PEOPLES BANCORP OF NORTH CAROLINA INC
Form 10-Q
August 10, 2012

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

FORM 10-Q

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

For the quarterly period ended: June 30, 2012

OR

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

For the transition period from __________ to __________

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

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

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

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

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

Yes X No

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

Yes X No

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

Large Accelerate Filer	Accelerated Filer	Non-Accelerated Filer

Smaller Reporting Company	X

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

Yes No X

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.
5,544,160 shares of common stock, outstanding at July 31, 2012.

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Statements made in this Form 10-Q, other than those concerning historical information, should be considered forward-looking statements pursuant to the safe harbor provisions of the Securities Exchange Act of 1934 and the Private Securities Litigation Act of 1995. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management and on the information available to management at the time that this Form 10-Q was prepared. These statements can be identified by the use of words like "expect," "anticipate," "estimate," and "believe," variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by Peoples Bank, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environments and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in other filings with the Securities and Exchange Commission, including but not limited to those described in Peoples Bancorp of North Carolina, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2011.

PART I. FINANCIAL INFORMATION

Item 1.Financial Statements

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(Dollars in thousands)

Assets		June 30, 2012 (Unaudited)		December 31, 2011 (Audited)	
Cash and due from banks, including reserve requirements	$	25,350		22,532	
of $9,265 in 2012 and $8,492 in 2011					
Interest bearing deposits		44,127		6,704	
Cash and cash equivalents		69,477		29,236	
Investment securities available for sale		280,735		321,388	
Other investments		5,734		5,712	
Total securities		286,469		327,100	
Mortgage loans held for sale		3,753		5,146	
Loans		642,815		670,497	
Less allowance for loan losses		(16,640	)	(16,604	)
Net loans		626,175		653,893	
Premises and equipment, net		16,342		16,896	
Cash surrender value of life insurance		13,040		12,835	
Other real estate		6,505		7,576	
Accrued interest receivable and other assets		13,328		14,381	
Total assets	$	1,035,089		1,067,063	
Liabilities and Shareholders' Equity					
Deposits:					
Non-interest bearing demand	$	147,825		136,878	
NOW, MMDA & savings		353,076		366,133	
Time, $100,000 or more		156,974		193,045	
Other time		122,671		131,055	
Total deposits		780,546		827,111	
Securities sold under agreements to repurchase		50,510		39,600	
FHLB borrowings		70,000		70,000	

Junior subordinated debentures		20,619	20,619
Accrued interest payable and other liabilities		18,574	6,706
Total liabilities		940,249	964,036
Commitments			
Shareholders' equity:			
Series A preferred stock, $1,000 stated value; authorized			
5,000,000 shares; issued and outstanding			
12,524 shares in 2012 and 25,054 shares in 2011		12,298	24,758
Common stock, no par value; authorized 20,000,000 shares;			
issued and outstanding 5,544,160 shares in 2012 and 2011		48,298	48,298
Retained earnings		29,617	26,895
Accumulated other comprehensive income		4,627	3,076
Total shareholders' equity		94,840	103,027
Total liabilities and shareholders' equity	$	1,035,089	1,067,063
See accompanying Notes to Consolidated Financial Statements.			

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

Three and six months ended June 30, 2012 and 2011

(Dollars in thousands, except per share amounts)

	Three months ended June 30,		Six months ended June 30,	
	2012 (Unaudited)	2011 (Unaudited)	2012 (Unaudited)	2011 (Unaudited)
Interest income:				
Interest and fees on loans	$ 8,227	9,159	16,652	18,774
Interest on due from banks	16	8	19	14
Interest on investment securities:				
U.S. Government sponsored enterprises, including mortgage-backed securities	737	1,413	1,807	2,494
States and political subdivisions	787	790	1,587	1,595
Other	68	52	132	102
Total interest income	9,835	11,422	20,197	22,979
Interest expense:				
NOW, MMDA & savings deposits	295	601	639	1,319
Time deposits	864	1,277	1,896	2,681
FHLB borrowings	684	753	1,374	1,497
Junior subordinated debentures	110	101	222	200
Other	34	77	73	156
Total interest expense	1,987	2,809	4,204	5,853
Net interest income	7,848	8,613	15,993	17,126
Provision for loan losses	1,603	3,368	3,652	6,318
Net interest income after provision for loan losses	6,245	5,245	12,341	10,808
Non-interest income:				
Service charges	1,192	1,316	2,379	2,572
Other service charges and fees	516	528	1,115	1,109
Gain on sale of securities	664	181	1,191	1,256
Mortgage banking income	271	218	497	405
Insurance and brokerage commissions	119	121	254	229
Loss on sale and write-down of other real estate	(195)	(361)	(384)	(708)

Miscellaneous		1,026	733	1,920	1,446
Total non-interest income		3,593	2,736	6,972	6,309
Non-interest expense:					
Salaries and employee benefits		3,931	3,673	7,772	7,340
Occupancy		1,300	1,331	2,600	2,696
Other		2,612	2,404	4,742	4,742
Total non-interest expense		7,843	7,408	15,114	14,778
Earnings before income taxes		1,995	573	4,199	2,339
Income tax expense (benefit)		486	(56)	1,031	349
Net earnings		1,509	629	3,168	1,990
Dividends and accretion on preferred stock		348	348	697	697
Net earnings available to common shareholders	$	1,161	281	2,471	1,293
Basic net earnings per common share	$	0.21	0.05	0.45	0.23
Diluted net earnings per common share	$	0.21	0.05	0.45	0.23
Cash dividends declared per common share	$	0.02	0.02	0.09	0.04

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

Three and Six Months Ended June 30, 2012 and 2011

(Dollars in thousands)

	Three months ended June 30,		Six months ended June 30,	
	2012 (Unaudited)	2011 (Unaudited)	2012 (Unaudited)	2011 (Unaudited)
Net earnings	$ 1,509	629	3,168	1,990
Other comprehensive income:				
Unrealized holding gains on securities available for sale	2,513	5,568	3,730	6,041
Reclassification adjustment for gains on securities available for sale included in net earnings	(664)	(181)	(1,191)	(1,256)
Unrealized holding losses on derivative financial instruments qualifying as cash flow hedges	-	(264)	-	(648)
Total other comprehensive income, before income taxes	1,849	5,123	2,539	4,137
Income tax expense related to other comprehensive income:				
Unrealized holding gains on securities available for sale	979	2,168	1,452	2,353
Reclassification adjustment for gains on securities available for sale included in net earnings	(259)	(70)	(464)	(489)
Unrealized holding losses on derivative financial instruments qualifying as cash flow				

hedges		-	(103)	-	(253)
Total income tax expense related to other comprehensive income		720	1,995	988	1,611
Total other comprehensive income, net of tax		1,129	3,128	1,551	2,526
Total comprehensive income	$	2,638	3,757	4,719	4,516

See accompanying Notes to Consolidated Financial Statements.

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Six Months Ended June 30, 2012 and 2011

(Dollars in thousands)

	2012 (Unaudited)	2011 (Unaudited)
Cash flows from operating activities:		
Net earnings	$ 3,168	1,990
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation, amortization and accretion	4,406	2,853
Provision for loan losses	3,652	6,318
Gain on sale of investment securities	(1,191)	(1,256)
Loss on sale of other real estate	40	143
Write-down of other real estate	344	565
Restricted stock expense	17	7
Change in:		
Mortgage loans held for sale	1,393	1,847
Cash surrender value of life insurance	(205)	(121)
Other assets	(267)	394
Other liabilities	11,867	(135)
Net cash provided by operating activities	23,224	12,605
Cash flows from investing activities:		
Purchases of investment securities available for sale	(25,473)	(80,971)
Proceeds from calls, maturities and paydowns of investment securities available for sale	31,641	24,749
Proceeds from sales of investment securities available for sale	34,788	35,269
Purchases of other investments	(493)	(232)
Proceeds from sale of other investments	471	153
Net change in loans	21,662	24,691
Purchases of premises and equipment	(426)	(1,214)
Proceeds from sale of other real estate	3,406	1,679
Net cash provided by investing activities	65,576	4,124
Cash flows from financing activities:		
Net change in deposits	(46,565)	(8,302)
Net change in demand notes payable to U.S. Treasury	-	(348)
	10,910	10,418

Net change in securities sold under agreement to repurchase					
Proceeds from FHLB borrowings		25,400		5,000	
Repayments of FHLB borrowings		(25,400	)	(5,000	)
Preferred Stock Repurchase		(11,695	)	-	
Restricted stock payout		-		9	
Cash dividends paid on Series A preferred stock		(710	)	(626	)
Cash dividends paid on common stock		(499	)	(222	)
Net cash (used) provided by financing activities		(48,559	)	929	
Net change in cash and cash equivalent		40,241		17,658	
Cash and cash equivalents at beginning of period		29,236		23,977	
Cash and cash equivalents at end of period	$	69,477		41,635	

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows, continued

Six Months Ended June 30, 2012 and 2011

(Dollars in thousands)

		2012 (Unaudited)	2011 (Unaudited)
Supplemental disclosures of cash flow information:			
Cash paid during the year for:			
Interest	$	4,737	5,924
Income taxes	$	985	112
Noncash investing and financing activities:			
Change in unrealized gain on investment securities available for sale, net	$	1,551	(2,921)
Change in unrealized gain on derivative financial instruments, net	$	-	395
Transfer of loans to other real estate and repossessions	$	2,707	6,051
Financed portion of sale of other real estate	$	303	3,222
Accretion of Series A preferred stock	$	70	70
Discount on preferred stock	$	835	-

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1) Summary of Significant Accounting Policies

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

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

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of the specific accounting guidance. A description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2011 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 3, 2012 Annual Meeting of Shareholders.

Recently Issued Accounting Pronouncements
In April 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-02, A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring. ASU No. 2011-02 provides additional guidance for determining what constitutes a troubled debt restructuring. ASU No. 2011-02 is effective for interim and annual periods ending after June 15, 2011. The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures.

In May 2011, FASB issued ASU No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards ("IFRS"). ASU No. 2011-04 is intended to result in convergence between GAAP and IFRS requirements for measurement of and disclosures about fair value. ASU No. 2011-04 is effective for interim and annual periods beginning after December 15, 2011. The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures.

In June 2011, FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. ASU No. 2011-05 requires companies to present the components of net income and other comprehensive income either as one continuous statement or as two consecutive statements. It eliminates the option to present components of other comprehensive income as part of the statement of changes in shareholders' equity. ASU No. 2011-05 does not change the items which must be reported in other comprehensive income, how such items are measured or when they must be reclassified to net income. ASU No. 2011-05 is effective for interim and annual periods beginning after December 15, 2011. Because ASU No. 2011-05 impacts presentation only, it has no impact on the Company's results of operations or financial position.

In December 2011, FASB issued ASU No. 2011-12, Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. ASU No. 2011-12 defers the effective date of the requirement to present separate line items on the income statement for reclassification adjustments of items out of accumulated other comprehensive income into net income. This deferral is temporary until FASB reconsiders the operational concerns and needs of financial statement users. FASB has not yet established a timetable for its reconsideration. Entities are still required to present reclassification adjustments within other comprehensive income either on the face of the statement that reports other comprehensive income or in the notes to the financial statements. The requirement to present comprehensive income in either a single continuous statement or two consecutive condensed statements remains for both annual and interim reporting. Because ASU No. 2011-12 impacts presentation only, it will have no impact on the Company's results of operations or financial position.

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

(2) Investment Securities

Investment securities available for sale at June 30, 2012 and December 31, 2011 are as follows:

(Dollars in thousands)

	June 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	$ 164,423	1,981	383	166,021
U.S. Government sponsored enterprises	2,853	77	-	2,930
State and political subdivisions	102,342	5,368	35	107,675
Corporate bonds	1,539	6	-	1,545
Trust preferred securities	1,250	-	-	1,250
Equity securities	748	566	-	1,314
Total	$ 273,155	7,998	418	280,735

(Dollars in thousands)

	December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	$ 213,378	1,371	1,056	213,693
U.S. Government sponsored enterprises	7,429	265	-	7,694
State and political subdivisions	92,996	4,157	56	97,097
Corporate bonds	546	-	3	543
Trust preferred securities	1,250	-	-	1,250
Equity securities	748	363	-	1,111
Total	$ 316,347	6,156	1,115	321,388

The current fair value and associated unrealized losses on investments in securities with unrealized losses at June 30, 2012 and December 31, 2011 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

	June 30, 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	$ 50,288	331	2,979	52	53,267	383
State and political subdivisions	4,149	35	-	-	4,149	35
Total	$ 54,437	366	2,979	52	57,416	418

(Dollars in thousands)

	December 31, 2011					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	$ 95,122	991	4,125	65	99,247	1,056
State and political subdivisions	4,444	56	-	-	4,444	56
Corporate bonds	542	3	-	-	542	3
Total	$ 100,108	1,050	4,125	65	104,233	1,115

At June 30, 2012, unrealized losses in the investment securities portfolio relating to debt securities totaled $418,000. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the June 30, 2012 tables above, four out of 134 securities issued by state and political subdivisions contained unrealized losses and 28 out of 93 securities issued by U.S. Government sponsored enterprises, including mortgage-backed securities, contained unrealized losses. These unrealized losses are considered temporary because of acceptable investment grades on each security and the repayment sources of principal and interest are government backed.

The amortized cost and estimated fair value of investment securities available for sale at June 30, 2012, 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.

(Dollars in thousands)

		Amortized Cost	Estimated Fair Value
Due within one year	$	2,604	2,648
Due from one to five years		13,130	13,489
Due from five to ten years		80,180	84,321
Due after ten years		12,070	12,942
Mortgage-backed securities		164,423	166,021
Equity securities		748	1,314
Total	$	273,155	280,735

Proceeds from sales of securities available for sale during the six months ended June 30, 2012 were $34.8 million and resulted in gross gains of $1.2 million. Proceeds from sales of securities available for sale during the six months ended June 30, 2011 were $35.3 million and resulted in gross gains of $1.3 million.

Securities with a fair value of approximately $87.2 million and $83.6 million at June 30, 2012 and December 31, 2011, respectively, were pledged to secure public deposits and for other purposes as required by law.

(3) Loans

Major classifications of loans at June 30, 2012 and December 31, 2011 are summarized as follows:

(Dollars in thousands)

		June 30, 2012	December 31, 2011
Real estate loans			
Construction and land development	$	86,498	93,812
Single-family residential		255,339	267,051
Commercial		207,245	214,415
Multifamily and farmland		5,285	4,793
Total real estate loans		554,367	580,071
Commercial loans (not secured by real estate)		59,416	60,646
Consumer loans (not secured by real estate)		10,205	10,490
All other loans (not secured by real estate)		18,827	19,290
Total loans		642,815	670,497

Less allowance for loan losses		16,640	16,604
Total net loans	$	626,175	653,893

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.

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

The following tables present an age analysis of past due loans, by loan type, as of June 30, 2012 and December 31, 2011:

June 30, 2012
(Dollars in thousands)

		Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Total Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Real estate loans							
Construction and land development	$	6,538	3,012	9,550	76,948	86,498	-
Single-family residential		6,711	4,175	10,886	244,453	255,339	1,797
Commercial		2,161	1,543	3,704	203,541	207,245	-
Multifamily and farmland		-	-	-	5,285	5,285	-
Total real estate loans		15,410	8,730	24,140	530,227	554,367	1,797
Commercial loans (not secured by real estate)		743	17	760	58,656	59,416	-
Consumer loans (not secured by real estate)		102	4	106	10,099	10,205	-
All other loans (not secured by real estate)		-	-	-	18,827	18,827	-
Total loans	$	16,255	8,751	25,006	617,809	642,815	1,797

December 31, 2011
(Dollars in thousands)

		Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Total Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Real estate loans							
Construction and land development	$	10,033	3,338	13,371	80,441	93,812	-
Single-family residential		16,536	6,189	22,725	244,326	267,051	2,709
Commercial		1,002	958	1,960	212,455	214,415	-
Multifamily and farmland		13	-	13	4,780	4,793	-
Total real estate loans		27,584	10,485	38,069	542,002	580,071	2,709
Commercial loans (not secured by real estate)		576	9	585	60,061	60,646	-
Consumer loans (not secured by real estate)		116	36	152	10,338	10,490	-
		-	-	-	19,290	19,290	-

All other loans (not secured by real estate)							
Total loans	$	28,276	10,530	38,806	631,691	670,497	2,709

The following table presents the Company's non-accrual loans as of June 30, 2012 and December 31, 2011:

(Dollars in thousands)

		June 30, 2012	December 31, 2011
Real estate loans			
Construction and land development	$	12,624	13,257
Single-family residential		4,626	5,522
Commercial		3,234	2,451
Multifamily and farmland		-	-
Total real estate loans		20,484	21,230
Commercial loans (not secured by real estate)		575	403
Consumer loans (not secured by real estate)		15	152
Total	$	21,074	21,785

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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, which is generally 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. 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 $35.0 million, $20.3 million and $30.6 million at June 30, 2012, June 30, 2011 and December 31, 2011, respectively. Interest income recognized on accruing impaired loans was $1.1 million, $595,000 and $1.7 million for the six months ended June 30, 2012, the six months ended June 30, 2011 and the year ended December 31, 2011, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as impaired.

The following tables present the Company's impaired loans as of June 30, 2012 and December 31, 2011:

June 30, 2012
(Dollars in thousands)

		Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Recorded Investment in Impaired Loans	Related Allowance	Average Outstanding Impaired Loans
Real estate loans							
Construction and land development	$	28,750	12,377	7,960	20,337	2,470	14,990
Single-family residential		29,103	5,475	22,927	28,402	1,533	28,841
Commercial		6,250	5,018	663	5,681	299	4,872
Multifamily and farmland		201	201	-	201	-	202
Total impaired real estate loans		64,304	23,071	31,550	54,621	4,302	48,905
Commercial loans (not secured by real estate)		1,408	1,408	-	1,408	15	1,222
Consumer loans (not secured by real estate)		22	-	17	17	-	42
Total impaired loans	$	65,734	24,479	31,567	56,046	4,317	50,169

December 31, 2011
(Dollars in thousands)

		Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Recorded Investment in Impaired Loans	Related Allowance	Average Outstanding Impaired Loans
Real estate loans							
	$	28,721	14,484	6,098	20,582	3,264	17,848

Construction and land development							
Single-family residential		26,382	969	24,719	25,688	1,427	25,102
Commercial		7,717	3,845	3,139	6,984	77	4,518
Multifamily and farmland		209	-	209	209	1	214
Total impaired real estate loans		63,029	19,298	34,165	53,463	4,769	47,682
Commercial loans (not secured by real estate)		1,111	-	1,083	1,083	26	1,485
Consumer loans (not secured by real estate)		157	-	152	152	2	140
Total impaired loans	$	64,297	19,298	35,400	54,698	4,797	49,307

Changes in the allowance for loan losses for the six months ended June 30, 2012 and the year ended December 31, 2011 were as follows:

Six months ended June 30, 2012
(Dollars in thousands)

	Real Estate Loans							
	Construction and Land Development	Single-Family Residential	Commercial	Multifamily and Farmland	Commercial	Consumer and All Other	Unallocated	Total
Allowance for loan losses:								
Beginning balance	$ 7,182	5,357	1,731	13	1,029	255	1,037	16,604
Charge-offs	(2,381)	(861)	(523)	-	(343)	(268)	-	(4,376)
Recoveries	218	69	374	-	11	88	-	760
Provision	2,626	561	(66)	-	(68)	116	483	3,652
Ending balance	$ 7,645	5,126	1,516	13	629	191	1,520	16,640
Ending balance: individually evaluated for impairment	$ 1,101	1,364	-	-	-	-	-	2,465
Ending balance: collectively evaluated for impairment	6,544	3,762	1,516	13	629	191	1,520	14,175
Ending balance	$ 7,645	5,126	1,516	13	629	191	1,520	16,640
Loans:								
Ending balance	$ 86,498	255,339	207,245	5,285	59,416	29,032	-	642,815
Ending balance: individually evaluated for impairment	$ 19,789	23,452	4,961	-	362	-	-	48,564
Ending balance: collectively evaluated for impairment	$ 66,709	231,887	202,284	5,285	59,054	29,032	-	594,251

Year ended December 31, 2011
(Dollars in thousands)

	Real Estate Loans							
	Construction and Land	Single-	Commercial	Multifamily and	Commercial	Consumer and All	Unallocated	Total

	Development	Family Residential		Farmland		Other		
Allowance for loan losses:								
Beginning balance	$ 5,774	6,097	1,409	17	1,174	430	592	15,493
Charge-offs	(7,164)	(2,925)	(1,271)	-	(314)	(586)	-	(12,260)
Recoveries	241	201	24	-	121	152	-	739
Provision	8,331	1,984	1,569	(4)	48	259	445	12,632
Ending balance	$ 7,182	5,357	1,731	13	1,029	255	1,037	16,604
Ending balance: individually evaluated for impairment	$ 1,250	1,289	-	-	-	-	-	2,539
Ending balance: collectively evaluated for impairment	5,932	4,068	1,731	13	1,029	255	1,037	14,065
Ending balance	$ 7,182	5,357	1,731	13	1,029	255	1,037	16,604
Loans:								
Ending balance	$ 93,812	267,051	214,415	4,793	60,646	29,780	-	670,497
Ending balance: individually evaluated for impairment	$ 20,280	20,661	3,845	-	-	-	-	44,786
Ending balance: collectively evaluated for impairment	$ 73,532	246,390	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 9. These risk grades are evaluated on an ongoing basis. A description of the general characteristics of the nine 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).

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- Risk Grade 4 – Management Attention: These loans have very high risk and servicing needs but still are acceptable. Evidence of marginal performance or deteriorating trends are evident. 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 are potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Company's position at some future date. This frequently results from deviating from prudent lending practices, for instance over-advancing on collateral.
- 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 – Low Substandard: These loans have the general characteristics of a Grade 6 Substandard loan, with heightened potential concerns. The exact amount of loss is not yet known because neither the liquidation value of the collateral nor the borrower's predicted repayment ability is known with confidence.
- Risk Grade 8 – 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 9 – Loss: Loans classified as Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be realized in the future. Loss is a temporary grade until the appropriate authority is obtained to charge the loan off.

The following tables present the credit risk profile of each loan type based on internally assigned risk grades as of June 30, 2012 and December 31, 2011.

June 30, 2012
(Dollars in thousands)

	Real Estate Loans							
	Construction and Land Development	Single-Family Residential	Commercial	Multifamily and Farmland	Commercial	Consumer	All Other	Total
1- Excellent Quality	$ 193	22,425	-	-	902	1,320	-	24,840
2- High Quality	5,506	61,133	24,729	41	8,293	4,170	2,611	106,483
3- Good Quality	26,624	94,484	123,709	3,637	36,186	4,065	16,210	304,915
4- Management Attention	26,320	46,754	47,325	686	12,503	374	6	133,968
5- Watch	11,861	11,701	5,263	720	325	115	-	29,985
6- Substandard	15,994	18,842	6,219	201	1,182	161	-	42,599
7- Low Substandard	-	-	-	-	-	-	-	-
8- Doubtful	-	-	-	-	-	-	-	-
9- Loss	-	-	-	-	25	-	-	25
Total	$ 86,498	255,339	207,245	5,285	59,416	10,205	18,827	642,815

December 31, 2011
(Dollars in thousands)

	Real Estate Loans							
	Construction and Land Development	Single-Family Residential	Commercial	Multifamily and Farmland	Commercial	Consumer	All Other	Total
1- Excellent Quality	$ 197	25,474	-	-	715	1,344	-	27,730
2- High Quality	5,183	64,817	25,506	50	8,801	4,070	2,774	111,201
3- Good Quality	27,675	100,388	136,137	3,448	36,585	4,259	16,509	325,001
4- Management Attention	28,138	50,253	40,312	358	12,882	429	7	132,379
5- Watch	15,923	11,767	2,795	728	622	89	-	31,924
6- Substandard	16,696	14,352	9,665	209	1,041	154	-	42,117
7- Low Substandard	-	-	-	-	-	-	-	-
8- Doubtful	-	-	-	-	-	-	-	-
9- Loss	-	-	-	-	-	145	-	145
Total	$ 93,812	267,051	214,415	4,793	60,646	10,490	19,290	670,497

At June 30, 2012, TDR loans were $22.7 million, including $1.7 million in performing TDR loans. Effective March 31, 2012, performing TDR balances reflect current year TDR loans only, in accordance with GAAP. Previously reported TDR amounts reflect cumulative TDR loans from prior periods in addition to current year TDR loans. At December 31, 2011, TDR loans were $44.1 million, including $15.1 million in performing TDR loans. 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.

The following table presents an analysis of TDR loans by loan type as of June 30, 2012 and December 31, 2011.

June 30, 2012
(Dollars in thousands)

	Number of Contracts		Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans				
Construction and land development	22	$	17,661	10,990
Single-family residential	100		10,557	9,726
Commercial	7		3,829	1,648
Total real estate TDR loans	129		32,047	22,364
Commercial loans (not secured by real estate)	9		503	379
Consumer loans (not secured by real estate)	3		7	5
Total TDR loans	141	$	32,557	22,748

December 31, 2011
(Dollars in thousands)

	Number of Contracts		Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans				
Construction and land development	29	$	19,762	12,840
Single-family residential	241		25,541	24,846
Commercial	15		7,200	5,013
Multifamily and Farmland	1		322	209
Total real estate TDR loans	286		52,825	42,908
Commercial loans (not secured by real estate)	21		1,711	1,083
Consumer loans (not secured by real estate)	8		124	142
Total TDR loans	315	$	54,660	44,133

(4) Net Earnings Per Common Share

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

The reconciliation of the amounts used in the computation of both "basic earnings per common share" and "diluted earnings per common share" for the three and six months ended June 30, 2012 and 2011 is as follows:

For the three months ended June 30, 2012

	Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	$ 1,161	5,544,160	$ 0.21
Effect of dilutive securities:			
Stock options	-	3,928	
Diluted earnings per common share	$ 1,161	5,548,088	$ 0.21

For the six months ended June 30, 2012

		Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares		Per Share Amount
Basic earnings per common share	$	2,471	5,544,160	$	0.45
Effect of dilutive securities:					
Stock options		-	1,964		
Diluted earnings per common share	$	2,471	5,546,124	$	0.45

For the three months ended June 30, 2011

		Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares		Per Share Amount
Basic earnings per common share	$	281	5,542,703	$	0.05
Effect of dilutive securities:					
Stock options		-	1,739		
Diluted earnings per common share	$	281	5,544,442	$	0.05

For the six months ended June 30, 2011

		Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares		Per Share Amount
Basic earnings per common share	$	1,293	5,542,126	$	0.23
Effect of dilutive securities:					
Stock options		-	1,646		
Diluted earnings per common share	$	1,293	5,543,772	$	0.23

(5) Stock-Based Compensation

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

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. The 1999 Plan expired on May 13, 2009.

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 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 to date). The amount of expense recorded each period reflects the changes in the Company’s stock price during the period. As of June 30,2012, there was no unrecognized compensation cost related to 2007 and 2008 restricted stock unit grants.

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 330,486 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 in March 2012 at a grant date fair value of $7.90 per share. 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 grants to date). The amount of expense recorded each period reflects the changes in the Company's stock price during the period. As of June 30, 2012, the total unrecognized compensation cost related to 2012 restricted stock unit grants was $219,000.

(6) Fair Value

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

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.

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. Impaired loans with current certified appraisals are included in the Level 2 fair value category. All other loans are included 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.

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.

Derivative Instruments
For derivative instruments, fair value is estimated as the amount that the Company would receive or pay to terminate the contracts at the reporting date, taking into account the current unrealized gains or losses on open contracts.

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.

Securities Sold Under Agreements to Repurchase
For securities sold under agreements to repurchase, the carrying value is a reasonable estimate of fair value.

Federal Home Loan Bank ("FHLB") Borrowings
The fair value of FHLB borrowings is estimated based upon discounted future cash flows using a discount rate comparable to the current market rate for such borrowings.

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.

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

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

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

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 following tables present the balance of securities available for sale, mortgage loans held for sale and derivatives, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of June 30, 2012 and December 31, 2011.

(Dollars in thousands)

	June 30, 2012			
	Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	$ 166,021	-	166,021	-
U.S. Government sponsored enterprises	$ 2,930	-	2,930	-
State and political subdivisions	$ 107,675	-	107,675	-
Corporate bonds	$ 1,545	-	1,545	-
Trust preferred securities	$ 1,250	-	-	1,250
Equity securities	$ 1,314	1,314	-	-
Mortgage loans held for sale	$ 3,753	-	-	3,753

(Dollars in thousands)

	December 31, 2011			
	Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	$ 213,693	-	208,349	5,344
U.S. Government sponsored enterprises	$ 7,694	-	7,694	-
State and political subdivisions	$ 97,097	-	97,097	-
Corporate bonds	$ 543	-	543	-
Trust preferred securities	$ 1,250	-	-	1,250
Equity securities	$ 1,111	1,111	-	-
Mortgage loans held for sale	$ 5,146	-	-	5,146

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the six months ended June 30, 2012. Transfers out of Level 3 during the six months ended June 30, 2012 are attributable to one available for sale security reported in Level 3 at December 31, 2011 because market pricing was unavailable from the Bank's third party bond accounting provider at that time. This security was reported in Level 2 at June 30, 2012, as the market valuation was provided by the Bank's third party bond accounting provider.

(Dollars in thousands)

	Investment Securities Available for Sale Level 3 Valuation
Balance, beginning of period	$ 6,594
Change in book value	-
Change in gain/(loss) realized and unrealized	-
Purchases/(sales)	-
Transfers in and/or (out) of Level 3	(5,344)
Balance, end of period	$ 1,250
Change in unrealized gain/(loss) for assets still held in Level 3	$ -

The Company's June 30, 2012 and December 31, 2011 fair value measurement for impaired loans and other real estate on a non-recurring basis is presented below:

(Dollars in thousands)

	Fair Value Measurements June 30, 2012	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for