating committee of the Board of Directors, interviews candidates for membership to the Board of Directors, recommends candidates to the full Board of Directors, slates candidates for 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 from other directors or from the Company’s management.

If a shareholder recommends a director candidate to the Governance Committee in accordance with the Company’s Bylaws, 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 shareholder 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 shareholder 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 has no written diversity policy; however, the Governance Committee defines diversity broadly to include, in addition to race, gender, ethnicity and age, differences in professional experience, educational background, geographic mix within the Company’s market area, skills and other individual qualities and attributes that foster board heterogeneity in order to encourage and maintain board effectiveness. While there are currently no women or minorities serving on the Board of Directors, any qualified candidate receives consideration regardless of race, gender or national origin.

The Governance Committee met once during the year ended December 31, 2013.

The Governance Committee has a written charter which is reviewed annually, and amended as needed, by the Governance Committee. A copy of the Governance Committee Charter is available on the Bank’s website ([www.peoplesbanknc.com](http://www.peoplesbanknc.com)) under Investor Relations.

Audit and Enterprise Risk Committee. The Company has a separately designated standing Audit and Risk Enterprise Committee (the “Audit Committee”) which was established in accordance with Section 3(a)(58)(A) of the Exchange Act. The Audit Committee’s responsibilities include oversight of enterprise risk. The Audit Committee has a written charter which is reviewed annually, and amended as needed, by the Audit Committee. A copy of the Audit Committee Charter is available on the Bank’s website ([www.peoplesbanknc.com](http://www.peoplesbanknc.com)) under Investor Relations. The Audit

Committee consists of Directors R. Abernethy, Howard, Matthews, Price, Timmerman and Zachary. The Board of Directors has determined that these members are independent as that term is defined in the applicable NASDAQ listing standards and the SEC's regulations. The Board of Directors determines on an annual basis each director's independence.

The Board of Directors has determined that each member of the Audit Committee qualifies as an "audit committee financial expert" based on each of the member's educational background and business experience.

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 SEC. The Audit Committee met eight times during the year ended December 31, 2013.

#### REPORT OF AUDIT AND ENTERPRISE RISK 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 Auditing Standards No. 16 as amended, as adopted by the Public Company Accounting Oversight Board in Rule 3200T. In addition, the Audit Committee has received the written disclosures and the letter from the independent accountants required by the applicable requirements of the Public Company Accounting Oversight Board regarding the independent accountant's communications with the Audit Committee concerning independence, and has discussed with the independent accountant the independent accountant's independence. Based upon these reviews and discussions, the Audit 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, 2013.

|                     |                       |
|---------------------|-----------------------|
| Robert C. Abernethy | Gary E. Matthews      |
| Benjamin I. Zachary | Dan R. Timmerman, Sr. |
| Douglas S. Howard   | Billy L Price, Jr. MD |

Compensation Committee. The Company's Compensation Committee is responsible for developing, reviewing, implementing and maintaining the Bank's salary, bonus, and incentive award programs and for making recommendations to the Company's and the Bank's Board of Directors regarding compensation of the executive officers. Upon recommendation from the Compensation Committee, the Company's Board of Directors ultimately determines such compensation.

Other than Director Lineberger, all of the members of the Compensation Committee are independent as defined in the applicable NASDAQ's listing standards. The Board of Directors determines on an annual basis each director's independence. The members of the Compensation Committee during 2013 were Directors R. Abernethy, J. Abernethy, Lineberger, Robinson, Terry and Timmerman. The Compensation Committee met three times during the year ended December 31, 2013.

The Compensation Committee has a written charter which is reviewed annually, and amended as needed, by the Compensation Committee. A copy of the Compensation Committee's Charter is available on the Bank's website ([www.peoplesbanknc.com](http://www.peoplesbanknc.com)) under Investor Relations.

What follows below is a discussion of the Company's and the Bank's compensation policies and practices and the review process used by the Compensation Committee.

The Compensation Committee did not engage a compensation consultant for the fiscal year ended December 31, 2013. The President and Chief Executive Officer of the Company and the Bank makes recommendations to the Committee regarding the compensation of the executive officers other than his own. The President and Chief Executive Officer participates in the deliberations, but not in the decisions, of the Compensation Committee regarding compensation of executive officers. He does not participate in the Compensation Committee's discussion or decisions regarding his own compensation. The Compensation Committee also considers the results of the shareholders' non-binding vote on executive compensation. Last year the Company's executive compensation as described in the 2013

Proxy Statement received a 63% approval rating from the shareholders. In addition, last year 52% of the shareholders who voted at the 2013 Annual Meeting of Shareholders elected to review the executive compensation of the Company's named executive officers once every three years. As a result, the Company will submit a vote to the shareholders on the compensation of its named executive officers at the 2016 Annual Meeting of Shareholders.

The overall objective of our compensation program is to align total compensation so that the individual executive believes it is fair and equitable and provides the highest perceived value to our shareholders and to that individual. In order to accomplish this overall objective, our compensation program is designed to: (i) attract the qualified executives necessary to meet our needs as defined by the Company's strategic plans, and (ii) retain and motivate executives whose performance supports the achievement of our long-term plans and short-term goals.

The Compensation Committee considers a number of factors specific to each executive's role when determining the amount and mix of compensation to be paid. These factors are:

- compensation of the comparable executives at comparable financial institutions;
- financial performance of the Company (especially on a "net operating" basis, which excludes the effect of one-time gains and expenses) over the most recent fiscal year and the prior three years;
  - composition of earnings;
  - asset quality relative to the banking industry;
  - responsiveness to the economic environment;
- the Company's achievement compared to its corporate, financial, strategic and operational objectives and business plans; and
  - cumulative shareholder return.

The Company's and the Bank's compensation program consists of the following elements:

(i)Base Salary. The salaries of our NEOs are designed to provide a reasonable level of compensation that is affordable to the Company and fair to the executive. Salaries are reviewed annually, and adjustments, if any, are made based on the review of competitive salaries in our peer group, as well as an evaluation of the individual officer's responsibilities, job scope, and individual performance. For example, we assess each officer's success in achieving budgeted earnings and return ratios, business conduct and integrity, and leadership and team building skills.

(ii)Annual Cash Incentive Awards. We believe that annual cash incentive awards encourage our NEOs to achieve short-term targets that are critical to achievement of our long-term strategic plan. The following officers were eligible during the fiscal year ended December 31, 2013 to receive annual cash incentive awards under our Management Incentive Plan, which provides for cash awards to the following NEOs upon achievement of certain financial objectives:

- Lance A. Sellers, President and Chief Executive Officer
- A. Joseph Lampron, Jr., Executive Vice President and Chief Financial Officer
- William D. Cable, Sr., Executive Vice President and Chief Operating Officer
- Joseph F. Beaman, Jr., Executive Vice President, Chief Administrative Officer and Corporate Secretary

We seek to ensure that a significant portion of each executive officer's total annual cash compensation is linked to the attainment of the annual performance objectives determined by the executive officer and the Compensation Committee under the Management Incentive Plan. No NEO earned or was paid a



cash incentive under the Management Incentive Plan during the fiscal year ended December 31, 2013.

(iii) Discretionary Bonus and Service Awards. From time to time the Compensation Committee may recommend to the Board of Directors that additional bonuses be paid based on accomplishments that significantly exceed expectations during the fiscal year. These bonuses are totally discretionary as to who will receive a bonus and the amount of any such bonus. In 2013, the Compensation Committee recommended, and the Board of Directors approved, discretionary bonuses as follows: \$20,000 for Mr. Sellers; \$20,000 for Mr. Lampron; \$15,000 for Mr. Beaman; and \$20,000 for Mr. Cable. These discretionary bonuses were paid in January of 2014. Under the Service Recognition Program, the Bank gives service awards to each employee and director for every five years of service with the Bank to promote longevity of service for both directors and employees. Service awards are made in the form of shares of the Company's common stock plus cash in the amount necessary to pay taxes on the award. The number of shares awarded increases with the number of years of service to the Bank.

(iv) Long-Term Equity Incentive Awards. The Company maintains the 2009 Omnibus Stock Ownership and Long Term Incentive Plan ("Omnibus Plan"), under which it is permitted to grant incentive stock options, restricted stock, restricted stock units, stock appreciation rights, book value shares, and performance units. 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 executives of the Company 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. In 2013, the NEOs were granted the following restricted stock units, each comprised of the right to receive one share of the Company's common stock:

| NEO                    | Grant Date   | No. of Restricted Stock Units |
|------------------------|--------------|-------------------------------|
| Lance A. Sellers       | May 23, 2013 | 4,875                         |
| A. Joseph Lampron, Jr. | May 23, 2013 | 3,410                         |
| William D. Cable, Sr.  | May 23, 2013 | 3,410                         |

(v) Retirement Benefits. The Company maintains supplemental executive retirement agreements (SERPs) for the benefit of Messrs. Sellers, Lampron, Cable and Beaman. The Committee's goal is to provide competitive retirement benefits given the restrictions on executives within tax-qualified plans. In prior years, the Compensation Committee worked with a compensation consultant in analyzing the possible benefits of using SERPs to address the issues of internal and external equity in terms of retirement benefits offered to all employees at the Company as a percentage of final average pay and executives in our peer group. The Compensation Committee approved supplemental retirement benefits targeting 40% of the final average pay for all NEOs. The Compensation Committee selected a target of 40% to match such benefits offered to other employees fully participating in qualified retirement plans offered by the Company. For more information on the SERPs, see page 25 of this Proxy Statement.

(vi) Employment Agreements. The Company has employment agreements with our NEOs which we believe serve a number of functions, including (i) retention of our

executive team; (ii) mitigation of any uncertainty about future employment and continuity of management in the event of a change in control; and (iii) protection of the Company and customers through non-compete and non-solicitation covenants. Additional information regarding the employment agreements, including a description of key terms may be found on page 20 of this Proxy Statement.

#### Compensation Committee Interlocks and Insider Participation

No member of the Compensation Committee is now, or formerly was, an officer or employee of the Company or the Bank. None of the NEOs serve as a member of the board of directors of another entity whose executive officers or directors serve on the Company's Board of Directors.

#### Board Leadership Structure and Risk Oversight

Our Company and the Bank have traditionally operated with separate Chief Executive Officer and Chairman of the Board of Directors positions. We believe it is our Chief Executive Officer's responsibility to manage the Company and the Chairman's responsibility to lead the Board of Directors. Robert Abernethy is currently serving as Chairman of the Board of Directors. All of the members of the Board of Directors are independent under applicable NASDAQ listing requirements. The Company has four standing committees: Executive, Governance, Audit and Compensation. The Chief Executive Officer serves on the Executive Committee. The Bank in addition to the above-named committees has a Loan Committee and a Loan Sub-Committee. The duties of the Company's committees and the qualifications of the independent directors have been described above. Each of the Company's and the Bank's committees considers risk within its area of responsibility. The Audit Committee and the full Board of Directors focus on the Company's most significant risks in the areas of liquidity, credit, interest rate and general risk management strategy. The Board of Directors sets policy guidelines in the areas of loans and asset/liability management which are reviewed on an on-going basis. While the Board of Directors oversees the Company's risk management, the Company's and the Bank's management are responsible for day-to-day risk management following the dictates of the policy decisions set by the Board of Directors.

The Governance Committee, as part of its annual review, evaluates the Board of Directors leadership structure and performance and reports its findings to the whole Board of Directors. The Board of Directors believes that having separate persons serving as Chief Executive Officer and Chairman and all independent directors provides the optimal board leadership structure for the Company and its shareholders.

Does the Company have a Code of Ethics?

The Company and the Bank have a Code of Business Conduct and Ethics for its directors, officers and employees. The Code of Business Conduct and Ethics requires that individuals avoid conflicts of interest, comply with all laws and other legal requirements, conduct business in an honest and ethical manner and otherwise act with integrity and in the best interests of the Company and the Bank. The Code of Business Conduct and Ethics is a guide to help ensure that all employees live up to the highest ethical standards of behavior.

A copy of the Code of Business Conduct and Ethics is available on the Bank's website ([www.peoplesbanknc.com](http://www.peoplesbanknc.com)) under Investor Relations.

As is permitted by SEC rules, the Company intends to post on its website any amendment to or waiver from any provision in the Code of Business Conduct and Ethics that applies to the Chief Executive Officer, the Chief Financial Officer, the Controller, or persons performing similar functions, and that relates to any element of the standards enumerated in the rules of the SEC.



How can you communicate with the Board or its members?

We do not have formal procedures for shareholder communication with our Board of Directors. In general, our directors and officers are easily accessible by telephone, postal mail or e-mail. Any matter intended for your Board of Directors, or any individual director, can be directed to Lance Sellers, our President and Chief Executive Officer, or Joe

Lampron, our Chief Financial Officer, at our principal executive offices at 518 West C Street, Newton, North Carolina 28658. You also may direct correspondence to our Board of Directors, or any of its members, in care of the Company at the foregoing address. Your communication will be forwarded to the intended recipient unopened.

What is our policy for director attendance at Annual Meetings?

Although it is customary for all of our directors to attend Annual Meetings of Shareholders, we have no formal policy in place requiring attendance. All members of the Board of Directors attended our 2013 Annual Meeting of Shareholders held on May 2, 2013.

How can a shareholder nominate someone for election to the Board of Directors?

Our 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 Governance Committee or the Board of Directors, must be 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. However, if less than 60 days' notice of the meeting is given to the 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 Board of Directors may disregard any nominations that do not comply with these requirements. Upon the instruction of the Board of Directors, the inspector of voting for the Annual Meeting may disregard all votes cast for a nominee if the nomination does not comply with these requirements. Written notice of nominations should be directed to the Secretary of the Company.

Who serves on the Board of Directors of the Bank?

The Bank has ten directors currently serving on its Board of Directors, who are the same people who are currently directors of the Company.

## DIRECTOR AND EXECUTIVE COMPENSATION AND BENEFITS

### Director Compensation

**Directors' Fees.** Members of the Company's 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. Each director receives 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 receives an annual retainer of \$9,000. The Chairman of the Bank's Board of Directors receives an additional \$250 per meeting attended and the chairpersons of each committee receive an additional \$150 per meeting attended. Directors who are members of the Board of Directors of Real Estate Advisory Services, Inc., and Peoples Investment Services, Inc., subsidiaries of the Bank, and Community Bank Real Estate Solutions, LLC, a subsidiary of the Company, received \$500 per meeting. Directors receive \$375 for special meetings via conference call rather than the normal committee or Board of Director meeting fees.

The Bank maintains a Service Recognition Program, under which directors, officers and employees are eligible for awards. Under the Service Recognition Program, directors, officers and employees are awarded a combination of common stock of the Company and cash in the amount necessary to pay taxes on the award, with the amount of the award based upon the length of service to the Bank. Any common stock awarded under the Service Recognition

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 Plan. On March 22, 2012, the Company granted 810 restricted stock units, each unit being comprised of the right to receive one share of the Company's common stock, to each director. The restricted stock units awarded to directors on March 22, 2012 will vest in full on March 22, 2017. On May 23, 2013, the Company granted 810 restricted

stock units, each unit being comprised of the right to receive one share of the Company's common stock, to each director. The restricted stock units awarded to directors on May 23, 2013 will vest in full on May 23, 2017.

**Directors' Deferred Compensation Plan.** The Bank maintains a non-qualified deferred compensation plan for all of its directors. The Bank's directors are also directors of the Company. Under the deferred compensation 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 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. The Bank has established a Rabbi Trust to hold the directors' accrued benefits under the plan. There are no "above-market" returns provided for in the deferred compensation plan. The Bank made no contributions to this plan in 2013.

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.

**Directors' Supplemental Retirement Plan.** The Bank maintains a non-qualified supplemental retirement benefits plan for all its directors. The supplemental retirement benefits 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. Under the supplemental retirement benefits plan, the Company purchased life insurance contracts on the lives of each director. The increase in cash surrender value of the contracts constitutes the Company's contribution to the supplemental retirement benefits plan each year. The Bank will pay annual benefits to each director for 15 years beginning upon retirement from the Board of Directors. The Bank is the sole owner of all of the insurance contracts.

The following table reports all forms of compensation paid to or accrued for the benefit of each director during the 2013 fiscal year.

## DIRECTOR COMPENSATION

| Name                         | Fees<br>Earned or<br>Paid in<br>Cash (\$) | Stock<br>Awards <sup>1</sup><br>(\$) | Option<br>Awards<br>(\$) | Non-Equity<br>Incentive Plan<br>Compensation<br>(\$) | Change in<br>Pension Value<br>and<br>Nonqualified<br>Deferred<br>Compensation<br>Earnings <sup>2</sup> (\$) | All Other<br>Compensation <sup>3</sup><br>(\$) | Total (\$) |
|------------------------------|-------------------------------------------|--------------------------------------|--------------------------|------------------------------------------------------|-------------------------------------------------------------------------------------------------------------|------------------------------------------------|------------|
| James S.<br>Abernethy        | 21,900                                    | 4,980                                | -                        | 0                                                    | 5,321                                                                                                       | 0                                              | 32,201     |
| Robert C.<br>Abernethy       | 31,250                                    | 4,980                                | -                        | 0                                                    | 8,056                                                                                                       | 0                                              | 44,286     |
| Douglas S.<br>Howard         | 24,500                                    | 4,980                                | -                        | 0                                                    | 3,303                                                                                                       | 0                                              | 32,783     |
| John W.<br>Lineberger, Jr.   | 21,900                                    | 4,980                                | -                        | 0                                                    | 7,846                                                                                                       | 0                                              | 34,727     |
| Gary E.<br>Matthews          | 24,000                                    | 4,980                                | -                        | 0                                                    | 4,824                                                                                                       | 0                                              | 33,804     |
| Billy L. Price,<br>Jr., M.D. | 26,200                                    | 4,980                                | -                        | 0                                                    | 4,363                                                                                                       | 0                                              | 35,543     |
| Larry E.<br>Robinson         | 22,900                                    | 4,980                                | -                        | 0                                                    | 14,579                                                                                                      | 2,500                                          | 44,959     |
| William Gregory<br>Terry     | 21,900                                    | 4,980                                | -                        | 0                                                    | 1,617                                                                                                       | 0                                              | 28,497     |
| Dan Ray<br>Timmerman, Sr.    | 27,650                                    | 4,980                                | -                        | 0                                                    | 11,052                                                                                                      | 0                                              | 43,682     |
| Benjamin I.<br>Zachary       | 24,000                                    | 4,980                                | -                        | 0                                                    | 4,382                                                                                                       | 0                                              | 33,362     |

<sup>1</sup> The amounts reported represent the aggregate fair value of the restricted stock units granted to the respective recipient on the date of grant under Financial Accounting Standards Board ASC Topic 718 (“Topic 718”). The fair market value of each restricted stock unit granted to each director was \$11.90 on May 23, 2013.

Change in Pension Value and Nonqualified Deferred Compensation Earnings represents the expense accrued by the Bank for each director under the Directors' Supplemental Retirement Plan as described above.

3 In 2013, Mr. Robinson received 152 shares and \$500 in cash for his 20 years of service as a director under the Bank's Service Recognition Program.

#### Executive Officers

Lance A. Sellers, age 51 (as of March 1, 2014), serves as the President and Chief Executive Officer of the Company and the Bank. Prior to becoming the President and Chief Executive Officer of the Company and the Bank, Mr. Sellers served as Executive Vice President and Assistant Corporate Secretary of the Company and Executive Vice President and Chief Credit Officer of the Bank. He has been employed by the Company and the Bank since 1998. Mr. Sellers has a total of 29 years of banking experience. He is a graduate of the University of North Carolina at Chapel Hill and upon graduation served as a senior credit officer at a regional bank headquartered in North Carolina.

Joseph F. Beaman, Jr., age 64 (as of March 1, 2014), serves as Executive Vice President and Corporate Secretary of the Company and Executive Vice President, Chief Administrative Officer and Secretary of the Bank. He has been employed by the Company and the Bank since 1977, where he has served as Vice President-Operations and Senior Vice President. Mr. Beaman has a total of 41 years of banking experience. He is a graduate of Pfeiffer University, the North Carolina School of Banking, and the Graduate School of Financial Management at the University of Texas in Austin.

William D. Cable, Sr., age 45 (as of March 1, 2014), serves as Executive Vice President, Assistant Corporate Treasurer and Assistant Corporate Secretary of the Company and Executive Vice President and Chief Operating Officer of the Bank. He has been employed by the Company and the Bank since 1995, where he has served as Senior Vice President-Information Services. Mr. Cable has a total of 22 years of banking experience. Prior to joining the Company,

Mr. Cable was a regulatory examiner with the Federal Deposit Insurance Corporation. He is a graduate of Western Carolina University and the School of Banking of the South at Louisiana State University.

A. Joseph Lampron, Jr., age 59 (as of March 1, 2014), serves as Executive Vice President, Chief Financial Officer and Corporate Treasurer of the Company and Executive Vice President and Chief Financial Officer of the Bank. He has been employed by the Company and the Bank since 2001. Mr. Lampron is a graduate of the University of North Carolina at Chapel Hill and upon graduation worked as a certified public accountant with a national accounting firm. His work with the firm included audits of banks and thrift institutions. Mr. Lampron has also served as Chief Financial Officer of a thrift institution and as a senior change manager in the finance group of a large North Carolina bank. Mr. Lampron has a total of 34 years of banking experience.

#### 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, 2013 and 2012, the cash compensation received by, as well as certain other compensation paid or accrued for those years, the NEOs whose total annual salary and bonus exceeded \$100,000.

## Summary Compensation Table

| Name and<br>Principal<br>Position                                                                                            | Year | Salary(\$) | Bonus(\$) | Awards(\$) | Awards(\$) | Non-Equity<br>Incentive Plan<br>Compensation(\$) | Change in<br>Pension Value<br>and<br>Nonqualified<br>Deferred<br>Earnings(\$) | All Other<br>Compensation(\$) | Total(\$) |
|------------------------------------------------------------------------------------------------------------------------------|------|------------|-----------|------------|------------|--------------------------------------------------|-------------------------------------------------------------------------------|-------------------------------|-----------|
| Lance A.<br>Sellers<br>President and<br>Chief<br>Executive<br>Officer                                                        | 2013 | 11,400     | 20,000    | 44,506     | 0          | 0                                                | 40,072                                                                        | 24,557                        | 440,535   |
| A. Joseph<br>Lampron, Jr.<br>Executive Vice<br>President,<br>Chief Financial<br>Officer                                      | 2012 | 238,010    | 0         | 11,840     | 0          | 0                                                | 46,930                                                                        | 16,6232                       | 313,403   |
| Joseph F.<br>Beaman, Jr.<br>Executive Vice<br>President,<br>Chief<br>Administrative<br>Officer<br>and Corporate<br>Secretary | 2013 | 140,700    | 15,000    | 0          | 0          | 0                                                | 64,566                                                                        | 15,594                        | 235,860   |
| William D.<br>Cable, Sr.<br>Executive Vice<br>President,<br>Chief<br>Operating<br>Officer                                    | 2012 | 140,700    | 6,000     | 5,0004     | 0          | 0                                                | 58,385                                                                        | 12,0284                       | 222,113   |
|                                                                                                                              | 2013 | 182,963    | 20,000    | 31,328     | 0          | 0                                                | 13,877                                                                        | 11,444                        | 259,611   |
|                                                                                                                              | 2012 | 178,500    | 15,000    | 8,695      | 0          | 0                                                | 18,135                                                                        | 10,3155                       | 230,645   |



1 Perquisites for the fiscal year ended December 31, 2012 did not exceed \$10,000 for any NEO. Other than for Mr. Sellers, perquisites for the fiscal year ended December 31, 2013 did not exceed \$10,000 for any NEO.

2 For Mr. Sellers, includes for 2012: \$7,338 under the 401(k) plan, \$1,034 premium paid for group term life insurance in excess of \$50,000 and \$371 paid for the Split Dollar Death Benefit; and for 2013: \$10,200 under the 401(k) plan, \$1,219 premium paid for group term life insurance in excess of \$50,000, \$396 paid for the Split Dollar Death Benefit, and perquisites consisting of country club dues of \$3,199, car allowance of \$4,113 and a disability insurance premium of \$5,151. In 2013, Mr. Sellers received 76 shares for 15 years of service with the Bank and \$279 in cash to pay the taxes associated with the award under the Bank's Service Program Recognition Program.

3 For Mr. Lampron, includes for 2012: \$5,865 under the 401(k) plan, \$1,484 premium paid for group term life insurance in excess of \$50,000 and \$839 paid for the Split Dollar Death Benefit; and for 2013: \$7,107 under the 401(k) plan, \$1,623 premium paid for group term life insurance in excess of \$50,000 and \$904 paid for the Split Dollar Death Benefit.

4 For Mr. Beaman, includes for 2012: \$4,618 under the 401(k) plan, \$1,741 premium paid for group term life insurance in excess of \$50,000 and \$1,454 paid for the Split Dollar Death Benefit; and for 2013: \$5,466 under the 401(k) plan, \$1,837 premium paid for group term life insurance in excess of \$50,000 and \$1,585 paid for the Split Dollar Death Benefit. In 2012, Mr. Beaman received 381 shares for 35 years of service with the Bank and \$1,000 in cash to pay the taxes associated with the award under the Bank's Service Recognition Program.

5 For Mr. Cable, includes for 2012: \$5,861 under the 401(k) plan, \$390 premium paid for group term life insurance in excess of \$50,000, \$296 paid for the Split Dollar Death Benefit; and for 2013: \$7,107 under the 401(k) plan, \$591 premium paid for group term life insurance in excess of \$50,000 and \$322 paid for the Split Dollar Death Benefit.

#### Employment Agreements

The Bank has entered into employment agreements with Lance A. Sellers, President and Chief Executive Officer; Joseph F. Beaman, Jr., Executive Vice President, Chief Administrative Officer and Corporate Secretary; A. Joseph Lampron, Jr., Executive Vice President, Chief Financial Officer and Corporate Treasurer; and William D. Cable, Sr., Executive Vice President, Chief Operating Officer, Assistant Corporate Treasurer and Assistant Corporate Secretary, 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 is always no less than two and no more than three years. The agreements also provide that the base salary will 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. 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 will 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 nine (9) middle management officers had employment agreements during 2013. The term of these agreements is until December 1, 2014, renewed annually and the agreements contain provisions similar to those discussed above.

In 2013, if a "change in control" event had occurred Mr. Sellers, Mr. Lampron, Mr. Beaman and Mr. Cable would have been entitled to receive total compensation of approximately \$991,000, \$606,000, \$457,000 and \$606,000, respectively. All amounts are calculated based on each NEO's 2013 base salary as shown in the Summary Compensation Table.

#### Omnibus Stock Option and Long Term Incentive Plan

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.

**Rights Which May Be Granted.** Under the Omnibus Plan, the Committee may grant or award eligible participants stock options, rights to receive restricted shares of common stock, restricted stock units, performance units (each equivalent to one share of common stock), SARs, and/or book value shares. These grants and awards are referred to herein as "Rights." All Rights must be granted or awarded by February 19, 2019, the tenth anniversary of the date the Board of Directors adopted the Omnibus Plan. The Board of Directors has provided for 360,000 shares of the Company's common stock to be included in the Omnibus Plan to underlie Rights which may be granted thereunder.

**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 ISO or NSO may not be less than 100% of the last-transaction price for the common stock quoted by the NASDAQ Stock Market on the date of grant.

**Restricted Stock and Restricted Stock Units.** The Committee may award Rights to acquire shares of common stock or restricted stock units, subject to certain transfer restrictions ("Restricted Stock" or "Restricted Stock Unit") 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 will determine the expiration date for each Restricted Stock or Restricted Stock Unit 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 or Restricted Stock Unit award will first become exercisable, which period or periods may be accelerated or shortened by the Committee. Under the terms of the Omnibus Plan, the Committee also has the discretion to pay out awards of Restricted Stock or Restricted Stock Units in the Company's common stock, cash or a combination of stock and cash.

**Performance Units.** Under the Omnibus Plan, the Committee may grant to eligible directors and employees awards of long term incentive performance 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.

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

awards in the form of a combination of shares of common stock and cash or cash only. 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. 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 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 Stock Market (the “Base Price”) on the date of the award. The Committee may adjust the Base Price of a stock appreciation right (“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 will 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 generally accepted accounting principles.

The expiration date of each Book Value Share awarded will be established by the Committee, up to a maximum of ten years from the date of award. However, awards of Book Value Shares will terminate earlier 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; and (iii) 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 are subsequently cancelled or forfeited will be available for further allocation upon such cancellation or forfeiture.

#### 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.

## OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

| Name                   | Option Awards                                           |                                                         |                                                                                                |                            |                        | Awards Number of Shares or Units of Stock That Have Not Vested (#) | Stock                                                              |                                                                                                         |                                                                                                                             |
|------------------------|---------------------------------------------------------|---------------------------------------------------------|------------------------------------------------------------------------------------------------|----------------------------|------------------------|--------------------------------------------------------------------|--------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------|
|                        | Number of Securities Underlying Unexercised Options (#) | Number of Securities Underlying Unexercised Options (#) | Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#) | Option Exercise Price (\$) | Option Expiration Date |                                                                    | Market Value of Shares or Units of Stock That Have Not Vested (\$) | Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#) | Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested(3) (\$) |
| (a)                    | (b)                                                     | (c)                                                     | (d)                                                                                            | (e)                        | (f)                    | (g)                                                                | (h)                                                                | (i)                                                                                                     | (j)                                                                                                                         |
| Lance A. Sellers       | -                                                       | -                                                       | -                                                                                              | -                          | -                      | -                                                                  | -                                                                  | 13,549(1)                                                                                               | 192,125                                                                                                                     |
| A. Joseph Lampron, Jr. | -                                                       | -                                                       | -                                                                                              | -                          | -                      | -                                                                  | -                                                                  | 9,780(2)                                                                                                | 138,680                                                                                                                     |
| Joseph F. Beaman, Jr.  | -                                                       | -                                                       | -                                                                                              | -                          | -                      | -                                                                  | -                                                                  | -                                                                                                       | -                                                                                                                           |
| William D. Cable, Sr.  | -                                                       | -                                                       | -                                                                                              | -                          | -                      | -                                                                  | -                                                                  | 9,780(2)                                                                                                | 138,680                                                                                                                     |

(1) Includes 6,505 restricted stock units that were granted on March 22, 2012 and vest on March 22, 2017, 2,169 restricted stock units that were granted on July 26, 2012 and vest on July 26, 2017 and 4,875 restricted stock units



that were granted on May 23, 2013 and vest on May 23, 2017.

(2) Includes 4,777 restricted stock units that were granted on March 22, 2012 and vest on March 22, 2017, 1,593 restricted stock units that were granted on July 26, 2012 and vest on July 26, 2017 and 3,410 restricted stock units that were granted on May 23, 2013 and vest on May 23, 2017.

(3) Based on a stock price of \$14.18 per share on December 31, 2013.

#### Deferred Compensation Plan

The Bank maintains 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. Participating officers may elect to invest their deferred compensation in a restricted list of investment funds. 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. The Bank has established a Rabbi Trust to hold the accrued benefits of the participants under the plan. There are no "above-market" returns provided for in this plan. The Bank made no contributions to the plan in 2013.

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.

#### Supplemental Retirement Plan

The Bank maintains a non-qualified supplemental retirement benefits plan ("SERP") 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. Under the SERP, the Company purchased life insurance contracts on the lives of certain officers. The increase in cash surrender value of the contracts constitutes the Company's contribution to the plan each year. The Bank will pay benefits to participating officers for a period between 13 years and the life of the officer. The Bank is the sole owner of all of the insurance contracts. Each NEO is fully vested in the benefits provided under the SERP.

#### 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. The Bank also gives service awards to each employee for every five years of service with the Bank. Service awards are made in the form of shares of the Company's common stock. The number of shares awarded increases with the years of service to the Bank.

#### 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, 2013. 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 4.00% of annual compensation. The Bank's 2013 contribution to the 401(k) Plan pursuant to this formula was approximately \$430,000. All contributions to the 401(k) Plan are tax deferred.

The Profit Sharing Plan and 401(k) Plan permit participants to choose from investment funds which are selected by a committee comprised of senior management. Employees are eligible to participate in both the 401(k) Plan and Profit Sharing Plan beginning in the second month of employment. Both plans provide for vesting of 20% of the benefit after two years of employment and 20% each year thereafter until participants are 100% vested after six years of employment.

#### Indebtedness of and Transactions with Management and Directors

The Company is a “listed issuer” under the rules and regulations of the Exchange Act whose common stock is listed on NASDAQ. The Company uses the definition of independence contained in NASDAQ’s listing standards to determine the independence of its directors and that the Board of Directors and each standing committee of the Board of Directors is in compliance with NASDAQ listing standards for independence.

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 2013. All outstanding loans, extensions of credit or overdrafts, endorsements and guarantees outstanding at any time during 2013 to the Bank's executive officers and directors and their family members were made in the ordinary course of its business. These loans are currently made on substantially the same terms, including interest rates and collateral, as those then prevailing for comparable transactions with persons not related to the lender, and did not involve more than the normal risk of collectability or present any other unfavorable features.

The Board of Directors routinely, and no less than annually, reviews all transactions, direct and indirect, between the Company or the Bank and any employee or director, or any of such person's immediate family members. Transactions are reviewed as to comparable market values for similar transactions. All material facts of the transactions and the director's interest are discussed by all disinterested directors and a decision is made about whether the transaction is fair to the Company and the Bank. A majority vote of all disinterested directors is required to approve the transaction.

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, during 2013 the Bank paid a total of \$210,909 to Shortgrass in lease payments for these facilities. Each of the facilities is subject to a 20-year lease between the Bank and Shortgrass.

The Board of Directors also evaluates the influence family relationships may have on the independence of directors who are related by blood or marriage. Christine S. Abernethy, a greater than ten percent (10%) shareholder of the Company, has two sons, Robert C. Abernethy and James S. Abernethy, who serve on the Board of Directors. All of the non-related directors have determined that the family relationships among Christine S. Abernethy, James S. Abernethy and Robert C. Abernethy do not affect the brothers' independence as directors.

## PROPOSAL 2

### RATIFICATION OF SELECTION OF INDEPENDENT AUDITOR

Porter Keadle Moore, LLC, of Atlanta, Georgia (or PKM in this Proxy Statement), has been selected by the Audit Committee as the Company's and the Bank's registered independent public accounting firm for the year ending December 31, 2014. Such selection is being submitted to the Company's shareholders for ratification. Representatives of PKM are expected to attend the Annual 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 2013 and 2012; (ii) review of the financial statements included in the Company's quarterly filings on Form 10-Q during those fiscal years; and (iii) assistance with the filing of a Registration Statement on Form S-1 in connection with the repurchase of preferred stock were approximately \$186,000 and \$222,000, respectively.

#### Audit Related Fees

The aggregate fees billed by PKM in 2013 and 2012 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 \$59,000 and \$59,000, 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 \$33,000 and \$29,000 in 2013 and 2012, 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 billed no other fees to the Company in 2013 and 2012.

The fees billed by PKM are pre-approved by the Audit Committee in accordance with the policies and procedures for the Audit Committee set forth in its 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 2013 and 2012, 100% of the total fees paid for audit, audit related and tax services were pre-approved. The Audit Committee has determined that the rendering of non-audit professional services by PKM, as identified above, is compatible with maintaining PKM's independence.

THE BOARD OF DIRECTORS RECOMMENDS THAT THE SHAREHOLDERS VOTE FOR RATIFICATION OF THE APPOINTMENT OF PKM AS THE COMPANY'S INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE FISCAL YEAR ENDING DECEMBER 31, 2014.

#### DATE FOR RECEIPT OF SHAREHOLDER PROPOSALS

It is presently anticipated that the 2015 Annual Meeting of Shareholders of the Company will be held on May 7, 2015. 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 26, 2014 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 2015 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 9, 2015, of his or her proposal. If the Secretary of the Company is not notified of the shareholder's proposal by February 9, 2015, 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 2015 Annual Meeting.

#### OTHER MATTERS

Management knows of no other matters to be presented for consideration at the Annual Meeting or any adjournments thereof. If any other matters shall properly come before the Annual 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, 2013, which includes financial statements audited and reported upon by the Company's registered independent public accounting firm, 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, JR.

By Order of the Board of  
Directors,

/s/ Lance A. Sellers  
Lance A. Sellers  
President and Chief  
Executive Officer

Newton, North Carolina  
March 25, 2014

APPENDIX A

ANNUAL REPORT  
OF  
PEOPLES BANCORP OF NORTH CAROLINA, INC.

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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 principal source of income is dividends declared and paid by the Bank on its capital stock, if any. The Company has no operations and conducts no business of its own other than owning the Bank and Community Bank Real Estate Solutions, LLC (“CBRES”). 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 22 banking offices located in Lincolnton, Newton, Denver, Catawba, Conover, Maiden, Claremont, Hiddenite, Hickory, Charlotte, Monroe, Cornelius, Mooresville and Raleigh, North Carolina. The Bank also operates a loan production office in Denver, North Carolina. At December 31, 2013, the Company had total assets of \$1.0 billion, net loans of \$607.5 million, deposits of \$799.4 million, total securities of \$302.9 million, and shareholders’ equity of \$83.7 million.

The Bank operates four offices focused on the Latino population under the name Banco de la Gente (“Banco”). These offices are operated as a division of the Bank. Banco offers normal and customary banking services as are offered in the Bank’s other branches such as the taking of deposits and the making of loans and therefore is not considered a reportable segment of the Company.

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, which include residential development loans to commercial customers. 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 Bank’s loan portfolio also includes Individual Taxpayer Identification Number (ITIN) mortgage loans generated through the Bank’s Banco offices. Additional discussion of the Bank’s loan portfolio and sources of funds for loans can be found in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” on pages A-4 through A-26.

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, 2013, the Company employed 257 full-time employees and 34 part-time employees, which equated to 279 full-time equivalent employees.

Subsidiaries

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

A-1

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

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

The Company established a new subsidiary, CBRES, in 2009. CBRES serves as a “clearing-house” for appraisal services for community banks. Other banks are able to contract with CBRES to find and engage appropriate appraisal companies in the area where the property is located. This type of service ensures that the appraisal process remains independent from the financing process within the bank

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, (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

|                                                          | 2013        | 2012      | 2011      | 2010      | 2009      |
|----------------------------------------------------------|-------------|-----------|-----------|-----------|-----------|
| <b>Summary of Operations</b>                             |             |           |           |           |           |
| Interest income                                          | \$36,696    | 39,245    | 45,259    | 47,680    | 50,037    |
| Interest expense                                         | 5,353       | 7,696     | 10,946    | 14,348    | 17,187    |
| Net interest earnings                                    | 31,343      | 31,549    | 34,313    | 33,332    | 32,850    |
| Provision for loan losses                                | 2,584       | 4,924     | 12,632    | 16,438    | 10,535    |
| Net interest earnings after provision<br>for loan losses | 28,759      | 26,625    | 21,681    | 16,894    | 22,315    |
| Non-interest income                                      | 12,652      | 12,537    | 14,513    | 13,884    | 11,823    |
| Non-interest expense                                     | 32,841      | 31,782    | 29,572    | 28,948    | 29,883    |
| Earnings before taxes                                    | 8,570       | 7,380     | 6,622     | 1,830     | 4,255     |
| Income taxes                                             | 1,879       | 1,587     | 1,463     | (11)      | 1,339     |
| Net earnings                                             | 6,691       | 5,793     | 5,159     | 1,841     | 2,916     |
| Dividends and accretion of preferred stock               | 656         | 1,010     | 1,393     | 1,394     | 1,246     |
| Net earnings available to common<br>shareholders         | \$6,035     | 4,783     | 3,766     | 447       | 1,670     |
| <b>Selected Year-End Balances</b>                        |             |           |           |           |           |
| Assets                                                   | \$1,034,684 | 1,013,516 | 1,067,063 | 1,067,652 | 1,048,494 |
| Available for sale securities                            | 297,890     | 297,823   | 321,388   | 272,449   | 195,115   |
| Loans, net                                               | 607,459     | 605,551   | 653,893   | 710,667   | 762,643   |
| Mortgage loans held for sale                             | 497         | 6,922     | 5,146     | 3,814     | 2,840     |
| Interest-earning assets                                  | 925,736     | 931,738   | 1,004,131 | 1,010,983 | 988,017   |
| Deposits                                                 | 799,361     | 781,525   | 827,111   | 838,712   | 809,343   |
| Interest-bearing liabilities                             | 715,111     | 745,139   | 820,452   | 850,233   | 826,838   |
| Shareholders' equity                                     | \$83,719    | 97,747    | 103,027   | 96,858    | 99,223    |
| Shares outstanding                                       | 5,613,495   | 5,613,495 | 5,544,160 | 5,541,413 | 5,539,056 |
| <b>Selected Average Balances</b>                         |             |           |           |           |           |
| Assets                                                   | \$1,023,609 | 1,029,612 | 1,074,250 | 1,078,136 | 1,016,257 |
| Available for sale securities                            | 293,770     | 289,010   | 295,413   | 219,797   | 161,135   |
| Loans                                                    | 614,532     | 648,595   | 697,527   | 757,532   | 782,464   |
| Interest-earning assets                                  | 950,451     | 965,994   | 1,015,451 | 999,054   | 956,680   |
| Deposits                                                 | 787,640     | 786,976   | 835,550   | 840,343   | 772,075   |
| Interest-bearing liabilities                             | 741,228     | 770,546   | 836,382   | 849,870   | 796,260   |
| Shareholders' equity                                     | \$100,241   | 103,805   | 102,568   | 101,529   | 101,162   |
| Shares outstanding                                       | 5,613,495   | 5,559,401 | 5,542,548 | 5,539,308 | 5,539,056 |
| <b>Profitability Ratios</b>                              |             |           |           |           |           |
| Return on average total assets                           | 0.65%       | 0.56%     | 0.48%     | 0.17%     | 0.29%     |
| Return on average shareholders' equity                   | 6.67%       | 5.58%     | 5.03%     | 1.81%     | 2.88%     |
| Dividend payout ratio*                                   | 11.17%      | 20.96%    | 11.78%    | 100.11%   | 86.22%    |
| <b>Liquidity and Capital Ratios (averages)</b>           |             |           |           |           |           |
| Loan to deposit                                          | 78.02%      | 82.42%    | 83.48%    | 90.15%    | 101.35%   |

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|                                      |         |        |       |       |       |
|--------------------------------------|---------|--------|-------|-------|-------|
| Shareholders' equity to total assets | 9.79%   | 10.08% | 9.55% | 9.42% | 9.95% |
| Per share of Common Stock            |         |        |       |       |       |
| Basic net income                     | \$1.08  | 0.86   | 0.68  | 0.08  | 0.30  |
| Diluted net income                   | \$1.07  | 0.86   | 0.68  | 0.08  | 0.30  |
| Cash dividends                       | \$0.12  | 0.18   | 0.08  | 0.08  | 0.26  |
| Book value                           | \$14.91 | 15.18  | 14.06 | 12.96 | 13.39 |

\*As a percentage of net earnings available to common shareholders.

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

The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors and the Company's consolidated financial statements and notes thereto on pages A-27 through A-64.

#### Introduction

Management's discussion and analysis of earnings and related data are presented to assist in understanding the consolidated financial condition and results of operations of the Company, for the years ended December 31, 2013, 2012 and 2011. The Company is a registered bank holding company operating under the supervision of the Federal Reserve Board (the "FRB") and the parent company of Peoples Bank (the "Bank"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg, Iredell, Union and Wake counties, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation (the "FDIC").

#### Overview

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

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

The unfavorable economic conditions experienced from 2008 to 2010 moderated in 2011 and 2012. Economic conditions were much more positive in 2013, although still far below the pre-crisis levels of 2006 and 2007. With the unemployment rate continuing to be higher than historical norms and home prices well below pre-crisis levels, the primary indicators of economic activity for our markets continue to point to challenging business conditions that will slow our return to pre-crisis levels of earnings. This is also reflected in our local markets, as the unemployment rate in our primary markets remains above the national and state unemployment rates.

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

Our business emphasis has been to operate as a well-capitalized, profitable and independent community-oriented financial institution dedicated to providing quality customer service. We are committed to meeting the financial needs of the communities in which we operate. We believe that we can be more effective in 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.

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The Federal Reserve has maintained the Federal Funds Rate at 0.25% since December 31, 2008. This has had a negative impact on 2011, 2012 and 2013 earnings and will continue to have a negative impact on the Bank's net interest income in the future periods. The negative impact from the Federal Funds Rate has been partially offset by the increase in earnings realized on interest rate contracts, including interest rate swaps and interest rate floors, utilized by the Bank. Additional information regarding the Bank's interest rate contracts is provided below in the section entitled "Asset Liability and Interest Rate Risk Management."

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

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

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

During the third quarter of 2012, the Company completed its repurchase of the Warrant to purchase 357,234 shares of the Company's common stock. The Company repurchased the Warrant for a total price of \$425,000. The exercise price of the Warrant was \$10.52 per common share and was exercisable at anytime on or before December 18, 2018. The Company is no longer accreting the discount associated with the Warrant, as the discount remaining at the time of repurchase was included in the cost of the Warrant. As of December 31, 2013, the Company had accreted a total of \$478,000 of the discount related to the Series A preferred stock.

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



The Company does not have specific plans for additional offices in 2014 but will continue to look for growth opportunities in nearby markets and may expand if considered a worthwhile opportunity.

#### Summary of Significant Accounting Policies

The consolidated financial statements include the financial statements of the Company and its wholly owned subsidiaries, the Bank and Community Bank Real Estate Solutions, LLC ("CBRES"), along with the Bank's wholly owned subsidiaries, Peoples Investment Services, Inc. and Real Estate Advisory Services, Inc. ("REAS"). 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 2013 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 1, 2014 Annual Meeting of Shareholders.

Many of the Company's assets and liabilities are recorded using various techniques that require significant judgment as to recoverability. The 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 this 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 U.S. Generally Accepted Accounting Principles ("GAAP").

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

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

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company.

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floors designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium. The Company had an interest rate swap contract that expired in June 2011. The Company did not have any interest rate derivatives outstanding as of December 31, 2013 or 2012.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in "Accumulated Other Comprehensive Income" and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The table below presents the balance of securities available for sale ("AFS"), which are measured at fair value on a recurring basis by level within the fair value hierarchy as of December 31, 2013 and 2012.

(Dollars in thousands)

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

(Dollars in thousands)

|                                       | December 31, 2012       |                   |                   |                   |
|---------------------------------------|-------------------------|-------------------|-------------------|-------------------|
|                                       | Fair Value Measurements | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
| Mortgage-backed securities            | \$148,024               | -                 | 148,024           | -                 |
| U.S. Government sponsored enterprises | \$18,837                | -                 | 18,837            | -                 |
| State and political subdivisions      | \$125,658               | -                 | 125,658           | -                 |
| Corporate bonds                       | \$2,586                 | -                 | 2,586             | -                 |
| Trust preferred securities            | \$1,250                 | -                 | -                 | 1,250             |
| Equity securities                     | \$1,468                 | 1,468             | -                 | -                 |

Fair values of investment securities AFS are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities.

The following is an analysis of fair value measurements of investment securities AFS using Level 3, significant unobservable inputs, for the year ended December 31, 2013.

(Dollars in thousands)

|                                               | Investment Securities Available for Sale Level 3 Valuation |
|-----------------------------------------------|------------------------------------------------------------|
| Balance, beginning of period                  | \$ 1,250                                                   |
| Change in book value                          | -                                                          |
| Change in gain/(loss) realized and unrealized | -                                                          |

|                                                                   |          |
|-------------------------------------------------------------------|----------|
| Purchases/(sales)                                                 | -        |
| Transfers in and/or (out) of Level 3                              | -        |
| Balance, end of period                                            | \$ 1,250 |
| Change in unrealized gain/(loss) for assets still held in Level 3 | \$ -     |

The fair value measurements for impaired loans and other real estate on a non-recurring basis at December 31, 2013 and 2012 are presented below. The fair value measurement process uses certified appraisals and other market-based information; however, in many cases, it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral, and other matters. As a result, all fair value measurements for impaired loans and other real estate are considered Level 3.

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(Dollars in thousands)

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

(Dollars in thousands)

|                   | Fair Value<br>Measurements<br>December 31, 2012 | Level 1<br>Valuation | Level 2<br>Valuation | Level 3<br>Valuation | Total Gains/(Losses)<br>for<br>the Year Ended<br>December 31, 2012 |
|-------------------|-------------------------------------------------|----------------------|----------------------|----------------------|--------------------------------------------------------------------|
| Impaired loans    | \$ 46,738                                       | -                    | -                    | 46,738               | (6,875 )                                                           |
| Other real estate | \$ 6,254                                        | -                    | -                    | 6,254                | (1,136 )                                                           |

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan that is collateral-dependent is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform appraisals for other companies. Factors including the assumptions and techniques utilized by the appraiser are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. An allowance for each impaired loan that is non-collateral dependent is calculated based on the present value of projected cash flows. If the recorded investment in the impaired loan exceeds the present value of projected cash flows, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under \$250,000 are not individually evaluated for impairment, with the exception of the Bank's troubled debt restructured ("TDR") loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Accruing impaired loans were \$27.6 million and \$30.6 million at December 31, 2013 and 2012, respectively. Interest income recognized on accruing impaired loans was \$1.3 million and \$1.5 million for the years ended December 31, 2013 and 2012, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as non-accrual.

The following tables present the Bank's impaired loans as of December 31, 2013 and 2012:

December 31, 2013

(Dollars in thousands)

|                                      | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Investment<br>With<br>Allowance | Recorded<br>Investment<br>in Impaired<br>Loans | Related<br>Allowance | Average<br>Outstanding<br>Impaired<br>Loans |
|--------------------------------------|-----------------------------------------------|------------------------------------------------|---------------------------------------------|------------------------------------------------|----------------------|---------------------------------------------|
| Real estate loans                    |                                               |                                                |                                             |                                                |                      |                                             |
| Construction and land<br>development | \$ 9,861                                      | 6,293                                          | 868                                         | 7,161                                          | 53                   | 8,289                                       |
| Single-family residential            | 7,853                                         | 1,428                                          | 5,633                                       | 7,061                                          | 123                  | 7,859                                       |
| Single-family residential            | -                                             | -                                              | -                                           | -                                              | -                    | -                                           |
|                                      | 22,034                                        | -                                              | 21,242                                      | 21,242                                         | 1,300                | 21,242                                      |

|                                  |           |        |        |        |       |        |
|----------------------------------|-----------|--------|--------|--------|-------|--------|
| Banco de la Gente stated income  |           |        |        |        |       |        |
| Commercial                       | 5,079     | 3,045  | 1,489  | 4,534  | 182   | 4,171  |
| Multifamily and farmland         | 177       | -      | 177    | 177    | 1     | 184    |
| Total impaired real estate loans | 45,004    | 10,766 | 29,409 | 40,175 | 1,659 | 41,745 |
| Loans not secured by real estate |           |        |        |        |       |        |
| Commercial loans                 | 999       | 257    | 724    | 981    | 15    | 826    |
| Consumer loans                   | 302       | 264    | 35     | 299    | 1     | 247    |
| Total impaired loans             | \$ 46,305 | 11,287 | 30,168 | 41,455 | 1,675 | 42,818 |

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December 31, 2012  
(Dollars in thousands)

|                                         | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Investment<br>With<br>Allowance | Recorded<br>Investment<br>in<br>Impaired<br>Loans | Related<br>Allowance | Average<br>Outstanding<br>Impaired<br>Loans |
|-----------------------------------------|-----------------------------------------------|------------------------------------------------|---------------------------------------------|---------------------------------------------------|----------------------|---------------------------------------------|
| <b>Real estate loans</b>                |                                               |                                                |                                             |                                                   |                      |                                             |
| Construction and land development       | \$ 17,738                                     | 11,795                                         | 680                                         | 12,475                                            | 61                   | 12,810                                      |
| Single-family residential               | 9,099                                         | 766                                            | 7,799                                       | 8,565                                             | 177                  | 7,590                                       |
| Single-family residential               | -                                             | -                                              | -                                           | -                                                 | -                    | -                                           |
| Banco de la Gente stated income         | 21,806                                        | -                                              | 21,000                                      | 21,000                                            | 1,278                | 21,158                                      |
| Commercial                              | 5,830                                         | 4,569                                          | 467                                         | 5,036                                             | 6                    | 5,433                                       |
| Multifamily and farmland                | 193                                           | -                                              | 193                                         | 193                                               | 1                    | 200                                         |
| Total impaired real estate loans        | 54,666                                        | 17,130                                         | 30,139                                      | 47,269                                            | 1,523                | 47,191                                      |
| <b>Loans not secured by real estate</b> |                                               |                                                |                                             |                                                   |                      |                                             |
| Commercial loans                        | 983                                           | 347                                            | 592                                         | 939                                               | 12                   | 1,125                                       |
| Consumer loans                          | 68                                            | -                                              | 66                                          | 66                                                | 1                    | 41                                          |
| Total impaired loans                    | \$ 55,717                                     | 17,477                                         | 30,797                                      | 48,274                                            | 1,536                | 48,357                                      |

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

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

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 GAAP. Actual results could differ from those estimates.

#### Results of Operations

Summary. The Company reported earnings of \$6.7 million in 2013, or \$1.19 basic and diluted net earnings per share, before adjustment for preferred stock dividends and accretion, as compared to \$5.8 million, or \$1.04 basic and diluted net earnings per share, before adjustment for preferred stock dividends and accretion, for the year ended December 31, 2012. After adjusting for dividends and accretion on preferred stock, net earnings available to common shareholders



for the year ended December 31, 2013 were \$6.0 million, or \$1.08 basic net earnings per common share and \$1.07 diluted net earnings per common share, as compared to \$4.8 million, or \$0.86 basic and diluted net earnings per common share, for the year ended December 31, 2012. The increase in year-to-date earnings is primarily attributable to a decrease in the provision for loan losses and an increase in non-interest income, which were partially offset by a decrease in net interest income and an increase in non-interest expense, as discussed below.

Net earnings for 2012 represented an increase of 27% as compared to 2011 net earnings of \$3.8 million, or \$0.68 basic and diluted net earnings per common share. The increase in 2012 net earnings was primarily attributable to a decrease in the provision for loan losses, which was partially offset by aggregate decreases in net interest income and non-interest income and aggregate increases in non-interest expense.

The return on average assets in 2013 was 0.65%, compared to 0.56% in 2012 and 0.48% in 2011. The return on average shareholders' equity was 6.67% in 2013 compared to 5.58% in 2012 and 5.03% in 2011.

**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 for 2013 was \$31.3 million compared to \$31.5 million in 2012. This decrease is primarily attributable to a decrease in interest income resulting from decreases in the year-to-date average balances outstanding on loans and the yield on earning assets, which were partially offset by a decrease in interest expense due to a reduction in the cost of funds and a reduction in interest bearing liabilities. Net interest income decreased in 2012 from \$34.3 million in 2011.

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, 2013, 2012 and 2011. 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 of 38.55% for securities that are both federal and state tax exempt, an effective tax rate of 31.65% for federal tax exempt securities and an effective tax rate of 6.90% for state tax exempt securities. Non-accrual loans and the interest income that was recorded on these loans, if any, are included in the yield calculations for loans in all periods reported.

Table 1- Average Balance Table

| (Dollars in thousands)               | December 31, 2013   |               |              | December 31, 2012 |               |              | December 31, 2011 |               |              |
|--------------------------------------|---------------------|---------------|--------------|-------------------|---------------|--------------|-------------------|---------------|--------------|
|                                      | Average Balance     | Interest      | Yield / Rate | Average Balance   | Interest      | Yield / Rate | Average Balance   | Interest      | Yield / Rate |
| <b>Interest-earning assets:</b>      |                     |               |              |                   |               |              |                   |               |              |
| Interest and fees on loans           | \$ 614,532          | 30,194        | 4.91%        | 648,595           | 32,758        | 5.05%        | 697,527           | 36,374        | 5.21%        |
| Investments - taxable                | 141,143             | 1,544         | 1.09%        | 188,625           | 2,901         | 1.54%        | 173,766           | 4,688         | 2.70%        |
| Investments - nontaxable*            | 158,535             | 7,070         | 4.46%        | 106,796           | 5,198         | 4.87%        | 128,543           | 5,865         | 4.56%        |
| Other                                | 36,241              | 85            | 0.23%        | 21,977            | 51            | 0.23%        | 15,615            | 33            | 0.21%        |
| <b>Total interest-earning assets</b> | <b>950,451</b>      | <b>38,893</b> | <b>4.09%</b> | <b>965,993</b>    | <b>40,908</b> | <b>4.23%</b> | <b>1,015,451</b>  | <b>46,960</b> | <b>4.62%</b> |
| Cash and due from banks              | 36,080              |               |              | 24,760            |               |              | 23,844            |               |              |
| Other assets                         | 51,239              |               |              | 55,618            |               |              | 50,829            |               |              |
| Allowance for loan losses            | (14,161 )           |               |              | (16,760 )         |               |              | (15,874 )         |               |              |
| <b>Total assets</b>                  | <b>\$ 1,023,609</b> |               |              | <b>1,029,611</b>  |               |              | <b>1,074,250</b>  |               |              |
| <b>Interest-bearing liabilities:</b> |                     |               |              |                   |               |              |                   |               |              |
|                                      | \$ 376,457          | 732           | 0.19%        | 351,748           | 1,180         | 0.34%        | 344,860           | 2,263         | 0.66%        |

NOW, MMDA &  
savings deposits

|                            |         |       |       |         |       |       |         |       |       |
|----------------------------|---------|-------|-------|---------|-------|-------|---------|-------|-------|
| Time deposits              | 230,880 | 1,650 | 0.71% | 282,218 | 3,205 | 1.14% | 357,094 | 5,035 | 1.41% |
| FHLB / FRB borrowings      | 69,740  | 2,518 | 3.61% | 70,350  | 2,744 | 3.90% | 70,027  | 2,956 | 4.22% |
| Trust preferred securities | 20,619  | 398   | 1.93% | 20,619  | 438   | 2.12% | 20,619  | 407   | 1.97% |
| Other                      | 43,532  | 55    | 0.13% | 45,611  | 129   | 0.28% | 43,782  | 285   | 0.65% |

Total  
interest-bearing  
liabilities

|  |         |       |       |         |       |       |         |        |       |
|--|---------|-------|-------|---------|-------|-------|---------|--------|-------|
|  | 741,228 | 5,353 | 0.72% | 770,546 | 7,696 | 1.00% | 836,382 | 10,946 | 1.31% |
|--|---------|-------|-------|---------|-------|-------|---------|--------|-------|

|                 |         |  |  |         |  |  |         |  |  |
|-----------------|---------|--|--|---------|--|--|---------|--|--|
| Demand deposits | 180,303 |  |  | 153,009 |  |  | 133,596 |  |  |
|-----------------|---------|--|--|---------|--|--|---------|--|--|

|                   |       |  |  |       |  |  |       |  |  |
|-------------------|-------|--|--|-------|--|--|-------|--|--|
| Other liabilities | 4,860 |  |  | 4,746 |  |  | 4,174 |  |  |
|-------------------|-------|--|--|-------|--|--|-------|--|--|

|                      |         |  |  |         |  |  |         |  |  |
|----------------------|---------|--|--|---------|--|--|---------|--|--|
| Shareholders' equity | 100,241 |  |  | 103,805 |  |  | 102,568 |  |  |
|----------------------|---------|--|--|---------|--|--|---------|--|--|

Total liabilities and  
shareholder's equity \$

|  |           |  |  |           |  |  |           |  |  |
|--|-----------|--|--|-----------|--|--|-----------|--|--|
|  | 1,026,632 |  |  | 1,032,106 |  |  | 1,076,720 |  |  |
|--|-----------|--|--|-----------|--|--|-----------|--|--|

|                     |  |        |       |  |        |       |  |        |       |
|---------------------|--|--------|-------|--|--------|-------|--|--------|-------|
| Net interest spread |  | 33,540 | 3.37% |  | 33,212 | 3.23% |  | 36,014 | 3.31% |
|---------------------|--|--------|-------|--|--------|-------|--|--------|-------|

Net yield on  
interest-earning  
assets

|  |  |       |  |  |       |  |  |       |  |
|--|--|-------|--|--|-------|--|--|-------|--|
|  |  | 3.53% |  |  | 3.44% |  |  | 3.55% |  |
|--|--|-------|--|--|-------|--|--|-------|--|

Taxable equivalent  
adjustment

|                       |  |       |  |  |       |  |  |       |  |
|-----------------------|--|-------|--|--|-------|--|--|-------|--|
| Investment securities |  | 2,197 |  |  | 1,663 |  |  | 1,701 |  |
|-----------------------|--|-------|--|--|-------|--|--|-------|--|

|                     |  |        |  |  |        |  |  |        |  |
|---------------------|--|--------|--|--|--------|--|--|--------|--|
| Net interest income |  | 31,343 |  |  | 31,549 |  |  | 34,313 |  |
|---------------------|--|--------|--|--|--------|--|--|--------|--|

\*Includes U.S. government agency securities that are non-taxable for state income tax purposes of \$20.2 million in 2013, \$5.3 million in 2012 and \$39.0 million in 2011. 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 Variance Analysis-Tax Equivalent Basis

| (Dollars in thousands)           | December 31, 2013               |                                   |                                 | December 31, 2012                  |                                   |                                 |
|----------------------------------|---------------------------------|-----------------------------------|---------------------------------|------------------------------------|-----------------------------------|---------------------------------|
|                                  | Changes<br>in average<br>volume | Changes<br>in<br>average<br>rates | Total<br>Increase<br>(Decrease) | Changes<br>in<br>average<br>volume | Changes<br>in<br>average<br>rates | Total<br>Increase<br>(Decrease) |
| <b>Interest income:</b>          |                                 |                                   |                                 |                                    |                                   |                                 |
| Loans: Net of unearned<br>income | \$ (1,697 )                     | (867 )                            | (2,564 )                        | (2,512 )                           | (1,104 )                          | (3,616 )                        |
| Investments - taxable            | (625 )                          | (732 )                            | (1,357 )                        | 315                                | (2,102 )                          | (1,787 )                        |
| Investments -<br>nontaxable      | 2,413                           | (541 )                            | 1,872                           | (1,025 )                           | 358                               | (667 )                          |
| Other                            | 33                              | 1                                 | 34                              | 15                                 | 3                                 | 18                              |
| Total interest income            | 124                             | (2,139 )                          | (2,015 )                        | (3,207 )                           | (2,845 )                          | (6,052 )                        |
| <b>Interest expense:</b>         |                                 |                                   |                                 |                                    |                                   |                                 |
| NOW, MMDA &<br>savings deposits  | 65                              | (513 )                            | (448 )                          | 34                                 | (1,117 )                          | (1,083 )                        |
| Time deposits                    | (475 )                          | (1,080 )                          | (1,555 )                        | (953 )                             | (877 )                            | (1,830 )                        |
| FHLB / FRB<br>Borrowings         | (23 )                           | (203 )                            | (226 )                          | 13                                 | (225 )                            | (212 )                          |
| Trust Preferred<br>Securities    | -                               | (40 )                             | (40 )                           | -                                  | 31                                | 31                              |
| Other                            | (4 )                            | (70 )                             | (74 )                           | 9                                  | (165 )                            | (156 )                          |
| Total interest expense           | (437 )                          | (1,906 )                          | (2,343 )                        | (897 )                             | (2,353 )                          | (3,250 )                        |
| Net interest income              | \$ 561                          | (233 )                            | 328                             | (2,310 )                           | (492 )                            | (2,802 )                        |

Net interest income on a tax equivalent basis totaled \$31.3 million in 2013 as compared to \$31.5 million in 2012. The interest rate spread, which represents the rate earned on interest-earning assets less the rate paid on interest-bearing liabilities, was 3.37% in 2013, an increase from the 2012 net interest spread of 3.23%. The net yield on interest-earning assets in 2013 increased to 3.53% from the 2012 net yield on interest-earning assets of 3.44%.

Tax equivalent interest income decreased \$2.0 million or 5% in 2013 primarily due to decreases in the year-to-date average balances outstanding on loans and the yield on earning assets. The yield on interest-earning assets decreased to 4.09% in 2013 from 4.23% in 2012. Average interest-earning assets decreased \$15.5 million primarily as the result of a \$34.1 million decrease in the average outstanding balance of loans, which was partially offset by a \$14.2 million decrease in other interest-earning assets. Other interest-earning assets including federal funds sold were \$36.2 million in 2013 and \$22.0 million in 2012.

Interest expense decreased \$2.3 million or 30% in 2013 primarily due to a decrease in the average rate paid on interest-bearing liabilities. The cost of funds decreased to 0.72% in 2013 from 1.00% in 2012. This decrease in the cost of funds was primarily attributable to decreases in the average rate paid on interest-bearing deposit accounts and a reduction in interest-bearing liabilities. The \$29.3 million decrease in average interest-bearing liabilities in 2013 was primarily attributable to a \$51.3 million decrease in certificates of deposit, which was partially offset by a \$24.7 million increase in interest-bearing checking and savings accounts.

In 2012 net interest income on a tax equivalent basis decreased to \$31.5 million from \$34.3 million in 2011. The interest rate spread was 3.23% in 2012, a decrease from the 2011 net interest spread of 3.31%. The net yield on interest-earning assets in 2012 decreased to 3.44% from the 2011 net yield on interest-earning assets of 3.55%.

**Provision for Loan Losses.** Provisions 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 Bank's loan portfolio, including the valuation of impaired loans, 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 \$2.6 million, \$4.9 million, and \$12.6 million for the years ended December 31, 2013, 2012 and 2011, respectively. The decrease in the provision for loan losses is primarily attributable to a \$3.6 million decrease in net charge-offs during the year ended December 31, 2013, compared to the year ended December 31, 2012 and a \$3.8 million reduction in non-accrual loans from December 31, 2012 to December 31, 2013. Please see the section below entitled "Allowance for Loan Losses" for a more complete discussion of the Bank's policy for addressing potential loan losses.

Non-Interest Income. Non-interest income was \$12.7 million for the year ended December 31, 2013, compared to \$12.5 million for the year ended December 31, 2012. This increase is primarily attributable to a \$554,000 reduction in losses and write-downs on other real estate owned properties and a \$144,000 increase in income from the Bank's subsidiary, Peoples Investment Services, Inc., and was partially offset by a \$604,000 decrease in the gain on sale of securities for the year ended December 31, 2013, as compared to the year ended December 31, 2012.

Non-interest income totaled \$12.5 million for the year ended December 31, 2012, compared to \$14.5 million for the year ended December 31, 2011. This decrease is primarily attributable to a \$3.2 million decrease in the gains on sale of securities, which was partially offset by a \$472,000 increase in mortgage banking income and a \$362,000 increase in income from CBRES, for the year ended December 31, 2012, as compared to the year ended December 31, 2011.

The Company periodically evaluates its investments for any impairment which would be deemed other-than-temporary. No investment impairments were deemed other-than-temporary in 2013 or 2012. As part of its evaluation in 2011, the Company determined that the fair value of one equity security was less than the original cost of the investment and that the decline in fair value was not temporary in nature. As a result, the Company wrote down its investment by \$144,000. The remaining fair value of the investment at December 31, 2011 was approximately \$264,000.

Net losses on other real estate and repossessed assets were \$581,000, \$1.1 million and \$1.3 million for 2013, 2012 and 2011, respectively. The increased level of net losses on other real estate and repossessed assets during 2012 and 2011 were primarily attributable to increased write-downs on foreclosed property during the years ended December 31, 2012 and 2011. Management determined that the market value of these assets had decreased significantly and charges were appropriate in 2012 and 2011.

Table 3 presents a summary of non-interest income for the years ended December 31, 2013, 2012 and 2011.

Table 3 - Non-Interest Income

| (Dollars in thousands)                           | 2013     | 2012    | 2011    |
|--------------------------------------------------|----------|---------|---------|
| Service charges                                  | \$4,566  | 4,764   | 5,106   |
| Other service charges and fees                   | 1,172    | 1,940   | 2,090   |
| Other than temporary impairment losses           | -        | -       | (144)   |
| Gain on sale of securities                       | 614      | 1,218   | 4,406   |
| Mortgage banking income                          | 1,228    | 1,229   | 757     |
| Insurance and brokerage commissions              | 661      | 517     | 471     |
| Loss on sale and write-down of other real estate | (581)    | (1,136) | (1,322) |
| Visa debit card income                           | 2,990    | 2,092   | 1,783   |
| Net appraisal management fee income              | 718      | 737     | 375     |
| Miscellaneous                                    | 1,284    | 1,176   | 991     |
| Total non-interest income                        | \$12,652 | 12,537  | 14,513  |

Non-Interest Expense. Non-interest expense was \$32.8 million for the year ended December 31, 2013, as compared to \$31.8 million for the year ended December 31, 2012. This increase is primarily due to the \$530,000 Federal Home Loan Bank ("FHLB") prepayment penalty paid during the fourth quarter of 2013 and a \$425,000 increase in salaries and employee benefits expense, which was primarily due to salary increases, an increase in the number of full-time equivalent employees and an increase in sales incentive expense during the year ended December 31, 2013, as compared to the year ended December 31, 2012. Non-interest expense was \$31.8 million for 2012 compared to \$29.6 million for 2011.



Table 4 presents a summary of non-interest expense for the years ended December 31, 2013, 2012 and 2011.

Table 4 - Non-Interest Expense

| (Dollars in thousands)          | 2013     | 2012   | 2011   |
|---------------------------------|----------|--------|--------|
| Salaries and employee benefits  | \$16,851 | 16,426 | 14,766 |
| Occupancy expense               | 5,539    | 5,236  | 5,339  |
| Office supplies                 | 498      | 369    | 403    |
| FDIC deposit insurance          | 864      | 894    | 1,061  |
| Visa debit card expense         | 823      | 729    | 658    |
| Professional services           | 632      | 560    | 428    |
| Postage                         | 230      | 284    | 326    |
| Telephone                       | 570      | 554    | 605    |
| Director fees and expense       | 246      | 266    | 223    |
| Advertising                     | 685      | 695    | 660    |
| Consulting fees                 | 468      | 499    | 316    |
| Taxes and licenses              | 307      | 325    | 289    |
| Foreclosure/OREO expense        | 356      | 677    | 904    |
| Internet banking expense        | 568      | 593    | 509    |
| FHLB advance prepayment penalty | 530      | -      | -      |
| Other operating expense         | 3,674    | 3,675  | 3,085  |
| Total non-interest expense      | \$32,841 | 31,782 | 29,572 |

**Income Taxes.** The Company reported income tax expense of \$1.9 million, \$1.6 million and \$1.5 million for the years ended December 31, 2013, 2012 and 2011, respectively. The Company's effective tax rates were 21.93%, 21.50% and 22.09% in 2013, 2012 and 2011, respectively. The 2013, 2012 and 2011 effective tax rates are lower than historical levels due to increases in tax exempt investment income, which had a greater impact on the effective tax rate at the reduced level of earnings before income taxes as experienced in 2013, 2012 and 2011.

**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, 2013, such unfunded commitments to extend credit were \$146.2 million, while commitments in the form of standby letters of credit totaled \$4.4 million.

The Company uses several funding sources to meet its liquidity requirements. The primary funding source is core deposits, which includes demand deposits, savings accounts and non-brokered 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, 2013, the Company's core deposits totaled \$683.9 million, or 86% of total deposits.

The other sources of funding for the Company are through large denomination certificates of deposit, including brokered deposits, federal funds purchased, securities under agreement to repurchase and FHLB borrowings. The Bank is also able to borrow from the FRB on a short-term basis. The Bank's policies include the ability to access wholesale funding up to 40% of total assets. The Bank's wholesale funding includes FHLB borrowings, FRB borrowings, brokered deposits and internet certificates of deposit. The Company's ratio of wholesale funding to total assets was 7.83% as of December 31, 2013.



At December 31, 2013, the Bank had a significant amount of deposits in amounts greater than \$100,000, including brokered deposits of \$15.1 million, which have an average original term of eight months. Brokered deposits include certificates of deposit participated through the Certificate of Deposit Account Registry Service (“CDARS”) on behalf of local customers. CDARS balances totaled \$15.1 million as of December 31, 2013. The balance and cost of brokered deposits are more susceptible to changes in the interest rate environment than other deposits. Access to the brokered deposit market could be restricted if the Bank were to fall below the well capitalized level. For additional information, please see the section below entitled “Deposits.”

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

The Bank also had the ability to borrow up to \$62.5 million for the purchase of overnight federal funds from six correspondent financial institutions as of December 31, 2013.

The liquidity ratio for the Bank, which is defined as net cash, interest-bearing deposits with banks, federal funds sold and certain investment securities, as a percentage of net deposits and short-term liabilities was 35.65% at December 31, 2013, 35.14% at December 31, 2012 and 32.19% at December 31, 2011. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy for on balance sheet liquidity is 10%.

As disclosed in the Company's Consolidated Statements of Cash Flows included elsewhere herein, net cash provided by operating activities was approximately \$37.4 million during 2013. Net cash used in investing activities of \$19.2 million consisted primarily of purchases of AFS investments totaling \$98.1 million, which were partially offset by maturities, calls and sales of AFS investments, which totaled \$63.6 million. Net cash provided by financing activities amounted to \$9.7 million, primarily due to a \$17.8 million net increase in deposits and a \$10.8 million increase in securities sold under agreements to repurchase, which were partially offset by a \$12.5 million decrease in preferred stock.

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 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, 2013.

Table 5 - Interest Sensitivity Analysis

| (Dollars in thousands)                      | Immediate      | 1-3<br>months | 4-12<br>months | Total<br>Within<br>One<br>Year | Over One<br>Year &<br>Non-sensitive | Total          |
|---------------------------------------------|----------------|---------------|----------------|--------------------------------|-------------------------------------|----------------|
| <b>Interest-earning assets:</b>             |                |               |                |                                |                                     |                |
| Loans                                       | \$ 279,708     | 11,565        | 17,016         | 308,289                        | 312,671                             | 620,960        |
| Mortgage loans held for sale                | 497            | -             | -              | 497                            | -                                   | 497            |
| Investment securities available<br>for sale | -              | 11,297        | 24,204         | 35,501                         | 262,389                             | 297,890        |
| Interest-bearing deposit<br>accounts        | 26,871         | -             | -              | 26,871                         | -                                   | 26,871         |
| Other interest-earning assets               | -              | -             | -              | -                              | 5,609                               | 5,609          |
| <b>Total interest-earning assets</b>        | <b>307,076</b> | <b>22,862</b> | <b>41,220</b>  | <b>371,158</b>                 | <b>580,669</b>                      | <b>951,827</b> |
| <b>Interest-bearing liabilities:</b>        |                |               |                |                                |                                     |                |

|                                                                         |               |            |            |            |         |         |
|-------------------------------------------------------------------------|---------------|------------|------------|------------|---------|---------|
| NOW, savings, and money market deposits                                 | 386,893       | -          | -          | 386,893    | -       | 386,893 |
| Time deposits                                                           | 18,667        | 33,563     | 74,806     | 127,036    | 90,167  | 217,203 |
| FHLB borrowings                                                         | -             | -          | -          | -          | 65,000  | 65,000  |
| Securities sold under agreement to repurchase                           | 45,396        | -          | -          | 45,396     | -       | 45,396  |
| Trust preferred securities                                              | -             | 20,619     | -          | 20,619     | -       | 20,619  |
| Total interest-bearing liabilities                                      | 450,956       | 54,182     | 74,806     | 579,944    | 155,167 | 735,111 |
| Interest-sensitive gap                                                  | \$ (143,880 ) | (31,320 )  | (33,586 )  | (208,786 ) | 425,502 | 216,716 |
| Cumulative interest-sensitive gap                                       | \$ (143,880 ) | (175,200 ) | (208,786 ) | (208,786 ) | 216,716 |         |
| Interest-earning assets as a percentage of interest-bearing liabilities | 68.09%        | 42.19%     | 55.10%     | 64.00%     | 374.22% |         |

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 quarterly 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. Rate sensitive assets at December 31, 2013 totaled \$951.8 million, exceeding rate sensitive liabilities of \$735.1 million by \$216.7 million.

Included in the rate sensitive assets are \$290.4 million in variable rate loans indexed to prime rate subject to immediate repricing upon changes by the Federal Open Market Committee ("FOMC"). The Bank utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At December 31, 2013, the Bank had \$203.1 million in loans with interest rate floors. The floors were in effect on \$200.6 million of these loans pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 1.05% higher than the indexed rate on the promissory notes without interest rate floors.

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. The Company did not have any interest rate derivatives outstanding as of December 31, 2013.

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

#### Analysis of Financial Condition

**Investment Securities.** 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.

All of the Company's investment securities are held in the AFS category. At December 31, 2013, the market value of AFS securities totaled \$297.9 million, compared to \$297.8 million and \$321.4 million at December 31, 2012 and 2011, respectively. Table 6 presents the market value of the AFS securities held at December 31, 2013, 2012 and 2011.

Table 6 - Summary of Investment Portfolio

| (Dollars in thousands)                 | 2013     | 2012    | 2011    |
|----------------------------------------|----------|---------|---------|
| U. S. Government sponsored enterprises | \$22,143 | 18,837  | 7,694   |
| State and political subdivisions       | 145,368  | 125,658 | 97,097  |
| Mortgage-backed securities             | 123,977  | 148,024 | 213,693 |
| Corporate bonds                        | 3,463    | 2,586   | 543     |
| Trust preferred securities             | 1,250    | 1,250   | 1,250   |
| Equity securities                      | 1,689    | 1,468   | 1,111   |

|                  |           |         |         |
|------------------|-----------|---------|---------|
| Total securities | \$297,890 | 297,823 | 321,388 |
|------------------|-----------|---------|---------|

The Company's investment portfolio consists of U.S. Government sponsored enterprise securities, municipal securities, U.S. Government sponsored enterprise mortgage-backed securities, corporate bonds, trust preferred securities and equity securities. AFS securities averaged \$293.8 million in 2013, \$289.0 million in 2012 and \$295.4 million in 2011. Table 7 presents the amortized cost of AFS securities held by the Company by maturity category at December 31, 2013. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields are calculated on a tax equivalent basis. Yields and interest income on tax-exempt investments have been adjusted to a tax equivalent basis using an effective tax rate 38.55% for securities that are both federal and state tax exempt, an effective tax rate of 31.65% for federal tax exempt securities and an effective tax rate of 6.90% for state tax exempt securities.

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Table 7 - Maturity Distribution and Weighted Average Yield on Investments

| (Dollars in thousands)           | 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:                      |                  |       |                                |       |                                |       |                |       |         |       |
| U.S. Government                  |                  |       |                                |       |                                |       |                |       |         |       |
| sponsored enterprises            | \$ 1,525         | 0.68% | 4,920                          | 2.07% | 7,513                          | 2.70% | 8,185          | 2.33% | 22,143  | 2.86% |
| State and political subdivisions | 2,523            | 3.35% | 23,715                         | 3.40% | 107,371                        | 3.03% | 11,759         | 3.78% | 145,368 | 3.41% |
| Mortgage-backed securities       | 31,453           | 2.34% | 57,370                         | 2.49% | 17,731                         | 2.53% | 17,423         | 2.67% | 123,977 | 2.23% |
| Corporate bonds                  | -                | -     | 2,468                          | 2.79% | 995                            | 1.24% | -              | -     | 3,463   | 2.32% |
| Trust preferred securities       | -                | -     | -                              | -     | 1,000                          | 4.34% | 250            | 5.26% | 1,250   | 4.89% |
| Equity securities                | -                | -     | -                              | -     | -                              | -     | 1,689          | 0.00% | 1,689   | 0.00% |
| Total securities                 | \$ 35,501        | 2.23% | 88,473                         | 2.61% | 134,610                        | 2.65% | 39,306         | 2.84% | 297,890 | 2.62% |

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 Bank grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg, Union and Wake counties in North Carolina.

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. Real estate mortgage loans include both commercial and residential mortgage loans. At December 31, 2013, the Bank had \$105.6 million in residential mortgage loans, \$85.5 million in home equity loans and \$275.1 million in commercial mortgage loans, which include \$220.5 million using commercial property as collateral and \$54.6 million using residential property as collateral. Residential mortgage loans include \$56.1 million made to customers in the Bank's traditional banking offices and \$49.5 million in mortgage loans originated in the Bank's Latino banking operations. All residential mortgage loans are originated as fully amortizing loans, with no negative amortization.

At December 31, 2013, the Bank had \$63.7 million in construction and land development loans. Table 8 presents a breakout of these loans.

Table 8 - Construction and Land Development Loans

| (Dollars in thousands)                                  | Number of Loans | Balance Outstanding | Non-accrual Balance |
|---------------------------------------------------------|-----------------|---------------------|---------------------|
| Land acquisition and development - commercial purposes  | 64              | \$ 14,993           | 844                 |
| Land acquisition and development - residential purposes | 292             | 40,673              | 5,702               |
| 1 to 4 family residential construction                  | 30              | 4,663               | -                   |
| Commercial construction                                 | 6               | 3,413               | -                   |
| Total acquisition, development and construction         | 392             | \$ 63,742           | 6,546               |

The mortgage loans originated in the traditional banking offices are generally 15 to 30 year fixed rate loans with attributes that prevent the loans from being sellable in the secondary market. These factors may include higher loan-to-value ratio, limited documentation on income, non-conforming appraisal or non-conforming property type. These loans are generally made to existing Bank customers and have been originated throughout the Bank's seven county service area, with no geographic concentration. At December 31, 2013, there were 27 mortgage loans originated in the traditional banking offices with an outstanding balance of \$2.3 million that were 30 days or more past due and 10 loans with an outstanding balance of \$1.6 million in non-accrual.

Banco de la Gente single family residential stated income loans originated from 2005 to 2009 were primarily adjustable rate mortgage loans that adjust annually after the end of the first five years of the loan. The loans are tied to the one-year T-Bill index and, if they were to adjust at December 31, 2013, would have a reduction in the interest rate on the loan. The underwriting on these loans includes both full income verification and no income verification, with loan-to-value ratios of up to 95% without private mortgage insurance. A majority of these loans would be considered subprime loans, as they were underwritten using stated income rather than fully documented income verification. No other loans in the Bank's portfolio would be considered subprime. The majority of these loans have been originated within the Charlotte, North Carolina metro area (Mecklenburg County). At this time, Charlotte has experienced a decline in values within the residential real estate market. At December 31, 2013, there were 107 loans with an outstanding balance of \$11.1 million 30 days or more past due and 28 loans with an outstanding balance of \$2.0 million in non-accrual. Total losses on this portfolio, since the first loans were originated in 2004, have amounted to approximately \$3.5 million through December 31, 2013.

The composition of the Bank's loan portfolio is presented in Table 9.

Table 9 - Loan Portfolio

| (Dollars in thousands)                                    | 2013       |            | 2012    |            | 2011    |            | 2010    |            | 2009    |            |
|-----------------------------------------------------------|------------|------------|---------|------------|---------|------------|---------|------------|---------|------------|
|                                                           | Amount     | % of Loans | Amount  | % of Loans | Amount  | % of Loans | Amount  | % of Loans | Amount  | % of Loans |
| Real estate loans                                         |            |            |         |            |         |            |         |            |         |            |
| Construction and land development                         | \$ 63,742  | 10.27%     | 73,176  | 11.80%     | 93,812  | 13.99%     | 124,048 | 17.08%     | 169,680 | 21.81%     |
| Single-family residential                                 | 195,975    | 31.56%     | 195,003 | 31.45%     | 212,993 | 31.77%     | 232,294 | 31.99%     | 226,651 | 29.13%     |
| Single-family residential-Banco de la Gente stated income | 49,463     | 7.97%      | 52,019  | 8.39%      | 54,058  | 8.06%      | 55,013  | 7.58%      | 55,035  | 7.07%      |
| Commercial Multifamily and farmland                       | 209,287    | 33.70%     | 200,633 | 32.36%     | 214,415 | 31.98%     | 213,487 | 29.40%     | 224,975 | 28.92%     |
| Total real estate loans                                   | 530,268    | 85.39%     | 529,782 | 85.45%     | 580,071 | 86.51%     | 631,298 | 86.94%     | 682,643 | 87.74%     |
| Loans not secured by real estate                          |            |            |         |            |         |            |         |            |         |            |
| Commercial loans                                          | 68,047     | 10.97%     | 64,295  | 10.38%     | 60,646  | 9.05%      | 60,994  | 8.40%      | 67,487  | 8.67%      |
| Farm loans                                                | 19         | 0.00%      | 11      | 0.00%      | -       | 0.00%      | -       | 0.00%      | -       | 0.00%      |
| Consumer loans                                            | 9,593      | 1.54%      | 10,148  | 1.64%      | 10,490  | 1.56%      | 11,500  | 1.58%      | 12,943  | 1.66%      |
| All other loans                                           | 13,033     | 2.10%      | 15,738  | 2.54%      | 19,290  | 2.88%      | 22,368  | 3.08%      | 14,983  | 1.93%      |
| Total loans                                               | 620,960    | 100.00%    | 619,974 | 100.00%    | 670,497 | 100.00%    | 726,160 | 100.00%    | 778,056 | 100.00%    |
| Less: Allowance for loan losses                           | 13,501     |            | 14,423  |            | 16,604  |            | 15,493  |            | 15,413  |            |
| Net loans                                                 | \$ 607,459 |            | 605,551 |            | 653,893 |            | 710,667 |            | 762,643 |            |

As of December 31, 2013, gross loans outstanding were \$621.0 million, compared to \$620.0 million at December 31, 2012. Loans originated or renewed during the year ended December 31, 2013, amounting to approximately \$138.3 million, were offset by paydowns and payoffs of existing loans. Included in the loans originated during the year ended December 31, 2013 were \$10.0 million in participation loans. These included a \$6.0 million participation in a church loan with another North Carolina bank, which was originated during the third quarter of 2013 and \$4.0 million in a multinational commercial loan, which was originated during the second quarter of 2013. While it is management's intention to grow loans in its local market, the Bank is open to opportunities to lend in other markets. The Bank underwrites all participation loans to the same standards as loans in its own market. Average



loans represented 65% and 67% of total earning assets for the years ended December 31, 2013 and 2012, respectively. The Bank had \$497,000 and \$6.9 million in mortgage loans held for sale as of December 31, 2013 and 2012, respectively.

Total TDR loans amounted to \$21.9 million and \$23.9 million at December 31, 2013 and 2012, respectively. The terms of these loans have been renegotiated to provide a reduction in principal or interest as a result of the deteriorating financial position of the borrower. There were \$335,000 and \$2.0 million in performing loans classified as TDR loans at December 31, 2013 and 2012, respectively.

Table 10 identifies the maturities of all loans as of December 31, 2013 and addresses the sensitivity of these loans to changes in interest rates.

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Table 10 - Maturity and Repricing Data for Loans

| (Dollars in thousands)                                        | Within one<br>year or less | After one<br>year<br>through<br>five<br>years | After<br>five<br>years | Total<br>loans |
|---------------------------------------------------------------|----------------------------|-----------------------------------------------|------------------------|----------------|
| <b>Real estate loans</b>                                      |                            |                                               |                        |                |
| Construction and land development                             | \$ 51,841                  | 8,966                                         | 2,935                  | 63,742         |
| Single-family residential                                     | 94,874                     | 55,242                                        | 45,531                 | 195,647        |
| Single-family residential- Banco de la Gente<br>stated income | 20,074                     | -                                             | 29,389                 | 49,463         |
| Commercial                                                    | 97,261                     | 72,666                                        | 39,360                 | 209,287        |
| Multifamily and farmland                                      | 3,799                      | 5,274                                         | 2,728                  | 11,801         |
| Total real estate loans                                       | 268,177                    | 142,148                                       | 119,943                | 530,268        |
| <b>Loans not secured by real estate</b>                       |                            |                                               |                        |                |
| Commercial loans                                              | 49,702                     | 13,041                                        | 5,304                  | 68,047         |
| Farm loans                                                    | 10                         | 9                                             | -                      | 19             |
| Consumer loans                                                | 3,998                      | 4,942                                         | 654                    | 9,593          |
| All other loans                                               | 9,088                      | 2,294                                         | 1,651                  | 13,033         |
| Total loans                                                   | \$ 330,974                 | 162,434                                       | 127,552                | 620,960        |
| Total fixed rate loans                                        | \$ 22,686                  | 141,309                                       | 127,552                | 291,547        |
| Total floating rate loans                                     | 308,289                    | 21,124                                        | -                      | 329,413        |
| Total loans                                                   | \$ 330,974                 | 162,434                                       | 127,552                | 620,960        |

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, 2013, outstanding loan commitments totaled \$146.2 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 commitment 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 Off-Balance Sheet Arrangements" 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.

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

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

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

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

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

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

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

Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Bank's loan portfolio as of the date of the financial statements. Management believes it has established the allowance in accordance with GAAP and in consideration of the current economic environment. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the year ended December 31, 2013 as compared to the year ended December 31, 2012. Revisions, estimates and assumptions may be made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

Effective December 31, 2012, stated income mortgage loans from the Banco de la Gente division of the Bank were analyzed separately from other single family residential loans in the Bank's loan portfolio. These loans are first mortgage loans made to the Latino market, primarily in Mecklenburg and surrounding counties. These loans are

non-traditional mortgages in that the customer normally did not have a credit history, so all credit information was accumulated by the loan officers. These loans were made as stated income loans rather than full documentation loans because the customer may not have had complete documentation on the income supporting the loan.

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

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Net charge-offs for 2013 were \$3.5 million. The ratio of net charge-offs to average total loans was 0.57% in 2013, 1.10% in 2012 and 1.65% in 2011. The Bank strives to proactively work with its customers to identify potential problems. If found, the Bank works to quickly recognize identifiable losses and to establish a plan, with the borrower, if possible, to have the loans paid off. This process increased the levels of charge-offs and provision for loan losses in 2010 through 2013 as compared to historical periods prior to 2009. Management expects the ratio of net charge-offs to average total loans to remain at a level above historical norms in 2014 due to current economic conditions and the higher than normal levels of non-performing and past due loans. The allowance for loan losses was \$13.5 million or 2.17% of total loans outstanding at December 31, 2013. For December 31, 2012 and 2011, the allowance for loan losses amounted to \$14.4 million or 2.33% of total loans outstanding and \$16.6 million, or 2.48% of total loans outstanding, respectively.

Table 11 presents the percentage of loans assigned to each risk grade at December 31, 2013 and 2012.

Table 11 - Loan Risk Grade Analysis

| Risk Grade                          | Percentage of Loans<br>By Risk Grade |        |
|-------------------------------------|--------------------------------------|--------|
|                                     | 2013                                 | 2012   |
| Risk Grade 1 (Excellent Quality)    | 2.40%                                | 2.93%  |
| Risk Grade 2 (High Quality)         | 18.82%                               | 16.94% |
| Risk Grade 3 (Good Quality)         | 49.49%                               | 47.74% |
| Risk Grade 4 (Management Attention) | 18.69%                               | 20.70% |
| Risk Grade 5 (Watch)                | 5.05%                                | 5.07%  |
| Risk Grade 6 (Substandard)          | 5.25%                                | 6.26%  |
| Risk Grade 7 (Doubtful)             | 0.00%                                | 0.00%  |
| Risk Grade 8 (Loss)                 | 0.00%                                | 0.00%  |

Table 12 presents an analysis of the allowance for loan losses, including charge-off activity.

Table 12 - Analysis of Allowance for Loan Losses

| (Dollars in thousands)                       | 2013      | 2012   | 2011   | 2010   | 2009   |
|----------------------------------------------|-----------|--------|--------|--------|--------|
| Allowance for loan losses at beginning       | \$ 14,423 | 16,604 | 15,493 | 15,413 | 11,025 |
| Loans charged off:                           |           |        |        |        |        |
| Commercial                                   | 502       | 555    | 314    | 1,730  | 697    |
| Real estate - mortgage                       | 2,441     | 2,491  | 4,196  | 4,194  | 3,384  |
| Real estate - construction                   | 777       | 4,728  | 7,164  | 10,224 | 1,754  |
| Consumer                                     | 652       | 557    | 586    | 763    | 835    |
| Total loans charged off                      | 4,372     | 8,331  | 12,260 | 16,911 | 6,670  |
| Recoveries of losses previously charged off: |           |        |        |        |        |
| Commercial                                   | 44        | 104    | 121    | 62     | 111    |
| Real estate - mortgage                       | 302       | 446    | 225    | 162    | 161    |
| Real estate - construction                   | 377       | 528    | 241    | 89     | 36     |
| Consumer                                     | 143       | 148    | 152    | 240    | 215    |
| Total recoveries                             | 866       | 1,226  | 739    | 553    | 523    |
| Net loans charged off                        | 3,506     | 7,105  | 11,521 | 16,358 | 6,147  |

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|                                                                                  |    |        |        |        |        |        |
|----------------------------------------------------------------------------------|----|--------|--------|--------|--------|--------|
| Provision for loan losses                                                        |    | 2,584  | 4,924  | 12,632 | 16,438 | 10,535 |
| Allowance for loan losses at end of year                                         | \$ | 13,501 | 14,423 | 16,604 | 15,493 | 15,413 |
| Loans charged off net of recoveries, as a percent of average loans outstanding   |    | 0.57%  | 1.10%  | 1.65%  | 2.16%  | 0.79%  |
| Allowance for loan losses as a percent of total loans outstanding at end of year |    | 2.17%  | 2.33%  | 2.48%  | 2.13%  | 1.98%  |

Non-performing Assets. Non-performing assets totaled \$16.4 million at December 31, 2013 or 1.58% of total assets, compared to \$26.3 million at December 31, 2012, or 2.60% of total assets. Non-accrual loans were \$13.8 million at December 31, 2013 and \$17.6 million at December 31, 2012. As a percentage of total loans outstanding, non-accrual loans were 2.23% at December 31, 2013 compared to 2.84% at December 31, 2012. Non-accrual loans include \$6.5 million in construction and land development loans, \$7.0 million in commercial and residential mortgage loans and \$277,000 in other loans at December 31, 2013, as compared to \$9.2 million in construction and land development loans,

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\$8.0 million in commercial and residential mortgage loans and \$391,000 in other loans at December 31, 2012. The Bank had loans 90 days past due and still accruing totaling \$882,000 and \$2.4 million as of December 31, 2013 and December 31, 2012, respectively. Other real estate owned totaled \$1.7 million as of December 31, 2013 as compared to \$6.3 million at December 31, 2012. The Bank had no repossessed assets as of December 31, 2013. The Bank had repossessed assets amounting to \$10,000 as of December 31, 2012.

At December 31, 2013, the Bank had non-performing loans, defined as non-accrual and accruing loans past due more than 90 days, of \$14.7 million or 2.37% of total loans. Non-performing loans at December 31, 2012 were \$20.0 million, or 3.23% of total loans.

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. While 2013 did see improvement in many leading economic indicators, management believes that the economy in 2014 will not improve to a point such that non-performing loans would return to historically low levels.

It is the general policy of the Bank to stop accruing interest income 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 13.

Table 13 - Non-performing Assets

| (Dollars in thousands)                                               | 2013      | 2012      | 2011   | 2010   | 2009   |
|----------------------------------------------------------------------|-----------|-----------|--------|--------|--------|
| Non-accrual loans                                                    | \$ 13,836 | \$ 17,630 | 21,785 | 40,062 | 22,789 |
| Loans 90 days or more past due and still accruing                    | 882       | 2,403     | 2,709  | 210    | 1,977  |
| Total non-performing loans                                           | 14,718    | 20,033    | 24,494 | 40,272 | 24,766 |
| All other real estate owned                                          | 1,679     | 6,254     | 7,576  | 6,673  | 3,997  |
| Repossessed assets                                                   | -         | 10        | -      | -      | -      |
| Total non-performing assets                                          | \$ 16,397 | \$ 26,297 | 32,070 | 46,945 | 28,763 |
| As a percent of total loans at year end                              |           |           |        |        |        |
| Non-accrual loans                                                    | 2.23%     | 2.84%     | 3.25%  | 5.5%   | 2.93%  |
| Loans 90 days or more past due and still accruing                    | 0.14%     | 0.39%     | 0.40%  | 0.03%  | 0.25%  |
| Total non-performing assets                                          | 2.64%     | 4.24%     | 4.78%  | 6.46%  | 3.70%  |
| Total non-performing assets as a percent of total assets at year end | 1.58%     | 2.60%     | 3.01%  | 4.40%  | 2.74%  |
| Total non-performing loans as a percent of total loans at year-end   | 2.37%     | 3.23%     | 3.65%  | 5.55%  | 3.18%  |

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, 2013, total deposits were \$799.4 million, compared to \$781.5 million



at December 31, 2012. Core deposits, which include demand deposits, savings accounts and non-brokered certificates of deposits of denominations less than \$100,000, amounted to \$683.9 million at December 31, 2013, compared to \$646.4 million at December 31, 2012.

Time deposits in amounts of \$100,000 or more totaled \$115.3 million and \$134.7 million at December 31, 2013 and 2012, respectively. At December 31, 2013, brokered deposits amounted to \$15.1 million as compared to \$21.4 million at December 31, 2012. CDARS balances included in brokered deposits amounted to \$15.1 million and \$20.1 million as of December 31, 2013 and 2012, respectively. 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, 2013 have a weighted average rate of 0.14% with a weighted average original term of eight months.

Table 14 is a summary of the maturity distribution of time deposits in amounts of \$100,000 or more as of December 31, 2013.

Table 14 - Maturities of Time Deposits over \$100,000

| (Dollars in thousands)                | 2013      |
|---------------------------------------|-----------|
| Three months or less                  | \$28,418  |
| Over three months through six months  | 14,488    |
| Over six months through twelve months | 18,670    |
| Over twelve months                    | 53,692    |
| Total                                 | \$115,268 |

**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, 2013 and 2012, FHLB borrowings totaled \$65.0 million and \$70.0 million, respectively. Average FHLB borrowings for 2013 and 2012 were \$69.7 million and \$70.4 million, respectively. The maximum amount of outstanding FHLB borrowings was \$70.0 million in 2013 and \$82.5 million in 2012. The FHLB borrowings outstanding at December 31, 2013 had interest rates ranging from 1.80% to 4.26% and maturity dates ranging from 2014 to 2019. Additional information regarding FHLB borrowings is provided in Note 6 to the Consolidated Financial Statements.

The Bank had no borrowings from the FRB at December 31, 2013 and 2012. FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At December 31, 2013, the carrying value of loans pledged as collateral totaled approximately \$315.2 million.

Securities sold under agreements to repurchase amounted to \$45.4 million and \$34.6 million as of December 31, 2013 and 2012, respectively.

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

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

These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, which became effective on June 28, 2011. As specified in the indenture, if the

debentures are redeemed prior to maturity, the redemption price will be the principal amount 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, 2013 are summarized in Table 15 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.

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Table 15 - Contractual Obligations and Other Commitments

| (Dollars in thousands)                                        |           | Within One<br>Year | One to<br>Three<br>Years | Three to<br>Five Years | Five Years<br>or More | Total          |
|---------------------------------------------------------------|-----------|--------------------|--------------------------|------------------------|-----------------------|----------------|
| <b>Contractual Cash Obligations</b>                           |           |                    |                          |                        |                       |                |
| Long-term borrowings                                          | \$        | 5,000              | 5,000                    | 50,000                 | 5,000                 | 65,000         |
| Junior subordinated debentures                                |           | -                  | -                        | -                      | 20,619                | 20,619         |
| Operating lease obligations                                   |           | 549                | 1,036                    | 905                    | 1,253                 | 3,743          |
| <b>Total</b>                                                  | <b>\$</b> | <b>5,549</b>       | <b>6,036</b>             | <b>50,905</b>          | <b>26,872</b>         | <b>89,362</b>  |
| <b>Other Commitments</b>                                      |           |                    |                          |                        |                       |                |
| Commitments to extend credit                                  | \$        | 64,157             | 7,950                    | 10,825                 | 63,311                | 146,243        |
| Standby letters of credit<br>and financial guarantees written |           | 4,361              | -                        | -                      | -                     | 4,361          |
| <b>Total</b>                                                  | <b>\$</b> | <b>68,518</b>      | <b>7,950</b>             | <b>10,825</b>          | <b>63,311</b>         | <b>150,604</b> |

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-14 and in Notes 1, 10, 11 and 16 to the Consolidated Financial Statements.

Capital Resources. Shareholders' equity was \$83.7 million as of December 31, 2013, compared to \$97.7 million as of December 31, 2012. This decrease reflects the Company's repurchase and redemption of its Series A preferred stock combined with a reduction in accumulated other comprehensive income resulting from a decrease in the unrealized gain on investment securities. Management expects the repurchase of the Company's preferred stock, which has a liquidation preference of \$12,524,000, to be approximately \$0.18 accretive to the Company's diluted earnings per common share in 2014 based on current interest rates.

During 2012, the Company purchased 12,530 shares of the Company's 25,054 outstanding shares of Series A preferred stock from the UST. The shares were purchased for \$933.36 per share, for a total purchase price of \$11,778,576, including \$83,575 accrued and unpaid dividends on the Series A preferred stock. The Company retired the 12,530 shares purchased. The \$834,999 difference between the \$12,530,000 face value of the Series A preferred stock retired and the \$11,695,001 purchase price of the Series A preferred stock retired was credited to retained earnings effective June 30, 2012.

During 2012, the Company completed its repurchase of the Warrant to purchase 357,234 shares of the Company's common stock that was issued to the UST. The Company repurchased the Warrant for a total price of \$425,000.

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 9.79%, 10.08% and 9.55% for 2013, 2012 and 2011, respectively. The return on average shareholders' equity was 6.67% at December 31, 2013 as

compared to 5.58% and 5.03% as of December 31, 2012 and December 31, 2011, respectively. Total cash dividends paid on common stock amounted to \$677,000, \$1.0 million and \$443,000 during 2013, 2012 and 2011, respectively. The Company paid dividends totaling \$656,000, \$1.0 million and \$1.3 million on preferred stock during 2013, 2012 and 2011, respectively.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights.

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

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December 31, 2013, 2012 and 2011 includes \$20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 14.83%, 16.04% and 16.10% at December 31, 2013, 2012 and 2011, respectively. Total risk-based capital is defined as Tier 1 capital plus supplementary capital. Supplementary capital, or Tier 2 capital, consists of the Company's allowance for loan losses, not exceeding 1.25% of the Company's risk-weighted assets. Total risk-based capital ratio is therefore defined as the ratio of total capital (Tier 1 capital and Tier 2 capital) to risk-weighted assets. The Company's total risk-based capital ratio was 16.14%, 17.34% and 17.38% at December 31, 2013, 2012 and 2011, respectively. In addition to the Tier 1 and total risk-based capital requirements, financial institutions are also required to maintain a leverage ratio of Tier 1 capital to total average assets of 4.0% or greater. The Company's Tier 1 leverage capital ratio was 10.08%, 11.12% and 11.06% at December 31, 2013, 2012 and 2011, respectively.

The Bank's Tier 1 risk-based capital ratio was 14.43%, 15.54% and 13.76% at December 31, 2013, 2012 and 2011, respectively. The total risk-based capital ratio for the Bank was 15.73%, 16.84% and 15.04% at December 31, 2013, 2012 and 2011, respectively. The Bank's Tier 1 leverage capital ratio was 9.79%, 10.76% and 9.44% at December 31, 2013, 2012 and 2011, 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, 2013, 2012 and 2011.

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

The Company's key equity ratios as of December 31, 2013, 2012 and 2011 are presented in Table 16.

Table 16 - Equity Ratios

|                                  | 2013   | 2012   | 2011   |
|----------------------------------|--------|--------|--------|
| Return on average assets         | 0.65%  | 0.56%  | 0.48%  |
| Return on average equity         | 6.67%  | 5.58%  | 5.03%  |
| Dividend payout ratio *          | 11.17% | 20.96% | 11.78% |
| Average equity to average assets | 9.79%  | 10.08% | 9.55%  |

\* As a percentage of net earnings available to common shareholders.

Quarterly Financial Data. The Company's consolidated quarterly operating results for the years ended December 31, 2013 and 2012 are presented in Table 17.

Table 17 - Quarterly Financial Data

|                                                  | 2013     |        |       |        | 2012      |        |       |        |
|--------------------------------------------------|----------|--------|-------|--------|-----------|--------|-------|--------|
| (Dollars in thousands, except per share amounts) | First    | Second | Third | Fourth | First     | Second | Third | Fourth |
| Total interest income                            | \$ 9,103 | 8,909  | 9,188 | 9,496  | \$ 10,362 | 9,835  | 9,655 | 9,393  |
| Total interest expense                           | 1,463    | 1,372  | 1,285 | 1,233  | 2,218     | 1,987  | 1,842 | 1,649  |
| Net interest income                              | 7,640    | 7,537  | 7,903 | 8,263  | 8,144     | 7,848  | 7,813 | 7,744  |
| Provision for loan losses                        | 1,053    | 773    | 337   | 421    | 2,049     | 1,603  | 761   | 511    |

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|                                                  |         |       |       |       |          |       |       |       |
|--------------------------------------------------|---------|-------|-------|-------|----------|-------|-------|-------|
| Other income                                     | 3,427   | 3,309 | 3,111 | 2,805 | 3,380    | 3,593 | 2,886 | 2,678 |
| Other expense                                    | 7,738   | 7,979 | 7,889 | 9,235 | 7,271    | 7,843 | 8,156 | 8,512 |
| Income before income taxes                       | 2,276   | 2,094 | 2,788 | 1,412 | 2,204    | 1,995 | 1,782 | 1,399 |
| Income taxes                                     | 518     | 461   | 870   | 30    | 545      | 486   | 369   | 187   |
| Net earnings                                     | 1,758   | 1,633 | 1,918 | 1,382 | 1,659    | 1,509 | 1,413 | 1,212 |
| Dividends and accretion of preferred stock       | 157     | 156   | 156   | 187   | 348      | 348   | 157   | 157   |
| Net earnings available to common shareholders \$ | 1,601   | 1,477 | 1,762 | 1,195 | \$ 1,311 | 1,161 | 1,256 | 1,055 |
| Basic earnings per common share                  | 0.29    | 0.26  | 0.31  | 0.22  | \$ 0.24  | 0.21  | 0.23  | 0.18  |
| Diluted earnings per common share                | \$ 0.29 | 0.26  | 0.31  | 0.21  | \$ 0.24  | 0.21  | 0.23  | 0.18  |

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## QUANTATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

The Company's market risk arises primarily from interest rate risk inherent in its lending and deposit taking activities. The structure of the Company's loan and deposit portfolios is such that a significant decline (increase) in interest rates may adversely (positively) 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, 2013, 2012 and 2011, 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 18 presents in tabular form the contractual balances and the estimated fair value of the Company's on-balance sheet financial instruments at their expected maturity dates for the period ended December 31, 2013. 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, 2013. 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 18 - Market Risk Table

|                                               | (Dollars in thousands) | Principal/Notional Amount Maturing in Year Ended December 31, |        |        |                   |            |         | Fair Value |
|-----------------------------------------------|------------------------|---------------------------------------------------------------|--------|--------|-------------------|------------|---------|------------|
|                                               |                        | 2014                                                          | 2015   | 2016   | 2017<br>&<br>2018 | Thereafter | Total   |            |
| <b>Loans Receivable</b>                       |                        |                                                               |        |        |                   |            |         |            |
| Fixed rate                                    | \$                     | 48,336                                                        | 43,370 | 31,685 | 77,813            | 95,200     | 296,404 | 301,077    |
| Average interest rate                         |                        | 4.65%                                                         | 5.42%  | 5.34%  | 4.93%             | 5.33%      |         |            |
| Variable rate                                 | \$                     | 96,463                                                        | 39,557 | 27,156 | 53,135            | 108,742    | 325,053 | 325,053    |
| Average interest rate                         |                        | 4.69%                                                         | 4.78%  | 4.61%  | 4.39%             | 4.35%      |         |            |
|                                               |                        |                                                               |        |        |                   |            | 621,457 | 626,130    |
| <b>Investment Securities</b>                  |                        |                                                               |        |        |                   |            |         |            |
| Interest bearing cash                         | \$                     | 26,871                                                        | -      | -      | -                 | -          | 26,871  | 26,871     |
| Average interest rate                         |                        | 0.26%                                                         | -      | -      | -                 | -          |         |            |
| Securities available for sale                 | \$                     | 35,501                                                        | 11,966 | 10,428 | 24,563            | 215,432    | 297,890 | 297,890    |
| Average interest rate                         |                        | 4.65%                                                         | 4.85%  | 4.93%  | 4.55%             | 4.70%      |         |            |
| <b>Nonmarketable equity securities</b>        | \$                     | -                                                             | -      | -      | -                 | 4,990      | 4,990   | 4,990      |
| Average interest rate                         |                        | -                                                             | -      | -      | -                 | 2.37%      |         |            |
| <b>Debt Obligations</b>                       |                        |                                                               |        |        |                   |            |         |            |
| Deposits                                      | \$                     | 127,062                                                       | 48,673 | 22,497 | 19,001            | 582,128    | 799,361 | 798,460    |
| Average interest rate                         |                        | 0.41%                                                         | 0.92%  | 1.04%  | 1.04%             | 0.11%      |         |            |
| Advances from FHLB                            | \$                     | 5,000                                                         | -      | 5,000  | 50,000            | 5,000      | 65,000  | 65,891     |
| Average interest rate                         |                        | 2.23%                                                         | -      | 3.73%  | 3.34%             | 4.26%      |         |            |
| Securities sold under agreement to repurchase | \$                     | 45,396                                                        |        |        |                   |            | 45,396  | 45,396     |
| Average interest rate                         |                        | 0.10%                                                         |        |        |                   |            |         |            |
|                                               | \$                     | -                                                             | -      | -      | -                 | 20,619     | 20,619  | 20,619     |



Junior subordinated  
debentures

|                       |   |   |   |   |       |
|-----------------------|---|---|---|---|-------|
| Average interest rate | - | - | - | - | 1.82% |
|-----------------------|---|---|---|---|-------|

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Table 19 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%, 2% and 3% 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%, 2% and 3% as 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 19 - Interest Rate Risk

(Dollars in thousands)

| Hypothetical rate change (ramp over 12 months) | Estimated Resulting Theoretical Net Interest Income |          |
|------------------------------------------------|-----------------------------------------------------|----------|
|                                                | Amount                                              | % Change |
| +3%                                            | \$ 33,917                                           | 1.51%    |
| +2%                                            | \$ 34,124                                           | 2.12%    |
| +1%                                            | \$ 33,655                                           | 0.72%    |
| 0%                                             | \$ 33,414                                           | 0.00%    |
| -1%                                            | \$ 32,680                                           | -2.20%   |
| -2%                                            | \$ 31,648                                           | -5.29%   |
| -3%                                            | \$ 30,972                                           | -7.31%   |

  

| Hypothetical rate change (immediate shock) | Estimated Resulting Theoretical Market Value of Equity |          |
|--------------------------------------------|--------------------------------------------------------|----------|
|                                            | Amount                                                 | % Change |
| +3%                                        | \$ 95,388                                              | -14.13%  |
| +2%                                        | \$ 109,439                                             | -1.49%   |
| +1%                                        | \$ 113,431                                             | 2.11%    |
| 0%                                         | \$ 111,089                                             | 0.00%    |
| -1%                                        | \$ 99,619                                              | -10.33%  |
| -2%                                        | \$ 88,628                                              | -20.22%  |
| -3%                                        | \$ 79,381                                              | -28.54%  |

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 Consolidated Financial Statements  
 December 31, 2013, 2012 and 2011

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

## Consolidated Balance Sheets

December 31, 2013 and 2012

(Dollars in thousands)

| Assets                                                                                                        | 2013         | 2012      |
|---------------------------------------------------------------------------------------------------------------|--------------|-----------|
| Cash and due from banks, including reserve requirements \$<br>of \$11,472 at 12/31/13 and \$9,625 at 12/31/12 | 49,902       | 32,617    |
| Interest-bearing deposits                                                                                     | 26,871       | 16,226    |
| Cash and cash equivalents                                                                                     | 76,773       | 48,843    |
| Investment securities available for sale                                                                      | 297,890      | 297,823   |
| Other investments                                                                                             | 4,990        | 5,599     |
| Total securities                                                                                              | 302,880      | 303,422   |
| Mortgage loans held for sale                                                                                  | 497          | 6,922     |
| Loans                                                                                                         | 620,960      | 619,974   |
| Less allowance for loan losses                                                                                | (13,501 )    | (14,423 ) |
| Net loans                                                                                                     | 607,459      | 605,551   |
| Premises and equipment, net                                                                                   | 16,358       | 15,874    |
| Cash surrender value of life insurance                                                                        | 13,706       | 13,273    |
| Other real estate                                                                                             | 1,679        | 6,254     |
| Accrued interest receivable and other assets                                                                  | 15,332       | 13,377    |
| Total assets                                                                                                  | \$ 1,034,684 | 1,013,516 |
| Liabilities and Shareholders' Equity                                                                          |              |           |
| Deposits:                                                                                                     |              |           |
| Non-interest bearing demand                                                                                   | \$ 195,265   | 161,582   |
| NOW, MMDA & savings                                                                                           | 386,893      | 371,719   |
| Time, \$100,000 or more                                                                                       | 115,268      | 134,733   |
| Other time                                                                                                    | 101,935      | 113,491   |
| Total deposits                                                                                                | 799,361      | 781,525   |
| Securities sold under agreements to repurchase                                                                | 45,396       | 34,578    |
| FHLB borrowings                                                                                               | 65,000       | 70,000    |
| Junior subordinated debentures                                                                                | 20,619       | 20,619    |
| Accrued interest payable and other liabilities                                                                | 20,589       | 9,047     |
| Total liabilities                                                                                             | 950,965      | 915,769   |
| Commitments                                                                                                   |              |           |

## Shareholders' equity:

Series A preferred stock, \$1,000 stated value; authorized

5,000,000 shares; issued and outstanding

12,524 shares in 2012 - 12,524

Common stock, no par value; authorized

20,000,000 shares; issued and outstanding

5,613,495 shares in 2013 and 2012 48,133 48,133

Retained earnings 36,758 31,478

Accumulated other comprehensive (loss) income (1,172 ) 5,612

Total shareholders' equity 83,719 97,747

Total liabilities and shareholders' equity \$ 1,034,684 1,013,516

See accompanying Notes to Consolidated Financial Statements.

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

## Consolidated Statements of Earnings

For the Years Ended December 31, 2013, 2012 and 2011

(Dollars in thousands, except per share amounts)

|                                                     | 2013      | 2012     | 2011     |
|-----------------------------------------------------|-----------|----------|----------|
| Interest income:                                    |           |          |          |
| Interest and fees on loans                          | \$ 30,194 | 32,758   | 36,374   |
| Interest on due from banks                          | 85        | 51       | 33       |
| Interest on investment securities:                  |           |          |          |
| U.S. Government sponsored enterprises               | 1,639     | 2,746    | 5,414    |
| States and political subdivisions                   | 4,427     | 3,403    | 3,180    |
| Other                                               | 351       | 287      | 258      |
| Total interest income                               | 36,696    | 39,245   | 45,259   |
| Interest expense:                                   |           |          |          |
| NOW, MMDA & savings deposits                        | 732       | 1,180    | 2,263    |
| Time deposits                                       | 1,650     | 3,205    | 5,035    |
| FHLB borrowings                                     | 2,518     | 2,744    | 2,956    |
| Junior subordinated debentures                      | 398       | 438      | 407      |
| Other                                               | 55        | 129      | 285      |
| Total interest expense                              | 5,353     | 7,696    | 10,946   |
| Net interest income                                 | 31,343    | 31,549   | 34,313   |
| Provision for loan losses                           | 2,584     | 4,924    | 12,632   |
| Net interest income after provision for loan losses | 28,759    | 26,625   | 21,681   |
| Non-interest income:                                |           |          |          |
| Service charges                                     | 4,566     | 4,764    | 5,106    |
| Other service charges and fees                      | 1,172     | 1,940    | 2,090    |
| Other than temporary impairment losses              | -         | -        | (144 )   |
| Gain on sale of securities                          | 614       | 1,218    | 4,406    |
| Mortgage banking income                             | 1,228     | 1,229    | 757      |
| Insurance and brokerage commissions                 | 661       | 517      | 471      |
| Loss on sale and write-down of other real estate    | (581 )    | (1,136 ) | (1,322 ) |
| Miscellaneous                                       | 4,992     | 4,005    | 3,149    |
| Total non-interest income                           | 12,652    | 12,537   | 14,513   |
| Non-interest expense:                               |           |          |          |

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|                                               |          |        |        |
|-----------------------------------------------|----------|--------|--------|
| Salaries and employee benefits                | 16,851   | 16,426 | 14,766 |
| Occupancy                                     | 5,539    | 5,236  | 5,339  |
| Other                                         | 10,451   | 10,120 | 9,467  |
| Total non-interest expense                    | 32,841   | 31,782 | 29,572 |
| Earnings before income taxes                  | 8,570    | 7,380  | 6,622  |
| Income tax expense                            | 1,879    | 1,587  | 1,463  |
| Net earnings                                  | 6,691    | 5,793  | 5,159  |
| Dividends and accretion of preferred stock    | 656      | 1,010  | 1,393  |
| Net earnings available to common shareholders | \$ 6,035 | 4,783  | 3,766  |
| Basic net earnings per common share           | \$ 1.08  | 0.86   | 0.68   |
| Diluted net earnings per common share         | \$ 1.07  | 0.86   | 0.68   |
| Cash dividends declared per common share      | \$ 0.12  | 0.18   | 0.08   |

See accompanying Notes to Consolidated Financial Statements.



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

## Consolidated Statements of Comprehensive Income (Loss)

For the Years Ended December 31, 2013, 2012 and 2011

(Dollars in thousands)

|                                                                                                 | 2013      | 2012     | 2011     |
|-------------------------------------------------------------------------------------------------|-----------|----------|----------|
| Net earnings                                                                                    | \$ 6,691  | 5,793    | 5,159    |
| Other comprehensive (loss) income:                                                              |           |          |          |
| Unrealized holding (losses) gains on securities available for sale                              | (10,498 ) | 5,371    | 9,316    |
| Reclassification adjustment for other than temporary impairment losses included in net earnings | -         | -        | 144      |
| Reclassification adjustment for gains on securities available for sale included in net earnings | (614 )    | (1,218 ) | (4,406 ) |
| Unrealized holding losses on derivative financial instruments qualifying as cash flow hedges    | -         | -        | (648 )   |
| Total other comprehensive (loss) income, before income taxes                                    | (11,112 ) | 4,153    | 4,406    |
| Income tax (benefit) expense related to other comprehensive (loss) income:                      |           |          |          |
| Unrealized holding (losses) gains on securities available for sale                              | (4,089 )  | 2,091    | 3,629    |
| Reclassification adjustment for gains on securities available for sale included in net earnings | (239 )    | (474 )   | (1,660 ) |
| Unrealized holding losses on derivative financial instruments qualifying as cash flow hedges    | -         | -        | (252 )   |
| Total income tax (benefit) expense related to                                                   |           |          |          |

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|                                                        |        |   |       |       |
|--------------------------------------------------------|--------|---|-------|-------|
| other comprehensive (loss) income                      | (4,328 | ) | 1,617 | 1,717 |
| Total other comprehensive (loss) income,<br>net of tax | (6,784 | ) | 2,536 | 2,689 |
| Total comprehensive (loss) income                      | \$ (93 | ) | 8,329 | 7,848 |

See accompanying Notes to Consolidated Financial Statements.

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

## Consolidated Statements of Changes in Shareholders' Equity

For the Years Ended December 31, 2013, 2012 and 2011

(Dollars in thousands)

|                                                              | Stock Shares |           | Stock Amount |        | Retained Earnings | Accumulated Other Comprehensive Income |           |
|--------------------------------------------------------------|--------------|-----------|--------------|--------|-------------------|----------------------------------------|-----------|
|                                                              | Preferred    | Common    | Preferred    | Common |                   | Total                                  | Total     |
| Balance, December 31, 2010                                   | 25,054       | 5,541,413 | \$ 24,617    | 48,281 | 23,573            | 387                                    | 96,858    |
| Accretion of Series A preferred stock                        | -            | -         | 141          | -      | (141 )            | -                                      | -         |
| Cash dividends declared on Series A preferred stock          | -            | -         | -            | -      | (1,253 )          | -                                      | (1,253 )  |
| Cash dividends declared on common stock                      | -            | -         | -            | -      | (443 )            | -                                      | (443 )    |
| Restricted stock payout                                      | -            | 2,747     | -            | 17     | -                 | -                                      | 17        |
| Net earnings                                                 | -            | -         | -            | -      | 5,159             | -                                      | 5,159     |
| Change in accumulated other comprehensive income, net of tax | -            | -         | -            | -      | -                 | 2,689                                  | 2,689     |
| Balance, December 31, 2011                                   | 25,054       | 5,544,160 | \$ 24,758    | 48,298 | 26,895            | 3,076                                  | 103,027   |
| Accretion of Series A preferred stock                        | -            | -         | 70           | -      | (70 )             | -                                      | -         |
| Preferred stock and warrant repurchase                       | (12,530 )    | -         | (12,304 )    | (704 ) | 886               | -                                      | (12,122 ) |
| Cash dividends declared on Series A preferred stock          | -            | -         | -            | -      | (1,023 )          | -                                      | (1,023 )  |
| Cash dividends declared on common stock                      | -            | -         | -            | -      | (1,003 )          | -                                      | (1,003 )  |
| Stock options exercised                                      | -            | 69,335    | -            | 539    | -                 | -                                      | 539       |
| Net earnings                                                 | -            | -         | -            | -      | 5,793             | -                                      | 5,793     |
| Change in accumulated other comprehensive income, net of tax | -            | -         | -            | -      | -                 | 2,536                                  | 2,536     |

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|                                                              |           |           |           |        |        |          |           |
|--------------------------------------------------------------|-----------|-----------|-----------|--------|--------|----------|-----------|
| Balance, December 31, 2012                                   | 12,524    | 5,613,495 | \$ 12,524 | 48,133 | 31,478 | 5,612    | 97,747    |
| Preferred stock repurchase                                   | (12,524 ) | -         | (12,524 ) | -      | -      | -        | (12,524 ) |
| Cash dividends declared on                                   |           |           |           |        |        |          |           |
| Series A preferred stock                                     | -         | -         | -         | -      | (734 ) | -        | (734 )    |
| Cash dividends declared on                                   |           |           |           |        |        |          |           |
| common stock                                                 | -         | -         | -         | -      | (677 ) | -        | (677 )    |
| Net earnings                                                 | -         | -         | -         | -      | 6,691  | -        | 6,691     |
| Change in accumulated other comprehensive income, net of tax | -         | -         | -         | -      | -      | (6,784 ) | (6,784 )  |
| Balance, December 31, 2013                                   | -         | 5,613,495 | \$ -      | 48,133 | 36,758 | (1,172 ) | 83,719    |

See accompanying Notes to Consolidated Financial Statements.

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

## Consolidated Statements of Cash Flows

For the Years Ended December 31, 2013, 2012 and 2011

(Dollars in thousands)

|                                                                                            | 2013          | 2012          | 2011          |
|--------------------------------------------------------------------------------------------|---------------|---------------|---------------|
| <b>Cash flows from operating activities:</b>                                               |               |               |               |
| Net earnings                                                                               | \$ 6,691      | 5,793         | 5,159         |
| <b>Adjustments to reconcile net earnings to net cash provided by operating activities:</b> |               |               |               |
| Depreciation, amortization and accretion                                                   | 8,453         | 8,876         | 6,226         |
| Provision for loan losses                                                                  | 2,584         | 4,924         | 12,632        |
| Deferred income taxes                                                                      | 534           | (213 )        | (678 )        |
| Gain on sale of investment securities                                                      | (614 )        | (1,218 )      | (4,406 )      |
| Write-down of investment securities                                                        | -             | -             | 144           |
| (Gain) loss on sale of other real estate                                                   | (14 )         | 98            | 272           |
| Write-down of other real estate                                                            | 595           | 1,038         | 1,050         |
| Restricted stock expense                                                                   | 173           | 42            | 7             |
| <b>Change in:</b>                                                                          |               |               |               |
| Mortgage loans held for sale                                                               | 6,425         | (1,776 )      | (1,332 )      |
| Cash surrender value of life insurance                                                     | (432 )        | (438 )        | (296 )        |
| Other assets                                                                               | 1,508         | (441 )        | 2,644         |
| Other liabilities                                                                          | 11,542        | 2,342         | 930           |
| <b>Net cash provided by operating activities</b>                                           | <b>37,445</b> | <b>19,027</b> | <b>22,352</b> |
| <b>Cash flows from investing activities:</b>                                               |               |               |               |
| Net change in certificates of deposit                                                      | -             | -             | 735           |
| Purchases of investment securities available for sale                                      | (98,129 )     | (88,304 )     | (208,863 )    |
| Proceeds from calls, maturities and paydowns of investment securities available for sale   | 63,597        | 63,225        | 54,041        |
| Proceeds from sales of investment securities available for sale                            | 17,463        | 47,076        | 110,978       |
| Purchases of other investments                                                             | -             | (493 )        | (215 )        |
| FHLB stock redemption                                                                      | 609           | 606           | 290           |
| Net change in loans                                                                        | (6,137 )      | 38,170        | 38,561        |
| Purchases of premises and equipment                                                        | (2,434 )      | (917 )        | (1,601 )      |
| Purchases of bank owned life insurance                                                     | -             | -             | (5,000 )      |
| Proceeds from sale of other real estate and repossessions                                  | 5,797         | 5,434         | 3,355         |

|                                                             |           |           |           |
|-------------------------------------------------------------|-----------|-----------|-----------|
| Net cash (used) provided by investing activities            | (19,234 ) | 64,797    | (7,719 )  |
| Cash flows from financing activities:                       |           |           |           |
| Net change in deposits                                      | 17,836    | (45,586 ) | (11,601 ) |
| Net change in demand notes payable to U.S. Treasury         | -         | -         | (1,600 )  |
| Net change in securities sold under agreement to repurchase | 10,818    | (5,022 )  | 5,506     |
| Proceeds from FHLB borrowings                               | 15,001    | 25,400    | 40,000    |
| Repayments of FHLB borrowings                               | (20,001 ) | (25,400 ) | (40,000 ) |
| Proceeds from FRB borrowings                                | 1         | 2         | 1         |
| Repayments of FRB borrowings                                | (1 )      | (2 )      | (1 )      |
| Preferred stock and warrant repurchase                      | (12,524 ) | (12,122 ) | -         |
| Restricted stock payout                                     | -         | -         | 17        |
| Stock options exercised                                     | -         | 539       | -         |
| Cash dividends paid on Series A preferred stock             | (734 )    | (1,023 )  | (1,253 )  |
| Cash dividends paid on common stock                         | (677 )    | (1,003 )  | (443 )    |
| Net cash provided (used) by financing activities            | 9,719     | (64,217 ) | (9,374 )  |
| Net change in cash and cash equivalents                     | 27,930    | 19,607    | 5,259     |
| Cash and cash equivalents at beginning of period            | 48,843    | 29,236    | 23,977    |
| Cash and cash equivalents at end of period                  | \$ 76,773 | 48,843    | 29,236    |

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

## Consolidated Statements of Cash Flows, continued

For the Years Ended December 31, 2013, 2012 and 2011

(Dollars in thousands)

|                                                                    | 2013        | 2012  | 2011     |
|--------------------------------------------------------------------|-------------|-------|----------|
| <b>Supplemental disclosures of cash flow information:</b>          |             |       |          |
| Cash paid during the year for:                                     |             |       |          |
| Interest                                                           | \$ 5,452    | 7,822 | 10,900   |
| Income taxes                                                       | \$ 2,256    | 2,013 | 283      |
| <b>Noncash investing and financing activities:</b>                 |             |       |          |
| Change in unrealized (loss) gain on investment securities          |             |       |          |
| available for sale, net                                            | \$ (6,784 ) | 2,536 | (3,087 ) |
| Change in unrealized gain on derivative financial instruments, net |             |       |          |
|                                                                    | \$ -        | -     | 398      |
| Transfer of loans to other real estate and repossessions           |             |       |          |
|                                                                    | \$ 2,353    | 6,323 | 10,787   |
| Financed portion of sale of other real estate                      |             |       |          |
|                                                                    | \$ 708      | 1,076 | 5,208    |
| Accretion of Series A preferred stock                              |             |       |          |
|                                                                    | \$ -        | 70    | 141      |
| Discount on preferred stock repurchased                            |             |       |          |
|                                                                    | \$ -        | 835   | -        |

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Summary of Significant Accounting Policies

Organization

Peoples Bancorp of North Carolina, Inc. (“Bancorp”) received regulatory approval to operate as a bank holding company on July 22, 1999, and became effective August 31, 1999. Bancorp is primarily regulated by the Board of Governors of the Federal Reserve System, and serves as the one-bank holding company for Peoples Bank (the “Bank”).

The Bank commenced business in 1912 upon receipt of its banking charter from the North Carolina State Banking Commission (the “SBC”). The Bank is primarily regulated by the SBC and the Federal Deposit Insurance Corporation (the “FDIC”) and undergoes periodic examinations by these regulatory agencies. The Bank, whose main office is in Newton, North Carolina, provides a full range of commercial and consumer banking services primarily in Catawba, Alexander, Lincoln, Mecklenburg, Iredell, Union and Wake counties in North Carolina.

Peoples Investment Services, Inc. is a wholly-owned subsidiary of the Bank and began operations in 1996 to provide investment and trust services through agreements with an outside party.

Real Estate Advisory Services, Inc. (“REAS”) is a wholly-owned subsidiary of the Bank and began operations in 1997 to provide real estate appraisal and property management services to individuals and commercial customers of the Bank.

Community Bank Real Estate Solutions, LLC is a wholly-owned subsidiary of Bancorp and began operations in 2009 as a “clearing house” for appraisal services for community banks. Other banks are able to contract with Community Bank Real Estate Solutions, LLC to find and engage appropriate appraisal companies in the area where the property is located.

Principles of Consolidation

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

Basis of Presentation

The accounting principles followed by the Company, and the methods of applying these principles, conform with accounting principles generally accepted in the United States of America (“GAAP”) and with general practices in the banking industry. In preparing the financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts in the financial statements. Actual results could differ significantly from these estimates. Material estimates common to the banking industry that are particularly susceptible to significant change in the near term include, but are not limited to, the determination of the allowance for loan losses and valuation of real estate acquired in connection with or in lieu of foreclosure on loans.

Cash and Cash Equivalents

Cash, due from banks and interest-bearing deposits are considered cash and cash equivalents for cash flow reporting purposes.

Investment Securities



There are three classifications the Company is able to classify its investment securities: trading, available for sale, or held to maturity. Trading securities are bought and held principally for sale in the near term. Held to maturity securities are those securities for which the Company has the ability and intent to hold until maturity. All other securities not included in trading or held to maturity are classified as available for sale. At December 31, 2013 and 2012, the Company classified all of its investment securities as available for sale.

Available for sale securities are recorded at fair value. Unrealized holding gains and losses, net of the related tax effect, are excluded from earnings and are reported as a separate component of shareholders' equity until realized.

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Management evaluates investment securities for other-than-temporary impairment on an annual basis. A decline in the market value of any investment below cost that is deemed other-than-temporary is charged to earnings for the decline in value deemed to be credit related and a new cost basis in the security is established. The decline in value attributed to non-credit related factors is recognized in comprehensive income.

Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to the yield. Realized gains and losses for securities classified as available for sale are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

#### Other Investments

Other investments include equity securities with no readily determinable fair value. These investments are carried at cost.

#### Mortgage Loans Held for Sale

Mortgage loans held for sale are carried at lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value.

#### Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are reported at the principal amount outstanding, net of the allowance for loan losses. Interest on loans is calculated by using the simple interest method on daily balances of the principal amount outstanding. The recognition of certain loan origination fee income and certain loan origination costs is deferred when such loans are originated and amortized over the life of the loan.

A loan is impaired when, based on current information and events, it is probable that all amounts due according to the contractual terms of the loan will not be collected. Impaired loans are measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or at the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent.

Accrual of interest is discontinued on a loan when management believes, after considering economic conditions and collection efforts, that the borrower's financial condition is such that collection of interest is doubtful. Interest previously accrued but not collected is reversed against current period earnings.

#### 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.

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

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

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

Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Bank's loan portfolio as of the date of the financial statements. Management believes it has established the allowance in accordance with GAAP and in consideration of the current economic environment. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the year ended December 31, 2013 as compared to the year ended December 31, 2012. Revisions, estimates and assumptions may be made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

Effective December 31, 2012, stated income mortgage loans from the Banco de la Gente division of the Bank were analyzed separately from other single family residential loans in the Bank's loan portfolio. These loans are first mortgage loans made to the Latino market, primarily in Mecklenburg and surrounding counties. These loans are non-traditional mortgages in that the customer normally did not have a credit history, so all credit information was accumulated by the loan officers. These loans were made as stated income loans rather than full documentation loans because the customer may not have had complete documentation on the income supporting the loan.

Various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require adjustments to the allowance based on their judgments of information available to them at the time of their examinations. Also, an independent loan review process further assists with evaluating credit quality and assessing potential performance issues.

#### Mortgage Banking Activities

Mortgage banking income represents net gains from the sale of mortgage loans and fees received from borrowers and loan investors related to the Bank's origination of single-family residential mortgage loans.

Mortgage loans serviced for others are not included in the accompanying balance sheets. The unpaid principal balances of mortgage loans serviced for others was approximately \$2.4 million, \$3.1 million and \$4.0 million at December 31, 2013, 2012 and 2011, respectively.

The Bank originates certain fixed rate mortgage loans and commits these loans for sale. The commitments to originate fixed rate mortgage loans and the commitments to sell these loans to a third party are both derivative contracts. The fair value of these derivative contracts is immaterial and has no effect on the recorded amounts in the financial statements.

#### Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed primarily using the straight-line method over the estimated useful lives of the assets. When assets are retired or otherwise disposed, the cost and related accumulated depreciation are removed from the accounts, and any gain or loss is reflected in earnings for the period. The cost of maintenance and repairs that do not improve or extend the useful life of the

respective asset is charged to earnings as incurred, whereas significant renewals and improvements are capitalized. The range of estimated useful lives for premises and equipment are generally as follows:

|                            |               |
|----------------------------|---------------|
| Buildings and improvements | 10 - 50 years |
| Furniture and equipment    | 3 - 10 years  |

#### Other Real Estate

Foreclosed assets include all assets received in full or partial satisfaction of a loan. Foreclosed assets are reported at fair value less estimated selling costs. Any write-downs at the time of foreclosure are charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management, and a valuation allowance is established if fair value declines below carrying value. Costs relating to the development and

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improvement of the property are capitalized. Revenues and expenses from operations are included in other expenses. Changes in the valuation allowance are included in loss on sale and write-down of other real estate. The balance of other real estate was \$1.7 million and \$6.3 million at December 31, 2013 and 2012, respectively.

#### Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Additionally, the recognition of future tax benefits, such as net operating loss carryforwards, is required to the extent that the realization of such benefits is more likely than not to occur. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which the assets and liabilities are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period that includes the enactment date.

In the event the future tax consequences of differences between the financial reporting bases and the tax bases of the Company's assets and liabilities results in a deferred tax asset, an evaluation of the probability of being able to realize the future benefits indicated by such asset is required. A valuation allowance is provided for the portion of the deferred tax asset when it is more likely than not that some portion or all of the deferred tax asset will not be realized. In assessing the realizability of a deferred tax asset, management considers the scheduled reversals of deferred tax liabilities, projected future taxable income, and tax planning strategies.

Tax effects from an uncertain tax position can be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more likely than not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Previously recognized tax positions that no longer meet the more likely than not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. The Company assessed the impact of this guidance and determined that it did not have a material impact on the Company's financial position, results of operations or disclosures.

#### Derivative Financial Instruments and Hedging Activities

In the normal course of business, the Company enters into derivative contracts to manage interest rate risk by modifying the characteristics of the related balance sheet instruments in order to reduce the adverse effect of changes in interest rates. All material derivative financial instruments are recorded at fair value in the financial statements. The fair value of derivative contracts related to the origination of fixed rate mortgage loans and the commitments to sell these loans to a third party is immaterial and has no effect on the recorded amounts in the financial statements.

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

On the date a derivative contract is entered into, the Company designates the derivative as a fair value hedge, a cash flow hedge, or a trading instrument. Changes in the fair value of instruments used as fair value hedges are accounted for in the earnings of the period simultaneous with accounting for the fair value change of the item being hedged. Changes in the fair value of the effective portion of cash flow hedges are accounted for in other comprehensive

income rather than earnings. Changes in fair value of instruments that are not intended as a hedge are accounted for in the earnings of the period of the change.

If a derivative instrument designated as a fair value hedge is terminated or the hedge designation removed, the difference between a hedged item's then carrying amount and its face amount is recognized into income over the original hedge period. Likewise, if a derivative instrument designated as a cash flow hedge is terminated or the hedge designation removed, related amounts accumulated in other accumulated comprehensive income are reclassified into earnings over the original hedge period during which the hedged item affects income.

The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm

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

The Company formally documents all hedging relationships, including an assessment that the derivative instruments are expected to be highly effective in offsetting the changes in fair values or cash flows of the hedged items.

#### Advertising Costs

Advertising costs are expensed as incurred.

#### Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan (the "1999 Plan") whereby certain stock-based rights, such as stock options, restricted stock and restricted stock units were granted to eligible directors and employees. The 1999 Plan expired on May 13, 2009 but still governs the rights and obligations of the parties for grants made thereunder.

Under the 1999 Plan, the Company granted incentive stock options to certain eligible employees in order that they may purchase Company stock at a price equal to the fair market value on the date of the grant. The options granted in 1999 vested over a five-year period. Options granted subsequent to 1999 vested over a three-year period. All options expire ten years after issuance. A summary of the stock option activity in the 1999 Plan is presented below:

#### Stock Option Activity For the Years Ended December 31, 2013, 2012 and 2011

|                                   | Shares    | Weighted<br>Average<br>Option<br>Price Per<br>Share | Weighted Average<br>Remaining<br>Contractual Term (in<br>years) | Aggregate<br>Intrinsic<br>Value<br>(Dollars in<br>thousands) |
|-----------------------------------|-----------|-----------------------------------------------------|-----------------------------------------------------------------|--------------------------------------------------------------|
| Outstanding, December 31,<br>2010 | 150,071   | \$ 8.32                                             |                                                                 |                                                              |
| Granted during the period         | -         | \$ -                                                |                                                                 |                                                              |
| Expired during the period         | (71,054 ) | \$ 8.71                                             |                                                                 |                                                              |
| Forfeited during the period       | -         | \$ -                                                |                                                                 |                                                              |
| Exercised during the period       | -         | \$ -                                                |                                                                 |                                                              |
| Outstanding, December 31,<br>2011 | 79,017    | \$ 7.97                                             |                                                                 |                                                              |
| Granted during the period         | -         | \$ -                                                |                                                                 |                                                              |
| Expired during the period         | -         | \$ -                                                |                                                                 |                                                              |
| Forfeited during the period       | (6,052 )  | \$ 8.89                                             |                                                                 |                                                              |
| Exercised during the period       | (69,335 ) | \$ 7.77                                             |                                                                 |                                                              |



|                                |       |    |       |      |          |
|--------------------------------|-------|----|-------|------|----------|
| Outstanding, December 31, 2012 | 3,630 | \$ | 10.31 |      |          |
| Granted during the period      | -     | \$ | -     |      |          |
| Expired during the period      | -     | \$ | -     |      |          |
| Forfeited during the period    | -     | \$ | -     |      |          |
| Exercised during the period    | -     | \$ | -     |      |          |
| Outstanding, December 31, 2013 | 3,630 | \$ | 10.31 | 0.35 | \$ 14.05 |
| Exercisable, December 31, 2013 | 3,630 | \$ | 10.31 | 0.35 | \$ 14.05 |

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Options outstanding at December 31, 2013 are exercisable at \$10.31. Such options have a weighted average remaining contractual life of less than one year. No options were granted during the years ended December 31, 2013, 2012 and 2011. No options were exercised during the years ended December 31, 2013 and 2011. 69,335 options were exercised during the year ended December 31, 2012.

In addition, under the 1999 Plan, the Company granted 3,000 restricted stock units in 2007 at a grant date fair value of \$17.40 per share. The Company granted 1,750 restricted stock units at a grant date fair value of \$12.80 per share during the third quarter of 2008 and 2,000 restricted stock units at a grant date fair value of \$11.37 per share during the fourth quarter of 2008. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (three years from the grant date for the grants of restricted stock units to date under the 1999 Plan). The amount of expense recorded each period reflects the changes in the Company's stock price during the period. As of December 31, 2013, there was no unrecognized compensation expense related to the 2007 and 2008 restricted stock unit grants granted under the 1999 Plan.

The Company also has an Omnibus Stock Ownership and Long Term Incentive Plan that was approved by shareholders on May 7, 2009 (the "2009 Plan") whereby certain stock-based rights, such as stock options, restricted stock, restricted stock units, performance units, stock appreciation rights or book value shares, may be granted to eligible directors and employees. A total of 303,691 shares are currently reserved for possible issuance under the 2009 Plan. All rights must be granted or awarded within ten years from the May 7, 2009 effective date of the 2009 Plan.

The Company granted 29,514 restricted stock units under the 2009 Plan at a grant date fair value of \$7.90 per share during the first quarter of 2012. 5,355 restricted stock units were forfeited by the executive officers of the Company as required by the agreement with the U.S. Department of the Treasury ("UST") in conjunction with the Company's participation in the Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP"). In July 2012, the Company granted 5,355 restricted stock units at a grant date fair value of \$8.25 per share. The Company granted 26,795 restricted stock units under the 2009 Plan at a grant date fair value of \$11.90 per share during the second quarter of 2013. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (five years from the grant date for the 2012 grants and four years from the grant date for the 2013 grants). The amount of expense recorded each period reflects the changes in the Company's stock price during the period. As of December 31, 2013, the total unrecognized compensation expense related to the restricted stock unit grants under the 2009 Plan was \$584,000.

The Company recognized compensation expense for restricted stock awards granted under the 2009 Plan of \$173,000 and \$42,000 for the years ended December 31, 2013 and 2012, respectively. The Company recognized compensation expense for restricted stock awards granted under the 1999 Plan of \$7,000 for the year ended December 31, 2011.

#### Net Earnings Per Share

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

The reconciliations of the amounts used in the computation of both "basic earnings per common share" and "diluted earnings per common share" for the years ended December 31, 2013, 2012 and 2011 are as follows:

|                                       |                                                        |                  |                     |
|---------------------------------------|--------------------------------------------------------|------------------|---------------------|
| For the year ended December 31, 2013: | Net Earnings<br>Available to<br>Common<br>Shareholders | Common<br>Shares | Per Share<br>Amount |
|---------------------------------------|--------------------------------------------------------|------------------|---------------------|

|                                   | (Dollars in thousands) |           |         |
|-----------------------------------|------------------------|-----------|---------|
| Basic earnings per common share   | \$ 6,035               | 5,613,495 | \$ 1.08 |
| Effect of dilutive securities:    |                        |           |         |
| Stock options                     | -                      | 9,725     |         |
| Diluted earnings per common share | \$ 6,035               | 5,623,220 | \$ 1.07 |

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|                                   | Net Earnings Available to Common Shareholders |               |                  |
|-----------------------------------|-----------------------------------------------|---------------|------------------|
|                                   | (Dollars in thousands)                        | Common Shares | Per Share Amount |
| Basic earnings per common share   | \$ 4,783                                      | 5,559,401     | \$0.86           |
| Effect of dilutive securities:    |                                               |               |                  |
| Stock options                     | -                                             | 3,206         |                  |
| Diluted earnings per common share | \$ 4,783                                      | 5,562,607     | \$0.86           |

|                                   | Net Earnings Available to Common Shareholders |               |                  |
|-----------------------------------|-----------------------------------------------|---------------|------------------|
|                                   | (Dollars in thousands)                        | Common Shares | Per Share Amount |
| Basic earnings per common share   | \$ 3,766                                      | 5,542,548     | \$0.68           |
| Effect of dilutive securities:    |                                               |               |                  |
| Stock options                     | -                                             | 1,301         |                  |
| Diluted earnings per common share | \$ 3,766                                      | 5,543,849     | \$0.68           |

#### Recent Accounting Pronouncements

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

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

#### Reclassification

Certain amounts in the 2011 and 2012 consolidated financial statements have been reclassified to conform to the 2013 presentation.

(2)

#### Investment Securities

Investment securities available for sale at December 31, 2013 and 2012 are as follows:

(Dollars in thousands)

|  | December 31, 2013 |                        |                         |                      |
|--|-------------------|------------------------|-------------------------|----------------------|
|  | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |

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

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(Dollars in thousands)

|                                       | December 31, 2012 |                        |                         |                      |
|---------------------------------------|-------------------|------------------------|-------------------------|----------------------|
|                                       | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Mortgage-backed securities            | \$ 146,755        | 1,875                  | 606                     | 148,024              |
| U.S. Government sponsored enterprises | 18,714            | 203                    | 80                      | 18,837               |
| State and political subdivisions      | 118,591           | 7,171                  | 104                     | 125,658              |
| Corporate bonds                       | 2,571             | 19                     | 4                       | 2,586                |
| Trust preferred securities            | 1,250             | -                      | -                       | 1,250                |
| Equity securities                     | 748               | 720                    | -                       | 1,468                |
| Total                                 | \$ 288,629        | 9,988                  | 794                     | 297,823              |

The current fair value and associated unrealized losses on investments in debt securities with unrealized losses at December 31, 2013 and 2012 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

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

(Dollars in thousands)

|                                       | December 31, 2012   |                   |                   |                   |            |                   |
|---------------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|                                       | Less than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|                                       | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| Mortgage-backed securities            | \$ 48,126           | 468               | 12,913            | 138               | 61,039     | 606               |
| U.S. Government sponsored enterprises | 3,402               | 80                | -                 | -                 | 3,402      | 80                |
| State and political subdivisions      | 9,490               | 104               | -                 | -                 | 9,490      | 104               |
| Corporate bonds                       | 1,035               | 4                 | -                 | -                 | 1,035      | 4                 |
| Total                                 | \$ 62,053           | 656               | 12,913            | 138               | 74,966     | 794               |

At December 31, 2013, unrealized losses in the investment securities portfolio relating to debt securities totaled \$5.9 million. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be

temporary. From the December 31, 2013 tables above, 80 out of 179 securities issued by state and political subdivisions contained unrealized losses, 28 out of 95 securities issued by U.S. Government sponsored enterprises, including mortgage-backed securities, contained unrealized losses, and three out of five securities issued by corporations contained unrealized losses. These unrealized losses are considered temporary because of acceptable financial condition and results of operations on each security and the repayment sources of principal and interest on U.S. Government sponsored enterprises, including mortgage-backed securities, are government backed.

The Company periodically evaluates its investments for any impairment which would be deemed other-than-temporary. No investment impairments were deemed other-than-temporary in 2013 or 2012. As part of its evaluation in 2011, the Company determined that the fair value of one equity security was less than the original cost of the investment and that the decline in fair value was not temporary in nature. As a result, the Company wrote down its investment by \$144,000. The remaining fair value of the investment at December 31, 2011 was approximately \$264,000.

The amortized cost and estimated fair value of investment securities available for sale at December 31, 2013, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

December 31, 2013

(Dollars in thousands)

|                            | Amortized<br>Cost | Estimated<br>Fair<br>Value |
|----------------------------|-------------------|----------------------------|
| Due within one year        | \$ 4,019          | 4,048                      |
| Due from one to five years | 31,725            | 32,103                     |
| Due from five to ten years | 119,313           | 115,878                    |
| Due after ten years        | 20,298            | 20,195                     |
| Mortgage-backed securities | 123,706           | 123,977                    |
| Equity securities          | 748               | 1,689                      |
| <b>Total</b>               | <b>\$ 299,809</b> | <b>297,890</b>             |

Proceeds from sales of securities available for sale during 2013 were \$17.5 million and resulted in gross gains of \$738,000 and gross losses of \$124,000. During 2012, the proceeds from sales of securities available for sale were \$47.1 million and resulted in gross gains of \$1.3 million and gross losses of \$103,000. During 2011, the proceeds from sales of securities available for sale were \$111.0 million and resulted in gross gains of \$4.4 million and gross losses of \$9,000.

Securities with a fair value of approximately \$86.0 million and \$73.9 million at December 31, 2013 and 2012, respectively, were pledged to secure public deposits, Federal Home Loan Bank of Atlanta ("FHLB") borrowings and for other purposes as required by law.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The table below presents the balance of securities available for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of December 31, 2013 and 2012.

(Dollars in thousands)

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

(Dollars in thousands)



|                                          | Fair Value<br>Measurements | December 31, 2012    |                      |                      |
|------------------------------------------|----------------------------|----------------------|----------------------|----------------------|
|                                          |                            | Level 1<br>Valuation | Level 2<br>Valuation | Level 3<br>Valuation |
| Mortgage-backed securities               | \$ 148,024                 | -                    | 148,024              | -                    |
| U.S. Government<br>sponsored enterprises | \$ 18,837                  | -                    | 18,837               | -                    |
| State and political subdivisions         | \$ 125,658                 | -                    | 125,658              | -                    |
| Corporate bonds                          | \$ 2,586                   | -                    | 2,586                | -                    |
| Trust preferred securities               | \$ 1,250                   | -                    | -                    | 1,250                |
| Equity securities                        | \$ 1,468                   | 1,468                | -                    | -                    |

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Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the year ended December 31, 2013.

(Dollars in thousands)

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

(3) Loans

Major classifications of loans at December 31, 2013 and 2012 are summarized as follows:

(Dollars in thousands)

|                                                                | December 31, 2013 | December 31, 2012 |
|----------------------------------------------------------------|-------------------|-------------------|
| Real estate loans                                              |                   |                   |
| Construction and land development                              | \$ 63,742         | 73,176            |
| Single-family residential                                      | 195,975           | 195,003           |
| Single-family residential -<br>Banco de la Gente stated income | 49,463            | 52,019            |
| Commercial                                                     | 209,287           | 200,633           |
| Multifamily and farmland                                       | 11,801            | 8,951             |
| Total real estate loans                                        | 530,268           | 529,782           |
| Loans not secured by real estate                               |                   |                   |
| Commercial loans                                               | 68,047            | 64,295            |
| Farm loans                                                     | 19                | 11                |
| Consumer loans                                                 | 9,593             | 10,148            |
| All other loans                                                | 13,033            | 15,738            |
| Total loans                                                    | 620,960           | 619,974           |
| Less allowance for loan losses                                 | 13,501            | 14,423            |
| Total net loans                                                | \$ 607,459        | 605,551           |

The Bank grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg, Union and Wake counties of North Carolina. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by improved and unimproved real estate, the value of which is dependent upon the real estate market. Risk characteristics of the major components of the Bank's loan portfolio are discussed below:

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- Construction and land development loans – The risk of loss is largely dependent on the initial estimate of whether the property’s value at completion equals or exceeds the cost of property construction and the availability of take-out financing. During the construction phase, a number of factors can result in delays or cost overruns. If the estimate is inaccurate or if actual construction costs exceed estimates, the value of the property securing the loan may be insufficient to ensure full repayment when completed through a permanent loan, sale of the property, or by seizure of collateral. As of December 31, 2013, construction and land development loans comprised approximately 10% of the Bank’s total loan portfolio.
- Single-family residential loans – Declining home sales volumes, decreased real estate values and higher than normal levels of unemployment could contribute to losses on these loans. As of December 31, 2013, single-family residential loans comprised approximately 40% of the Bank’s total loan portfolio, including Banco de la Gente single-family residential stated income loans which were approximately 8% of the Bank’s total loan portfolio.
- Commercial real estate loans – Repayment is dependent on income being generated in amounts sufficient to cover operating expenses and debt service. These loans also involve greater risk because they are generally not fully amortizing over a loan period, but rather have a balloon payment due at maturity. A borrower’s ability to make a balloon payment typically will depend on being able to either refinance the loan or timely sell the underlying property. As of December 31, 2013, commercial real estate loans comprised approximately 34% of the Bank’s total loan portfolio.
- Commercial loans – Repayment is generally dependent upon the successful operation of the borrower’s business. In addition, the collateral securing the loans may depreciate over time, be difficult to appraise, be illiquid, or fluctuate in value based on the success of the business. As of December 31, 2013, commercial loans comprised approximately 11% of the Bank’s total loan portfolio.

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

The following tables present an age analysis of past due loans, by loan type, as of December 31, 2013 and 2012:

December 31, 2013

(Dollars in thousands)

|                                      | Loans 30-89<br>Days Past<br>Due | Loans 90<br>or<br>More<br>Days<br>Past Due | Total<br>Past Due<br>Loans | Total<br>Current<br>Loans | Total<br>Loans | Accruing<br>Loans 90<br>or<br>More Days<br>Past Due |
|--------------------------------------|---------------------------------|--------------------------------------------|----------------------------|---------------------------|----------------|-----------------------------------------------------|
| Real estate loans                    |                                 |                                            |                            |                           |                |                                                     |
| Construction and land<br>development | \$ 3,416                        | 5,426                                      | 8,842                      | 54,900                    | 63,742         | -                                                   |
| Single-family residential            | 4,518                           | 1,555                                      | 6,073                      | 189,902                   | 195,975        | -                                                   |
| Single-family residential -          | 9,833                           | 1,952                                      | 11,785                     | 37,678                    | 49,463         | 881                                                 |

|                                  |           |       |        |         |         |     |
|----------------------------------|-----------|-------|--------|---------|---------|-----|
| Banco de la Gente stated income  |           |       |        |         |         |     |
| Commercial                       | 1,643     | 486   | 2,129  | 207,158 | 209,287 | -   |
| Multifamily and farmland         | 177       | -     | 177    | 11,624  | 11,801  | -   |
| Total real estate loans          | 19,587    | 9,419 | 29,006 | 501,262 | 530,268 | 881 |
| Loans not secured by real estate |           |       |        |         |         |     |
| Commercial loans                 | 424       | 29    | 453    | 67,594  | 68,047  | -   |
| Farm loans                       | -         | -     | -      | 19      | 19      | -   |
| Consumer loans                   | 181       | 3     | 184    | 9,409   | 9,593   | 1   |
| All other loans                  | -         | -     | -      | 13,033  | 13,033  | -   |
| Total loans                      | \$ 20,192 | 9,451 | 29,643 | 591,317 | 620,960 | 882 |

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December 31, 2012  
(Dollars in thousands)

|                                                             | Loans 30-89<br>Days Past<br>Due | Loans 90<br>or<br>More<br>Days<br>Past Due | Total<br>Past Due<br>Loans | Total<br>Current<br>Loans | Total<br>Loans | Accruing<br>Loans 90<br>or<br>More Days<br>Past Due |
|-------------------------------------------------------------|---------------------------------|--------------------------------------------|----------------------------|---------------------------|----------------|-----------------------------------------------------|
| <b>Real estate loans</b>                                    |                                 |                                            |                            |                           |                |                                                     |
| Construction and land development                           | \$ 1,280                        | 6,858                                      | 8,138                      | 65,038                    | 73,176         | -                                                   |
| Single-family residential                                   | 4,316                           | 1,548                                      | 5,864                      | 189,139                   | 195,003        | -                                                   |
| Single-family residential - Banco de la Gente stated income | 11,077                          | 3,659                                      | 14,736                     | 37,283                    | 52,019         | 2,378                                               |
| Commercial                                                  | 1,720                           | 1,170                                      | 2,890                      | 197,743                   | 200,633        | -                                                   |
| Multifamily and farmland                                    | 7                               | -                                          | 7                          | 8,944                     | 8,951          | -                                                   |
| Total real estate loans                                     | 18,400                          | 13,235                                     | 31,635                     | 498,147                   | 529,782        | 2,378                                               |
| <b>Loans not secured by real estate</b>                     |                                 |                                            |                            |                           |                |                                                     |
| Commercial loans                                            | 888                             | 66                                         | 954                        | 63,341                    | 64,295         | 23                                                  |
| Farm loans                                                  | -                               | -                                          | -                          | 11                        | 11             | -                                                   |
| Consumer loans                                              | 250                             | 10                                         | 260                        | 9,888                     | 10,148         | 2                                                   |
| All other loans                                             | -                               | -                                          | -                          | 15,738                    | 15,738         | -                                                   |
| Total loans                                                 | \$ 19,538                       | 13,311                                     | 32,849                     | 587,125                   | 619,974        | 2,403                                               |

The following table presents the Bank's non-accrual loans as of December 31, 2013 and 2012:

(Dollars in thousands)

|                                                             | December 31, 2013 | December 31, 2012 |
|-------------------------------------------------------------|-------------------|-------------------|
| <b>Real estate loans</b>                                    |                   |                   |
| Construction and land development                           | \$ 6,546          | 9,253             |
| Single-family residential                                   | 2,980             | 2,491             |
| Single-family residential - Banco de la Gente stated income | 1,990             | 2,232             |
| Commercial                                                  | 2,043             | 3,263             |
| Total real estate loans                                     | 13,559            | 17,239            |
| <b>Loans not secured by real estate</b>                     |                   |                   |
| Commercial loans                                            | 250               | 344               |
| Consumer loans                                              | 27                | 47                |
| Total                                                       | \$ 13,836         | 17,630            |

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

appraisals for other companies. Factors including the assumptions and techniques utilized by the appraiser are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. An allowance for each impaired loan that is non-collateral dependent is calculated based on the present value of projected cash flows. If the recorded investment in the impaired loan exceeds the present value of projected cash flows, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under \$250,000 are not individually evaluated for impairment, with the exception of the Bank's troubled debt restructured ("TDR") loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Accruing impaired loans were \$27.6 million and \$30.6 million at December 31, 2013 and 2012, respectively. Interest income recognized on accruing impaired loans was \$1.3 million and \$1.5 million for the years ended December 31, 2013 and 2012, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as non-accrual.

The following tables present the Bank's impaired loans as of December 31, 2013 and 2012:

(Dollars in thousands)

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

December 31, 2012

(Dollars in thousands)

|                                                             | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Investment<br>With<br>Allowance | Recorded<br>Investment<br>in Impaired<br>Loans | Related<br>Allowance | Average<br>Outstanding<br>Impaired<br>Loans |
|-------------------------------------------------------------|-----------------------------------------------|------------------------------------------------|---------------------------------------------|------------------------------------------------|----------------------|---------------------------------------------|
| <b>Real estate loans</b>                                    |                                               |                                                |                                             |                                                |                      |                                             |
| Construction and land development                           | \$ 17,738                                     | 11,795                                         | 680                                         | 12,475                                         | 61                   | 12,810                                      |
| Single-family residential                                   | 9,099                                         | 766                                            | 7,799                                       | 8,565                                          | 177                  | 7,590                                       |
| Single-family residential - Banco de la Gente stated income | 21,806                                        | -                                              | 21,000                                      | 21,000                                         | 1,278                | 21,158                                      |
| Commercial                                                  | 5,830                                         | 4,569                                          | 467                                         | 5,036                                          | 6                    | 5,433                                       |
| Multifamily and farmland                                    | 193                                           | -                                              | 193                                         | 193                                            | 1                    | 200                                         |
| Total impaired real estate loans                            | 54,666                                        | 17,130                                         | 30,139                                      | 47,269                                         | 1,523                | 47,191                                      |
| <b>Loans not secured by real estate</b>                     |                                               |                                                |                                             |                                                |                      |                                             |
| Commercial loans                                            | 983                                           | 347                                            | 592                                         | 939                                            | 12                   | 1,125                                       |
| Consumer loans                                              | 68                                            | -                                              | 66                                          | 66                                             | 1                    | 41                                          |



|                      |    |        |        |        |        |       |        |
|----------------------|----|--------|--------|--------|--------|-------|--------|
| Total impaired loans | \$ | 55,717 | 17,477 | 30,797 | 48,274 | 1,536 | 48,357 |
|----------------------|----|--------|--------|--------|--------|-------|--------|

The fair value measurements for impaired loans and other real estate on a non-recurring basis at December 31, 2013 and 2012 are presented below. The fair value measurement process uses certified appraisals and other market-based information; however, in many cases, it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral, and other matters. As a result, all fair value measurements for impaired loans and other real estate are considered Level 3.

(Dollars in thousands)

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

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(Dollars in thousands)

|                   | Fair Value Measurements<br>December 31, 2012 | Level 1<br>Valuation | Level 2<br>Valuation | Level 3<br>Valuation | Total Gains/(Losses)<br>for<br>the Year Ended<br>December 31, 2012 |
|-------------------|----------------------------------------------|----------------------|----------------------|----------------------|--------------------------------------------------------------------|
| Impaired loans    | \$ 46,738                                    | -                    | -                    | 46,738               | (6,875 )                                                           |
| Other real estate | \$ 6,254                                     | -                    | -                    | 6,254                | (1,136 )                                                           |

Changes in the allowance for loan losses for the year ended December 31, 2013 were as follows:

(Dollars in thousands)

|                                                                      | Construction<br>and<br>Land<br>Development | Single-<br>Family<br>Residential | Real Estate Loans<br>Single-<br>Family<br>Residential<br>- Banco de<br>la Gente<br>Stated<br>Income | Commercial | Multifamily<br>and<br>Farmland | Commercial<br>Farm | Consumer<br>and All<br>Other | Unallocated | Total |          |
|----------------------------------------------------------------------|--------------------------------------------|----------------------------------|-----------------------------------------------------------------------------------------------------|------------|--------------------------------|--------------------|------------------------------|-------------|-------|----------|
| Allowance<br>for loan<br>losses:                                     |                                            |                                  |                                                                                                     |            |                                |                    |                              |             |       |          |
| Beginning<br>balance                                                 | \$4,399                                    | 3,231                            | 1,998                                                                                               | 2,049      | 28                             | 1,088              | -                            | 245         | 1,385 | 14,423   |
| Charge-offs                                                          | (777 )                                     | (1,724 )                         | (272 )                                                                                              | (445 )     | -                              | (502 )             | -                            | (652 )      | -     | (4,372 ) |
| Recoveries                                                           | 377                                        | 111                              | 141                                                                                                 | 50         | -                              | 44                 | -                            | 143         | -     | 866      |
| Provision                                                            | (781 )                                     | 1,505                            | (4 )                                                                                                | 565        | 9                              | 439                | -                            | 509         | 342   | 2,584    |
| Ending<br>balance                                                    | \$3,218                                    | 3,123                            | 1,863                                                                                               | 2,219      | 37                             | 1,069              | -                            | 245         | 1,727 | 13,501   |
| Ending<br>balance:<br>individually<br>evaluated<br>for<br>impairment | \$-                                        | 39                               | 1,268                                                                                               | 171        | -                              | -                  | -                            | -           | -     | 1,478    |
| Ending<br>balance:<br>collectively<br>evaluated<br>for<br>impairment | 3,218                                      | 3,084                            | 595                                                                                                 | 2,048      | 37                             | 1,069              | -                            | 245         | 1,727 | 12,023   |
| Ending<br>balance                                                    | \$3,218                                    | 3,123                            | 1,863                                                                                               | 2,219      | 37                             | 1,069              | -                            | 245         | 1,727 | 13,501   |
| Loans:                                                               |                                            |                                  |                                                                                                     |            |                                |                    |                              |             |       |          |
|                                                                      | \$63,742                                   | 195,975                          | 49,463                                                                                              | 209,287    | 11,801                         | 68,047             | 19                           | 22,626      | -     | 620,960  |

Ending  
balance

Ending  
balance:  
individually  
evaluated  
for

|            |         |       |        |       |   |     |   |     |   |        |
|------------|---------|-------|--------|-------|---|-----|---|-----|---|--------|
| impairment | \$6,293 | 3,127 | 19,958 | 3,767 | - | 256 | - | 265 | - | 33,666 |
|------------|---------|-------|--------|-------|---|-----|---|-----|---|--------|

Ending  
balance:  
collectively  
evaluated  
for

|            |          |         |        |         |        |        |    |        |   |         |
|------------|----------|---------|--------|---------|--------|--------|----|--------|---|---------|
| impairment | \$57,449 | 192,848 | 29,505 | 205,520 | 11,801 | 67,791 | 19 | 22,361 | - | 587,294 |
|------------|----------|---------|--------|---------|--------|--------|----|--------|---|---------|

Changes in the allowance for loan losses for the year ended December 31, 2012 were as follows:

(Dollars in thousands)

|                                                        | Construction<br>and<br>Land<br>Development | Single-<br>Family<br>Residential | Real Estate Loans<br>Single-<br>Family<br>Residential<br>- Banco de<br>la Gente<br>Stated<br>Income | Commercial | Multifamily<br>and<br>Farmland | Commercial<br>Farm | Consumer<br>and All<br>Other | Unallocated | Total |         |
|--------------------------------------------------------|--------------------------------------------|----------------------------------|-----------------------------------------------------------------------------------------------------|------------|--------------------------------|--------------------|------------------------------|-------------|-------|---------|
| Allowance<br>for loan<br>losses:                       |                                            |                                  |                                                                                                     |            |                                |                    |                              |             |       |         |
| Beginning<br>balance                                   | \$7,182                                    | 3,253                            | 2,104                                                                                               | 1,731      | 13                             | 1,029              | -                            | 255         | 1,037 | 16,604  |
| Charge-offs                                            | (4,728)                                    | (886)                            | (668)                                                                                               | (937)      | -                              | (555)              | -                            | (557)       | -     | (8,331) |
| Recoveries                                             | 528                                        | 72                               | -                                                                                                   | 374        | -                              | 104                | -                            | 148         | -     | 1,226   |
| Provision                                              | 1,417                                      | 792                              | 562                                                                                                 | 881        | 15                             | 510                | -                            | 399         | 348   | 4,924   |
| Ending<br>balance                                      | \$4,399                                    | 3,231                            | 1,998                                                                                               | 2,049      | 28                             | 1,088              | -                            | 245         | 1,385 | 14,423  |
| Ending<br>balance:<br>individually<br>evaluated<br>for |                                            |                                  |                                                                                                     |            |                                |                    |                              |             |       |         |
| impairment                                             | \$24                                       | 84                               | 1,254                                                                                               | -          | -                              | -                  | -                            | -           | -     | 1,362   |
| Ending<br>balance:<br>collectively<br>evaluated<br>for |                                            |                                  |                                                                                                     |            |                                |                    |                              |             |       |         |
| impairment                                             | 4,375                                      | 3,147                            | 744                                                                                                 | 2,049      | 28                             | 1,088              | -                            | 245         | 1,385 | 13,061  |
|                                                        | \$4,399                                    | 3,231                            | 1,998                                                                                               | 2,049      | 28                             | 1,088              | -                            | 245         | 1,385 | 14,423  |

Ending  
balance

Loans:

Ending  
balance

|          |         |        |         |       |        |    |        |   |         |
|----------|---------|--------|---------|-------|--------|----|--------|---|---------|
| \$73,176 | 195,003 | 52,019 | 200,633 | 8,951 | 64,295 | 11 | 25,886 | - | 619,977 |
|----------|---------|--------|---------|-------|--------|----|--------|---|---------|

Ending  
balance:  
individually  
evaluated  
for

impairment

|          |       |        |       |   |     |   |   |   |        |
|----------|-------|--------|-------|---|-----|---|---|---|--------|
| \$11,961 | 3,885 | 20,024 | 4,569 | - | 346 | - | - | - | 40,785 |
|----------|-------|--------|-------|---|-----|---|---|---|--------|

Ending  
balance:  
collectively  
evaluated  
for

impairment

|          |         |        |         |       |        |    |        |   |         |
|----------|---------|--------|---------|-------|--------|----|--------|---|---------|
| \$61,215 | 191,118 | 31,995 | 196,064 | 8,951 | 63,949 | 11 | 25,886 | - | 579,188 |
|----------|---------|--------|---------|-------|--------|----|--------|---|---------|

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Changes in the allowance for loan losses for the year ended December 31, 2011 were as follows:

(Dollars in thousands)

|                                                                      | Construction<br>and<br>Land<br>Development | Single-<br>Family<br>Residential | Real Estate Loans<br>Single-<br>Family<br>Residential<br>- Banco de<br>la Gente<br>Stated<br>Income | Commercial | Multifamily<br>and<br>Farmland | Commercial | Consumer<br>and All<br>Other | Unallocated | Total    |
|----------------------------------------------------------------------|--------------------------------------------|----------------------------------|-----------------------------------------------------------------------------------------------------|------------|--------------------------------|------------|------------------------------|-------------|----------|
| Allowance<br>for loan<br>losses:                                     |                                            |                                  |                                                                                                     |            |                                |            |                              |             |          |
| Beginning<br>balance                                                 | \$5,774                                    | 3,992                            | 2,105                                                                                               | 1,409      | 17                             | 1,174      | 430                          | 592         | 15,493   |
| Charge-offs                                                          | (7,164)                                    | (2,233)                          | (692)                                                                                               | (1,271)    | -                              | (314)      | (586)                        | -           | (12,260) |
| Recoveries                                                           | 241                                        | 184                              | 17                                                                                                  | 24         | -                              | 121        | 152                          | -           | 739      |
| Provision                                                            | 8,331                                      | 1,310                            | 674                                                                                                 | 1,569      | (4)                            | 48         | 259                          | 445         | 12,632   |
| Ending<br>balance                                                    | \$7,182                                    | 3,253                            | 2,104                                                                                               | 1,731      | 13                             | 1,029      | 255                          | 1,037       | 16,604   |
| Ending<br>balance:<br>individually<br>evaluated<br>for<br>impairment | \$1,250                                    | 46                               | 1,243                                                                                               | -          | -                              | -          | -                            | -           | 2,539    |
| Ending<br>balance:<br>collectively<br>evaluated for<br>impairment    | 5,932                                      | 3,207                            | 861                                                                                                 | 1,731      | 13                             | 1,029      | 255                          | 1,037       | 14,065   |
| Ending<br>balance                                                    | \$7,182                                    | 3,253                            | 2,104                                                                                               | 1,731      | 13                             | 1,029      | 255                          | 1,037       | 16,604   |
| Loans:<br>Ending<br>balance                                          | \$93,812                                   | 212,993                          | 54,058                                                                                              | 214,415    | 4,793                          | 60,646     | 29,780                       | -           | 670,497  |
| Ending<br>balance:<br>individually<br>evaluated<br>for<br>impairment | \$20,280                                   | 2,352                            | 18,309                                                                                              | 3,845      | -                              | -          | -                            | -           | 44,786   |

Ending  
balance:  
collectively  
evaluated  
for

|            |          |         |        |         |       |        |        |   |         |
|------------|----------|---------|--------|---------|-------|--------|--------|---|---------|
| impairment | \$73,532 | 210,641 | 35,749 | 210,570 | 4,793 | 60,646 | 29,780 | - | 625,711 |
|------------|----------|---------|--------|---------|-------|--------|--------|---|---------|

The Company utilizes an internal risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 1 to 8. These risk grades are evaluated on an ongoing basis. The Low Substandard risk grade was removed from the Company's internal risk grading matrix during the first quarter of 2013. No loans were classified Low Substandard at December 31, 2012. A description of the general characteristics of the eight risk grades is as follows:

- Risk Grade 1 – Excellent Quality: Loans are well above average quality and a minimal amount of credit risk exists. CD or cash secured loans or properly margined actively traded stock or bond secured loans would fall in this grade.
- Risk Grade 2 – High Quality: Loans are of good quality with risk levels well within the Company's range of acceptability. The organization or individual is established with a history of successful performance though somewhat susceptible to economic changes.
- Risk Grade 3 – Good Quality: Loans of average quality with risk levels within the Company's range of acceptability but higher than normal. This may be a new organization or an existing organization in a transitional phase (e.g. expansion, acquisition, market change).
- Risk Grade 4 – Management Attention: These loans have higher risk and servicing needs but still are acceptable. Evidence of marginal performance or deteriorating trends is observed. These are not problem credits presently, but may be in the future if the borrower is unable to change its present course.
- Risk Grade 5 – Watch: These loans are currently performing satisfactorily, but there has been some recent past due history on repayment and there are potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Company's position at some future date.
- Risk Grade 6 – Substandard: A Substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or the collateral pledged (if there is any). There is a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.
- Risk Grade 7 – Doubtful: Loans classified as Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.
- Risk Grade 8 – Loss: Loans classified as Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be realized in the future. Loss is a temporary grade until the appropriate authority is obtained to charge the loan off.

The following tables present the credit risk profile of each loan type based on internally assigned risk grades as of December 31, 2013 and 2012.

December 31, 2013  
(Dollars in thousands)

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

December 31, 2012  
(Dollars in thousands)

|                      | Real Estate Loans                 |                           |                                                             |            |                          |                 |          |           |        | Total   |
|----------------------|-----------------------------------|---------------------------|-------------------------------------------------------------|------------|--------------------------|-----------------|----------|-----------|--------|---------|
|                      | Construction and Land Development | Single-Family Residential | Single-Family Residential - Banco de la Gente Stated Income | Commercial | Multifamily and Farmland | Commercial Farm | Consumer | All Other |        |         |
| 1- Excellent Quality | \$11                              | 24,662                    | -                                                           | -          | -                        | 672             | -        | 1,239     | -      | 26,584  |
| 2- High Quality      | 4,947                             | 56,829                    | -                                                           | 27,511     | 32                       | 9,260           | -        | 4,122     | 2,317  | 105,018 |
| 3- Good Quality      | 24,952                            | 62,018                    | 24,724                                                      | 114,001    | 4,975                    | 40,814          | 11       | 4,186     | 13,416 | 289,097 |

|                               |          |         |        |         |       |        |    |        |        |         |
|-------------------------------|----------|---------|--------|---------|-------|--------|----|--------|--------|---------|
| 4-<br>Management<br>Attention | 18,891   | 35,727  | 11,366 | 47,603  | 3,039 | 11,844 | -  | 392    | 5      | 128,867 |
| 5- Watch                      | 9,580    | 9,504   | 3,597  | 6,911   | 712   | 976    | -  | 134    | -      | 31,414  |
| 6-<br>Substandard             | 14,795   | 6,263   | 12,332 | 4,607   | 193   | 729    | -  | 70     | -      | 38,989  |
| 7- Low<br>Substandard         | -        | -       | -      | -       | -     | -      | -  | -      | -      | -       |
| 8- Doubtful                   | -        | -       | -      | -       | -     | -      | -  | -      | -      | -       |
| 9- Loss                       | -        | -       | -      | -       | -     | -      | -  | 5      | -      | 5       |
| Total                         | \$73,176 | 195,003 | 52,019 | 200,633 | 8,951 | 64,295 | 11 | 10,148 | 15,738 | 619,974 |

Total TDR loans amounted to \$21.9 million and \$23.9 million at December 31, 2013 and 2012, respectively. The terms of these loans have been renegotiated to provide a reduction in principal or interest as a result of the deteriorating financial position of the borrower. There were \$335,000 and \$2.0 million in performing loans classified as TDR loans at December 31, 2013 and 2012, respectively.



The following table presents an analysis of TDR loans by loan type as of December 31, 2013.

December 31, 2013  
(Dollars in thousands)

|                                                                | Number of<br>Contracts | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
|----------------------------------------------------------------|------------------------|-----------------------------------------------------------|------------------------------------------------------------|
| <b>Real estate loans</b>                                       |                        |                                                           |                                                            |
| Construction and land development                              | 15                     | \$ 10,222                                                 | 6,528                                                      |
| Single-family residential                                      | 20                     | 1,281                                                     | 1,754                                                      |
| Single-family residential -<br>Banco de la Gente stated income | 91                     | 10,038                                                    | 8,605                                                      |
| Commercial                                                     | 10                     | 3,775                                                     | 4,272                                                      |
| Multifamily and farmland                                       | 1                      | 322                                                       | 177                                                        |
| Total real estate TDR loans                                    | 137                    | 25,638                                                    | 21,336                                                     |
| <b>Loans not secured by real estate</b>                        |                        |                                                           |                                                            |
| Commercial loans                                               | 7                      | 519                                                       | 344                                                        |
| Consumer loans                                                 | 3                      | 284                                                       | 266                                                        |
| Total TDR loans                                                | 147                    | \$ 26,441                                                 | 21,946                                                     |

The following table presents an analysis of 2013 loan modifications included in the December 31, 2013 TDR table above.

Year ended December 31, 2013  
(Dollars in thousands)

|                                                                | Number of<br>Contracts | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
|----------------------------------------------------------------|------------------------|-----------------------------------------------------------|------------------------------------------------------------|
| <b>Real estate loans</b>                                       |                        |                                                           |                                                            |
| Construction and land development                              | 2                      | \$ 841                                                    | 824                                                        |
| Single-family residential -<br>Banco de la Gente stated income | 7                      | 796                                                       | 788                                                        |
| Total real estate TDR loans                                    | 9                      | 1,637                                                     | 1,612                                                      |
| Total TDR loans                                                | 9                      | \$ 1,637                                                  | 1,612                                                      |

The following table presents an analysis of TDR loans by loan type as of December 31, 2012.

December 31, 2012  
(Dollars in thousands)

|                                   | Number of<br>Contracts | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
|-----------------------------------|------------------------|-----------------------------------------------------------|------------------------------------------------------------|
| <b>Real estate loans</b>          |                        |                                                           |                                                            |
| Construction and land development | 11                     | \$ 10,465                                                 | 6,633                                                      |

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|                                                                |     |           |        |
|----------------------------------------------------------------|-----|-----------|--------|
| Single-family residential                                      | 33  | 3,014     | 4,084  |
| Single-family residential -<br>Banco de la Gente stated income | 122 | 13,459    | 12,170 |
| Commercial                                                     | 4   | 1,457     | 682    |
| Multifamily and farmland                                       | -   | -         | -      |
| Total real estate TDR loans                                    | 170 | 28,395    | 23,569 |
| Loans not secured by real estate                               |     |           |        |
| Commercial loans                                               | 9   | 511       | 368    |
| Consumer loans                                                 | 1   | 2         | -      |
| Total TDR loans                                                | 180 | \$ 28,908 | 23,937 |

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The following table presents an analysis of 2012 loan modifications included in the December 31, 2012 TDR table above.

Year ended December 31, 2012  
(Dollars in thousands)

|                                         | Number of<br>Contracts | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
|-----------------------------------------|------------------------|-----------------------------------------------------------|------------------------------------------------------------|
| <b>Real estate loans</b>                |                        |                                                           |                                                            |
| Single-family residential               | 5                      | \$ 674                                                    | 673                                                        |
| <b>Single-family residential -</b>      |                        |                                                           |                                                            |
| Banco de la Gente stated income         | 20                     | 2,046                                                     | 1,992                                                      |
| <b>Total real estate TDR loans</b>      | <b>25</b>              | <b>2,720</b>                                              | <b>2,665</b>                                               |
| <b>Loans not secured by real estate</b> |                        |                                                           |                                                            |
| Commercial loans                        | 1                      | 14                                                        | 13                                                         |
| <b>Total TDR loans</b>                  | <b>26</b>              | <b>\$ 2,734</b>                                           | <b>2,678</b>                                               |

(4) Premises and Equipment

Major classifications of premises and equipment are summarized as follows:

(Dollars in thousands)

|                                         | 2013             | 2012          |
|-----------------------------------------|------------------|---------------|
| <b>Land</b>                             | <b>\$ 3,667</b>  | <b>3,657</b>  |
| Buildings and improvements              | 15,126           | 14,815        |
| Furniture and equipment                 | 16,239           | 17,660        |
| <b>Total premises and equipment</b>     | <b>35,032</b>    | <b>36,132</b> |
| <b>Less accumulated depreciation</b>    | <b>18,674</b>    | <b>20,258</b> |
| <b>Total net premises and equipment</b> | <b>\$ 16,358</b> | <b>15,874</b> |

Depreciation expense was approximately \$1.9 million for the years ended December 31, 2013 and 2012. The Company recognized approximately \$2.0 million in depreciation expense for the year ended December 31, 2011.

(5) Time Deposits

At December 31, 2013, the scheduled maturities of time deposits are as follows:

(Dollars in thousands)

|      |            |
|------|------------|
| 2014 | \$ 127,036 |
| 2015 | 48,913     |
| 2016 | 22,318     |
| 2017 | 10,155     |

|                     |            |
|---------------------|------------|
| 2018 and thereafter | 8,781      |
| Total               | \$ 217,203 |

At December 31, 2013 and 2012, the Company had approximately \$15.1 million and \$21.4 million, respectively, in time deposits purchased through third party brokers, including certificates of deposit participated through the Certificate of Deposit Account Registry Service (“CDARS”) on behalf of local customers. CDARS balances totaled \$15.1 million and \$20.1 million as of December 31, 2013 and 2012, respectively. The weighted average rate of brokered deposits as of December 31, 2013 and 2012 was 0.14% and 0.29%, respectively.

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## (6) Federal Home Loan Bank and Federal Reserve Bank Borrowings

The Bank has borrowings from the FHLB with monthly or quarterly interest payments at December 31, 2013. The FHLB borrowings are collateralized by a blanket assignment on all residential first mortgage loans, home equity lines of credit and loans secured by multi-family real estate that the Bank owns. At December 31, 2013, the carrying value of loans pledged as collateral totaled approximately \$132.9 million. As additional collateral, the Bank has pledged securities to the FHLB. At December 31, 2013, the market value of securities pledged to the FHLB totaled \$17.3 million.

Borrowings from the FHLB outstanding at December 31, 2013 consist of the following:

(Dollars in thousands)

| Maturity Date     | Call Date | Rate   | Rate Type              | Amount    |
|-------------------|-----------|--------|------------------------|-----------|
| March 25, 2019    | N/A       | 4.260% | Convertible            | 5,000     |
| November 12, 2014 | N/A       | 2.230% | Fixed Rate Hybrid      | 5,000     |
| October 17, 2016  | N/A       | 3.734% | Adjustable Rate Hybrid | 5,000     |
| October 17, 2018  | N/A       | 3.414% | Adjustable Rate Hybrid | 5,000     |
| October 17, 2018  | N/A       | 3.654% | Adjustable Rate Hybrid | 15,000    |
| October 17, 2018  | N/A       | 3.429% | Adjustable Rate Hybrid | 5,000     |
| October 17, 2018  | N/A       | 3.484% | Adjustable Rate Hybrid | 5,000     |
| May 8, 2018       | N/A       | 1.799% | Floating to Fixed      | 5,000     |
| May 8, 2018       | N/A       | 3.439% | Floating to Fixed      | 15,000    |
|                   |           |        |                        | \$ 65,000 |

The Bank is required to purchase and hold certain amounts of FHLB stock in order to obtain FHLB borrowings. No ready market exists for the FHLB stock, and it has no quoted market value. The stock is redeemable at \$100 per share subject to certain limitations set by the FHLB. The Bank owned \$4.1 million and \$4.7 million of FHLB stock at December 31, 2013 and 2012, respectively.

As of December 31, 2013 and 2012, the Bank had no borrowings from the Federal Reserve Bank (“FRB”). FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At December 31, 2013, the carrying value of loans pledged as collateral totaled approximately \$315.2 million.

## (7) Junior Subordinated Debentures

In June 2006, the Company formed a second wholly-owned Delaware statutory trust, PEBK Capital Trust II (“PEBK Trust II”), which issued \$20.0 million of guaranteed preferred beneficial interests in the Company’s junior subordinated

deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase \$20.6 million of junior subordinated debentures of the Company. The proceeds received by the Company from the sale of the junior subordinated debentures were used to repay in December 2006 the trust preferred securities issued in December 2001 by PEBK Capital Trust, a wholly-owned Delaware statutory trust of the Company, and for general purposes. The debentures represent the sole assets of PEBK Trust II. PEBK Trust II is not included in the consolidated financial statements.

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

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

(8) **Income Taxes**

The provision for income taxes is summarized as follows:

(Dollars in thousands)

|          | 2013     | 2012   | 2011   |
|----------|----------|--------|--------|
| Current  | \$ 1,345 | 1,800  | 2,141  |
| Deferred | 534      | (213 ) | (678 ) |
| Total    | \$ 1,879 | 1,587  | 1,463  |

The differences between the provision for income taxes and the amount computed by applying the statutory federal income tax rate to earnings before income taxes are as follows:

(Dollars in thousands)

|                                          | 2013     | 2012     | 2011     |
|------------------------------------------|----------|----------|----------|
| Pre-tax income at statutory rate (34%)   | \$ 2,914 | 2,509    | 2,251    |
| Differences:                             |          |          |          |
| Tax exempt interest income               | (1,481 ) | (1,168 ) | (1,052 ) |
| Nondeductible interest and other expense | 141      | 52       | 62       |
| Cash surrender value of life insurance   | (147 )   | (149 )   | (101 )   |
| State taxes, net of federal benefits     | 428      | 324      | 233      |
| Nondeductible capital losses             | -        | -        | 49       |
| Other, net                               | 24       | 19       | 21       |
| Total                                    | \$ 1,879 | 1,587    | 1,463    |

The following summarizes the tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities. The net deferred tax asset is included as a component of other assets at December 31, 2013 and 2012.

(Dollars in thousands)

|                                                  | 2013     | 2012  |
|--------------------------------------------------|----------|-------|
| Deferred tax assets:                             |          |       |
| Allowance for loan losses                        | \$ 5,205 | 5,560 |
| Accrued retirement expense                       | 1,489    | 1,409 |
| Other real estate                                | 218      | 628   |
| Other                                            | 413      | 362   |
| Unrealized loss on available for sale securities | 747      | -     |
| Total gross deferred tax assets                  | 8,072    | 7,959 |
| Deferred tax liabilities:                        |          |       |
| Deferred loan fees                               | 581      | 794   |
| Premises and equipment                           | 530      | 417   |
| Unrealized gain on available for sale securities | -        | 3,581 |

|                                      |          |       |
|--------------------------------------|----------|-------|
| Total gross deferred tax liabilities | 1,111    | 4,792 |
| Net deferred tax asset               | \$ 6,961 | 3,167 |

(9) Related Party Transactions

The Company conducts transactions with its directors and executive officers, including companies in which they have beneficial interests, in the normal course of business. It is the policy of the Bank that loan transactions with directors and officers are made on substantially the same terms as those prevailing at the time made for comparable loans to other persons. The following is a summary of activity for related party loans for 2013:

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(Dollars in thousands)

|                   |          |
|-------------------|----------|
| Beginning balance | \$ 5,385 |
| New loans         | 3,409    |
| Repayments        | (4,454 ) |
| Ending balance    | \$ 4,340 |

At December 31, 2013 and 2012, the Bank had deposit relationships with related parties of approximately \$17.6 million and \$13.9 million, respectively.

## (10) Commitments and Contingencies

The Company leases various office spaces for banking and operational facilities and equipment under operating lease arrangements. Future minimum lease payments required for all operating leases having a remaining term in excess of one year at December 31, 2013 are as follows:

(Dollars in thousands)

|                          |          |
|--------------------------|----------|
| Year ending December 31, |          |
| 2014                     | \$ 549   |
| 2015                     | 517      |
| 2016                     | 519      |
| 2017                     | 469      |
| 2018                     | 436      |
| Thereafter               | 1,253    |
| Total minimum obligation | \$ 3,743 |

Total rent expense was approximately \$672,000, \$643,000 and \$735,000 for the years ended December 31, 2013, 2012 and 2011, respectively.

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and financial guarantees. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit and financial guarantees written is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

In most cases, the Bank requires collateral or other security to support financial instruments with credit risk.

(Dollars in thousands)

|                                                                    |                    |      |
|--------------------------------------------------------------------|--------------------|------|
|                                                                    | Contractual Amount |      |
|                                                                    | 2013               | 2012 |
| Financial instruments whose contract amount represent credit risk: |                    |      |

|                                                            |            |         |
|------------------------------------------------------------|------------|---------|
| Commitments to extend credit                               | \$ 146,243 | 133,919 |
| Standby letters of credit and financial guarantees written | \$ 4,361   | 3,297   |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and because they may expire without being drawn upon, the total commitment amount of \$150.6 million does not necessarily represent future cash requirements.

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Standby letters of credit and financial guarantees written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to businesses in the Bank's delineated market area. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds real estate, equipment, automobiles and customer deposits as collateral supporting those commitments for which collateral is deemed necessary.

In the normal course of business, the Company is a party (both as plaintiff and defendant) to a number of lawsuits. In the opinion of management and counsel, none of these cases should have a material adverse effect on the financial position of the Company.

Bancorp and the Bank have employment agreements with certain key employees. The agreements, among other things, include salary, bonus, incentive stock option, and change in control provisions.

The Company has \$62.5 million available for the purchase of overnight federal funds from six correspondent financial institutions as of December 31, 2013.

#### (11) Derivative Financial Instruments and Hedging Transactions

##### Accounting Policy for Derivative Instruments and Hedging Activities

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

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

##### Risk Management Objective of Using Derivatives

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. The Company did not have any interest rate derivatives outstanding as of December 31, 2013 or 2012.

##### Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floors designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium. The Company had an interest rate swap contract that expired in June 2011. The Company did not have any interest rate derivatives outstanding as of December 31, 2013 or 2012.

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The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in "Accumulated Other Comprehensive Income" and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings.

(12) Employee and Director Benefit Programs

The Company has a profit sharing and 401(k) plan for the benefit of substantially all employees subject to certain minimum age and service requirements. Under the 401(k) plan, the Company matched employee contributions to a maximum of 4.00% of annual compensation in 2013, 3.50% of annual compensation in 2012 and 2.50% of annual compensation in 2011. The Company's contribution pursuant to this formula was approximately \$430,000, \$345,000 and \$219,000 for the years 2013, 2012 and 2011, respectively. Investments of the 401(k) plan are determined by a committee comprised of senior management. No investments in Company stock have been made by the 401(k) plan. The vesting schedule for the 401(k) plan begins at 20 percent after two years of employment and graduates 20 percent each year until reaching 100 percent after six years of employment.

In December 2001, the Company initiated a postretirement benefit plan to provide retirement benefits to key officers and its Board of Directors and to provide death benefits for their designated beneficiaries. Under the postretirement benefit plan, the Company purchased life insurance contracts on the lives of the key officers and each director. The increase in cash surrender value of the contracts constitutes the Company's contribution to the postretirement benefit plan each year. Postretirement benefit plan participants are to be paid annual benefits for a specified number of years commencing upon retirement. Expenses incurred for benefits relating to the postretirement benefit plan were approximately \$395,000, \$546,000 and \$355,000 for the years 2013, 2012 and 2011, respectively.

The Company is currently paying medical benefits for certain retired employees. Postretirement medical benefits expense, including amortization of the transition obligation, as applicable, was approximately \$24,000 and \$23,000 for the years ended December 31, 2012 and 2011, respectively. The Company did not incur any postretirement medical benefits expense due to an over accrual reversal in 2013.

The following table sets forth the change in the accumulated benefit obligation for the Company's two postretirement benefit plans described above:

(Dollars in thousands)

|                                           | 2013     | 2012  |
|-------------------------------------------|----------|-------|
| Benefit obligation at beginning of period | \$ 3,382 | 2,923 |
| Service cost                              | 336      | 430   |
| Interest cost                             | 65       | 89    |
| Benefits paid                             | (142 )   | (60 ) |
| Reversal of excess accrual                | (60 )    | -     |
| Benefit obligation at end of period       | \$ 3,581 | 3,382 |

The amounts recognized in the Company's Consolidated Balance Sheet as of December 31, 2013 and 2012 are shown in the following two tables:

(Dollars in thousands)

2013                      2012

|                           |    |       |       |
|---------------------------|----|-------|-------|
| Benefit obligation        | \$ | 3,581 | 3,382 |
| Fair value of plan assets |    | -     | -     |

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(Dollars in thousands)

|                                         | 2013        | 2012     |
|-----------------------------------------|-------------|----------|
| Funded status                           | \$ (3,581 ) | (3,382 ) |
| Unrecognized prior service cost/benefit | -           | -        |
| Unrecognized net actuarial loss         | -           | -        |
| Net amount recognized                   | \$ (3,581 ) | (3,382 ) |
| Unfunded accrued liability              | \$ (3,581 ) | (3,382 ) |
| Intangible assets                       | -           | -        |
| Net amount recognized                   | \$ (3,581 ) | (3,382 ) |

Net periodic benefit cost of the Company's post retirement benefit plans for the years ended December 31, 2013 and 2012 consisted of the following:

(Dollars in thousands)

|                                                                                | 2013   | 2012  |
|--------------------------------------------------------------------------------|--------|-------|
| Service cost                                                                   | \$ 336 | 430   |
| Interest cost                                                                  | 65     | 89    |
| Net periodic cost                                                              | \$ 401 | 519   |
| Weighted average discount rate assumption used to determine benefit obligation | 5.46%  | 5.43% |

The Company paid benefits under the two postretirement plans totaling \$142,000 and \$60,000 during the years ended December 31, 2013 and 2012, respectively. Information about the expected benefit payments for the Company's two postretirement benefit plans is as follows:

(Dollars in thousands)

| Year ending December 31, |          |
|--------------------------|----------|
| 2014                     | \$ 205   |
| 2015                     | \$ 234   |
| 2016                     | \$ 233   |
| 2017                     | \$ 262   |
| 2018                     | \$ 275   |
| Thereafter               | \$ 8,648 |

## (13) Regulatory Matters

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must

meet specific capital guidelines that involve quantitative measures of the assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios of capital in relation to both on- and off-balance sheet items at various risk weights. Total capital consists of two tiers of capital. Tier 1 Capital includes common shareholders' equity and trust preferred securities less adjustments for intangible assets. Tier 2 Capital consists of the allowance for loan losses, up to 1.25% of risk-weighted assets and other adjustments. Management believes, as of December 31, 2013, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

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As of December 31, 2013, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table below. There have been no conditions or events since that notification that management believes have changed the Bank's category.

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

The Company's and the Bank's actual capital amounts and ratios are presented below:

(Dollars in thousands)

|                                          | Actual     |        | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|------------------------------------------|------------|--------|-------------------------------|-------|------------------------------------------------------------------|--------|
|                                          | Amount     | Ratio  | Amount                        | Ratio | Amount                                                           | Ratio  |
| As of December 31, 2013:                 |            |        |                               |       |                                                                  |        |
| Total Capital (to Risk-Weighted Assets)  |            |        |                               |       |                                                                  |        |
| Consolidated                             | \$ 114,185 | 16.14% | 56,582                        | 8.00% | N/A                                                              | N/A    |
| Bank                                     | \$ 110,935 | 15.73% | 56,412                        | 8.00% | 70,515                                                           | 10.00% |
| Tier 1 Capital (to Risk-Weighted Assets) |            |        |                               |       |                                                                  |        |
| Consolidated                             | \$ 104,890 | 14.83% | 28,291                        | 4.00% | N/A                                                              | N/A    |
| Bank                                     | \$ 101,733 | 14.43% | 28,206                        | 4.00% | 42,309                                                           | 6.00%  |
| Tier 1 Capital (to Average Assets)       |            |        |                               |       |                                                                  |        |
| Consolidated                             | \$ 104,890 | 10.08% | 41,622                        | 4.00% | N/A                                                              | N/A    |
| Bank                                     | \$ 101,733 | 9.79%  | 41,584                        | 4.00% | 51,981                                                           | 5.00%  |
| As of December 31, 2012:                 |            |        |                               |       |                                                                  |        |
| Total Capital (to Risk-Weighted Assets)  |            |        |                               |       |                                                                  |        |
| Consolidated                             | \$ 121,246 | 17.34% | 55,928                        | 8.00% | N/A                                                              | N/A    |
| Bank                                     | \$ 117,453 | 16.84% | 55,784                        | 8.00% | 69,730                                                           | 10.00% |
| Tier 1 Capital (to Risk-Weighted Assets) |            |        |                               |       |                                                                  |        |
| Consolidated                             | \$ 112,135 | 16.04% | 27,964                        | 4.00% | N/A                                                              | N/A    |
| Bank                                     | \$ 108,379 | 15.54% | 27,892                        | 4.00% | 41,838                                                           | 6.00%  |
| Tier 1 Capital (to Average Assets)       |            |        |                               |       |                                                                  |        |
| Consolidated                             | \$ 112,135 | 11.12% | 40,342                        | 4.00% | N/A                                                              | N/A    |
| Bank                                     | \$ 108,379 | 10.76% | 40,302                        | 4.00% | 50,377                                                           | 5.00%  |

(14)

Shareholders' Equity

Shareholders' equity was \$83.7 million as of December 31, 2013, compared to \$97.7 million as of December 31, 2012. This decrease reflects the Company's repurchase and redemption of its Series A preferred stock combined with a reduction in accumulated other comprehensive income resulting from a decrease in the unrealized gain on investment securities. The Company received regulatory approval in December 2013 to repurchase and redeem the remaining 12,524 outstanding shares of its Series A preferred stock. The repurchase and redemption was completed on January 17, 2014 and is reflected on the Company's Consolidated Balance Sheets as of December 31, 2013. "Accrued interest payable and other liabilities" at December 31, 2013 includes \$12.6 million for the payment to preferred shareholders of principal and accrued dividends on January 17, 2014.

During 2012, the Company purchased 12,530 shares of the Company's 25,054 outstanding shares of Series A preferred stock from the UST. The shares were purchased for \$933.36 per share, for a total purchase price of \$11,778,576, including \$83,575 accrued and unpaid dividends on the Series A preferred stock. The Company retired the 12,530 shares purchased. The \$834,999 difference between the \$12,530,000 face value of the Series A preferred stock retired and the \$11,695,001 purchase price of the Series A preferred stock retired was credited to retained earnings effective June 30, 2012.

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During 2012, the Company completed its repurchase of the Warrant to purchase 357,234 shares of the Company's common stock that was issued to the UST. The Company repurchased the Warrant for a total price of \$425,000.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board of Directors is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights.

(15) Other Operating Income and Expense

Other operating income for the years ended December 31, 2013, 2012 and 2011 included the following items that exceeded one percent of total revenues at some point during the following three-year period:

(Dollars in thousands)

|                                     | 2013     | 2012  | 2011  |
|-------------------------------------|----------|-------|-------|
| Visa debit card income              | \$ 2,990 | 2,092 | 1,783 |
| Net appraisal management fee income | \$ 718   | 737   | 375   |
| Insurance and brokerage commissions | \$ 661   | 517   | 471   |

Other operating expense for the years ended December 31, 2013, 2012 and 2011 included the following items that exceeded one percent of total revenues at some point during the following three-year period:

(Dollars in thousands)

|                                 | 2013   | 2012 | 2011  |
|---------------------------------|--------|------|-------|
| Advertising                     | \$ 685 | 695  | 660   |
| FDIC insurance                  | \$ 864 | 894  | 1,061 |
| Visa debit card expense         | \$ 823 | 729  | 658   |
| Telephone                       | \$ 570 | 554  | 605   |
| Foreclosure/OREO expense        | \$ 356 | 677  | 904   |
| Internet banking expense        | \$ 568 | 593  | 509   |
| FHLB advance prepayment penalty | \$ 530 | -    | -     |

(16) Fair Value of Financial Instruments

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

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

- Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

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

#### Cash and Cash Equivalents

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

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#### Investment Securities Available for Sale

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Fair values for investment securities with quoted market prices are reported in the Level 1 fair value category. Fair value measurements obtained from independent pricing services are reported in the Level 2 fair value category. All other fair value measurements are reported in the Level 3 fair value category.

#### Other Investments

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

#### Mortgage Loans Held for Sale

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

#### Loans

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

#### Cash Surrender Value of Life Insurance

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

#### Other Real Estate

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

#### Deposits

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

#### Securities Sold Under Agreements to Repurchase

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

#### FHLB Borrowings

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

#### Junior Subordinated Debentures

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

Commitments to Extend Credit and Standby Letters of Credit

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

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### Limitations

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

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

The carrying amount and estimated fair value of the Company's financial instruments at December 31, 2013 and 2012 are as follows:

(Dollars in thousands)

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

(Dollars in thousands)

|                                          | Carrying<br>Amount | Fair Value Measurements at December 31,<br>2012 |         |         | Total   |
|------------------------------------------|--------------------|-------------------------------------------------|---------|---------|---------|
|                                          |                    | Level 1                                         | Level 2 | Level 3 |         |
| <b>Assets:</b>                           |                    |                                                 |         |         |         |
| Cash and cash equivalents                | \$ 48,843          | 48,843                                          | -       | -       | 48,843  |
| Investment securities available for sale | 297,823            | 1,468                                           | 295,105 | 1,250   | 297,823 |
| Other investments                        | 5,599              | -                                               | -       | 5,599   | 5,599   |
| Mortgage loans held for sale             | 6,922              | -                                               | -       | 6,922   | 6,922   |
| Loans, net                               | 605,551            | -                                               | -       | 599,996 | 599,996 |

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|                                                   |            |   |         |   |         |
|---------------------------------------------------|------------|---|---------|---|---------|
| Cash surrender value of life insurance            | 13,273     | - | 13,273  | - | 13,273  |
| <b>Liabilities:</b>                               |            |   |         |   |         |
| Deposits                                          | \$ 781,525 | - | 780,662 | - | 780,662 |
| Securities sold under agreements<br>to repurchase | 34,578     | - | 34,578  | - | 34,578  |
| FHLB borrowings                                   | 70,000     | - | 76,375  | - | 76,375  |
| Junior subordinated debentures                    | 20,619     | - | 20,619  | - | 20,619  |

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## (17) Peoples Bancorp of North Carolina, Inc. (Parent Company Only) Condensed Financial Statements

## Balance Sheets

December 31, 2013 and 2012

(Dollars in thousands)

| Assets                                            | 2013              | 2012           |
|---------------------------------------------------|-------------------|----------------|
| Cash                                              | \$ 12,879         | 324            |
| Interest-bearing time deposit                     | -                 | 800            |
| Investment in subsidiaries                        | 102,113           | 115,386        |
| Investment securities available for sale          | 1,721             | 1,596          |
| Other assets                                      | 273               | 260            |
| <b>Total assets</b>                               | <b>\$ 116,986</b> | <b>118,366</b> |
| <b>Liabilities and Shareholders' Equity</b>       |                   |                |
| Junior subordinated debentures                    | \$ 20,619         | 20,619         |
| Liabilities                                       | 12,648            | -              |
| Shareholders' equity                              | 83,719            | 97,747         |
| <b>Total liabilities and shareholders' equity</b> | <b>\$ 116,986</b> | <b>118,366</b> |

## Statements of Earnings

For the Years Ended December 31, 2013, 2012 and 2011

(Dollars in thousands)

| Revenues:                                                    | 2013          | 2012       | 2011       |
|--------------------------------------------------------------|---------------|------------|------------|
| Interest and dividend income                                 | \$ 13,576     | 113        | 226        |
| Impairment of securities                                     | -             | -          | (144 )     |
| <b>Total revenues</b>                                        | <b>13,576</b> | <b>113</b> | <b>82</b>  |
| <b>Expenses:</b>                                             |               |            |            |
| Interest                                                     | 398           | 438        | 407        |
| Other operating expenses                                     | 159           | 476        | 190        |
| <b>Total expenses</b>                                        | <b>557</b>    | <b>914</b> | <b>597</b> |
| <b>Income/(Loss) before income tax benefit and equity in</b> |               |            |            |

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|                                                                       |          |        |        |
|-----------------------------------------------------------------------|----------|--------|--------|
| undistributed earnings of subsidiaries                                | 13,019   | (801 ) | (515 ) |
| Income tax benefit                                                    | 84       | 166    | 56     |
| Income/(Loss) before equity in undistributed earnings of subsidiaries | 13,103   | (635 ) | (459 ) |
| Equity in undistributed earnings of subsidiaries                      | (6,412 ) | 6,428  | 5,618  |
| Net earnings                                                          | \$ 6,691 | 5,793  | 5,159  |

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## Statements of Cash Flows

For the Years Ended December 31, 2013, 2012 and 2011  
(Dollars in thousands)

|                                                                                 | 2013      | 2012      | 2011     |
|---------------------------------------------------------------------------------|-----------|-----------|----------|
| Cash flows from operating activities:                                           |           |           |          |
| Net earnings                                                                    | \$ 6,691  | 5,793     | 5,159    |
| Adjustments to reconcile net earnings to net cash used by operating activities: |           |           |          |
| Equity in undistributed earnings of subsidiaries                                | 6,412     | (6,428 )  | (5,618 ) |
| Impairment of investment securities                                             | -         | -         | 144      |
| Change in:                                                                      |           |           |          |
| Other assets                                                                    | (73 )     | -         | 112      |
| Accrued income                                                                  | -         | 11        | (11 )    |
| Accrued expense                                                                 | 27        | 41        | (216 )   |
| Other liabilities                                                               | 12,632    | -         | -        |
| Net cash provided (used by) operating activities                                | 25,689    | (583 )    | (430 )   |
| Cash flows from investing activities:                                           |           |           |          |
| Proceeds from maturities of investment securities available for sale            |           |           |          |
|                                                                                 | 1         | -         | -        |
| Net change in interest-bearing time deposit                                     | 800       | 14,200    | 2,000    |
| Net cash provided by investing activities                                       | 801       | 14,200    | 2,000    |
| Cash flows from financing activities:                                           |           |           |          |
| Cash dividends paid on Series A preferred stock                                 |           |           |          |
|                                                                                 | (734 )    | (1,023 )  | (1,253 ) |
| Cash dividends paid on common stock                                             | (677 )    | (1,003 )  | (443 )   |
| Preferred stock and warrant repurchase                                          | (12,524 ) | (12,122 ) | -        |
| Restricted stock payout                                                         | -         | -         | 17       |
| Proceeds from exercise of stock options                                         | -         | 539       | -        |
| Net cash used by financing activities                                           | (13,935 ) | (13,609 ) | (1,679 ) |
| Net change in cash                                                              | 12,555    | 8         | (109 )   |
| Cash at beginning of year                                                       | 324       | 316       | 425      |
| Cash at end of year                                                             | \$ 12,879 | 324       | 316      |

Noncash investing and financing activities:

Change in unrealized gain on investment securities

|                         |    |    |     |   |    |   |
|-------------------------|----|----|-----|---|----|---|
| available for sale, net | \$ | 77 | (46 | ) | (3 | ) |
|-------------------------|----|----|-----|---|----|---|

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DIRECTORS AND OFFICERS OF THE COMPANY

DIRECTORS

Robert C. Abernethy – Chairman

Chairman of the Board, Peoples Bancorp of North Carolina, Inc. and Peoples Bank;  
President, Secretary and Treasurer, Carolina Glove Company, Inc. (glove manufacturer)  
Secretary and Assistant Treasurer, Midstate Contractors, Inc. (paving company)

James S. Abernethy

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

Douglas S. Howard

Vice President, Secretary and Treasurer, Denver Equipment of Charlotte, Inc.

John W. Lineberger, Jr.

President, Lincoln Bonded Warehouse Company (commercial warehousing facility)

Gary E. Matthews

President and Director, Matthews Construction Company, Inc. (general contractor)

Billy L. Price, Jr. MD

Managing Partner and Practitioner of Internal Medicine, Catawba Valley Internal Medicine, PA

Larry E. Robinson

President and Chief Executive Officer, The Blue Ridge Distributing Co., Inc. (beer and wine distributor)  
Partner and Chief Operating Officer, United Beverages of North Carolina, LLC (beer distributor)

William Gregory (Greg) Terry

General Manager, Drum & Willis-Reynolds Funeral Homes and Crematory

Dan Ray Timmerman, Sr.

Chairman of the Board and Chief Executive Officer, Timmerman Manufacturing, Inc. (wrought iron furniture, railings and gates manufacturer)

Benjamin I. Zachary

President, Treasurer, General Manager and Director, Alexander Railroad Company

OFFICERS

Lance A. Sellers

President and Chief Executive Officer

A. Joseph Lampron, Jr.

Executive Vice President, Chief Financial Officer and Corporate Treasurer

William D. Cable, Sr.

Executive Vice President, Assistant Corporate Treasurer and Assistant Corporate Secretary

Joseph F. Beaman, Jr.

Executive Vice President and Corporate Secretary

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