FIRST BANCORP /NC/
Form 10-Q
November 09, 2005

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

FORM 10-Q

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

For the quarterly period ended
September 30, 2005

Commission File Number 0-15572

FIRST BANCORP
(Exact Name of Registrant as Specified in its Charter)

North Carolina	56-1421916
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)
341 North Main Street, Troy, North Carolina	27371-0508
(Address of Principal Executive Offices)	(Zip Code)
(Registrant's telephone number, including area code)	(910) 576-6171

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 twelve 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.

[X] YES [ ] NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

[X] YES [ ] NO

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

[ ] YES [X] NO

As of November 1, 2005, 14,212,493 shares of the registrant's Common Stock, no par value, were outstanding. The registrant had no other classes of securities outstanding.

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INDEX
FIRST BANCORP AND SUBSIDIARIES

Part I. Financial Information
Item 1 - Financial Statements

First Bancorp and Subsidiaries
Consolidated Balance Sheets

($ in thousands-unaudited)	September 30, 2005	December 31, 2004 (audited)	Septembe 200

ASSETS			
Cash & due from banks, noninterest-bearing	$ 21,853	28,486	3
Due from banks, interest-bearing	47,402	45,135	5
Federal funds sold	28,586	15,780	
Total cash and cash equivalents	97,841	89,401	8
Securities available for sale (costs of $115,686, $87,368, and $90,938)	115,622	88,554	9
Securities held to maturity (fair values of $12,820, $14,451, and $14,242)	12,799	14,025	1
Presold mortgages in process of settlement	3,586	1,771	
Loans	1,446,185	1,367,053	1,33
Less: Allowance for loan losses	(15,879)	(14,717)	(1
Net loans	1,430,306	1,352,336	1,32
Premises and equipment	33,395	30,318	2
Accrued interest receivable	7,779	6,832	
Intangible assets	49,300	49,330	5
Other	7,406	6,346	
Total assets	$ 1,758,034	1,638,913	1,61
LIABILITIES			
Deposits: Demand - noninterest-bearing	$ 192,399	165,778	16
Savings, NOW, and money market	460,709	472,811	46
Time deposits of $100,000 or more	349,620	334,756	28
Other time deposits	472,800	415,423	40
Total deposits	1,475,528	1,388,768	1,32
Repurchase agreements	12,409	--	
Borrowings	101,239	92,239	13
Accrued interest payable	3,543	2,677	
Other liabilities	14,386	6,751	
Total liabilities	1,607,105	1,490,435	1,46
SHAREHOLDERS' EQUITY			
Common stock, No par value per share Issued and outstanding: 14,196,987, 14,083,856, and 14,055,137 shares	53,574	51,614	5
Retained earnings	97,655	96,347	9
Accumulated other comprehensive income (loss)	(300)	517	
Total shareholders' equity	150,929	148,478	14
Total liabilities and shareholders' equity	$ 1,758,034	1,638,913	1,61

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Income

($ in thousands, except share data-unaudited)	Three Months Ended September 30, 2005	2004	Nin S 200
INTEREST INCOME			
Interest and fees on loans	$ 24,240	19,321	68
Interest on investment securities:			
Taxable interest income	1,315	1,167	3
Tax-exempt interest income	114	123	
Other, principally overnight investments	398	123	1
Total interest income	26,067	20,734	73
INTEREST EXPENSE			
Savings, NOW and money market	1,042	636	2
Time deposits of $100,000 or more	3,015	1,579	8
Other time deposits	3,532	2,062	9
Other, primarily borrowings	1,126	916	3
Total interest expense	8,715	5,193	23
Net interest income	17,352	15,541	50
Provision for loan losses	690	770	2
Net interest income after provision for loan losses	16,662	14,771	48
NONINTEREST INCOME			
Service charges on deposit accounts	2,180	2,325	6
Other service charges, commissions and fees	961	809	2
Fees from presold mortgages	328	220	
Commissions from sales of insurance and financial products	388	387	
Data processing fees	38	104	
Securities gains	--	100	
Other gains (losses)	(116)	351	
Total noninterest income	3,779	4,296	11
NONINTEREST EXPENSES			
Salaries	5,402	5,037	16
Employee benefits	1,407	1,487	4
Total personnel expense	6,809	6,524	20
Net occupancy expense	797	686	2
Equipment related expenses	744	735	2
Intangibles amortization	71	95	
Other operating expenses	3,065	3,052	9

Total noninterest expenses	11,486	11,092	35
Income before income taxes	8,955	7,975	24
Income taxes	9,646	2,778	15
NET INCOME (LOSS)	$ (691)	5,197	8
Earnings (loss) per share:			
Basic	$ (0.05)	0.37	
Diluted	(0.05)	0.36	
Weighted average common shares outstanding:			
Basic	14,186,887	14,112,489	14,150
Diluted	14,186,887	14,335,860	14,353

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Comprehensive Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
($ in thousands-unaudited)	2005	2004	2005	2004
Net income (loss)	$ (691)	5,197	8,677	14,803
Other comprehensive income (loss):				
Unrealized gains (losses) on securities available for sale:				
Unrealized holding gains (losses) arising during the period, pretax	(824)	2,079	(1,252)	(188
Tax benefit (expense)	322	(811)	491	73
Reclassification to realized gains	--	(100)	(2)	(288
Tax expense	--	39	1	112
Adjustment to minimum pension liability:				
Additional pension charge related to unfunded pension liability	--	--	(90)	(46
Tax benefit	--	--	35	18
Other comprehensive income (loss)	(502)	1,207	(817)	(319
Comprehensive income (loss)	$ (1,193)	6,404	7,860	14,484

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Shareholders' Equity

(In thousands, except per share - unaudited)	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumul Oth Compreh Income
Balances, January 1, 2004	14,153	$ 55,392	85,502	
Net income			14,803	
Cash dividends declared ($0.49 per share)			(6,875)	
Common stock issued under stock option plan	139	914		
Common stock issued into dividend reinvestment plan	51	1,080		
Purchases and retirement of common stock	(288)	(6,212)		
Tax benefit realized from exercise of nonqualified stock options		341		
Other comprehensive loss				
Balances, September 30, 2004	14,055	$ 51,515	93,430	
Balances, January 1, 2005	14,084	$ 51,614	96,347	
Net income			8,677	
Cash dividends declared ($0.52 per share)			(7,369)	
Common stock issued under stock option plan	58	656		
Common stock issued into dividend reinvestment plan	55	1,204		
Tax benefit realized from exercise of nonqualified stock options		100		
Other comprehensive loss				
Balances, September 30, 2005	14,197	$ 53,574	97,655	

See notes to consolidated financial statements.

Page 6

First Bancorp and Subsidiaries
Consolidated Statements of Cash Flows

Nine Months Ended
September 30,

($ in thousands-unaudited)	2005	2004
Cash Flows From Operating Activities		
Net income	$ 8,677	14,80
Reconciliation of net income to net cash provided by operating activities:		
Provision for loan losses	2,115	2,08
Net security premium amortization	83	13
Loss (gain) on disposal of other real estate	112	(34
Gain on sale of securities available for sale	(2)	(28
Other losses	63	7
Decrease in loan fees and costs deferred	(288)	(24
Depreciation of premises and equipment	2,005	1,89
Tax benefit from exercise of nonqualified stock options	100	34
Amortization of intangible assets	217	28
Deferred income tax benefit	(224)	(69
Originations of presold mortgages in process of settlement	(54,838)	(45,13
Proceeds from sales of presold mortgages in process of settlement	53,023	44,66
Increase in accrued interest receivable	(947)	(34
Decrease in other assets	180	69
Increase in accrued interest payable	866	40
Increase in other liabilities	7,196	88
Net cash provided by operating activities	18,338	19,18
Cash Flows From Investing Activities		
Purchases of securities available for sale	(47,755)	(26,60
Purchases of securities held to maturity	--	(39
Proceeds from maturities/issuer calls of securities available for sale	19,355	24,14
Proceeds from maturities/issuer calls of securities held to maturity	1,171	2,03
Proceeds from sales of securities available for sale	8	12,02
Net increase in loans	(82,150)	(120,93
Proceeds from sales of other real estate	1,732	90
Purchases of premises and equipment	(5,082)	(4,55
Net cash used by investing activities	(112,721)	(113,37
Cash Flows From Financing Activities		
Net increase in deposits and repurchase agreements	99,169	73,26
Proceeds from borrowings, net	9,000	56,23
Cash dividends paid	(7,206)	(6,79
Proceeds from issuance of common stock	1,860	1,99
Purchases and retirement of common stock	--	(6,21
Net cash provided by financing activities	102,823	118,48
Increase in Cash and Cash Equivalents	8,440	24,29
Cash and Cash Equivalents, Beginning of Period	89,401	62,91
Cash and Cash Equivalents, End of Period	$ 97,841	87,21
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	$ 22,179	14,10
Income taxes	8,931	6,60
Non-cash transactions:		

Unrealized loss on securities available for sale, net of taxes	(762)	(29
Additions to held to maturity securities and borrowings related to deconsolidation of subsidiary trusts	--	1,23
Foreclosed loans transferred to other real estate	2,353	1,19
Other real estate transferred to premises and equipment	--	18

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Notes To Consolidated Financial Statements

(unaudited) For the Periods Ended September 30, 2005 and 2004

Note 1 - Basis of Presentation

In the opinion of the Company, the accompanying unaudited consolidated financial statements contain all adjustments necessary to present fairly the consolidated financial position of the Company as of September 30, 2005 and 2004 and the consolidated results of operations and consolidated cash flows for the periods ended September 30, 2005 and 2004. All such adjustments were of a normal, recurring nature. Reference is made to the 2004 Annual Report on Form 10-K filed with the SEC for a discussion of accounting policies and other relevant information with respect to the financial statements. The results of operations for the periods ended September 30, 2005 and 2004 are not necessarily indicative of the results to be expected for the full year.

Note 2 - Accounting Policies

Note 1 to the 2004 Annual Report on Form 10-K filed with the SEC contains a description of the accounting policies followed by the Company and discussion of recent accounting pronouncements. The following paragraph updates that information as necessary.

In December 2003, the American Institute of Certified Public Accountants issued Statement of Position 03-3 (SOP 03-3), "Accounting for Certain Loans or Debt Securities Acquired in a Transfer." SOP 03-3 provides guidance on the accounting for differences between contractual and expected cash flows from the purchaser's initial investment in loans or debt securities acquired in a transfer, if those differences are attributable, at least in part, to credit quality. The scope of SOP 03-3 includes loans that have shown evidence of deterioration of credit quality since origination, and includes loans acquired individually, in pools or as part of a business combination. Among other things, SOP 03-3: (1) prohibits the recognition of the excess of contractual cash flows over expected cash flows as an adjustment of yield, loss accrual or valuation allowance at the time of purchase; (2) requires that subsequent increases in expected cash flows be recognized prospectively through an adjustment of yield; and (3) requires that subsequent decreases in expected cash flows be recognized as impairment. In addition, SOP 03-3 prohibits the creation or carrying over of a valuation allowance in the initial accounting of all loans within the scope that are acquired in a transfer. Under SOP 03-3, the difference between expected cash flows and the purchase price is accreted as an adjustment to yield over the life of the loans. For loans acquired in a business combination that have shown deterioration of credit quality since origination, SOP 03-3 represents a significant change from the previous purchase accounting practice whereby the acquiree's allowance for loan losses is typically added to the acquirer's allowance for loan losses. SOP 03-3 became effective for loans or debt securities acquired by the Company beginning on January 1, 2005. The adoption of this statement in the first quarter of 2005 did not have an impact on the Company's financial statements; however it will change, on a prospective basis, the way that the Company accounts for loans and debt securities that it acquires in the future.

Note 3 - Reclassifications

Certain amounts reported in the period ended September 30, 2004 have been reclassified to conform with the presentation for September 30, 2005. These reclassifications had no effect on net income (loss) or shareholders' equity for the periods presented, nor did they materially impact trends in financial information.

Note 4 - Stock Option Plans

At September 30, 2005, the Company has six stock-based employee compensation plans, four of which were assumed in acquisitions. The Company accounts for each plan under the recognition and measurement principles of Accounting Principles Board Opinion No. 25 (APB Opinion No. 25), "Accounting for Stock Issued to Employees," and related interpretations. No stock-based employee compensation cost

is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," to stock-based employee compensation.

		Three Months Ended		Nine Months
		September 30,		September
(In thousands except per share data)		2005	2004	2005
Net income (loss), as reported		$ (691)	5,197	8,677
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(52)	(52)	(284)
Pro forma net income		$ (743)	5,145	8,393
Earnings per share:	Basic-As reported	$ (0.05)	0.37	0.61
	Basic-Pro forma	(0.05)	0.36	0.59
	Diluted-As reported	(0.05)	0.36	0.60
	Diluted-Pro forma	(0.05)	0.36	0.58

Note 5 - Earnings Per Share

Basic earnings per share were computed by dividing net income by the weighted average common shares outstanding. Diluted earnings per share includes the potentially dilutive effects of the Company's stock option plan. The following is a reconciliation of the numerators and denominators used in computing basic and diluted earnings per share:

	For the Three Months Ended Septembe			
	2005			
($ in thousands except per share amounts)	Income (Numer- ator)	Shares (Denom- inator)	Per Share Amount	Income (Numer- ator)
Basic EPS				
Net income (loss)	$ (691)	14,186,887	$ (0.05)	$ 5,197
Effect of Dilutive Securities	--	--		--
Diluted EPS	$ (691)	14,186,887	$ (0.05)	$ 5,197

	For the Nine Months Ended Septemb			
	2005			
($ in thousands except per share amounts)	Income (Numer- ator)	Shares (Denom- inator)	Per Share Amount	Income (Numer- ator)
Basic EPS				
Net income	$ 8,677	14,150,527	$ 0.61	$ 14,803
Effect of Dilutive Securities	--	202,642		--
Diluted EPS	$ 8,677	14,353,169	$ 0.60	$ 14,803

Because the Company reported a net loss for the three months ended September 30, 2005, all options are considered to be anti-dilutive. If the Company had reported net income for the three months ended September 30, 2005, the "Effect of Dilutive Securities" in the table above would have been 170,840 shares. For the three months ended September 30, 2005, there were 189,230 options for which the exercise price exceeded the average market price for the period. For the three months ended September 30, 2004, there were 142,509 options that were anti-dilutive because the exercise price exceeded the average market price for the period. For the nine months ended September 30, 2005 there were no anti-dilutive options, and for the nine months ended September 30, 2004, there were 142,509 antidilutive options. Anti-dilutive options have been omitted from the calculation of diluted earnings per share for the respective periods.

Note 6 - Asset Quality Information

Nonperforming assets are defined as nonaccrual loans, loans past due 90 or more days and still accruing interest, restructured loans and other real estate. Nonperforming assets are summarized as follows:

($ in thousands)	September 30, 2005	December 31, 2004	September 2004
Nonperforming loans:			
Nonaccrual loans	$ 3,330	3,707	3
Restructured loans	14	17	
Accruing loans > 90 days past due	--	--	
Total nonperforming loans	3,344	3,724	3
Other real estate	2,023	1,470	1
Total nonperforming assets	$ 5,367	5,194	5
Nonperforming loans to total loans	0.23%	0.27%	
Nonperforming assets as a percentage of loans and other real estate	0.37%	0.38%	
Nonperforming assets to total assets	0.31%	0.32%	
Allowance for loan losses to total loans	1.10%	1.08%	

Note 7 - Deferred Loan Fees

Loans are shown on the Consolidated Balance Sheets net of net deferred loan costs of $75,000 at September 30, 2005 and net deferred loan fees of approximately $213,000, and $359,000 at December 31, 2004, and September 30, 2004, respectively.

Note 8 - Goodwill and Other Intangible Assets

The following is a summary of the gross carrying amount and accumulated amortization of amortizable intangible assets as of September 30, 2005, December 31, 2004, and September 30, 2004 and the carrying amount of unamortized intangible assets as of those same dates.

	September 30, 2005		December 31, 2004	
($ in thousands)	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortizable intangible				

assets:				
Customer lists	$ 394	108	394	85
Noncompete agreements	50	50	50	50
Core deposit premiums	2,441	945	2,441	751
Total	$ 2,885	1,103	2,885	886
Unamortizable intangible assets:				
Goodwill	$ 47,247		47,247	
Pension	$ 273		84	

Amortization expense totaled $71,000 and $95,000 for the three months ended September 30, 2005 and 2004, respectively. Amortization expense totaled $217,000 and $284,000 for the nine months ended September 30, 2005 and 2004, respectively.

The following table presents the estimated amortization expense for each of the five calendar years ending December 31, 2009 and the estimated amount amortizable thereafter. These estimates are subject to change in future periods to the extent management determines it is necessary to make adjustments to the carrying value or estimated useful lives of amortized intangible assets.

(Dollars in thousands)	Estimated Amortization Expense
2005	$ 290
2006	242
2007	220
2008	219
2009	218
Thereafter	810
Total	$ 1,999

Note 9 - Pension Plans

The Company sponsors two defined benefit pension plans - a qualified retirement plan (the "Pension Plan") which is generally available to all employees, and a Supplemental Executive Retirement Plan (the "SERP Plan"), which is for the benefit of certain senior management executives of the Company.

The Company recorded pension expense totaling $447,000 and $399,000 for the three months ended September 30, 2005 and 2004, respectively, related to the Pension Plan and the SERP Plan. The following table contains the components of the pension expense for the three months ended September 30, 2005 and 2004.

	For the Three Months En		
(in thousands)	2005 Pension Plan	2004 Pension Plan	2005 SERP Plan

Service cost - benefits earned during the period	$ 284	239	62
Interest cost on projected benefit obligation	192	161	38
Expected return on plan assets	(237)	(190)	--
Net amortization and deferral	86	76	22
Net periodic pension cost	$ 325	286	122

The Company recorded pension expense totaling $1,341,000 and $1,197,000 for the nine months ended September 30, 2005 and 2004, respectively, related to the Pension Plan and the SERP Plan. The following table contains the components of the pension expense for the nine months ended September 30, 2005 and 2004.

	For the Nine Months Ended		
(in thousands)	2005 Pension Plan	2004 Pension Plan	2005 SERP Plan
Service cost - benefits earned during the period	$ 852	717	186
Interest cost on projected benefit obligation	576	482	114
Expected return on plan assets	(711)	(569)	--
Net amortization and deferral	258	229	66
Net periodic pension cost	$ 975	859	366

The Company's contributions to the Pension Plan are based on computations by independent actuarial consultants and are intended to ensure that the Pension Plan exceeds minimum funding standards at all times. The contributions are invested to provide for benefits under the Pension Plan. The Company made a contribution to the Pension Plan in the amount of $1,419,000 during the third quarter of 2005. No further contributions to the Pension Plan are expected in 2005.

The Company's funding policy with respect to the SERP Plan is to fund the related benefits through investments in life insurance policies, which are not considered plan assets for the purpose of determining the SERP Plan's funded status. The cash surrender values of the life insurance policies are included in the line item "other assets." The Company does not believe that there will be any payments to participants of the SERP Plan in 2005.

Note 10 - Contingency

During the third quarter of 2005, the Company recorded a contingency tax loss accrual amounting to $6,320,000, or $0.44 per diluted share, net of the federal tax benefit. As previously reported, the Company is currently undergoing a tax audit by the North Carolina Department of Revenue. Although the Company has not received any assessment at this time, the Company concluded that applicable accounting standards required that a loss be accrued in the third quarter to reserve for an operating structure involving a real estate investment trust (REIT) that resulted in a reduction of the Company's state tax liability.

The North Carolina Department of Revenue has indicated that it will challenge the tax benefits that the Company received as a result of the REIT structure. This operating structure was established based on consultations with the Company's tax advisors, and the Company believes its state tax returns complied with the relevant North Carolina tax statutes. Therefore, the Company will devote all reasonable resources to minimize any ultimate liability. The Company does not believe that there is any additional exposure related to this item beyond the amount of the accrual other than ongoing interest on the unpaid taxes amounting to $48,000 per quarter (after-tax).

Item 2 - Management's Discussion and Analysis of Consolidated Results of Operations and Financial Condition

CRITICAL ACCOUNTING POLICIES

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 and with general practices followed by the banking industry. Certain of these principles involve a significant amount of judgment and/or use of estimates based on the Company's best assumptions at the time of the estimation. The Company has identified three policies as being more sensitive in terms of judgments and estimates, taking into account their overall potential impact to the Company's consolidated financial statements - 1) the allowance for loan losses, 2) tax uncertainties, and 3) intangible assets.

Allowance for Loan Losses

Due to the estimation process and the potential materiality of the amounts involved, the Company has identified the accounting for the allowance for loan losses and the related provision for loan losses as an accounting policy critical to the Company's consolidated financial statements. The provision for loan losses charged to operations is an amount sufficient to bring the allowance for loan losses to an estimated balance considered adequate to absorb losses inherent in the portfolio.

Management's determination of the adequacy of the allowance is based primarily on a mathematical model that estimates the appropriate allowance for loan losses. This model has two components. The first component involves the estimation of losses on loans defined as "impaired loans." A loan is considered to be impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The estimated valuation allowance is the difference, if any, between the loan balance outstanding and the value of the impaired loan as determined by either 1) an estimate of the cash flows that the Company expects to receive from the borrower discounted at the loan's effective rate, or 2) in the case of a collateral-dependent loan, the fair value of the collateral.

The second component of the allowance model is to estimate losses for all loans not considered to be impaired loans. First, loans that have been risk graded by the Company as having more than "standard" risk but are not considered to be impaired are assigned estimated loss percentages generally accepted in the banking industry. Loans that are classified by the Company as having normal credit risk are segregated by loan type, and estimated loss percentages are assigned to each loan type, based on the historical losses, current economic conditions, and operational conditions specific to each loan type.

The reserve estimated for impaired loans is then added to the reserve estimated for all other loans. This becomes the Company's "allocated allowance." In addition to the allocated allowance derived from the model, management also evaluates other data such as the ratio of the allowance for loan losses to total loans, net loan growth information, nonperforming asset levels and trends in such data. Based on this additional analysis, the Company may determine that an additional amount of allowance for loan losses is necessary to reserve for probable losses. This additional amount, if any, is the Company's "unallocated allowance." The sum of the allocated allowance and the unallocated allowance is compared to the actual allowance for loan losses recorded on the books of the Company and any adjustment necessary for the recorded allowance to equal the computed allowance is recorded as a provision for loan losses. The provision for loan losses is a direct charge to earnings in the period recorded.

Although management uses the best information available to make evaluations, future adjustments may be necessary if economic, operational, or other conditions change. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan

losses. Such agencies may require the Company to recognize additions to the allowance based on the examiners' judgment about information available to them at the time of their examinations.

For further discussion, see "Nonperforming Assets" and "Summary of Loan Loss Experience" below.

Tax Uncertainties

The Company reserves for tax uncertainties in instances when it has taken a position on a tax return that may differ from the opinion of the applicable taxing authority. In accounting for tax contingencies, the Company assesses the relative merits and risks of certain tax transactions, taking into account statutory, judicial and regulatory guidance in the context of the Company's tax position. For those matters where it is probable that the Company will have to pay additional taxes, interest or penalties and a loss or range of losses can be reasonably estimated, the Company records reserves in the consolidated financial statements. For those matters where it is reasonably possible but not probable that the Company will have to pay additional taxes, interest or penalties and the loss or range of losses can be reasonably estimated, the Company only makes disclosures in the notes and does not record reserves in the consolidated financial statements. The process of concluding that a loss is reasonably possible or probable and estimating the amount of loss or range of losses and related tax reserves is inherently subjective and future changes to the reserve may be necessary based on changes in management's intent, tax law or related interpretations, or other functions.

The section below entitled "Liquidity, Commitments, and Contingencies" and Note 10 to the consolidated financial statements above includes the disclosure of a tax uncertainty that the Company recorded a loss accrual for during the third quarter of 2005.

Intangible Assets

Due to the estimation process and the potential materiality of the amounts involved, the Company has also identified the accounting for intangible assets as an accounting policy critical to the Company's consolidated financial statements.

When the Company completes an acquisition transaction, the excess of the purchase price over the amount by which the fair market value of assets acquired exceeds the fair market value of liabilities assumed represents an intangible asset. The Company must then determine the identifiable portions of the intangible asset, with any remaining amount classified as goodwill. Identifiable intangible assets associated with these acquisitions are generally amortized over the estimated life of the related asset, whereas goodwill is tested annually for impairment, but not systematically amortized. Assuming no goodwill impairment, it is beneficial to the Company's future earnings to have a lower amount assigned to identifiable intangible assets and higher amount of goodwill as opposed to having a higher amount considered to be identifiable intangible assets and a lower amount classified as goodwill.

For the Company, the primary identifiable intangible asset typically recorded in connection with a whole-bank or bank branch acquisition is the value of the core deposit intangible, whereas when the Company acquires an insurance agency, the primary identifiable intangible asset is the value of the acquired customer list. Determining the amount of identifiable intangible assets and their average lives involves multiple assumptions and estimates and is typically determined by performing a discounted cash flow analysis, which involves a combination of any or all of the following assumptions: customer attrition/runoff, alternative funding costs, deposit servicing costs, and discount rates. The Company typically engages a third party consultant to assist in each analysis. For the whole-bank and bank branch transactions recorded to date, the core deposit intangible in each case has been estimated to have a ten year life, with an accelerated rate of amortization. For insurance agency acquisitions, the identifiable intangible assets related to the customer lists were determined to have a life of ten to fifteen years, with amortization occurring on a straight-line basis.

Subsequent to the initial recording of the identifiable intangible assets and goodwill, the Company amortizes the identifiable intangible assets over their estimated average lives, as discussed above. In addition, on at least an annual basis, goodwill is evaluated for impairment by comparing the fair value of the Company's reporting units to their related carrying value, including goodwill (the Company's community banking operation is its only material reporting unit). At its last evaluation, the fair value of the Company's community banking operation exceeded its carrying value, including goodwill. If the carrying value of a reporting unit were ever to exceed its fair value, the Company would determine whether the implied fair value of the goodwill, using a discounted cash flow analysis, exceeded the carrying value of the goodwill. If the carrying value of the goodwill exceeded the implied fair value of the goodwill, an impairment loss would be recorded in an amount equal to that excess. Performing such a discounted cash flow analysis would involve the significant use of estimates and assumptions.

The Company reviews identifiable intangible assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The Company's policy is that an impairment loss is recognized, equal to the difference between the asset's carrying amount and its fair value, if the sum of the expected undiscounted future cash flows is less than the carrying amount of the asset. Estimating future cash flows involves the use of multiple estimates and assumptions, such as those listed above.

Current Accounting Matters

See Note 2 to the Consolidated Financial Statements above as it relates to accounting standards that have been recently adopted by the Company. The following accounting standards will be adopted by the Company subsequent to September 30, 2005, to the extent applicable.

In November 2003, the FASB ratified a consensus reached by its Emerging Issues Task Force ("EITF") regarding quantitative and qualitative disclosures required by EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." EITF Issue No. 03-1 requires certain quantitative and qualitative disclosures as it relates to investments that have unrealized losses that have not been recognized as other-than-temporary impairments and is effective for fiscal years ending after December 15, 2003. The additional disclosures required for the Company were included in Note 3 to the Company's 2004 Form 10-K. In March 2004, the EITF released Consensus 03-1 (EITF 03-1). EITF 03-1 as released, codified the provisions of SEC Staff Accounting Bulletin No. 59 and required additional information about unrealized losses associated with debt and equity securities and also provided more detailed criteria that must be followed in evaluating whether to record losses on impaired debt and equity securities. The disclosure requirements were applicable for annual reporting periods ending after June 15, 2004 and were presented in Note 3 to the Company's 2004 Form 10-K. The impairment accounting requirements were to have been effective for periods beginning after June 15, 2004. However, in September 2004, the FASB indefinitely delayed the effective date of the requirement to record impairment losses caused by the effect of increases in interest rates or "sector spreads." In June 2005, the FASB voted to delete the proposed new impairment accounting requirements, instead deciding to provide further clarification of existing guidance at a future date. The clarification of existing guidance is not expected to materially impact the Company.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004) (Statement 123(R)), "Share-Based Payment." Statement 123(R) replaces FASB Statement No. 123 (Statement 123), "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25 (Opinion 25), "Accounting for Stock Issued to Employees." Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, Statement 123 permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Statement 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in financial

statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Currently, the only share-based compensation arrangement utilized by the Company is stock options. Under the original provisions of Statement 123(R), it was to have become effective as of the first interim or annual reporting period that began after June 15, 2005. However in April 2005, the Securities and Exchange Commission effectively delayed the adoption of Statement 123(R) for the Company until January 1, 2006. Based on the provisions of Statement 123(R) and the options that the Company currently has outstanding, the Company's stock-based compensation expense related to options currently outstanding will be approximately $123,000 and $43,000 in 2006 and 2007, respectively. These expense amounts are lower than they otherwise would have been had the Company required five year vesting in connection with approximately 157,000 options what were granted to employees on April 1, 2004. Instead, no vesting periods were required for these options. The Compensation Committee of the Board of Directors of the Company granted the April 2004 options without any vesting requirements for two reasons - 1) the options were granted primarily as a reward for past performance and therefore had already been "earned" in the view of the Committee, and 2) to potentially minimize the impact that any change in accounting standards for stock options could have on future years' reported net income. The Company expects that future employee stock option grants will revert to having five year vesting periods. New stock option grants that vest after January 1, 2006 will increase the amount of stock-based compensation expense recorded by the Company. Except for grants to directors (see below), the Company cannot estimate the amount of future stock option grants at this time. In the past, stock option grants to employees have been irregular, generally falling into three categories - 1) to attract and retain new employees, 2) to recognize changes in responsibilities of existing employees, and 3) to periodically reward exemplary performance. As it relates to director stock option grants, the Company expects to continue to grant 2,250 stock options to each of the Company's directors on June 1 of each year until the 2014 expiration of the current stock option plan. In 2005, the amount of pro forma expense associated with the director grants was $127,000, which is a component of the $284,000 in pro forma stock based employee compensation expense in Note 4 to the consolidated financial statements for the nine months ended September 30, 2005.

In March 2005, the FRB issued a final rule concerning the regulatory capital treatment of Trust Preferred Securities ("TPS") by bank holding companies. After a five-year transition period ending March 31, 2009, the aggregate amount of TPS and certain other capital elements will be limited to 25% of Tier I capital elements - net of goodwill, less any associated deferred tax liability. Amounts of restricted core capital elements in excess of these limits generally may be included in Tier 2 capital. The Company does not expect this rule to materially impact the Company's capital ratios.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154 (Statement 154), "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3." Statement 154 applies to all voluntary changes in accounting principle as well as to changes required by an accounting pronouncement that does not include specific transition provisions. Statement 154 eliminates the previous requirement that the cumulative effect of changes in accounting principle be reflected in the income statement in the period of change. Instead, to enhance the comparability of prior period financial statements, Statement 154 requires that changes in accounting principle be retrospectively applied. Under retrospective application, the new accounting principle is applied as of the beginning of the first period presented, as if that principle had always been used. Statement 154 carries forward the requirement that an error be reported by restating prior period financial statement as of the beginning of the first period. Statement 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company does not expect the initial adoption of Statement 154 to materially impact the Company's financial statements; however the adoption of this statement could result in a material change to the way the Company reflects future changes in accounting principles, depending on the nature of future changes in accounting principles and whether specific transition provisions are included.

RESULTS OF OPERATIONS

Overview

The Company recorded a net loss for the three months ended September 30, 2005 amounting to $691,000, or $0.05 per diluted share, compared to net income of $5,197,000, or $0.36 per diluted share, recorded in the third quarter of 2004. Net income for the nine months ended September 30, 2005 was $8,677,000, or $0.60 per diluted share, a 41.7% decrease in diluted earnings per share from the net income of $14,803,000, or $1.03 per diluted share, reported for the nine months ended September 30, 2004. As discussed below, during the third quarter of 2005 the Company recorded a contingency loss accrual related to income tax exposure amounting to $6,320,000 (after-tax), or $0.44 per diluted share, that is included in the Company's income tax expense for the three and nine months ended September 30, 2005. Share amounts for September 30, 2004 have been adjusted from their originally reported amounts to reflect the 3-for-2 stock split paid on November 15, 2004.

Net interest income for the third quarter of 2005 amounted to $17.4 million, an 11.7% increase over the $15.5 million recorded in the third quarter of 2004. Net interest income for the nine months ended September 30, 2005 amounted to $50.6 million, a 12.1% increase over the $45.2 million recorded in the same nine month period in 2004. Both of these increases are primarily attributable to growth in loans and deposits during the periods indicated.

The Company's net interest margins (tax-equivalent net interest income divided by average earning assets) realized for the three and nine month periods ended September 30, 2005 were slightly higher than the net interest margins realized for the comparable periods in 2004. The Company's net interest margin for the third quarter of 2005 was 4.32% compared to 4.28% for the third quarter of 2004. The Company's net interest margin for the first nine months of 2005 was 4.32% compared to 4.30% for the same nine months of 2004. The positive impact of the rising interest rate environment on the Company's net interest margin has been largely offset by the mix of the Company's deposit growth being more concentrated in the categories of time deposits and time deposits greater than $100,000, the Company's highest cost categories of deposits.

The provision for loan losses recorded by the Company for the three and nine months ended September 30, 2005 did not vary significantly from the comparable periods in 2004, amounting to $690,000 in the third quarter of 2005 compared to $770,000 in the third quarter of 2004, and $2,115,000 for the first nine months of 2005 compared to $2,080,000 for the first nine months of 2004. The Company's ratios of annualized net charge-offs to average loans were 12 basis points and 9 basis points for the three and nine month periods ended September 30, 2005, respectively, compared to 22 basis points and 14 basis points for the same three and nine month periods in 2004, respectively. The Company's level of nonperforming assets to total assets was 0.31% at September 30, 2005 compared to 0.34% a year earlier.

Noninterest income amounted to $3,779,000 for the third quarter of 2005, a 12.0% decrease from $4,296,000 recorded in the third quarter of 2004. Noninterest income for the nine months ended September 30, 2005 amounted to $11,201,000, a decrease of 6.7% from the $12,001,000 recorded in the first nine months of 2004. The decreases for both periods in 2005 compared to 2004 were partly a result of lower service charges on deposit accounts. Also, in 2005 the Company has recorded significantly lower "securities gains" and "other gains" compared to 2004.

Noninterest expenses amounted to $11.5 million in the third quarter of 2005, a 3.6% increase over the $11.1 million recorded in the third quarter of 2004. Noninterest expenses for the nine months ended September 30, 2005 amounted to $35.5 million, a 9.4% increase from the $32.4 million recorded in the first nine months of 2004. The increase in noninterest expenses is primarily attributable to costs associated with the Company's overall growth in loans, deposits and branch network.

The Company's income tax expense for the three and nine months ended September 30, 2005 includes the previously noted contingency accrual of

$6,320,000. Excluding this accrual, the Company's effective tax rate in 2005

has generally been 38%-39% compared to approximately 34%-35% in 2004. The higher effective tax rate in 2005 compared to 2004 is the result of the Company discontinuing, effective January 1, 2005, the operating structure involving a real estate investment trust (REIT) that gave rise to this quarter's contingency tax accrual. For additional information, see Note 10 to the consolidated financial statements above and the section below entitled "Liquidity, Commitments, and Contingencies."

The Company's annualized return on average assets for the third quarter of 2005 was (0.16%) compared to 1.32% for the third quarter of 2004. The Company's annualized return on average assets for the nine months ended September 30, 2005 was 0.69% compared to 1.30% for the comparable period of 2004.

The Company's annualized return on average equity for the second quarter of 2005 was (1.73%) compared to 14.18% for the third quarter of 2004. The Company's annualized return on average equity for the nine months ended September 30, 2005 was 7.49% compared to 13.59% for the first nine months of 2004.

Components of Earnings

Net interest income is the largest component of earnings, representing the difference between interest and fees generated from earning assets and the interest costs of deposits and other funds needed to support those assets. Net interest income for the three month period ended September 30, 2005 amounted to $17,352,000, an increase of $1,811,000, or 11.7%, from the $15,541,000 recorded in the third quarter of 2004. Net interest income for the nine months ended September 30, 2005 amounted to $50,644,000, an increase of $5,471,000, or 12.1%, from the $45,173,000 recorded in the first nine months of 2004.

For internal purposes and in the discussion that follows, the Company evaluates its net interest income on a tax-equivalent basis by adding the tax benefit realized from tax-exempt securities to reported interest income. Tax equivalent net interest income is a non-GAAP performance measure used by management in operating its business, which the Company also believes provides investors with a more accurate picture of net interest income and net interest margins for comparative purposes. Net interest income on a taxable equivalent basis for the three month period ended September 30, 2005 amounted to $17,463,000, an increase of $1,804,000, or 11.5%, from the $15,659,000 recorded in the third quarter of 2004. Net interest income on a taxable equivalent basis for the nine months ended September 30, 2005 amounted to $50,979,000, an increase of $5,446,000, or 12.0%, from the $45,533,000 recorded in the first nine months of 2004. The following table is a reconciliation of net interest income as calculated by GAAP to non-GAAP tax-equivalent net interest income:

	Three Months Ended September 30,		Nine Months Ended
	2005	2004	2005
Net interest income, as reported	$ 17,352	15,541	50,644
Tax-equivalent adjustment	111	118	335
Net interest income, tax-equivalent	$ 17,463	15,659	50,979

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There are two primary factors that cause changes in the amount of net interest income recorded by the Company - 1) growth in loans and deposits, and 2) the Company's net interest margin. For the three and nine month periods ended September 30, 2005, growth in loans and deposits were the primary cause for the increases in net interest income, as the Company's net interest margins in 2005 were just slightly higher than those realized in 2004.

The following tables present net interest income analysis on a taxable-equivalent basis.

For the Three Months Ended September

($ in thousands)	2005 Average Volume	2005 Average Rate	2005 Interest Earned or Paid	20 Average Volume	Ave R
Assets					
Loans (1)	$1,433,874	6.71%	$ 24,240	$1,320,391	
Taxable securities	118,927	4.39%	1,315	97,405	
Non-taxable securities (2)	10,438	8.55%	225	11,451	
Short-term investments	41,144	3.84%	398	24,632	
Total interest-earning assets	1,604,383	6.47%	26,178	1,453,879	
Liabilities					
Savings, NOW and money market deposits	$ 465,089	0.89%	$ 1,042	$ 463,995	
Time deposits >$100,000	347,057	3.45%	3,015	268,911	
Other time deposits	468,170	2.99%	3,532	408,440	
Total interest-bearing deposits	1,280,316	2.35%	7,589	1,141,346	
Other, principally borrowings	85,643	5.22%	1,126	108,094	
Total interest-bearing liabilities	1,365,959	2.53%	8,715	1,249,440	
Non-interest-bearing deposits	186,867			160,357	
Net yield on interest-earning assets and net interest income		4.32%	$ 17,463		
Interest rate spread		3.94%			
Average prime rate		6.42%			

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(1) Average loans include nonaccruing loans, the effect of which is to lower the average rate shown.

(2) Includes tax-equivalent adjustments of $111,000 and $118,000 in 2005 and

2004, respectively, to reflect the tax benefit that the Company receives related to its tax-exempt securities, which carry interest rates lower than similar taxable investments due to their tax exempt status. This amount has been computed assuming a 39% tax rate and is reduced by the related nondeductible portion of interest expense.

For the Nine Months Ended September

	2005			2	
($ in thousands)	Average Volume	Average Rate	Interest Earned or Paid	Average Volume	Ave R
Assets					
Loans (1)	$1,408,736	6.49%	$ 68,331	$1,276,713	
Taxable securities	113,785	4.56%	3,881	100,253	
Non-taxable securities (2)	10,830	8.58%	695	12,321	
Short-term investments	44,780	3.34%	1,117	24,900	
Total interest-earning assets	1,578,131	6.27%	74,024	1,414,187	
Liabilities					
Savings, NOW and money market deposits	$ 472,361	0.82%	$ 2,881	$ 466,545	
Time deposits >$100,000	349,677	3.09%	8,085	258,669	
Other time deposits	446,894	2.70%	9,013	405,784	
Total interest-bearing deposits	1,268,932	2.11%	19,979	1,130,998	
Other, principally borrowings	79,753	5.14%	3,066	84,374	
Total interest-bearing liabilities	1,348,685	2.28%	23,045	1,215,372	
Non-interest-bearing deposits	180,667			156,355	
Net yield on interest-earning assets and net interest income		4.32%	$ 50,979		
Interest rate spread		3.99%			
Average prime rate		5.93%			

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(1) Average loans include nonaccruing loans, the effect of which is to lower the average rate shown.

(2) Includes tax-equivalent adjustments of $335,000 and $360,000 in 2005 and 2004, respectively, to reflect the tax benefit that the Company receives related to its tax-exempt securities, which carry interest rates lower than similar taxable investments due to their tax exempt status. This amount has been computed assuming a 39% tax rate and is reduced by the related nondeductible portion of interest expense.

Average loans outstanding for the third quarter of 2005 were $1.434 billion, which was 8.6% higher than the average loans outstanding for the third quarter of 2004 ($1.320 billion). Average loans outstanding for the nine months ended September 30, 2005 were $1.409 billion, which was 10.3% higher than the average loans outstanding for the nine months ended September 30, 2004 ($1.277 billion).

The mix of the Company's loan portfolio remained substantially the same at September 30, 2005 compared to December 31, 2004, with approximately 85% of the Company's loans being real estate loans, 10% being commercial, financial, and agricultural loans, and the remaining 5% being consumer installment loans. The majority of the Company's real estate loans are primarily various personal and commercial loans where real estate provides additional security for the loan.

Average total deposits outstanding for the third quarter of 2005 were $1.467 billion, which was 12.7% higher than the average deposits outstanding for the third quarter of 2004 ($1.302 billion). Average deposits outstanding for the nine months ended September 30, 2005 were $1.450 billion, which was 12.6% higher than the average deposits outstanding for the nine months ended September 30, 2004 ($1.287 billion). Generally, the Company can reinvest funds from deposits at higher yields than the interest rate being paid on those deposits, and therefore increases in deposits typically result in higher amounts of net interest income for the Company.

See additional discussion regarding the nature of the growth in loans and deposits in the section entitled "Financial Condition" below. The effect of the higher amounts of average loans and deposits was to increase net interest income in 2005.

As derived from the tables above, yields on interest earning assets and liabilities are both 60-90 bps higher for the periods presented in 2005 compared to 2004 as a result of the rising rate environment that began in the third quarter of 2004. From July 1, 2004 to September 30, 2005, the Federal Reserve raised short-term interest rates eleven times totaling 275 basis points. The Company's net interest margin (tax-equivalent net interest income divided by average earning assets) has remained fairly stable during the period of rising rates, with the Company's net interest margin amounting to 4.32% in the third quarter of 2005 compared to 4.28% in the third quarter of 2004, and the Company's net interest margin amounting to 4.32% for the nine months ended September 30, 2005 compared to 4.30% for the same nine months of 2004.

See additional information regarding net interest income in the section entitled "Interest Rate Risk."

The provisions for loan losses recorded by the Company for the three and nine months ended September 30, 2005 did not vary significantly from the comparable periods in 2004, amounting to $690,000 in the third quarter of 2005 compared to $770,000 in the third quarter of 2004, and $2,115,000 for the first nine months of 2005 compared to $2,080,000 for the first nine months of 2004. Net loan growth in 2005 has been less than that experienced in 2004, with the Company experiencing $20 million in net loan growth in the third quarter of 2005 compared to $40 million in the third quarter of 2004, and net loan growth for the nine months ended September 30, 2005 amounting to $79 million compared to $119 million for the first nine months of 2004. The favorable impact of the lower net loan growth on the provision for loan losses has been offset by the impact of having more internally classified loans. Internally classified loans amounted to $16.6 million at September 30, 2005 compared to $10.3 million at September 30, 2004.

Noninterest income amounted to $3,779,000 for the third quarter of 2005, a 12.0% decrease from $4,296,000 recorded in the third quarter of 2004.

Noninterest income for the nine months ended September

30, 2005 amounted to $11,201,000, a decrease of 6.7% from the $12,001,000 recorded in the first nine months of 2004. The decreases for both periods in 2005 compared to 2004 were partly a result of lower service charges on deposit accounts. Service charges on deposit accounts have decreased primarily as a result of the negative impact that higher short term interest rates have on the service charges that the Company earns from its commercial depositors - in the Company's commercial account service charge rate structure, commercial depositors are given "earnings credits" (negatively impacting service charges) on their average deposit balances that are tied to short term interest rates.

Other service charges, commissions, and fees amounted to $961,000 and $2,950,000 for the three and nine months ended September 30, 2005, reflecting increases of approximately $150,000 in each of the first three quarters of 2005 compared to the same three periods of 2004. The increases have been primarily a result of growth in credit card merchant income as a result of growth in the Company's merchant card base, and debit card income as a result of growing acceptance and usage by customers.

Fees from presold mortgages amounted to $328,000 and $851,000 for the three and nine months ended September 30, 2005 compared to $220,000 and $698,000 for the comparable periods in 2004, respectively. The low single-family home mortgage interest rate environment that has been in effect over the past few years continues to result in a relatively high volume of mortgage loan originations. Over the past seven quarters, fees from presold mortgages have ranged from $188,000 to $328,000 per quarter, with an average of $260,000 per quarter.

Commissions from sales of insurance and financial products amounted to $388,000 in the third quarter of 2005 compared to the $387,000 in the third quarter of 2004, and amounted to $997,000 in the first nine months of 2005 compared to $1,064,000 for the same period of 2004. This line item includes commissions the Company receives from three sources - 1) sales of credit insurance associated with new loans, 2) commissions from the sales of investment, annuity, and long-term care insurance products, and 3) commissions from the sale of property and casualty insurance. The following table presents these components for the three and nine month periods ended September 30, 2005 compared to the same periods in 2004:

($ in thousands)	Three Months Ended September 30,				Nine Months	
	2005	2004	$ Change	% Change	2005	2004
Commissions earned from:						
Sales of credit insurance	$ 76	72	4	5.6%	$ 233	
Sales of investments, annuities, and long term care insurance	81	74	7	9.5%	174	
Sales of property and casualty insurance	231	241	(10)	(4.1)%	590	

Total	$ 388	387	1	0.3%	$ 997	1,
	=========	=========	=========		=========	======

As shown in the table above, lower "sales of investments, annuities, and long-term care insurance" is the primary cause for the decrease in recorded insurance and financial product commissions for the nine months ended September 30, 2005. The decrease in this component is primarily due to an employee in this area being transferred to another division of the Company and not yet being replaced.

The Company's data processing subsidiary makes its excess data processing capabilities available to area financial institutions for a fee. At September 30, 2004, the Company had five community bank customers using this service. However, during the fourth quarter of 2004, the Company was notified by three of the customers that they intended to terminate their contracts with the Company in the first half of 2005, with each customer switching to a lower cost service provider. Data processing fees amounted to

$38,000 in the third quarter of 2005 compared to $104,000 in the third quarter of 2004, while data processing fees for the first nine months of 2005 amounted to $243,000 compared to $304,000 in the same period in 2004. The Company intends to continue to market this service to area banks, but does not have any new contracts in place at this time.

In 2005 the Company has recorded significantly lower "securities gains" and "other gains" compared to 2004. For the three months ended September 30, 2005, the Company recorded a combined net loss of $116,000 for these two line items compared to a net gain of $451,000 for the third quarter of 2004, a negative change of $567,000. For the nine months ended September 30, 2005, the Company recorded a combined net loss of $173,000 for these two line items compared to a net gain of $557,000 in 2004, a negative change of $730,000. The "other losses" for both periods in 2005 primarily relate to write-downs and losses of other real estate owned. The "other gains" in 2004 primarily reflects the third quarter 2004 sale of a former bank branch building for a gain of approximately $351,000.

Noninterest expenses amounted to $11.5 million in the third quarter of 2005, a 3.6% increase over the $11.1 million recorded in the third quarter of 2004. Noninterest expenses for the nine months ended September 30, 2005 amounted to $35.5 million, a 9.4% increase from the $32.4 million recorded in the first nine months of 2004. The increase in noninterest expenses is primarily attributable to costs associated with the Company's overall growth in loans, deposits and branch network. Noninterest expenses for the nine months ended September 30, 2005 were also impacted by the following expenses: (i) immediately vested post-retirement benefits granted to the Company's CEO totaling $196,000 granted in the second quarter of 2005, (ii) higher external Sarbanes-Oxley costs, which have amounted to $600,000 through September 30, 2005 compared to $74,000 for the first nine months of 2004, and (iii) public relation expenses of $123,000 incurred in the second quarter of 2005 associated with the Company's sponsorship of the 2005 U.S. Open Golf Tournament that was held in the Company's largest market - Moore County, North Carolina.

The Company's income tax expense for the three and nine months ended September 30, 2005 includes the previously discussed contingency accrual of $6,320,000. Excluding this accrual, the Company's effective tax rate in 2005 has generally been 38%-39% compared to approximately 34%-35% in 2004. The higher effective tax rate in 2005 compared to 2004 is the result of the Company discontinuing, effective January 1, 2005, the operating structure involving a real estate investment trust (REIT) that gave rise to this quarter's contingency tax accrual - see Note 10 to the consolidated financial statements and in the section below entitled "Liquidity, Commitments, and Contingencies" for additional detail. The Company expects its effective tax rate to continue to be in the 38-39% range for the foreseeable future.

The Consolidated Statements of Comprehensive Income reflect "Other Comprehensive Loss" of $502,000 during the third quarter of 2005 and "Other Comprehensive Loss" of $817,000 for the nine months ended September 30, 2005, compared to "Other Comprehensive Income" of $1,207,000 for the three months ended September 30, 2004 and "Other Comprehensive Loss" of $319,000 for the nine months ended September 30, 2004, respectively. The primary component of other comprehensive income/loss for the periods presented relates to changes in unrealized holding gains/losses of the Company's available for sale securities. The Company's available for sale securities portfolio is predominantly comprised of fixed rate bonds that increase in value when market yields for fixed rate bonds decrease and decline in value when market yields for fixed rate bonds increase. Fixed rate bond yields have generally risen over the past two years, except for the third quarter of 2004 during which fixed rate bond yields declined.

FINANCIAL CONDITION

Total assets at September 30, 2005 amounted to $1.76 billion, 9.2% higher than a year earlier. Total loans at September 30, 2005 amounted to $1.45 billion, an 8.1% increase from a year earlier, and total deposits amounted to $1.48 billion at September 30, 2005, an 11.6% increase from a year earlier.

The following tables present information regarding the nature of the Company's growth since September 30, 2004.

October 1, 2004 to September 30, 2005	Balance at beginning of period	Internal Growth	Change in Brokered Deposits	Balance at end of period	pe
			($ in thousands)		
Loans	$ 1,337,583	108,602	--	1,446,185	
Deposits - Noninterest bearing	$ 160,791	31,608	--	192,399	
Deposits - Savings, NOW, and Money Market	463,144	(2,435)	--	460,709	
Deposits - Time>$100,000	288,988	82,773	(22,141)	349,620	
Deposits - Time					