

Peoples Bancorp

Accountants' Report and Consolidated Financial Statements

September 30, 2010 and 2009

Peoples Bancorp
September 30, 2010 and 2009

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Independent Accountants' Report

Audit Committee, Board of Directors
and Stockholders
Peoples Bancorp
Auburn, Indiana

We have audited the accompanying consolidated balance sheets of Peoples Bancorp as of September 30, 2010 and 2009, and the related consolidated statements of income, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Peoples Bancorp as of September 30, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

BKD, LLP

Indianapolis, Indiana
November 11, 2010

Peoples Bancorp
Consolidated Balance Sheets
September 30, 2010 and 2009

Assets

	<u>2010</u>	<u>2009</u>
Cash and cash equivalents	\$ 17,431,175	\$ 8,608,642
Investment securities		
Available for sale	177,205,610	173,246,748
Held to maturity (fair value of \$0 and \$264,118)	-	252,351
Total investment securities	<u>177,205,610</u>	<u>173,499,099</u>
Mortgage loans held for sale	1,190,800	839,400
Loans, net of allowance for loan losses of \$2,196,120 and \$1,653,931	249,813,132	278,042,813
Premises and equipment	5,184,434	5,555,970
Federal Home Loan Bank of Indianapolis stock, at cost	4,462,500	4,462,500
Goodwill	2,392,698	2,330,198
Cash surrender value of life insurance	8,577,172	8,377,308
Other assets	<u>6,265,473</u>	<u>6,125,797</u>
Total assets	<u>\$ 472,522,994</u>	<u>\$ 487,841,727</u>

Liabilities

NOW and savings deposits	\$ 162,566,765	\$ 150,528,982
Certificates of deposit	<u>176,225,341</u>	<u>184,184,838</u>
Total deposits	338,792,106	334,713,820
Short-term borrowings	3,020,296	1,255,599
Federal Home Loan Bank advances	66,723,665	87,250,000
Other liabilities	<u>3,773,525</u>	<u>3,751,568</u>
Total liabilities	<u>412,309,592</u>	<u>426,970,987</u>

Commitments and Contingencies

Stockholders' Equity

Preferred stock, \$1 par value		
Authorized and unissued - 5,000,000 shares		
Common stock, \$1 par value		
Authorized - 7,000,000 shares		
Issued and outstanding - 2,484,880 and 2,667,725 shares	2,484,880	2,667,725
Retained earnings	54,537,708	55,467,946
Accumulated other comprehensive income	<u>3,190,814</u>	<u>2,735,069</u>
Total stockholders' equity	<u>60,213,402</u>	<u>60,870,740</u>
Total liabilities and stockholders' equity	<u>\$ 472,522,994</u>	<u>\$ 487,841,727</u>

Peoples Bancorp
Consolidated Statements of Income
Years Ended September 30, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Interest Income		
Loans	\$ 15,926,443	\$ 18,331,019
Investment securities	5,672,273	5,232,571
Other interest and dividend income	89,280	134,282
	<u>21,687,996</u>	<u>23,697,872</u>
Interest Expense		
Deposits		
NOW and savings deposits	559,185	822,220
Certificates of deposit	4,687,772	5,712,593
Short-term borrowings	16,368	7,731
Federal Home Loan Bank advances	3,154,649	3,422,527
	<u>8,417,974</u>	<u>9,965,071</u>
Net Interest Income	13,270,022	13,732,801
Provision for loan losses	1,041,874	733,257
Net Interest Income After Provision for Loan Losses	<u>12,228,148</u>	<u>12,999,544</u>
Non-Interest Income		
Fiduciary activities	420,997	388,598
Fees and service charges	1,234,239	1,211,471
Net realized gains on available-for-sale securities	583,720	554,855
Gain on sale of loans	411,176	686,724
Cash surrender value	527,572	359,813
Other income	222,213	81,291
Total other income	<u>3,399,917</u>	<u>3,282,752</u>
Non-Interest Expenses		
Salaries and employee benefits	6,821,079	6,905,707
Net occupancy expense	951,010	1,026,680
Equipment expense	794,722	901,167
Data processing expense	540,661	551,291
Deposit insurance expense	454,702	521,381
Other expenses	2,268,370	2,550,517
Total other expenses	<u>11,830,544</u>	<u>12,456,743</u>
Income Before Income Tax	3,797,521	3,825,553
Income tax expense	506,977	704,466
Net Income	<u>\$ 3,290,544</u>	<u>\$ 3,121,087</u>
Basic Earnings Per Share	\$ 1.28	\$ 1.14
Diluted Earnings Per Share	\$ 1.28	\$ 1.14
Weighted-Average Shares Outstanding - Basic	2,564,473	2,730,595
Weighted-Average Shares Outstanding - Diluted	2,564,473	2,730,595

Peoples Bancorp
Consolidated Statements of Stockholders' Equity
Years Ended September 30, 2010 and 2009

	Common Stock		Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive	Total
	Outstanding	Amount			Income (Loss)	
Balances, October 1, 2008	2,801,007	\$ 2,801,007		\$ 55,626,060	\$ (895,826)	\$ 57,531,241
Comprehensive income						
Net income			\$ 3,121,087	3,121,087		3,121,087
Other comprehensive income, net of tax						
Unrealized gains on securities, net of reclassification adjustment			3,630,895		3,630,895	3,630,895
Comprehensive income			<u>\$ 6,751,982</u>			
Cash dividends (\$.76 per share)				(2,062,771)		(2,062,771)
Repurchase of common stock	<u>(133,282)</u>	<u>(133,282)</u>		<u>(1,216,430)</u>		<u>(1,349,712)</u>
Balances, September 30, 2009	2,667,725	2,667,725		55,467,946	2,735,069	60,870,740
Comprehensive income						
Net income			\$ 3,290,544	3,290,544		3,290,544
Other comprehensive income, net of tax						
Unrealized gains on securities, net of reclassification adjustment			455,745		455,745	455,745
Comprehensive income			<u>\$ 3,746,289</u>			
Cash dividends (\$.76 per share)				(1,932,536)		(1,932,536)
Repurchase of common stock	<u>(182,845)</u>	<u>(182,845)</u>		<u>(2,288,246)</u>		<u>(2,471,091)</u>
Balances, September 30, 2010	<u>2,484,880</u>	<u>\$ 2,484,880</u>		<u>\$ 54,537,708</u>	<u>\$ 3,190,814</u>	<u>\$ 60,213,402</u>

Peoples Bancorp

Consolidated Statements of Cash Flows

Years Ended September 30, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Operating Activities		
Net income	\$ 3,290,544	\$ 3,121,087
Items not requiring (providing) cash		
Provision for loan losses	1,041,874	733,257
Depreciation and amortization	815,404	919,425
Investment securities amortization, net	2,739,768	925,938
(Gain) loss from sale of premises and equipment	(3,000)	24,350
Gain on sale of loans	(411,176)	(686,724)
Loss on real estate owned	100,684	369,092
Amortization of deferred loan fees	(229,196)	(423,332)
Net realized gains on available-for-sale securities	(583,720)	(554,855)
Increase in cash surrender value of life insurance	(360,010)	(359,813)
Deferred income tax	(158,032)	221,852
Change in		
Loans held for sale	(351,400)	(551,400)
Interest receivable	(85,635)	194,449
Interest payable	(85,789)	(48,635)
Other adjustments	(730,026)	(961,561)
Net cash provided by operating activities	<u>4,990,290</u>	<u>2,923,130</u>
Investing Activities		
Purchases of securities available for sale	(92,032,572)	(117,794,502)
Proceeds from maturities, calls and paydowns of securities held to maturity	19,591	81,954
Proceeds from maturities, call and paydowns of securities available for sale	40,019,492	27,821,454
Proceeds from sales of securities available for sale	46,569,858	25,523,028
Proceeds from sales of securities held to maturity	283,575	-
Net change in loans	26,975,569	37,029,891
Proceeds from cash surrender value of life insurance	160,146	-
Purchase of FHLB stock	-	(58,600)
Purchases of premises and equipment	(466,775)	(139,261)
Proceeds from sales of premises and equipment	25,907	40,736
Proceeds from sale of foreclosed real estate	1,396,446	1,396,986
Net cash provided by (used in) investing activities	<u>22,951,237</u>	<u>(26,098,314)</u>
Financing Activities		
Net change in		
NOW and savings deposits	12,037,783	4,951,362
Certificates of deposit	(7,959,497)	10,516,745
Short-term borrowings	1,764,697	1,064,419
Proceeds from Federal Home Loan Bank advances	27,500,000	45,250,000
Repayment of Federal Home Loan Bank advances	(48,026,335)	(33,350,000)
Cash dividends	(1,964,551)	(2,088,094)
Repurchase of common stock	(2,471,091)	(1,349,712)
Net cash provided by (used in) financing activities	<u>(19,118,994)</u>	<u>24,994,720</u>
Net Change in Cash and Cash Equivalents	8,822,533	1,819,536
Cash and Cash Equivalents, Beginning of Year	<u>8,608,642</u>	<u>6,789,106</u>
Cash and Cash Equivalents, End of Year	<u>\$ 17,431,175</u>	<u>\$ 8,608,642</u>
Additional Cash Flows Information		
Interest paid	\$ 8,503,763	\$ 10,013,706
Income tax paid	20,000	894,851
Transfer to other real estate from loans	852,610	1,766,078

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Notes to Consolidated Financial Statements

September 30, 2010 and 2009

Note 1: Nature of Operations and Summary of Significant Accounting Policies

The accounting and reporting policies of Peoples Bancorp (Company), its wholly owned subsidiary, Peoples Federal Savings Bank of DeKalb County (Bank), the Bank's wholly owned subsidiaries, Peoples Financial Services, Inc. (Peoples Financial), PFDC Investments, Inc. and Alpha Financial, Inc. (Alpha) conform to accounting principles generally accepted in the United States of America and reporting practices followed by the thrift industry. The more significant of the policies are described below.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The Company is a thrift holding company whose principal activity is the ownership and management of the Bank. The Bank operates under a federal thrift charter and provides full banking services, including trust services. As a federally-chartered thrift, the Bank is subject to the regulation of the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation.

The Bank generates commercial, mortgage and consumer loans and receives deposits from customers located primarily in north central and north eastern Indiana and south central Michigan. The Bank's loans are generally secured by specific items of collateral including real property and consumer assets.

Consolidation - The consolidated financial statements include the accounts of the Company, the Bank, Alpha, PFDC Investments, Inc. and Peoples Financial after elimination of all material intercompany transactions.

Cash Equivalents - Cash and cash equivalents include amounts due from banks and overnight investments with the Federal Home Loan Bank (FHLB). Net cash flows are reported for customer loan and deposit transactions, interest-bearing deposits in other financial institutions and repurchase agreements.

Investment Securities - Certain debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as held to maturity, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

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Notes to Consolidated Financial Statements
September 30, 2010 and 2009

Mortgage Loans Held for Sale - Mortgage loans held for sale are carried at the lower of cost or fair value, determined using an aggregate basis. Write-downs to fair value are recognized as a charge to earnings at the time the decline in value occurs. Forward commitments to sell mortgage loans are acquired to reduce market risk on mortgage loans in the process of origination and mortgage loans held for sale. Gains and losses resulting from sales of mortgage loans are recognized when the respective loans are sold to investors. Gains and losses are determined by the difference between the selling price and the carrying amount of the loans sold, net of discounts collected or paid and considering a normal servicing rate.

Loans Receivable - Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal amount outstanding, net of deferred loan fees and costs and the allowance for loan losses. Interest income is accrued on the principal balances of loans. Generally, loans are placed on nonaccrual status at 90 days past due. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed when considered uncollectible. Interest income is subsequently recognized only to the extent cash payments are received. Certain loan fees and direct costs are being deferred and amortized as an adjustment of yield on the loans.

Allowance for loan losses is maintained at a level believed by management to absorb probable incurred losses in the loan portfolio and is based on the size and current risk characteristics of the loan portfolio, an assessment of individual problem loans, actual loss experience, current economic events in specific industries and geographical areas, and other pertinent factors including general economic conditions. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience and consideration of economic trends, all of which may be susceptible to significant change. Allocations of the allowance may be made for specific loans, however, the entire allowance is available for any loan that, in management's judgment, should be charged off. A loan is impaired when full payment under the loan terms is not expected.

Loan losses are charged off against the allowance when, in management's estimation, it is unlikely that the loan will be collected, while recoveries of amounts previously charged off are credited to the allowance. A provision for loan losses is charged to operations based on management's periodic evaluation of the factors previously mentioned, as well as other pertinent factors in order to maintain the allowance for loan losses at the level deemed adequate by management. The determination of whether a loan is considered past due or delinquent is based on the contractual payment terms. Management believes that, as of September 30, 2010, the allowance for loan losses is adequate based on information currently available. A worsening or protracted economic decline in the area within which the Company operates would increase the likelihood of additional losses due to credit and market risks and could create the need for additional loss provisions.

Peoples Bancorp

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using either a straight-line or accelerated method with useful lives ranging from 5 to 39 years. Furniture, fixtures and equipment are depreciated using a straight-line or accelerated method with useful lives ranging from 3 to 10 years. Land is carried at cost. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are included in current operations.

Federal Home Loan Bank stock is a required investment for institutions that are members of the Federal Home Loan Bank system. The required investment in the common stock is based on a predetermined formula.

Foreclosed assets are carried at the lower of cost or fair value less estimated selling costs. When foreclosed assets are acquired, any required adjustment is charged to the allowance for loan losses. All subsequent activity is included in current operations.

Goodwill is annually tested for impairment. If the implied fair value of goodwill is lower than its carrying amount, a goodwill impairment is indicated and goodwill is written down to its implied fair value. Subsequent increases in goodwill value are not recognized in the consolidated financial statements.

Cash surrender value of life insurance - The Bank has purchased life insurance policies on certain key executives. The insurance is recorded at its cash surrender value, or the amount that can be realized.

Investments in limited partnerships are included in other assets. The Company utilizes the equity method of accounting for these investments. At September 30, 2010 and 2009, these investments totaled \$110,000 and \$171,000, respectively.

Pension plan costs are based on actuarial computations and charged to current operations. The funding policy is to pay at least the minimum amounts required by ERISA. The Company froze its defined-benefit plan effective August 1, 2007.

Income tax in the consolidated statements of income includes deferred income tax provisions or benefits for all significant temporary differences in recognizing income and expenses for financial reporting and income tax purposes. The Company files consolidated income tax returns with its subsidiaries.

Earnings per share have been computed based upon the weighted-average common shares outstanding during each year.

Mortgage-Servicing Rights - Mortgage-servicing rights on originated loans that have been sold are initially recorded at fair value. Capitalized servicing rights are amortized in proportion to and over the period of estimated servicing revenues. Impairment of mortgage-servicing rights is assessed based on the fair value of those rights. Fair values are estimated using discounted cash flows based on a current market interest rate. For purposes of measuring impairment, the rights are stratified based on the predominant risk characteristics of the underlying loans. The predominant characteristic currently used for stratification is type of loan. The amount of impairment recognized is the amount by which the capitalized mortgage-servicing rights for a stratum exceed their fair value.

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Notes to Consolidated Financial Statements
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Current economic conditions - The current protracted economic decline continues to present financial institutions with difficult circumstances and challenges, which in some cases have resulted in large declines in the fair values of investments and other assets, constraints on liquidity and significant credit quality problems, including severe volatility in the valuation of real estate and other collateral supporting loans. The consolidated financial statements have been prepared using values and information currently available to the Company.

Due to national, state and local economic conditions, values for commercial and development real estate have declined significantly, and the market for these properties is depressed. The accompanying consolidated financial statements have been prepared using values and information currently available to the Company.

Given the volatility of current economic conditions, the values of assets and liabilities recorded in the consolidated financial statements could change rapidly, resulting in material future adjustments in asset values, the allowance for loan losses and capital that could negatively impact the Company's ability to meet regulatory capital requirements and maintain sufficient liquidity.

Reclassifications - Reclassifications have been made to the 2009 financial statements to conform to the 2010 financial statement presentation. These reclassifications had no effect on net income.

Note 2: Concentration of Funds and Restriction on Cash and Cash Equivalents

As of September 30, 2010 and 2009, respectively, there were no balances with other financial institutions in excess of the balance insured by the Federal Deposit Insurance Corporation. Additionally, the Company had \$12,103,000 and \$3,644,000 on deposit with the Federal Home Loan Bank of Indianapolis, and \$651,000 and \$140,000 on deposit with the Federal Reserve Bank of Chicago as of September 30, 2010 and 2009, respectively, which is not federally insured.

The Bank is required to maintain reserve funds in cash and/or on deposit with the Federal Reserve Bank. The reserve funds required at September 30, 2010 totaled \$2,755,000.

Note 3: Investment Securities

	2010			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Available for sale				
Federal agencies	\$ 35,858,195	\$ 699,855	\$ 84,911	\$ 36,473,139
State and municipal obligations	57,650,840	2,446,756	42,501	60,055,095
Mortgage-backed securities	78,826,668	2,117,896	267,188	80,677,376
	<u>\$ 172,335,703</u>	<u>\$ 5,264,507</u>	<u>\$ 394,600</u>	<u>\$ 177,205,610</u>

Peoples Bancorp
Notes to Consolidated Financial Statements
September 30, 2010 and 2009

	2009			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Available for sale				
Federal agencies	\$ 38,440,761	\$ 377,779	\$ 265,504	\$ 38,553,036
State and municipal obligations	47,004,866	2,211,855	24,950	49,191,771
Mortgage-backed securities	83,653,716	1,865,568	17,343	85,501,941
Total available for sale	<u>169,099,343</u>	<u>4,455,202</u>	<u>307,797</u>	<u>173,246,748</u>
Held to maturity				
Mortgage-backed securities	<u>252,351</u>	<u>11,767</u>	<u>-</u>	<u>264,118</u>
Total investment securities	<u>\$ 169,351,694</u>	<u>\$ 4,466,969</u>	<u>\$ 307,797</u>	<u>\$ 173,510,866</u>

The amortized cost and fair value of securities held to maturity and available for sale at September 30, 2010, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

Maturity Distributions at September 30	2010 Available for Sale	
	Amortized Cost	Fair Value
Within one year	\$ 4,052,349	\$ 4,059,568
One to five years	9,069,114	9,157,238
Five to ten years	42,899,995	44,235,853
After ten years	<u>37,487,577</u>	<u>39,075,575</u>
	93,509,035	96,528,234
Mortgage-backed securities	<u>78,826,668</u>	<u>80,677,376</u>
	<u>\$ 172,335,703</u>	<u>\$ 177,205,610</u>

Securities with a carrying value of \$8,221,000 and \$1,819,000 were pledged at September 30, 2010 and 2009 to secure repurchase agreements. Securities with a carrying value of \$2,722,000 and \$2,624,000 were pledged at September 30, 2010 and 2009 to secure certain deposits.

Proceeds from sales of securities available for sale during 2010 and 2009 were \$46,853,000 and \$25,523,000, respectively. Gross gains of \$722,000 and \$559,000 were realized on investment transactions during 2010 and 2009, respectively. Gross losses of \$138,000 and \$4,000 were realized on investment transactions during 2010 and 2009, respectively.

Peoples Bancorp

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

Certain investments in debt securities are reported in the financial statements at an amount less than their historical cost. Total fair value of these investments at September 30, 2010 and 2009 was \$24,745,000 and \$15,773,000, which is approximately 14% and 9% of the Company's available-for-sale and held-to-maturity investment portfolio. These declines primarily resulted from fluctuations in market interest rates after the purchase.

Based on evaluation of available evidence, including recent changes in market interest rates, credit rating information and information obtained from regulatory filings, management believes the declines in fair value for these securities are temporary.

Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in either net income or accumulated other comprehensive loss in the period the other-than-temporary impairment is identified.

The following table shows our investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2010:

Description of Securities	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Federal agencies	\$ -	\$ -	\$ 1,462,784	\$ 84,911	\$ 1,462,784	\$ 84,911
State and municipal obligations	466,754	401	1,541,441	42,100	2,008,195	42,501
Mortgage-backed securities	21,273,737	267,188	-	-	21,273,737	267,188
Total temporarily impaired securities	<u>\$ 21,740,491</u>	<u>\$ 267,589</u>	<u>\$ 3,004,225</u>	<u>\$ 127,011</u>	<u>\$ 24,744,716</u>	<u>\$ 394,600</u>

The following table shows our investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2009:

Description of Securities	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Federal agencies	\$ 7,991,702	\$ 108,220	\$ 342,715	\$ 157,284	\$ 8,334,417	\$ 265,504
State and municipal obligations	471,795	10,015	1,407,433	14,935	1,879,228	24,950
Mortgage-backed securities	5,236,295	16,012	322,678	1,331	5,558,973	17,343
Total temporarily impaired securities	<u>\$ 13,699,792</u>	<u>\$ 134,247</u>	<u>\$ 2,072,826</u>	<u>\$ 173,550</u>	<u>\$ 15,772,618</u>	<u>\$ 307,797</u>

Peoples Bancorp
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Federal Agencies

The unrealized losses on the Company's investments in direct obligations of federal agencies were caused by changes in market interest rates. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2010.

Mortgage-Backed Securities

The unrealized losses on the Company's investment in mortgage-backed securities were caused by changes in market interest rates. The Company expects to recover the amortized cost basis over the term of the securities. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2010.

Note 4: Loans and Allowance

	2010	2009
Commercial and commercial mortgage loans	\$ 51,398,371	\$ 43,156,432
Real estate loans	197,595,871	232,810,475
Construction loans	268,987	-
Individuals' loans for household and other personal expenditures	3,530,791	4,474,784
	<u>252,794,020</u>	<u>280,441,691</u>
Less:		
Undisbursed portion of loans	281,799	149,290
Deferred loan fees and discounts	502,969	595,657
Allowance for loan losses	2,196,120	1,653,931
	<u>2,980,888</u>	<u>2,398,878</u>
Total loans	<u>\$ 249,813,132</u>	<u>\$ 278,042,813</u>

Peoples Bancorp
Notes to Consolidated Financial Statements
September 30, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Allowance for loan losses		
Balances, October 1	\$ 1,653,931	\$ 1,871,970
Provision for losses	1,041,874	733,257
Recoveries on loans	15,000	85,000
Loans charged off	<u>(514,685)</u>	<u>(1,036,296)</u>
Balances, September 30	<u>\$ 2,196,120</u>	<u>\$ 1,653,931</u>

Impaired loans were as follows:

	<u>2010</u>	<u>2009</u>
Year-end loans with no allocated allowance for loan losses	\$ 550,707	\$ 259,588
Year-end loans with allocated allowance for loan losses	<u>1,015,230</u>	<u>1,692,560</u>
	<u>\$ 1,565,937</u>	<u>\$ 1,952,148</u>
Amount of the allowance for loan losses allocated	\$ 140,000	\$ 217,000

	<u>2010</u>	<u>2009</u>
Average balance of impaired loans during the year	\$ 1,773,255	\$ 2,419,232
Interest income recognized during impairment	109,905	138,086
Cash-basis interest income recognized	117,254	126,315

The Company considers its investment in one-to-four family residential loans and consumer loans to be homogeneous and therefore excluded from separate identification for evaluation of impairment.

At September 30, 2010 and 2009, nonaccruing loans were \$3,012,000 and \$3,632,000, respectively. There are no loans delinquent 90 days or more and still accruing as of September 30, 2010 and 2009, respectively.

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Note 5: Premises and Equipment

	<u>2010</u>	<u>2009</u>
Land and land improvements	\$ 1,373,936	\$ 1,362,040
Buildings	9,124,047	9,114,263
Equipment	<u>8,060,025</u>	<u>7,658,393</u>
Total cost	18,558,008	18,134,696
Accumulated depreciation	<u>(13,373,574)</u>	<u>(12,578,726)</u>
Net	<u>\$ 5,184,434</u>	<u>\$ 5,555,970</u>

Note 6: Deposits

	<u>2010</u>	<u>2009</u>
Noninterest-bearing demand deposits	\$ 18,213,327	\$ 15,652,475
Interest-bearing demand deposits	84,469,100	79,940,526
Savings deposits	59,884,338	54,935,981
Certificates and other time deposits of \$100,000 or more	39,277,462	40,826,320
Other certificates and time deposits	<u>136,947,879</u>	<u>143,358,518</u>
	<u>\$ 338,792,106</u>	<u>\$ 334,713,820</u>

Certificates and other time deposits maturing in years ending September 30:

2011	\$ 104,315,069
2012	40,329,630
2013	15,809,030
2014	6,347,080
2015	<u>9,424,532</u>
	<u>\$ 176,225,341</u>

Deposits from related parties held by the Company at September 30, 2010 and 2009 totaled \$3,126,000 and \$2,764,000, respectively.

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Note 7: Short-Term Borrowings

	2010	2009
Securities sold under agreements to repurchase	\$ 3,020,296	\$ 1,255,599

At September 30, 2010 and 2009, the securities sold under agreements to repurchase obligations were secured by investment securities and such collateral is held by a safekeeping agent. The maximum amount of outstanding agreements at any month-end during 2010 and 2009 totaled \$4,068,000 and \$1,256,000 and the average of such agreements for the years ended September 30, 2010 and 2009 totaled \$1,866,000 and \$536,000, respectively.

Note 8: Federal Home Loan Bank Advances

Federal Home Loan Bank advances at September 30, 2010 and 2009 totaled \$66,724,000 and \$87,250,000 and were at various rates ranging from 2.03% to 5.21% maturing at various dates through August 2022. The Federal Home Loan Bank advances are secured by first mortgage loans totaling \$158,303,000. Advances are subject to restrictions or penalties in the event of prepayment.

Maturities in years ending September 30	Amount
2011	\$ 11,113,852
2012	3,833,636
2013	18,305,926
2014	6,280,600
2015	8,257,546
Thereafter	18,932,105
	\$ 66,723,665

Amounts advanced totaling \$3,000,000 are subject to an option for the FHLB to convert the entire advance to a periodic adjustable rate. If the FHLB exercises its option to convert the advance to an adjustable rate, the advance will be pre-payable at the Bank's option, at par without a penalty fee.

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Note 9: Loan Servicing

Mortgage loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balance of mortgage loans serviced for others was \$89,960,000 and \$82,951,000 at September 30, 2010 and 2009, respectively.

	2010	2009
Mortgage-servicing rights		
Balance, beginning of year	\$ 425,359	\$ 186,571
Servicing rights capitalized	167,656	358,636
Amortization of servicing rights	<u>(166,373)</u>	<u>(119,848)</u>
Balance, end of year	<u>\$ 426,642</u>	<u>\$ 425,359</u>

The fair value of servicing rights subsequently measured using the amortization method was as follows:

	2010	2009
Fair value, beginning of period	\$ 620,000	\$ 187,000
Fair value, end of period	538,000	620,000

Note 10: Income Tax

	2010	2009
Income tax expense		
Currently payable		
Federal	\$ 659,012	\$ 416,722
State	5,997	65,892
Deferred		
Federal	(156,785)	250,444
State	<u>(1,247)</u>	<u>(28,592)</u>
Total income tax expense	<u>\$ 506,977</u>	<u>\$ 704,466</u>
Reconciliation of federal statutory to actual tax expense		
Federal statutory income tax at 34%	\$ 1,291,157	\$ 1,300,687
Tax exempt interest	(613,119)	(502,467)
Nondeductible expenses	809	1,085
Effect of state income taxes	3,135	24,618
Cash surrender value	(179,374)	(122,336)
Effect of low income housing credits	(3,729)	(21,933)
Other	<u>8,098</u>	<u>24,812</u>
Actual tax expense	<u>\$ 506,977</u>	<u>\$ 704,466</u>

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A cumulative net deferred tax asset (liability) is included in other assets (liabilities). The components of the asset are as follows:

	<u>2010</u>	<u>2009</u>
Assets		
Allowance for loan losses	\$ 761,337	\$ 613,412
Loan fees	206,306	244,044
Capital loss carryforward	31,611	31,398
Other real estate owned	112,615	166,569
Net operating loss	2,772	35,801
Alternative minimum tax and low income housing credits	137,475	117,364
Other	188,381	178,457
Total assets	<u>1,440,497</u>	<u>1,387,045</u>
Liabilities		
Depreciation	142,463	34,770
State income tax	47,961	52,008
FHLB of Indianapolis stock dividend	253,986	253,694
Net unrealized gains on securities available for sale	1,633,697	1,441,192
Prepaid expenses	88,445	144,325
Other	345,430	380,708
Total liabilities	<u>2,511,982</u>	<u>2,306,697</u>
	<u>\$ (1,071,485)</u>	<u>\$ (919,652)</u>

Management believes no valuation allowance is necessary at September 30, 2010 and 2009.

Retained earnings at September 30, 2010 include approximately \$8,102,000 for which no deferred income tax liability has been recognized. This amount represents an allocation of income to bad debt deductions as of June 30, 1988 for tax purposes only. Reduction of amounts so allocated for purposes other than tax bad debt losses or adjustments arising from carryback of net operating losses would create income for tax purposes only, which income would be subject to the then current corporate income tax rate. The unrecorded deferred income tax liability on the above amount was approximately \$2,755,000 at September 30, 2010.

At September 30, 2010, the Company had credit carryforwards totaling \$137,000. Of that amount, \$112,000 represents alternative minimum tax with no expiration date and \$25,000 is related to low income housing credits that will expire in 2029.

The Company adopted new accounting standards related to accounting for uncertain tax positions on October 1, 2009. As a result, the Bank has not identified any uncertain tax positions that it believes should be recognized in the consolidated financial statements. The Bank's tax years still subject to examination by taxing authorities are years subsequent to 2006.

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Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation. Collateral held varies, but may include residential real estate, income-producing commercial properties, or other assets of the borrower.

The Company has employment agreements with three officers which include provisions for payment to them of three years salary, respectively, in the event of their termination in connection with any change in ownership or control of the Company, other than by agreement. The agreements have terms of three years, which may be extended annually for successive periods of one year.

The Company and subsidiaries are also subject to possible claims and lawsuits which arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate determination of such possible claims or lawsuits will not have a material adverse effect on the consolidated financial position, results of operations and cash flows of the Company.

Note 13: Dividends and Capital Restrictions

Without prior approval, current regulations allow the Bank to pay dividends to the Company not exceeding net profits (as defined) for the current calendar year to date plus those for the previous two years. The Bank normally restricts dividends to a lesser amount because of the need to maintain an adequate capital structure.

Note 14: Regulatory Capital

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies and are assigned to a capital category. The assigned capital category is largely determined by ratios that are calculated according to the regulations. The ratios are intended to measure capital relative to assets and credit risk associated with those assets and off-balance sheet exposures of the entity. The capital category assigned to an entity can also be affected by qualitative judgments made by regulatory agencies about the risk inherent in the entity's activities that are not part of the calculated ratios.

There are five capital categories defined in the regulations, ranging from well capitalized to critically undercapitalized. Classification of a bank in any of the undercapitalized categories can result in actions by regulators that could have a material effect on a bank's operations. At September 30, 2010, the Bank was categorized as well capitalized and met all subject capital adequacy requirements. There are no conditions or events since September 30, 2010 that management believes have changed the Bank's classification.

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Peoples' actual and required capital amounts and ratios are as follows:

	Actual		2010 Required for Adequate Capital ¹		To Be Well Capitalized ¹	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total risk-based capital ¹ (to risk-weighted assets)	\$ 54,447,000	23.02%	\$ 18,920,000	8.00%	\$ 23,650,000	10.00%
Tier 1 risk-based capital ¹ (to risk-weighted assets)	52,252,000	22.09%	9,460,000	4.00%	14,190,000	6.00%
Core capital ¹ (to adjusted total assets)	52,252,000	11.23%	18,605,000	4.00%	23,256,000	5.00%
Core capital ¹ (to adjusted tangible assets)	52,252,000	11.23%	9,302,000	2.00%	NA	NA
Tangible capital ¹ (to adjusted total assets)	52,252,000	11.23%	6,977,000	1.50%	NA	NA
	Actual		2009 Required for Adequate Capital ¹		To Be Well Capitalized ¹	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total risk-based capital ¹ (to risk-weighted assets)	\$ 50,655,000	21.02%	\$ 19,276,000	8.00%	\$ 24,095,000	10.00%
Tier 1 risk-based capital ¹ (to risk-weighted assets)	49,009,000	20.34%	9,638,000	4.00%	14,457,000	6.00%
Core capital ¹ (to adjusted total assets)	49,009,000	10.19%	19,240,000	4.00%	24,050,000	5.00%
Core capital ¹ (to adjusted tangible assets)	49,009,000	10.19%	9,620,000	2.00%	NA	NA
Tangible capital ¹ (to adjusted total assets)	49,009,000	10.19%	7,215,000	1.50%	NA	NA

¹As defined by Regulatory Agencies

Note 15: Employee Benefit Plans

The Bank is a participant in a pension fund known as the Financial Institutions Retirement Fund (FIRF). This plan is a multi-employer plan; separate actuarial valuations are not made with respect to each participating employer. This plan provides pension benefits for substantially all of the Company's employees. Pension expense was approximately \$231,000 and \$326,000 for 2010 and 2009. The benefits of this plan were frozen on August 1, 2007.

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A profit-sharing plan is maintained for the benefit of substantially all of the Company's employees and allows for both employee and Company contributions. The Company contribution consists of a matching contribution of 50 percent of employee contributions, up to 6 percent of eligible employee compensation. The Company may also contribute an additional discretionary amount to each employee, regardless of participation in the matching program. The Company's contribution to the plan, for the matching program was approximately \$100,000 and \$83,000 for 2010 and 2009. The Company's contribution for the discretionary program was \$131,000 and \$143,000 for 2010 and 2009.

Note 16: Earnings Per Share

For the years ended September 30, 2010 and 2009, no options to purchase shares of common stock were outstanding. Earnings per share (EPS) were computed as follows:

	Income	2010 Weighted- Average Shares	Per-Share Amount
Basic Earnings Per Share			
Net income available to common stockholders	\$ 3,290,544	2,564,473	\$ 1.28
Effect of Dilutive Securities			
Stock options	-	-	
Diluted Earnings Per Share			
Income available to common stockholders and assumed conversions	<u>\$ 3,290,544</u>	<u>2,564,473</u>	\$ 1.28
	Income	2009 Weighted- Average Shares	Per-Share Amount
Basic Earnings Per Share			
Net income available to common stockholders	\$ 3,121,087	2,730,595	\$ 1.14
Effect of Dilutive Securities			
Stock options	-	-	
Diluted Earnings Per Share			
Income available to common stockholders and assumed conversions	<u>\$ 3,121,087</u>	<u>2,730,595</u>	\$ 1.14

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Note 17: Fair Values of Financial Instruments

ASC Topic 820, *Fair Value Measurements*, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Topic 820 also specifies a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

- Level 1** Quoted prices in active markets for identical assets or liabilities
- Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities
- Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

Following is a description of the inputs and valuation methodologies used for assets and liabilities measured at fair value on a recurring basis and recognized in the accompanying consolidated balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy.

Available-for-Sale Securities

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. Level 2 securities include agency securities, state and municipal obligations and mortgage-backed securities. Third-party vendors compile prices from various sources and may apply such techniques as matrix pricing to determine the value of identical or similar investment securities (Level 2). Matrix pricing is a mathematical technique widely used in the banking industry to value investment securities without relying exclusively on quoted prices for specific investment securities but rather relying on the investment securities' relationship to other benchmark quoted investment securities. In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy.

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The following tables present the fair value measurements of assets recognized in the accompanying consolidated balance sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2010 and 2009:

2010				
Fair Value Measurements Using				
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Federal agencies	\$ 36,473,139	\$ -	\$ 36,473,139	\$ -
State and municipal obligations	60,055,095	-	60,055,095	-
Mortgage-backed securities	<u>80,677,376</u>	<u>-</u>	<u>80,677,376</u>	<u>-</u>
	<u>\$ 177,205,610</u>	<u>\$ -</u>	<u>\$ 177,205,610</u>	<u>\$ -</u>

2009				
Fair Value Measurements Using				
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Federal agencies	\$ 38,553,036	\$ -	\$ 38,553,036	\$ -
State and municipal obligations	49,191,771	-	49,191,771	-
Mortgage-backed securities	<u>85,501,941</u>	<u>-</u>	<u>85,501,941</u>	<u>-</u>
	<u>\$ 173,246,748</u>	<u>\$ -</u>	<u>\$ 173,246,748</u>	<u>\$ -</u>

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Following is a description of the valuation methodologies used for assets and liabilities measured at fair value on a nonrecurring basis and recognized in the accompanying consolidated balance sheets, as well as the general classification of such assets and liabilities pursuant to the valuation hierarchy.

Impaired Loans

Loans for which it is probable that the Company will not collect all principal and interest due according to contractual terms are measured for impairment. Allowable methods for determining the amount of impairment include estimating fair value of the collateral for collateral dependent loans.

If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value.

Impaired loans that are collateral dependent are classified with Level 3 of the fair value hierarchy when impairment is determined using the fair value method.

The following tables present the fair value measurements of assets and liabilities recognized in the accompanying consolidated balance sheets measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2010 and 2009.

	2010			
	Fair Value Measurements Using			
Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Impaired loans (collateral dependent)	\$ 797,345	\$ -	\$ -	\$ 797,345

	2009			
	Fair Value Measurements Using			
Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Impaired loans (collateral dependent)	\$ 1,476,560	\$ -	\$ -	\$ 1,476,560

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The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

Cash and Cash Equivalents - The fair value of cash and cash equivalents approximates carrying value.

Loans and Loans Held for Sale - For both short-term loans and variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value for other loans is estimated using discounted cash flow analyses using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

Interest Receivable/Payable - The fair values of interest receivable/payable approximate carrying values.

FHLB Stock - Fair value of FHLB stock is based on the price at which it may be resold to the FHLB.

Deposits - The fair values of noninterest-bearing, interest-bearing demand and savings accounts are equal to the amount payable on demand at the balance sheet date. The carrying amounts for variable rate, fixed-term certificates of deposit approximate their fair values at the balance sheet date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on such time deposits.

Short-Term Borrowings - The fair value of short-term borrowings approximates carrying value.

Federal Home Loan Bank Advances - The fair value of these borrowings is estimated using a discounted cash flow calculation, based on current rates for similar advances.

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The following table presents estimated fair values of the Company's financial instruments and their related carrying value at year end.

	2010		2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets				
Cash and cash equivalents	\$ 17,431,175	\$ 17,431,175	\$ 8,608,642	\$ 8,608,642
Investment securities available for sale	177,205,610	177,205,610	173,246,748	173,246,748
Investment securities held to maturity	-	-	252,351	264,118
Loans, including loans held for sale	251,003,932	255,755,000	278,882,213	283,897,000
FHLB stock	4,462,500	4,462,500	4,462,500	4,462,500
Interest receivable	2,851,172	2,851,172	2,936,807	2,936,807
Liabilities				
Deposits	338,792,106	340,951,000	334,713,820	336,605,000
Short-term borrowings	3,020,296	3,020,296	1,255,599	1,255,599
Federal Home Loan Bank advances	66,723,665	71,817,000	87,250,000	91,281,000
Interest payable	189,647	189,647	275,436	275,436

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Note 18: Condensed Financial Information (Parent Company Only)

Presented below is condensed financial information as to financial position, results of operations and cash flows of the Company.

Condensed Balance Sheets

	2010	2009
Assets		
Cash	\$ 2,741,801	\$ 7,252,984
Investment in subsidiaries	57,938,788	54,117,530
Other assets	8,366	7,818
Total assets	\$ 60,688,955	\$ 61,378,332
Liabilities		
Dividends payable on common stock	\$ 474,853	\$ 506,868
Other	700	724
Total liabilities	475,553	507,592
Stockholders' Equity		
Common stock	2,484,880	2,667,725
Retained earnings	54,537,708	55,467,946
Accumulated other comprehensive income	3,190,814	2,735,069
	60,213,402	60,870,740
Total liabilities and stockholders' equity	\$ 60,688,955	\$ 61,378,332

Condensed Statements of Income

	2010	2009
Income		
Dividends from subsidiaries	\$ -	\$ 6,700,000
Interest on investments securities	50	100
	50	6,700,100
Expenses		
	114,020	123,864
Income before distribution in excess of income of subsidiaries and income tax expense	(113,970)	6,576,236
Undistributed income (distribution in excess of income) of subsidiaries	3,365,514	(3,497,149)
Income before income tax	3,251,544	3,079,087
Income tax benefit	(39,000)	(42,000)
Net income	\$ 3,290,544	\$ 3,121,087

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Condensed Statements of Cash Flows

	2010	2009
Cash flows from operating activities		
Net income	\$ 3,290,544	\$ 3,121,087
Items not requiring (providing) cash		
Undistributed income (distributions in excess of income) of subsidiaries	(3,365,514)	3,497,159
Other adjustments	(571)	11,409
Net cash provided by (used in) operating activities	(75,541)	6,629,655
Cash flows from financing activities		
Stock repurchased	(2,471,091)	(1,349,712)
Cash dividends	(1,964,551)	(2,088,094)
Net cash used in financing activities	(4,435,642)	(3,437,806)
Net change in cash	(4,511,183)	3,191,849
Cash at beginning of year	7,252,984	4,061,135
Cash at end of year	\$ 2,741,801	\$ 7,252,984

Note 19: Subsequent Events

Subsequent events have been evaluated through November 11, 2010, which is the date the consolidated financial statements were available to be issued.