FIRST BANCORP /NC/
Form 10-Q
May 10, 2006

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 March 31, 2006

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer.
[ ] Large Accelerated Filer [X] Accelerated Filer [ ] Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). [ ] YES [X] NO

The number of shares of the registrant's Common Stock outstanding on April 30, 2006 was 14,306,284.

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FIRST BANCORP AND SUBSIDIARIES

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Part I. Financial Information

Item 1 - Financial Statements

First Bancorp and Subsidiaries
Consolidated Balance Sheets

($ in thousands-unaudited)	March 31, 2006	December 31, 2005 (audited)	March 31, 2005
ASSETS			
Cash & due from banks, noninterest-bearing	$ 32,687	32,985	32,409

Due from banks, interest-bearing	82,331	41,655	25,938
Federal funds sold	25,294	28,883	23,252
Total cash and cash equivalents	140,312	103,523	81,599
Securities available for sale (costs of $113,840, $114,662, and $114,703)	112,695	113,613	114,575
Securities held to maturity (fair values of $15,427, $14,321, and $13,670)	15,331	14,172	13,376
Presold mortgages in process of settlement	2,086	3,347	2,400
Loans	1,553,371	1,482,611	1,395,324
Less: Allowance for loan losses	(16,610)	(15,716)	(15,066)
Net loans	1,536,761	1,466,895	1,380,258
Premises and equipment	35,339	34,840	30,133
Accrued interest receivable	8,993	8,947	7,096
Intangible assets	49,131	49,227	49,445
Other	7,239	6,486	8,278
Total assets	$ 1,907,887	1,801,050	1,687,160
LIABILITIES			
Deposits: Demand - noninterest-bearing	$ 213,661	194,051	175,698
Savings, NOW, and money market	473,655	458,221	477,838
Time deposits of $100,000 or more	372,232	356,281	361,567
Other time deposits	505,492	486,024	433,589
Total deposits	1,565,040	1,494,577	1,448,692
Securities sold under agreements to repurchase	32,939	33,530	--
Borrowings	131,739	100,239	76,239
Accrued interest payable	4,312	3,835	3,030
Other liabilities	14,886	13,141	8,420
Total liabilities	1,748,916	1,645,322	1,536,381
SHAREHOLDERS' EQUITY			
Common stock, No par value per share Issued and outstanding: 14,291,060, 14,229,148, and 14,138,379 shares	54,994	54,121	52,459
Retained earnings	104,926	102,507	98,660
Accumulated other comprehensive income (loss)	(949)	(900)	(340)
Total shareholders' equity	158,971	155,728	150,779
Total liabilities and shareholders' equity	$ 1,907,887	1,801,050	1,687,160

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Income

($ in thousands, except share data-unaudited)	Three Months Ended March 31, 2006	2005
INTEREST INCOME		
Interest and fees on loans	$ 26,762	21,359
Interest on investment securities:		
Taxable interest income	1,329	1,155
Tax-exempt interest income	127	129
Other, principally overnight investments	497	272
Total interest income	28,715	22,915
INTEREST EXPENSE		
Savings, NOW and money market	1,333	881
Time deposits of $100,000 or more	3,677	2,345
Other time deposits	4,432	2,474
Securities sold under agreements to repurchase	262	--
Borrowings	1,158	930
Total interest expense	10,862	6,630
Net interest income	17,853	16,285
Provision for loan losses	1,015	580
Net interest income after provision for loan losses	16,838	15,705
NONINTEREST INCOME		
Service charges on deposit accounts	2,074	2,008
Other service charges, commissions and fees	1,205	1,054
Fees from presold mortgages	267	238
Commissions from sales of insurance and financial products	439	295
Data processing fees	36	147
Securities gains	--	--
Other gains (losses)	(67)	(32)
Total noninterest income	3,954	3,710
NONINTEREST EXPENSES		
Salaries	5,785	5,372
Employee benefits	1,781	1,514
Total personnel expense	7,566	6,886
Net occupancy expense	816	739
Equipment related expenses	811	695
Intangibles amortization	61	73
Other operating expenses	3,475	3,322
Total noninterest expenses	12,729	11,715

Income before income taxes	8,063	7,700
Income taxes	3,072	2,984
NET INCOME	$ 4,991	4,716
Earnings per share:		
Basic	0.35	0.33
Diluted	0.35	0.33
Weighted average common shares outstanding:		
Basic	14,254,785	14,105,577
Diluted	14,421,639	14,363,606

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Comprehensive Income

($ in thousands-unaudited)	Three Months Ended March 31, 2006	2005
Net income	$ 4,991	4,716
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available for sale:		
Unrealized holding gains (losses) arising during the period, pretax	(96)	(1,314)
Tax benefit	37	512
Adjustment to minimum pension liability:		
Additional pension charge related to unfunded pension liability	16	(90)
Tax benefit (expense)	(6)	35
Other comprehensive income (loss)	(49)	(857)
	$ 4,942	3,859

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 Other Comprehe Income (
Balances, January 1, 2005	14,084	$ 51,614	96,347	
Net income			4,716	
Cash dividends declared ($0.17 per share)			(2,403)	
Common stock issued under stock option plan	38	452		
Common stock issued into dividend reinvestment plan	16	393		
Other comprehensive loss				
Balances, March 31, 2005	14,138	$ 52,459	98,660	
Balances, January 1, 2006	14,229	$ 54,121	102,507	
Net income			4,991	
Cash dividends declared ($0.18 per share)			(2,572)	
Common stock issued under stock option plan	44	429		
Common stock issued into dividend reinvestment plan	18	397		
Stock-based compensation	--	47		
Other comprehensive loss				
Balances, March 31, 2006	14,291	$ 54,994	104,926	

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Consolidated Statements of Cash Flows

($ in thousands-unaudited)	Three Months Ended March 31, 2006	2005
Cash Flows From Operating Activities		
Net income	$ 4,991	4,7
Reconciliation of net income to net cash provided by operating activities:		
Provision for loan losses	1,015	5
Net security premium amortization	21	

Other losses	67	
Decrease (increase) in net deferred loan fees and costs	107	(1
Depreciation of premises and equipment	688	6
Stock-based compensation expense	47	
Amortization of intangible assets	61	
Deferred income tax benefit	(416)	(1
Origination of presold mortgages in process of settlement	(15,623)	(13,8
Proceeds from sales of presold mortgages in process of settlement	16,884	13,2
Increase in accrued interest receivable	(46)	(2
Increase in other assets	(62)	(1
Increase in accrued interest payable	477	3
Increase in other liabilities	1,778	1,3
Net cash provided by operating activities	9,989	6,4
Cash Flows From Investing Activities		
Purchases of securities available for sale	(6,495)	(37,6
Purchases of securities held to maturity	(1,968)	
Proceeds from maturities/issuer calls of securities available for sale	7,300	10,2
Proceeds from maturities/issuer calls of securities held to maturity	751	6
Net increase in loans	(71,238)	(29,4
Purchases of premises and equipment	(1,187)	(4
Net cash used by investing activities	(72,837)	(56,6
Cash Flows From Financing Activities		
Net increase in deposits and repurchase agreements	69,872	59,9
Proceeds from (repayments of) borrowings, net	31,500	(16,0
Cash dividends paid	(2,561)	(2,3
Proceeds from issuance of common stock	826	8
Net cash provided by financing activities	99,637	42,3
Increase (decrease) in cash and cash equivalents	36,789	(7,8
Cash and cash equivalents, beginning of period	103,523	89,4
Cash and cash equivalents, end of period	$ 140,312	81,5
Supplemental Disclosures Of Cash Flow Information:		
Cash paid during the period for:		
Interest	$ 10,385	6,2
Income taxes	1,243	
Non-cash transactions:		
Unrealized gain (loss) on securities available for sale, net of taxes	(59)	(8
Foreclosed loans transferred to other real estate	250	1,0

See notes to consolidated financial statements.

First Bancorp and Subsidiaries
Notes to Consolidated Financial Statements

(unaudited) For the Periods Ended March 31, 2006 and 2005

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 March 31, 2006 and 2005 and the consolidated results of operations and consolidated cash flows for the periods ended March 31, 2006 and 2005. Reference is made to the 2005 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 March 31, 2006 and 2005 are not necessarily indicative of the results to be expected for the full year.

Note 2 - Accounting Policies

Note 1 to the 2005 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.

On January 1, 2006, the Company adopted 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 Accounting Principles Board Opinion No. 25 (Opinion 25), "Accounting for Stock Issued to Employees." Statement 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. Statement 123(R) permits public companies to adopt its requirements using one of two methods. The "modified prospective" method recognizes compensation for all stock options granted after the date of adoption and for all previously granted stock options that become vested after the date of adoption. The "modified retrospective" method includes the requirements of the "modified prospective" method described above, but also permits entities to restate prior period results based on the amounts previously presented under Statement 123 for purposes of pro-forma disclosures. The Company has elected to adopt Statement 123(R) under the "modified prospective" method and accordingly will not restate prior period results. See Note 4 for a more detailed description the Company's adoption of Statement 123(R).

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 initial adoption of Statement 154 did not have a material impact on 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.

In December 2005, the FASB issued Staff Position SOP 94-6-1, "Terms of Loan Products that May Give Rise to a Concentration of Credit Risk" ("FSP SOP 94-6-1"). FSP SOP 94-6-1 addresses 1) the circumstances under which the terms of loan products give rise to a concentration of credit risk, and 2) the disclosures or other accounting considerations that apply for entities that originate, hold, guarantee, service, or invest in loan products with terms that may give rise to a concentration of credit risk. The disclosures required by FSP SOP 94-6-1 are required for interim and annual periods ending after December 19, 2005. Note 12 of the Company's 2005 Form 10-K contains this discussion and there have been no material changes since that time.

Note 3 - Reclassifications

Certain amounts reported in the period ended March 31, 2005 have been reclassified to conform with the presentation for March 31, 2006. These reclassifications had no effect on net income or shareholders' equity for the periods presented, nor did they materially impact trends in financial information.

Note 4 - Equity-Based Compensation Plans

At March 31, 2006, the Company had the following equity-based compensation plans, all of which are stock option plans: the First Bancorp 2004 Stock Option Plan, the First Bancorp 1994 Stock Option Plan, and four plans that were assumed from acquired entities, which are all described below. The Company's shareholders approved all equity-based compensation plans, except for those assumed from acquired companies. As of March 31, 2006, the First Bancorp 2004 Stock Option Plan is the only plan that had shares available for future grants.

The First Bancorp 2004 Stock Option Plan and its predecessor plan, the First Bancorp 1994 Stock Option Plan, were intended to serve as a means of attracting, retaining and motivating key employees and directors and to associate the interests of the plans' participants with those of the Company and its shareholders. Stock option grants to non-employee directors have historically had no vesting requirements, whereas, except as discussed below, stock option grants to employees have generally had five-year vesting schedules (20% vesting each year). In April 2004, the Company granted 128,000 options to employees with no vesting requirements. These options were granted 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. Employee stock option grants since the April 2004 grant have reverted to having five year vesting periods. The Company's options provide for immediate vesting if there is a change in control (as defined in the plans). Under the terms of these two plans, options can have a term of no longer than ten years, and all options granted thus far under these plans have had a term of ten years. 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 directors, the Company has historically granted 2,250 stock options to each of the Company's non-employee directors in June of each year, and expects to continue doing so for the foreseeable future. At March 31, 2006, there were 647,220 options outstanding related to these two plans with exercise prices ranging from $4.45 to $22.12. At March 31, 2006, there were 1,211,590 shares remaining available to grant under the 2004 First Bancorp Stock Option Plan.

The Company also has four stock option plans as a result of assuming plans of acquired companies. At March 31, 2006, there were 53,686 stock options outstanding in connection with these plans, with option prices ranging from $4.17 to $11.49.

The Company issues new shares when options are exercised.

Prior to January 1, 2006, the Company accounted for all of these plans using the intrinsic value method prescribed by Opinion 25 and related interpretations. Because all of the Company's stock options had an exercise price equal to

the market value of the underlying common stock on the date of grant, no compensation cost had ever been recognized. On January 1, 2006, the Company adopted Statement 123(R). Statement 123(R) supersedes Opinion 25 (and related interpretations) and requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. Statement 123(R) permits public companies to adopt its requirements using one of two methods. The "modified prospective" method recognizes compensation for all stock options granted after the date of adoption and for all previously granted stock options that become vested after the date of adoption. The "modified retrospective" method includes the requirements of the "modified prospective" method described above, but also permits entities to restate prior period results based on the amounts previously presented under Statement 123 for purposes of pro-forma disclosures. The Company has elected to adopt Statement 123(R) under the "modified prospective" method and accordingly will not restate prior period results.

The Company measures the fair value of each option award on the date of grant using the Black-Scholes option-pricing model. The Company determines the assumptions used in the Black-Scholes option pricing model as follows: the risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant; the dividend yield is based on the Company's dividend yield at the time of the grant (subject to adjustment if the dividend yield on the grant date is not expected to approximate the dividend yield over the expected life of the option); the volatility factor is based on the historical volatility of the Company's stock (subject to adjustment if historical volatility is reasonably expected to differ from the past); the weighted-average expected life is based on the historical behavior of employees related to exercises, forfeitures and cancellations.

As noted above, prior to the adoption of Statement 123(R), the Company applied Opinion 25 to account for its stock options. The following table illustrates the effect on net income and earnings per share had the Company accounted for share-based compensation in accordance with Statement 123(R) for the period indicated:

(In thousands except per share data)	Three Months Ended March 31, 2005
Net income, as reported	$ 4,716
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(52)
Pro forma net income	$ 4,664

Earnings per share:	Basic - As reported	$ 0.33
	Basic - Pro forma	0.33
	Diluted - As reported	0.33
	Diluted - Pro forma	0.32

In the first quarter of 2006, the adoption of Statement 123(R) resulted in stock-based compensation expense of $47,000, with no associated tax benefits, which was classified as "salaries expense" on the Consolidated Statements of Income and reduced both income before income taxes and net income by that same amount. The impact on basic and diluted earnings per share was approximately one-third of one cent per share. This expense related to the vesting of several stock option grants made prior to January 1, 2006, as there were no option grants in the first quarter of 2006. This compensation expense was reflected as an adjustment to cash flows from operating activities on the Company's Consolidated Statement of Cash Flows. At March 31, 2006, the Company had $136,000 of unrecognized compensation costs related to unvested stock options. The cost is expected to be amortized over a weighted-average life of 1.12 years, with $46,000 being expensed in the second quarter of 2006, $22,000 being expensed in the third quarter of 2006, $12,000 being expensed in the fourth quarter of 2006, $47,000 being expensed in 2007 equally distributed among each of the four quarters, and $3,000 being expensed in each of 2008, 2009 and 2010, equally distributed among each of the four quarters of each year. In addition, as discussed above, the Company expects to grant 2,250 options, without vesting

requirements, to each of its non-employee directors on June 1, 2006 and on June 1 of each year thereafter. In 2005, the amount of pro forma expense associated with the June director grants was $127,000.

As noted above, certain of the Company's stock option grants contain terms that provide for a graded vesting schedule whereby portions of the award vest in increments over the requisite service period. As provided for under Statement 123(R), the Company has elected to recognize compensation expense for awards with graded vesting schedules on a straight-line basis over the requisite service period for the entire award. Statement 123(R) requires companies to recognize compensation expense based on the estimated number of stock options and awards for which service is to be rendered. Over the past five years, there has been only one forfeiture or expiration, totaling 600 options, and therefore the Company assumes that all options granted will become vested.

There were no option grants during either of the first quarters of 2005 or 2006.

The following table presents information regarding the activity during the first three months of 2006 related to all of the Company's stock options outstanding:

	All Options Outstanding			
Three months ended March 31, 2006	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggre Intrinsi ($00

Outstanding at the beginning of the period	746,882	$ 15.75		
Granted during the period	--	--		
Exercised during the period	45,976	10.22		
Forfeited or expired during the period	--	--		
Outstanding at end of period	700,906	$ 16.12	5.7	$
Exercisable at March 31, 2006	649,281	$ 16.14	5.6	$

The Company received $429,000 and $452,000 as a result of stock option exercises during the three months ended March 31, 2006 and 2005, respectively. The intrinsic value of the stock options exercised during the three months ended March 31, 2006 and 2005 was $527,000 and $444,000, respectively. No nonqualified stock options were exercised during the first quarter of 2006, and thus the Company did not record any associated tax benefits.

The following table presents information regarding the activity during the first three months of 2006 related to the Company's stock options outstanding that are nonvested:

Three months ended March 31, 2006	Number of Shares	Nonvested Options Weighted-Average Grant-Date Fair Value
Nonvested options outstanding at the beginning of the period	67,999	$ 4.75
Granted during the period	--	--
Vested during the period	(16,374)	4.83
Forfeited or expired during the period	--	--
Nonvested options outstanding at end of period	51,625	$ 4.74

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 March 31,				
	2006			2005	
($ in thousands except per	Income (Numer-	Shares (Denom-	Per Share	Income (Numer-	Shares (Denom-

share amounts)	ator)	inator)	Amount	ator)	inator)
Basic EPS					
Net income	$ 4,991	14,254,785	$ 0.35	$ 4,716	14,105,577
Effect of Dilutive Securities	--	166,854		--	258,029
Diluted EPS	$ 4,991	14,421,639	$ 0.35	$ 4,716	14,363,606

For the three months ended March 31, 2006 there were 191,730 options that were antidilutive because the exercise price exceeded the average market price for the period, and these options were excluded from the calculation of the effect of dilutive securities. For the three months ended March 31, 2005, there were no antidilutive options.

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)	March 31, 2006	December 31, 2005	March 31, 2005
Nonperforming loans:			
Nonaccrual loans	$ 3,283	1,640	4,249
Restructured loans	12	13	15
Accruing loans > 90 days past due	--	--	--
Total nonperforming loans	3,295	1,653	4,264
Other real estate	1,451	1,421	2,401
Total nonperforming assets	$ 4,746	3,074	6,665
Nonperforming loans to total loans	0.21%	0.11%	0.31%
Nonperforming assets as a percentage of loans and other real estate	0.31%	0.21%	0.48%
Nonperforming assets to total assets	0.25%	0.17%	0.40%
Allowance for loan losses to total loans	1.07%	1.06%	1.08%

Note 7 - Deferred Loan Fees

Loans are shown on the Consolidated Balance Sheets net of net deferred loan costs (fees) of approximately $76,000, $184,000, and ($82,000) at March 31, 2006, December 31, 2005, and March 31, 2005, respectively.

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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 March 31, 2006, December 31, 2005, and March 31, 2005 and the carrying amount of unamortized intangible assets as of those same dates.

	March 31, 2006		December 31, 2005		Mar
($ in thousands)	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization	Gross Carry Amount
Amortizable intangible assets:					
Customer lists	$ 394	123	394	115	3
Noncompete agreements	50	50	50	50	
Core deposit premiums	2,441	1,064	2,441	1,011	2,4
Total	$ 2,885	1,237	2,885	1,176	2,8
Unamortizable intangible assets:					
Goodwill	$ 47,247		47,247		47,2
Pension	$ 237		273		2

Amortization expense totaled $61,000 and $73,000 for the three months ended March 31, 2006 and 2005, respectively.

The following table presents the estimated amortization expense for each of the five calendar years ending December 31, 2010 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
2006	$ 242
2007	220
2008	219
2009	218
2010	218
Thereafter	592
Total	$ 1,709

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 $581,000 and $447,000 for the three months ended March 31, 2006 and 2005, respectively, related to the Pension Plan and the SERP Plan. The following table contains the components of the pension expense.

	For the Three Months			
(in thousands)	2006 Pension Plan	2005 Pension Plan	2006 SERP Plan	2 SER
Service cost - benefits earned during the period	$ 341	284	79	
Interest cost on projected benefit obligation	227	192	52	
Expected return on plan assets	(268)	(237)	--	
Net amortization and deferral	119	86	31	
Net periodic pension cost	$ 419	325	162	

The Company's contributions to the Pension Plan are based on computations by independent actuarial consultants and are intended to provide the Company with the maximum deduction for income tax purposes. The contributions are invested to provide for benefits under the Pension Plan. The Company estimates that its contribution to the Pension Plan will be $945,000 during 2006.

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 estimates that its payments to participants of the SERP Plan will be $164,000 in 2006.

Note 10 - Contingency

The Company recorded a loss amount of $6,320,000, or $0.44 per diluted share, in the third quarter of 2005 to accrue for contingent tax loss exposure involving the North Carolina Department of Revenue. In February 2006, the North Carolina Department of Revenue announced a "Settlement Initiative" that offered companies with certain transactions that had been challenged by the North Carolina Department of Revenue the opportunity to resolve such matters with reduced penalties by agreeing to participate in the initiative by June 15, 2006. Although the Company believed that its tax returns complied with the relevant statutes, the board of directors of the Company decided that it was in the best interests of the Company to settle this matter by participating in the initiative. Based on the terms of the initiative, the Company estimated that its total liability to settle the matter will be approximately $4.3 million, net of the federal tax benefit, or $2.0 million less than the amount that was originally accrued. Accordingly, in March 2006, the Company adjusted its originally reported 2005 earnings to reflect the impact of this subsequent event by reducing originally reported tax expense for the three and twelve months ended December 31, 2005 by $1,982,000, or $0.14 per diluted share. The Company believes it has fully reserved for this liability and does not have any additional state income tax exposure other than the ongoing interest that will continue to accrue ($65,000 per quarter on an after-tax basis) until the Settlement Initiative is completed and the Company pays the amounts due in accordance with the settlement, which is expected to occur in the fourth quarter of this year.

Note 11 - Pending Acquisitions and Subsequent Events

On January 20, 2006, the Company reported that it had agreed to purchase a bank branch in Dublin, Virginia with approximately $20 million in deposits from another financial institution. This transaction is expected to close in July 2006.

On April 26, 2006, the Company reported that it had agreed to purchase a bank branch in Carthage, North Carolina from another financial institution. This transaction is expected to close in September 2006.

On April 13, 2006, the Company borrowed $25.8 million in the form of trust preferred capital securities. These securities have a floating interest rate of 3-month LIBOR plus 1.39% and qualify as regulatory capital. These securities have a thirty year maturity, but can be redeemed at par by the Company after five years.

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.

See Note 10 to the Consolidated Financial Statements above for information related to a tax loss contingency accrual that was recorded in 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 a higher amount to 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 the 2003 insurance agency acquisition, the identifiable intangible asset related to the customer list was determined to have a ten year life, 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.

RESULTS OF OPERATIONS

Overview

Net income for the three months ended March 31, 2006 was $4,991,000, a 5.8% increase from the $4,716,000 recorded in the first quarter of 2005. The net income for the three month period ended March 31, 2006 amounted to $0.35 per diluted share, a 6.1% increase over the $0.33 net income per diluted share for the same period in 2005.

Total assets at March 31, 2006 amounted to $1.91 billion, 13.1% higher than a year earlier. Total loans at March 31, 2006 amounted to $1.55 billion, an 11.3% increase from a year earlier, and total deposits were $1.57 billion, an 8.0% increase from a year earlier.

The increase in loans and deposits over the past twelve months resulted in an increase in the Company's net interest income when comparing the first quarter of 2006 to the first quarter of 2005. Net interest income for the first quarter of 2006 amounted to $17.9 million, a 9.6% increase over the $16.3 million recorded in the first quarter of 2005.

The Company's net interest margin (tax-equivalent net interest income divided by average earning assets) was 4.33% for the first quarter of 2006, which is the same as it was in the first quarter of 2005. This net interest margin was a four basis point decrease from the 4.37% realized in the fourth quarter of 2005. The slight decrease in margin from the previous quarter was primarily a result of the average rates paid on deposits rising by more than the corresponding increases in average yields realized from loans.

The Company's provision for loan losses amounted to $1,015,000 in the first quarter of 2006 compared to $580,000 in the first quarter of 2005. The increase was primarily the result of strong loan growth in 2006, as asset quality ratios remained stable. Loan growth was $71 million in the first quarter of 2006 compared to $28 million in the first quarter of 2005. The Company's ratio of annualized net charge-offs to average loans amounted to 3 basis points for the first quarter of 2006 compared to 7 basis points for the first quarter of 2005. The Company's ratio of nonperforming assets to total assets was 0.25% at March 31, 2006 compared to 0.40% at March 31, 2005.

Noninterest income amounted to $4.0 million for the first quarter of 2006, a 6.6% increase from the first quarter of 2005. Noninterest expenses amounted to $12.7 million in the first quarter of 2006, an 8.7% increase over 2005. There were no unusual items of noninterest income or expense that were significant in either period. In

accordance with the new accounting requirements regarding stock-based compensation (FASB Statement 123(R)) that were effective on January 1, 2006, the Company recorded $47,000 in expense related to stock options in the first quarter of 2006.

The Company's effective tax rate remained relatively unchanged in comparing the first quarter of 2006 to the first quarter of 2005 - 38.1% in the first quarter of 2006 compared to 38.8% for the first quarter of 2005.

The Company's annualized return on average assets for the first quarter of 2006 was 1.12% compared to 1.16% for the first quarter of 2005. The Company's annualized return on average equity for the first quarter of 2006 was 12.78% compared to 12.57% for the first quarter of 2005.

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 March 31, 2006 amounted to $17,853,000, an increase of $1,568,000, or 9.6% from the $16,285,000 recorded in the first quarter of 2005. Net interest income on a taxable equivalent basis for the three month period ended March 31, 2006 amounted to $17,979,000, an increase of $1,581,000, or 9.6% from the $16,398,000 recorded in the first quarter of 2005. Management believes that analysis of net interest income on a tax-equivalent basis is useful and appropriate because it allows a comparison of net interest income amounts in different periods without taking into account the different mix of taxable versus non-taxable investments that may have existed during those periods.

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 months ended March 31, 2006, the increase in net interest income was caused by growth in loans and deposits, as the Company's net interest margin of 4.33% in the first quarter of 2006 was unchanged from the first quarter of 2005.

The following table presents net interest income analysis on a taxable-equivalent basis.

	For the Three Months Ended March 31,				
	2006			200	
($ in thousands)	Average Volume	Average Rate	Interest Earned or Paid	Average Volume	Aver Ra
Assets					
Loans (1)	$1,516,456	7.16%	$ 26,762	$ 1,383,216	
Taxable securities	114,910	4.69%	1,329	103,248	
Non-taxable securities (2)	11,822	8.68%	253	11,340	
Short-term investments, principally federal funds	39,347	5.12%	497	39,361	
Total interest-earning assets	1,682,535	6.95%	28,841	1,537,165	
Liabilities					
Savings, NOW and money market deposits	$ 467,760	1.16%	$ 1,333	$ 474,683	
Time deposits >$100,000	365,465	4.08%	3,677	342,487	
Other time deposits	494,847	3.63%	4,432	424,878	
Total interest-bearing deposits	1,328,072	2.88%	9,442	1,242,048	

Securities sold under agreements to repurchase	30,314	3.51%	262	--
Borrowings	73,550	6.39%	1,158	76,683
Total interest-bearing liabilities	1,431,936	3.08%	10,862	1,318,731
Non-interest-bearing deposits	197,095			172,673
Net yield on interest-earning assets and net interest income		4.33%	$ 17,979	
Interest rate spread		3.87%		
Average prime rate		7.42%		

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

(2) Includes tax-equivalent adjustments of $126,000 and $113,000 in 2006 and 2005, 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 first quarter of 2006 were $1.516 billion, which was 9.6% higher than the average loans outstanding for the first quarter of 2005 ($1.383 billion). The mix of the Company's loan portfolio remained substantially the same at March 31, 2006 compared to December 31, 2005, with approximately 86% of the Company's loans being real estate loans, 9% 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 deposits outstanding for the first quarter of 2006 were $1.525 billion, which was 7.8% higher than the average amount of deposits outstanding in the first quarter of 2005 ($1.415 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 2006.

As shown in the table above, yields on interest earning assets and liabilities both generally increased in 2006 compared to 2005 as a result of the rising rate environment that began in the third quarter of 2004. In 2005, the Federal Reserve increased interest rates eight times totaling 200 basis points, which followed five rate increases totaling 125 basis points that occurred in the second half of 2004. In the first quarter of 2006, the Federal Reserve increased interest rates two times by a total of 50 basis points.

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

The Company's provision for loan losses increased significantly in 2006 compared to 2005, amounting to $1,015,000 in the first quarter of 2006 versus $580,000 in the first quarter of 2005. The increase was primarily the result of the strong loan growth realized in 2006, as asset quality ratios remained stable. Loan growth was $71 million in the first quarter of 2006 compared to $28 million in the first quarter of 2005. The Company's ratio of annualized net charge-offs to average loans amounted to 3 basis points for the first quarter of 2006 compared to 7 basis points for the first quarter of 2005. The Company's ratio of nonperforming assets to total assets was 0.25% at March 31, 2006 compared to 0.40% at March 31, 2005.

Noninterest income amounted to $3,954,000 for the first quarter of 2006, a 6.6% increase from the $3,710,000 recorded in the first quarter of 2005. The increase was primarily a result of general growth in the Company's customer base, increased usage of credit cards and debit cards by the Company's customers (which impacted the line item "other service charges, commissions and fees"), and increased commissions from financial product sales resulting from increased sales, as well as $55,000 more in "experience bonuses" recorded by the Company. Experience bonuses are received annually in the first quarter of each year from the insurance companies that the Company acts as an agent for and can fluctuate depending on the actual loss experience that the insurance companies experience related to the Company's customers.

These increases were partially offset by a $111,000 decrease in data processing income in the first quarter of 2006 compared to 2005. The Company's data processing subsidiary makes its excess data processing capabilities available to area financial institutions for a fee. At January 1, 2005, the Company had five community bank customers using this service. Three of these customers terminated their contracts with the Company in the latter half of 2005, which resulted in the decrease in data processing fee income. The Company intends to continue to market this service to area banks, but does not currently have any near-term prospects for additional business.

Noninterest expenses for the three months ended March 31, 2006 increased 8.7% to $12,729,000 from $11,715,000 in the first quarter of 2005. The increase in noninterest expenses occurred in all categories and is associated with the overall growth of the Company in terms of branch network, employees and customer base. In accordance with the new accounting requirements regarding stock-based compensation that were effective on January 1, 2006, the Company recorded $47,000 in expense related to stock options in the first quarter of 2006 - see Note 4 to the Consolidated Financial Statements above for additional discussion.

The provision for income taxes was $3,072,000 in the first quarter of 2006, an effective tax rate of 38.1%, compared to $2,984,000 in the first quarter of 2005, an effective tax rate of 38.8%. The Company expects its effective tax rate to remain at approximately 38-39% for the foreseeable future.

The Consolidated Statements of Comprehensive Income reflect "Other Comprehensive Loss" of $49,000 and $857,000 during the first quarters of 2006 and 2005, respectively, related primarily to unrealized available for sale security holding losses occurring during the quarter. The unrealized security holding losses were caused by an increase in market yields for fixed income securities during each quarter. The Company's available for sale securities portfolio is predominantly comprised of fixed income securities that decline in value when market yields for fixed income securities increase.

FINANCIAL CONDITION

Total assets at March 31, 2006 amounted to $1.91 billion, 13.1% higher than a year earlier. Total loans at March 31, 2006 amounted to $1.55 billion, an 11.3% increase from a year earlier, and total deposits amounted to $1.57 billion at March 31, 2006, an 8.0% increase from a year earlier.

The following tables present information regarding the nature of the Company's growth since March 31, 2005.

April 1, 2005 to March 31, 2006	Balance at beginning of period	Internal Growth	Change in brokered deposits	Balance at end of period
			($ in thousands)	
Loans	$ 1,395,324	158,047	--	1,553,371
Deposits - Noninterest bearing	$ 175,698	37,963	--	213,661
Deposits - Savings, NOW, and Money Market	477,838	(4,183)	--	473,655
Deposits - Time>$100,000	361,567	60,538	(49,873)	372,232
Deposits - Time				